Response to consultation on draft Guidelines on the management of ESG risks

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Question 1: Do you have comments on the EBA's understanding of the plans required by Article 76(2) of the CRD, including the definition provided in paragraph 17 and the articulation of these plans with other EU requirements in particular under CSRD and the draft CSDDD?

No comment

Question 2: Do you have comments on the proportionality approach taken by the EBA for these guidelines?

ESG risks can affect institutions of all sizes and should be addressed across the banking sector. Smaller banks, especially those with limited diversification and higher regional exposure, may face heightened concentration risks compared to larger institutions and therefore equally vulnerable to ESG risks. Limited budgets often impede dedicated ESG resource allocation, posing challenges to effective ESG risk management at smaller

Question 3: Do you have comments on the approach taken by the EBA regarding the consideration of, respectively, climate, environmental, and social and governance risks? Based on your experience, do you see a need for further guidance on how to handle interactions between various types of risks (e.g. climate versus biodiversity, or E versus S and/or G) from a risk management perspective? If yes, please elaborate and provide suggestions.

No comment.

Question 4: Do you have comments on the materiality assessment to be performed by institutions?

We support the proposed materiality assessment in the Consultation Paper and particularly endorse the recommendation for banks to adopt a long-term planning horizon of up to 10 years. This approach more effectively accounts for the extended timeframe over which climate change impacts likely unfold. However, we recommend that this assessment should align with EU frameworks, including the Corporate Sustainability Reporting Directive (CSRD) and the Corporate Sustainability Due Diligence Directive (CSDDD). In this context, we also believe that it would be crucial to consider the interdependencies between impact materiality and financial materiality.[1]

Examining banks' exposures to sectors with significant contributions to climate change, while also considering exceptions aligned with the EU taxonomy, is an important initial step in assessing materiality. We believe that granting banks the flexibility to exclude exposures aligned with taxonomy from climate materiality assessments may encourage transition finance, aligning with the EU's climate goals and creating a self-reinforcing effect. Moreover, we acknowledge that material risk exposure in ESG is not limited to climate change. As highlighted in the European Sustainability Reporting Standards (ESRS)[2], a comprehensive review of ESG data, possibly involving additional indicators, is required. For example, the MSCI ESG Industry Materiality Map[3] evaluates long-term resilience of companies to ESG

[1] Sustainability Reporting Standards, Commission Delegated Regulation 2023/2772 (EU Commission, December 2023)

[2] EU Commission adopts the European Sustainability Reporting Standards (EU Commission, July 2023)

[3] ESG Industry Materiality Map (MSCI)

Question 5: Do you agree with the specification of a minimum set of exposures to be considered as materially exposed to environmental transition risk as per paragraphs 16 and 17, and with the reference to the EU taxonomy as a proxy for supporting justification of non-materiality? Do you think the guidelines should provide similar requirements for the materiality assessment of physical risks, social risks and governance risks? If yes, please elaborate and provide suggestions.

Please refer our response to Question 4.

Question 6: Do you have comments on the data processes that institutions should have in place with regard to ESG risks?

EBA's proposal regarding the establishment of robust data collection and analysis processes for ESG risk assessment is a welcome step. Particularly, we emphasize the significance of forecasted Scope 1, Scope 2, and Scope 3 emissions as forward-looking data points. These metrics provide valuable insights into transition risks, which predominantly emerge in the future, offering a more informative perspective than solely relying on current or past emissions data.

Regarding the collection of geographical location of key assets, we recommend that, at a minimum, longitude and latitude coordinates, addresses, square meters, and building type should be collected. Additionally, if feasible, the information on activity being carried out at the asset, along with the revenues generated from the location, production quantity, or

type of data, estimates or proxy data from third parties could be sourced.

Question 7: Do you have comments on the measurement and assessment principles?

For the measurement and assessment of material ESG risks, MSCI recommends that banks employ data quality scores. For instance, the Partnership for Carbon Accounting Financials (PCAF)[1] employs a five-step data quality scale (from 1 to 5) to assess the quality of data used in financed emissions calculations. The granularity and specificity of emissions data influence the score. This type of approach could also be employed when measuring other ESG risk types such as physical or nature-related risks. Employing such data quality scores in the prudential management of ESG risks could help banks enhance their risk assessment and improves market discipline by encouraging transparent disclosure.

[1] PCAF explained: The standard to measure financed emissions

Question 8: Do you have comments on the exposure-based methodology?

In addition to the exposure-based risk assessment suggested by the EBA, ESG considerations could also be relevant in the due diligence and risk assessment process, for example:

1. ESG risk analysis could be included in the business or project due diligence report. This could include qualitative analysis (e.g., regulatory landscape, technological development) and quantitative analysis (e.g., financial forecasting taking into consideration transition risks).
2. ESG and climate factors such as transition and physical risk impacts may be integrated into traditional credit rating models. Alternatively, a shadow Probability of Default factoring in climate-related financial risks could be maintained by the banks.
3. Banks could follow a risk-based approach in the post-loan management process to monitor the development of ESG risks. For example, counterparties and projects with higher transition and physical risk impacts could be reviewed more frequently.

Question 9: Do you have comments on the portfolio alignment methodologies, including the reference to the IEA net zero scenario? Should the guidelines provide further details on the specific scenarios and/or climate portfolio alignment methodologies that institutions should use? If yes, please elaborate and provide suggestions.

We strongly support the disclosure of portfolio alignment methodologies, whose robustness has grown in recent years. However, to ensure the integrity and effectiveness of these methodologies, it would be essential to address certain downsides.

Mandating a specific scenario provider such as the International Energy Agency (IEA) or even a specific scenario (IEA NZE2050) entails certain risks of systemic misallocation of capital and unintended climate effects. This approach could inadvertently create an oligopoly situation in the portfolio alignment metrics market, limiting competition and inadvertently imposing additional costs and complexity, particularly for smaller banks. For instance, the IEA focuses only on CO_2 emissions and not on other GHGs, e.g. methane, a much more potent gas. By contrast, other scenarios take into account GHGs more comprehensively, crucial for accomplishing a Paris-aligned transition. Some portfolio alignment methodologies are misaligned with science-based design, thus exposing those to greenwashing risks as highlighted by the European Central Bank (ECB).[1]

To mitigate these risks, we would recommend that regulated banks provide transparency on their measurement of portfolio alignment, based on the best practice recommendations, as set out by the Glasgow Financial Alliance for Net Zero (GFANZ)[2].

The GFANZ report suggests selecting a scenario type compatible with the IEA Net Zero scenario, without mandating a specific scenario provider. For instance, it could align with the NGFS Net Zero 2050 scenario.[3]

"The benchmark scenario provides an approximately 50% or 66% chance, given current knowledge of the climate response, of global warming either remaining below 1.5 degrees C or returning to 1.5 degrees C by around 2100 following an overshoot. Pathways giving at least 50% probability based on current knowledge of limiting global warming to below 1.5 degrees C are classified as "no overshoot" while those limiting warming to below 1.6

More broadly, the report suggests the measurement of portfolio alignment through nine key design judgments as outlined in the figure below. This framework offers key principles for banks to adopt as best practice and aligned with science when assessing portfolio alignment.

For figure please refer the attached response document.

[1] An examination of net-zero commitments by the world's largest banks (EBA, November 2023)

[2] Glasgow Financial Alliance for Net Zero (GFANZ, November 2022)

[3] Measuring Portfolio Alignment Enhancement Convergence and Adoption (GFANZ, November 2022)

Question 10: Do you have comments on the ESG risks management principles?

No comment.

Question 11: Do you have comments on section 5.2 – consideration of ESG risks in strategies and business models?

No comment.

Question 12: Do you have comments on section 5.3 – consideration of ESG risks in risk appetite?

No comment.

controls?

No comment.

Question 14: Do you have comments on section 5.5 – consideration of ESG risks in ICAAP and ILAAP?

No comment.

Question 15: Do you have comments on section 5.6 – consideration of ESG risks in credit risk policies and procedures?

No comment.

Question 16: Do you have comments on section 5.7 – consideration of ESG risks in policies and procedures for market, liquidity and funding, operational, reputational and concentration risks?

No comment.

Question 17: Do you have comments on section 5.8 – monitoring of ESG risks?

No comment.

Question 18: Do you have comments on the key principles set by the guidelines for plans in accordance with Article 76(2) of the

Question 19: Do you have comments on section 6.2 – governance of plans required by the CRD?

We are supportive of the approach regarding governance of plans required by the CRD, emphasizing the importance of clearly delineated responsibilities for ESG risk governance across all levels of the institution. According to our analysis on director climate expertise and climate targets[1], we observed that companies with at least one climate expert on the board generally performed worse on our climate target assessment than companies without board experts. These findings caution against only focusing on the presence of a climate expert on the board in investor engagements on climate change. Rather they support a broader approach to analyzing climate governance practices, including board committee structure, director skills and education, executive pay, and senior management composition as reflected in the results below. 88% of firms with executive directors with climate expertise were on track with some or all targets, compared to only 61% of firms with non-executive directors with climate expertise.

For figure on progress with climate targets, by director type please refer the attached response.

[1] Director Climate Expertise and Climate Targets, MSCI ESG Research LLC, March 2024

Question 20: Do you have comments on the metrics and targets to be used by institutions as part of the plans required by the CRD? Do you have suggestions for other alternative or additional metrics?

We strongly support these proposed metrics and targets, recognizing their comprehensive nature in addressing sustainability transitions and climate risks across various sectors and activities. The EBA's reference to absolute emissions in CO_2 equivalent supports our argument for extending scenario selection beyond IEA scenarios. Unlike IEA scenarios, which narrowly focus on CO_2 emissions and overlook other greenhouse gases convertible

Please also refer to our response to Q.9 on Portfolio-based methodologies. Portfolio alignment metrics are also a key metric for gauging alignment with the Paris agreement and provide some indication of transition risk.

We suggest the following additional metrics for consideration by EBA:

Assessing transition risk under a range of climate scenarios:

To establish potential future sources of transition risk, banks should consider the Climate Value-at-Risk of counterparties under a range of climate scenarios and across multiple time-horizons. Climate Value-at-Risk quantifies forward-looking and return-based valuation assessment of transition and physical risks and helps financial practitioners' model potential financial losses under a range of climate scenarios.

Assessing the emissions profile for mortgages and real estate assets:

Assessing the energy efficiency of buildings as outlined provides valuable insights into buildings' energy consumption. For example, buildings with effective insulation tend to consume less energy. However, assessing energy consumption alone does not provide any information about the building's actual emissions profile. While energy consumption will likely stabilize in well-insulated buildings, further reducing emissions remains the most important goal to reach net-zero emissions. Therefore, we recommend that financial institutions also assess the financed emissions of their real estate assets in addition to energy efficiency.

Assessing resilience to physical risks:

We recommend performing a comprehensive assessment that distinguishes between chronic and acute risk impacts, across various climate scenarios, as well as appropriate granularity depending on the use case. Best practices could include hazard exposure and loss assessment for all relevant chronic and acute hazards expressed in return periods (i.e.100/200) and translating this exposure to financial impacts. In this context, it would be critical to employ a range of climate scenarios encompassing a range of time horizon considerations to anticipate potential differences in the severity of the hazard exposures and loss impacts. Finally, tailoring the assessment's granularity to the context would be crucial. While portfolio- or company-level assessments may enable a materiality assessment and heat mapping of physical risk, drill-down to asset level exposure and loss metrics may be required for use cases including due diligence, risk management and engagement.

Assessing biodiversity and nature risks:

To ensure a thorough understanding by financial institutions of both environmental and financial impacts of biodiversity and nature risks, we recommend adopting a double materiality approach informed by the recommendations of the Taskforce on Nature-related Financial Disclosures (TNFD). This approach would entail on the one hand evaluating how companies impact nature and biodiversity, and on the other hand how biodiversity loss may affect companies financially. Screening metrics could identify operations in biodiversity-sensitive areas, contributions to deforestation, or involvement in activities harming biodiversity. Similarly, assessing financial impacts could involve examining revenues/assets in regions facing high water stress, operations in fragile ecosystems, and segments with land or marine disturbances. It would be vital to gauge companies' ability to mitigate these impacts through existing governance, strategies, risk management, and targets.

Question 21: Do you have comments on the climate and environmental scenarios and pathways that institutions should define and select as part of the plans required by the CRD?

To foster effective risk management practices, real-world and decision-useful scenarios would be essential to empower financial institutions take ownership of modeling choices and assumptions. We encourage the EBA to offer guidance on defining appropriate time frames, identifying relevant ESG risks and outlining criteria for meaningful scenarios but would caution over-prescription of climate scenarios as this could inadvertently disrupt markets via 'group think'[1]. Institutions need flexibility to tailor scenarios to their unique circumstances. In this context, providing transparency on the underlying model choices and assumptions would be crucial. Additionally, for physical risk analysis, institutions should consider capturing longer-term impacts through the end of the century and incorporate second and third order impacts of physical risks, so called 'systemic risk'. Also, over time, institutions should progress from qualitative to quantitative assessments.

[1] The Emperor's New Climate Scenarios Limitations and assumptions of commonly used climate-change scenarios in financial services, Institute and Faculty of Actuaries, University of Exeter, (University of Exeter, July 2023)

We recommend that the EBA introduce a uniform approach and framework for CRD-based transition plans, including clear guidelines on what constitutes green and transition finance to avoid greenwashing. Establishing a common format for these plans would help to enhance clarity and consistency for financial institutions and facilitate effective implementation and comparability of transition strategies with a focus on short- to medium-term actionable risk management. Additionally, ensuring interoperability with other regulatory requirements, such as the CSRD, would be crucial for streamlining reporting processes and avoiding duplication of efforts. Despite the importance of transition planning, challenges may arise in its implementation, including data management complexities, counterparties' varying levels of ESG readiness, and the need for updated risk management policies to address emerging risks. Clarifications and further guidance from the EBA on these aspects could greatly assist institutions in effectively implementing the guidelines.

Question 23: Do you think the guidelines have the right level of granularity for the plans required by the CRD? In particular, do you think the guidelines should provide more detailed requirements?

Please refer our response to Question number 22.

Question 24: Do you think the guidelines should provide a common format for the plans required by the CRD? What structure and tool, e.g. template, outline, or other, should be considered for such common format? What key aspects should be considered to ensure interoperability with other (e.g. CSRD) requirements?

Please refer our response to Question number 22.

implementation of these guidelines, and what changes or clarifications would help you to implement them.

Please refer our response to Question number 22.

Question 26: Do you have other comments on the draft guidelines?

Please refer our response to Question number 22.

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MSCI Response_EBA_Draft_Guidelines_on_the_management_of_ESG_risks.pdf (376.99 KB)

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