Role of environmental risks in the prudential framework

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About the EBA

- An independent EU agency established on 1 January 2011, which took over all tasks and responsibilities from the Committee of European Banking Supervisors (CEBS).

- Mission: to build a single regulatory and supervisory framework for the entire banking sector in the 27 EU Member States, to ensure an **efficient, transparent and stable Single Market** that is beneficial to consumers, businesses and the broader economy in the EU.

  - Develop an European Single Rulebook
  - Promote supervisory convergence and cross-border supervisory cooperation
  - Assess risks and vulnerabilities across the EU banking system
  - Enhance consumer protection
  - Other tasks (AML, breach of Union law, cross border mediation, advisory to EP, EC, EC)

- To perform these tasks, the EBA can produce regulatory and non-regulatory documents including binding Technical Standards, Guidelines, Recommendations, Opinions and ad-hoc or regular reports.

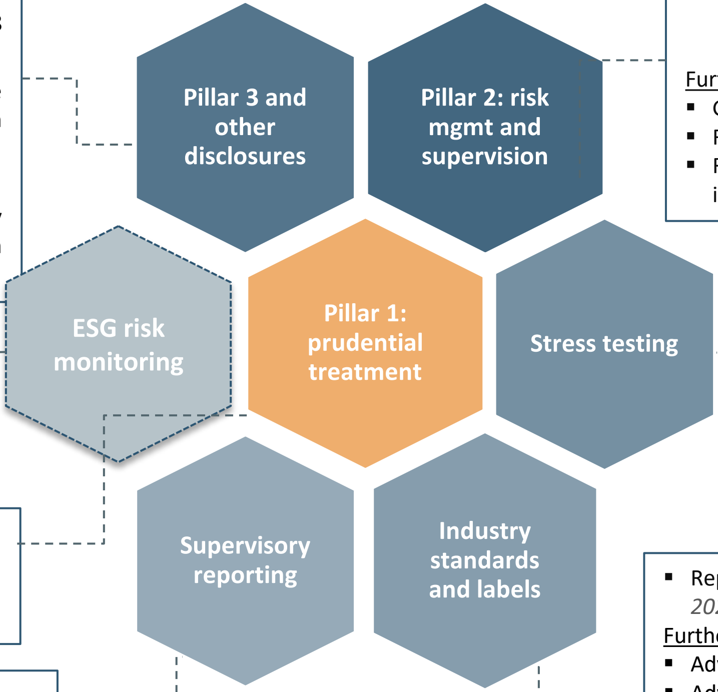
Overview of EBA's work on ESG

- ITS on Pillar 3 disclosures on ESG risks *(implementation from 2023, further updates to be expected)*
- 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 planned)*
- Joint ESAs RTS on sustainability disclosures for STS securitisation *(under development)*

<u>Planned work on:</u>
- 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)*

<u>Planned work on:</u>
ITS on the inclusion of banks' exposures to ESG risks in supervisory reporting



- Report on ESG risk management and supervision *(published in June 2021)*
- Update of various guidelines to incorporate ESG considerations – loan origination, governance, remuneration

<u>Further work planned:</u>
- Guidelines on ESG risk management
- Review of SREP Guidelines
- Report on incorporating ESG aspects in supervision of investment firms

Pilot climate exercise (2020/2021)

<u>Preparatory work on:</u>
- One-off system-wide climate stress test
- Regular climate stress tests, with ESRB, ESAs and ECB
- Guidelines on institutions' ESG risks stress testing
- Joint ESAs Guidelines on supervisory stress testing

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

<u>Further work planned:</u>
- 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: Prudential treatment of ESG exposures

EUROPEAN BANKING AUTHORITY

Discussion Paper published on 2 May 2022 → Evidence gathering (2022-2023) → Final report (2023) → Commission to decide on legislative proposals

Discussion Paper

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

Evidence gathering

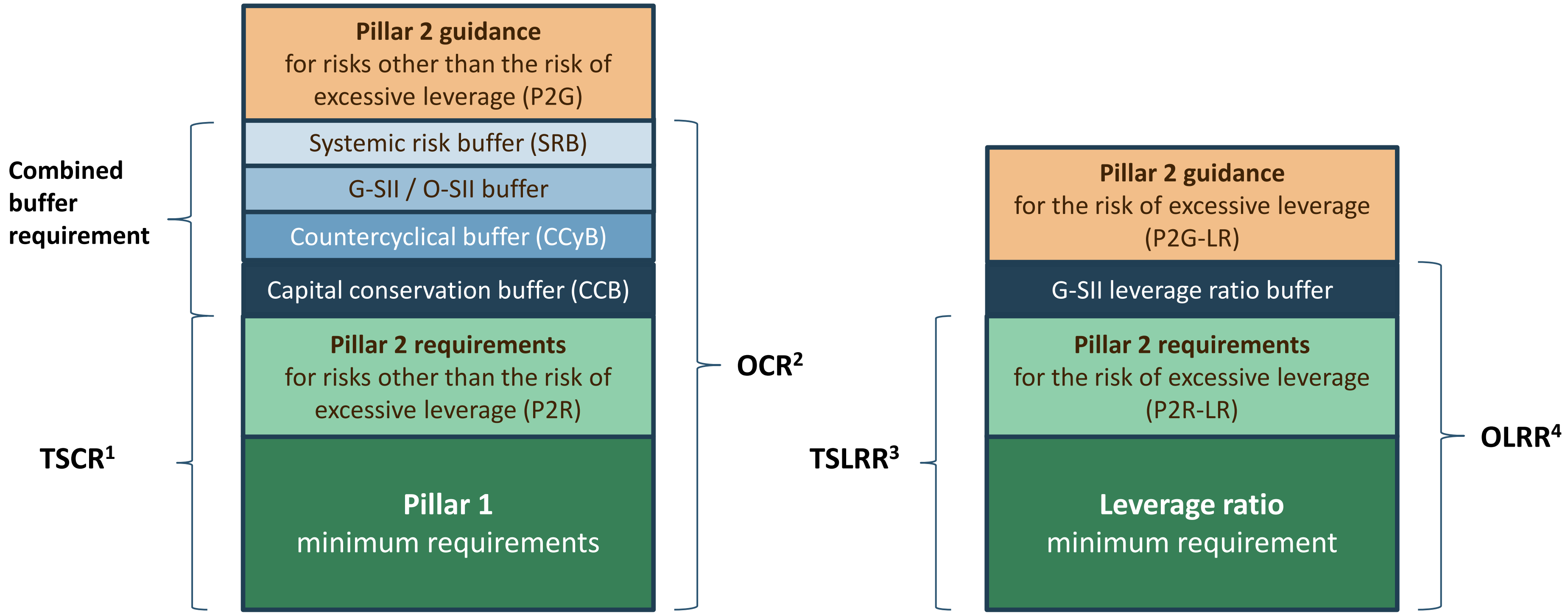
- Responses to the Discussion Paper welcome until **2 August 2022**
- Further analysis, including on social risks

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

TREA and LR-based stacks of own funds requirements



Scale not meaningful

[1] TSCR – total SREP capital requirement
[2] OCR – overall capital requirement

[3] TSLRR – total SREP leverage ratio requirement
[4] OLRR – overall leverage ratio requirement

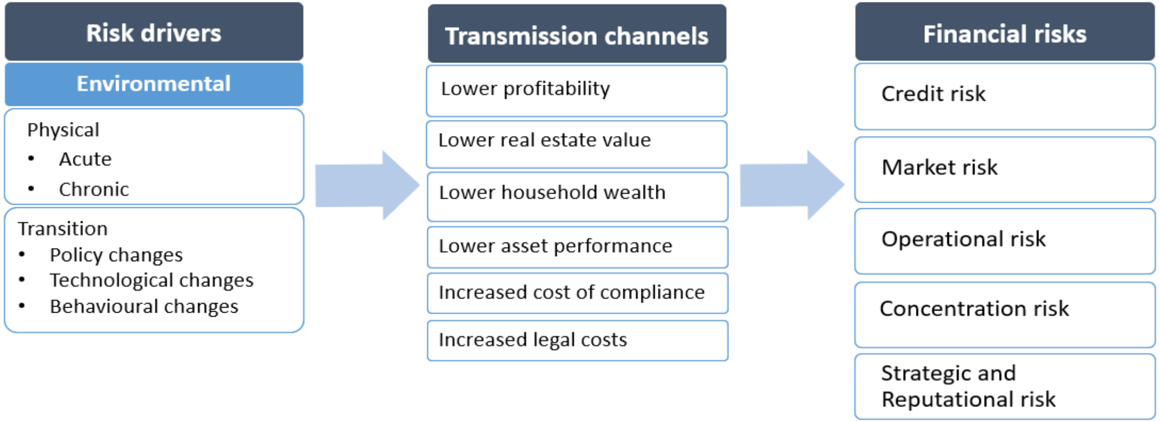
Principles for the analysis of Pillar 1 requirements

- **Holistic approach:**
  Pillar 1 is only part of the overall prudential framework, other tools must also be taken into consideration, avoiding double counting with:
  - accounting framework
  - supervisory activities and Pillar 2 requirements
  - supervisory stress testing and Pillar 2 guidance
  - macroprudential buffers

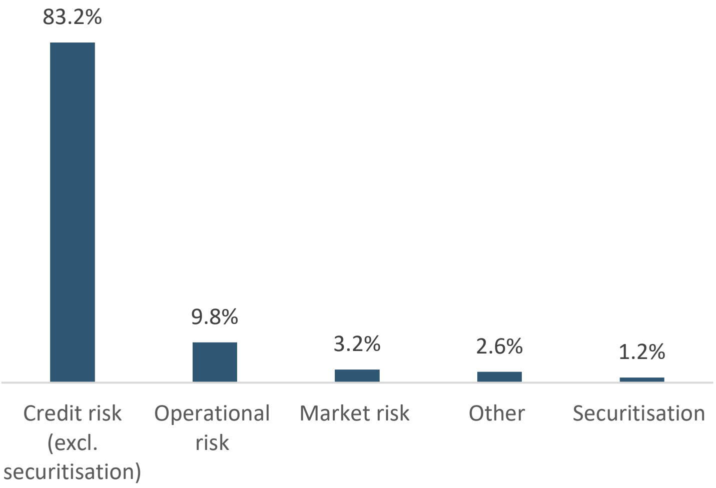
- **Risk-based approach:**
  Objective is to keep resilience of the financial sector, prudential framework should not substitute other policy tools

- **Specific nature of environmental risks** causes challenges related to:
  - Data availability and reliability
  - Estimation based on historical observations (forward-looking perspective, non-cyclicality, non-linearity)
  - Time horizon of the prudential framework

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

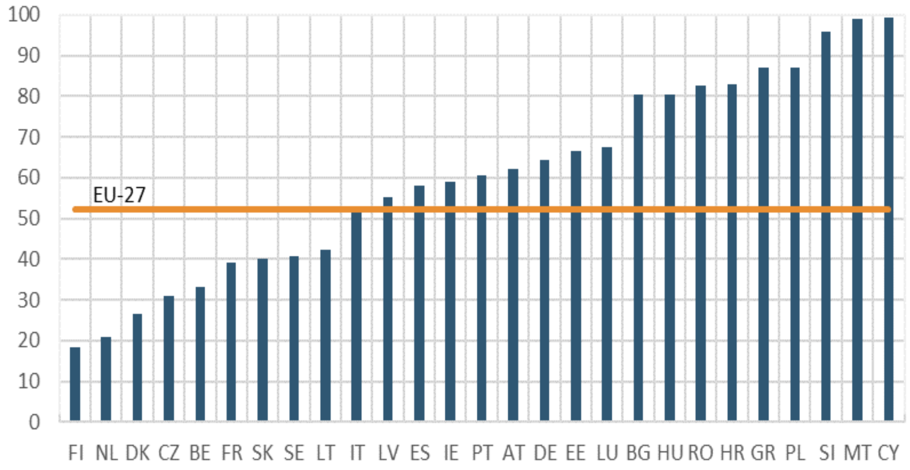


Environmental risk in credit risk framework



RWA composition (EU/EEA) by risk type (credit institutions only)

Source: EBA Risk Dashboard September 2021



Weight of the standardised approach in the credit risk framework

Share of total credit-risk-weighted exposure amounts derived through the Standardised Approach

Source: COREP supervisory data as of 2021 Q3, covering all credit institutions

Environmental risk in credit risk framework

Standardised Approach

- **Adaptive mechanisms allowing incorporation of new risk drivers:**
  - 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

Discussion Paper – questions posed

- **Fundamental questions on…**
  - Overall level of capital in the banking sector
  - The concept of 'double materiality'
  - The appropriate time horizon for the prudential framework
  - How to reflect forward-looking nature of environmental risks

Responses welcome until 2 August 2022

- **Specific questions about…**
  - Existing mechanisms within the framework which allow capturing new risks (external credit ratings, valuations, internal models, due diligence)
  - Possible targeted adjustments to the granularity of risk weights
  - Potential other adjustments to the framework, including specific clarifications
  - Some risks currently treated under Pillar 2 (strategic risk, reputational risk, concentration risk)
  - Possible introduction of dedicated risk-weights adjustment factors

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