Panel 4: Prudential treatment
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Key messages

1. We are not asking to reconsider the GSF. We are proposing a new Sustainable Finance Supporting Factor (SFSF) that is risk driven
2. Differently from the GSF the SFSF grants a **reduction of capital requirements only for certain eligible sustainable exposures that show a lower financial/credit risk**

SFSF: why

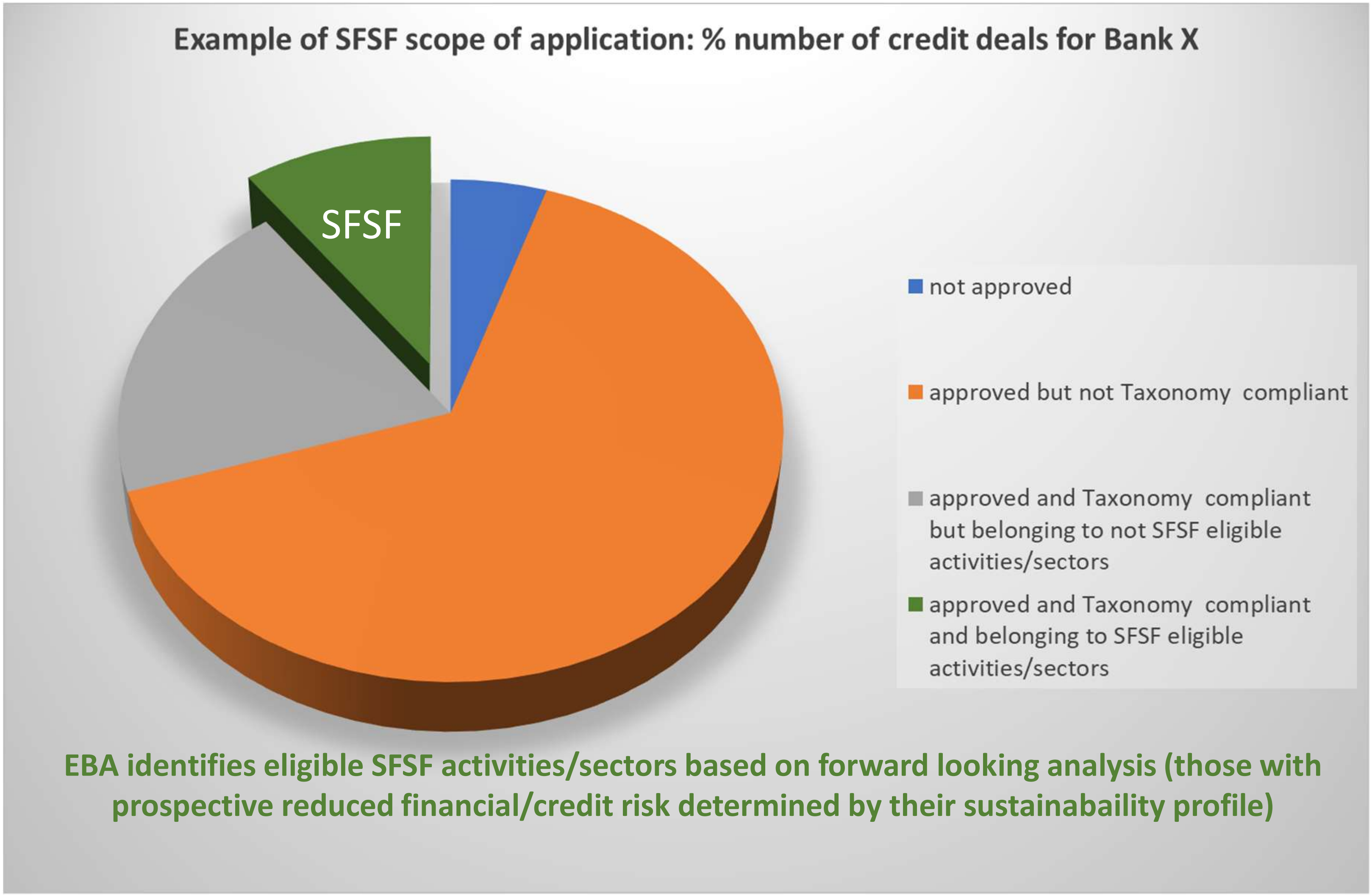
- We believe that there are groups of assets/activities under the EU taxonomy that **have a lower financial risk** in respect to their peers and specifically a lower credit risk profile, exactly **because they are sustainable** (lower transition and physical risk)
- Pending the development of the methodologies for incorporation of the ESG factors into supervisory framework, and in line with the objective to maintain the link between risk considerations and capital our position is asking for a **transitional** sound adjustment of Minimum Capital Requirements.
- May be the name supporting is misleading: it is more an “**adjusting” factor**.
- The supporting factor would only apply to such eligible assets after the capital has been computed as usual and therefore be used as a “discount at checkout”, irrespective of the use of the standard or the IRB/IRBA approach, the type of financial product or its duration.

SFSF: why

- **Credit risk sensitivity** should be followed as a main principle when considering any capital reduction measures. The capital relief should be, to a certain extent, reflective of the **reduced financial risk, while acting as an incentive** to invest in sustainable activities at the same time.

SFSF: examples

- A potential eligible SSAP could be the one that might be identified with the EEMAP project on energy efficient mortgages.
- Others: energy efficiency device production, circular economy projects, etc.


Example of SFSF scope of application: % number of credit deals for Bank X
SFSF
not approved
approved but not Taxonomy compliant
approved and Taxonomy compliant but belonging to not SFSF eligible activities/sectors
approved and Taxonomy compliant and belonging to SFSF eligible activities/sectors
EBA identifies eligible SFSF activities/sectors based on forward looking analysis (those with prospective reduced financial/credit risk determined by their sustainabaility profile)

SFSF: positive «side effects»

- SFSF **recognize the efforts to steer portfolios towards decarbonisation BUT from a risk management perspective**
- SFSF and the ex-ante work needed to identify eligible exsposures can **accelerate the implementation of forward-looking ESG** risk assessments by regulator and banks;
- **SFSF is an incentive to use the Taxonomy for banks and their counterparties:**
  - fostering the decision of corporates and SMEs to invest in the transition towards a sustainable business under the Taxonomy definition thanks to the better credit conditions that banks are likely to apply under a more favourable prudential treatment for eligible sustainable exposures;
  - improving performance of the business sector as companies' awareness of the ESG impact tends to lead to better management decisions, thus contributing to improved and more stable performance.

SFSF: recap

Summary of the main SFSF features

- **Limited scope** – application to **eligible Sustainable Sectors / Activities/Projects (SSAP)** with reduced financial risk identified by the EBA.
- **Risk sensitivity**: the eligible SSAP - with reduced financial risk assessed by forward-looking approaches - could be clustered into a number of **eligible sustainable asset classes (ESAC)** under the prudential regime (e.g. green mortgages, energy efficiency device production, circular economy projects, etc.).
- **Objectivity –** scope defined by the EBA.
- **Level playing field** – the SFSF would apply to both standard and IRB / IRBA approaches.
- **Not replacing risk management** – the application of the SFSF would not exempt the banks from the prior creditworthiness analysis. The SFSF would apply only after calculating own funds requirements as usual. The SFSF would be applied as a "discount at checkout", similar to the SME Supporting Factor.
- **Relatively easy implementation based on information provided by third parties in terms of simple codes of eligible SSAP or ESAC.**
- **Evaluation after 3 years.**

SFSF: more in detail presentation

Pending the development of the methodologies for incorporation of the ESG factors into the supervisory framework and in line with the objective to maintain the link between long-term risk considerations and capital, we suggest that the European Banking Authority explores the possibility of **introducing a supporting factor for certain assets** that are classified as sustainable under the EU taxonomy and, at the same time, meet additional eligibility criteria established by the European Banking Authority.

The proposed supporting factor (**Sustainable Finance Supporting Factor)** would therefore apply to exposures related to **a sub-category** of sectors/activities/projects **(SSAP)** of sustainable taxonomy currently under development in the EU.

Using forward-looking methodologies, we suggest that the European Banking Authority investigates whether there are groups of SSAP under the EU taxonomy that show a lower financial risk, and, specifically, a lower credit risk profile.

To evaluate if some SSAP show a reduced climate related financial risk, we suggest to take into account at least two time horizons: (3-5 years) and (5-10) years.

To identify the eligible SSAPs, we suggest that the **EBA** conducts sample studies in order to collect evidence as to which SSAPs show a reduced financial/credit risk after integration of ESG considerations.

The objectives of such studies would be the identification of **SSAPs with samples that are characterised by a positive delta ESG risk**.[11]

A positive delta ESG risk means that given a certain level of foreseen financial risk, by integrating the ESG profile (regardless of the approach)[12], a decrease in the level of financial risk will occur. We call these **eligible SSAPs**. The eligible SSAPs should be **disclosed by the EBA**.

The exposures belonging to such eligible SSAPs could then **benefit from a lowered capital requirement by means of application of a supporting (reduction) factor on their already calculated RWA**.

[11] A potential eligible SSAP could be the one that might be identified with the EEMAP project on energy efficient mortgages.

[12] Some technics already used in other ESG studies could be applied at a sectorial/SSAP level in order to integrate the ESG dimension into the traditional prospective economic evaluation. Among these:

- Sectorial forecasted financials: Adjustments are made to forecasted financials for the expected impact of ESG factors.
- Sensitivity/scenario analysis: Adjustments are made to variables (sensitivity analysis) and different ESG scenarios (scenario analysis) are applied to valuation models to compare the difference between the base-case sectorial valuation and the ESG-integrated valuation.

SFSF: methodology to individuate eligible exsposures

- The speed of negative climate change impact, potential new climate regulation or taxation and changing consumer behaviour represent a structural breach. The traditional retrospective approach does not capture the risk and **sound forward-looking techniques** capturing the longer-term nature of environmental risks are needed.

- Some forward-looking approaches are emerging even if mainly in the field of investment portfolios.
- For example **CLIMAFIN methodology**, is now applied by several central banks and regulators (e.g. EIOPA) to price climate transition risks in the value of sovereign bonds and assess the largest losses on insurances' portfolios.
- The methodology is transparent and peer reviewed and already operational and applied e.g. to the portfolio of the Austrian National Bank)
- The logical framework (taking into account climate scenarios and climate policy/transition scenarios in order to assess the risk connected to some assets) could be analysed in order to be replicated on sample exposure from a portfolios of loan exposures asset classes.
- For the climate stress test methodology using forward looking climate transition scenarios and shocks trajectories to calculate climate financial risk metrics, please refer to: *Battiston S., Mandel A, Monasterolo I., Schuetze F. & G. Visentin (2017). A Climate stress-test of the EU financial system. Nature Climate Change, 7, 283–288.*Reference to the methodology for pricing forward-looking climate risks in the value of sovereign bonds: *Battiston, S. and Monasterolo, I. (2019). A climate risk assessment of sovereign bonds' portfolio. Working paper available at SSRN: https://ssrn.com/abstract=3376218.*"Climate risk and financial stability in the network of banks and investment funds" *Alan Roncoroni, Stefano Battiston, Luis Onesimo Leonardo Escobar Farfan, and Serafin Martinez Jaramillo.*

For a well-calibrated prudential regime, eligible SSAPs could be further clustered into a number of **Eligible Sustainable Asset Classes (ESAC)**.

For instance, in the CRR, "Salary found credits" exposures are a specific asset class (a sub-asset class of retail exposures) and receive a specific treatment.

Therefore, other sub-asset classes can be defined in relation to some eligible SSAP (e.g. green or energy efficient mortgages, energy efficiency device production, etc.).

Introducing a targeted supporting factor for eligible SAAPs exposures **does not substitute the creditworthiness assessment** performed by credit institutions and required by the existing prudential framework[13].

As with any other credit exposure, the first prerequisite to grant the credit remains a proper credit quality standing and proper risk management. Therefore, as in the case of any other specific asset class already foreseen in the CRR, the creditworthiness of eligible borrowers and capital requirements will be assessed by banks according to the Regulations and Guidelines in force, before the supporting factor is applied, as an adjustment to risk weights for non-defaulted exposures.

The supporting factor would only apply after the capital has been computed as usual and therefore be used as a "discount at checkout", irrespective of the use of the standard or the IRB/IRBA approach, the type of financial product or its duration.