EBA Report on role of environmental and social risks in the prudential framework

Executive Summary

Role of environmental and social risks in the prudential framework

1 Executive summary

EBA has published a Report on the role of E&S risks in the prudential framework to accelerate the integration of E&S risks into Pillar 1 through specific short, medium and long term actions

Regulatory context

- CRR3 contains a **mandate** for the EBA to develop a **report assessing the prudential treatment of exposures to E&S factors**.
- The EBA Discussion Paper published in 2022 initiated the discussion on the appropriateness of the current Pillar 1 framework to address **environmental risks**.
- The Report on the role of environmental and social risks takes the **Discussion paper as a starting point** to introduce short term and medium to long term actions for financial institutions.

Next steps

Alongside other policy initiatives outside the prudential framework, **EBA will continue to strengthen the integration of E&S risks across all pillars** of the regulatory framework.

Short term actions

Recommendations for **actions to be taken over the next three years** as part of the implementation of the **CRR3/CRD6.**

- Include environmental risks as part of **stress testing programmes** under both the **internal ratings-based** (IRB) and the **Internal Model Approaches** (IMA) under the **Fundamental Review of the Trading Book** (FRTB).
- Encourage inclusion of E&S factors as part of **external credit assessments** by credit rating agencies.
- Encourage the inclusion of E&S factors as part of **due diligence requirements** and **valuation of immovable property collateral.**
- Require institutions to identify whether E&S factors constitute **triggers** of **operational risk losses**.
- Progressively develop environment-related **concentration risk metrics** as part of supervisory reporting.

Medium to long term actions

Possible **revisions of the Pillar 1 framework** reflecting the growing importance of E&S risks:

- The possible use of **scenario analysis** to enhance the forward-looking elements of the prudential framework.
- The role of **transition-plans** as part of the development of further **risk-based enhancements** to Pillar 1 framework.
- Reassessing the appropriateness of the **IRB supervisory formula** and the **standardised approach** (SA) for credit risk to better reflect environmental risk elements.
- The introduction of **environment-related concentration risk metrics** under the Pillar 1 framework.

Access to document

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Key aspects

In its work, the EBA considers a number of premises and principles, as well as the main challenges that should be considered when assessing E&S risks

Objective	▪ **Addressing evolving risks**: respond to the consequences of climate change, biodiversity loss and other E&S concerns. ▪ **Adapting prudential framework:** assess the need for specific clarifications to account for E&S risk drivers in risk management. ▪ **Supporting sustainable transition:** mitigate risks arising from ESG factors while ensuring the overall financial stability.
Background and rationale	▪ **Emerging risks:** acknowledge the increasing challenges leading to heightened physical and transition risks for financial stability. ▪ **Role of financial sectors:** manage E&S risks as sources of financial risk materialising through traditional prudential risk categories. ▪ **Report scope and approach:** clarify the prudential framework, focusing on elements affected by environmental risk drivers.
Principles and premises	▪ **Risk based approach:** to assess the justification for dedicated prudential treatment of exposures related to E&S objectives. The focus is on exploring specificities in risks to adjust prudential treatment while maintaining safety, soundness, and financial stability. ▪ **E&S risks as drivers:** institutions can be impacted by E&S factors through their core business activities, influencing exposures to counterparties and invested assets. Considering **double materiality** to recognise the dual impact of institutions on E&S risks and vice versa through fully controlled activities and core business activities. Institutions should consider the economic and financial activities of counterparties and invested assets in relation to E&S risks for financial performance and solvency.
Challenges	▪ **Data availability and measurement challenges:** data gaps, lack of standardised classifications, and difficulties in linking forward-looking ESG information to prudential parameters. Availability of relevant and high-quality data, remains a significant challenge. ▪ **Estimation of losses due to E&S risks:** historical data and market prices may not fully reflect E&S risks, posing challenges in quantifying the extent of impact on capital levels. ▪ **Time horizon considerations:** potential mismatch between the time horizon of the Pillar 1 framework and the long-term manifestation of environmental risks poses a fundamental challenge. As **challenge in the estimation of systemic risks**, if E&S risks will grow the overall systemic risks or lead to a re-profiling of risk between sustainable and unsustainable sectors.

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Key aspects: points of attention (1/3)

Credit risk – Standardised appoach	**Institutions**	• It is recommended that **external credit assessments** integrate E&S factors as drivers, wether relevant. Although further assessment on the **robustness of the methodologies,** the level of **transparency and disclosure** to the public is needed. • **Verification** by Competent Authority (CA) that **due diligence requirements explicitly integrate environmental aspects** to ensure that environmental risks are appropriately captured and reflected in the prudential framework whenever relevant.
	EBA	• **Monitor** that **financial collateral valuations** increasingly reflect environmental factors, in the **medium to long term.** • Assess whether **high-quality specialized lending corporate exposures** (introduced in CRR3) **could be subject to similar environmental provisions as under the infrastructure supporting factor** (ISF), where only exposures meeting strong environmental standards may benefit, in the **medium to long term**. • **Reassess** whether environmental risks should be considered in evaluating the **appropriateness of risk weights** assigned to **real estate exposures** and how can be reflected in the **prescribed risk weights in STA**, in the **medium to long term**.
Credit risk – Internal ratings-based approach	**Institutions**	• E&S risks should be considered in the **rating assignment** (e.g. risk differentiation step), **risk quantification** (e.g. MOCs, downturn component, calibration segments) and in the **application** (e.g. human judgment and overrides)**,** in the **short term**. • **Reflect** E&S risks in their **PD** and **LGD estimates** through a re-development or recalibration of their rating systems in the **long term** (once the impact of E&S risks on default and loss rates become available). • **Consider** E&S risks as part of their **stress testing programmes** in the **short term.**
	EBA	• Need for **guidance on data collection** regarding potential **E&S risk** drivers to benefit institutions in **designing rating models**. • **Assess** whether relevant **E&S risk drivers** should be added to the **existing lists of risk drivers** mentioned in the EBA GL on PD and LGD estimation and the treatment of defaulted exposures, in the **medium to long term**. • **Premature** to consider **further differentiation** in the **RW supervisory formula,** the **RWs** applied to specialised lending under **slotting approach** and **F-IRB parameters**. The EBA will **reassess the appropriatenesss in the medium/long term.**

Main challenges in the short term

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Key aspects: points of attention (2/3)

Credit risk – collateral valuations	**Institutions**	• Account for **relevant environmental factors** in the prudent valuation of immovable property collateral, in the **short term.** • **Adjust** the **current market value** of the collateral when does not adequately **address the relevant risks** associated with environmental factors, in the **short term**. Covering **valuation at origination, re-valuation and monitoring**.
	EBA	• **Monitor how ESG factors** are reflected at **collateral value**, considering the national specificities.
Credit risk – Adjustment factors	**EBA**	• **Does not recommend** introducing adjustment factors related to environmental risk drivers, at this stage. • Reassess if and how **environment-related adjustment factors** could be taken into account as part of a **prudentially sound** and **risk-based prudential treatment** of individual exposures, in the medium to long term.
Market risk	**Institutions**	• Consider environmental risks in their **trading book risk appetites**, **internal trading limits and new product approvals**, in the **short term.** • Consider environmental risks in their **stress testing programmes by IMA instutions,** in the **short term.** • CA should assess how **ESG-linked products** are treated in relation to the **risk-residual add-on** to ensure **harmonised treatment** across institutions and how they are treated in the **internal risk measurement model**, in the **medium/long term.** • Consider **ESG risks** when monitoring risks that are **not included** in the model. ECB' **RNIME[1] framework** could be used.
	EBA	• Reassess the appropriateness of **including** under the **sensitivity-based method (SbM) a dimension**, in the equity and credit-spread risk classes, reflecting ESG risks to establish the buckets into which a **risk factor falls**, or of including an environmental risk class, in the medium to long term. • Reassess the appropriateness of introducing **regulatory provisions** explicitly requiring institutions to capture material environmental risk drivers in their **internal models**, in the medium to longer term.

Main challenges in the short term

[1] RNIME: risks not in the model engines

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Key aspects: points of attention (3/3)

Operational risk	**Institutions**	• **Identify** whether E&S constitute **triggers of operational risk losses,** in the *short term*.
	EBA	• Reassess the appropriateness of revisions to the **BCBS SA methodology** based on the evidences of E&S risk drivers may **trigger operational losses** in increased frequency and severity.
Liquidity risk		• At this stage, the EBA **does not recommend** changes to the **LCR and NSFR framework.**
Concentration risk	**EBA**	• Definition of **environment-related concentration risk** (e.g. exposures to counterparties/issuers, supply chain risk events…) • Development of **exposure-based metrics** for the quantification of environment-related **concentration risks,** in the short term. Implement those metrics as part of supervisory reporting. • Consider an **improved concentration risk metric**, in the medium/long term. • Reassess introducing **environmental-related concentration risks** under the **Pillar 1 framework**, in the medium/long term, including the design of **limits and thresholds**, **add-ons or buffers**, and **consequences** if there are breaches.
Capital buffers	**EBA**	• The **systemic risk buffer** (SyRB) appears as the **most relevant tool to address environmental risks within the current macroprudential framework**. The EBA will assess the need for **changes to its guidelines** on the appropriate subsets of sectoral exposures to which a SyRB may be applied, in the short term. • Coordinate with other ongoing initiatives to address environmental risks, in the medium to long term.
Investment firms	**EBA**	• **Treatment** of E&S risks remain under the **Pillar 2 framework** for all **K-factor**s including those related to **Risk to Client** (RtC), in the short term. EBA **does not recommend** changing the **prudential framework**, in the short term. • Extending the **potential changes** of CRR framework to the investment firms' prudential framework at medium/long term.

Main challenges in the short term

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