25 June 2020

EBF comments and questions on the ECB Climate Stress Testing in preparation for the meeting with the ECB

General comments

Objectives

- We would appreciate if ECB could clearly state and clarify the purpose of the climate stress testing exercise and apply proportionate and material approach to the scope and methodologies to achieve the objectives.
- Will the outputs be used to challenge bank net-zero strategies in case of dynamic balance sheet option? Will the methodology be required in the ICAAP process? Will this be a structural exercise?
- Will the exercise be conducted on a best effort basis?
- Could ECB confirm that the outcome of the stress test would only be reflected qualitatively and that no implication in terms of P2G is to be expected?
- At this stage indeed it would be **premature to have capital implication arising from this 2022 exercise. However, we would be interested to understand how will the exercise be articulated via scores, and how will this kind of exercises with time horizon outside the regular SREP time horizon be articulated in the future.**
- Banks usually refer to climate scenario analyses as opposed to climate stress tests to reflect the fact that related methodologies and data availability have a fundamentally different level of maturity in the case of climate-related exercises. Given the exploratory nature of the exercise, the developing phase of climate methodologies, the challenges with customer level data, assumptions for long term scenario application and the expert judgment involved in for example reputational risk losses, which results could vary widely, the assessment of the exercise, qualitative or quantitative, as mentioned above, should have no capital implication

Preparation

- **Could ECB share a detailed roadmap from July -December 2021 and also a granular planning post 2021?**
- Could the SSM share more information regarding the announced workshops to facilitate banks preparation? When will feedback regarding the industry's comments on the methodology and templates submitted in June be provided to banks? When will all the potential involved banks be informed on the exercise? When will banks have information on the subset chosen to run projections on Module 3?
- Banks would welcome clarification, **an ongoing industry dialogue** and a more detailed planning of ECB in the period leading to the stress testing exercise. Ay updates decided by the SSM on the methodology and templates including potential adjustments to the NGFS scenarios should be shared with the industry as soon as possible, well before December 2021.
- Banks would also appreciate an online interactive Q&A tool that would be essential for clarity and consistency
- How will the responses provided in the Climate Action Plans submitted to the ECB (Questionnaire A&B) be used to benchmark participating banks? The information provided to the SSM as part of the Climate risk self-assessment and the following action plan should not be requested again as they are not supposed to have changed significantly. In contrast, the requested breakdown of actions by NACE sector generates an excessive complexity for banks.
- What criteria is used by the ECB when determining which bank should or should not participate in module 3 (scenarios)? Could you please confirm that the information provided by the banks in the replies to the questionnaires in respect of their gaps and connected required actions will be considered in determining the participation?
- When determining the waiver, **proportional approach** should be considered as well as the business model of banks. If the exposures are not material or the impact on the figures is small, it would be disproportionate to ask banks to fill the module 3 template as the usefulness of comparison with other banks is questionable. Banks would appreciate more clarity on the approach.
- Also, we understood that it is the intention of the ECB to determine which banks will participate in module 3 at the end of 2021. This however is too late for the complexities involved in the exercise of very long term projections on a new set of less known variables and relationships with existing more" standard" risk models. This is new for a large number of (small) banks and requires a different approach from that of the EBA EU-wide stress test. To properly develop these methodologies and have them reviewed in a timely manner, this requires a long lead time, which is better in the preparation than during the exercise. It is therefore necessary for banks to understand in advance whether they need to reserve resources. We would appreciate the announcement of which banks have to participate in full exercise ideally **before end of August 2021.** We would appreciate at least **clarification on which banks should participate in any case** and which are still to be considered as soon as possible.
- In this context, we would also like to draw attention to the banks that have a standardized approach, that require a low modelling ambition and therefore have a limited quant department. It would also be desirable to provide a (conservative) generic **proxy/benchmark model for transition rates, lifetime loss rates, etc., so that a small bank without a waiver** can make use of this. This also has the advantage that there is no great diversity between (work) assumptions between all banks, and that there is a clear mindset.

Scope

- The breadth and depth of the exercise means it will be challenging to meaningfully complete it in a few months' time. Sufficient time should be given to institutions for organization of the stress test and particularly to collect the missing data and undertake the necessary R&D work on methodologies, leading to an increase of the overall quality of banks' submissions.
- **Narrowing the scope** of the exercise could be considered (E.g. narrower scope of customers in case of financed emissions, postponing SME Retail (module 3))?
- As a starting exercise, ECB could consider a phased approach, with the 2022 exercise more focused on simple data collection and simulations:
- **Staggering Modules 1, 2 and 3** could facilitate the allocation of resources in banks, whose teams are already stretched.
- 2022 exercise should be conducted on a **best effort basis** in 2022, allowing banks to intervene where gaps exist (e.g., GHG emissions and EPCs)
- There could also be clarification on whether the exercise is **limited to the banking activity** of the group in case of conglomerate structure, meaning that all exposures, revenues and stress projections are to be provided for banking activities only.

Simplification

- Some **computation prescriptions should be adapted** to avoid unnecessary workload.
- The **treatment of operational and reputational risks** of the current methodology would be highly burdensome for very limited insights. This part should be made simpler, for example by replacing computations by qualitative elements.
- Given the length of processes related to models and the timing of the exercise, banks will not be in a position to conduct and provide a **validation of proxies and models used**, similar to what is done in other supervisory exercises.
- Simplified modelling solutions on less emitting sectors could be envisaged.

Data

- Expectations by the ECB on the availability and interoperability of the data requested across Modules 2 and 3 are high. For example, customer level information is in fact not widely available, as banks are in the process of progressively assessing customers and the assumptions used by banks for this purpose can be widely divergent. In the case of financed emissions, the ECB could consider **allowing a narrower scope of customers**, as in the PRA exercise (e.g., top 100 counterparties, or setting a threshold under which counterparties should not be reported). Other data related challenges include e.g. availability of EPCs or accuracy of NACE codes that may impact the meaningfulness of the final results. We would also recommend **reducing the scope of NACE codes** e.g. in accordance to SBTi NACE codes.
- Following the data collection and the analysis ECB conducted for its top-down stress test earlier this year, ECB should grant **access to the data collected on the 4**

million counterparties belonging to the scope (regarding GHG emission but also other types of data such as asset's location), to facilitate and ensure homogeneity/consistency in the filling of the template on GHG emissions. Many institutions have common customers, and this way of proceeding would avoid having too disparate data among participating banks (hence a loss of consistency in the results), as well as a heavy quality assurance work. A common data-warehouse managed internally by ECB to foster data consistency across banks would be much appreciated. Alternatively, would **ECB consider calculating scope 3 emissions on data** (LEIs submitted by banks) as done by EBA in the pilot sensitivity exercise?

- **Use of proxies** for missing EPCs based on other available data samples should be allowed.
- Are tolerance buffers envisaged in the consistency checks with FINREP and COREP (e.g., 90% reconciliation or reconciliation through "other" residual bucket)?
- The timelines of the ECB climate stress test are currently based on FINREP and COREP publications. However, data is required that are published in different timelines, such as emission data. For example, pillar 3 reports and/or annual reports are needed, which are published later than the Q4 2021 FINREP/COREP. Banks call to **align deadlines** with broader publications.

Communication of the outputs

- We welcome those results will only be disclosed on an **aggregated basis with focus on main conclusions** and not at bank level. Indeed, given the high reliance on assumptions (e.g. dynamic balance sheet, long term projections), insufficient maturity of methodologies s, and the lack of guidance on the use of proxies (e.g. EPC, GHG emissions), a peer benchmark of banks' results will be quite meaningless.
- To avoid misinterpretation in the communication of the ultimate results, a **clear distinction and *naming* of the various simulations** of this SSM Climate Risk Stress Test 2022 should be applied, between *stress tests* for the three-year scenarios and *climate scenario analyses* for the longer-term exercises."
- Clear **explanations and caveats** should be provided to stakeholders and the public regarding:

(i) any possible methodological shortcomings (e.g. linking P&L impact with past events and building projections)

(ii) data quality

(iii) the short term transition risk stress scenario where the increase of carbon price unrealistically takes place as soon as 2022 instead of around 2030 in NGFS disorderly scenario,

(iv) the reporting of gross interest income (whereas only the net part may be at risk)

(v) the judgmental nature of projections related to operational risk and reputational risk

Validation

- Banks will have to develop models to conduct this exercise, after gathering the related data. Given the length of such processes and the timing of the exercise, institutions will **not be in a position to conduct and provide a validation of proxies and models used**, similar to what is done in other supervisory exercises.
- On top of that, in the module 2: Climate risk metrics it is foreseen that as regards the classification in EPC categories, "the methodology is conservative, robust and approved by the internal audit function of the bank. It is not realistic to assume that on such a new topic and within such a limited timeline internal audits of banks will be able to review EPC classification models.

Specific comments

Notwithstanding the comments provided to ECB by each participant, please find below a list of some common concerns raised by our members:

Module 1

Using income from pre-defined high emitting NACE codes, as a proxy for transition risk exposure, has granularity limitations that should be acknowledged. For example, within segments such as D35 "production of electricity" income may come from different energy mixes both across and within counterparties economic activities.

Module 2

Additional guidance should be provided regarding the expectation of what should be included in the explanatory note on climate-related actions, that should be provided with climate metrics in module 2. Could it be confirmed that a set of references to banks disclosed information (i.e. Climate report) will be sufficient?

Metric 1

- Could you please confirm that asset management fees are not included in the calculation of metric 1 ? We understand that only fees received from corporates are targeted.
- Is the data request for this template same as the one for Pillar 3 template?

Metric 2

Metric 2 is at counterparty level and does not consider separately loans financing the green transition of enterprises in high GHG emission sectors, resulting in penalization of banks with such exposures. This comment is valid also for Module2 Metric 1 as well as Module 3 Transition risk for Credit Risk (green loans) and Market Risk (investment in green bonds).

<u>GHG emission data</u>

Ability for banks to provide accurate GHG emissions data for all requested counterparties across Scopes 1, 2 and 3 is limited, raising concerns about the meaningfulness of the results. This is especially the case for counterparties' Scope 3 emissions, where quality and availability of information are known to be limited. Low data quality was raised by the EBA, in reference to their own 2020 exercise, as a potential limitation and important consideration determining the meaningfulness of early climate change exercises.

Clarification on the use of proxies for counterparties' Scope 1 and 2 emissions is also requested, especially when disclosed information is limited in certain geographies. Indeed, the maturity of corporates regarding emissions reporting is still low (even for scope 1 and 2 data) and when banks can have access to this information, perimeters and methodologies of reporting may be different from one corporate to the other, which would lead to low consistency at consolidated NACE code level. **Alternatively, much more guidance should be given to banks for estimate GHG emission, especially for scope 3**. We would appreciate grants access to the data used in the top down exercise earlier this year to facilitate and ensure homogeneity/consistency in the filling of the template on GHG emissions. **In the alternative, banks should agree on a third-party data provider or banks should be allowed to exchange information.** If this is not possible, the **ECB should consider calculating the scope 3 emission itself,** based on information (LEI of counterparties) provided by banks.

Concerning the emissions of the top 20 corporates of each sector, we believe it is preferred, from a risk-based perspective, to **focus on e.g., the top 100 corporates, regardless of the sector in which these counterparties are active.** This view is supported by the Bank of England, who recently scaled down its climate stress test in that respect. As an alternative, **a top 5 corporate per sector** would keep the principle proposed (top-list corporates of each sector) but allowing a more proportionate workload. Also concerning missing data, we would appreciate clarification as to whether banks skip the counterparty and use another counterparty or should estimate GHG based on proxies (e.g., average of the available counterparties within the same NACE sector)?

Finally, we would like to remark that there will be very little time between the disclosure of counterparties emissions as of 31/12/21 and the submission of data to the ECB for Metric 2. Flexibility should be given to banks (as it is done for revenues -using previous years average revenue excluding 2021- or for credit exposure starting date -using estimates) to **use 2020 GHG emission** (and this would allow banks to start working on data at the earliest).

Data on revenues

Banks must enter returns from counterparties for the past 3 years (2019 to 2021). Requesting **revenue from 2021 is an unrealistic** request. That data is not yet available. The ECB itself acknowledges this by also offering alternative options, but this does not include an option to request 2018 to 2020.

Module 3

- The SSM Climate Risk Stress Test 2022 will combine three-year disorderly transition scenario, which will be severe and thus with low probability of occurrence, and longer-term scenarios over a 30-year horizon, with different transition pathways which will be more likely to occur with a reduced severity by construction. To avoid misinterpretation in the communication of the ultimate results, a clear distinction and **naming of the various simulations** of this SSM Climate Risk Stress Test 2022 should be applied, between *stress tests* for the three-year scenarios and *climate scenario analyses* for the longer-term exercises."
- In relation to the use of the NGFS scenarios, attention should be paid to **the consistency of the NGFS scenarios with projections and parameters currently in place for other purposes**, at least for the short term scenarios.

- On module 3, banks have the challenge that they do not have modules that are developed on a sector level, or one that take emissions into account. It is **not feasible to develop and validate models before January 2022** (paragraph "Validation" - see above). Also, banks have stated that these kinds of models are not (yet) available on the market or have not yet been developed internally.
- Scope of application - can **SME Retail be postponed** given most sensitive climate sectors and current exercises mainly focused on Large Corporates?
- Need for further clarifications on climate stress test modelling (techniques, approaches, etc.). **How is comparability and consistency ensured across banks (given potential different modelling/usage of scenarios)?**
- On less emitting sectors, is it possible to **use simplified modelling solutions**?

Credit risk

- **Long Term objective of the static balance sheet on 2030, 2040 and 2050 is unclear**. Heaviness of the templates on those years (cf. beginning of year / within the year…).
- Banks should have sufficient **flexibility to make their balance sheet projections** based on the data provided by the SSM for the different scenarios. Together with a detailed documentation explaining how scenarios parameters are integrated, this will allow comparability across institutions.
- The internal stress methodology for credit losses seems relatively open. Given the available data, it seems **necessary to allow banks, for their credit risk projections, to conduct (i) a portfolio approach for all exposures, and (ii), at their initiative, an individual assessment approach, where they assess this is possible and meaningful.**
- Further **explanations on approaches to be used for long term projections** (i.e., impacts on PD_PIT vs. PD_LT) and on dynamic balance sheet hypothesis (portfolio alignment strategies) is needed. What dynamic balance sheet targets should banks use if no official/formal commitment has been made?
- Credit risk modeling by sector and EPC: How will banks transfer sectoral disaggregation of GDPs, equity prices and real estate prices by EPC to impacts on PDs and LGDs? Can banks rely solely on macroeconomic scenario which already embeds the climate scenario? **Will ECB provide benchmarks for the exercise, similar to the ECB path generator for credit risk parameters?**
- Clarification would be appreciated as to **how to perform extrapolation on residual portfolio (**e.g., macroeconomic approach or based on proxies from bottom-up counterparties).
- It is not **clear if for mortgages the impact should only be reflected on the LGD, or also on the PD of those mortgages.**
- While we recognize the relevance of the reporting of credit exposures by EPC rating, it is still a challenging exercise that will lose its relevance if most of the exposures are classified as unknown. As first data collection on the matter, it would be important to accept more flexibility on the use of proxies. We cannot expect a high robustness of a proxy on a variable with such recent interest. The request of an internal validation is also difficult to manage on short term. We would therefore welcome **clarification as to whether banks can proxy missing EPCs based on other available data samples**. We take the opportunity to highlight the fact that we believe that **EPCs**

should be centralized[1] **in open public sources** provided by all EU Member States or by European authorities, and free of access by banks that need to automate their processes. In addition, European Authorities should also pr**ovide an equivalence table among all European EPCs,** as they are not harmonised among countries and even within a same country and as the evaluation may differ a lot.

- Data on insurance companies and public natural disaster relief schemes. Could ECB provide further indications? **More guidance should be given regarding the consideration of private insurance coverage and public natural disaster relief schemes in the credit projection for physical risks.**
- In the transition risk, **what is the purpose of presenting data by country?** (EU countries could be gathered in one region as they will face the same climate-related policies). Are countries outside EU be aggregated and considered as one or e.g if the main presence of an European bank is in 2 European countries and 3 countries outside Europe, does this count as '5 countries', or as the ones ones outside the EU are aggregated they count only as one?
- Request for confirmation that **counterparty credit risk (CCR) is excluded.**
- It is explicitly evidenced in the Meth Doc that FVOCI positions are not included in Credit Risk Perimeter and they are not mentioned in Market Risk section either, **can you clarify that this understanding is correct and FVOCI perimeter is not part of the exercise?**

<u>Market Risk</u>

- According to Methodological Note par. 3.3.1.1 page 18 the **scope** is the trading book, but in the same Methodological Note, page 20, there is a reference to hedging instruments designed to hedge positions measured at fair value or amortised cost, i.e. including banking book positions.
- The information provided is **not sufficient to perform the full revaluation of positions;** link between methodological note and template regarding *"before/after hedging".*
- Starting point paragraph states that "*For the market risk exposures, the total equity and corporate bond holdings split into long and short positions and disaggregated by the 22 NACE sectors need to be re*ported. In addition, potential hedges (derivatives) directly connected to the equity and corporate bond positions split into long and short positions need to be reported." As it is stated, it appears that **derivatives** should only be included in the template if they hedge equity and corporate bond holdings. It often happens that bank hold equity/credit derivatives as a result of a client-driven activity which are then delta-hedged with linear holdings (e.g. single stocks/equity or credit indexes) or with other derivatives. **Could you please clarify whether such exposures should be included in the exercise or not.**

<u>Operational/reputational risk</u>

- Reliability of OpRisk projections: When making projections banks are expected to take into account the growing share of green products both in their exposures and in the financial markets more broadly, the increasing frequency of extreme weather events, changing public sentiment and increasing public scrutiny. **Given the short projection period of three years, and very limited loss history such projections would be**

[1] The Public EPC registers template shows that banks have limited or non-access to public EPC data https://ec.europa.eu/energy/content/public-epc-registers_en

highly speculative and not reliable. The exercise generates a significant workload for very limited insights (which is the same for RepRisk).

- **Complexities on model development for operational and reputational risk**. Could ECB provide further explanations?
- Given the approximate narrative, we question the **reliability and feasibility of (i) linking P&L impact with past events and (ii) building projections**. Also, it is not clear what to do in case banks are not able to identify **historical events** (2 comments seem contrary page 37 of the methodological note regarding operational risk, and this possibility is not even mentioned regarding reputational risks). There are very few quantitative elements regarding reputational risk, which can be deemed a business risk for which isolating the impacts can be very difficult considering a wide array of other potential factors.
- Regarding reputational risk, it seems **difficult to differentiate between case studies** as these have interconnections and may trigger one another.
- The **quantitative outcome would likely be highly hypothetical**, while the exercise will be very costly. An alternative could be to re**quest related risk management frameworks in place** within the institutions, rather than figures.

***