August 2, 2022

European Banking Authority
Tour Europlaza, 20 avenue André Prothin,
CS 30154, 92927 Paris La Défense CEDEX, France

Japanese Bankers Association

# JBA comments on the EBA Discussion Paper: "*The Role of Environmental Risks in the Prudential Framework*"

Dear Sirs/Madams:

The Japanese Bankers Association[1] (JBA) appreciates the opportunity to provide our comments on the European Banking Authority's (EBA) discussion paper: "The Role of Environmental Risks in the prudential framework" (hereafter the "DP") on May 2, 2022. It is one of the most prioritized topics not only within the European Union but globally to incorporate ESG risks to financial institutions' business strategy and risk management framework. The JBA welcomes EBA's work on ESG risks, including definitions, methodologies, banks' risk management framework, and monitoring by regulators, based on the mandate from the European Commission and relevant regulations/directives.

The JBA member banks, as non-EU financial institutions, have operations in the EU. We hope our comments will contribute to the policy debate going forward. In addition to the responses we have made to specific questions, we would like to provide some high-level comments as follows.

## General comments

Financial institutions are making progress in developing management framework of climate-related financial risks. Recently, some regulators have begun to examine the relationship between climate-related financial risks and the regulatory capital framework, such as the Network of Central Banks and Supervisors for Greening the Financial System (NGFS)[2], Financial Stability Board (FSB)[3], and Bank of England[4]. The Basel Committee on Banking Supervision (BCBS)[5] is also assessing the gap between the current Pillar 1 framework and climate-related financial risks. These exercises are mainly focusing on climate-related financial risks, however, the DP expands its scope on environmental objectives and provides insights about how environmental risks are to be

---

[1] The Japanese Bankers Association is the leading trade association for banks, bank holding companies and bankers associations in Japan. As of August 2, 2022, JBA has 114 Full Members (banks), 3 Bank Holding Company Members (bank holding companies), 77 Associate Members (banks & bank holding companies), 58 Special Members (regionally-based bankers associations) and one Sub-Associate Member for a total of 253 members.

[2] "Capturing risk differentials from climate-related risks: A Progress Report", May 19, 2022 (https://www.ngfs.net/en/capturing-risk-differentials-climate-related-risks-progress-report)

[3] "Supervisory and Regulatory Approaches to Climate-related Risks: Interim Report", April 29, 2022 (https://www.fsb.org/2022/04/supervisory-and-regulatory-approaches-to-climate-related-risks-interim-report)

[4] PRA Climate Change Adaptation Report, October 28, 2021 (https://www.bankofengland.co.uk/prudential-regulation/publication/2021/october/climate-change-adaptation-report-2021)

[5] Remarks by Pablo Hernández de Cos, Chair of the Basel Committee on Banking Supervision and Governor of the Bank of Spain, titled "A resilient transition to net zero" delivered at the International Economic Forum of the Americas, 28th edition of the Conference of Montreal, July 11, 2022 (https://www.bis.org/speeches/sp220711.htm)

incorporated into the Pillar1 framework. In this context, we believe that the consultation of the DP may have a broader implication for future global discussions.

We would like to express our general support for the EBA's following approaches taken in the DP:

- Prudential regulation should remain risk-based and evidence-based to maintain robustness of the prudential framework, and the prudential framework should not be used to achieve specific environmental objectives.
- Pillar 1 own funds requirements do not intend to cover all existing risks, and the EBA highlights the need for a holistic regulatory approach, including Pillar 2.
- Targeted amendments to the existing prudential framework would address the environmental risks more accurately than dedicated risk-weight adjustment factors. Any further adjustment should be designed in a way that avoids double counting, to ensure the framework's consistency and robustness.

## Challenges due to the environmental risks

The JBA also appreciates the EBA's recognition of challenges regarding the data gaps, time horizon, and forward-looking nature associated with environmental risks. Therefore, we agree with the EBA's view that emphasis at this stage should be on environmental-risk-related data collection and ensuring that institutions' risk management tools and practices explicitly consider environmental risks.

## Importance of globally standardized framework

The JBA would like to ask the EBA to consider the alignment with other international discussions being made at the BCBS, the FSB, and the NGFS etc., and to continue close engagement with the global industry stakeholders during their work before finalizing the DP by 2023.

## Specific comments

Please refer to each answer/comment to the questions provided in the designated format.

*　　*　　*

We thank again the EBA for the opportunity to comment on the DP and hope our comments will contribute to further consideration in the EBA.

Yours faithfully,

Japanese Bankers Association

EBA DISCUSSION PAPER "THE ROLE OF ENVIRONMENTAL RISKS IN THE PRUDENTIAL FRAMEWORK"

Chapter 3 – Background and rationale

| Question | Comment |
| --- | --- |
| 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. | With regard to social objectives, the scope is broad and many quantitative assessments are at an early stage. Moreover, data availability and methodologies for social objectives are much more premature than environmental risks, and the relationship between social objectives of a corporate and/or social impacts caused by corporate activities and the financial impact of the corporate cannot be quantitatively demonstrated.<br>We recognize that there is a consensus that climate-related financial risks can be managed within the existing comprehensive risk management framework as a result of the active global discussions held prior to discussions on social objectives and social impacts at forums such as the Network for Greening the Financial System (NGFS) where authorities from various jurisdictions participate. On the other hand, discussions on social objectives and social impacts have not yet matured in international organizations such as the NGFS.<br>Therefore, before expanding the scope of risks to be considered in the prudential framework, it is necessary to conduct an objective analysis to identify transmission channels and to examine whether it is possible to consider social objectives and social impacts in the framework of comprehensive risk management or whether a different approach is necessary.<br>The world should gain experience from an approach toward climate-related risks first and the lessons learned should be leveraged to discuss other environmental risks and social objectives. |

Chapter 4 – Principles, premises and challenges

| Question | Comment |
| --- | --- |
| 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? | We agree with the EBA's view:<br>– As per the EBA's view, a leverage ratio is a non-risk-based measure, and therefore has no direct relationship with environmental risks and does not need to be considered.<br>– As for liquidity, the Liquidity Coverage Ratio (LCR) is a standard requiring banks to hold high quality liquid assets to cover "cash outflows over the 30-day stress period," and as per the EBA's view, LCR will not be materially affected by environmental risks that are expected to have medium- to long-term impacts.<br>However, because the analysis and verification of liquidity risk have not progressed sufficiently, it is too early to conduct a definitive assessment of this risk. Therefore, we believe it is necessary to accumulate the results of objective risk analysis. We also believe that careful consideration should be made, taking into account international discussions by the Basel Committee on Banking Supervision and other global standard setting bodies. |
| 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? | Although there are no established measurement methodologies for forward-looking environmental risks nor sufficient objective analyses of the amount of risks in the overall financial system and the level of capital charge for financial institutions, environmental risks will depend on the climate change scenario. Appropriate global progress in reducing GHG emissions would result in a limited increase in overall risk, as well as in reallocation of risks between sectors. If GHG emissions reductions do not progress smoothly, this would result in an increase in overall risk.<br>The timing and process of achieving carbon neutrality varies from sector to sector, and in the process of transition as a whole, the amount of credit risk may increase due to capital investment and other activities, regardless of whether emissions decrease or not. When considering the optimum capital level, it should be noted that such credit risk is managed within the normal credit risk management framework. |

| Question | Comment |
|---|---|
| Q4: Should the 'double materiality' concept be incorporated within the prudential framework? If so, how could it be addressed? | The future impact of the environment on a company (i.e. financial materiality) would be incorporated into the prudential framework, but it is difficult to define the scope of measurement of the impact. In addition, incorporating the impact of company's activities on the environment (i.e. environmental materiality) into the prudential framework would not be appropriate because it is unclear how and in which risk category such risk is to be measured. Therefore, it is difficult to incorporate the concept of double materiality into the prudential framework. |
| 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? | Enhancing the quality and quantity of disclosures of clients' risk information is essential for improving availability of meaningful and comparable data at financial institutions. We believe that close cooperation between financial regulators and non-financial industry authorities is important to address the data challenges, and it is also desirable to create common data templates on a global basis.<br>In the financial sector, some industry associations are working on the data templates and there are efforts related to the establishment of a data platform announced by the Glasgow Financial Alliance for Net Zero as well as the data gap initiative of the NGFS. Globally consistent approach would be appreciated. |
| 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. | We are supportive of the approach of the EBA in so far as it concludes that environmental risks should be reflected within the existing prudential framework, rather than through the introduction of specific green supporting /brown penalizing factors. We also agree with the EBA's view that a risk-based approach should be adopted. We believe that the prudential framework should remain fundamentally risk-oriented and the risk should be accurately measured according to the actual amount of risk when assessing these investments and lending whether for environmental objectives or other objectives.<br>When considering the reflection of environmental risks in prudential regulation and credit ratings, etc. under the risk-based approach, we would like to request that EBA consider reflecting such risks based on a time horizon that takes into account the development of international discussions. |
| Q7: What is your view on the appropriate time horizon (s) to be reflected in the Pillar 1 own funds requirements? | We believe that the Pillar 1 own funds requirements do not need to be changed from the current short-term time horizon. As noted in Para 43(c), if risk were to be measured on a long-term time horizon, it should reflect changes in the balance sheet of individual financial institutions and changes in the external environment over time. However, this would require future projections, which would be difficult to implement in practice. Even if such a measurement were to be made, the inclusion of forecasts would increase the uncertainty in risk measurement results and make it impossible to ensure comparability.<br>If the forward-looking element of environmental risks is to be reflected in Pillar 1, the concept of Pillar 1 in Basel Framework itself would need to be changed. Therefore, we believe that careful consideration is needed to agree on the rationale for reflecting only the environmental risk factors of ESG in Pillar 1 as a global standard and to establish measurement methodologies for credit risk based on objective evidence and analyses. |

Chapter 5 – Credit risk

| Question | Comment |
|---|---|
| Q9: Have you performed any further studies or are you already using any specific ESG dimensions to differentiate within credit risk? If so, would you be willing to share your results? | Risks that will materialize in the short-term period have already been included and evaluated in credit ratings.<br>However, ESG factors such as climate change risk need to be evaluated from a longer-term perspective and due to the lack of globally established standards, they have not yet been reflected in specific credit ratings. |

| Question | Comment |
|---|---|
| Q10: What are the main challenges that credit rating agencies face in incorporating environmental considerations into credit risk assessments? Do you make use of external ratings when performing an assessment of environmental risks? | The lack of standardized data templates and development stage of companies in disclosures could be considered as challenges. Also, it is difficult to verify the correlation and dependence between environmental risks and PD due to the lack of historical data and this could be considered as challenging as well.<br>Furthermore, there is no global standard of the time horizon in which environmental risks should be considered. |
| Q11: Do you see any challenge in broadening due diligence requirements to explicitly integrate environmental risks? | There are following challenges in reflecting environmental risks in credit risk methodologies:<br>– the lack of established global standards;<br>– the extent to which environmental risks that have forward-looking nature should be integrated into current credit risk assessments; and<br>– the lack of time-based and historical data.<br>We recognize that it will take time to establish a quantitative risk management framework and these challenges should be considered in integrating environmental risks into due diligence requirements.<br>Environmental risks should be incorporated in credit risk management and due diligence requirements in a consistent way with international discussions. |
| Q12: Do you see any specific aspects of the CRM framework that may warrant a revision to further account for environmental risks? | There is not enough data at this point for incorporating transition risk into the CRM framework, such as medium- to long-term impacts by, for example, regulatory changes, but we believe that physical risk has been incorporated to a certain extent.<br>On the other hand, there are not many collateral assets affected by environmental risks to consider changing the CRM framework, and therefore the CRM framework should not be immediately changed. |
| Q13: Does the CRR3 proposal's clarification on energy efficiency improvements bring enough risk sensitiveness to the framework for exposures secured by immovable properties? Should further granularity of risk weights be introduced, considering energy-efficient mortgages? Please substantiate your view. | Further analysis is needed as the correlation between the energy efficiency and sales prices of mortgages vary by region and country. Therefore, we believe that careful consideration should be given to the introduction of this proposal. In addition, we believe that further granularity of risk weights by energy efficiency should be considered only when a correlation is identified between the two as a result of the above analysis. |
| Q14: Do you consider that high-quality project finance and high-quality object finance exposures introduced in the CRR3 proposal should potentially consider environmental criteria? If so, please provide the rationale for this and potential implementation issues. | If PDs and LGDs of project and object finance may change depending on future environmental factors, then we believe that environmental criteria should be considered, but objective analytical results are needed to support that they may change. |
| Q15: Do you consider that further risk differentiation in the corporate, retail and/or other exposure classes would be justified? Which criteria could be used for that purpose? In particular, would you support risk differentiation based on forward-looking analytical tools? | As stated in Section 5.1, no risk differentiation between green and environmentally harmful assets has been identified at this time. Therefore, risk differentiation should not be considered. If risk differentiation is to be considered based on forward-looking analytical tools, objective analytical results are necessary. |
| Q16: Do you have any other proposals on integrating environmental risks within the SA framework? | Risk weights are evaluated based on external ratings within the SA framework and we recognize that credit rating agencies are at the stage of considering incorporating environmental risks into external ratings. Therefore, it is unnecessary and unreasonable to consider other methodologies than external ratings. |

| Question | Comment |
| --- | --- |
| Q17: What are your views on the need for revisions to the IRB framework or additional guidance to better capture environmental risks? Which part of the IRB framework is, in your view, the most appropriate to reflect environmental risk drivers? | We think that the risk measurement models in the current IRB framework are measured based on observed losses and are not developed to capture risks for long-term horizons in mind.<br>Some accounting standards require the measurement of PDs and LGDs based on past performance with a reasonable estimation method even on a long-term horizon when measuring conventional risks. However, we recognize that environmental risks have not accumulated enough actual performance to enable a reasonable estimation of PDs and LGDs both in the short and long-term. Therefore, it is necessary to accumulate many assumptions in order to estimate them, and we believe that it is very difficult to incorporate them into the IRB framework at present.<br>A complementary framework to the limitations of evidence-based Pillar1 is the Pillar 2 framework of scenario analysis and stress testing, and we think that the role of each pillar for capturing environmental risks should be distinguished. |
| Q18: Have you incorporated the environmental risks or broader ESG risk factors in your IRB models? If so, can you share your insight on the risk drivers and modelling techniques that you are using? | We do not explicitly incorporate environmental or ESG risk factors as parameters in the IRB model. |
| Q19: Do you have any other proposals on integrating environmental risks within the IRB framework? | At this point, we believe that data collection should be prioritized.<br>Appropriate methodologies should be identified according to the results of analysis based on objective data collected in the future. |
| Q20: What are your views on potential strengthening of the environmental criterion for the infrastructure supporting factor? How could this criterion be strengthened? | We believe that consideration on whether the environmental criterion for the infrastructure supporting factor should be strengthened or not based on an objective analysis of correlation between the environmental criterion and credit risk. |
| Q21: What would in your view be the most appropriate from a prudential perspective: aiming at integrating environmental risks into existing Pillar 1 instruments, or a dedicated adjustment factor for one, several or across exposure classes? Please elaborate. | We are supportive of the approach of the EBA in so far as it concludes that environmental risks should be reflected within the existing prudential framework, rather than through the introduction of specific green supporting /brown penalizing factors. We are also supportive of the EBA's view that highlights the need for a holistic regulatory approach, which includes not only Pillar 1 but also Pillars 2 and 3.<br>In our view, the Pillar 1 framework (as well as Pillar 2) already includes mechanisms that allow for the inclusion of new types of risk drivers such as those related to environmental risks. These include internal models, external credit ratings and valuations of collateral and financial instruments. We agree with the EBA's view that targeted amendments to the existing prudential requirements in a risk-based and evidence-based way would address these risks more accurately.<br>As noted in the DP, we agree that whatever methodologies are introduced, data and methodologies for quantifying environmental risks do not exist at this time, and therefore we believe that data collection should be prioritized. |
| Q22: If you support the introduction of adjustment factors to tackle environmental risks, in your view how can double counting be avoided and how can it be ensured that those adjustment factors remain risk-based over time? | Environmental risks (ESG risk) are risk drivers for each risk category. When counting by IRB and other approaches, double counting is considered unavoidable because environmental risks (ESG risk), which are reflected in inputs to IRB as they materialize, are incorporated into observation data at some point in the future.<br>In order to eliminate this duplication, it is necessary to identify those directly linked with environmental risks from PDs and LGDs and adjust for the duplication, but this is technically and practically very difficult.<br>Therefore, we believe that careful discussion is needed before introducing adjustment factors. |

**Chapter 6 – Market risk**

| Question | Comment |
| --- | --- |

| Question | Comment |
|---|---|
| Q23: What are your views on possible approaches to incorporating environmental risks into the FRTB Standardised Approach? In particular, what are your views with respect to the various options presented: increase of the risk-weight, inclusion of an ESG component in the identification of the appropriate bucket, a new risk factor, and usage of the RRAO framework? | While we believe that capturing the risks in the RRAO framework will be one of the options, we believe that when new methodologies or new risk weights are introduced, results of objective analysis and a rationale for introduction are necessary. |
| Q24: For the Internal Model Approach, do you think that environmental risks could be better captured outside of the model or within it? What would be the challenges of modelling environmental risks directly in the model as compared to modelling it outside of the internal model? Please describe modelling techniques that you think could be used to model ESG risk either within or outside of the model. | In the current situation where there is no clear-cut risk factor for ESG risk, we do not think the environmental risks should be captured in the general market-risk VaR, and it would be more realistic to consider environmental risks outside of the model. If environmental risks were to be taken into account for market risks, further study for measurement methodologies are necessary. As stated in the DP, environmental risks are captured to a certain extent in the model (Para. 171), and there are studies showing that climate change risk is incorporated into market prices (Para. 172). Therefore, separately accounting for climate change risk outside of the model may result in double counting of risks. Therefore, we believe that careful consideration is necessary for its introduction. |
| Q25: Do you have any other proposals on integrating environmental risks within the market risk framework? | We believe that it is important to advance the understanding of the impact of environmental risks that have a forward-looking nature through the accumulation of analytical results from scenario analysis and stress testing. In addition, as it will take time to establish a methodology for quantifying climate-related market risks, discussions should be essential regarding such methodologies. |

Chapter 7 – Operational risk

| Question | Comment |
|---|---|
| Q26: What additional information would need to be collected in order to understand how environmental risks impact banks' operational risk? What are the practical challenges to identifying environmental risk losses on top of the existing loss event type classification? | At present, as noted in Para. 187 of this DP, there are no criteria for determining which loss events that have occurred are attributable to environmental risks, making it difficult for individual banks to identify them. For example, it is difficult for individual banks to assume transmission channels of impacts, such as an outbreak of an epidemic due to rising temperatures. In addition, even if each loss event is attributable to environmental risks, it is likely that some portion of the loss event is attributable to factors other than environmental risks. In such cases, it is also difficult to identify the breakdown showing how much of one loss event is attributable to environmental risks.<br>Therefore, it is important to establish some clear taxonomies that take into account the complexity of such transmission channels in order to comprehensively and properly capture environmental factors included in the existing loss event type. |

| Question | Comment |
| --- | --- |
| Q27: What is your view on potential integration of a forward-looking perspective into the operational risk framework to account for the increasing severity and frequency of physical environmental events? What are the theoretical and practical challenges of introducing such a perspective in the Standardised Approach? | We recognize that integrating a forward-looking perspective is increasingly important. On the other hand, given the uncertainty of occurrence and the complexity of transmission channels, it is necessary to establish some rules/criteria from the perspective of ensuring comparability between banks when forward-looking perspectives are integrated into the operational risk framework. As for the Standardized Approach, in particular, it should be noted that there might be a difficulty in comparing risk capital among banks without any clear rules.<br>It may also be appropriate to use the method of estimating the increase rate of the future operational risk loss events attributable to environmental risks through a scenario analysis. However, since the results of scenario analysis depend on what scenarios are applied it is necessary to ensure the certainty of the scenarios.<br>In addition, it should be noted that the uncertainty of the predictions may lead to overly conservative risk assessments and costly countermeasures. |
| Q28: Do you agree that the impact of environmental risk factors on strategic and reputational risk should remain under the scope of the Pillar 2 framework? | We agree with the EBA's view that strategic and reputational risks should remain captured in the Pillar 2 framework. We believe that the establishment of a global consensus on the significance of the impact of environmental risks on strategic risks and reputational risks and the transmission channels of those risks will enable the inclusion of environmental risks in Pillar 2. |
| Q29: Do you have any other proposals on integrating environmental risks within the operational risk framework? | Since the majority of environmental risks from an operational risk perspective is considered to overlap with the risk that disasters and epidemics pose to business continuity, we believe that it would be more efficient to capture both risks in an integrated manner. In addition, we believe that some well-founded prediction regarding the extent to which operational risk will increase in the process of future climate change is necessary, but we believe that it is very difficult to accurately predict. |

Chapter 8 – Concentration risk

| Question | Comment |
| --- | --- |
| Q30: What, in your view, are the best ways to address concentration risks stemming from environmental risk drivers? | We think that concentration risks stemming from environmental risk drivers could be addressed by upgrading the existing framework, such as reducing credit cost accruals through transition plans and FE reduction targets set by financial institutions, and managing RAF based on environmental risk (ESG risk). |
| Q31: What is your view on the potential new concentration limit? Do you identify other considerations related to such a limit? How should such a limit be designed to avoid the risk of disincentivising the transition? | LEX regulation is designed as a tool for limiting the maximum loss a bank could face in the event of the sudden default of a single counterparty or a group of connected counterparties. The rationality of setting an exposure limit for a group of connected counterparties is warranted by the assumptions that once one of the counterparties failed, all of the other connected counterparties would highly likely to fail.<br>We are, however, skeptical whether the same rationality as above can be applied to the climate-related financial risks. Even though clients significantly exposed to environmental risks may be susceptible to a common environmental risk driver, it does not necessarily mean that once one of the client failed due to the environmental risk driver, the other clients would also highly likely to fail. The potential transmission channels of environmental risks to the viability of the respective clients are not homogeneous. They are much more complex than the concept of "connected" or "economical |

| Question | Comment |
| --- | --- |
| | dependency" assumed in LEX. We believe that the level of correlation between the viability of respective clients and a common environmental risk driver will be, at least, much weaker than that of the connectedness or dependency assumed in LEX.<br>Therefore, we are of the view that setting a limit to the total amount of the exposures to carbon-intensive counterparties is not a legitimate approach in nature and that will not complement the Pillar 1 framework.<br>Although the level of concentration of the exposures to carbon-intensive counterparties or sectors can be a signal for a further analysis for supervisors, that purpose can be achieved by other supervisory tools, such as a scenario analysis, and will not warrant the introduction of new blanket monitoring and reporting requirements.<br>In addition, corporate transitions are essential to achieving carbon neutrality. We believe that a concentration limit that uniformly limits environmental risks by individual company, industry, or country in the process of transitioning to carbon neutrality may impair flexibility in terms of avoiding the risk of disincentivizing the transition and such an approach is not suitable. |