afme/
Finance for Europe

Mr P Amis
Mr S Walter
European Central Bank
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25 June 2021

Dear Mr Amis and Mr Walter,

The Association for Financial Markets in Europe (AFME) notes that the ECB held a virtual forum on 26 May with SSM supervised banks on how it will conduct its 2022 climate risk stress tests and subsequently shared the related documents with attending banks. In so doing, it asked banks to respond with comments on Modules 1 and 2 of the exercise by 11 June and comments on Module 3 by 25 June. While AFME was not party to the forum we would nonetheless like to provide feedback on the process, scope, and technical aspects of the exercise on behalf of our members, who have expressed a strong wish for a collective industry response on this highly relevant and important topic.

Our members have appreciated the initiatives taken by the ECB to engage with banks through informal and formal industry workshops since the launch of its consultation on its climate-related supervisory expectations in May 2020. Regarding the overall process for the forthcoming stress tests however, our members have voiced their concern that the SSM has not pursued a more comprehensive and transparent industry consultation. Given that the final instructions and templates are only to be published in December, a full consultation process of at least 4-6 weeks would have been appreciated and appropriate for an exercise of this importance and scope (we note that the Bank of England conducted a public 3-month consultation in 2020 on its similar exercise). In the same vein, and in the spirit of greater transparency, it would have been helpful if the ECB had made the documents publicly available to allow for consolidated and efficient industry feedback including from industry associations.

In terms of the timeline which the ECB has set out, our members are concerned by the limited time available to prepare for the stress test and the data challenge this presents – much of the data supporting this exercise are scarce and, in certain instances, will be difficult to collect. This issue is compounded by the intention of the ECB to only release the final methodology in December. To mitigate this challenge we would like to put forward the following suggestions:

- For the ECB to publish at least some aspects of the methodology before December to help banks better prepare;

- For the ECB to share the data it used for its own economy-wide climate stress test exercise (for instance the data on the 4 million counterparties) - this would ensure consistency and comparability between banks;

- Since not all banks will be requested to produce Module 3 data and projections, it would be helpful to know as soon as possible, and at the latest by end of August, regarding the ECB selection process and when the information on the selected banks will be provided. This will help banks to build resource and capacity to undertake this new exercise;

- As the exercise will require large sets of new data and modelling approaches, we would suggest that this initial stress test should be undertaken as a best-effort basis exercise, allowing banks to use proxies where gaps exist (e.g., GHG emissions and EPCs);

- For the ECB to adopt an open and interactive approach with industry during the exercise both via trades bodies and individual firms to resolve any questions or issues that arise;

- To focus the exercise on the largest/main supervised groups only for the quantitative exercise, similar to the approach adopted by other supervisory authorities for such stress tests to date (i.e. ACPR, BoE, DNB, FINMA/SNB, JFSA) with optionality for smaller entities, including those belonging to 3rd country groups to join on a voluntary basis (i.e. similar to HKMA).

Aside from these practical suggestions, which are intended to help foster and support a collaborative approach between the ECB and industry in the next stages of the climate stress tests, we note there are still several open questions which were not clarified during the industry forum on 26 May. While we welcome the recent comments of Andrea Enria and Frank Elderson, that the stress tests will not result in direct P2 requirements, it would be useful to have early clarity on how the results may lead to indirect P2 requirements, and ultimately how this will feed into the 2022 SREP exercise at this early stage in the development of climate risk stress tests. In particular, we would like to understand how the 30-year time horizon could be reflected in the 1-year SREP time horizon and what elements of the SREP are likely to be most affected by the newly established different modules of the 2022 climate stress-tests.

In this regard, the EBA has acknowledged that “the existing assessment under the Supervisory Review and Evaluation Process (SREP) of credit institutions might not sufficiently enable supervisors to understand the longer-term impact of ESG risks, its breadth and magnitude, on future financial positions and related long-term vulnerabilities. In this context, the EBA sees a need to introduce a new area of analysis in the supervisory assessment”[1]. Following the publication of the EBA’s final report on this topic, which will inform changes to CRR and lead to the revision of the EBA’s SREP guidelines in relation to climate risk management, we caution the ECB to be mindful before amending its supervisory approach, at least until the EU Single Rulebook gives certainty as to the future EU regulatory framework.

[1] EBA Report on management and supervision of ESG risks for credit institutions and investment firms (EBA/REP/2021/18)

Furthermore, it would be extremely helpful if the ECB could confirm that, at least for the 2022 exercise, there is no direct implication for ICAAP, and participating banks will not need to apply BCBS 239 data quality standards for the purpose of this exercise.

Finally, we have included an annex to this letter collating some more technical feedback on the ECB's climate stress test proposals. Although this comes after the deadline for feedback on Modules 1 and 2, we hope you will nonetheless be able to take these points into account.

We remain at your disposal and open to any dialogue with you that helps to bring together the industry to discuss any outstanding questions with regards to the climate stress tests which are an essential exercise to better inform us of the risks posed by climate change to the financial sector and wider economy.

Yours sincerely,

Annex providing technical feedback on the methodology of the proposed climate risk stress tests:

Overarching comments:

- It is unclear if Modules 1 and 2 are performed at the consolidated level, or if subsidiaries may be required to undertake individually.
- We welcome that the ECB has confirmed the results will only be published in aggregate.
- Can the ECB confirm more clearly the intended outcomes of the exercise - for instance will the outputs be used in other areas such as to challenge bank net -zero strategies?
- ECB should apply Scope 1, 2, and 3 emissions factors centrally given that a decentralised approach risks inconsistency across firms (see, e.g., EBA risk sensitivity pilot experience with application of EU Taxonomy).

Module 1

- Consistency with Climate Action Plan submitted to ECB (i.e., Questionnaire A and B). Can the ECB clarify how the answers will be used to benchmark participating banks and avoid duplication of the answers banks have already submitted?

Module 2

- It will be challenging to obtain data for the scope requested. Is there value in having a common Datawarehouse managed internally by ECB to foster data consistency across banks?
- Availability of Scope 1, 2 and 3 emission data at a counterparty level. If a top 20 counterparty has missing data, should banks not use it and use another counterparty or should estimate GHG based on proxies (e.g., average of the available counterparties within the same NACE sector)?
- 'Counterparty' is defined as ultimate parent undertaking, or direct counterparty if more prudent. However, we would note this could lead to very conservative emission levels if banks are financing more sustainable operations of the counterparty.
- Is it envisaged in the consistency checks with FINREP and COREP some tolerance buffer (e.g., 90% reconciliation or reconciliation through "other" residual bucket)?
- Explanatory note on past climate-related actions: we understand that there is no particular format required for this note. Could it be confirmed that a set of references to our disclosed information (i.e. public Climate report) will be sufficient?
- GES emissions: there will be very little time between the disclosure of banks' counterparties' emission as of 31/12/21 and the submission of data to the ECB for Metric 2. Is it correct that as for Metric 1 we could use previous years data as proxy or even base our analysis on estimations of 31/12/21 data?
- More guidance would be appreciated on how banks should estimate GHG emission (which methodology to use), especially for scope 3 (if not provided centrally?)

Module 3

- Can the ECB set out how they intend to ensure comparability and consistency ensued across banks with a counterparty level modelling approach (given potential different modelling/usage of scenarios)?
- It is not clear why intra-year flows are needed in Module 3. We think this should just be a single beginning and end of period balances and parameters based on the defined shocks.

Credit risk

- We would like to propose SME Retail is done at a later stage given the sectors most sensitive to climate and current exercises are mainly Large Corporates.
- Credit risk modelling by sector and EPC: how will banks be expected to transfer sectoral disaggregation of GDPs, equity prices and real estate prices by EPC to impacts on PDs and LGDs? Can banks rely solely on macroeconomic scenario which already embeds the climate scenario? Will ECB provide benchmarks for the exercise, similar to the ECB path generator for credit risk parameters?
- Can banks proxy missing EPCs based on other available data samples? It is not clear if for mortgages the impact should only be reflected on the LGD, or also on the PD of those mortgages.
- Can the ECB provide information on how banks should perform extrapolation on residual portfolio? (e.g., macroeconomic approach or based on proxies from bottom-up counterparties).
- Can the ECB provide more detail/explanation on the 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). What dynamic balance sheet targets should banks use if no official/formal commitment has been made?
- Would it be possible to use simplified modelling solutions for lower emitting sectors?
- Could the ECB please confirm that review and validation of methodologies by internal audit only concerns ECP classification through internal models (when data not available and when such model exist as stated p16), and not credit/market/operational/reputational risks projections models?
- Referring to the 3rd paragraph page 20, could the ECB confirm that conducting counterparty-level analysis will not be mandatory and that higher approaches (as at sectoral level) will be accepted?
- In terms of data provided along with the scenario by the ECB, it would be helpful to also receive data on turnover evolution by sector (in addition to value added by sector which is planned to be included), as it was the case in the 2020 ACPR Exercise.
- Could the ECB provide guidance regarding dynamic balance sheet constraints, on how we should consider if "enough suitable clients will potentially be available" by sector (page 23).

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. It would be helpful to have clarity on whether this covers market risk in the trading book and/or banking book.

- Could ECB provide further indications for data on insurance companies and public natural disaster relief schemes?
- In the third paragraph, it is written p12: "… the methodology follows the 2021 EBA stress test methodology, with deviations clearly described below". Should we infer that the impacts of the scenario must be computed with a full revaluation approach as for the EBA stress test, or a sensitivity-based one could be considered?
- The CCR (Counterparty Credit Risk) on market activities is not mentioned in the methodological note and there is no tab for this section in the results template. Could the ECB confirm that CCR is not considered for the exercise?
- Regarding the paragraph which 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 reported. In addition, potential hedges (derivatives) directly connected to the equity and corporate bond positions split into long and short positions need to be reported." it appears that derivatives should only be included in the template if they hedge equity and corporate bond holdings. We would note that banks often 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 it be clarified whether such exposures should be included in the exercise or not?
- It is explicitly evidenced in the Methodology document that FVtOCI positions are not included in Credit Risk Perimeter, and they are not mentioned in Market Risk section either, can it be clarified that this understanding is correct and FVtOCI perimeter is not part of the exercise?

Drought and flood:

- In terms of data provided along with the scenario by the ECB, it would be helpful to also receive data on turnover evolution by sector (in addition to value added by sector which is planned to be included), as it was the case in the 2020 ACPR Exercise.
- Could ECB communicate more guidance regarding the consideration of private insurance coverage and public natural disaster relief schemes in the credit projection for physical risks

Operational and reputational risks:

- Although we expect this section would lead to a significant workload, we consider that quantitative outcome related to operational risks and reputational risks would remain highly hypothetical, with very limited added value and would be very costly Furthermore, we would note that Operational and particularly Reputational Risk assessment is completely speculative and judgmental. An alternative could be to request banks to describe the risk management frameworks in place within the institutions regarding those risks, rather than providing quantitative estimation as of now. Ideally however, we would leave this to a future iteration of the exercise (note: no other country has tried to include these risk types in a quantitative exercise).
- It will be difficult to identify the channel through which historical reputational event will have the greatest impact on their income (reduced credit demand, deposit withdrawal, market share loss…).
- If the ECB does go ahead with this it would be helpful if it could provide further explanation on the complexities on model development for operational and reputational risk.

Data Templates

- Not clear why limited to 5 countries in Template 1, 2, and 3. Would be better to do this in aggregate perhaps split by EU and non-EU exposures per domicile of counterparty. Not clear what benefit of individual country level splits are.

Module 2:

- Data challenges: Could ECB reduce the scope (e.g., number of NACE selected or bank's total scope) or provide phasing alternatives? This would allow for better focus on materiality similar to PRA exercise (Top 100 counterparties by exposure and top 3 per NACE code).
- In particular banks have noted it will be difficult to obtain income data for SME segments per NACE, and Real Estate related by EPC.
- We would note that the assignment of individual counterparties to a single NACE in Template 2 Metric 1 will potentially overstate carbon intensity of exposures (same as per EBA exercise) – no known solution but should be acknowledged from outset
- Are asset management fees included in the calculation of metric 1?
- Is the data request for this template same as the one for Pillar 3 template?

Module 3:

- According to the Methodological Note, par. 3.3.1.1, "Fair Value Measure Calculation", a double calculation of stressed values is required, with and without hedging positions. We do not think there should be a second "without hedges" calculation. The arbitrary removal of trades (hedges or otherwise) from a portfolio radically distorts its true risk profile. What is being proposed essentially requires banks to apply a hypothetical scenario to a hypothetical portfolio. This does not provide any insight and is purely speculative.
- Could the aggregation of all historical data and the required details/splits be simplified currently it will be very time consuming.
- Given the difficulty in accessing EPC data across countries could the process be simplified and/or banks use internal proxies?