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Draft Guidelines on the management of ESG risks

EBA´s consultative document highlights


ESG

EBA has published a Consultation Paper Draft Guidelines on the management of ESG Risks to set up the preliminary requirements for institutions

Objective	• Define the **requirements for institutions** for the **identification, measurement, management and monitoring of ESG risks**, including through **plans** aimed at addressing the risks arising from the **transition towards an EU climate-neutral economy**.
Calendar	• **Public hearing** on the consultation paper on **28 February 2024** • Comments' **submission** until **18 April 2024** • **Expected final guidelines by the end 2024. Application: TBC** (aligned with the amended CRD6 application date)
Scope	• **Requirements for environmental**, **social and governance risks. Extending environmental beyond climate**-related ones, such as risks stemming from **degradation of ecosystems and biodiversity loss**, as well as of other ESG factors[1]. • Applicable to **all institutions including SNCI[2]**, considering the **proportionally** criteria and covering their **material ESG risks**. • **Cover all material subsidiaries in and outside of the EU**, by having regard to applicable local legislation and ESG regulatory objectives. • **Proportionality** criteria based on size and internal organization, and the nature, scale and complexity of their activities, when developing and implementing the approaches for ESG risks management[3].
Main challenges	• Assessment and monitoring of **ESG risks** over institutions' **exposures/assets** in different **time horizons** and **climate scenarios through…** o Exposure method to obtain a short-term view of how **ESG risks are impacting the credit risk profile and the profitability of counterparties** (embedding in **KRIs, internal credit scoring or rating models or valuation of collateral**, when it is applicable). o Portfolio-based & Scenario-based methods to support the **medium-term planning process** and to define **risk limits**, **appetite and EWIs** steering the institution towards its strategic objectives and assess their **sensitivities to ESG risks** in different time horizons. • **Data collection** related to **ESG factors at least for large corporates** based on client engagement approach to gather it (onboarding or periodic reviews), public information or external providers. Possible application of estimation/proxies to be reduced progressively. • **Portfolio alignment & transition plan:** setting of **targets at least for the most climate contributing sectors,** as well as definition and monitoring of **transition plan** leveraged on embedding in **lending policies, new product offering, client engagement tools**…

1. Annex 1 of EBA Report on management and supervision of ESG risks
2. Small and non-complex institutions.
3. Title I of the EBA guidelines on internal governance. Paragraphs 17 & 18.
4. Early Warning Indicators

Access to Document

1 General overview
Calendar

EBA has published a Consultation Paper Draft Guidelines on the management of ESG Risks to set up the preliminary requirements for institutions

Calendar

January 2024
Publication of **new Guidelines on the management of ESG Risks (Draft)**

February 2024
Public hearing on the consultation on **28 February**

April 2024
The **deadline** for the **submission** of comments is **18 April.**

December 2024
Publication of **Final Guidelines on the management of ESG Risks**

January 2025
Expected application of CRR3 from 1 January 2025, with certain elements of the regulation phasing in over the coming years

June 2025
Amendment of the CRDVI expected to be **transposed by member states by mid-2025**.

EBA is **consulting on the draft guidelines for a period of three months**. Feedback from the public consultation will be taken into account when finalising the guidelines. It is planned that the **guidelines** will be finalised **by end-2024** and **apply from [tbc – depending on CRD6 application date]**

EBA requirements
Key aspects (1/4)

EBA CP Draft Guidelines on ESG Risks management is split by three building blocks: i) reference methodology for identification and measurement of ESG Risks; ii) minimum standards and reference methodology for the management and monitoring of ESG risks; iii) Plans in accordance with CRD6

i) Reference methodology for identification & measurement of ESG Risks

Materiality

- Execution of **materiality assessment of ESG risks at least annually** (every 2 years for SNCI) to ensure that ESG risk identification and measurement are integrated into their strategies and internal procedures. To be included in ICAAP.
- **Covering all financial risk categories** (credit, market, liquidity, operational, reputational, business model, and concentration) and **highly climate contibuting sectors[1] at short, medium and long term.**
- Include **qualitative and quantitative data and ESG assessment of impacts** on the most significant **activities, services and products** (considering the climate risk drivers under different climate scenarios)
- Use of **risk-based approach** that considers the **likelihood and the severity of the materialisation of the risks**.

Identification & Measurement

Data processes

- **Implementation** of **systems to collect and aggregate ESG risks-related data across the institution** as part of the overall data governance and IT infrastructure (including arrangements to assess and improve ESG data quality)
- **Capture of data** for the assessment of the **current and forward-looking ESG risk profile** of **counterparties** (at least for large corporates), including **client and asset-level data**. Data collection from onboarding or periodic reviews or external sources[2]. Examples:
  - i. for **environmental**, emissions, material impacts on climate and biodiversity, dependency on fossil fuels energy and water demand, EPCs, forward-looking adaptive capacity such as transition plans, etc.;
  - ii. for **social and governance risks:** compliance with and due diligence on social standards, governance practices,…

Methodologies

Combination of three methodologies to assess ESG risks across time horizons, supported by **Key Risk Indicators:**

- **Exposured-based:** assess the exposure of their counterparties' activities and key assets to ESG factors (including risk factors and mitigants). Considering ESG factors into overall assessment of default risk of a borrower and, where justified by their materiality, embedded in the risk indicators, internal credit scoring or rating models, as well as the valuation of collateral.
- **Portfolio-based:** use of at least one portfolio alignment methodology to assess the degree of alignment of institution's portfolios with climate-related sustainability targets. Measuring the gap between existing portfolios and benchmark scenarios and its financial impacts[3].
- **Scenario-based**: perform climate/environmental scenario-based analyses.

1. Sectors listed in Sections A to H and Section L of Annex I to Regulation (EC) No 1893/2006.Exceptions may be considered if it is justified by institution.
2. Where data from counterparties and public sources is not available, institutions should have remediating actions (e.g. estimations/ or data providers)
3. List of sectors with portfolio alignment required: power; fossil fuel combustion; automotive; aviation; maritime transport; cement, clinker and lime production; iron and steel, coke, and metal ore production, chemicals.

2 EBA requirements
Key aspects (2/4)

EBA CP Draft Guidelines on ESG Risks management is split by three building blocks: i) reference methodology for identification and measurement of ESG Risks; ii) minimum standards and reference methodology for the management and monitoring of ESG risks; iii) Plans in accordance with CRD6

ii) Minimum standards and reference methodology for the management and monitoring of ESG risks

ESG risks management principles	• Embedding **of ESG risks within the regular risk management framework, systems and processes** ensuring consistency with the overall business and risk strategies, including policies and limits. • **Manage and mitigate ESG risks** over the short, medium and long term through **risk management tools.** • Tools should be considered, among others, **engagement** with counterparties, **financial or conditions terms or pricing** adjustments, ESG embedding within **global, regional and sectoral risk limits, diversification** of lending portfolios or financing reallocation to better ESG profiles.
Strategies & Business Models	• Consider **ESG risks** when **developing and implementing business and risk strategies**. • Understand how **ESG risks can impact** the **company's business model** and its **strategic objectives.** • Formulating and monitoring **ESG risk-related strategic objectives** and related **Key Performance Indicators** based on insights **from portfolio alignment, environmental scenario analyses and stress testing.**
Risk appetite	• Clearly define **all material ESG risks** to which the institution is exposed and the type and extent that it is **willing to assume**. • Set **risk appetite** and associated **KRIs** are appropriately **cascaded down** within institution, including limits, thresholds and exclusions. • At least consider **metrics listed by EBA** with backward-looking and forward-looking views.
Internal culture, capabilities & controls	• Clear **communication from the management** body (‘tone from the top’) and appropriate measures to **promote knowledge of ESG factors** and risks **across the institution**, as well as **awareness** of the institution’s **ESG strategic objectives and commitments.** • Ensure, through training policies, that management body and staff are **adequately trained** to understand implications of **ESG factors.** • Embed ESG risks into **internal control frameworks** across the **three lines of defense** with a clear definition and assignment of responsabilities and reporting lines.

2 EBA requirements
Key aspects (3/4)

EBA CP Draft Guidelines on ESG Risks management is split by three building blocks: i) reference methodology for identification and measurement of ESG Risks; ii) minimum standards and reference methodology for the management and monitoring of ESG risks; iii) Plans in accordance with CRD6

ii) Minimum standards and reference methodology for the management and monitoring of ESG risks

ICAAP/ILAAP	• **Material effects of ESG risks** to be embedded in ICAAP and ILAAP considering appetite, thresholds and limits set for material impacts to **identify and measure internal capital needs.** • Include in the ICAAP a **forward-looking** view of institution's capital adequacy **under an adverse scenario** that includes environmental elements specifying any changes to their business plan derived from climate risk stress testing, in line with EBA Stress Testing Guidelines[1].
Credit risk policies & procedures	• Embedding **in credit risk policies** to ensure clear **processes to identify, measure, manage, mitigate and monitor** impacts from ESG. • Implement **quantitative credit risk metrics** covering most significant client segments, type of collaterals and risk mitigation instruments. • Ensure that **credit sectoral policies,** reflecting ESG risks, are **cascaded down** to business lines and business relationships officers.
Other risk policies	**Assess current and potential future** ESG-related impacts on **market, liquidity & funding, operational, reputational & concentration risks**: • **Market**: how ESG risk affect the **value of the financial instruments,** evaluate the **potential risk of losses and increased volatility in their portfolio's value,** and establish effective processes to control or mitigate the impacts. • **Liquidity**: how ESG risks affect **net cash outflows** or the value of assets comprising their **liquidity buffers** and, where appropriate, incorporate these impacts into the calibration of their buffers or risk management framework. Also assess the **availability and stability of funding sources** at different time horizons and normal/adverse conditions (including potential impacts of ESG reputational risks). • **Operations: how ESG risks affect regulatory risk event types** and the potential impacts on **conduct risks, litigation and reputational risk** related to **lending and investing** in business which may be prone to **ESG-related controversies**. • **Concentration:** assess of **shares of exposure affected** relative to total & if ESG-related concentration **aggravates its financial vulnerability**.
Monitoring	• **Monitor** ESG risks on a **continuous basis** through **internal reporting framework** to senior management, implementing a granular monitoring of counterparties, exposures and portfolios. Include ESG factors in **regular credit reviews for medium-sized and large counterparties**. • Set **Early Warning Indicators** and **backward & forward-looking ESG risk metrics** such as historical losses related to ESG risks or share of income stemming from business with counterparties that contribute to climate change.

1. EBA Guidelines on institutions stress testing (EBA/GL/2018/04). Paragraph 90.

2 EBA requirements
Key aspects (4/4)

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iii) Plans in accordance with Article 76(2) CRD6

Key principles

- Institution's **transition plan** should **address and mitigate** the portfolios and exposures **materially exposed to ESG risks**, covering those that **highly contribute to climate change** (Sectors A to H, plus L) unless institution may provide an appropriate justification.
- Ensure that **short, medium and long-term objectives and targets interact and are well-articulated,** including long-term objectives translate into medium-term strategies and that short term financial metrics or targets are consistent (e.g. profitability indicators, cost of risk, …)
- **Transition plan** should be properly reflected in **risk appetite** (PIA[1], limits) aligned with business strategy in different time horizons and their **internal capital needs**, considering potential deviations over planned trajectory under adverse scenarios.

Governance

- **Roles & responsibilities:** assign ESG responsibilities at 3LoD. Approval/oversee of plan implementation by management bodies.
- **Internal process and capacity:** regular **interaction** at **all levels of the organization** to ensure that insights and feedback from internal stakeholders. Ensure **sufficient capacity, expertise and resources** to develop, implement and monitor their transition planning process, identifying existing gaps in skills and expertise and take **remedial actions where necessary**.

Metrics, Targets & Climate scenarios

- **Set and monitor the targets with cascade these down to the sectoral/portfolio levels** at least for the **materially exposed sectors and portfolios** more subject to these risks (different time horizons and **applying scenarios and patways consistent across the organization**).
- **Use of metrics:** financed GHG emissions, portfolio alignment metrics, climate-related income, energy efficiency of real estate collateral and % counterparty engagement on sustainable economy. **Also require** other metrics to assess the **resilicience to physical risk**, management of **nature and biodiversity-related risks**, **ESG-related concentration and reputational risks**.

Transition Planning

- Clearly lay out **processes** and implement **objectives and targets for transition** such as integrating ESG factors in loan origination policies, changes in strategic financing choices or development of new products or services.
- Define **data processes** to collect verify and aggregate data needed to **formulate and monitor transition plans.**
- **Client engagement** through tools such as reviewing counterparties ESG risk profile and transition plans and actions to promote the client transition through adjusting product offering or agreements to enhance the counterparty's transition.
- Assess the **implications of transition process** (e.g. revenues impact) and **align the financing activity evolution** with **risk management policies.**

1. Profitability impact assessment.

A

Annex 1
Data requirements

Environmental risks	Social & Governance risks
• **Geographical location of key assets and exposure** to environmental hazards (e.g. floods, water stress, soil erosion)	• **Compliance with and due diligence on social standards** (ej. ILO conventions or World Bank's Environmental and Social Standards)
• **Current & forecasted GHG scope 1, 2 and 3 emissions** in absolute and/or intensity such as per million-euro revenues or per units of production	• **Governance practices**
• **Material impacts on the environment,** including **climate change and biodiversity**, and related **mitigation or adaptation policies**	• **Adherence to voluntary or mandatory social and governance reporting**
• **Dependency on fossil fuels**, either in terms of economic factor inputs or revenue base	• **Negative impact on local communities,** including due diligence policies to prevent that
• **Energy and water demand and/or consumption**, either in terms of economic factor inputs or revenue base	• **Litigation risks including imminent, pending or completed litigation** case related to social or governance issues and due diligence policies
• **Energy performance certificates** and score in kWh/m² for real estate	
• **Adherence to voluntary or mandatory climate/environmental reporting**	
• **Litigation risk including imminent, pending or completed** litigation case related to environmental issues	
• **Forward-looking adaptive capacity,** including transition plans prepared by non-financial corporates	

A | Annex 2
List of metrics (1/2)

Metrics of Plans in accordance with Article 76(2) CRD6 (to be considered for risk apettite)
• **Financed GHG emissions** by scope 1, 2 and 3 emissions split by sectors (absolute emissions and intensity of emissions, relative to revenues or units of production)
• **Portfolio alignment metrics** (projections and (mis)alignment with a pathway consistent)
• **Amount and/or share of income** related to business with counterparties operating in **sectors that highly contribute to climate change**
• Breakdown of **real estate portfolio by energy efficiency level**
• **% counterparties** with whom the institution **actively engages** regarding **adaptability and resilience to the transition** to a sustainable economy
• **% positive outcomes** with whom the institution **actively engages** regarding **adaptability and resilience to the transition** to a sustainable economy
• **Other metrics** to support risk assessment and strategic steering related to: (i) **resilience to physical risk;** **(ii) management of environmental risks** other than climate-related (**nature and biodiversity);** **(iii) ESG-related concentration risks;** **(iv) ESG-related reputational risk**

Annex 2

List of metrics (2/2)

Monitoring Indicators
• **Historical losses and forward-looking estimate(s) of exposures-at-risk and (potential) financial losses** related to ESG risks
• **Amount and share of income** (interest, fee and commission) stemming from business relationships with counterparties **operating in sectors that highly contribute to climate change**
• **Gap between existing portfolios vs benchmark portfolios** consistent with the **climate target applicable**
• **GHG financed emissions,** at least for sectors towards which the institution has material exposures
• **% counterparties** with whom the institution has **engaged on ESG risks** matters, supplemented with the **results and/or outcomes of such engagement**
• **% environmentally sustainable exposures financing activities** that contribute or enable the objective of **climate change mitigation vs total exposure** • **% carbon-intense exposures** over total institution's exposures Also for **large institutions**: ○ **% Taxonomy-aligned exposures for other objectives of the EU Taxonomy vs total exposure** ○ **% exposures detrimental** to the achievement of these objectives For exposures detrimental to the objective of biodiversity, assess material negative impacts of their counterparties' production sites, processes or products on biodiversity.
• **Concentration risk related to physical risk drivers** (e.g. measurement of exposures and/or collaterals in high flood risks or wildfire risks areas)
• **ESG-related litigation claims** in which the institution has been, is or may become involved
• **Progress against all institution's targets** set in relation to ESG risks and ESG objectives

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