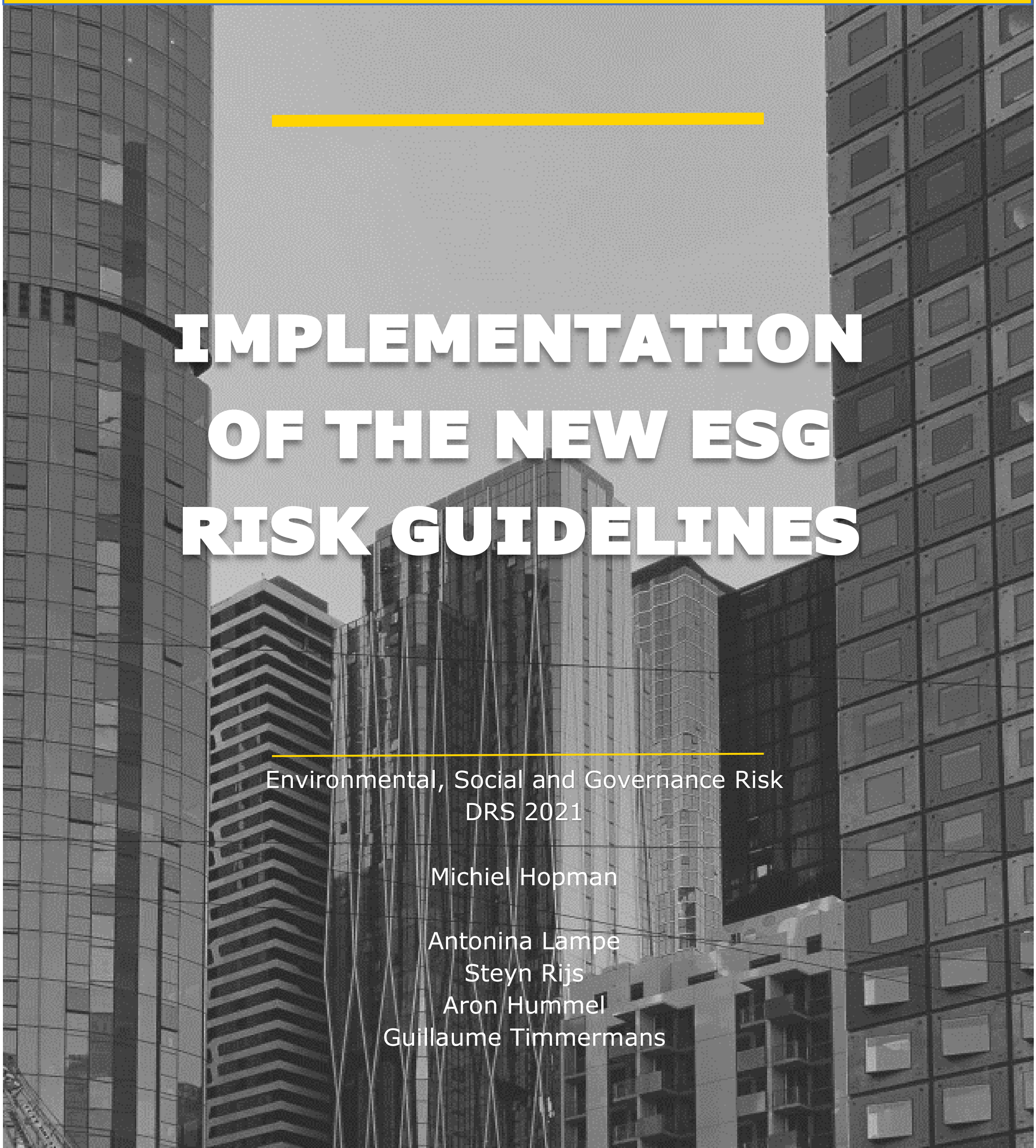

IMPLEMENTATION OF THE NEW ESG RISK GUIDELINES

Environmental, Social and Governance Risk
DRS 2021

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ABOUT DRS

Hopman Data & Risk Solutions is a consultancy firm supporting financial companies on the topics of Risk and Data. Our objective is to bring together academics, companies and students on relevant topics and assignments. For more information, please refer to: www.hopmandatarisk.nl

SUMMARY

Climate change became a widely discussed topic since it has an immense impact on our environment and our economy. That's why several goals were set to encounter the current climate movements.

There are seventeen Sustainable Development Goals (SDGs) and 169 associated targets to be reached by 2030. Achieving the SDGs requires major societal transformations in the next fifteen years and will depend on the mobilization of significant financial resources from the public and private sectors, with a SDG financing gap currently estimated at an incremental USD2-3 trillion per year for all countries.

It is crucial to implement these goals in the short run to ensure a level-playing field as well as to increase transparency and customer protection. However, at the moment there are little to no regulations concerning ESG. In the whitepaper, upcoming regulations and an approach on how to implement them will be introduced.

OBJECTIVE EU ESG RISK REGULATIONS

The little amount of existing EU ESG regulations are largely based on qualitative benchmarks in the form of environmental risks, social risks, and governance risks. These benchmarks are often subjective and give no clear targets and expectations for firms' ESG risk policy. A major step towards introducing quantitative data are benchmarks in the EU ESG supervisory framework, however, there are still obstacles to overcome for EU policymakers. The two most important issues are explained in this section.

The first problem with current ESG regulation is that there is no framework for the disclosure of quantitative data of financial institutions and banks. A direct result of this lack of regulation is the fact that almost all data published by financial institutions and banks are reported voluntarily and is mostly unaudited and unreliable information. Unaudited information cannot be the basis for an ESG regulation and policy as EU policymakers demand empirical evidence for the introduction of quantitative benchmarks [1].

Another challenge resulting from the current lack of ESG data disclosure regulation is the methods by which data is currently gathered and processed. As there are no clear quantitative ESG data disclosure regulations nor guidelines, institutions use varying methods of data recording and cherry-pick quantitative methods that fit them best. As a result data from the past is often hard to use when creating a model predicting future trends.

The inclusion of ESG in future regulation

In the coming years, the introduction of industry-wide data collection and data storage standards will give way for the introduction of empirically-based ESG regulation in the EU. These new standards will allow for clear benchmarks and expectations of firms by EU supervisors. In turn, quantitative benchmarks and objective industry-wide standards allow EU policymakers to introduce industry-wide ESG goals and a framework that keeps track that these goals are met. The first step taken is the introduction of ESG factors and benchmarks into the Capital Requirements Directive (CRD) for banks from 2021 onwards. Additionally, the European Banking Authority (EBA) is currently working on professional proposals for legislators, which are expected to be materialized in a report scheduled for June 2021[1].

From 2021, major banks issuing public securities must disclose their pertaining ESG risks (and within this their physical and transition risks specified) as a result of a 2019 provision of the Capital Requirements Regulation (CRR). Detailed rules in this area will in the future be elaborated by the EBA. The EBA initiated a detailed ESG survey[1], which can give us hints of regulation to come, in October 2020 into the following factors:

1. Environmental risks based on EU Taxonomy
2. Transition climate risk
3. Physical climate risk
4. Proportion of green assets
5. Proportion of brown assets
6. Social sustainability risks
7. Corporate governance risks

[1] Please refer to the EBA discussion paper October 30th 2020 (link)

As one element of supervision, the EBA will prepare an analysis of how ESG risks impact the financial stability of institutions in the short, medium and long term, while also elaborating appropriate qualitative and quantitative criteria for the evaluation of such impacts. These criteria will need to include stress testing procedures and scenario analyses serving to assess the impact of ESG risks under different scenarios of varying degrees of severity.

EBA GUIDE

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 five defining **ESG factors** are:

1. Factors traditionally considered as non-financial
2. Uncertainty about the impact
3. Negative economic externalities
4. Patterns arising from the value chain
5. Increased sensitivity to changes

ESG risks are defined as “the risks of any negative financial impact to the institution stemming, from the current or prospective impacts of ESG factors on its counterparties”. ESG factors may impact institutions’ financial performance through financial or non-financial prudential risks, such as credit, market, operational, liquidity and funding risks.
ESG risks can be categorized into two groups:

1. **Financial materiality**, which may arise from internal economic, and financial activities
2. **Environmental and social materiality**, stemming from the external impact of those economic and financial activities

Environmental risks are defined as “the risks posed by the exposure of institutions to counterparties that may potentially be negatively affected by environmental factors”
The three main transmission channels:
1. **Physical transmission** channels and 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, including acute physical risks, which arise from particular events and chronic physical risks, which arise from longer-term changes in the climate
2. **Transition transmission** channels and 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, including climate and environment-related policy changes, technological changes as well as behavioral changes.
3. **Liability transmission** channels and risks are the risks posed by the exposure of institutions to counterparties that may potentially be held accountable for the negative impact through their activities on the environment, the society, and their governance factors.
These are likely to fall under three different categories: failure to mitigate; failure to adapt; failure to disclose.
The interaction of physical and transition risk is close and a trade-off between physical and transition risks exists, depending on how and when the transition to a sustainable economy takes place.

Social risks are the risks posed by the exposure of institutions to counterparties that may potentially be negatively affected by social factors.
Social criteria involve aspects of society or community, relationships with employees or labor standards, customers, human rights, and poverty.

Environmental and social risks are closely interrelated where environmental degradation can exacerbate migration, social and political unrest in the most affected regions, with potentially more devastating repercussions and contagion across the globe.

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

SUSTAINABLE FINANCIAL DISCLOSURE REGULATIONS

The EU wants to have a better overview of the financial products for financial market participants (FMP) and financial advisors (FA). Therefore, European Supervisory Agencies (ESAs) proposed technical standards that will need to be disclosed under the Sustainable Finance Disclosure Regulation (SFDR). With the introduction of the SFDR, the EU wants to reorient capital towards sustainable businesses and prevent companies from greenwashing. The key part of this regulation is transparency, where the manager takes adverse impacts on sustainability into account.

The action plan of the EU will start from March 2021, to start financing sustainable growth and a greener Europe, with the implementation of the SFDR. With the EU action plan, all participants have the same criteria to define, measure, and report on sustainability attributes and economic activities. The action plan will also mean that other existing legislation like MiFID II, BMR and AIFMD, and UCITS directives require revision. SFDR is linked to two other documents of legislation. The first piece of documentation is the EU Taxonomy legislation, which indicates criteria to indicate whether economic activities contribute to the environmental objectives. Currently, the taxonomy mainly focuses on environmental issues but will include social and governance in the future. The second legislation is the Non-Financial Reporting Directive (NFRD), which is already required for companies to include in their annual report[3].

From March 2021, Financial Market Participants (FMPs) and Financial Advisors (FA) can start considering principal adverse impacts. For the FMPs and FAs, the final moment is June 2021 where principal adverse impacts must be considered. The timeline gives an overview of some important dates regarding SFDR on the entity level.

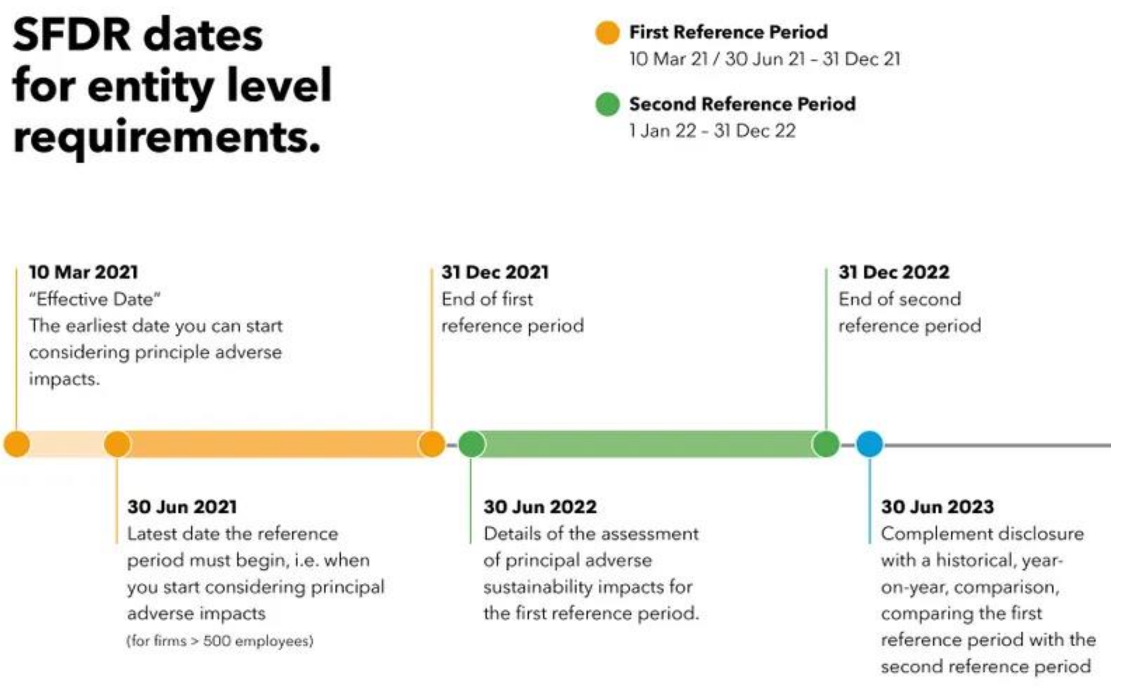

Figure 1: Timeline with some important dates for sustainable financial disclosure regulations on the entity level. Source Bloomberg 2020[4]

To identify the principal adverse impacts FMPs and FAs must do the following steps:

- Collect data from various data sources: data providers with data on a company level, financial product level, entity level as well as data from fund administrators, fund management companies, and proprietary data sources;
- Map data from various sources into a singular and robust data model for aggregation, calculation, and comparability purposes; and
- Perform various data quality checks;
- Be transparent on the coverage or the availability of data you need to comply with the reporting obligations;
- Have look-through data for mutual funds and ETFs available; and
- Produce, publish and disseminate raw data, aggregated and normalized data, documents, and periodic report[5]

Next to the reporting on entity-level, there will also be some disclosure obligations on a product level. For the product level, the specific dates are not yet fully known. For the product level articles, 8 and 9 of the SFDR are the most important. Article 8 states that a financial product is promoting environmental or social characteristics. Article 9 states that products are financial products with a sustainable objective. With the recently published technical standards (RTS), the following disclosure obligations can be distinguished:

- Pre-contract disclosure for financial products.
- Website product disclosure
- Product disclosure in periodic report[6]

TRENDS & POSSIBILITIES

The following statistics can give a picture of the size and the increasing popularity of financial funds with an ESG approach. Between 2018 and 2020 around $100 billion of new capital has flowed into funds managed with an ESG approach. And in each of the past 5 years, ESG focused mutual funds have outgrown all other types of mutual funds. Also, this difference in growth is continuing to widen: in 2019 there was a net inflow of 20% for ESG funds, while growth was less than 4% in other funds. In the second quarter of 2020, every 1/3rd of a euro flowed through an ESG fund. Currently, only around 15% of assets of European mutual funds are managed under ESG policy, however current trends suggest that by 2025 this will have increased to around half the market (PWC,2020). The ESG based fund market is a market where not only in the future but already today large amounts of profits can be made.

Figure 2: Source: PWC (2020)[7].

What is important to understand concerning the growth of the ESG market is the factors that underlie this growth. The following list gives an overview of trends that are likely to impact the ESG market in the coming years:

- Environmental and social changes as important drivers for investment decisions
- A more accurate and better-grounded understanding of these drivers, especially concerning the quantification of these drivers on economic performance
- Introduction of new strict environmental policies and costly compliance
- Responsible investment preferences of new generations
- Return-maximising decision making in financial institutions (often ESG funds have high ROI)
- ESG is assisted by advances incorporate data analysis

- Finally, the status of relationships with suppliers in the current arena is based on the full supply chain, as a result, big public companies will only work with high scoring ESG suppliers

METHODOLOGICAL APPROACH FOR ASSESSING ESG RISK

In the discussion paper the European Banking Authority provides an approach for the assessment of ESG risks. Companies should identify, evaluate and incorporate ESG risks. The following figure provides a view of their comprehensive approach to the assessment of ESG risks.

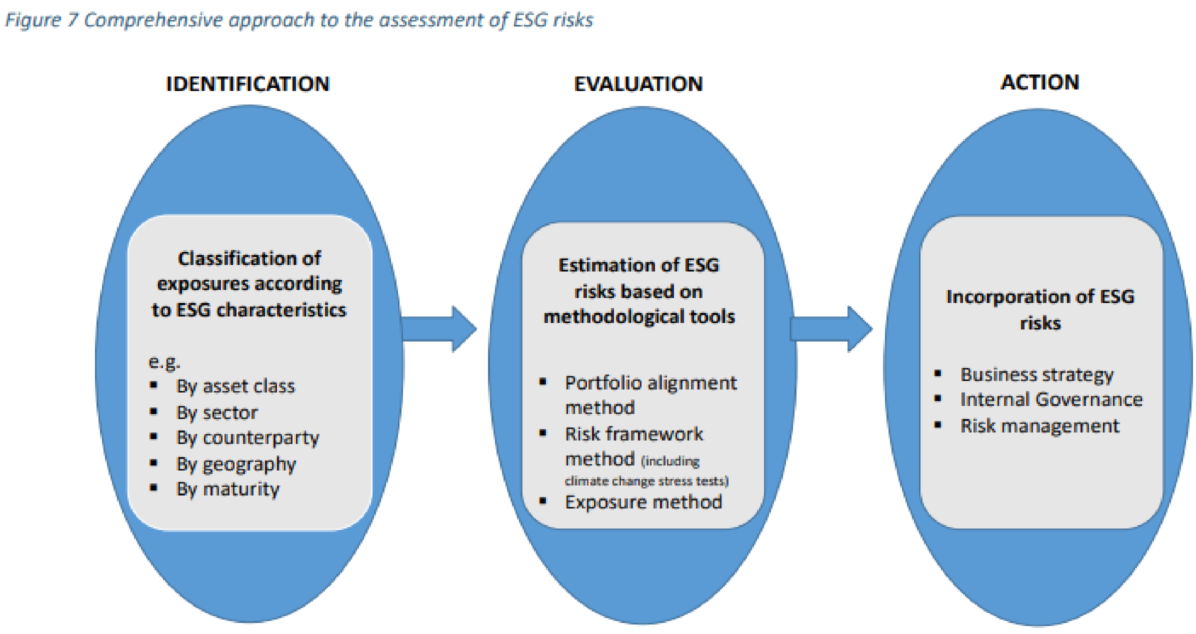

Figure 3: Source: EBA Discussion paper (p.52)

Identify ESG risks

In the identification stage, you should classify your exposures according to their ESG characteristics. This can be done by dividing your assets into different categories according to their ESG characteristics. Some examples of categories are asset classes, sectors, counterparties, geographies, or your assets' length of maturity or position in their life cycles. The categorization helps to identify the portion of assets that are particularly vulnerable to certain risks specific to their category. The result of this process is a better understanding of the main potential drivers of ESG risks for each category which could be looked at in more depth.

Evaluate ESG risks

After you have classified your exposures the application of methodological tools helps to assess the potential impact of ESG risks. The choice of method could depend on the type of ESG risk that needs to be assessed and on the size, complexity, and business model of your company. All approaches ultimately have the goal of assessing the alignment of institutions' portfolios with global sustainability goals and offering insights into the risk caused by exposures to certain sectors. However, there are different ways of achieving these objectives. Each approach is different in terms of what it measures and how the outcome can be used.

The EBA divides the methods for assessing ESG risks in 3 types. They are the Portfolio Alignment Method, the Risk Framework Method and the Exposure Method.

1. Portfolio Alignment Method

You should use the Portfolio Alignment Method if you want to know how aligned your portfolio is relative to global sustainability targets like the Paris Agreement. This method focuses on how much your portfolio would need to change for it to align with sustainability targets. By using you get a clear view of how you would need to change your portfolio and activities to align with sustainability targets.

2. Risk Framework Method

You should use the Risk Framework Method if you want to know how sustainability-related issues will affect your risk profile and its standard risk indicators. It focuses on the sensitivity of your portfolio and the impact on the actual riskiness of your portfolio. Contrary to the Portfolio Alignment Method it does not give information about the way your portfolio is composed relative to sustainability targets.

3. Exposure Method

You should use the Exposure Method if you want to know how individual exposures and clients perform in terms of ESG risk. The ESG risk is measured individually for each counterparty. Whereas the Portfolio Alignment Method focuses on the portfolio as a whole, the Exposure Method looks at individual exposures. The EBA describes this as the easiest method to implement.

Incorporate ESG risks

After having identified and evaluated ESG risks you should incorporate those risks into your business strategy, internal governance arrangements, and your risk management framework. How this could be done is elaborated on in a different section of this document.

HOW TO MANAGE ESG RISKS?

ESG risks need to become a major feature in corporate and public sector decision-making. Potential impacts are regressive and rising over time, and stakeholders may be underprepared to manage them. Decision-making will need to reflect these characteristics.

For companies, this will mean taking climate considerations into account when looking at capital allocation, development of products or services, and supply-chain management, for example.

Changes in mindset, operating model, and tools and processes will be needed to integrate climate risk into decision making. For centuries, we have made decisions based on a world of relative climate stability.

With the changing climate, it will be important to understand and embrace the probabilistic nature of climate risk and be mindful of possible biases and outdated mental models; experiences and heuristics of the past may no longer be a reliable guide to the future. The systemic nature of climate risk requires a holistic approach to understand and identify the full range of possible direct and indirect impacts.

One of the biggest challenges from climate risk will be rethinking the current models we use to quantify risk. The pace and scale of adaptation will likely need to increase significantly. Concludingly, it is crucial to integrate ESG factors to account for ESG risks

Key measures that need to be considered:

- protecting people and assets
- building resilience
- reducing exposure
- ensuring that appropriate insurance and financing are in place

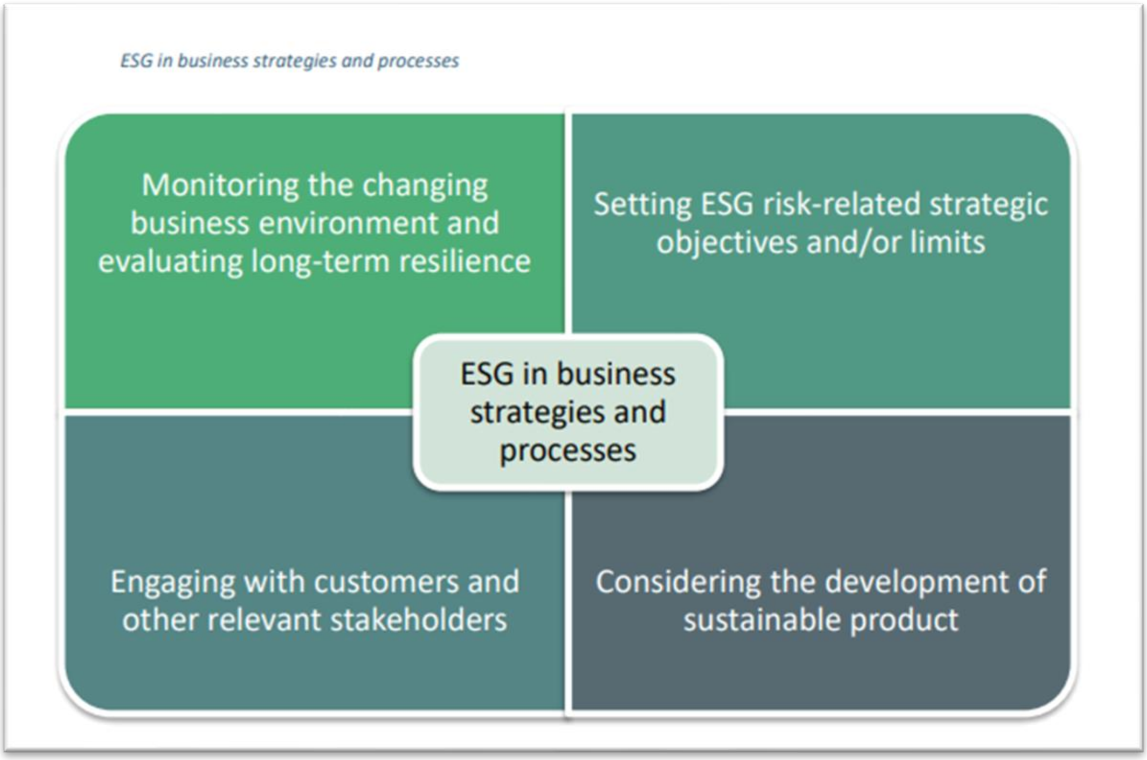

Figure 4: Source : EBA Discussion paper (p.87)

Business Strategy and Business Processes

Current business strategies and processes implement the negative impact from ESG risks on the short and medium-term horizon, the full impact of these risks will most likely happen in the long term. Therefore, businesses must take into account ESG risk now before they are too late to avoid or mitigate long-term impacts. Businesses have to steer their business that is consistent with the expected environmental and social transformations. The next big target businesses should focus on is the UN 2030 agenda for sustainable development and the Paris agreement. With all the targets the EU is setting to reach these goals, there will be significant changes in the business environment in the upcoming years. The following areas were identified as the most relevant for ESG in strategies and processes:

- **Monitoring the changing business environment and evaluating long-term resilience**
  ESG factors of the business environment can be seen in the business strategy of an institution. Here it is important to look at how the ESG risk affects the macro-economic conditions. Different risks arise depending on geographical location, counterparties, and economic sector. Institutions have to adapt their ESG risks depending on one of these factors. ESG risk may also bring along reputational risk if institutions aren't ready to commit to sustainable products.

- **Setting ESG risk related strategic objectives and/or limits**
  Institutions have to design or redesign their business strategies to take ESG into account based on its internal processes. Businesses can then look at the business environment to set goals and/or limits. Institutions can use different European goals to set some objectives. Some examples can be the EU Taxonomy or the sustainable development goals.

- **Engaging with customers and other relevant stakeholders**
  When implementing ESG risks into the business processes, institutions should discuss with their stakeholders. The stakeholders can be internal and external. Internally institutions have to focus on attracting the right person to understand the impact of ESG on the business model. On the other hand, they can do this externally by helping their counterparties implementing ESG in their business models.

- **Considering the development of sustainable products.**
  As an institution you have to develop new services where you as an institution have to come up with ideas that give a loan where you have to pay less rent if the purchase with that money is for environmental purposes and helps to contribute to get to a 0-emission culture.

Internal Governance

The management body and committees have the final word in an institution. To make decisions regarding ESG risk and implementing it in business models and processes all information has to be available. Besides the availability of information, the management body has to understand what the risks are enabling them to change the strategy. They must have an understanding of the short, medium, and long-term effects. Duties and tasks between specialized committees and the management body have to be clear ensuring an optimal working environment. It is key for both parties to work together where the ESG committee has the knowledge, skill, and expertise and where management can then make their strategies based on this knowledge. An institution can set risk management functions to properly control risk. The compliance function complements the risk management framework and monitors the institutions' activities which are legal and regulatory requirements and the internal policies. The other function is the internal audit function where the institution will review all the processes to control that ESG is well incorporated.

Risk Management Framework

For institutions to identify risks in a timely matter and respond to them, they use the risk management framework. An important category for the framework is the risk appetite, the risk an institution is willing to take within its risk capacity to achieve its objectives. By doing this they will be able to have more control over their counterparties in a way that they can interact with them about the policies. Institutions should also include a description of risk appetite in their ICAAP and ILAAP looking at the short, medium, and long-term materialization of ESG risks. For a risk management framework, data availability and accuracy are key. Collecting data from counterparties regarding ESG will be crucial to achieving their objectives. Within the framework, institutions could incorporate ESG risk as drivers for existing prudential risk like market, credit, operational, and liquidity risk. To monitor and mitigate all these risks, institutions should look at the risk limits and risk policies they have put together in the framework. By using correct models and data it is easier to monitor ESG risks continuously. Stress testing is an essential tool for credit institutions but for the moment most stress testing frameworks just include the environmental side of ESG because social and governance risks are more challenging in terms of modeling and data availability.

PLAN OF APPROACH

To be prepared for the upcoming ESG-related guidelines the following approach is recommended:

Identify ESG risks

- Establish exposure categories to divide your assets by
  - For example asset classes, sectors, geographies, or length of maturity
- Collect ESG-related data on your assets

    - For example CO_2 emissions or waste production
- Classify your exposures by category

Evaluate ESG risks
- Establish what approach(es) best fit(s) your company (could be more than one)
    - Portfolio Alignment Method
    - Risk Framework Method
    - Exposure Method
- Use a methodological tool(s) to assess the potential impact of ESG risks on your company

Incorporate ESG risks…
1. into business strategy and processes by, for example:
    - Monitoring the changing business environment and evaluating long-term resilience
    - Setting ESG risk related strategic objectives and/or limits
    - Engaging with customers and other relevant stakeholders
    - Considering the development of sustainable products

2. into risk management by, for example:
    - Creating and/or extend exposure limits to include ESG risks
    - Including risk appetite, thresholds, limits, and time horizons in ICAAP and ILAAP
    - Including the process applied to keeping the thresholds and limits up to date in ICAAP and ILAAP

3. into internal governance arrangements by, for example:
    - Ensuring appropriate monitoring of ESG risks and developments
    - Ensuring that management understands the potential impact of ESG risks on the business model
    - Implement a Governmental framework covering ESG

Support

As a consultancy company, DRS can support you to make a start with implementing an ESG risk framework with the following services:

1. Designing and performing the first plan of approach towards the EBA discussion paper to make visible and decide on which adaptations are necessary.
2. Defining, drafting, and implementing an ESG risk framework based on the EBA discussion paper ensuring adaptability for upcoming stricter regulation.
3. Performing data quality assessment and remediation on existing data sets while offering more suitable data sources plus the data management services if needed.

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