Frankfurt,
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BVI[1] position paper on EBA's discussion paper on the role of environmental risks in the prudential framework

In view of the challenges of climate change, the entire financial sector must deal with the associated risks and opportunities. The EBA's discussion paper on the role of environmental risks in the prudential framework makes an important contribution to the evaluation of the understanding of potential financial vulnerabilities. We stand ready to support EBA in finding practical and efficient solutions. We focus our response on the impact on investment firms and the related general questions.

Market impact in Germany: Germany represents about 700 MiFID investment firms, accounting for nearly one quarter of all European investment firms affected by the IFD/IFR framework. The vast majority of these firms (about 600) is only authorised to provide MiFID services such as portfolio management, investment advice, reception and transmission of orders in relation to one or more financial instruments or execution of orders on behalf of clients without a licence to hold client money or securities belonging to clients or to deal on own account. According to the EBA's analyses of the population of all concerned firms by category there are a total of about 870 investment firms in Europe (including UK) with such a limited licence. Therefore, Germany is the biggest market in this field (about 70 per cent of such limited licence firms in Europe).

Premature timing for constructive proposals: We are aware that Article 34 IFR requires EBA to provide a report whether dedicated prudential treatment of assets exposed to activities associated substantially with environmental or social objectives (in the form of adjusted K-factors or adjusted K-factor coefficients) would be justified from a prudential perspective. As an important preliminary remark, currently not even all necessary Delegated Acts and supervisory measures of the EBA for a full implementation of the new requirements of the IFD/IFR framework introduced for the first-time last year have been adopted. It would therefore not even be possible (neither by supervisory authorities nor by the investment firms themselves) to conclusively assess whether the existing K-factors adequately cover the respective risks. We therefore consider the timing for an appropriate assessment regarding additional (new) prudential requirements for environmental and social risks beyond the current scope of the IFD/IFR to be premature. This applies even more as the necessary data for an assessment about any need for further prudential requirements regarding environmental and social risks are not yet available. Therefore, one of the main outcomes of the report should be that an appropriate analysis with further regulatory proposals is not yet possible for investment firms.

Moreover, the supervision of investment firms regarding the treatment of risk should consider that the new IFD/IFR framework only applies to non-systemic investment firms. Hence, there is no need for approaches which under the CRD/CRR are required for (systemic) credit institutions. Regarding the potential risks of limited licence investment firms (such as portfolio managers with no dealing on own account), we do not see a need for establishing the same level of prudential supervision.

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[1] BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Asset Managers act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI's 116 members manage assets of some EUR 4 trillion for retail investors, insurance companies, pension and retirement schemes, banks, churches and foundations. With a share of 28%, Germany represents the largest fund market in the EU. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

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Irrespective of these general comments, we would like to respond to the specific questions with focus on investment firms as follows:

Chapter 3 – Background and rationale

Q1: In your view, how could exposures associated with social objectives and/or subject to social impacts, which are outside the scope of this DP, be considered in the prudential framework? Please provide available evidence and methodologies which could inform further assessment in that regard.

As mentioned in our general statement, at the current stage we do not see the need to consider separately exposures associated with social objectives and/or subject to social impacts in the IFD/IFR prudential framework as a new approach. However, we refer to our remarks regarding the treatment of exposures associated with environmental risks in the IFD/IFR framework which also apply to the exposures associated with social objectives and/or subject to social impacts.

Chapter 4 – Principles, premises and challenges

Q2: Do you agree with the EBA's assessment that liquidity and leverage ratios will not be significantly affected by environmental risks? If not, how should these parts of the framework be included in the analysis?

Investment firms are required to hold a minimum of one third of their fixed overheads in liquid assets at all times. To account for the difference in liquidity profiles of investment firms compared to credit institutions, the list of appropriate liquid assets is supplemented in the IFR, in particular by the unencumbered own cash and short-term deposits. It is precisely the latter that make up the overwhelming share of liquid own funds at investment firms providing portfolio management services. Moreover, competent authorities can exempt certain investment firms (such as small and non-interconnected investment firms) from the liquidity ratio. In view of the special proportionality principle applicable under the IFR, we see no need to expand the liquidity requirements to include additional requirements for the consideration of environmental risks. This applies all the more if the EBA sticks to its assumption that the liquidity ratios of credit institutions are not significantly affected by environmental risks.

Q3: In your view, are environmental risks likely to be predominantly about reallocation of risk between sectors, or does it imply an increase in overall risk to the system as a whole? What are the implications for optimum levels of bank capital?

It is important to understand that the concept of sustainability risk (including environmental risks) is not a new stand-alone risk element, but rather a specific sub-set of financial risk. To put it differently: sustainability risk is financial risk inherent in a portfolio due to sustainability factors. Therefore, as it stands, environmental risk is in general not identified and measured separately from other risks. Rather, it is included in the exposure of other relevant risks or considered part of the price valuation of portfolio assets. As such it could – if relevant – have an impact on the overall risk to the system as a whole. However, the impact of own fund investments of portfolio managers (or their potential failure) covered by the IFD to the financial system as whole is likely to be insignificant.

Q4: Should the 'double materiality' concept be incorporated within the prudential framework? If so, how could it be addressed?

We do not see the need to incorporate the 'double materiality' concept within the IFD/IFR prudential framework, in particular for investment firms without a licence to hold client money or securities belonging to clients or to deal on own account.

Environmental indicators are only relevant for the purpose of identifying and managing environmental risks if they flag issues that are material in terms of financial performance. In this regard, due caution should be used when pointing to the indicators for ***principal adverse impacts (PAIs)*** developed under the European framework for sustainable disclosure (SFDR). There is a clear conceptual difference between PAIs and the notion of sustainability risk (such as environmental risk). While sustainability risk is defined as a subtype of financial risks, i.e. the risk of actual or potential material negative impact on the value of the investment resulting from an environmental event, PAIs shall capture negative implications of investment decisions on environmental and social matters. This means that PAI indicators should only be used for identifying sustainability risks if they are systematically supplemented by an assessment of financial materiality. On the other hand, consideration of PAIs at company level implies that material adverse impacts of investment decisions on sustainability factors need to be identified and managed. Hence it already leads to implementation of the double materiality concept at portfolio level.

The purely company-related processes of an investment firm (e.g., the increase of prudential risks and their impact on the performance and solvency of the investment firm) will be limited to professional liability risks of portfolio managers which should only play a subordinate role, if at all. This is because the clients' assets/portfolios, which are to be kept strictly separate from own funds of the investment firm, are to be managed according to their specific specifications. As mentioned in our answer to Q2, portfolio managers invest their own capital mostly in short-term deposits. Especially in the case of such own capital investments, it makes no sense to examine a double materiality of particular environmental risks. Here it should be sufficient to focus on whether the counterparty is subject to prudential regulation, including sufficient capital requirements, and effective supervision.

Q5: How can availability of meaningful and comparable data be improved? What specific actions are you planning or would you suggest to achieve this improvement?

All supervisory and regulatory approaches need a wealth of climate-related data and analytics. Comprehensive disclosure of consistent, comparable and reliable climate-related data is therefore needed. In this regard, we highly welcome the adaption of the new framework for corporate sustainability reporting (CSRD) at the EU level as well as ongoing discussions on common reporting standards in the EU and on a global scale. However, it will table some time before these reforms show first effects in practice. Meanwhile, investment firms and other market participants have no other choice than to rely on commercial ESG data providers to cover their ESG data needs.

Competent Authorities and regulators should take into account the existing market practices in order to deal with conflicts of interests by disclosure of types of research received and the main counterparties. We believe that a uniform quality standard for the evaluation process for external data (such as ESG ratings) is necessary. However, supervisory authorities should be aware of the problems of licencing costs, the lack of transparency of the methodologies underlying the ratings and the disproportionate market power of individual US providers. This situation has implications for the quality and reliability of data, since investors and financial market participants need to rely on research and qualitative assessments of climate-related aspects as basis for ratings that might not fully incorporate and take into account the development of the sustainable finance regulations, enacted, e.g., in the EU. This is particularly relevant in relation to investments outside the EU, where EU investors will also in the long-term have difficulties to rely on corporate disclosures, which do not meet the EU data and transparency requirements. With increased regulatory focus on sustainability also in the Americas and Asia this outcome cannot be deemed satisfactory from a global policy perspective. Therefore, the costs of sustainability data (data prices, licencing practices, definitions, verification procedures and connectivity fees) must be subject to regulatory oversight. Strict oversight of the entire business of ESG data is critical in order to maximise the resulting economic and social benefits.

Q6: Do you agree with the risk-based approach adopted by the EBA for assessing the prudential treatment of exposures associated with environmental objectives / subject to environmental impacts? Please provide a rationale for your view.

Considering the principle of proportionality under the IFD/IFR framework applying to non-systemically important entities only is of utmost importance. Moreover, we understand the principle of proportionality in such a way that simpler structures, processes and methods may be sufficient for a more limited business scope or lower risk profile.

Q7: What is your view on the appropriate time horizon(s) to be reflected in the Pillar 1 own funds requirements?
Q8: Do you have concrete suggestions on how the forwardlooking nature of environmental risks could be reflected across the risk categories in the Pillar 1 framework?

Environmental risks can indeed materialise in the long term. The main challenge in assessing ESG risks for the purpose of risk management or prudential own capital is that no standards exist yet, no empirical data is available on a historical basis and with respect to comparability and reliability, and the time horizon differs between the short-term view in assessing the existing financial risks and the long-term view in assessing the ESG risk. Data on long-term risk aspects is still scarce. Identification of a specific exposure of a portfolio to ESG risk will thus be a challenging exercise.

However, as already mentioned, investment firms should be treated differently compared to credit institutions, such as being part of a non-complex approach which considers the principle of proportionality. This could also include a solution that the current K-factor approach is sufficient to cover the relevant risks.

Moreover, it must be clarified that there is no obligation to use quantitative and qualitative indicators related to the identification of environmental risks. At the current stage, approaches in the market for the measurement of ESG risk are not standardised so that the use of qualitative indicators only (such as descriptive considerations of interdependencies between ESG indicators and financial risks) should be possible as a first step to identify ESG risks. Consequently, standard quantitative indicators, such as those used throughout the industry to manage market and counterparty risks, cannot be used at present. We assume that the EBA is aware of these de facto limitations; nevertheless, they should be explicitly emphasised. The capability of financial institutions to account for sustainability risk within their processes depends to a great extent upon the availability of public, transparent, relevant, and reliable data related to sustainability considerations. The metrics and methods used to assess environmental risks are neither compulsory nor do they have a specific ranking. Such a principle-based approach should be clarified in the final report.

Chapter 9 – Investment firms

Q32: With reference to the three risk categories the IFR is based on (Risk-to-Client, Risk-to-Market and Risk-to- Firm), which of these could be related to environmental risks, and to what extent?

We welcome EBA's approach to separate the analyses for investment firms from the banking assessments, whose prudential requirements and business models differ significantly from those of investment firms providing portfolio management services. The main focus in the banking business lies on the risks to which the bank may be exposed via the impact of environmental factors on its counterparties such as the increase of credit risk of the counterparty due to higher probability of default and loss given default and its impact on the solvency or performance of the institution. In our view, the solvency risk is closely connected with the level of concentration risks (associated with the default of counterparties and with trading positions of the own balance sheet). Portfolio managers have a very low solvency risk which results more from professional liability and operational risks and not from their supervised activities. Their focus is more on the impact of climate-related risks on the portfolio managed on behalf of clients.

As mentioned in our general statement, at the current stage we do not see the need to consider separately exposures associated with environmental or social objectives and/or subject to environmental or social impacts in the IFD/IFR prudential framework as a new approach. Further assessments are needed, whether and to what extent the IFD's existing capital requirements take account of the relevant risks.

If the EBA assesses any need for further requirements, the proportionality principle needs to be considered. Moreover, a distinction between so called 'class 1' (entities which qualify as credit institutions), 'class 2' (investment firms which do not meet the thresholds of Article 12 IFR) and 'class 3' firms (small and non-interconnected investment firms in the meaning of Article 12 IFR) proposed by the EBA seems an appropriate first step to enter into an assessment. This also applies with regard to the differentiation of the respective risks (risk to clients, risk to market and risk to firms).

However, any potential future requirements, if any, should be (at least) limited to investment firms which do not meet the criteria referred to in Article 32(4) of the IFD. This would be in line with the current disclosure approach in Article 53 of the IFR: From 26 December 2022, only these investment firms shall disclose information on environmental, social and governance risks, including physical risks and transition risks, as defined in the EBA report referred to in Article 35 of the IFD. The disclosure will be expected in 2023 for the first time. Assessing the outcome of this disclosure could also be helpful for further analysis regarding any need for further prudential requirements.

Furthermore, even though Article 34 IFR focuses on the aspects of the K-factor approach, the special own funds requirements of investment firms must be taken into account. Although they have to calculate K-factors (if they do not qualify as small and non-interconnected in the meaning of Article 11 IFR), the capital to be held is also measured according to the fixed overheads requirements (FOR). If the capital requirements based on FOR are higher than those based on K-factors, the latter are not relevant. In our experience so far, the own funds of portfolio managers are regularly measured according to the FOR and not according to the K-factors. Therefore, if necessary, an appropriate approach must be found that also takes this circumstance into account. This could also be an approach, that all investment firms without a licence to hold client money or securities belonging to clients or to deal on own account will be exempted from new prudential requirements regarding a dedicated prudential treatment of assets exposed to activities associated substantially with environmental or social objectives.

Q33: Should any of the existing K-factors incorporate explicitly risks related to environmental factors?

We agree that the Risk-to-Client K-factors (such as assets under managements) are not appropriate and should be not part of the assessment. There is a fiduciary relationship between the portfolio manager and clients, according to which, in principle, no performance is promised. The risks of the investment are borne solely by the client. The clients' assets/portfolios, which are to be kept strictly separate from own funds of the investment firm, are to be managed according to their specific specifications.

We see the point that investment firms may face reputational risk or operational risks. But we do not agree with the conclusion that such an assumption should be based on the composition of assets under management and to what extent the environmental profile is not taken into account by the portfolio manager. Operational risks (including reputational risks) should only play a subordinate role, if at all. We therefore refer to our remarks to question 35.

Q34: What elements should be considered concerning the risk from environmental factors for commodity and emission allowance dealers? Are there any other specific business models for which incorporation of environmental factors into the Pillar 1 requirements of the IFR would be particularly important?

Not applicable for our members.

Q35: Do you have any other suggestions as to how the prudential framework for investment firms could be adjusted to account for environmental risk factors?

We do not see the need to adjust the current IFD/IFR framework to cover assets exposed to activities associated substantially with environmental or social objectives separately.

The main structural difference between the business models of banks and limited licence investment firms such as portfolio managers is that the impact of ESG risks on activities provided by portfolio managers is focused on portfolio level and not on company level. Therefore, the methods discussed in the asset management sector (including portfolio managers qualifying as investment firms) are all focused on the assessment of ESG risks based on an event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment/portfolio managed on behalf of clients or investors (portfolio level). These methods vary between quantitative and qualitative methods or a combination of both. The spectrum here ranges from very simple approaches to multifactor methods. However, as already mentioned, these methods should be not applicable to assess the need for further prudential requirements to cover the company level of the investment firm.

We definitely see the need to further discuss the final outcome of the EBA report to cover ESG risks in the internal processes of investment firms which was not part of the consultation process. According to the EBA report, investment firms (such as portfolio managers) should consider how ESG factors harm the financial position of their clients and have an impact on their own capital and liquidity position. In our view, it is not an appropriate approach singling out mere ESG risks as a key vulnerability to which the investment firm's business model and strategy expose it or may expose it.

In particular, the analysis proposed by the EBA to assess how ESG factors may have an impact on the fees and commissions and other monetary gains that the investment firm may generate from the provision of portfolio management is also too complex and costly for investment firms acting as portfolio managers. A portfolio manager will not lose a client because he has not adequately assessed the ESG risks. This will always be a conglomerate of different reasons. Measuring such effects is almost impossible in practice. This applies even more as the ESG risks are not a separate risk category but are inherent to the overall material financial risks.

Therefore, we kindly request the EBA to establish a more principle-based approach, if needed. The required level should be always a regular assessment in which the investment firm compares its own capital as risk coverage potential with its overall risk profile without separating this to certain risk categories or factors. The overall risk profile is then composed of material operational/liability risks (e.g., based on year average of losses) and other business risks (e.g., decrease of assets under management within one year). Material risks that cannot be limited (e.g. operational risks) would then have to be taken into account when determining the overall risk profile on the basis of a plausibility check.

As the topic is very complex, we propose to hold further round table discussions in which we will be happy to provide support and additional technical input.

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