

Financial Stability Board

By email: fsb@fsb.org

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Subject: Supervisory and Regulatory Approaches to Climate-related Risks

EBF response to FSB consultation on Supervisory and Regulatory Approaches to Climate-related Risks

INTRODUCTION

We would like to thank the FSB for the opportunity to answer its consultation on supervisory and regulatory approaches to climate-related risks.

Before responding the specific questions, we would like to make some overarching comments on the role of the FSB on climate-related risk.

About EBF

The European Banking Federation is the voice of the European banking sector, uniting 32 national banking associations in Europe that together represent some 4,500 banks - large and small, wholesale and retail, local and international - employing about 2.1 million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that securely handle more than 300 million payment transactions per day. Launched in 1960, the EBF is committed to creating a single market for financial services in the European Union and to supporting policies that foster economic growth.

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Since 2017 the FSB has played a key role in prefiguring (voluntary) climate disclosure standards through the TCFD, that was reviewed and improved in 2021. This work has been widely adopted by the industry with more than 2600 companies publishing a TCFD report, which is a huge achievement. However, the limit of voluntary standards has now been reached. The responsibility for global climate and ESG disclosure standards has now been assigned to the ISSB. In addition, banking regulation standards are being defined by the BCBS, and securities-related climate disclosures standards are defined by IOSCO. The overall coordination is done by the G20 and the G20 Sustainable Finance WG.

In addition to the global initiatives there are several initiatives taking place at jurisdictional level. We believe the FSB can play an important role in fostering convergence and harmonization, leveraging the work and progress of various regions. However, given the number of regulatory and supervisory requirements in place, or awaiting implementation, with very specific data requirements (Pillar 3 in the EU, scenarios analysis exercises in several jurisdiction, etc.) we would appreciate more details on how this report and its recommendations will be used.

Although the FSB oversees systemic risk, we believe it should avoid launching work around the consideration of ESG in Systemic Risk Buffers.

We see the greatest leverage in mitigating physical and transition risks not in the issue of capital adequacy, but in the strategic orientation of an institution and the anchoring of these risks in the organisation's guidelines and, especially, in the credit decision process.

Questions:

Supervisory and regulatory reporting and collection of climate-related data from financial institutions

- 1. Does the report highlight the most important climate-related data (qualitative and quantitative) for supervisors' and regulators' identification of exposures and understanding of the impacts of climate-related risks of financial institutions and across financial sectors? Please provide examples of climate-related data deemed most relevant and that should be prioritized.**

Data

The most relevant issue regarding climate-related supervisory reporting is data reliability and the lack of maturity of the data needed. ESG data providers acknowledge that there are still many data quality issues and completeness gaps and that solving those issues may take some time. For instance, there is a general lack of information of the location of the production facilities and their respective share in the total production of the counterparties that jeopardizes the correct assessment of the physical risk due to climate change. Another example is related to the lack of information of the allocation of the income/revenue to economic activities, so it is not easy for banks to understand the share of sustainable activities of a company. Corporates, and only the large and listed ones are only starting to disclose climate related or ESG information. No disclosure is expected to be mandatory for SMEs. To date, authorities have not provided fallback methodologies or more detailed guidance as to how to fill the data gaps, for example by using proxies and estimates, which will improve the comparability amongst reporting entities and avoid potential legal suits against financial institutions, should previously use estimates deemed to be inaccurate at a later stage.

Also, we wish to highlight that the maturity and availability of ESG data differ a lot according to the topic. For instance, if climate data are becoming more available it is still extremely rare to find data on other topics such as biodiversity, water consumption and

social impacts. Therefore, we believe that a sequenced, building block approach should always be considered among the ESG topics starting with climate.

The reliance of financial undertakings on the publicly available information on their counterparties should also be better reflected in the report and reporting obligations of non-financial institutions should be reflective of financial. Otherwise, financial institutions cannot be expected to be in the position to fulfil their disclosure requirements should non-financial undertakings not provide the needed data.

Finally, we would like to mention that for some countries, there is no regulation regarding the energy performance information such as Energy Performance Certificates for mortgages which hampers the assessment of the lending to retail customers. The authorities are not open to provide 'fallback' methodologies or more detailed guidance on how to fill those data gaps by using proxies and estimates, which could be the cornerstone for keeping the level playing field and comparability amongst reporting entities and avoid any potential legal suits against financial institutions.

2. Does the report draw attention to the appropriate areas to increase the reliability of climate related data reported by financial institutions?

Convergence

We favour international harmonization, standardization and level playing field, in terms of both contents and implementation timeline.

There is a need for commonly agreed definitions of metrics and methodologies including scope 1, 2, and 3, financed emissions, the use of carbon offsets, transition plans, portfolio alignment, etc. There is also a need for consistent implementation of these metrics and methodologies by the local jurisdictions. We believe the FSB could play an active role in fostering convergence and harmonization of definitions as part of its mandate.

We therefore appreciate the statement that 'Authorities and standard-setting bodies are encouraged to work towards common regulatory reporting requirements as part of future work'. We are however concerned that in the meantime, jurisdictional regulators and supervisors develop their own views and requirements. The current flexibility regulators are providing in terms of methodological choices and proportionality should therefore be maintained over time, considering the large-scale investments and time required for development of internal methodologies and systems. Also, as common definition might include elements such as double/single materiality approach which differs between jurisdictions, we would appreciate clarification on how differences are expected to be reconciled

Data value chain

Data value chain must be correctly framed. Banks are leveraging to a great extent on data provided by companies. We therefore believe that greater focus should be on companies as quality of data throughout the value chain depends on the initial data quality. Scope 1, 2 and 3 GHG emission need to be accurately disclosed by companies. Third party verification should be placed in the origin of the data, not on financial institutions (or only financial institutions). A strong oversight, governance and processes should be placed on all actors in the value chain, subject to proportionality. Value chain should be better defined and methodologies to assess the value chain not only for climate but also for other environmental, social and governance topics are still to be developed. Furthermore, in terms of liability one cannot put on an equal footing, the responsibility a corporate could have for the parties in its value chain with whom it has direct contractual relationships as opposed to where such a direct contractual relationship does not exist.

Global data repositories

There is a need for global data repositories at an appropriate level of granularity to increase access to reliable data.

3. Does the report appropriately identify the elements of a common high-level definition of climate-related risks (physical, transition and liability risks)?

We agree with the common elements identified by the FSB for delivering physical and transitions risks and for differentiating between these two types of risks. However, there are challenges linked to the identification of both risks. In the case of the physical risk, it implies having:

- a. information on the geolocation of the assets of obligors (by asset categories and their respective share in the total production or turnover of obligors),
- b. models that define the activities with a greater degree of sensitivity,
- c. the impact of the physical risks in the value chain of those obligors (how it affects their supply and suppliers, and of course their customers),
- d. differentiating by type of physical risk and probability (based on projected climate change scenarios).

These types of factors must be measured to determine the financial impact of climate.

It is not easy to predict potential outcomes of climate disasters and estimate the risk. This is because it is not possible to rely on historical data and it is very difficult to follow movements and find patterns that may make outcomes predictable with assigned probabilities. The measurements of these risks will not be homogenous without the definition by authorities (in collaboration with industry) of methodologies that help establish practices that allow benchmarking exercises or looking at alternative ways for dealing with the uncertainties. The report could elaborate on the management of uncertainty.

We agree on the need for common definitions of transition and physical risk and would encourage FSB to consider the definitions provided by the European Banking Authority.

Concerning transition risk, the EBA defines transition risk as the risks of any negative financial impact on the institution stemming from the current or prospective impacts of the transition to an environmentally sustainable economy on its counterparties or invested assets. We noted there are often discrepancies in definitions within the context of resolution. Definitions should be harmonized at international level considering the already established jurisdictional practices.

Concerning liability risk, we agree with 'Having a clear definition of liability risk, whether as a separate definition of risk or a subset of physical and transition risk, could increase the consistency in how such risk is identified and assessed.' We would however appreciate more clarity on the regulatory approach to 'liability risk' and who is expected to provide the definition. We would also like to stress the fact that regulatory requirements for financial institutions to disclose information that they cannot verify (rely on ESG data providers) or where estimates or proxies must be used to fill the data gap, increases the liability risk for banks.

On top, we would like to provide the following specific comments on the text in the report:

When defining transition risk, ‘...technological developments that would make less environmentally friendly technology obsolete...’ Less environmentally friendly does not necessarily mean obsolete. It just may be outperformed by another environmentally friendly technology. Given the technological advancements necessary for successful transition, assumptions of obsolescence will likely need continuous review. On top we wonder how a less carbon intensive technology which could have more adverse impacts on other environmental and/or social aspects could be qualified in this case? Would it be considered as decreasing transition risks while increasing them on other ESG aspects?

4. Do the proposed recommendations help accelerate the identification of authorities’ climate related information needs from financial institutions and work towards common regulatory reporting frameworks? Please elaborate on areas where the recommendations could be enhanced, if any.

The regulators and supervisors in several jurisdictions are already requiring very specific data requirements. Supervisors and regulators could work towards more consistency by providing guidelines on use of proxies and estimates.

When authorities require financial institutions to publish a public report in an aggregated format, those institutions will have to use proxies or estimates that are discretionary. For example, the same borrower in several financial institutions may have different levels of physical risk impact measured in a significantly different way. However, if the reporting authorities establish the necessary guidelines or proxies to determine the physical risks to which it would be subjected, the reporting could gain consistency and comparability. Additionally, in some ESG thematic data blocks, where discretion and different criteria lead to reporting non-homogeneous data (physical data, climate mitigation tag), a more granular information approach would allow the authorities themselves to apply the methodology they consider most appropriate.

Please find below more specific comments:

The suggestion to report ‘credit quality of exposures by sector’ as an indicator of transition risk might be misleading. It might suggest that most polluting sectors will have worst PDs/LGDs, whereas climate is only one of many drivers of the risk parameters and may not lead to worse credit quality.

Exposures to top carbon-intensive companies in the world and/or country by average maturity’ is provided in the FBS consultative report as an example of regulatory reporting content. We suggest that all reporting requirements of this kind are preceded by the provision of such list of ‘top carbon-intensive companies’ by the supervisor/regulator . There are many potential criteria to build such a list and leaving the design choices on financial entities can lead to inconsistencies, comparability problems, (e.g., difference depending on whether scope 3 is being considered or not, etc.) On top, if such reporting is meant for public disclosure as opposed to supervisory/regulatory reporting, additional legal and confidentiality issues may arise.

Incorporating systemic risks into supervisory and regulatory approaches

5. Does the report identify relevant system-wide aspects that should be considered as part of supervisory and regulatory approaches to incorporate systemic risks arising from climate change? Please elaborate on other aspects that should be considered, if any.

System-wide aspect should be incorporated only once there is a common approach at an international level The authorities that are considering potential system-wide effects of climate change are in the initial stages of analysis, which leads us to believe that it is too early for such exercise.

Having said that, a system-wide approach should go beyond the financial system as risk related to climate change start outside the financial system. As such, we believe the feedback loop is not properly framed in the document. It gives the impression that the loop starts with the financial intermediaries cutting funding to carbon-emitting companies.

Most financial entities are willing to fund carbon intensive companies' transition to a more sustainable economy as long as these have credible transition plans.

6. Does the report accurately reflect the extent to which current supervisory and regulatory tools and policies address climate-related risks?

No. We believe the report is missing on some essential topics that have been covered in the EBA's report on the role of environmental risks in the prudential framework, as well as in the PRA's report on climate risk of November 2021. In particular:

- the report does not mention anything on the extent to which these risks are already considered in the prudential framework (credit risk, market risk, operational risk), for example in internal models or in external ratings, and would therefore have an overall neutral impact
- the report does not mention anything on the extent to which these risks are already considered in accounting data (probable losses as opposed to unexpected losses covered by Pillar 1

Please also find below some specific comments:

- Explanation of the difference between bullets 1 (Supervisory review and evaluation processes, including risk assessments, supervisory expectations of financial institutions' risk management practices) and 3 (supervision and reviews, as well as deployment of supervisory capital add-ons to address deficiencies in the risk management) in the description of the regulatory/supervisory 'toolbox' would be welcome.
- 'Stress test' and 'Scenario analyses are used as interchangeable. It might be worth to set the differences between the two types of exercises.
- The description of the SSM Climate Stress Test as 'The ECB focused on Europe, covering 80% of loan exposures present in the AnaCredit database' is not accurate, because it also covers in some modules exposures outside Europe, and the limit of 80% is not based on the presence of the exposures in Anacredit but a % of the bank's exposures.

7. Do the proposed recommendations on incorporating systemic risks into supervisory and regulatory approaches, including the expanded use of climate scenario analysis and stress testing for macroprudential purposes, address the appropriate areas?

No. The report does not mention anything about the need for supervisors to develop robust and reliable methodologies for assessing climate risks. The FSB affirms these risks exist but does not elaborate on the need for supervisors to understand how to identify and measure them in a harmonized way. In the past supervisors invented the internal models that they imposed on banks in Basel II. We expect, after years of work on climate risks that supervisors will come up with robust and convergent methodologies for measuring climate risk rather than passing on the issue onto banks.

Please elaborate if there are any other features or tools that should be considered.

The other feature that should be considered is that the prudential framework should be based on risks. It would be useful for the FSB to ensure that basic principles are respected at the international level, to avoid prudential divergences based on political biases.

- Prudential requirements must reflect risk exposures and no other objectives,
- Prudential regulations should be risk- and fact-based. banks will have to measure the risk profiles of exposures, regardless of their sustainability character.
- Risk assessments must be based on objective and observable data.

Climate Stress Tests

As experienced in the recent exercises such as the ECB climate stress test, huge challenges remain for this novel process with major differences compared to the traditional stress tests given the data and modeling capabilities (like projections for the following 30 years) are still under construction. The integration into the Supervisory Review and Evaluation Process (SREP) of the climate Stress Test exercises and the potential capital impact via Pillar 2 is premature. Caution should be given to the interpretation of the results and the comparability of the exercise among entities or regions given that methodologies have not converged yet. We are at a learning stage.

The results of internal and external scenario analyses ought to be used to set out (strategic) courses of action. They do not, however, indicate a concrete risk that can be mitigated with capital.

Not every systemic risk requires a macroprudential solution. We do not believe that macroprudential intervention is necessary as long as climate-related risks are appropriately covered by the microprudential policy and there should not be a double counting of risks. Some ESG risks are already analyzed in the supervisory review process (SREP) and they might be covered, if necessary.

It would be very premature to include these risks in the macroprudential framework, at least until it is not clear how microprudential supervisors include them in their supervisory process. Otherwise, there is the risk of overlapping requirements and double-counting to cover the same risks. An additional buffer introduced as part of the EU macroprudential framework would be counterproductive as it would both dis-incentivize banks to invest in their own risk management capabilities, and “freeze” capital resources that are much-needed for investments into transition. . There is need to avoid overlapping and double counting among the different approaches.

Before presenting any proposal, regulators should assess and prove that the use of macroprudential tools is the most adequate and efficient way to address ESG risks. Macroprudential approach should play a part once it is proven the microprudential one does not fit for purpose and the risks and related uncertainties are not sufficiently covered.

Early considerations on other macroprudential tools and policies

- 8. Are there other areas of work, literature or research being conducted on macroprudential tools and policies on climate-related risks that should be considered in the report?**

As ESG are drivers of other type of risks and are different in their nature (more MT/LT, heterogenous ...) supervisors should contemplate other tools than classical micro/macroprudential tools.

Additional considerations

- 9. Are there any other issues that should be considered in future work of the FSB on supervisory and regulatory approaches to climate-related risks?**

There are several references in the report to 'carbon intensive sectors/exposures' for designing the set of tools. This has to be carefully considered, to avoid defining a de-facto additional Taxonomy.

Considerations should also be given to avoid unintended consequences. For instance, when talking about buffers, they require financial institutions to limit the number of resources that can be used to support lending. This can potentially reduce profitability and impact financial intermediation (e.g. lending decisions) to minimize buffer requirements. Reduced lending may as well have an impact on regional employment and economic activity'. A concept of procyclicality: if companies in need of transition finance are penalized too soon, they may find it difficult to access finance, aggravating their initial difficulties to transition.

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