Sustainable Finance

Pre-CRR3 position paper

July 2019

Introduction

The RRM package, which included "CRR2" and which entered into force in June 2019, represented a large step forward in forming a more resilient banking sector in the EU, introducing among other things important international standards for liquidity (e.g. NSFR) and resolution (e.g. MREL). In the negotiation of this package it also became clear that banking legislation was a means of addressing the pressing challenges of climate change for the wider economy – not only the risks associated with it for the financial industry and their clients, but also the opportunity for the industry to finance the transition to a sustainable economy. As building a sustainable economy remains high on the Commission's priorities for 2019-2024, we would expect the EU's commitment to the Paris Agreement may continue to be considered in CRR3 and have set out our views on these in more detail below.

Background

Following the adoption of the 2015 Paris agreement on climate change and the United Nations 2030 Agenda for Sustainable Development, the European Commission published its "Action Plan: Financing Sustainable Growth" having three main objectives:

- reorient capital flows towards sustainable investment, in order to achieve sustainable and inclusive growth;
- manage financial risks stemming from climate change, environmental degradation and social issues;
- foster transparency and long-termism in financial and economic activity.

In the context of CRR2, European legislators reflected on the Paris Agreement and its interaction with prudential regulation in the following respects:

- A mandate for the EBA to assess the inclusion of ESG risks in the supervisory review and evaluation process (SREP) and submit a report to the European Commission by 28 June 2021 (CRD Art. 98d);
- A requirement for large institutions to disclose ESG related risks as of 28 June 2022 on the basis of the EBA report done on ESG risks (CRR2 Art. 449a);
- A mandate for the EBA to assess a specific prudential treatment of assets exposed to or associated with environmental or social objectives in the form of different capital charges based on available data and the findings of the High-level expert group on Sustainable Finance by 28 June 2025 (Art. 501c).
- A mandate for the EBA to report on the Infrastructure Supporting Factor (Art.501a CRR2) an analysis of the evolution of the trends and conditions in markets for infrastructure

lending and project finance over 3 years. (N.B. the Infrastructure Supporting Factor includes additional criteria related to environmental objectives.

AFME's position:

AFME members welcome the above mandates and will be closely engaging on the areas identified with the EBA to support the development of the reports and any subsequent policy recommendations. In the meantime, following the EU institutional change over, AFME remains aware that climate-related policy remains high on the agenda of the financial services industry and legislators alike. This could lead to additional mandates and prudential considerations in the process of legislating for CRR3 and other areas of financial services legislation which are interlinked. One example of interlinked legislation is the development of the EU 'Taxonomy' Regulation which is intended to set out what can be considered an environmentally sustainable economic activity. AFME consider that the definition of common sustainability criteria is a significant positive step in an orderly transition towards a low-carbon and climate resilient economy, to which AFME is fully committed. In relation to CRR3, we are aware this could be linked to the development of prudential treatment of assets. We think it would have been premature to introduce changes in the CRR2 to the prudential framework at this stage and it is better to wait until the taxonomy is well established, which will look at existing data. Indeed, we would note that the taxonomy as developed by the technical expert group on sustainable finance is focused on purely green activities, and for the present would not be an appropriate basis for a future prudential regime, which should take into account how banks support their clients in transition.

With regard to the content of the CRR2 mandates of the EBA, we understand that a revision of Pillar 3 disclosure requirements by the European Commission (EC) may be needed in the future, to incorporate any integration of ESG risks into the credit risk framework. However, discussions are still ongoing within the EC technical expert group (TEG) on sustainable finance on disclosure guidelines on sustainable finance that are intended to be practical tools to help with the transition to more sustainable reporting but are not legally binding. Moreover, a revision of the Non-financial Reporting Directive (NFRD) would probably take place during the next Commission mandate as there are structural elements that need to be addressed. Therefore, any further amendment of Pillar 3 should be tabled after the finalisation of the EU taxonomy and the above-mentioned disclosure requirements, in order to avoid any duplication and unnecessary operational burden. In the meantime, we stress that many financial institutions are already disclosing climate related information also by following the recommendations such as those of the TCFD.

Another point of focus in addressing climate related risks has been the stress-testing of banks' balance sheets. This has been widely under discussion by central banks – namely through the Network for Greening the Financial System (NGFS) made up of representatives from 36 central banks and supervisors. It will also be part of the EBA's CRR2 mandates to assess how stress testing and scenario analysis could reflect the impact of ESG risks. Indeed, some European national central banks have already taken action on this, for example, in April 2019 the Prudential Regulation Authority (PRA) issued a supervisory statement setting out specific governance, disclosure and ICAAP expectations in relation to climate risks and for firms to run 'scenario analysis'. Similarly in France, the ACPR is working on defining 3-4 types of macro-climate scenarios, in line with the next deliverables of the NGFS [1](i) a handbook on climate and environment-related risk management for supervisory authorities and financial institutions; (ii) voluntary guidelines on scenario-based risk analysis (iii) best practices for incorporating sustainability criteria into Central Banks portfolio management (particularly with regard to climate-friendly investments). The Dutch National Bank also published a paper in February 2019 setting out a comprehensive framework for analysing financial stress under scenarios with a disruptive transition to a low-carbon economy, the outcome suggesting that climate transition risks warrant a close and timely attention from a financial stability perspective. In light of this, we strongly urge European Regulators to reflect on best practices and experience of supervisors in this area to date. Indeed, given the numerous initiatives in this area it could be worth reflecting in CRR3 how to best harmonise approaches among supervisors to ensure best practices.

Last but not least, one uncertainty remains on the future of the Infrastructure Supporting Factor (including ESG-like pre-conditions to apply it) introduced in CRR2. In July 2019 the EBA recommended removing this prudential treatment in future CRR3 proposals. The recommendation stems from the QIS analysis, where the compliance of institutions to this factor was deemed low (although only a very new measure at the time the analysis was undertaken). The analysis was also accompanied by a disclaimer noting small sample of banks for the study and that low compliance is potentially due to difficulties to assess criteria on existing portfolios. Therefore, there seems to be room to explore better practicality of the Infrastructure Supporting Factor and maintaining this preferential treatment if it is relevant to promote green activities, before reaching conclusions when this factor has not yet been adopted by institutions.

AFME welcomes the progress made by the EU legislators and policymakers in actioning the Commission's legislative proposals to drive the achievement of the objectives set by the wider Sustainable Finance Action Plan to transition towards a more sustainable, low-carbon and climate resilient economy, which AFME is fully committed to. Should there be further changes to the prudential framework in CRR3 to reflect developments in relation to supervisory practices assessing climate related risks for banks, we strongly support these supported by data , and note this may take time to build up given reporting on these risks is a relatively new undertaking by banks. Industry remains ready to participate and provide data, where available, in prior consultation of such legislative proposals.

Contact details:

Constance Usherwood

Director Prudential

Direct +44 (0)20 3828 2719

[1] NGFS 17 April 2019 Report