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BNPP reply to the EBA discussion paper on management and supervision of ESG risks for credit institutions and investment firms

We welcome the EBA proposal as we believe it is comprehensive and globally well-balanced and it demonstrates a good understanding of the challenges faced by credit institutions when incorporating ESG factors into risk management.

Chapter 4: Common definitions of ESG factors, ESG risks and their transmission channels

Question 1: Please provide details of other relevant frameworks for ESG factors you use.

In BNP Paribas terminology, **ESG factors are referred to as ESG "risk drivers" and not as a separate risk type**. As part of BNPP Risk Identification and Assessment process, "risk drivers" are causes or factors that can give rise to "risk events" (i.e. "severe but plausible" scenarios) and explain the magnitude of their severity.

The themes, subjects, concerns underlying BNP Paribas ESG drivers are very comparable - if not the same - as the ones included in EBA discussion paper, but they are larger, less granular, less specific.
ESG factors as defined by EBA are very detailed. In its approach, BNP Paribas has aggregated ESG factors / drivers in wider and uniting factors, namely: "climate change" factors, "other environmental" factor and "human rights and social" factor. Current BNP Paribas definitions of ESG drivers do not always explicitly mention all the elements listed by EBA and that underlie the 3 ESG pillars but this is more about exhaustiveness rather than fundamental divergence in approach.
BNP Paribas ESG risk drivers taxonomy will evolve to take into account relevant developments in that respect.

Question 2: Please provide your views on the proposed definition of ESG factors and ESG risks

We agree with the definition of ESG factors in § 30 and the fact that they may have positive and negative impacts, potentially acting as risk mitigators or risk drivers.

Regarding the definition of ESG risks in § 30, we suggest replacing "the risks of any negative financial impact to the institution" by "the risks of a material negative financial impact to the institution", to better reflect risk-based approach and proportionality.

Most importantly, there are currently many initiatives covering ESG factors and ESG risks, including the ECB Guide on climate and environmental related risks. It is of the outmost importance to **reach a common understanding of ESG factors and ESG risks**, so banks do not have to constantly adapt their processes and reporting. Accordingly, **we** call for close coordination and phase-in of regulatory and supervisory initiatives and approaches.

Equally, as stated in the discussion paper, ESG factors and their associated risks are likely to evolve over time. We share the view **that any policy framework should allow enough flexibility** to adequately address emerging issues in the transition to a sustainable economy.

The distinction between ESG factors and ESG risks may be somewhat confusing and we would like to propose some clarifications and simplifications.
If the definition of ESG factors is pretty straightforward and intuitively understandable, in the sense that those factors can trigger either a reduction of ESG risks or a materialization of some risk types such as credit risk market risk or operational risk, introducing the notion of ESG risk, suggesting that it could be a separate risk type, does not bring clarity. **A credit risk that is triggered or aggravated by one or several ESG factors does not change the intrinsic nature of the risk type, it remains a credit risk**. **While it is important to identify situations where credit risk events are triggered or aggravated by ESG factors, they should not be considered as distinct ESG risk events, on the basis that they are "coloured" by ESG factors, they are still credit risk events.**

For EBA, ESG risks are defined as "risks of any negative financial impact to the institution stemming, from the current or prospective impacts of ESG factors on its counterparties". This means that all scenarios and risk events which driver(s) are ESG factors and that lead to negative financial impacts for the institution shall be considered as ESG risks no matter what their intrinsic risk types are (credit, market, operational...). While we believe that the notion of ESG risks is not a prerequisite necessary to perform such analyses, it can be acknowledged that the ability to identify the risk events and scenarios (belonging to any risk type) that are triggered or aggravated by ESG factors is certainly necessary. **Therefore, in case the concept of ESG risk has to be used for the sake of simplification, it should be defined as "risk events triggered or aggravated by ESG factors**".
The concept of "ESG risk event" should be defined as "risk events triggered or aggravated by ESG factors". In any case, the framework should avoid any risk of double counting which may arise if an ESG risk event is taken into account in an ESG risk and in a traditional risk (credit, market, operational).

Last remark, we support the *double materiality concept* ($36) of ESG Risks (for climate for instance, the impacts of climate risks on banks financial risks vs the impacts of banks on climate**). Our primary objective is to set business strategy and commercial priorities in order to encourage and accompany our customers to contribute positively to the decrease of the climate warming and to a sustainable society and planet.** However, we also believe that it could **be useful to have some examples** on how to assess the double materiality for environmental risks and social risks, especially when considering **the full value chain in a company's production cycle.**

Question 3: Do you agree that, for the purpose of assessing their inclusion in institutions' and supervisors' practices from a prudential perspective, ESG risks should be approached primarily from the angle of the negative impacts of ESG factors on institutions' counterparties?

We consider the **ESG is, above all, a business development strategy**, that is to say, it does not solely represent potential negative impacts over Institutions' counterparties, it should be considered primarily as the key vector for business opportunities and development in the coming years, and therefore, **supervisors' practices from a prudential perspective should consider positive effects and incentives as well.**
When comparing individual companies in individual sectors, a positive assessment of the company's management of its ESG factors will have a positive impact on its ESG profile and should therefore be taken into account ("best in class" per sector for instance).

Indeed, given the massive investments to be financed in European and globally to achieve the goals of the Paris agreement, the policy framework should adopt a symmetrical approach to both positive and negative ESG drivers.

Question 4: Please provide your views on the proposed definitions of transition risks and physical risks included in section 4.3.

We agree on the definition of physical risks proposed by the EBA in §$ 54.

Regarding transition risks, we agree with the EBA proposal of definitions that include examples. However, we propose to complement the list of examples (climate and environmental policy changes, technological changes and behavioral changes) with other examples related to « market conditions » …Alternatively, it could be useful to clarify that the impact of ESG drivers on market conditions have not yet been analyzed and therefore will be dealt with at a later stage.

Question 5: Please provide your views on the proposed definition of social risks and governance risks. As an institution, to which extent is the on-going COVID-19 crisis having an impact on your approach to ESG factors and ESG risks?

Banks are currently developing their understanding on assessing and addressing climate risks, especially transition risks, whereas other risks such as biodiversity and other environmental risks do not benefit from a similar level of understanding and offer an even more limited availability of relevant data. It is even more true for **social risks and governance risks**. We propose to **include them, as a first stage, in a purely qualitative manner**. ***A phased-in approach*** is highly necessary to get a better understanding of risks at stake, organize internal processes and systems, retrieve appropriate data and develop robust methodologies.

Same remark **for Social risks** as for ESG risks (see response to question 2). **Situations where counterparties are negatively affected by social factors should not be identified as Social risks but rather as risk events triggered or aggravated by social factors**. The Social risk drivers used by BNPP are:

- Human rights,
- violence, torture or cruel treatment/non-respect of the right to life and liberty,
- non-respect of the right to education and to self-determination,
- labor standards in the supply chain,
- child, slave and bonded labor, workplace health and safety,
- non-respect of freedom of association and freedom of expression,
- human capital management and employee relations,
- non-respect of diversity,
- relations with local communities,
- activities in conflict zones,
- health and access to medicine,
- Non-respect of consumer protection and data privacy and use of controversial weapons.

Same remark for Governance risks as for ESG risks (see response to question 2) and Social risks (see the first part of the response to question 5). Situations where counterparties are negatively affected by governance factors should not be identified as Governance risks but rather as **risk events triggered or aggravated by governance factors.**

Regarding the **COVID 19 crisis**, its interaction with ESG risks is not straightforward. We find it is too early yet to elaborate on the potential impact of the ongoing COVID crisis on our approach to ESG factors and ESG risks. However, the on-going **COVID crisis** sheds a new light on the negative impact human activities can have on environment and health. With that regard, this crisis dramatically increases the awareness regarding the potential severity of ESG factors.

Question 6: Do you agree with the description of liability transmission channels/liability risks, including the consideration that liability risks may also arise from social and governance factors? If not, please explain why.

Yes we do agree with the EBA definition in § 90 : "*Liability transmission channels/liability risks are the risks posed by the exposure of institutions to counterparties that may potentially be held accountable for the negatively impact through their activities on the environment, the society and their governance factors.*"

Same remark for **Liability risks** as for ESG risks (see response to question 2), Social risks (see the first part of the response to question 5) and Governance risks (see the second part of the response to question 5). Situations where counterparties are held accountable for the negative impact through their activities on the environment, the society and their governance factors should not be identified as Liability risks but rather as **risk events triggered or aggravated by Liability transmission** channel of ESG factors.

Question 7: Do the specificities of investment firms compared to credit institutions justify the elaboration of different definitions, or are the proposed definitions included in chapter 4 also applicable to them (in particular the perspective of counterparties)? Please elaborate on the potential specificities of investment firms in relation to ESG risks and on how these specificities, if any, could be reflected in this paper.

Based on the "same activity, same risks, same rules" principle, we do expect a level playing field between competitors.
For BNP Paribas, the sensitivity of investment firms to ESG factors does not impose to define a different framework to apprehend ESG concerns.

Chapter 5: Quantitative and qualitative indicators, metrics and methods to assess ESG risks

Question 12 (p53): Do you agree with the sequential steps identified in this discussion paper for the incorporation of ESG risks in institutions 'management practices? If not, explain why?

We do agree with the three-step approach (identification, evaluation, action) described into the discussion paper for the incorporation of ESG risks in institutions 'management practices.
However, we find the term "ESG characteristics" unclear. Regarding the "evaluation" part, the proposed evaluation methods will enable to create ESG indicators (that may be a valuable indication of the level of exposures of the institution to ESG factors).

In addition, it is a process that requires **flexibility** and should be driven by the credit institutions, based on their risk profile and the general level of knowledge on ESG risks drivers.

Besides, current methodologies or data available are not accurate enough to be used as reliable tools leading to management decisions. Given the levels of uncertainty, they can only give estimations and trends.

Question 8: Please provide your views on the relevance and use of qualitative and quantitative indicators related to the identification of ESG risks.

BNPP uses some EBA examples for classification purposes: by counterparty, by sector and by geography.

Regarding the classification by asset class, BNPP is developing its own internal methodology (ESG classification criteria and reporting structure) to assess the greenness of its portfolio at transaction level. This methodology is being internally validated for a first implementation during 2021.
BNPP does use the EU Taxonomy classification as one of the inputs, among others, to its internal classification approach.

By bringing a common set of definitions and thresholds for sustainability performance that is also publicly available, the EU Taxonomy will bring consistency, transparency and comparability across the financial industry. This should be a great mitigating factor against the risk of being perceived as "greenwashing" and help to reduce reputational risk for financial institutions and liability risks for all stakeholders alike.
In addition, a consistent set of definitions for economic activities, environmental impacts and benefits will give to banks and their clients a common language which will facilitate banks' engagement efforts with their clients.
Banks see also in the EU Taxonomy increased business opportunities with, for instance, advisory services to client on the basis of their newly gained understanding of the EU Taxonomy and potential increased demand for sustainable finance products.
Finally, the increased transparency on assets, use of Ecolabel or standards related to the EU Taxonomy, could increase certainty and confidence of retail customers as the framework is shared by all investors and will have the 'approval stamp' of the EU.

As the **ECB clearly states**, the taxonomy captures positive substantial contribution assessing the alignment of a given economic activity with defined sustainability goals – and not from a risk management perspective, which is aimed at minimising exposures to climate and environmental risks. (Cf. ECB answer to the consultation on the Renewed Sustainable Finance (p.9)). Indeed, the EU Taxonomy does not embed any risk characteristics. **The ESG risk management framework needs to include, in addition to the sustainability of the activity, many other components** such as the holistic ESG profile of the clients and their transition risk profile, the location of the funded assets, the risk the counterpart to invest in the loosing technology (electric / hybrid)… ESG **salient risks** need to be determined and monitored based on **internal ESG assessment of counterparties and on sector sensitivity to the risk analysis**.

The use of the EU Taxonomy for ESG risk management purposes should remain voluntary for those banks that do not aim at developing an internal classification framework.

Both **qualitative and quantitative indicators** are relevant to support ESG risk drivers. Nevertheless as mentioned in the EBA DP institutions are facing data quality issues that's why in the short/medium **term a limited set of accurate kpis** (sector specific if needed) should be selected and required by non financial reporting **from corporate** in order for financial institutions (FIs) to collect data with a sufficient level of quality and homogeneity. Aligning disclosure requirement from corporate and quantitative KPIs supporting ESG risk identification for FIs is key.

Question 9: As an institution, do you use or plan to use some of the ESG indicators (including taxonomies, standards, labels and benchmarks) described in section 5.1 or any other indicators, inter alia for the purpose of risks management? If yes, please explain which ones.

Cf. our answer to question 8. We need to distinguish the ESG indicators that can only be used for disclosure purposes from those for ESG Risk management purposes. **The classification framework, standards, labels and benchmarks based on the EU Taxonomy** are appropriate only for disclosure purposes, and **not for risk management purposes.**

The EU Taxonomy or 'green assets ratio' is a tool that indicates the current level of sustainability of the banks assets. It does not assess companies' strategies or overall management of ESG. It needs therefore to **be complemented with other tools in order to properly assess and steer the bank's portfolio. That's why the bank chose as a monitoring tool the measure of the alignment of the credit portfolio on the Paris Accord well below 2 degrees scenario and why it has embarked upon its sustainable business strategic plan 2022-2025 to increase our share of wallet in sustainable solutions we currently provide to our clients**.

Question 10: As an institution, do you use or plan to use a portfolio alignment method in your approach to measuring and managing ESG risks? Please explain why and provide details on the methodology used.

We are of the views that the three methodological approaches proposed by the EBA in chapter 5.2, portfolio alignment, risk framework and exposure method, should remain voluntary. Flexibility is key at this stage where banks and regulators are at the beginning of the learning curve on ESG risks drivers. However, BNPP is developing its ESG risk framework including these three methodological approaches, as we consider they respond to different objectives and complement each other.

We believe that the portfolio alignment method is the most appropriate tool to analyse and manage the climate-transition risk attached to our credit portfolios.

Following the Paris Agreement, signed in 2015 by 195 countries, BNP Paribas has committed to contributing to the objective of keeping the level of global warming well below 2° Celsius with respect to pre-industrial levels. To achieve this, the Group has implemented several financing and investment policies, intended to oversee the sectors that generate the largest quantity of greenhouse gases. These policies are among the strictest in the world, but they are not sufficient for ensuring that the entirety of our loan activity will be driven by reducing greenhouse gases and achieving the climate objectives in the Paris Agreement.

Therefore, in December 2018, during the COP24 in Katowice, BNP Paribas and four other banks (BBVA, ING, Société Générale and Standard Chartered) committed to measuring the alignment of their loan portfolios with climate targets and studying their capacities for gradually moving their financial flows towards activities compatible with the Paris Agreement.

On September 2020, these banks jointly published with 2 Degrees Investment Initiative a report on the application of the Paris Agreement Capital Transition Assessment (PACTA) to their credit portfolios. It is worth mentioning that PACTA is Open Source. In addition, the approach is dynamic. The analysis proposed is sectoral and was tested as a priority on the economic sectors producing the most GHG emissions: **automotive, power and fossil fuels**. The extension of its application to other sectors, along with the availability of the data will probably lead to further adjustments. And lastly, its adoption by banks and industrial stakeholders should also enable further improvements.

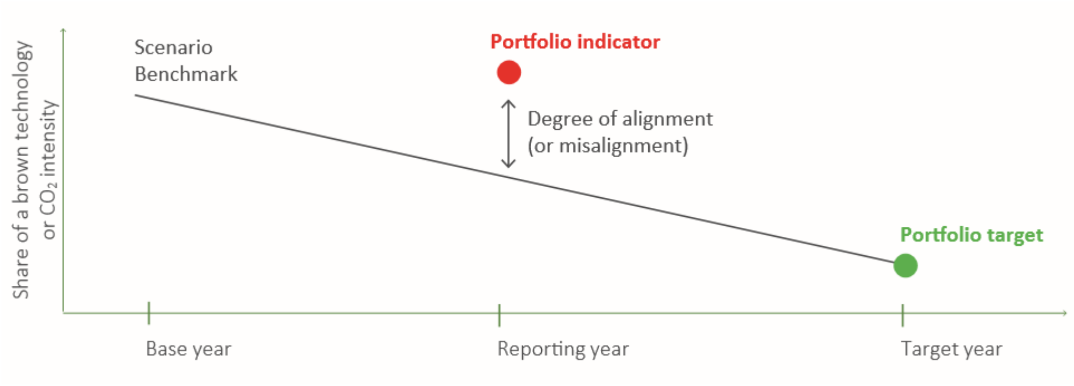
Measuring alignment requires drawing links between financial instruments, the clients' activities being financed, and the goals of the Paris Agreement. First, the 'goals' of the Paris Agreement (achieve well below 2°C and if possible 1.5°C increase in average temperatures relative to pre-industrial levels) can be translated into usable data and indicators using a climate scenario. Such socioeconomic scenarios outline the potential pathways needed to reach the Paris goals. They operationalise the Paris Agreement into carbon budgets and **sector-specific transition pathways** or 'technology roadmaps' using the shift in types of physical asset (e.g. from brown to green power plants) over time and financial metrics to show a potential pathway to achieve the global warming target. We refer to these physical and financial metrics as **scenario benchmarks**: they reflect the specific transition pathways for a given activity (a technology, a commodity, a process or an industrial sector), depending on the sector and activity (e.g. in automotive, a shift to zero-tailpipe emission propulsion technology, while in steel the focus would be on a shift in the industrial process of steelmaking). The **negative or positive contribution (or impact) of the counterparties' operations is captured using one or several indicators**, for instance, using the counterparty electricity production mix for the power sector or emission intensity of oil & gas production for the fossil fuel sector, etc. Several types of indicators may be used to represent various features of the transition: some indicators may capture technological substitutions (i.e. decrease in brown and increase in green, such as switching from conventional to electric cars), while others may capture the technological improvement (e.g. increasing the energy efficiency/decreasing the CO2 intensity). And for sectors where a phase out is needed, for example coal mining, a change in the total financing provided can also be adequate.

The financial instrument / portfolio/ client/ asset is considered '**aligned' if the level of the indicator is below that of the benchmark for decreasing benchmarks (brown activities) or above for increasing benchmarks (green activities).**

This methodology enables the steering process of reorienting the financial instrument so that it stays on track with the trajectory. It can be achieved at portfolio level, either by accompanying existing counterparties to align their activities, or by adjusting the customer base (ending relationship with less aligned clients or starting relationships with better aligned companies).

PACTA enables to analyse and manage the alignment of the Bank portfolio to specific climate scenarios.

FIGURE 2 | *Illustration of alignment at portfolio level*



The benefit of this approach is that it better addresses the transition pathways: alignment is measured versus the trajectory and not versus the target.

Question 11: As an institution, do you use or plan to use a risk framework method (including climate stress testing and climate sensitivity analysis) in your approach to measuring and managing ESG risks? Please explain why and provide details on the methodology used.

a. "Climate Stress Tests" wording should be usefully replaced by "climate risk scenario analysis"

Regarding scenario analyses, we would like to insist on the fact that no agreed methodology exists so far and that the primary focus is currently on climate transition risks with little progress on climate physical risk scenarios and none in relation to other environmental risks.

BNP Paribas is today actively participating to the exploratory pilot exercises lead by several European regulators based on different approaches. In particular, we contribute actively to the ACPR exercise which is conducted on a "test and learn" mode.

We fully support that those exercises are not aimed at developing a prudential approach yet. The results of scenario analyses should be considered with great caution and the preliminary findings should not give rise to formal expectations at this stage.

We agree on EBA's analysis that "*Climate stress tests remain work in progress and should not be expected to provide the same level of precision as standard bank stress tests. To-date they remain of less comprehensive nature than the usual stress tests – they are an assessment of certain portfolios but do not make any conclusions about potential capital implications. Climate stress tests based on scenario analysis are a useful and important tool, however given their complexities and many uncertainties, they also need to be assessed and interpreted with caution*."(§124)

This is the reason why we believe that, for the moment, the "Climate Stress Tests" wording should be replaced by "climate risk scenario analysis", to avoid any confusion by stakeholders, and any attempt to incorporate climate scenarios into the existing Stress Testing framework. Vulnerability to climate risk should be assessed with a limited number of exploratory scenarios, over a much

longer horizon (10/30y) on a best effort basis, including with the Supervisors lead climate pilot exercises, and outside the usual stress test exercises.

This would prevent any confusion with the existing EBA Stress Tests (next in 2023) and make it clear that climate related scenario analysis outcomes should not lead to any capital charge, whereas the traditional stress tests result in a Pillar 2G charge.

Last, we would like to remind that the prudential capital requirements aim to cover the unexpected losses at one year horizon (the expected losses being covered by the provisions). Hence, it is not appropriate to require regulatory capital to cover the Long Term horizon climate risk impacts on banks.

As a conclusion, regarding **climate-related scenario analysis**, Banks consider them as the **most appropriate tool the measure the materiality of ESG risk drivers and their impacts on the business model and welcome the pilot exercises launched by supervisors such as ACPR's pilot exercise on assessment of climate risks.** Thanks to fruitful experience and lessons learnt, such exercises pave the way, on both supervisors and institutions' sides, for the development of reliable and robust regulatory and internal methodologies for climate-related scenario analyses. Forward-looking analyses are naturally the best approach for capturing potential impacts of ESG risk drivers, because ESG risk drivers are intrinsically forward-looking in the very long-term. Moreover, climate-related sensitivity analyses outcomes should for the time being focus on ESG-related KPIs, and in a secondary manner, specific financial indicators, in order to focus on the measurement of ESG risk drivers on the business model. **Consequently, such climate-relate scenario analyses should remain clearly differentiated from solvency-related stress testing exercises, which use different methodologies, pursue different objectives and therefore measure different impacts, based on different indicators.**

b. We believe that the ACPR pilot exercise on climate related risks has built the most relevant methodologic framework on climate transition risks, and through in depth dialogue and co-construction manner

We welcome the ACPR approach that aims to measure the impact on credit risk and market risk of scenarios of late / fast transition with a detailed focus on sectors. ACPR defines its base line scenario in fully alignment with carbon neutrality in 2050. The main characteristics of the ACPR pilot exercise are that:

- Climate variables are reflected into the macro financial variables at granular sector level
- It will not lead to any capital requirement nor prudential ratio
- A robust first methodology has been jointly developed with the French Banking sector
- It is consistent with the NGFS recommendations related to climate risk scenarios
- The overall framework is an adaptation of EBA ST approach and templates facilitating the understanding by all stakeholders

We have also committed to participate to the BoE 2021 biennial exploratory scenario on the financial risks from climate change ('BES'), which has been postponed for covid reasons to June 2021. This exercise requires more granularity and more complex scenarios Hence, it raises more feasibility challenges, leaving potentially to strong impact of methodological shortcuts, than the ACPR pilot exercise. In addition, it is less focused than ACPR on Paris Accord trajectory and transmission channels through macro-financial variables.

On the basis of the work conducted, we strongly support ACPR framework and encourage the ECB to leverage on it in its upcoming 2022 climate risk exercise, with some adjustments (especially on the scenario side).

c. The EBA climate sensitivity analysis should be performed jointly with the banks

We understand that the first objective of the exercise requested by the EBA is to test the readiness of banks to apply the EU green taxonomy, for disclosure purposes, which is a separate topic from climate sensitivity analysis.

As regards the sensitivity analysis itself, we insist that EBA should clarify that "No sensitivity analysis on the EU green taxonomy classification will be run". Indeed, we strongly believe that, while the EU taxonomy is a major component of the overall ESG framework, allowing the harmonization of the definition of "what is green", and therefore eliminating the risk of "green-washing", the EU taxonomy is not to be used in ESG risk management. Indeed, risk management requires a more comprehensive analysis of ESG risk drivers, as well as a more forward-looking approach, such as for example in the PACTA methodology, in the ACPR climate exercise on climate relates risks, or in the customer ESG risk profile and transition strategy assessment.
For the risk sensitivity analysis, we reiterate our recommendation that it should be conducted by EBA in a spirit of "co-construction" with banks, in order to maximize the benefits for banks and regulators.

Question 13 (p71): As an institution, do you use or plan to use an exposure method in your approach to measuring and managing ESG risks? Please explain why and provide details on the methodology used.

BNPP is developing its own methodology and tool to assess, on a holistic approach the ESG profile of its clients, and among others, their transition risk profile. The BNP Paribas methodology aims to determine and monitor the ESG salient risks, based on internal ESG assessment of counterparties and on sector sensitivity to the risk analysis.

We welcome EBA do not impose overly prescriptive methodologies. **Regulatory requirements on ESG Risk management should be principles based**. No quantitative KPIs nor mandatory EU Taxonomy classification should be required. Regulatory guidelines on common climate scenario design, alignment of banks' portfolios to Paris Agreement would be helpful. However, when it comes **to client knowledge, assessment of clients' ESG profiles and credit risks, flexibility should be maintained to build expertise and allow banks to perform idiosyncratic risk analysis.** Credit committees or senior credit officers can review, challenge, and integrate ESG profiles of customers into the holistic view they have on clients and in their decision process.
However, a **Standard Approach** could be developed for small banks.

Question 13 (p77): As an institution, do you use or plan to use any different approaches in relation to ESG risk management than the ones included in chapter 5? If yes, please provide details.

No.

Question 14: Specifically for investment firms, do you apply other methodological approaches, or are the approaches described in this chapter applicable also for investment firms?

N/A

Chapter 6: The management of ESG risks by institutions

Question 15: Please provide your views on the extent to which smaller institutions can be vulnerable to ESG risks and on the criteria that should be used to design and implement a proportionate ESG risks management approach.

We do not agree that institutions are per se more vulnerable to ESG risks drivers depending on their size. Vulnerability will be more directly linked to a bank's business model, its sectorial exposures and its level of risk concentration. Instead, **the materiality of ESG risk drivers should be the main point of focus.**

Depending on the institution's business model, some ESG risk drivers may more relevant than others. The proportionality principle should then apply, with the institution developing full internal methodologies for the most relevant risks and simplified ones for less relevant risks, at least in the short term.

In CRR2/ CRD5, proportionality covers only **reporting and disclosing requirements** (frequency…). We could apply the same approach for ESG Risk Management.

Question 16: Through which measures could the adoption of strategic ESG risk-related objectives and/or limits be further supported?

Many banks have already made several commitments in the area of ESG and are developing adequate tools to monitor progress towards those commitments. Those are related to ESG business strategies and should remain outside the regulatory space.

Question 17: Please provide your views on the proposed ways how to integrate ESG risks into the business strategies and processes of institutions.

Engagement with customers and other relevant stakeholders: While we support engagement with clients on ESG risks assessments, we share the view that banks should have flexibility in implementing such a dialogue. Notably, banks should be able to define their top priorities, based on their business model.

Development of sustainable products: We do not think that "sustainable" labelled products are necessarily more resilient to ESG risks. Even a portfolio that is 100% green may be very high risk as it may be subject to transition risk. Battery-powered vehicles, for instance, may become obsolete if, in the future, hydrogen cars turn out to be the best mobility alternative.

In this regard, we would like to reiterate that the EU taxonomy is not aimed at risk management, even though the expectation is that steering towards sustainable product offering will help to reduce the exposure to many other unfavourable factors that may affect a bank's counterparty, apart from ESG factors.

Time horizon: As already stated, the time horizon for ESG risks is significantly longer than the average time horizon for strategic planning. Due to the lack of reliable data, it might prove challenging to integrate long-term effects of ESG risks into business strategies.

The framework should distinguish between two risk horizons:
In the **short-term**, ESG factors are progressively taken into account in the business strategies and in the business decisions. This requires significant efforts to deploy the ESG risks classification, train a large number of staff and adapt governance and policies.
In the **medium/long-term, strategy of institutions** is built considering ESG factors and expected ESG trends, and monitoring a limited number of KPIs to measure long term **alignment with international** objectives (such as Paris agreement goals). **Scenario analysis** could be a useful tool to feed thought around business strategy and participation of banks to pilot exercises will help to develop further robust methodologies in that respect.

Question 18: Please provide your views on the proposed ways how to integrate ESG risks into the internal governance of institutions.

Process and governance on ESG risk drivers should be included in the existing processes and governance.

Referring to Section 6.1, more specifically to $151, $157 and $158 ESG Risks in Governance and 6.3.1 Management body and committees:

As laid down by the French AFEP-MEDEF code on corporate governance, "the board of directors endeavours to promote long-term value creation by the company by considering the social and environmental aspects of its activities. If applicable, it suggests any statutory change that it considers appropriate".

In addition, due consideration of social and environmental stakes of business activities has recently been embedded in French law. The "Pacte Law" stipulates that corporations must "be managed in the interest of the corporation itself, while considering the social and environmental stakes of its activity".

The law also revises the very definition of corporate purpose and enable companies to define a purpose beyond profits, based on the principles it gives to itself to guide its business policy and strategic decisions.

Therefore, **both the Management Body in its Management Function and Management Body in its Supervisory Function (including via specialised committees) take social and environmental challenges into consideration. In particular, the Supervisory Function takes ESG risks into consideration when determining business orientations and when supervising the Management Function.**

When determining how the Management Body shall be tasked regarding ESG Risks missions**, it is key to avoid advocating or preferring any specific structure** and to interpreted this concept in accordance with the applicable law within each Member State. The Supervisory Function shall therefore be responsible for taking ESG Risks into consideration only for the purposes of the missions provided in accordance with Member States' regulation. More specifically, it is key to **make sure that the guidelines take into consideration the collegiality principle applicable to Boards in France, by**

avoiding the allocation of different roles and responsibilities to different board members. Roles within the Board are primarily attributed for the enhancement of checks and balances, as well as to enable an optimum supervision and control and adequate running of the institution, but decisions within a collegial body carry no tags as to the types of members who adopted it.

Members of the Management Body should receive dedicated training on ESG Risks generally. **Key function holders (KFH) are not defined in the CRD V Directive. In addition to this, we do not agree on any assessment of KFH by the supervisor as they are of the sole responsibility of the employer, namely the institution.**

As regards Conflicts of interest, CRD V already provides for provisions on loans. Pursuant to CRD V, institutions shall ensure that data on loans to Board members of the management body and their related parties, as explicitly defined, are properly documented and made available to competent authorities upon request.
In addition to the above, in France (but also in some other Member States) there are already provisions governing transactions concluded by members of the Management Body and their related parties. Pursuant to French regulation, there are two different types of processes by distinguishing if transactions concluded under normal market conditions or not. Indeed, the Board shall put in place a process regarding transactions concluded under normal transactions by members of the Management Body and their related parties. Such process ensures that these transactions were concluded under normal conditions. If not there are deemed to be "related parties agreements" (*conventions réglementées*), in which case they shall be approved by the Board, reviewed by the independent auditors in a report and presented to the Shareholders during the Annual General Meeting for them to vote on such related parties transactions.

Finally, **EBA Guidelines on Fit and Proper imposes Credit Institutions to put in place a policy to manage any potential conflicts of interests in a very detailed manner.**
We therefore do not consider there is a lack of regulation as regards conflicts of interests as regards members of the Management Body.

As regards other functions, **EBA guidelines on Internal Governance** already provides for provisions on conflicts of interests applicable to employees. Finally, "senior functions" is not a defined terminology and there is no assessment of any Key Function Holders provided in the CRDV directive.

<u>Referring to Section 6.3.3 Remuneration:</u>

Concerning the remuneration part, we consider that as set out in the EBA Guidelines and as we already do it within BNP Paribas Group, it is important to align remuneration policies and practices with the institution's risk appetite, the business strategy and long-term objectives. It is also essential that appropriate incentives-based mechanism support achieving an appropriate risk culture, including ESG risks drivers.

However, we consider that not all MRT staff may have a material and direct impact on ESG institution's strategy. Therefore, it would be more appropriate and relevant that remuneration policies should be linked to ESG related objectives **only for senior management members directly responsible for ESG related topics and potentially for MRT staff directly involved in ESG institution's strategy.**

Question 19: Please provide your views on the proposed ways how to integrate ESG risks into the risk management framework of institutions.

In the Group risk taxonomy **ESG factors** have been introduced as **drivers of existing risk categories.** As such, during each Risk Identification exercise, all contributors have to identify all risk events deriving from those factors.

The Bank agrees that **material ESG factors** are incorporated into risk management framework as **drivers of existing prudential risks** (credit, operational, market, and liquidity).

Credit Risk: Our credit policies and procedures - which allow the Bank to select and limit its exposure to specific sectors or activities - include:

- **Sectoral policies**: which cover 8 sectors (and 1 excluded sector: tobacco) independently of their location (sectors: agriculture, coal fired power generation, defence & security, mining, nuclear, unconventional oil & gas, palm oil, wood pulp)
- **Duty of Care procedure**: which covers clients operating in 13 sensitive sectors (agriculture, food & tobacco, material and ores, energy excluding electricity, transport and storage, utilities, equipment excluding IT, chemicals excluding pharmaceuticals, building and public works, IT, household goods, healthcare & pharmaceuticals, hotel, tourism & leisure, automotive)
- **Exclusion and monitoring lists**, including excluded activities and goods, with the objective to (explanation of objectives)
- **Equator principles** for project financing
- **Specific credit policies**

For the clients not captured by those policies and procedures, the Group uses other ESG frameworks (ex: CIB CSR screening).

As part of the credit process at client level, the compliance with the aforementioned policies and procedures, exclusion and monitoring lists as well as the check on controversies must be verified in order to evaluate and control ESG risk drivers (including climate-related and environmental risk drivers) before granting a credit.

Regarding **operational risk management**, the Group has implemented a Business Continuity Plan worldwide in order to protect its own operations. Thanks to this plan, the Group is able to mitigate those ESG risks and to react quickly in case of occurrence of a physical risk.

In the context of the COVID-19, the BCP has demonstrated being effective enabling the Bank to continue its operations relying notably on work from home.

A setup has been designed with the objective to mitigate the **reputational** and liability risks stemming from climate-related and environmental issues. This setup is composed of controversies checks performed at onboarding of a new client relationship and more detailed assessments in the context of the credit process.

Market risk : It is noted that market risk generally focuses on extreme yet plausible events over a relatively short time horizon. The time horizon of core climate scenarios is far longer and should not be mapped as instantaneous shocks into market risk portfolios. Regulatory focus to include market risk in ESG/climate scenarios may hence unnecessarily draw attention away from priority risk management areas in this field.

Nevertheless in view of the emerging risk posed by the sudden realisation of climate-related events (either physical or transition events such as a sudden policy announcement), we appreciate the need to investigate ways of evolving the existing monitoring and scenarios platforms to factor in climate-centric scenarios and their potential immediate impact on the bank's trading and banking books. However, given these idiosyncratic and relatively small scale shocks are a lesser macro risk than that of long term credit and market deterioration, the optimal approach would be to firstly build knowledge through the climate credit risk developments and to place a secondary priority on market risk.

Liquidity risk is a very short term risk, whereas climate and environmental risks are rather expected to have significant consequences in a long term horizon. The disconnection between these two timeframes means it might be irrelevant to consider the materialization of climate risks in the definition and management of liquidity buffers today for banks.

Nevertheless, to the extent there would be consequences on liquidity driven by climate and environmental risk driver (e.g. physical risk may lead to default risk which itself may have ramification on liquidity), it would make sense to take those consequences into account:

- For transition risks: expected to materialize slowly, which means the liquidity portfolio can adapt without losses to the new paradigm. A shorter horizon could come from drastic political measures, new tax….
- Physical risks might occur more suddenly (extreme weather events…), with possible impacts on certain assets. However, they are expected to arise in rather localized areas and accordingly with circumscribed impacts unlikely to affect significantly the management of a liquidity buffer itself. Regarding physical risk on bank premises, the consequences would above all relate to operational risk and are captured by the prudential requirements on this risk.

Nevertheless, it cannot be excluded that climate and environmental risks could affect to some extent net cash outflows or the liquidity of the banks. Most probably in the long term, climate change risk should rather be considered in scenario analysis as a risk driver on some class of assets/ geography area and the consequential impacts on liquidity if any should be taken into account through these scenarios.

In addition, specific metrics related to energy transition are integrated into **the Risk Appetite Statement**.

Overall, the Bank agrees that, given the state of maturity in ESG assessment methodology and data availability, there will be a **phase-in** approach as for the development and use of quantitative limits and metrics.

Question 20: The EBA acknowledges that institutions' approaches to environmental, and particularly climate-related, risks might be more advanced compared to social and governance risks and gives particular prominence in this report to the former type of risks. To what extent do you support this approach? Please also provide your views on any specificities associated with the management of social and governance risks.

The Bank shares the view that the understanding of **environmental risks** - and more particularly climate-related risks - is more mature, compared to social and governance risks. Consequently, it is of the outmost importance to address ESG risks in a **phase-in** perspective, based on the maturity of the topics and notably the availability and reliability of data.

Regarding "social factors", defined as "situations where counterparties are negatively affected by social factors should not be identified as "social risks" but rather as "risk events" triggered or aggravated by social factors". Human rights & social drivers relate to the non-respect of rights, well-being and interests of people. They refer notably to the topics detailed in our response to Question 5.

Regarding "governance factors", defined, as situations where counterparties are negatively affected by governance factors should not be identified as "governance risks" but rather as "risk events" triggered or aggravated by governance factors.
Potential drivers (among others): controversial weapons, bribery and corruptions, etc

Question 21: Specifically, for investment firms, what are the most relevant characteristics or particularities of business strategies, internal governance and risk management that should be taken into account for the management of the ESG risks? Please provide specific suggestions how could these be reflected.

As already stated, based on the "same activity, same risks, same rules" principle, we do expect a level playing field between competitors.

Chapter 7: ESG factors and ESG risks in supervision

Question 22: Please provide your views on the incorporation of ESG factors and ESG risks considerations in the business model analysis of credit institutions.

We do agree with the incorporation of ESG factors and ESG *impacts or drivers* to the business model analysis of credit institutions. NB: we prefer to not to use the wording "*ESG risks"* (see our answer to Q2).

Indeed, as already stated, Banks consider the ESG is above all a business development strategy, that is to say, it does not solely represent potential negative impacts over Banks' solvency, it should be considered primarily as the key vector for business development in the coming years. **Consequently, the first step would be to connect ESG to the Business Model Analysis. A strong business model analysis enables informed strategic decision-making, supports the transition to a more green and sustainable business model, and therefore strongly mitigates risks potentially impacted by ESG risk drivers, such as business and strategic risks.**

We also appreciate the proportionality approach put forward in the discussion paper and we would like to reiterate the fact that size is only one component of it (see our answer to Q15).

Regarding other environmental factors than climate, the supervisor should consider that methodologies are still at an early stage and that available and reliable data will be a prerequisite. In this regard, the introduction of social and governance factors will be even more challenging, as maturity on these topics is even less developed.

Question 23: Do you agree with the need to extend the time horizon of the supervisory assessment of the business model and introduce as a new area of analysis the assessment of the long term resilience of credit institutions in accordance with relevant public policies? Please explain why.

Conceptually, we do understand that the time horizon of the supervisory assessment of ESG factors and ESG impacts should be extended. As answered in Q 17, at medium and long-term horizon, the focus should be making sure that strategy of institutions is built considering ESG factors and expected ESG trends in a qualitative manner. The monitoring of a limited number of KPIs to measure long term alignment with international objectives (such as Paris agreement goals) seems a fitted approach. Scenario analysis could be also a useful tool to feed thought around business strategy and resilience.

However, from a practical point of view, a longer time horizon would create many challenges. Indeed, an assessment based on an extended time horizon would present a great amount of uncertainty and the reliability of the results might questionable. The main hurdles would be the access to adequate historical data and the lack of convergence of methodologies used.
Customers data are hardly available beyond 5 years. The time horizon of the trajectories is progressively extended to longer terms but the exercise is very complex and embeds many uncertainties. We believe that this new area of analysis the assessment of the long term resilience of credit institutions in accordance with relevant public policies should be carried out on a very **pragmatic 'test and learn' approach.**

Question 24: Please provide your views on the incorporation of ESG risks considerations into the assessment of the credit institution's internal governance and wide controls.

Cf. our answer to question 18.

Question 25: Please provide your views on the incorporation of ESG risks considerations in the assessment of risks to capital, liquidity and funding.

Regarding the integration of ESG climate-related and environmental risk drivers into the prudential supervisory framework and the SREP, we would like first to remind (as clearly stated by ECB in its ICAAP Guide) that **ICAAP (and ILAAP) is an internal process fully owned and managed under Banks' responsibility**. Therefore, methods for integrating ESG climate-related and environmental risk drivers should be defined and implemented by Banks in the way they deem adequate for internal economic risks monitoring and decision-making purposes. Indeed, ICAAP (or ILAAP) is a complex process that connects several **strategic decision-making and risk management processes**, articulated with a **comprehensive internal economic perspective, a normative regulatory perspective, and a forward-looking dimension,** all together enabling the Bank to demonstrate its present and future capital adequacy (or liquidity adequacy for ILAAP).
The Banks generally agree with NGFS and EBA findings that integrating ESG climate-related and environmental risk drivers into the prudential supervision framework remains very challenging, for several reasons:

- ESG covers a wide range of concepts, some of them being still under development as of today.
- Understanding and awareness of ESG still requires a huge mobilisation to achieve the defined goals.

- From a practical point of view, after all progress and achievements realised in the recent years, there is still a lot of work to be done only to build a common understanding and definition of ESG.

Consequently, considering the above-mentioned complexity and stakes of the ICAAP (or the ILAAP) and the SREP, the optimal prerequisites for a consistent integration of ESG into the current prudential supervisory framework are not met yet.

Beyond such general considerations, the Banks generally agree with NGFS findings that within the regulatory perspective of the ICAAP, **the Basel capital framework is not adapted to a relevant integration of ESG climate-related and environmental risk drivers**:

- The Basel capital framework largely relies on **backward data** that are used to quantify, in particular, the regulatory capital requirement for credit risk and operational risks (the most impacted prudential risk types). This is contradictory with the intrinsic forward-looking nature of ESG risk drivers.
- Moreover, the **Basel capital framework is intended to cover a specific amount of potential loss at a 1-year horizon**. This is again contradictory with the intrinsic long-term nature of ESG risk drivers.

Based on such considerations, the Banks underline the risk of unexpected adverse second round effects resulting from a careless, inadequate or inconsistent integration of ESG risk drivers into the Basel capital framework, leading to unjustified increases in regulatory capital requirements, and finally hampering financial institutions capabilities to contribute to the fight against climate change and environmental damage.

Regarding the **business model analysis, please refer to our answer to question 22**.

Another interesting path for **connecting ESG and ICAAP (or ILAAP) is the Risk Identification Process**. As of today, **Banks already integrate ESG risk drivers into some of the risk events** of its Risk Inventory that ultimately enable to identify its material risks. This setup paves the way for capturing ESG risk drivers' impacts into the **calculation of the internal capital requirement for material risks**. Indeed, by doing so, climate and environmental risk drivers are be **reflected in the calibration of the internal risk models through their impact on the frequency, severity and dependency of risk events**. They hence already contribute to the establishment of capital needs under the internal perspective, and this contribution will increase as their materiality will grow in the medium term.

At this stage, it is helpful to specify that the Banks allocate internal capital to defined material risk categories, but it does not allocates individually capital to risk drivers, which contribute, at an earlier stage of the risk identification methodology, to the risks materiality assessments.

Regarding climate-related scenario analysis (cf. our answer to Q11), the Bank consider them as the most appropriate tool to **measure the materiality of ESG risk drivers and their impacts on the business model** and welcome the participation to pilot exercises such as **ACPR's pilot exercise on assessment of climate risks**.

Question 26: If not covered in your previous answers, please provide your views on whether the principle of proportionality is appropriately reflected in the discussion paper, and your suggestions in this respect keeping in mind the need to ensure consistency with a risk-based approach.

We strongly support the principle of proportionality elaborated in the discussion paper. However, we would like to emphasize that size is only one component of it. Assuming that larger or smaller banks are vulnerable to ESG factors simply because of their size is not accurate. The business model of an institution, its internal governance, the nature and complexity of its activities and their location are also crucial.
As regards ESG risks, we would recommend to consider proportionality as a function of the materiality of client salient risks and, in particular, we strongly recommend not to overburden SMEs with complex data requests.

Question 27: Are there other important channels (i.e. other than the ones included in chapter 7) through which ESG risks should be incorporated in the supervisory review of credit institutions?

N/A

Annex 1: non-exhaustive list of indicators and metrics

Question 28: As an institution, do you use or plan to use some of the indicators and metrics included in Annex 1? If yes, please describe how they are used in relation to your ESG risk management approach.

We welcome the fact that list proposed by the EBA is not **prescriptive. It is key that it remains optional at banks hand. Banks need to remain free to choose the most feasible (data availability, costs…) and appropriate indicators in relation with their activities and geographic locations.**

We also acknowledge the fact that the list of indicators and metrics provided in the discussion paper is a non-exhaustive and indicative one. Going forward when the topics become more mature, it could be usefully supplemented, with social and governance factors indicators.

Some of the listed indicators may be a starting point to gather information from banks' counterparties on ESG matters. They may also be used in the development of product offerings. In addition. Some banks have taken them into consideration as part of a product taxonomy development (separate from a risk taxonomy of sectors). **However, most of these indicators are not suitable for risk management purposes and would be difficult to implement outside the EU.**

Regarding more specifically the **Scope 3 metric**, we consider it as a piece of the ESG risk management framework according to supervisor methodologies that remains very challenging for banks.
Methodologies for scope 3 on the bank lending portfolios for the financial sector are under development, **except for the sector of the energy**. Banks currently disclose: their scope 1 Direct GHG emissions from sources owned by the company (tCO_2) and scope 2 Indirect GHG emissions from the generation of consumed electricity, steam, heat, or cooling (collectively referred to as "electricity") with the % coming from renewable energy and non-renewable. BNPP is exploring a few other methodologies for scope 3 and beyond carbon, other methodologies and standards, along with necessary data tools, related to natural capital".
On top of that, the Bank believes that this indicator (Scope 3) is a static one, providing a picture of the portfolio emissions of a bank. Hence, it is not an adequate tool to monitor a lending book.

Question 29: If relevant, please elaborate on potential obstacles, including scope of applicability, granularity and data availability, associated with the indicators and metrics included in Annex 1.

The main obstacle about the non-exhaustive list of ESG indicators and metrics provided in the discussion paper relates to the **availability and reliability of data**. Some data may be too old, too generic, or too expensive.

In addition, some of the indicators (such as the carbon footprint for instance) are calculated by the banks' counterparties themselves. Therefore, they may **not always be available, notably for SMEs**.