

Global Credit Data

by banks for banks

A Regulator's view on Climate Risk in Pillar I | EBA



Jacob Gyntelberg | Director Economic & Risk Analysis, European Banking Authority



AGENDA

Disclaimer: Any views expressed in this presentation are those of the presenter and do not necessarily represent the views of Global Credit Data or its members.

- ❑ Presentation: Jacob Gyntelberg
- ❑ State of the current EBA consultation
- ❑ EBA slides (AUG 2022)

Is Environmental Risk a Driver of Financial Risks?

- ❑ Rhetorical question it is 😊. EBA, ECB, PRA, BOE, FED, OSFI... NGFS, IIF, AFME, ... all answer positively
- ❑ Our guest speaker **Jacob Gyntelberg | Director Economic & Risk Analysis, European Banking Authority (EBA)**
 - ⇒ Will guide us through the current preparation of EBA policy recommendations on the incorporation of environmental risks in the Pillar 1 bank capital framework ; potentially also including requirements for institutions' internal scenario analyses and climate transition plans to establish strong ESG risk management practices
 - ⇒ EBA is consulting the industry for feedbacks on the [discussion paper](#) published earlier this year

The logo for the European Banking Authority (EBA) is located in the top left corner. It consists of the letters 'EBA' in a bold, white, sans-serif font, set against a dark blue background with a subtle grid pattern. To the right of the letters, the words 'EUROPEAN BANKING AUTHORITY' are written in a smaller, white, sans-serif font, stacked vertically.

EBA

EUROPEAN
BANKING
AUTHORITY

A Regulator's view on Climate Risk in Pillar I

Jacob Gyntelberg, Director, Economic and Risk Analysis Department

Presentation for Global Credit Data, 7 November 2022

Focus for today

- EBA sustainable finance roadmap
- Pillar I discussion paper
- Data requirements push form regulation and supervision
 - Disclosure requirements
 - Supervisory reporting
 - Supervisory expectations
- Climate stress testing

- EBA SUSTAINABLE FINANCE ROADMAP

EBA sustainable finance roadmap

Key objectives

1. Develop regulatory and supervisory framework and associated tools
2. Support the European banking sector mitigate of ESG risks and its transition to a sustainable economy



- Anchoring ESG risk aspects in regulation
 - Provide guidance on risk management and supervisory practices for ESG risks
 - Carrying out risk analysis and monitoring
 - Conduct stress-testing
- Resilience of EU banking sector
 - Appropriate support to the implementation of EU sustainable finance objectives
- Holistic and sequenced approach in implementing the ESG agenda
 - Importance of international cooperation and coordination with ESAs and other relevant bodies

EBA sustainable finance roadmap



- ITS on Pillar 3 disclosures on ESG risks (*implementation from 2023, further updates planned*)
- EBA's advice to EU COM n Article 8 of the Taxonomy Regulation
- Joint ESAs RTS under Sustainable Finance Disclosure Regulation (*implementation from 2023, further updates ongoing*)
- Joint ESAs RTS on sustainability disclosures for STS securitisation (*under development*)

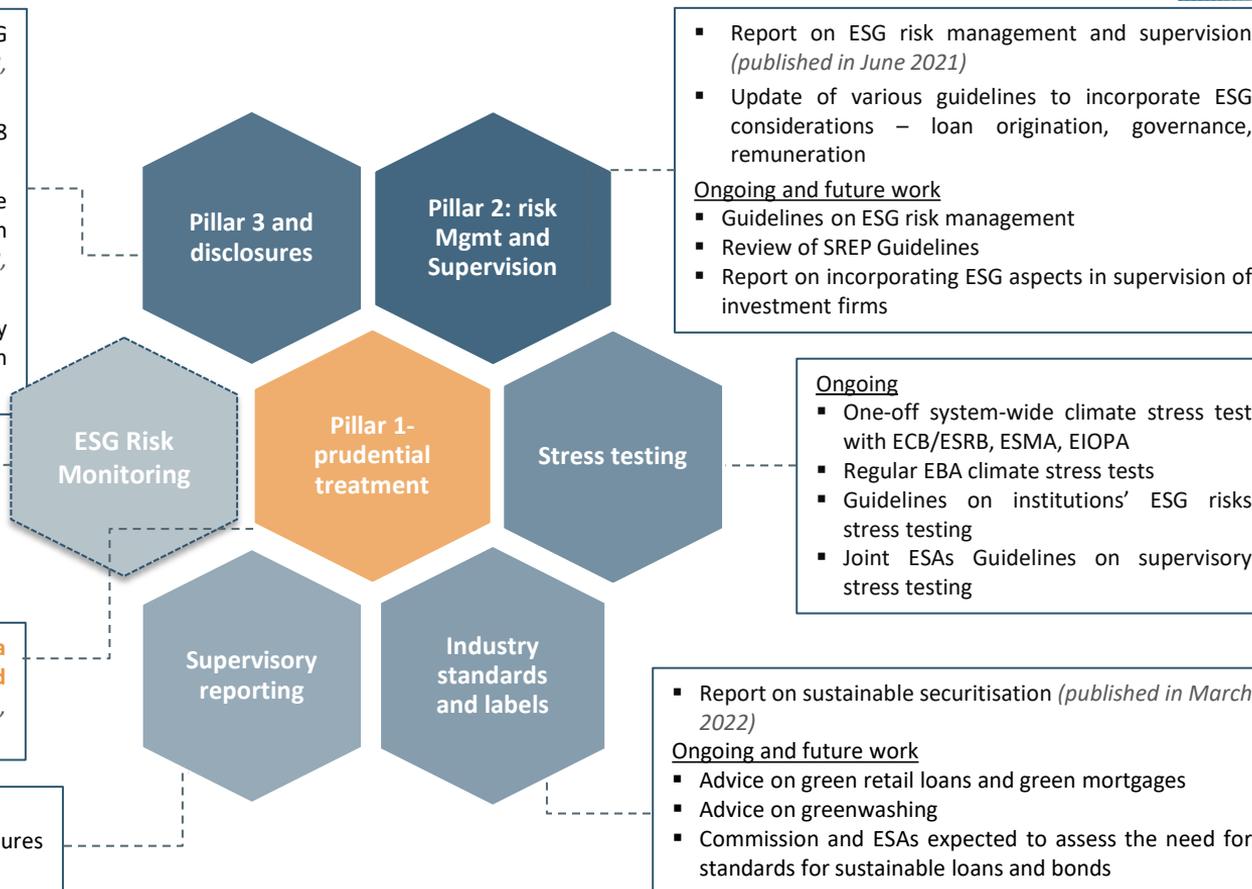
Planned work on:

- Monitoring of climate-related financial stability risks by EC, ECB, ESAs and NCAs
- Monitoring of ESG risks

EBA discussion paper leading to a report under Article 501c CRR and Article 34 IFR (*published in May 2022, final report planned for 2023*)

Planned work on:

ITS on the inclusion of banks' exposures to ESG risks in supervisory reporting



Pillar 3 and disclosures

Pillar 2: risk Mgmt and Supervision

Pillar 1- prudential treatment

Stress testing

Supervisory reporting

Industry standards and labels

ESG Risk Monitoring

- Report on ESG risk management and supervision (*published in June 2021*)

- Update of various guidelines to incorporate ESG considerations – loan origination, governance, remuneration

Ongoing and future work

- Guidelines on ESG risk management
- Review of SREP Guidelines
- Report on incorporating ESG aspects in supervision of investment firms

Ongoing

- One-off system-wide climate stress test with ECB/ESRB, ESMA, EIOPA
- Regular EBA climate stress tests
- Guidelines on institutions' ESG risks stress testing
- Joint ESAs Guidelines on supervisory stress testing

- Report on sustainable securitisation (*published in March 2022*)

Ongoing and future work

- Advice on green retail loans and green mortgages
- Advice on greenwashing
- Commission and ESAs expected to assess the need for standards for sustainable loans and bonds

PILLAR 1 DISCUSSION PAPER

Pillar 1: Prudential treatment of ESG exposures



Discussion Paper

- Initial analysis of the Pillar 1 framework for credit institutions and investment firms
- Focus is on environmental risk drivers
- Questions for consultation

Evidence gathering

- Responses to the Discussion Paper
- Further analysis, including on social risks

Final report

- Mandates specified in Article 501c CRR and Article 34 IFR
- To cover environmental and social risks

Monitoring of and contribution to developments at Basel level

Main conclusions in Discussion Paper

- Acknowledges the need to evolve the existing framework in a holistic manner
- Risk-based approach is crucial to maintain robustness of the framework
- Pillar 1 requirements do not intend to cover all existing risks – they are part of a broader overall framework, most appropriate tools should be considered to address environmental risks
- Better use of existing adaptive mechanisms and targeted amendments to the framework would address the environmental risks more accurately than dedicated risk-weight adjustment factors
- Forward-looking aspect should be further considered, but the framework should remain evidence-based (in this context scientific evidence is key)
- At this stage emphasis should be on environmental risk-related data collection and development of risk management tools and practices

Principles for the analysis

■ Holistic view at regulatory framework

Pillar 1 is only one part of the overall prudential framework - other tools must also be considered to avoiding double counting with:

- Accounting framework
- Supervisory Pillar 2 requirements – including from testing
- Macroprudential buffers

■ Environmental risks considered as risk drivers that impact traditional categories of financial risks

- Credit risk
- Market risk
- Operational risk
- Concentration risk
- Other risks

■ Risk-based approach is crucial

- Objective to keep resilience of the financial sector against the risks
- Financial sector must remain stable and reliable to allow financing transition
- Prudential framework should not substitute other policy tools
 - ▶ policy actions in specific industry sectors can be reinforced by a risk-based prudential framework
- Own funds requirements should reflect real riskiness of exposures

Environmental risk in credit risk framework

Standardised Approach

- **Adaptive mechanisms allowing incorporation of new risk drivers**
(level of ESG incorporation expected to increase over time)
 - External credit assessments
 - Due diligence
 - Valuation of collateral
 - financial instruments
 - immovable properties
- **Potential further considerations:**
 - Further granularity of risk weights?
 - Other forward-looking mechanisms?

Internal Ratings Based Approach

- **Internal models allow recognition of new risk drivers, subject to conditions:**
 - Model performance
 - Data representativeness
 - Possible conservatism in model application
- Value of collateral reflected in LGD estimates and regulatory LGD values
- Slotting approach for specialised lending exposures can incorporate environmental aspects
- **Potential further considerations:**
 - Adaptation of risk-weight function?
 - Other forward-looking mechanisms?

Environmental risk in concentration risk framework

Large exposures regime

- **Existing mechanisms are not addressing specifically environmental risks but may implicitly capture some of them through:**
 - Limits to individual exposures to groups of connected clients (control relationships and economic dependencies)
 - Exemptions from LEX regime (e.g. intragroup, sovereigns, covered bonds)
- **Potential further considerations:**
 - Additional reporting requirements related to largest exposures subject to environmental risk?

Potential new concentration limit

- **Considerations and challenges related to potential design of a new limit:**
 - Single factor or various environmental risks
 - Hard limit or monitoring intensity
 - How not to hinder financing the transition
 - Need for standardised classification of both environmental impacts and transition paths
 - Impact on smaller institutions
- **Relation to the treatment of concentration risk under Pillar 2 framework** – the current treatment includes among others sectoral and geographical concentration

- DATA REQUIREMENTS PUSH FORM REGULATION AND SUPERVISION

Climate risk data requirements will increase

Disclosure requirements

- **First round has been completed**
 - First reporting to take place next year
- **New requirements**
 - Next steps are other than climate (E), the S and G elements in ESG
 - Further E and S indicators in product-related disclosures (under SFDR)
 - Extension of Pillar 3 disclosures to smaller banks a possibility (proportionality)

Supervisory Reporting

- **More reporting to come**
 - Risk focused
 - Reporting on credit, market and operational risk elements
 - More granular reporting on exposures highly likely
 - Reporting on both credit and market risk models clearly in scope
 - Reporting on concentration risk aspects also highly likely
 - Proportionality considerations part of the game

- CLIMATE STRESS TESTING

Traditional stress tests and climate risk



A climate risk stress test although similar to a classic stress test exercise has different features and objectives:

Supervisory
stress test
(e.g. EU-wide
stress test)

- **Focus:** Solvency, impact on capital (ratios).
- **Static balance sheet assumption** → achieve comparability of the results.
- **Short term horizon** (e.g. 3 years).
- **Baseline / adverse scenario.**

Climate risk
stress test

- **Focus:** wider on business models.
- **The scenario time horizon is diverging** → A climate stress test has a longer horizon (10+ years) than a typical stress test. Baseline?
- **Static balance sheet assumption does not fit well** → Keeping the balance sheet constant over several years may be too unrealistic and therefore a dynamic balance sheet is needed. This would allow banks to adapt to the conditions along time and would mitigate the impact through business decision.
- **Multiple scenarios** are desirable to cover the uncertainty around the developments of climate risk events.
- Different **granularity** and wider set of **indicators** for the **scenarios**.
- **The assets classification is different** → Assets are categorized as vulnerable or not vulnerable to climate risks.

EBA mandates on climate risk ST



Existing

**EBA founding regulation
(Art. 23 and 32)**

Develop common methodologies to assess the effect of adverse environmental developments on financial institutions

- Develop criteria for the identification and measurement of systemic risk and an adequate stress-testing regime, including potential environmental related systemic risk.
- Develop: (a) common methodologies for assessing the effect of economic scenarios on an institution's financial position taking into account inter alia risks stemming from adverse environmental developments....

New

Mandates from EC's renewed sustainable finance strategy (RSFS) and proposed amendments of CRD V

Regular climate risk stress testing

The Commission will mandate the ESAs and ask the ECB to perform regular climate change stress tests or scenario analyses, using a bottom-up and top-down approach respectively.

Conduct coordinated climate stress tests with other ESAs

One-off exercise, ESAs together with the ECB to conduct a coordinated, bottom-up and top-down EU-level climate change stress test.

Guidelines (GL) on stress testing for both supervisors and banks

EBA to provide GLs on banks' internal ESG risk management, incl. stress testing, in order to ensure that institutions adequately test their resilience to long-term negative impacts of ESG factors. In addition, the EBA should also draft GLs together with other ESAs on supervisory ESG stress test, starting with climate risk (art. 100 of Draft CRDVI)

What's next?



- **One-off system wide climate stress test**
 - *Coordination with ESRB, ECB, ESAs and EC*
- Guidelines for banks and supervisors on ESG risk stress testing
 - Priority will be environmental aspects
- **EBA preparatory work for an EU-wide climate risk stress test:**
 - Take learnings from others – public and private sector as well as academia
 - How do we address data challenges – partly from disclosure and reporting
 - Methodological issues – time horizon, dynamic balance sheet and scenario design

The logo for the European Banking Authority (EBA) is located in the top left corner. It consists of the letters 'EBA' in a bold, white, sans-serif font. The 'E' and 'B' are partially overlaid by a vertical bar that is orange on the left and blue on the right. To the right of this bar, the words 'EUROPEAN BANKING AUTHORITY' are written in a smaller, white, sans-serif font, stacked vertically.

EBA

EUROPEAN
BANKING
AUTHORITY

EUROPEAN BANKING AUTHORITY

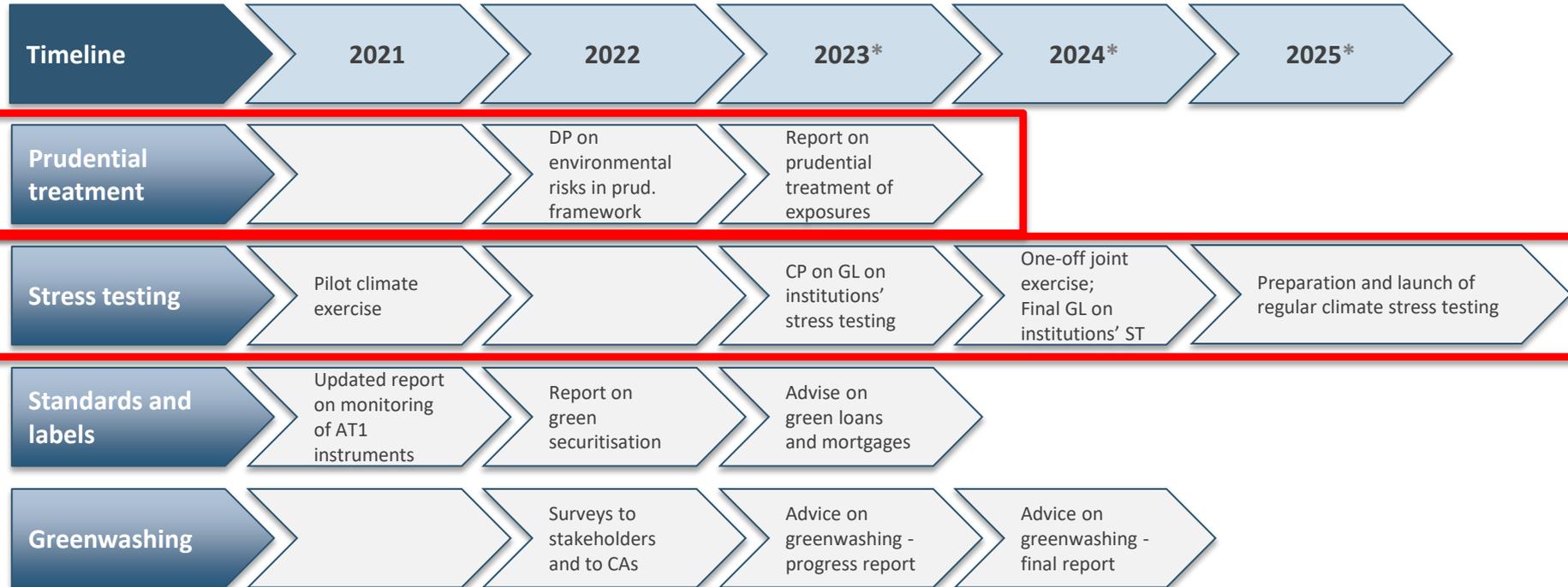
Floor 24-27, Tour Europlaza
20 Avenue André Prothin
92400 Courbevoie, France

Tel: +33 1 86 52 70 00

E-mail: info@eba.europa.eu

<https://eba.europa.eu/>

Milestones (1)



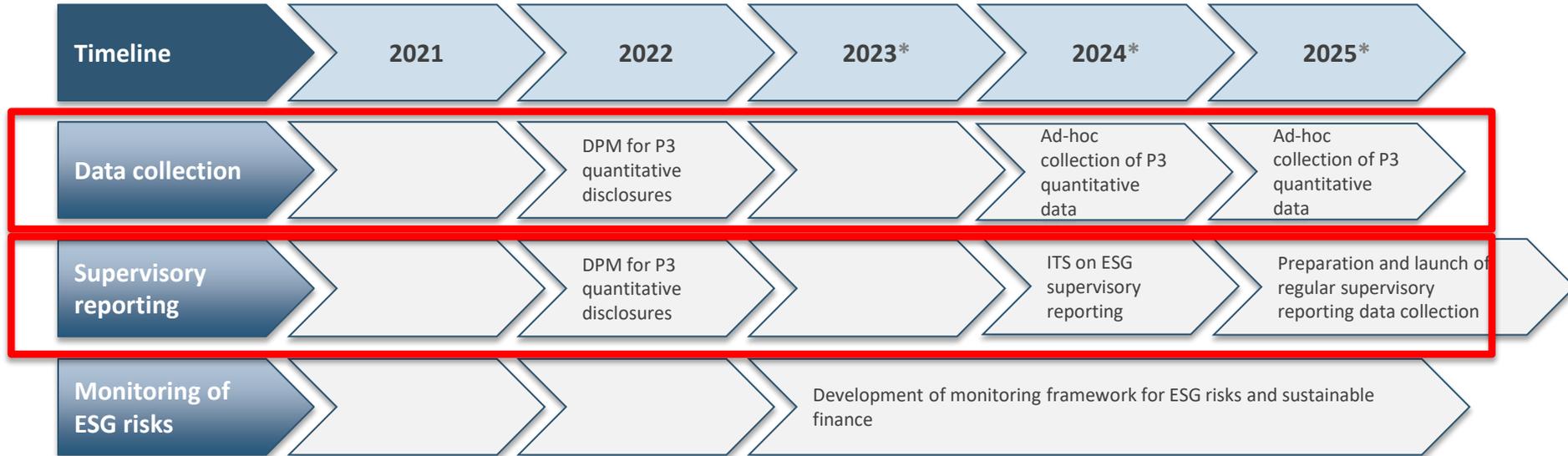
* Tentative

Milestones (2)



* Tentative

Milestones (3)



Environmental risk in market risk framework

FRTB Standardised Approach

- **Sensitivity-based method:**
 - Existing mechanisms: requirement to apply high and low correlation scenarios (even if not historically observed)
 - To consider: further granularity of risk weight or risk factors?
- **Default Risk Charge** – considerations the same as for credit risk framework
- **Residual risk add-on:**
 - Existing mechanisms: residual risk of exotic instruments e.g. weather options
 - To consider: use of RRAO to address environmental risk by extending also to simple trading book instruments?

Internal Model Approach

- **Internal models aim at calculating capital appropriate for stress periods based on historical data:**
 - Shortfall measure at 97.5% confidence level
 - Stress scenario risk measure
- Uncertainty about the extent to which the environmental risk is already captured by market prices (expected to increase over time)
- **Potential further considerations:**
 - Capturing environmental risk outside of the model through an add-on based on scenarios not historically observed?
 - Incorporation in the existing capital adequacy stress testing programmes?

Environmental risk in operational risk framework

New Standardised Approach in accordance with Basel III accord

- Environmental factors fall within the existing categories of operational losses (e.g. physical damage, interruption of services, litigation processes)
- Capital requirements oriented historically based on:
 - financial statements (through Basic Indicator Component)
 - historical losses (through Loss Component – irrelevant if Internal Loss Multiplier set to 1 as in the Commission’s proposal)
- **Potential further considerations:**
 - Operational loss data to explicitly identify environmental risk factors?
 - Other forward-looking mechanisms?

Strategic and reputational risk

- Explicitly excluded from operational risk
- May be significantly affected by environmental risk factors
- Strongly linked to business model, strategy and activities of an institution
- Currently treated under Pillar 2 framework – case-by-case approach
- **Initial conclusions:**
 - Institution-specific risks warrant case-by-case approach
 - Pillar 2 treatment seems appropriate

Environmental risk in prudential framework for investment firms

General considerations

- Considerations apply to firms subject to K-factors requirements (small and non-interconnected investment firms are excluded)
- Permanent minimum capital and fixed overheads requirements are not affected by environmental risk
- Relations between the framework for banks and investment firms should be considered to ensure consistency and proportionality
- Exposure to specific risks depends strongly on the business model (activities) of the investment firm

K-factor requirements

- **Risk-to-clients:**
 - Addressing mostly operational risk and generally not affected by environmental risks
 - Reputational and strategic risk if the composition of assets under management does not account for their environmental profile
- **Risk-to-market and risk-to-firm:**
 - For firms trading on own account – considerations equivalent to market risk, counterparty credit risk and concentration risk in the framework for banks
- **Potential further considerations:**
 - Specific considerations for commodity and emission allowance dealers?

Initiatives by central banks and supervisors



2018-10	DNB	<u>An energy transition risk stress test for the financial system of the Netherlands</u>
2020-04	ACPR	<u>A first assessment of financial risks stemming from climate change</u>
2020-12	EIOPA	<u>Sensitivity analysis of climate-change related transition risks</u>
2021-05	EBA	<u>EU-wide pilot exercise on climate risk</u>
2021-07	ESRB	<u>Climate-related risk and financial stability</u>
2021-09	ECB	<u>ECB economy-wide climate stress test</u>
2022-04	BoE	<u>Climate Biennial Exploratory Scenario (CBES)</u>
2022-07	SSM	<u>2022 climate risk stress test</u>
2022-12	EIOPA	<u>2022 Occupational pensions stress test</u>

Closing Slide

□ Main takeaways:

- A holistic approach to the needed evolution of the regulatory framework is needed
- Climate risk is not a separate risk but a “driver of other risks” such as credit, market, operational and operational risk across the entire balance sheet
- Evidence and data are key – not much sympathy for opinions based on fact free preconceptions
- Legacies can be challenged
- Proportionality will taken into account
- There is awareness of the need to calibrate the overall regulatory impact on the system as well as for individual bank scale

□ Amongst key Issues:

- Who “holds the risk” from climate events ?
- What are the transmission channel between obligors and lenders?
- Which climate risk drivers should be observed (collected) and analyzed?
- Volatility and inconsistencies of current ESG ratings illustrate that time is needed to build consensus
- Capital charge ? Double counting? Provisions? Are these issues as old as banking itself?