EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Template for comments

Guide on the management and disclosure of climate-related and environmental risks

Institution/Company

Expert group "Draft ECB Guide on climate-related and environmental risks"

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General comments

General Comments from the Expert Group "Draft ECB Guide on climate-related and environmental risks"

The Guide is a very welcome development in EU financial supervision and makes an important contribution to greater consideration of climate and environmental risks within the broader economic policy objective of the EU. We fully support ECB Banking Supervision's role in aligning existing financial market practices with a long-term time horizon. Today, as the ECB notes, "only a small number of institutions have fully incorporated climate-related and environmental risks into their risk management framework" (p. 13). Hence, we agree with the ambitious approach that the Guide takes to future climate-related risks; the ECB is right to restate that risks should not be ignored just because they might be "difficult to quantify or because the relevant data are not available" (p. 29). Instead, to the extent possible, they should be incorporated into the business strategy, governance, risk management and disclosure practices of supervised institutions. Overall, the Guide is a historical step in supervisory work to promote long-term value creation and break the tragedy of the horizon.

Based on our research and collaborative discussions within the Expert Group "Draft ECB Guide on climate-related and environmental risks" we have seven main requests for clarification and suggestions for further improving the current draft and the ECB's Supervisory Review and Evaluation Process (SREP) that it will inform. For each of these general comments, we also provide more detailed and targeted comments on individual parts of the draft.

First, the ECB should develop procedures to communicate, guide and standardize the process by which supervisory expectations are calibrated to different institutions and become stricter over time. The current draft states that methodologies and tools to address environmental climate-related risks are "evolving and expected to mature over time" and expectations need to be applied "proportionately to the risk profile and business model of the institution" (p. 9). Missing from the Guide as currently conceived is an account of how supervisory expectations will be calibrated in relation to greater risk over time. For example, in five years from now expectations for how banks should integrate climate and environment-related risks understood as drivers of established risk categories will be much stricter. To work towards meeting those higher expectations, supervisors will need to gradually adapt expectations. More detailed procedures for making expectations gradually more strict will be important for supervisors, who need sufficiently fine-grained standards to impose meaningful requirements and ensure that these are consistently applied across the euro area. Banks, in turn, need clear guidance from supervisors on how supervisory expectations are evolving to ensure a level playing field and allow banks to properly anticipate the requirements they face. Finally, it is important for the public to be able to evaluate and understand the standards to which banks are held.

Accordingly, the ECB should set out procedures in the Guide for dealing effectively with the evolving nature of supervisory expectations. The revised Guide should answer four main questions in more detail: First, what types of communications will the ECB develop to clarify the nature of expectations over time? Second, what procedures will be used to set benchmarks for where banks should be in terms of their own strategy, internal risk management and governance practices as well as disclosures? Third, if there is to be calibration of the requirements depending on the size of the bank, how would this be operationalized and what indicators would serve as benchmarks? Fourth, how will the ECB and the NCAs make sure that the criteria in the Guide and adjacent rules and regulations concerning climate-related and environmental risk will be applied and implemented in a standardized fashion to ensure a level playing field? We would recommend a timeline for regular updating the Guide to reflect improvements in the understanding of environmental and climate-related risks.

Second, the ECB should strive to embed the Guide in the evolving EU legal framework on environmental risk governance and report regularly on the results achieved. The EU legislator has introduced a number of specific regulations on climate-related risks in the context of micro-prudential and macro-prudential supervision. The Sustainable Disclosures Regulation, the Taxonomy Regulation and the CRR II all provide transparency requirements that place demands on financial institutions and their governance of sustainability risks. Furthermore, Regulation (EU) 2019/2175 has characterized climate and environmental risks as a potential source of systemic risk. We encourage the ECB to reference these regulations as well as CRD IV explicitly in the Guide. In this context, we ask for clarifications as to how the ECB plans to draw on the EBA's current work instigated by Article 501c CRR2 towards a dedicated prudential treatment of investments that contribute to the EU's environmental objectives. We would also like to draw attention to the fact that the ECB does not clearly state how it intends to rely on this Guide in the course of its supervisory activities and whether its related supervisory expectations will be integrated into SREP. In this regard, it would be useful for the ECB to signal that, pursuant to art. 98(8) CRD, the legislature has specifically mandated the EBA to integrate ESG-risks considerations into its SREP guidelines, which will be binding for the ECB, once adopted. We recall in this context that the European Court of Justice has long considered that, although soft law is in principle not binding for individuals and undertakings, the EU institution that issues soft law is bound by it in the exercise of its competence an5d powers. However, this legal consideration is insufficient for ensuring the consistent implementation of the ECB's supervisory expectations by institutions and supervisors alike. Given the heterogeneity of approaches and supervisory cultures across the Banking Union, we would encourage the ECB to outline more clearly how it expects to address regulatory risks stemming from divergent interpretations by NCAs (especially in the context of cross-border banks) and to minimize distortions to the level-playing field across the EU. Moreover, specific political accountability mechanisms, first and foremost involving the European Parliament, are needed to monitor the results achieved by the ECB's supervisory approach.

We encourage the ECB to devote a dedicated section in its Annual Report to supervisory activities, detailing how it implemented its supervisory expectations concerning climate risk. This could be used to underline the best, but also the worst, practices by supervised entities. Furthermore, given the many stakeholders who are directly affected by climate change as well as the specificity of climate change-related knowledge, we would propose that regular engagement with non-bank stakeholders. Finally, the ECB should be proactive in communicating its supervisory policy regarding climate-related and environmental risks to the European Parliament.

Third, it is not clear how the ECB will push for better environmental risk-screening and how it will push banks to develop an accurate understanding of medium and long-term risk, which however remains divorced from their actual business practice. Carrots are a good first step but moral suasion alone, even by a supervisor, is unlikely to induce significant and durable changes in business practice of banks. What is missing from the draft Guide is a stick. Because investments that are environmentally harmful will remain profitable in the short to medium term, merely acknowledging these risks may not discourage such investments. A possible "stick" would be adjustments to capital requirements, but there is currently no clear connection between the supervisory dialogue and the Pillar-2 capital requirements. From the Public Hearing on 2 September, we understand that environmental risk will not trigger changes to capital requirements, at least not in the short term. This leaves us wondering whether the Guide provides supervisors with sufficient levers to incentivize adaptation to climate risk. Alternatively, if the goal of the Guide is only to start a discussion with banks about their own thinking, this should be stated more clearly. We note that if this was indeed the case, it is unlikely that regulated entities will incorporate environmental risks properly into their business strategy and operations.

Therefore, the Guide should lay out possible ways to make compliance with environmental risk supervision enforceable. Specifically, which of the supervisory powers mentioned in Article 16(2) of the SSM Regulation will the ECB rely on to ensure compliance with its requirements? Public disclosures through benchmarking and rankings might serve as an effective non-prudential tool.

Fourth, it is currently unclear whether banking supervisors are adequately equipped to assess whether the banks "understand the impact of climate-related and environmental risks on the business environment in which they operate". The Guide correctly points out that climate-related and environmental risk will depend on factors such as, inter alia, "macroeconomic variables, the competitive landscape, policy and regulation, technology, societal/demographic developments, and geopolitical trends" (Guide, p. 15). The ECB should make sure that its supervisors have recourse to an evidence-based and sufficiently robust set of assumptions concerning these factors, even if uncertainties remain. For example, "expert judgement" (p. 17) could be defined as "expert judgement from a diverse set of scholars and practitioners from a wide variety of disciplines, including but not limited to climate science, economics, philosophy, physics, anthropology, political science, and other relevant areas". The IPCC's Shared Socioeconomic Pathways (SSPs), Integrated assessment modelling, and the IEA Sustainable Development Scenario, might be a good starting point in this regard. While expertise in climate science is widely available, it is crucial that its role in the SREP is incorporated and monitored by the joint supervisory teams (JSTs). For this, it is necessary that supervisory teams have access to and make use of the required expert knowledge.

The ECB should develop its own assumptions concerning climate risk and its impact on financial stability should be checked for their adequacy and updated regularly. These assumptions should form the basis for assessing the medium and long-term assumptions that inform the business strategies and risk management practices of supervised entities. The Guide should provide more clarity on how the ECB and the NCAs will organize and develop climate-related and environmental risk expertise within their own organizations. How, for example, will responsibilities concerning climate-related and environmental risk be distributed within joint supervisory teams? Will a single supervisor within the JST be responsible or will there be a separate expert team that the JST might consult? Further, to ensure that climate expertise does not depend on the composition of a specific the supervisory team, the ECB should formalize the role of climate expertise in day to day supervision and develop adequate climate science expertise. A possible way to do this is by providing a separate expert team with a mandate to initiate their own research at institutions. Alternatively, the ECB/NCAs might disclose in their reports the frequency with which climate experts were involved in matters of supervision, including the SREP.

Fifth, the ECB should not just rely on environmental risk management practices the banks themselves developed and should instead establish its own standards and techniques. There is a steep gap between the expectation that supervised entities should "consider" a given risk in their strategy and risk management framework, and the expectation that these risks will be weighed accurately and reflected in lending and bank capital requirements. We worry that the ECB currently takes a hands-off approach to the development of adequate environmental risk management techniques. This seems inspired by the legacy of the 1990s, when private institutions developed their own internal risk management methodologies (in particular, Value at Risk as developed by JP Morgan), which were subsequently incorporated into the 1996 Market Risk Amendment and formed the basis for the Basel II Capital Accord. Experience suggests that such a hands-off approach is ill-advised. To properly supervise and evaluate risk management techniques used in the private sector, supervisors must themselves develop and refine technical standards for environmental risk management. As the history of private risk assessments illustrates, the creation of new risk management techniques can easily have unintended consequences for financial stability and beyond. A hands-off approach also places supervisors at an epistemic disadvantage, because it leaves expertise on environmental risk management inside the banking system. This is particularly problematic given that the incentives of banks may not be properly aligned with long-term value creation that is consistent with environmental risk.

Accordingly, the ECB should be actively involved in the development of better risk management techniques. Such efforts need not take place within the supervisory arm of the ECB alone, since these new environmental risk related challenges also arise in regulation and monetary policy.

Sixth, while we acknowledge the pivotal significance of existing quantitative risk management frameworks as a regulatory instrument, the ECB should more critically evaluate their usefulness and limitations in the context of the distinctively difficult to model risks of climate change. As the Guide acknowledges, "Climate-related and environmental risks have distinctive characteristics that warrant particular consideration by supervisors and institutions alike." Given "the far-reaching impact in breadth and magnitude, an uncertain and extended time horizon and the dependency on short-term action" (§3.2, p. 12) both physical climate impacts and the technological-, policy-, and economic adjustments towards a more sustainable economy will likely feature feedback mechanisms, complex interactions, and multiple equilibria. These, in turn, may drive non-linearities in financial markets that existing risk models are unable to predict. The core problem of uncertainty not only affects backward-looking risk methodologies, but also forward-looking stress tests and scenario analyses. While quantitative risk techniques will remain critical in assessing the interactions between variables with a well-established distribution, the ECB should initiate a sustained discussion of the usefulness and limitations of all these policy frameworks aimed at producing improbably precise metrics and predictions. We would encourage the ECB to make explicit when it believes these risk techniques to be most useful, the types of knowledge and information they draw on, but also their limitations. Further, the ECB should address the problem of uncertainty and the need to rely on precautionary measures when precise risk measures are not available.

The ECB should put forward a sustained discussion of the usefulness and the limitations of these techniques in relation to distinct forms of environmental risk. This can be based on in-house expertise or by bringing together a high-level expert group that represents different stakeholders.

Seventh, we agree with the Guide that scenario analysis and stress testing is a promising method to model and potentially manage the distinctive characteristics of climate-related and environmental risks. For this reason, it would be desirable to better specify supervisory expectations. As the Guide observes, “scenario analysis … is particularly useful in the context of climate-related and environmental risks given the uncertainty associated with the future course of climate change and society’s response to it.” (§4.2, p. 17). We agree and welcome the associated expectation (expectation 2.1). Concerning the design of scenarios to be tested, we also welcome the expectation that “For physical risk, institutions are expected to consider using scenarios that are in line with specific climate change pathways, such as IPCC or IEA scenarios.” (§6.5, p. 37).

The ECB could specify in more detail how it will approach scenario analysis and stress testing. The aim should be to draw on the broadest possible inputs into the developments of these methodologies. In line with Comment 4, we emphasize that it matters what counts as “expert judgement” (p. 17) and that for this reason the role of climate science experts involved throughout the stress testing process should be formalized. To this end, the ECB should say more about who will be involved in developing the scenarios (for example, a collaborative panel composed of regulators, regulated institutions, and experts from academia and civil society) and specify core scenarios for assessing transition risk (we propose using a 1.5 degree warming scenario as the default). If the ECB were to conduct its own climate-related stress tests, it should consider publishing their results in a manner conducive to public scrutiny. The results should be presented to the European Parliament to foster a risk dialogue, analogous to the monetary dialogue.

The Expert Group "Draft ECB Guide on climate-related and environmental risks" consists of:

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Template for comments

Guide on the management and disclosure of climate-related and environmental risks

Please enter all your feedback in this list.
When entering feedback, please make sure that:
- **each comment deals with a single issue only;**
- **you indicate the relevant article/chapter/paragraph, where appropriate;**
- **you indicate whether your comment is a proposed amendment, clarification or deletion.**

Deadline:	25 September 2020

ID	Chapter	Paragraph	Expectation or box number	Page	Type of comment	Detailed comment	Concise statement as to why your comment should be taken on board	Name of commenter	Personal data
1	Chapter 1	2		3	Clarification	It may appear misleading to claim that the ECB has identified climate-related risks as a key risk driver on the SSM Risk Map when this map classifies climate change as having the lowest probability and impact of all key risk drivers identified by the ECB, in regression with respect to probability in 2020 compared to the 2019 SSM Risk Map. This does not correspond to the forward-looking and comprehensive approach the ECB is calling for in this Guide and may contribute to the underestimation of risks by institutions. Indeed, the ECB takes the risk of contributing to the "Tragedy of the Horizon" by lowering the importance of the risks associated with climate change that need to be tackled in the short to the medium term in order to avoid a sudden and late transition. It would be, thus, advisable that the ECB upgrades its internal classification of climate-related risks.	Internal consistency is required to ensure that climate-related risks are taken seriously by institutions.	Nathan de Arriba-Sellier	Publish
2	Chapter 2	2.1		6	Clarification	The Guide states that significant institutions should inform the ECB from the end of 2020 about "any divergences of their practices from the supervisory expectations described in this guide". This requirement is much too general and should be made more precise. Ideally, the ECB should issue guidance on what divergences should be reported and in what way.	As explained under our General Comment 1, the ECB should provide clear guidance for supervised institutions.	Jens van 't Klooster	Publish
3	Chapter 2			7	Clarification	The Guide has been developed to ensure "the consistent application of high supervisory standards across the euro area". How do supervisors at the ECB and NCA ensure that this is the case? The guide at present leaves considerable discretion to supervisors, for example where it comes to assessing risk managment practices	See our General Comment 4	Valerie Schreur	Publish
4	Chapter 2	2.4		8	Amendment	The Guide should add, among the legal references, a reference to Article 449a CRD, requiring from 2022 disclosures of ESG and climate-related risks.	This amendment supports the institutions' understanding of their forthcoming transparency obligations.	Nathan de Arriba-Sellier	Publish
5	Chapter 4	4.1		16	Amendment	The Guide states that the supervised institutions is "advised" to monitor relevant policy intiatives to understand changes to its business environment. This should instead be a clear requirement.	As explained under our General Comment 1, the ECB should provide clear guidance for supervised institutions.	Jens van 't Klooster	Publish
6	Chapter 4	4.2	2	17	Amendment	We agree and welcome the ECB's emphasis on scenario analysis in responding to climate and environmental risks. Nevertheless, we believe that certain expectations could be specified in greater detail. In particular, “expert judgement” (p. 17) could be specified and further expanded, for example as “expert judgement from a diverse set of scholars and practitioners from a wide variety of disciplines, including but not limited to climate science, economics, anthropology, history, political science, and other relevant areas”. The manner in which these experts are involved throughout the stress testing process, including with respect to the interpretation of their results as well as the decisions concerning their policy implications, should also be clearly specified.	Because of the complexity, and globality, of environmental and climate risks, it is important to ensure that a diverse range of expertise is drawn upon to ensure we build a multifaceted understanding of the realities we face.	Irene Claeys	Publish
7	Chapter 4	4.2	2.1	17	Amendment	The ECB cannot expect institutions to be forward-looking in their risk measurement and at the same time suggest implicitly that assumptions regarding the impact of climate-related and environmental risks may be mostly based on historical experience. With respect to climate change, historical data is largely inadequate to assess the materiality of risks. The language has here to be amended so that the reliance on historical experiences forms only a minor part of the assumptions basing the institutions' scenario analyses. The ECB should expect institutions' models and analyses to be science-based, in accordance with IPCC's scenarios. This comment is also relevant for the 11th expectation of chapter 6, p. 37, as historical data is similarly inadequate to assess the appropriateness of stress-testing.	Internal consistency as well as an adequate understanding of the challenges posed by climate change require such an amendment. See also our General Comments 4, 5 and 6	Nathan de Arriba-Sellier and Irene Claeys	Publish
8	Chapter 4	4.1		15	Clarification	Art. 74 CRD applies as well to cross-border bank groups as defined by the BRRD. What are the ECB's expectations with regard to risk management in cross-border bank groups?	See our General comment 2	Agnieszka Smoleńska	Publish
9	Chapter 5	5.1		20	Deletion	The Guide suggests that the supervised institution should decide how to comply with the objectives of the 2015 Paris Argeement, but this should be left to regulators and supervisors to translate what these requirements mean in practice (as the Guide explains on p.3).	As suggested in General Comment 5, the ECB should not just rely on environmental risk management practices developed by banks themselves and should instead develop its own standards	Jens van 't Klooster	Publish
9	Chapter 5	5.2	4.3	22	Deletion	While commendable attempt to align incentives, in the absence of a general regulatory framework such remuneration policy seems difficult to implement, especially given absence of obvious climate-related performance benchmarks.	See our General comment 3	Agnieszka Smoleńska	Publish

10	Chapter 6	6.1		29	Clarification	It is not clear how the ECB understands the formulation "make active efforts" in relation to developing appropriate tools and methods	In line with our General Comment 1 on more clear guidance for supervised institutions.	Jens van 't Klooster	Publish
11	Chapter 6		7	28	Clarification	The ECB's understanding of the precise role of banks', as well as its own potential risk models, is unclear. The ECB should put forward a sustained discussion of the usefulness and limitations of all quantitative risk techniques aimed at producing improbably precise metrics and predictions – be they backward-looking models, or forward-looking stress tests. Among other things, these discussions should consider the circumstances in which the ECB believes these risk techniques are most useful, the types of expertise that are typically drawn upon and their limitations, and what to do about the problem of uncertainty, including how to incorporate transparent and effective precautionary measures in response to it.	Clearly stating the aims of risk management approaches, and the conditions under which they can achieve those aims, will secure greater buy-in from all relevant stakeholders, as well as maximise their chances of success by implementing them together with complementary policies, or using them in more targeted ways. See also our General Comment 6.	Irene Claeys and Max Krahé	Publish
12	Chapter 6		11	37	Amendment	Concerning the design of scenarios to be tested, we welcome the expectation that "For physical risk, institutions are expected to consider using scenarios that are in line with specific climate change pathways, such as IPCC or IEA scenarios." However, we believe that further specification might be helpful: first, a specific expectation to use scenarios consistent with a 1.5-degree warming trajectory, in addition to whatever other scenarios are analyzed. Second, a specific expectation to use certain core scenarios for transition risk, too, which could be drawn up by a collaborative panel composed of regulators, regulated institutions, and experts from academia and civil society, and which could be expected in addition to whatever other transition risk scenarios banks choose to analyse.	We should ensure that the scenarios chosen to stress test banks' portfolios are consistent with scientific, and other expert, opinion so that banks are not testing against implausibly weak scenarios. See also our General Comment 7	Irene Claeys and Max Krahé	Publish
13	Chapter 6	6.1	7.5	31	Clarification	The content of the recommendation is too unspecific to ensure that institutions will meet the ECB's supervisory expectation. The ECB has correctly determined that physical risks and transition risks stemming from climate change and the environment translate into financial risks, which are sufficiently material to take supervisory action and to expect institutions to take action. Accordingly, this should be reflected in ICAAP. Institutions' models should particularly be science-based and consistent with the Paris Agreement, in accordance with the IPCC scenarios. It is paramount for the correct prevention of, and response to, risks by financal institutions. Therefore, the ECB should be more specific in its supervisory expectations and provide concrete examples for institutions to upgrade their methodologies and assessments.	Capital adequacy is determinant to tackle the materiality of financial risks originating from climate change and the environment. Compliance is rendered difficult by unspecific supervisory expectations.	Nathan de Arriba-Sellier	Publish
14	Chapter 6			29	Clarification	When is the case that banks "adequately quantify the climate-related and environmental risks"? Under what conditions does the ECB accept that risks are at present not open to adequate quantification?	See our General comment 5	Jens van 't Klooster	Publish
15	Chapter 6	6.2	8.1	32	Clarification	With regard to the climate-related and environmental risks expected to be included in all relevant stages of the credit-granting process and credit processing, has the ECB considered potentially discriminatory impact on small creditors? Furthermore, we note than in a number of jurisdictions there has been specific regulation in the area of real estate energy efficiency (e.g. the Netherlands). How will the the ECB's expectations be influenced by such national legislation?		Agnieszka Smoleńska	Publish
16	Chapter 6	6.2	8.4	33	Clarification	What is the expectation of the ECB with regard to the implementation of sectoral/geographical concentration analysis specifically with regard to cross-border bank groups, in particular with regard to consistency across different organisational levels?		Agnieszka Smoleńska	Publish
17	Chapter 7			40	Amendment	Rather than mentioning it in a footnote, the ECB should emphasize the forthcoming obligation for large institution to disclose information on ESG risks, pursuant to Article 449a CRD as well as mention that it should be read in conjunction with the disclosures requirements provided in the Sustainability Disclosures Regulation (Reg (EU) 2019/2088), and the Taxonomy Regulation (Regulation (EU) 2020/852).	A legal update is necessary, given recent regulatory developments. See also our General Comment 2.	Nathan de Arriba-Sellier	Publish