RESPONSE TO EBA DISCUSSION PAPER: THE ROLE OF ENVIRONMENTAL RISKS IN THE PRUDENTIAL FRAMEWORK

FINANCE DENMARK

Memo

August 2, 2022
Doc: FIDA-2060232074-691732-v1
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Chapter 3 – Background and rationale

Q1: In your view, how could exposures associated with social objectives and/or subject to social impacts, which are outside the scope of this DP, be considered in the prudential framework? Please provide available evidence and methodologies which could inform further assessment in that regard.

We would recommend the EBA to start the work given that the timing of the forthcoming social taxonomy is late vis-à-vis ongoing ESG-implementation in banks.

Chapter 4 – Principles, premises and challenges

Q2: Do you agree with the EBA's assessment that liquidity and leverage ratios will not be significantly affected by environmental risks? If not, how should these parts of the framework be included in the analysis?

Yes, we agree with the EBA's assessment.

Q3: In your view, are environmental risks likely to be predominantly about reallocation of risk between sectors, or does it imply an increase in overall risk to the system as a whole? What are the implications for optimum levels of bank capital?

We mainly see environmental risks as being about reallocation between sectors but it is difficult to predict the development. For the time being we do not see environmental risks that imply an increase in the overall risk.

Q4: Should the 'double materiality' concept be incorporated within the prudential framework? If so, how could it be addressed?

Q5: How can availability of meaningful and comparable data be improved? What specific actions are you planning or would you suggest to achieve this improvement?

Meaningful and comparable data will be key for institutions in evaluating the risks of their customers. In this regard, the draft European Sustainability Reporting Standards (ESRS) under consultation until August 8 is foreseen to be a cornerstone, but at first glance they seem too comprehensive – at least for the first years of reporting. A phased-in approach is in our opinion needed with focus on key information on environmental data, including CO2 emissions etc., that can be attributed to requirements for the financial sector in SFDR, CRR, etc. Furthermore, ESAP could be a useful instrument starting with environmental data.

In addition, the relationship between the EU taxonomy and riskiness is not coherently discussed. The taxonomy has not been built from a risk correlation perspective and it's not clear that there will be correlation going forward. E.g., taxonomy-based reporting may not provide sufficient data for risk modelling.

Q6: Do you agree with the risk-based approach adopted by the EBA for assessing the prudential treatment of exposures associated with environmental objectives / subject to environmental impacts? Please provide a rationale for your view.
We agree that a prudential risk-based perspective should underlie the assessment. A risk-based approach is key to the prudential regulation and that's why we strongly object to the introduction of the floor in the Basel package.

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Q7: What is your view on the appropriate time horizon (s) to be reflected in the Pillar 1 own funds requirements?
We need more guidance on physical collateral, especially regarding short term vs. long term risks. Common methodologies that take into account the long durations of some exposures would be preferred. We find it difficult to include the longer time horizons appropriately in the Pillar 1 framework. Instead, stress testing and scenario analysis are beneficial tools to help understand environmental risks considering their forward-looking horizons.

Q8: Do you have concrete suggestions on how the forward- looking nature of environmental risks could be reflected across the risk categories in the Pillar 1 framework?
We find it difficult to include the longer time horizons appropriately in the Pillar 1 framework. Instead, stress testing and scenario analysis are beneficial tools to help understand environmental risks considering their forward-looking horizons.

Chapter 5 – Credit risk
Q9: Have you performed any further studies or are you already using any specific ESG dimensions to differentiate within credit risk? If so, would you be willing to share your results?

Q10: What are the main challenges that credit rating agencies face in incorporating environmental considerations into credit risk assessments? Do you make use of external ratings when performing an assessment of environmental risks?
As users of credit ratings, it is very important to understand to what extent individual credit rating actions have been influenced by sustainability factors. The level of disclosure of information from rating agencies as to the effect of sustainability factors on credit ratings has improved since the entry into effect of the ESMA

Guidelines in 2020. We see much larger challenges in the ESG ratings market with lack of transparency regarding methods used.

Q11: Do you see any challenge in broadening due diligence requirements to explicitly integrate environmental risks?

Q12: Do you see any specific aspects of the CRM framework that may warrant a revision to further account for environmental risks?

Q13: Does the CRR3 proposal's clarification on energy efficiency improvements bring enough risk sensitiveness to the framework for exposures secured by immovable properties? Should further granularity of risk weights be introduced, considering energy-efficient mortgages? Please substantiate your view.
The CRR3 proposal does partially incorporate risk sensitivity in the exposures secured by immovable properties since energy efficiency is one of several factors affecting the value of the property. Improved energy efficiency improves the value of the property but other factors including ESG factors will also influence the value in a positive or negative direction. Thus, further granularity of risk weights according only to energy efficiency will not be a risk-based approach and might lead to untended consequences. ESG risks should be "picked up" through the valuation of the asset.

Q14: Do you consider that high-quality project finance and high-quality object finance exposures introduced in the CRR3 proposal should potentially consider environmental criteria? If so, please provide the rationale for this and potential implementation issues.

Q15: Do you consider that further risk differentiation in the corporate, retail and/or other exposure classes would be justified? Which criteria could be used for that purpose? In particular, would you support risk differentiation based on forward-looking analytical tools?
We do not think that further risk differentiation is justified for the time being, we need more evidence of ESG as a risk driver before differentiation can be justified. We also see a risk of double counting.

Q16: Do you have any other proposals on integrating environmental risks within the SA framework?

Q17: What are your views on the need for revisions to the IRB framework or additional guidance to better capture environmental risks? Which part of the IRB framework is, in your view, the most appropriate to reflect environmental risk drivers?

Sufficient flexibility around the IRB integration should be allowed to enable integration into different modelling approaches with further guidance on supervisory expectations for a stepwise approach to IRB integration. In addition, the introduction of the output floor will mute the risk sensitivity of the capital requirements for IRB, also when it comes to environmental factors. Making the transitional arrangements for mortgages and unrated corporates in CRR3 permanent would enable risk differentiation through the model outcomes as well.

Q18: Have you incorporated the environmental risks or broader ESG risk factors in your IRB models? If so, can you share your insight on the risk drivers and modelling techniques that you are using?

The possibility to directly include ESG factors as explanatory variables in the asset valuation models could be further considered

Q19: Do you have any other proposals on integrating environmental risks within the IRB framework?

Q20: What are your views on potential strengthening of the environmental criterion for the infrastructure supporting factor? How could this criterion be strengthened?

Q21: What would in your view be the most appropriate from a prudential perspective: aiming at integrating environmental risks into existing Pillar 1 instruments, or a dedicated adjustment factor for one, several or across exposure classes? Please elaborate.

It is important that the prudential framework remains risk-based. Environmental factors can be integrated into existing Pillar 1 instruments where there is sufficient evidence that those factors are risk drivers.

Q22: If you support the introduction of adjustment factors to tackle environmental risks, in your view how can double counting be avoided and how can it be ensured that those adjustment factors remain risk-based over time?

<u>Chapter 6 – Market risk</u>

Q23: What are your views on possible approaches to incorporating environmental risks into the FRTB Standard-sed Approach? In particular, what are your views with respect to the various options presented: increase of the risk-weight, inclusion of an ESG component in the identification of the appropriate bucket, a new risk factor, and usage of the RRAO framework?

Q24: For the Internal Model Approach, do you think that environmental risks could be better captured outside of the model or within it? What would be the challenges of modelling environmental risks directly in the model as compared to modelling it outside of the internal model? Please describe modelling techniques that you think could be used to model ESG risk either within or outside of the model.

Q25: Do you have any other proposals on integrating environmental risks within the market risk framework?

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Chapter 7 – Operational risk

Q26: What additional information would need to be collected in order to understand how environmental risks impact banks' operational risk? What are the practical challenges to identifying environmental risk losses on top of the existing loss event type classification?

Q27: What is your view on potential integration of a forward-looking perspective into the operational risk framework to account for the increasing severity and frequency of physical environmental events? What are the theoretical and practical challenges of introducing such a perspective in the Standardised Approach?

Q28: Do you agree that the impact of environmental risk factors on strategic and reputational risk should remain under the scope of the Pillar 2 framework?
Yes

Q29: Do you have any other proposals on integrating environmental risks within the operational risk framework?

Chapter 8 – Concentration risk

Q30: What, in your view, are the best ways to address concentration risks stemming from environmental risk drivers?

Q31: What is your view on the potential new concentration limit? Do you identify other considerations related to such a limit? How should such a limit be designed to avoid the risk of disincentivising the transition?
We do not find it necessary to introduce new concentration limits. However, if limits should be imposed it is important not to set the limits too hard. To support the transition, we will see large exposures to sectors e.g., working on renewable energy so we should be careful not to limit the exposures. It could hamper the transition.

Chapter 9 – Investment firms

Q32: With reference to the three risk categories the IFR is based on (Risk-to-Client, Risk-to-Market and Risk-to- Firm), which of these could be related to environmental risks, and to what extent?

Q33: Should any of the existing K-factors incorporate explicitly risks related to environmental factors?

Q34: What elements should be considered concerning the risk from environmental factors for commodity and emission allowance dealers? Are there any other specific business models for which incorporation of environmental factors into the Pillar 1 requirements of the IFR would be particularly important?

Q35: Do you have any other suggestions as to how the prudential framework for investment firms could be adjusted to account for environmental risk factors?