Climate stress testing

Meeting – ECB/EBF

24 June 2021

European Banking Federation

General questions

Objectives and outcomes

What is the purpose and the stated objective of the exercise?
We welcome that results will only be disclosed on an aggregated basis with focus on main conclusions.

- 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?
- Could ECB confirm that this is a learning exercise and no capital implications are expected?
- 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?
- How will ECB envisage the communication of the results to avoid misinterpretation? (in particular *stress tests* for the three-year scenarios and *climate scenario analyses* for the longer-term exercises.)?
- Will all the caveats, gaps and limitations be clearly communicated?
- Are there any plans/coordination regarding LSI? (too complex for LSI, proportionality and materiality key)

Preparation

Need of an ongoing industry dialogue and a more detailed roadmap of ECB in the period July-December 2021 but also granularity on planning beyond 2021
Need for planning and announcement of which banks have to participate in full exercise ideally before end of August 2021. Which banks should participate in any case?

- **Could the SSM share a detailed roadmap from July to December**? Can more information regarding the announced workshops to facilitate banks preparation be provided?
- 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? When will the adjusted NGFS scenarios be shared with the market? (need for clarity well before December 2021).
- **Can ECB open an interactive online Q&A tool?**
- What criteria is used by the ECB when determining which bank should or should not participate in module 3 (scenarios)? Will proportionality and business model be considered? Is ECB considering to provide a generic **proxy/benchmark model for transition rates, lifetime loss rates, etc., so that a small bank without a waiver** can make use of this? If this is not provided what are the expectations
- 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 action plans will be taken into account in determining the participation? How will the responses provided in the Climate Action Plans submitted to the ECB (Questionnaire A&B) be used to benchmark participating banks?

Data

Need for central datawarehouse

- Would ECB consider providing access to common data(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?
- Scope 3 data: Could ECB provide clarification on the use of proxies for counterparties' Scope 1 and 2 emissions especially when disclosed information is limited in certain geographies? Is ECB considering providing more guidance for estimate GHG emission, especially for scope 3? In case no data are provided by the ECB, will banks be allowed to agree on a third party data provider or be allowed to exchange information. Alternatively, would ECB consider calculating scope 3 emissions itself on counterparties'LEI provided by banks (as done by EBA in the pilot sensitivity?)
- EPC: Wil banks be allowed to use proxy for missing EPCs based on other available data samples? Central EPC database needed.
- Top 20 corporates per sector : Is ECB considering an alternative approach? (e.g. top 100 regardless of sector or top 5 per sector)? What approach to apply for missing data for corporates in the required "Top"?
- Counterparty level approach does not consider separately loans financing the green transition of enterprises in high GHG emission sectors. Is ECB considering reflecting such exposures?
- Will ECB reconsider requesting revenues from 2021 as this request is unrealistic?
- 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. Is ECB envisaging to align deadlines with broader publications?
- Are tolerance buffers envisaged in the consistency checks with FINREP and COREP (e.g., 90% reconciliation or reconciliation through "other" residual bucket)?

Scope

- How will proportionality and materiality be reflected in relation to stated objectives of the exercise?
- Is ECB considering a phased approach? (e.g best effort basis in 2022, staggering Modules 1, 2 and 3)?
- Is the ST limited to the banking activity of the group in case of conglomerate structure (i.e. all exposures, revenues and stress projections for banking activities only)?
- Is ECB envisaging to narrow the scope? (E.g. narrower scope of customers in case of financed emissions, postponing SME Retail (module 3) , reducing the scope of NACE codes e.g. in accordance with SBTi NACE codes.
- Is ECB envisaging some simplification? (e. Some computation prescription, operational risk, validation requirements as banks will not be in a position to conduct and provide a validation of proxies and models used, simplified modelling solutions on less emitting sectors)?

Specific comments

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. (e..g 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
- Could it be confirmed that a set of references to banks disclosed information (i.e. Climate report) will be sufficient?
- Metric 1
  - **Is the data request for this template same as the one for Pillar 3 template**?
  - Could you please confirm that asset management fees are not included in the calculation of metric 1 ?

Module 3

- **Modules are not yet developed on a sector level and do not take emissions into account. It is not feasible to develop and validate models before January 2022**
- 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)?
- The ECB should ensure consistency of the NGFS scenarios with projections and parameters currently in place for other purposes, at least for the short term scenarios.

Credit risk

- **Long term objective of the static balance sheet on 2030, 2040 and 2050 is unclear.**

- 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 LGD**s? 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?

Credit risk

- 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).

- **Clarification is needed as to whether for mortgages the impact should only be reflected on the LGD, or also on the PD of those mortgages.**

- **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.*

- *Request for confirmation that FVOCI positions excluded.*

Market Risk

- 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 lease clarify whether such exposures should be included in the exercise or not.**

Operational/reputational risk

- Projections 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 highly speculative and not reliable**
- **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 PnL 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 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 request related risk management frameworks in place within the institutions, rather than figures.**