

---

## CRR3 – Sustainable Finance

---

### Executive Summary

Sustainable finance has a key role to play in mobilising the necessary capital to deliver on the policy objectives under the European Green Deal, the Paris Agreement and the EU's commitment to reaching climate-neutrality by 2050<sup>1</sup>. Consequently, the Commission has put sustainable finance at the core of its financial policymaking for the next five years, through the commitment to put forward a Renewed Sustainable Finance Strategy<sup>2</sup>, following its previous Action Plan on Financing Sustainable Growth. In terms of prudential regulation, this commitment will be reflected by building on existing mandates to drive better consideration of ESG (Environmental, Social, and Governance) risks agreed in the second iteration of the Capital Requirements Regulation ("CRR2") and help ensure that investments support a sustainable economy, as part of the recovery from the impacts of the COVID-19 pandemic.

AFME is a strong supporter of these aims. In the context of the upcoming CRR3 proposal, we expect this to manifest in a further consideration of the prudential treatment of green and brown assets, which may be driven by some of the existing mandates already assigned to the EBA.

There are two key issues to consider which we explore in the paper.

Firstly, any differentiated prudential treatment in CRR3 will depend upon the identification of green and brown assets, which should be undertaken in a dynamic, forward-looking, and risk-oriented way. In other words, the classification of an asset under the current taxonomy should not be a proxy for its risk profile, nor lead to automatic risk weighting adjustment. For instance, AFME opposes any direct penalising policy action towards financial institutions that invest in or lend to high carbon-emitting sectors, that are on their journey to transition, as these sectors require capital in order to transform. Notably, there is a risk that the introduction of a penalizing factor could be counterproductive by leading to an abrupt slow-down in financing to those high-carbon emitting sectors, preventing them from transitioning to lower-carbon emission and further aggravating climate risks.

Secondly, the adaptation of any prudential policy related to environmental performance considerations must be balanced and requires the use of sensible and quantitative methodologies, based on experience and scientific data. Any potential specific treatment distinguishing between 'green' or 'brown' assets needs to be consistent with the principles of traditional prudential regulation and therefore grounded in the risk characteristics of such assets. It should also be agreed at an international level, as far as possible.

### **Sustainable Finance and Prudential Regulation: A Brief Primer**

The European Commission's Action Plan on Promoting Sustainable Growth<sup>1</sup>, following the work of the High-Level Forum on Sustainable Finance, was originally conceived in the context of the Capital Markets Union. The original Action Plan on the Capital Markets Union<sup>2</sup>, released in 2015, thus served as the basis for the launch of the Sustainable Finance Agenda.

---

<sup>1</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52018DC0097>

<sup>2</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=&uri=CELEX:52015DC0468>

### **Sustainable Finance Policy in the EU: Three Goals of the Action Plan on Financing Sustainable Growth**

1. Reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth.
2. Manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and
3. Foster transparency and long-termism in financial and economic activity.

Through the evolution of the sustainable finance agenda in the European Union, its focus has in part extended to the role of banks in promoting the transition to a low-carbon economy. Much of this discussion has been centered around the notion of “a green supporting factor” and “brown penalizing factor”.

A green supporting factor refers to a “discount” applied to the capital requirements held against certain assets classified as “green”. The premise is similar to that of the SME and Infrastructure Supporting Factors which aims to encourage support for lending to such entities or on certain categories of assets. In short, it is a capital incentive for banks to increase their exposure to such assets. A brown penalizing factor would take the opposite approach, namely by functioning as a capital add-on, or higher risk weights, for exposures to assets that would exacerbate climate change, thus acting as a disincentive for banks to be exposed to those assets. In the process of agreeing CRR2, it was considered that there was not enough empirical evidence of the actual risk associated with green and brown assets to take the concepts of these “factors” forward – as any prudential treatment of green and brown assets should be explicitly risk-based. Consequently, legislators have extended mandates to the EBA to explore this question further, by collecting data on the riskiness of green and brown assets from a prudential perspective, and by developing supervisory treatment and better disclosure (please see Box 1).

#### **Box 1 - The EBA’s Mandates on Sustainable Finance in CRR and CRD**

Pillar I (Article 501c – CRR2) – June 2025: The EBA is expected to assess whether a prudential treatment of exposures linked to sustainability-related assets would be justified through assessing methodologies for determining the risk-profile of sustainability-related exposures, criteria for the assessment of physical and transition risks, and the effects of this prudential treatment on financial stability and bank lending.

Pillar II (Article 98.8 – CRD2) – June 2021: The EBA is expected to assess the inclusion of ESG risks in the supervisory review and evaluation process (SREP), by examining how NCAs should consider the development of a uniform definition of ESG risks (including physical and transition risks), the impact of ESG risks on institutions in the short, medium, and long terms, and the effectiveness of risk mitigation techniques used.

Pillar III (Article 434a – CRR2) – June 2021: The EBA is expected to develop a technical standard which will set out how financial institutions are expected to report against Article 499a of CRR2, which mandates financial institutions with publicly listed issuances to disclose information on ESG risks, physical risks and transition risks. Following the development of this standard, the EBA will further specify these disclosures as a comprehensive reporting technical standard.

*The EBA’s work on sustainable finance also comprises its December 2019 [Report](#) on Undue Short-term Pressure from the Financial Sector on Corporations, examining three dimensions of short-termism: the banking perspective, the corporate perspective, and the sustainable finance perspective.*

In 2019, the EBA released its Roadmap for Sustainable Finance<sup>3</sup> based on these mandates, setting objectives for how to accelerate the inclusion of banks in the Sustainable Finance Agenda. At the same time, initiatives such as the Network of Central Banks and Supervisors for Greening the Financial System (NGFS)<sup>4</sup>, launched in 2017, have released multiple reports and analysis linked to these same mandates.

As part of the Renewed Sustainable Finance Strategy, expected in Q4 2020, the Commission plans to review the question of green supporting and brown penalising factors. The Commission have considered doing so on

<sup>3</sup> <https://eba.europa.eu/eba-pushes-early-action-sustainable-finance>

<sup>4</sup> <https://www.ngfs.net/en>

a faster timescale than that set out in the EBA mandates in CRR2 outlined above. AFME considers that potential integration of ESG considerations into the prudential framework as part of CRR3 should be based on a premise that this would be done in a pragmatic and risk-sensitive manner, taking account of the EBA's progress in its CRR2 mandates. It is critical for any such measures agreed as part of the Renewed Sustainable Finance Strategy should be well-coordinated with existing legislation and international initiatives, where possible, given that climate change is a global phenomenon. They should also be based on a realistic and coherent implementation timeline, allowing banks the time to adjust and adopt new methodologies to align themselves with these potential requirements.

## **Building blocks to integrating sustainability in prudential regulation**

In order to support further integration of ESG considerations into the prudential framework, as part of CRR3, in a pragmatic and risk-sensitive way, we urge legislators to take the following considerations into account.

### **1. Limitations of developing a classification system for use in prudential regulation**

A key component of the Sustainable Finance Action Plan was the establishment of an EU classification for sustainable activities, otherwise known as the Taxonomy. The Taxonomy has since been agreed and entered into force through the introduction of the Taxonomy Regulation<sup>5</sup>, on 12 July 2020. In the first instance, the Taxonomy will focus on economic activities deemed to make a substantial contribution to climate change mitigation or adaptation. The Regulation also includes a further mandate to explore a "brown taxonomy" – i.e. economic activities that significantly harm the environment. Overall, the top priority for the Commission should be to finalize the Green Taxonomy and assess its effectiveness in supporting the redirection of financial flows towards sustainable activities, as well as assess if any gaps/issues exist, before deciding to develop a brown, or any other taxonomy.

Given the aim of the Taxonomy Regulation is to encourage investment in green activities and avoid "green washing"<sup>6</sup>, the link is often made to applying the Taxonomy in the context of prudential regulation, as a means of identifying green and brown assets, and using it to determine the prudential treatment of these assets. While we support the development of the Taxonomy as a driver of investment and important way of identifying of the kinds of underlying activities that could constitute climate-friendly investments, AFME considers there to be considerable barriers to applying the Taxonomy in the context of prudential regulation. For instance, the Taxonomy may not fully take into account the dynamic risk strategy of a corporate, whereby, all things being equal, the business model of a client which develops, adopts and implements a robust transition strategy is expected to be more resilient than that of a client which does not proactively manage its transition risk.

With regard to developing a brown taxonomy, while we fully support a framework which will improve reporting and disclosure around carbon-intensive sectors, including those that cannot change their business models, creating a detailed brown taxonomy or developing a form of brown "asset-tagging" would be premature and might have unintended negative consequences such as an abrupt divestment in those sectors/activities. This could ultimately hamper the needed transition and could have negative socio-economic consequences. We urge policymakers to focus rather on establishing industry-specific transition pathways towards 2050 net zero carbon emission targets, that would provide clarity about the capacity of and steps needed for real economy actors to transition towards this goal, while helping banks measure the associated risks. Moreover, any potential application of such a "brown" taxonomy to the banking prudential framework should await the completion of the EBA's mandate on the prudential treatment of green/brown assets and potential international standards. In this context, a better understanding of the extent to which

---

<sup>5</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R0852>

<sup>6</sup> Greenwashing is the process of conveying a false impression or providing misleading information about how a company's products are more environmentally sound. Greenwashing is considered an unsubstantiated claim to deceive consumers into believing that a company's products are environmentally friendly.

banks' exposures to different sectors/activities are already adequately captured in banks' models is important. This needs to be based on common scenarios and disclosures that inform risk managers how these assets will perform in a dynamic forward-looking risk-oriented way.

Last but not least, the upcoming review of the Non-Financial Reporting Directive will provide a crucial missing piece to the development of these methodologies, by ensuring companies are able to communicate the necessary non-financial information lying at the base of these future assessments<sup>7</sup>. Indeed, we note the conclusions of the recent report conducted by the BCBS, which show that the lack of available data is a key impediment to the prudential consideration of green and brown assets.<sup>8</sup>

## **2. The prudential treatment of green and brown assets in CRR3**

We recognise the climate emergency and ambition of the EU institutions, not least to support a green recovery from the COVID-crisis. In light of this, we welcome the Commission exploring how to better incorporate ESG risks into the prudential framework, while ensuring that this is based on a coherent and consistent timeline for implementation and standardization of risk management processes, disclosure, and risk analysis. Overall, while we support adapting prudential policy to better consider environmental performance of assets and the associated risks, this should use balanced, quantitative constructs, based on observation and scientific data – driven not least by forward-looking risk-sensitivity.

In respect of the timeline, we note the EBA plans to publish a discussion paper for consultation in 2020, and then produce a final report by 2025 at the latest. We are supportive of a faster adaptation of prudential policy related to the treatment of green and brown assets - including in the context of the CRR3 proposal - if the appropriate risk methodology can be developed and the EBA mandates have sufficiently progressed. Furthermore, banks should be given adequate time to implement any changes.

Regarding the approach, aside from our concerns regarding the potential use of current Taxonomy Regulation, AFME is generally extremely cautious on how environmental performance assessments should be incorporated into assessing the risk of assets under prudential frameworks. Some of this concern is already reflected in the report of the NGFS<sup>9</sup> on financial institutions' practices with respect to introducing risk differentials between green, non-green and brown financial assets. The report found no strong conclusions on a risk differential between green and brown assets on the institutions they surveyed.

In respect of a green supporting or brown penalising factor, the NGFS report highlighted the risk of double-counting and distorting the regulatory capital requirements for assets through the introduction of green/brown factors. This report also recognised the need for a review of international standards to introduce any changes to the Pillar 1 framework. As per this report, AFME considers that any specific treatment distinguishing between 'green' or 'brown' assets be consistent with the principles of traditional prudential regulation.

Indeed, in the current absence of evidence of a risk differential between green, non-green and brown assets, the EC should encourage the development – ideally at international level – of risk assessment methodologies that include a forward-looking perspective in addition to existing backward-looking analysis, to enable a more accurate calibration of regulatory capital requirements reflecting the long term risk profile of assets. In particular, the classification of an asset should not lead to automatic risk weighting adjustment, particularly given that loss severity and transition risk is going to be constantly evolving.

---

<sup>7</sup>[https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20ISDA%20NFRD%20revision%20consultation%20response\\_Final\\_11062020.pdf](https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20ISDA%20NFRD%20revision%20consultation%20response_Final_11062020.pdf)

<sup>8</sup> <https://www.bis.org/bcbs/publ/d502.pdf>

<sup>9</sup> [https://www.banque-france.fr/sites/default/files/media/2019/04/17/ngfs\\_first\\_comprehensive\\_report\\_-\\_17042019\\_0.pdf](https://www.banque-france.fr/sites/default/files/media/2019/04/17/ngfs_first_comprehensive_report_-_17042019_0.pdf)

### **AFME recommendations on Sustainable Finance**

AFME would recommend that:

- The European Commission and co-legislators should focus on the development of a robust, dynamic green taxonomy in the first instance, and only then carefully assess the possibilities for any further development of a brown taxonomy. Furthermore, would not be appropriate to apply the Taxonomy Regulation as designed to the prudential framework for risk management purposes.
- Any adaptation of the prudential framework should be based on a risk-based approach and subject to common disclosure frameworks, lexicons, statistics, and forward-looking risk methodologies.