Nederlandse Vereniging van Banken

CONSULTATION RESPONSE

Discussion Paper on management and supervision of ESG risks for credit institutions and investment firms

This Discussion Paper provides a comprehensive proposal on how ESG factors and ESG risks could be included in the regulatory and supervisory framework for credit institutions and investment firms. The paper identifies for the first time common definitions of ESG risks, building on the EU taxonomy and an overview of current evaluation methods. It also outlines recommendations for the incorporation of ESG risks into business strategies, governance, and risk management as well as supervision.

Documents:

- Discussion paper on management and supervision of ESG risks for credit institutions and investment firms

Links:

- Discussion Paper on management and supervision of ESG risks for credit institutions and investment firms (EBA/DP/2020/03)
- Public hearing
- News

Discussion form

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions detailed below.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- are supported by a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- provide alternative regulatory options for consideration by the EBA.

Important note to users:

All the fields marked (*) are mandatory. In case a question is not relevant for you, please answer with "Non-Applicable" or "NA".

All contributions received will be published following the close of the consultation unless you request otherwise by ticking the relevant box in the form below. Please note that a request to access a confidential response may be submitted in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

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Common definitions of ESG factors, ESG risks and their transmission channels (Chapter 4)

1. Please provide details of other relevant frameworks for ESG factors you use.

The Dutch Banking Association (Nederlandse Vereniging van Banken, NVB) recognizes and stresses the importance of the mentioned international frameworks in the discussion paper. These include the United Nations' Principles for Responsible Investment (UNPRI); the United Nations' Environment Programme Finance Initiative (UNEP FI)'s Principles for Responsible Banking, the Global Reporting Initiative's from the Global Sustainability Standards Board (GRI-GSSB); the Equator Principles and the Natural Capital Protocol + Supplement. The NVB would however like to stress that not all the international initiatives mentioned by the EBA mention ESG risks as financial risks. Therefore, we urge alignment, but not recommend using these as a guiding risk framework.

First, the NVB would like to stress that the ECB Guide on climate and environmental risks, which is important framework, is not mentioned sufficiently throughout the paper. Both this ECB Guide and this EBA Discussion Paper and subsequent Final Report, will provide the basis for supervisory dialogue and purposes. It is hence important that both regulators (EBA/ECB) are aligned in terms of definitions and approaches for climate and environmental risks or aeras where these two overlap.
Second, besides the ECB Guide, the NVB would like to supplement the list in the Discussion Paper with the following:

- Equator Principles
- ESG requirements IORP II
- EU Climate Benchmarks
- EU Green Deal (+ Next Generation EU)
- Green Bond Principles
- International Integrated reporting framework (IR), which aims to establish Guiding Principles and Content Elements that govern the overall content of an integrated report, and to explain the fundamental concepts that underpin them.
- OECD Guidelines for Multinational Enterprises and the *GRI* Sustainability Reporting Framework
- Task Force on Climate-related Financial Disclosures (TCFD)
- The standards for social and environmental performance and the explanatory notes of the International Finance Corporation (IFC).
- United Nations Global Compact
- United Nations Guiding Principles for Responsible Business Conduct
- United Nations Paris Climate Agreement
- United Nations Guiding Principles on Business and Human Rights

Third, the NVB would like to opt the following point for deletion:

- SASB should be removed since it has too narrow a view in terms of stakeholders.

Lastly, the NVB would like to mention various initiatives that have been developing within the Netherlands together with the Dutch banking sector, regulator and government.

- Dutch Climate Accord – link
- The Dutch Banking Sector Agreement on international responsible business conduct regarding human rights (IMVO Convenant Banken) – link
- Covenant International Socially Responsible Investment of Pension Funds (Dutch: IMVB Covenant Convenant Internationaal Maatschappelijk Verantwoord Beleggen Pensioenfondsen or IMVB Convenant) – link
- The Sustainable Finance Platform as established by De Nederlandsche Bank (DNB). See relevant publications below:
    - Climate risk and the financial sector: sharing of good practices – link
    - A Guideline on The Use of Deforestation Risk Mitigation Solutions for Financial Institutions- link
    - Biodiversity Opportunities and Risks for the Financial Sector – link

2. Please provide your views on the proposed definition of ESG factors and ESG risks.

We welcome one of the goals of EBA to evaluate and measure ESG risks in a common and comparable way and have a common understanding of these risks. As is set out in the discussion paper (§20), it is paramount to have common definitions.

ESG factor definition

*“**ESG factors** are environmental, social or governance characteristics that may have a positive or negative impact on the financial performance or solvency of an entity, sovereign or individual”*

The NVB believes the definition of ESG factors is acceptable, especially in light of the additional information and explanations provided on what is considered a “factor” and the fact these are considered as drivers of existing risks. The NVB welcomes the recognition that ESG factors may have both, positive and negative impacts, although the paper focuses on negative impact in terms of identification of increased risks. Yet, the definition of ESG factors and its possible positive and negative impacts could be defined broader than just in terms of financial performance. In other words, non-financial performance could also be included in here, such as reputation and their role in society.

Also, the NVB would like to stress that the definition of ‘sustainability factor’ is defined in the Sustainable Finance Disclosure Regulation in article 2(24). We ask whether ‘Sustainability Factors’ as defined in SFDR are the same as ‘ESG Factors’ as defined in this paper.

ESG risk definition

***“ESG risks** mean the risks of any negative financial impact to the institution stemming, from the current or prospective impacts of ESG factors on its counterparties’. ESG risks materialise themselves through their impact on prudential risk categories.”*

In response to the proposed definition of ESG risks, the NVB would like to make various general observations:

- The NVB would like to stress the importance of aligning the ESG risk definition with other legal initiatives, like SFDR, MiFID, ECB guide on climate and environmental risks and NFRD. For instance, the NVB would like to stress that the definition of ‘sustainability risk’ is defined in the Sustainable Finance Disclosure Regulation in article 2(22). We ask whether ‘Sustainability Risks’ as defined in SFDR are the same as ‘Sustainability Risks’ as defined in this paper.
- The NVB understands the focus on the negative impact a risk may have when defining ESG risks. In general, the NVB would like to state that the proposed definitions are mostly focused on financial materiality (financial impact of ESG on the institution). Yet, the environmental (or climate) and social impact itself are not fully excluded in the ESG risk definition, as the definition does make reference to ‘impacts of ESG factors’ which is the actual impact on people and planet.
- It has to be noted that the suggested definition of ESG Risk focusses on the definition of ESG factors and thereby focusses on the features of the counterparties of the financial institution alone. We believe that ESG Risks may also materialize via events that are not related to a counterparty. For example, ESG Risks could potentially affect a financial institution directly, e.g., the reputational consequences of not meeting society’s expectation on ESG standards.

In light of the above, the NVB would like to propose the following change and would like additional clarification on the following wording with regard to the ESG risk definition.

1. The inclusion of the word ‘any’ will, in our opinion, end up being an incentive for institutions to focus on backward looking strategies to include any ESG possible risk which might not have been identified at an earlier stage. Also, we would note that in terms of “social” risks, the use of the word “any” opens financial firms to potential liabilities in the event of failure to identify non-disclosed risks (or even disclosed risks) and this should be avoided. By changing the word ‘any’ to ‘identifiable’, the definition becomes more forward looking and less likely to raise concerns about liabilities as a result of overlooked ESG risks. This is also in line with the Double Materiality perspective (36) in which “can be identified” is mentioned.

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Therefore, we would suggest modifying the wording by using “identifiable” instead of “any” in the following sentence: *“ESG risks mean the* ***identifiable*** *risks of negative financial impact to the institution stemming from the current or prospective impacts of ESG factors on its counterparties’. ESG risks materialise themselves through their impact on prudential risk categories”.*

2. The ‘prospective’ impact of an ESG factor seems to be a rather ambiguous term in the definition. ESG factors could materialize to ESG risk at some time in the future, but the impact for an institution depends highly on the time horizon in combination with the likelihood of materialization of the risk. It would be helpful to clarify the meaning of ‘prospective’ in the definition. Preferable accompanied by a clearly defined forward looking timeframe.

Materiality

The NVB finds that the EBA should clarify on the scope, interpretation and distinction of the EBA definitions with regard to potential financial impact on the clients and banks (impact on banks/ financial materiality) and actual impact on people and planet (impact by banks). This would also be in line with statements throughout the paper that ESG risk management includes both managing the ESG impact (ESG materiality) and the financial consequences thereof (financial materiality).

In addition, we would like to make the following remarks:

- First, the NVB remarks that the proposed EBA interpretation (36,37) would be at odds with the NFRD 2019 supplement, where environmental and social materiality are defined separately from financial materiality. This could create an extra complexity for disclosures and internal processes where these concepts are understood differently in different contexts, e.g., risk management, disclosures, strategy setting, etc. With the concepts already differing between the generally accepted TCFD framework (only financial materiality) and the NFRD 2019 supplement from the European Commission (E&S materiality separate from financial materiality), introducing another definition might further scatter the sustainable finance landscape.
- Second, the fact that both are included in the EBA definition begs the question: what if there is an ESG risk that does not negatively impact financial performance or in other words: how this definition addresses the questions of double materiality? What prevails, mitigating ESG risks in itself, or mitigating the potential financial impacts resulting from that? What if there is a negative ESG impact that does not (yet) have a negative financial impact)? We would like to understand EBA’s point of view on this.
- Third, the EBA states in 36 that *‘’double materiality perspective in terms of the impact that the counterparty’s activities can have on the institutions’ performance can be identified and include [..] financial materiality, which may arise from such economic and financial activities throughout their entire value chain, both upstream and downstream, affecting the value (returns) of such activities and therefore typically of most interest to institutions.’’* In this regard, the NVB is of the opinion that the scope of the full value chain (upstream and downstream) is too broad for the first implementation.

Rules based or principles based?

Lastly, we would like to understand if the EBA poses these definitions as binding, or whether institutions remain to have some room for own definitions. It has to be stated that ESG risks are developing rapidly. This may lead to an adjustment of the definitions. Therefore, the definitions must have any flexibility.

We would discourage rigidity, too prescriptive a view particularly in light of dual materiality. Each institution should be given flexibility to identify the risks in their portfolios and operations and build appropriate processes, structures, and appetite frameworks to manage and mitigate these risks. An institution’s regulator can and should apply proportionality depending on the size, complexity, product offering and geographic footprint. This is important for smaller institutions (LSIs) which often act more locally/regionally, rather than internationally.

3. Do you agree that, for the purpose of assessing their inclusion in institutions' and supervisors' practices from a prudential perspective, ESG risks should be approached primarily from the angle of the negative impacts of ESG factors on institutions' counterparties? Please explain why.

For the mentioned purpose of assessment and supervisory practices, from a prudential perspective it makes sense to primarily look at the ESG impacts of ESG factors on counterparties. Yet it must be stated that financial impact from ESG risks can also occur in other parts of a financial institutions value chain, is not solely related to counterparties and their supply chains.

On the stance that ESG risks should be approached primarily from the angle of the negative impacts, the NVB would like to remark the following:

- By limiting the definition to negative impacts, it does not contribute to the possibilities institutions have to reach (sustainability) goals. Risks is about the balance of risk and rewards. Risks is part of business and sometimes banks have to take more risk, when the rewards (in sustainable terms) are high.
- The concept of ESG risks requires a balanced view between de various components of it (E, S and G), otherwise unintended consequences may result. For example, cuts in exposures related to fossil fuels (reduced environmental /emissions risk) will lead to cuts in fossil fuel related jobs (increased human rights risk).
- Looking at the nature of many of the factors, negative impacts from a factor on one client/sector/industry can at the same time have beneficial consequences for other parts of the economy/environment/society. Therefore, a proper quantification of a negative impact of a factor or risk should also take into account the potential benefits created by it. One factor or risk considered by itself might be perceived as negative, but the more holistic result of the factor could be positive. In other words, a limited focus on the potential negatives of ESG factors (for example transition risks), might actually overlook or underestimate the (larger) benefits in a wider context of the same risk materialization. Only looking at negative impacts implies that it is not possible to compensate these impacts with positive impacts elsewhere.
- It has to be stated that institutions are expected to take both impact by banks as impact on banks' balance sheets into account. However, these sides are also not always aligned. A positive impact on society can lead to a negative financial impact on the institution and vice versa. Banks should aim to manage the negative impact while maximizing reward from ESG factors.
- That being said, ESG risks are just starting to be properly understood. Hence, it is more sensible to do a start with the negative impact and eventually, incorporate other ESG risk effects. Therefore, we do agree with the negative view at the moment, however, we also want to outline that this negative view only supports one of the three objectives of the EC Action plan (managing financial risks stemming from climate change, resource depletion, environmental degradation and social issues). It does not directly support the *"reorienting capital flows towards sustainable investment in order to achieve sustainable and inclusive growth".*

4. Please provide your views on the proposed definitions of transition risks and physical risks included in section 4.3.

General remarks
We have the following general observations with regard to the formulated environmental risks, including the transmission channels:

- With regard to the definition of environmental risks, the focus should not be on climate only. Environmental risks can manifest themselves by human made degradation which is mentioned in the definition but should also be properly accounted in the EBA text. It seems likely that further work could be done to define the factors underlying the definition of environmental risks, especially with a view to make these factors ubiquitously relevant, and more distinction from operational risk types.
- The definitions of both physical risks and transition risks do not seem to be aligned with the general definition of ESG risks mentioned earlier in the paper. An ESG risk is defined as a risk with a negative financial impact on an institution stemming from impact on its counterparties. In our opinion, events that 'may potentially' have a result that a counterparty 'be negatively affected' has a much larger scope and ambiguity to it than the ESG risks that can be identified by their negative financial impact on an institution. We strongly advise to align the definitions of physical and transition risks with the more objective definition of ESG risks.
- The definition of both transition and Physical Risk do not reflect the risk for Investment firms and examples in this regard would be welcome. Hence, advise to also Incorporate an example for Investment firms in, for instance, figure and figure 4. Although the EBA is invited to use examples, it should be noted that examples should leave room for a broader interpretation of the possible way in which, for example transition/physical risk, can manifest itself.
- With regards to transition and physical risk definition. The way we read this under point 47, all risks are grouped under environmental risks, and physical, transition and liability are named as transmission channels/risks under that. The definition and set up here is a slightly different set up than ECB used in its draft guide. Hence, the definitions among regulators should be aligned (ECB guide).
- We consider liability risk as a risk type in all the various risks as mentioned in 59. Also, ESG risks (climate risks, environmental risks, social risks) are drivers - or transmission channels - of potential reputation, liability, and financial risk.

Physical transmission channels/physical risks
Physical transmission channels/physical risks are the risks posed by the exposure of institutions to counterparties that may potentially be negatively affected by the physical effects of climate change or other environmental factors.

- Definition physical risk: Both ECB and EBA have added *"chronic physical effects, which arise from longer-term trends, such as temperature changes, rising sea levels, reduced water availability, biodiversity loss and changes in land and soil productivity"* to their definition of physical risk. Banks can currently only assess this in a qualitative way (and I assume we also do that as part of WB loan applications or RB strategies). Quantifying these risks is very difficult as we do not have data or models to do so. For some risks (biodiversity loss) these models are even more difficult to determine since the impact is probably only indirect on banks.

- Regarding physical risks (point 54): this is explained as physical effects of climate change or other environmental factors, including A) acute physical effects and B) Chronic physical effects. Given that 'other environmental factors' are mentioned, to us it would make sense if EBA added a category 'C' here explaining these other environmental factors. Physical risks are also about environmental degradation (air, water, and land pollution). Hence, we presume that this category is related to environmental degradation, in part as a result of the business of clients/counterparties.

Transition transmission channels/transition risks
"Transition transmission channels/transition risks are the risks posed by the exposure of institutions to counterparties that may potentially be negatively affected by the transition to a low carbon, climate-resilient or environmentally sustainable economy,"

- The risks mentioned in 59 (a to e) are not transition risks but risk types for which transition to a low carbon and climate-resilient economy can be a driver.
- The transition risk definition under point 68 makes sense to us, although we would suggest here as well to just call them risks, not risks/transmission channels.
- Policy, technological and behavioural changes are not a novity and should be part of risk identification and thus it should be possible to link with existing definitions. Maybe made more concrete or compatible to ESG risks. However, this lies more in examples than definition or risk management framework. As such, these examples should be part of the scenario's (comparable to integrity risks) used by institutions.

5. Please provide you views on the proposed definition of social risks and governance risks. As an institution, to which extent is the on-going COVID-19 crisis having an impact on your approach to ESG factors and ESG risks?

Social risks are the risks posed by the exposure of institutions to counterparties that may potentially be negatively affected by social factors."

Governance risks are the risks posed by the exposure of institutions to counterparties that may potentially be negatively affected by governance factors".

Alignment and scope

- The definitions of both social risks and governance risks do not seem to be aligned with the general definition of ESG risks mentioned earlier in the paper. An ESG risk is defined as a risk with a negative financial impact on an institution stemming from impact on its counterparties. In our opinion events that 'may potentially' have a result that a counterparty 'be negatively affected' has a much larger scope and ambiguity to it than the ESG risks that can be identified by their negative financial impact on an institution. We strongly advise to align the definitions of social and governance risks with the more objective definition of ESG risks.
- We suggest making the distinction clear between the social risk itself (risk to people) and its potential financial consequences for clients and financial institutions.

Clarity on definitions

We also suggest including in this definition what is meant with the social/governance *factors* that are mentioned. From point 72 we understand that EBA refers to social *factors* as related to '*the rights, well-being and interests of people and communities' and they include for example '(in)equality, health, inclusiveness, labour relations, and investing in human capital and communities'.*
Could EBA expand on how these risk factors relate to what is part of the UNGP's and the Declaration on Human Rights? The definition as it is now, is quite high level and thus does not provide much guidance or detail. We understand from the paper that the primary focus of the EBA for now is on climate and environmental risks, but we would expect the EBA over time to come with a more comprehensive definition of social risks, as ESG risks are all introduced here as part of the mandate of EBA.

This also counts for the governance risks definition. As with social risks, for clarity's sake, we suggest adding to this definition what is meant by governance *factors*. We would appreciate more elaborate examples and detail (like 'Environmental' risks).

COVID-19

With regard to COVID-19 impact on approach to ESG, the relation between ESG risks for bank's counterparties and COVID-19 is not always obvious or straight-forward. For some banks, it is currently too early to identify any negative impact on client as a result of COVID-19. For some banks, COVID-19 has resulted in additional questions in specific client engagements in sectors that appear seriously impacted. In general, it can be stated that COVID-19 has certainly increased attention and awareness of ESG risks themes as influencing financial risk.

6. Do you agree with the description of liability transmission channels/liability risks, including the consideration that liability risks may also arise from social and governance factors? If not, please explain why.

With regard to the proposed description of liability risks, we have the following general remarks:

- We are calling the EBA to align the definition of liability risk with treatment and definitions by other regulators (such as in the ECB Guide).

- With regard to the wording ‘may potentially’ in the definition of liability risk, we remark that risks are uncertainties. If it would be certain, it would not be a risk but rather a fact. Therefore, in our view, this wording is not necessary in the definition.
- Liability risks (just like reputation risks) may arise from environmental, social and governance issues. ESG risks may influence liability, but likely only in combination with traditional financial risks or failure to act. In turn, reputation and liability risks may potentially lead to financial risks for clients and financial institutions, depending on the circumstances at hand.
- The NVB wants to state that there might be ESG liability risk that materialises solely to the financial institution itself, which would fit the definition of the EBA: *“Liability risk relates to the risks stemming from people or businesses seeking compensation for losses they may have incurred due to ESG factors”. However, t*he paper only mentions counterparties in the example (“*e.g., when institutions’ counterparties are held accountable for the negative impact through their activities on the environment, the society and their governance factors”*). As liability risk might also arise without the exposure to counterparties, but also through the operations of the institution itself, the EBA is invited to clarify on this point.
- Lastly, the current definition of Liability Risk does not reflect the risk for investments films.

7. Do the specificities of investment firms compared to credit institutions justify the elaboration of different definitions, or are the proposed definitions included in chapter 4 also applicable to them (in particular the perspective of counterparties)? Please elaborate on the potential specificities of investment firms in relation to ESG risks and on how these specificities, if any, could be reflected in this paper.

The NVB finds that the proposed definitions included in chapter 4 should also be applicable to investment firms. Hence, it would indeed be good if the different definitions would be aligned for banks and investment firms. Yet, there are some differences between the two institutions on why risks can be different:

- Difference lies in complexity at the counterparties. Listed companies are more complex as, for example, projects.
- Investment firms are most often able to change their portfolio composition very swiftly.
- The due diligence process for an investment by an investment manager is often more limited in scope then a bank does for its lending. The limitations come from the ability to change the composition of the portfolio but also from a different fee structure which makes it harder to do the same due diligence.
- Investment firms can more easily add investment instruments for diversification or hedging purposes, which will influence the risk perspective.
- These differences between the two institutions lead to different perspectives on risk, financial and ESG risk. While defining ESG risks, one should take account of these different perspectives.
- Nevertheless, it should be noted that various banks also provide investment services.

Additionally, when looking at all definitions proposed, we remark that the part "*exposure of institutions to counterpar*ties" that comes back in the definition of transition risk, physical risk, social risk and governance risk, might not be applicable to the counterparties of investment firms as the counterparties. This could be the case as investment firms are exposed to the ESG risks to through the assets they hold on behalf of their clients. In this light, it is advised to also incorporate examples for Investment firms in, for instance, figure and figure 4 of the paper.

Additional notion for promotional banks

We would like to stress that a further distinction in the definitions and assumed risk metrics for public and promotional banks would be appreciated. The paper now focusses mainly on private counterparties who by the nature of their activities could be negatively affected by ESG factors. The client base of public and promotional banks consists mainly (up to 100%) of public entities or entities closely related to the government or guaranteed by the government (either directly or indirectly). The typical clients of public and promotional banks have a different position with regards to ESG factors as private companies. Their clients tend to be the first initiators of sustainable initiatives, by providing funding, infrastructure, advice, and cooperation between public and private parties. The scenario's in which ESG factors will have a negative financial impact on these public entities are less obvious and more remote than the ones in which private companies could be negatively impacted. The clients of promotional banks typically initiate mitigating measure for ESG factors before they materialize into ESG risks.

Quantitative and qualitative indicators, metrics, and methods to assess ESG risks (Chapter 5)

8. Please provide your views on the relevance and use of qualitative and quantitative indicators related to the identification of ESG risks.

The impact of climate change on the financial system can manifest itself in different ways. There are different types of ‘events’ to consider, like flooding or new abrupt regulations. These events can be complex, hard to predict and correlated to one another. To analyse these risk events upon their materiality one has to rely to rely on qualitative as well as quantitative indicators.

Example: When a bank investigates the risk of real estate foundation damage due to drought, it considers indicators such as soil property and building characteristics. These indicators can give an estimate of the houses at risk, but not the exact size of the risk. Crucial information that is required to identify climate related risks in a uniform way with a low uncertainty, is lacking. This makes the risk identification process rather hard, as you want to steer the bank upon trustworthy results. The use of these indicators should therefore be carefully dealt with it.

In the light of this challenge, the NVB has the following views with regard to the relevance and use of qualitative and quantitative indicators related to the identification of ESG risks:

- The use of indicators is relevant, but the draft paper EBA focusses most on climate and environment. It would be helpful to suggest indicators for other environmental risks, social and governance risks. Looking forward, when does EBA expect to ask for quantification of social and governance risks as well?
- Ideally, banks would be able to assess the ESG risks we are exposed to both qualitatively and quantitatively. At the moment, given the different restraints or challenges described in chapter 5 (incl. uncertainty, lack of data, methodological constraints, time horizon mismatch etc) it is not yet possible to have many quantitative indicators indicating financial implications of ESG risks, certainly not over all sectors of portfolio’s over the short, medium and long term. This remains a works in progress for us and other institutions (as well as supervisors). EBA should give flexibility and encourage alternative methods, metrics, and indicators in the short term in order to bring all ideas forward. Also, where quantification is not straight forward or possible, qualitative provides an alternative.
- On a client level in certain cases there is more quantitative information, depending on its reporting and transparency, on specific indicators. That does not mean there is a methodology quantitively estimate what those datapoints mean in terms of future (financial) risks for that client.

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9. As an institution, do you use or plan to use some of the ESG indicators (including taxonomies, standards, labels, and benchmarks) described in section 5.1 or any other indicators, inter alia for the purpose of risks management? If yes, please explain which ones.

The NVB would like to stress that their members are already using indicators. A few examples and observations:

- For example, the EU taxonomy is being used for the categorization of sustainable finance product offering. That is not (yet) linked to risk management, although the expectation is that steering towards sustainable product offering will help de-risk portfolios.
- An example of qualitative sustainability criteria in bank's policies are the sustainability criteria in bank's policies. An example of quantitative indicators -to minimize inside out sustainability risk- is financed emissions for climate and indicators for biodiversity.
- Other standards like ISO are of course known to banks. That does not mean quantitative information is available on how clients are doing compared to these standards or how many of them have aligned their business practice with these standards.
- Some banks are likely to use directional indicators which give more context to traditional financial risk indicators. Data availability will drive much of this. The current versions of TCFD and EU NFRD could be the starting point, again giving some flexibility depending on the context for an institution.
- Generally, we clearly acknowledge the many fast developments in this area. We welcome concreter guidance from ECB on this question, that is which taxonomies, standards, labels, and benchmarks does EBA consider useful for risk management, and what would integration into risk look like exactly.

10. As an institution, do you use or plan to use a portfolio alignment method in your approach to measuring and managing ESG risks? Please explain why and provide details on the methodology used.

[No NVB answer to this question]

11. As an institution, do you use or plan to use a risk framework method (including climate stress testing and climate sensitivity analysis) in your approach to measuring and managing ESG risks? Please explain why and provide details on the methodology used.

[No NVB answer to this question]

12. As an institution, do you use or plan to use an exposure method in your approach to measuring and managing ESG risks? Please explain why and provide details on the methodology used.

We are on the view that compared to using ESG ratings for supervision of ESG risk purposes, the Exposure Method may be more suitable in nature for the risk management of ESG Risks related to large portfolios of small counterparties. For example, the Exposure Method could be based on collateral and loan type characteristics rather than counterparty ratings. This possible application seems undervalued in the Discussion Paper.

13. As an institution, do you use or plan to use any different approaches in relation to ESG risk management than the ones included in chapter 5? If yes, please provide details. (CR)

[No NVB answer to this question]

14. Specifically for investment firms, do you apply other methodological approaches, or are the approaches described in this chapter applicable also for investment firms?

The NVB has no specific remarks on this question. However, we want to make the observation that the described methodological approaches in chapter 5 are not described from investment firms approach perspective. The Exposure method is probably not usable for investment firms.

The management of ESG risks by institutions (Chapter 6)

15. Please provide your views on the extent to which smaller institutions can be vulnerable to ESG risks and on the criteria that should be used to design and implement a proportionate ESG risks management approach.

To start, the NVB wants to elucidate that the identification of risks to objectives, their assessment and determination how to respond should of every regular Enterprise Risk Management cycle. It is important that ESG risks are top of mind and are not overlooked. This should be ensured by defining and changing the strategy of the institution, translating them into policies, procedures and processes. In general, this same risk management approach also applies to smaller institutions. That said, the NVB strongly endorses the notion that smaller institutions are indeed more vulnerable to ESG risks and advocates for clear notion on proportionality.

Vulnerability
The NVB believes smaller institutions, such as credit institutions and investment firms, can be more vulnerable than larger institutions. The extent to which smaller institutions may be precisely vulnerable to ESG risks varies. It is a function of the institution's business model, relative size, internal organisation and nature and complexity of its activities. In addition, one might look at the markets they operate in (how regulated they are) as well as their investment strategy (private banking focused, mortgage lending, or an investment fund focused on fossil fuels) as indicators of their vulnerability to ESG risks. An example of a specific vulnerability we would like to mention is the complexity and cost of data and data handling.

Proportionality
The principle of proportionality is also important.

First, the NVB would like to remark that there is a need to get more substance to the definition and translation of the principle of proportionality. It is yet unclear (how to assess) to what extent proportionality can be applied by banks in terms of depth and speed of incorporating and managing ESG risks. The principle of proportionality does not only relate to size and the complexity of banks. It relates to a great extent to the materiality of ESG risks resulting from the business model.

Example: Take for instance the business model of promotional banks, they work in close alignment with, and are instrumental to, governmental policy and serve sectors which are deemed essential by the government. Governmental policy aimed at the transition to a more sustainable economy for these sectors will be balanced with their essential nature mitigating the ESG risk. In addition, the risks from public sector entities to which banks are exposed are perceived as low. This general risk perception should proportionally be applied to managing ESG risks. The risks faced by promotional banks, also from an ESG point of view, have differences compared to those faced by commercial banks. The materialization of ESG risk manifest in different risks metrics. This distinction is important when applying the principle of proportionality and could be more substantiated.

Second, the NVB wants to stress that a proportional approach should be taken which ensures that LSIs further develop, but that the management system and oversight are not disproportionate to the level and materiality of the financial risk. It is suggested to make the criteria for LSIs more straightforward, for instance by making ESG risk /climate risk part of an institutions Risk Appetite Framework, a Sustainability Risk Management Framework (or integrated in the full risk Management framework), TCFD reporting, due diligence, and monitoring, but in proportion to the ESG-related financial risk. Assurance is a point of attention as this is already costly for LSIs on the normal financial elements. We emphasise proportionality and materiality emphasized here, since cost and resource constraints are a very real issue.

16. Through which measures could the adoption of strategic ESG risk-related objectives and/or limits be further supported?

First, we suggest EBA to provide further guidance on this question. What is meant with ‘strategic’ ESG risk objectives for example? Does that mean goals aimed at reducing financial risk, or also goals aimed at reducing actual climate risks (i.e., aligning with the Paris goals)? We note that if ‘strategic ESG risk-related objectives’ were to include non-financial risks as well, this would fall outside the scope of (i) prudential supervision, and (ii) EBA’s mandate which is to contribute to a single set of harmonized prudential rules for financial institutions throughout the EU.

Second, we would like to mention one major issue that will need support: the availability of reliable, adequate, recent, and low-cost data. Banks have only access to public information (be it disclosed by the companies or external tracking services – e.g., rating agencies, sustainalytics), but even so, sources of information may be limited and hard to compare and interpret. This needs to be addressed in coordination with supervisors and institutions. Besides, also methodologies should be developed to translate these data to tangible risk-data. Currently financial institutions are limited because of a lack of data coming from counterparties.

Third, the variety in determining parameters of materiality or assessing counterparty risk makes it very hard to compare results (also between institutions) and as a consequence, the content of reports. This calls for more guidance (in time).

Fourth, not only the publication of ESG specific papers and guidelines is useful. Extending the currently existing guidance and level 2 regulation on specific risk type to include more practical approaches and solutions to ESG risks would be beneficial. In addition, clear alignment between all publications within and across the European institution/agencies and should be ensured.

Lastly, governments and regulators need to prevent arbitrage by institutions and/or counterparties and strive for a level playing field. For instance, there is a difference between Western countries and emerging countries, both in objectives, policies, and priorities as well as in most urgent risks.

17. Please provide your views on the proposed ways how to integrate ESG risks into the business strategies and processes of institutions.

This section advocates that institutions adjust their business strategy incorporate ESG risks as drivers of prudential risks, which EBA sees as a progressive risk management tool to mitigate the potential impact of ESG risks: namely through extending the time horizon for strategic planning, including ESG risk scenarios, setting and disclosing ESG KPIs, offering sustainable products, and adjusting business processes to reflect ESG risk-related strategic objectives and/or limits in the engagement with borrowers, investee companies and other stakeholders in order to lower the ESG risks associated with those exposures. Much of this section is explaining or evidencing trends in the marketplace, such as how the Principles for Responsible Banking, Equator Principles, Sustainable Development Goals and EU Taxonomy have shaped ESG risk management and led to sustainability linked products. In this respect, the NVB agrees.

Various institutions have focused their business model on sustainability to varying degrees, starting with philanthropic focus and moving towards integrated business strategy along the way. Promoting sustainability through green bonds, social bonds, sustainability-linked financings and sustainable improvement loans are good examples of how niche-financings spurred industry-wide competition (via league tables etc). The NVB believes it to be necessary and good industry practice to have prudential management of ESG risk of general products as well as Green / Sustainable products.

Major concerns

The main challenges with regard to ESG risk management also apply to the integration of ESG risks into the business strategies and processes of institutions. For instance, the time horizon of ESG risks is longer than the regular time horizon for strategic planning. There are many uncertainties about the actual effects, which is partly due to the absence of historical data. Especially environmental (transition) risk is more of a long-term risk. How do you ensure that long-term effects of environmental risks are sufficiently highlighted in business strategies?

On the other hand, the NVB is concerned about the increasing role and responsibility for ESG risk management and their resolution that is being placed on them. The suggestions advocated in this EBA Discussion Paper effectively push credit institutions further away from their basic function as credit intermediaries, apply more hurdles for investment firms when investing the pooled capital of investors in financial securities, and potentially move Regulators away from their mission of safeguarding the financial system. While this is for a good cause, improving the ESG and sustainability profiles across the market, it is not entirely risk-free even when responsibly implemented. The EBA is invited to give their view on this concern.

Additional comments on notions made in Chapter 6

The NVB has the following additional remarks:

- The section on engaging with customers and other relevant stakeholders, 180-184, is an important concept that banks have started implementing. Client engagement on ESG risks has become an important (and still growing) aspect of business.
- On the proposal to extend the time horizon for strategic planning and by including environmental and social scenarios into the planning process (p.94), the NVB would like to learn wat time is referred to (how many years). EBA is invited to specify scenarios more concretely as one can think of a multitude of events and scenarios. A concretisation for all banks would be helpful.
- On the proposal to setting and disclosing specific ESG risk-related strategic objectives and/or limits, in accordance with the risk appetite (p.94). The NVB agrees to set and publish ESG goals and limits. This is driving progress in the banking sector. However, it is important to first have insight into exposures to ESG risks before one can set goals and limits. It is important to then set goals and limits or keep goals / limits as qualitative as possible to maintain flexibility.
- On the proposal to consider ESG risk-related considerations in directives and regulations applicable to the banking sector (p.94), the NVB remarks that these should not immediately be included in legislation and regulations. It is advised to first set up and develop Enterprise Risk Management framework and processes by setting mandatory guidelines and monitoring these via SREP. After further developments, it is advised to proceed to include it in legislation and regulations.

18. Please provide your views on the proposed ways how to integrate ESG risks into the internal governance of institutions.

Incorporating ESG risks into business strategies and processes is the starting point for progressive risk management. Next steps include integration into the internal governance as proposed by EBA. The EBA proposed ways on how to integrate ESG risks into the internal governance of institutions are broad – covering 1) risk committees or creating specialized committees such as sustainability finance committees or ethics committees, 2) allocating the responsibility related to ESG risks to a board member, 3) involving risk when integrating ESG risks into the risk appetite, 4) considering ESG risks when implementing risk policies, 5) having internal audit function include ESG risks, 6) encouraging staff behaviour to be consistent with the institutions' ESG risks appetite, 7) remuneration policy including ESG KPIs, and 8) managing conflict of interest which may incentivize short-term-oriented undue ESG-related risk-taking.

First, the NVB wants to state that ESG risk is a relatively new subject and a lot of new legislation is coming. We remark that implementation of these proposals needs to be in balance, the proposed recommendations have far-reaching consequences for all kinds of processes and frameworks. Before the integration of ESG risks into internal governance, the impact of ESG on the institution must be adequately analysed. The availability of expertise to do this is a challenge. In addition, we also remain concerned about the availability of ESG data that will be necessary in order to develop ESG related risk monitoring metrics and management practices, and eventually to model and/or stress test them. This represents a complicated new frontier which at present still lacks appropriate definition and guidance from regulators.

Then, It should also be pointed out that Regulators play an important role into the integration of ESG risks into the internal governance of institutions. For instance, the mentioned challenge of data availability is partly due to existing regulations that are preventing access to information. For instance, EBA can and should help address this with peer authorities within the EU to ensure free/unfettered access of banks to the data that is needed to carry out the task. Also, regulators can also play an important role into by giving capital relief or some other regulatory benefit for the prudential management of ESG risks. If the concepts contained within this EBA Discussion Paper were put into full force and effect, then institutions would need another significant capital outlay within a short time in order to comply with the 'spirit' and the letter of these proposals. Hence, institutions ask for clear guidance, a pragmatic approach, and some manner of benefit for its achievement herein. Therefore, a phase-in approach is recommended.

Compliance function
With regard to the compliance function (as mentioned on p.99), we would like to state that ESG should be integrated in the Know your Client process (suitable advice in relation to the ESG profile of the client) and the Client Due Diligence. Besides Regulations, this should also include the Standards and rules, as stated in ECB Guide expectation 5.5; '*The compliance function should advise the management body on measures to be taken to ensure compliance with applicable laws, rules, regulations and standards, and should assess the possible impact of any changes in the legal or regulatory environment on the institution's activities and compliance framework'.*
Also. if Commissions are part of Renumerations they should be transparent. Also, they should not be allowed for certain products (mostly complex products).

Allocation of responsibility related to ESG risks to a member of the management body
On page 100, EBA states the recommendation to *"allocate the responsibility related to ESG risks to a member of the management body".* The NVB considers that this EBA proposal should be deleted.

The first reason for this suggested deletion is the proposed obligation in the EBA discussion paper appears to contradict with what is stated in the EBA Guidelines on Internal Governance on the Internal Control Functions. According to the EBA Guidelines, the heads of internal control functions should be directly accountable to the management body and *"be able to have access and report directly to the management body in its supervisory function to raise concerns and warn the supervisory function, where appropriate, when specific developments affect or may affect the credit institution"* (EBA GL on Internal Governance page 46).

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The second reason for this suggested deletion is that appropriate norms have been laid down in national codes. An example from the Netherlands is the Dutch Corporate Governance Code. Hence, there is no need for EU legislation or requirements at this point. Still, if there would be any new legal obligations at EU level, we strongly recommend these to be:

- for the company, not the (individual) board members;
- in line with international commitments;
- proportionate, and
- create legal certainty.

In light of the above, it is suggested to delete the recommendation to "*allocate the responsibility related to ESG risks to a member of the management body*".

19. Please provide your views on the proposed ways how to integrate ESG risks into the risk management framework of institutions.

First, the NVB would like to mention that ESG risks have already been integrated into the risk management of various credit institutions over a decade. For instance, there are 45 (mainly) credit institutions from Europe (and 110 worldwide) who are signatories of the Equator Principles, which is a *"risk management framework, adopted by financial institutions, for determining, assessing and managing environmental and social risk in projects and is primarily intended to provide a minimum standard for due diligence and monitoring to support responsible risk decision-making."* The Equator Principles Financial Institutions (EPFI) have a large number of guidance documents, best practices, roundtables and members-only forums available to members to discuss the management of ESG risks.

Then, we would like to state that ESG risks should be incorporated within existing Risk Management framework (assuming they are already found sufficient). A concrete recommendation could be to have a formal requirement to include ESG risk as a theme in Risk Appetite Frameworks. This is probably the only main requirement needed, since that change by itself would have a cascade effect through risk management governance, processes, and reporting. It is important that this is simply managed as another mainstream financial risk theme, one which can influence credit risk, liquidity risk, market risk, operational risk. If formally recognised as a risk theme, it will be among the many aspects which are integrated into governance and management. Similarly, a separate statement regarding remuneration would be redundant/duplicative, since ESG would *already* be part of the integrated financial performance and risk considerations.

In chapter 6, we take particular note of paragraph 253, which calls on institutions adjust their *pricing "which should reflect also the risks driven from the ESG factors. Institutions should account for ESG risks in their pricing strategies."* This is an important step forward which needs very careful consideration given that pricing is already dependent on global market forces, namely an institution's borrow rate and a risk premium. For example, larger institutions who are active outside of Europe may therefore face a pricing, and hence competitive disadvantage if Regulators outside of the EU do not adopt the same measures. Particular attention should be on the United States, as most commodities are funded in US Dollars which usually means European based institutions start at a disadvantage.

In chapter 6, the NVB values the attention given to climate stress testing. It is also good to see that the EBA emphasized the limitation that exists with regards to climate stress testing and emphasizes that institutions should be careful when using the outcomes of such analyses.

<u>Challenges</u>
What has not been widely established yet is the assessment and forward-looking quantification of those ESG risks, in other words: the potential financial implications. The EBA Discussion paper now asks for banks to 1) formalize their ESG [financial] risk appetite, 2) set out appropriate policies and procedures, 3) collect data related to ESG risks [and financial impacts], 4) develop risk monitoring metrics and management practices, and 5) stress test them. Over time these expectations should be achievable, but there are still major challenges:

1. The first challenge is the availability of reliable, adequate, recent, and low-cost data. The EBA should realize that for proper origination and monitoring with respect to ESG, significant amount of quality information (data) will be needed. Therefore, the regulator should not expect that institution will be able to produce the same level of origination and monitoring done for financial risks.
2. The methods on how to integrate ESG risks into the risk management framework are still under construction. We find it important that the measures/methodology are based on the same Regulatory Standards and Risk/Financial disclosure standards. This in order to have the same burden and the ESG numbers from various institutions are comparable.
3. To incorporate the long-term time horizon in which ESG risks could materialize into a risk management framework which is typically less long term, to deal with other, more short- and medium-term risk types such as credit and market risk, provides an additional challenge. This is already the case for climate change risks and will be even more of a challenge for social and governance risks and their financial impacts.

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20. The EBA acknowledges that institutions' approaches to environmental, and particularly climate-related, risks might be more advanced compared to social and governance risks and gives particular prominence in this report to the former type of risks. To what extent do you support this approach? Please also provide your views on any specificities associated with the management of social and governance risks.

On the second part of the question, "*To what extent do you support this approach?".*
The NVB acknowledges the importance of taking into account the E, S and G of ESG risks. Currently and lately, a lot of (regulatory) focus has been on climate dimension. It is a matter of fact that Regulators and Governments, particularly in the EU, have thus far shown interest in climate-related and as of late Environmental-related risks. This is evidenced through the many climate related questionnaires that have been sent to institutions over the past 3-4 years, the attention given to TCFD, and even the recently published EU Taxonomy on Sustainable Finance. There has been less focus on and guidance with regard to the extent to which institutions/banks are expected to acknowledge the "S" and "G" risks in their risk management framework. More technical standards are necessary. Additional attention for the "Social" and "Governance" risks could be encouraged through this policy, which might be beneficial to extending the focus beyond "Environmental" risks only. With regard to social risk and Governance risk, these can be mitigated in other ways. The S is already incorporated in (client) processes (KYC and CCD – together with environmental) and the G in the culture of the organization and is being controlled (soft controls).

The NVB believes there are consequences for institutions of not managing these risks, as can be seen through the activities of Business at OECD (BIAC) and increased use of the National Contact Point for the resolution of issues that arise from the alleged non-observance of the OECD Guidelines for MNEs in specific instances. We believe that the potential negative financial impacts of social (human rights) and governance risks can be just as large as the financial impacts of environmental and climate change risks. Hence, we would expect EBA to formulate a clearer point of view on this, also keeping in mind the many and fast regulatory developments with regards to human rights, children's rights and required due diligence at EU level.

On the second part of the question, "*Please also provide your views on any specificities associated with the management of social and governance risks*". Various Dutch banks are already partly managing social and governance risks in specific portfolios. For example, institutions which do not match specific social/governmental values for example on living wage, labour conditions and corporate governance, are not included in the portfolio. However, this has to be further developed across the sector. Institutions would welcome the EBA to use its leadership and leverage to define what is expected of institutions with the management of social and governance risks. An EU Taxonomy covering these risks (definitions, concepts, and expectations) could be a starting point.

21. Specifically for investment firms, what are the most relevant characteristics or particularities of business strategies, internal governance and risk management that should be taken into account for the management of the ESG risks? Please provide specific suggestions how could these be reflected.

The NVB would like to note that these aspects of ESG Risk are not only relevant for investment firms. Credit institutions offering investment services would be affected in an equal way.

ESG factors and ESG risks in supervision (Chapter 7)

22. Please provide your views on the incorporation of ESG factors and ESG risks considerations in the business model analysis of credit institutions.

The NVB generally agrees with the notion in the paper to proportionately incorporate the ESG factors and considerations into the business model analysis of credit institutions. It however has to be noted that the developing regulatory calendar should be followed to avoid inconsistent introduction of requirements that are based on a still developing internal methodology and both internal and external data environment.

The main challenge with regard to the incorporation of both ESG risks and ESG risks considerations in the business model analysis of credit institutions particularly lie in the Social and Governance sphere. More clarification is needed for the introduction of requirements for E, S and G as the Environmental part is more advanced while S and G are still at an early stage. Additional attention for the “S” and “G” risks could be encouraged through this policy, which might be beneficial to extending the focus beyond “E” risks only.

23. Do you agree with the need to extend the time horizon of the supervisory assessment of the business model and introduce as a new area of analysis the assessment of the long-term resilience of credit institutions in accordance with relevant public policies? Please explain why.

From a conceptual point of view, the NVB understands why the time horizon of the supervisory assessment needs to be extended. Benefit lies in looking at a variety of time horizons to manage the impact of climate change as different risks could materialize and inform strategic choices as well as risk appetite setting. Whereas classic stress testing models focus on quantifying the near-term impact that corresponds with the financial planning horizon, we recognize that for climate the impact is predominantly noticeable in the long term (reaching up to 2050).

From a practical point of view, there are a number of obstacles.

- We would like to express our concern how the proposal to introduce a new area of analysis in the SREP, i.e., evaluating whether institutions sufficiently test the long-term resilience of the business model against the time horizon of the relevant public policies or broader transition trends, interacts and relates to the existing SREP framework.
- It is not clear what precisely is meant by "long-term" in the context of the bank strategy. Different references are made to 2030, 2050 and 2100 (§2 and §314). A frame of 10 years would represent a considerable extension of the current 3 to 5 years strategic planning horizon and may be compatible with the weighted average life of banks assets. However, ESG risks may have different time horizons (§155) and 10 years do not do justice to some more long-term risks and objectives. Some ESG risks will have a major impact in the long run but are not apparent within a few years. Objectives and strategies usually have a timeframe of 3-5 years. Determining short term/and mid-term objectives/strategies should therefore deducted from long term objectives to mitigate the long-term risks. However, objectives change or are adjusted over time. As an institution you need to be able to steer on the short/mid-term relying on a long-term goal. Is there overall agreement on the long-term goal and a level playing field in the EU (and worldwide) for banks?
- The reason why the current forward-looking assessment is in practice constrained to about 5 years is that the longer the time horizon, the greater the uncertainty. Extending the time horizon to 10 years or more would introduce a significant amount of uncertainty into this assessment. It is difficult to gauge if such an assessment would then lead to credible outcome.
- Given that ESG risks can materialise in the short and medium-term paragraphs 302 and 303 provide considerations to understand the quantitative impact from ESG factors and the areas qualitative analysis should cover. It would be advantageous if the discussion paper would provide more details as to how this long-term resilience should be operationalised by credit institutions.
- The key hurdle on assessing either of these time horizons is around the access to adequate (historic) data and convergence of methodologies that can support the quantification of the impact. The need for long-term assessments is clear given the fact that loans with a long maturity, such as residential mortgages, that are given today should already be able to withstand a substantial part of the energy transition and/or potentially strong physical effects from climate change. However, the outcomes should obviously be treated cautiously and in a very different way from the more traditional short to medium term assessments. This is clearly an example where banks, regulators and supervisors should team up to collectively determine approaches for this.

24. Please provide your views on the incorporation of ESG risks considerations into the assessment of the credit institution's internal governance and wide controls.

The NVB finds that the elements described concerning the risk management framework are clear and understandable. The NVB supports the EBA's approach that ESG risks are drivers of existing risks and as such should be integrated in the existing governance framework. This is consistent with the ECB Guide on Climate & Environmental risks, where the EBA discussion paper provides more granular guidance. Yet, there are challenges with regard to the incorporation of ESG risks into the internal governance and controls.

Incorporation of ESG risks into the internal governance and controls

As the discussion paper states, the supervisory review should proportionately incorporate ESG risk-specific considerations into the assessment of the credit institution's internal governance and wide controls**.** A proportionate approach to the implementation, requires a more robust or mature process for the identification and assessment of ESG risks. Similar to the need for generic approaches to long-term scenarios and stress testing, the notion of a proportionate incorporation of ESG risks into the assessment of the credit institution's internal governance and wide controls requires a solid basis of measurement of these risks in order to establish objective supervision. This is also depending on and is related to the introduction of more complete taxonomy and finalization of the non-financial reporting directive (NFRD).

Also, ESG risks are one theme among many which may influence financial risk. Therefore, they should have an appropriate amount of consideration in proportion to the financial risk that the ESG theme represents for the institution.

In addition, institutions are expected to take both sides of materiality into account. The considerations of this paper are very focused on financial materiality. A positive impact on society can lead to a negative financial impact on the institution and vice versa. This can be a challenge with the incorporation of ESG risks into the internal governance and controls.

Introduction of the requirements/timelines

The EBA mentions that they foresee a gradual introduction of the ESG risk management requirements: *"The EBA also sees a need to gradually develop methodologies and approaches to a climate risk stress test, while considering the methodological and data constraints''*. The objective of a climate risk stress test should be to inform on the resilience of institutions' own business model and investment strategies. In order to reflect the ESG risks in the supervisory evaluation, the EBA sees a need to proportionately incorporate the ESG factors and considerations into the business model analysis, in particular with regards to the analysis of business environment, the current business model, the analysis of the strategy, and the assessment of the viability and sustainability of the business model." Although this is preferred over the January 2021 deadline of the ECB, it also creates some uncertainties. It is unknown when certain requirements will apply, and this may also result in an unlevel playing field. We would welcome more clarity on this point.

Consistency with the ECB Guide on Climate Risk

We observe different level of detail between the ECB and EBA requirements and would assume that the EBA determines the overarching requirements that are further detailed out by the ECB. In this guide it seems the other way around: the EBA provides more detail on certain requirements than ECB. Still the EBA can miss some elements. An example is the impact of climate risk on operational risk: ECB is clear and concise about this and expects banks to take into account physical risks (damage to buildings, processes, etc) and legal/reputational risks, whereas EBA is less clear and only mentions the latter. It would therefore be helpful if both will be further aligned.

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25. Please provide your views on the incorporation of ESG risks considerations in the assessment of risks to capital, liquidity, and funding.

The NVB sees merit to further investigate the incorporation of ESG risks considerations in the assessment of risks to capital, liquidity, and funding. In general, it has to be stated that ESG risks are one theme among many which may influence financial risk. Therefore, they should have an appropriate amount of consideration in proportion to the financial risk that the ESG theme represents for the institution.

Capital
With respect to capital, the described indirect effect from ESG seems plausible in the sense that it materialises through other risk types. The paper mentions market, credit, and operational risk, this seems an inexhaustive list of relevant risks.

It makes sense to assess credit risk driven by ESG risks on both short and long horizon and the provided list of controls are useful for this. For credit risk we find it useful to state explicitly that an ESG risk event transmits to a credit risk impact via either increased risk of default of the counterparty, devaluated collateral value, or both. Although important, it can also be noted that transition risks are inherently hard to assess quantitatively, especially in the long term and in case of a disorderly transition, due to possibly unpredictable government measures, market effects and linkage within the economy. Avoiding financing of sectors or counterparties with a high ESG risk however is a safe measure against many transition risks, making being able to quantify these less of a priority.

Lastly, the NVB agrees with the following statement in 7.5.5. regarding risk management of social and governance risk: *"In the medium term, however, it is reasonable to expect that both credit institutions and supervisors will have accumulated enough experience on the topic to be able to incorporate in a proportionate manner all ESG risks in their risk identification, measurement, monitoring and reporting frameworks."*

Liquidity and funding
For liquidity and funding, it seems plausible that liquidity and value of assets could impacted, as well as retail cash flows. These are incorporated in liquidity stress testing, although not explicitly attributed to ESG risks. However, liquidity and funding seem less pressing as the ESG risks are also largely considered to have a longer-term impact.

While we support the use of scenarios and stress testing to assess the potential impact of ESG risks on capital and liquidity buffers, this underpins the need for base-line scenarios with the associated definitions of ESG risks. This is in line with EBA's conclusion (page 139), where we consider that a staged approach of translation into Pillar 2 requirements should be taken.

The remaining points with respect to liquidity and funding seem rather unspecified. The paper regularly mentions "changing assumptions", e.g., with respect to funding planning, but elaboration on how and why certain assumptions would change is lacking.

26. If not covered in your previous answers, please provide your views on whether the principle of proportionality is appropriately reflected in the discussion paper, and your suggestions in this respect keeping in mind the need to ensure consistency with a risk-based approach.

Based on the principle of proportionality, EBA considers it is important that both institutions and supervisors are able to distinguish and form a view on the relevance of ESG risks, following a proportionate, risk-based approach that takes into account the likelihood and the severity of the materialisation of ESG risks. Institutions are to proportionately incorporate ESG risks in their internal governance arrangements. Supervisors are to proportionately incorporate the ESG factors and considerations into the business model analysis in order to reflect the ESG risks in the supervisory evaluation.

The NVB strongly endorses the application of the principle of proportionality, but invites EBA to elaborate on the following aspects:

- There is a need to get more substance to the definition and translation of the principle of proportionality. It is unclear (how to assess) to what extent proportionality can be applied by banks in terms of depth and speed of incorporating and managing ESG risks.
- The principle of proportionality does not only relate to size and the complexity of banks. It relates to a great extent to the materiality of ESG risks resulting from the business model. An example aimed at the business model of promotional banks. These banks work in close alignment with, and are instrumental to, governmental policy and serve sectors which are deemed essential by the government. Governmental policy aimed at the transition to a more sustainable economy for these sectors will be balanced with their essential nature mitigating the ESG risk. In addition, the risks from public sector entities to which banks are exposed are perceived as low. This general risk perception should proportionally be applied to managing ESG risks. The risks faced by promotional banks, also from an ESG point of view, have differences compared to those faced by commercial banks. The materialization of ESG risk manifest in different risks metrics. This distinction is important when applying the principle of proportionality and could be more substantiated.
- The EBA is invited to give more clarity on how proportionality can be achieved both with regard to requirements imposed on institutions’ risk controls as with regard to supervisors’ assessment of these control frameworks. Institutions and supervisors can only take into account the principle of proportionality in practice, if there is a clear and precise framework that is proportionate itself. Rules on the quantification of ESG risks should not go beyond the legitimate objectives pursued by the legislation at issue and should not exceed the limits of what is appropriate and necessary to achieve those objectives.

Lastly, we reiterate that any framework developed by EBA should be consistent with the ECB’s framework.

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Annex 1

28. As an institution, do you use or plan to use some of the indicators and metrics included in Annex 1? If yes, please describe how they are used in relation to your ESG risk management approach.

The members of the NVB recognize illustrative, non-exhaustive overview of indicators and metrics in Annex 1. With regard to the usage of them in relation to ESG risk management approach, the NVB would like to make the following remarks:

- Many of the mentioned indicators play a role in the assessment the ESG risks of clients and transactions. Yet, these are not yet used directly in relation to ESG risk management as they are used purpose driven (inside out), while most of them also have an outside in effect in reducing risk automatically.
- We note that the social indicators are less granular and complete than the climate and environmental indicators.
- During the public hearing about this paper, the NVB took note of the fact that this overview of indicators will not become mandatory or leading but is purely illustrative.

29. If relevant, please elaborate on potential obstacles, including scope of applicability, granularity, and data availability, associated with the indicators and metrics included in Annex 1.

The potential obstacles with regard to the non-exhaustive list of ESG factors, indicators and metrics, mainly point at the issue of data availability. The NVB finds that more availability of corporate and retail data will be a key factor for adequate banks' risk management, for the development of new financial products and for helping consumer and businesses to transition. Available, reliable, and standardized environmental and social data (E&S) data and non-E&S data on clients are a prerequisite for the development of quantification methodologies.

There is a continuous improvement in data quality and availability. For example, data are becoming more affordable and easier to access. However, for all indicators and metrics, data availability and accuracy continue to be a point of attention. A few of the main challenges and considerations are as follows:

- Data could be too general. For example, this is the case when data only differentiate between sectors and not between companies. Or when the data only differentiate on country level and not regionally or locally.
- Data could be too old. Banks sometimes we have to work with data that are several years old.
- Data can be too expensive or unreliable.
- It has however to be stated that data are of course not a goal in itself. Data are used for modelling and can models never mirror reality for a 100%. With regard to modelling and scenario developing, the lack of (historical) data also provides challenges to test the resilience of the business model or to judge the possible impact of climate-related and environmental risks and the time horizon over which these effects are expected. The use of quantitative data and models could give the false idea of actual control of reality.
- Although the developments in non-financial reporting and related legislation (like the EU non-financial reporting directive) have accelerated in the last few years, reporting and data availability is not yet at the level of the financial reporting and information. Recent disclosure legislation, such as the EU Taxonomy and SFDR, do provide more granular guidelines for disclosure.
- Depending on a bank's lending footprint, data may only be available in certain (more "advanced") geographies, making consistent analysis across an entire portfolio very challenging. Given the nature of ESG risks, it might provide an additional challenge to extrapolate data across regions (E.g., Europe to Africa).

Lastly, the NVB would like to remark that the Indicators in Annex I have a focus on environmental and social materiality. It would be helpful to suggest indicators that focus on financial materiality.

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