REPORT ON INCORPORATING ESG RISKS IN THE SUPERVISION OF INVESTMENT FIRMS

REPORT COMPLEMENTING EBA/REP/2021/18

EBA/REP/2022/26

EBA
EUROPEAN BANKING AUTHORITY

Contents

Abbreviations

CRD	Capital Requirement Directive
EBA	European Banking Authority
ESG	Environmental, Social and Governance
EU	European Union
IFD	Investment Firms Directive
IFR	Investment Firms Regulation
K-AUM	K factor for Assets under Management
K-CON	K factor for Concentration Risk
K-TCD	K factor for Trading Counterparty Default
SFDR	Sustainable Finance Disclosure Regulation
SREP	Supervisory Review and Evaluation Process

Executive Summary

Background

This report complements the EBA report on management and supervision of ESG risks for credit institutions and investment firms (EBA/REP/2021/18) published in accordance with Article 98(8) of Directive 2013/36/EU, i.e. Capital Requirements Directive (CRD) and Article 35 Directive (EU) 2019/2034, i.e. Investment Firms Directive (IFD). More specifically this report is addressing point (d) of Article 35 of IFD, which mandates the EBA to report on "*the criteria, parameters and metrics by means of which supervisors and investment firms can assess the impact of short-, medium- and long-term ESG risks for the purposes of the supervisory review and evaluation process*".

The EBA postponed finalising the section on the supervision of investment firms in the area of ESG risks and addressing point (d) of Article 35 of IFD until the supervisory review and evaluation process (SREP) framework for investment firms was fully established. This report completes the EBA's work on this pending mandate. The completion follows the finalisation of the EBA Guidelines on common procedures and methodologies for the supervisory review and evaluation process under IFD (EBA/GL/2022/09) as well as the entry into force of the Commission Delegated Regulation (EU) 2021/1253 on the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms.

This report outlines the EBA's views and recommendations on the integration of ESG factors and risks in the supervision of investment firms. It should be considered in conjunction with EBA report on management and supervision of ESG risks for credit institutions and investment firms (EBA/REP/2021/18) and EBA Guidelines on common procedures and methodologies for the supervisory review and evaluation process under IFD (EBA/GL/2022/09). This report sets out the foundations for integration of the ESG considerations in the process of supervisory review and evaluation of investment firms in a proportionate manner.

Content

Integration of the ESG factors and risks is considered under all main SREP elements including: (i) business model analysis, (ii) assessment of internal governance and risk management, and (iii) assessment of risks, covering risk to capital and liquidity risk.

The EBA sees the need to embed ESG considerations in the scope of the supervisory review, where the ESG factors and risks could affect the risk profile of the investment firm by acting as drivers of financial risk categories and manifest on investment firm's balance sheet and/or income statement materially. This integration should be carried out proportionately by taking into account investment firm's business model, size, internal organisation and the nature, scale, and complexity of its services and activities, as well as the materiality of its exposure to ESG risks.

The EBA acknowledges the challenges presented by the assessment of ESG risks in light of current data and methodological constraints. It is recommended that the supervisory processes follow a gradual approach, prioritising the recognition of ESG risks in investment firms' strategies and governance arrangements, and later incorporating ESG risks in the assessments of risks to capital and liquidity. Supervisory assessment practices are expected to develop over time, alongside the expected improvements in the availability of ESG data as well as the development of methodologies to assess the impact of ESG factors on financial risks. Competent authorities should monitor and encourage investment firms' efforts to put in place the necessary infrastructure and processes to increase coverage and collection of ESG data.

1. Introduction

1. In June 2021 the EBA published a report on management and supervision of ESG risks for credit institutions and investment firms (EBA/REP/2021/18). The Report provides common definitions of ESG risks and elaborates on the arrangements, processes, mechanisms, and strategies to be implemented by credit institutions and investment firms (institutions) to identify, assess, and manage ESG risks. The report also provides recommendations as to how ESG risk considerations should be included in the supervisory review and evaluation of institutions performed by competent authorities. While the report was aimed at the supervision of credit institutions and those investment firms that are subject to Title VII of Directive 2013/36/EU (CRD), it does not address the aspects of prudential supervision of investment firms within the scope of application of Title IV of Directive (EU) 2019/2034 (IFD).

2. The EBA has been mandated by Article 35 of IFD to "*prepare a report on the introduction of technical criteria related to exposures to activities associated substantially with environmental, social, and governance (ESG) objectives for the supervisory review and evaluation process, with a view to assessing the possible sources and effects of risks on investment firms, taking into account applicable Union legal acts in the field of ESG taxonomy*." It also stipulates that the EBA report shall comprise, among others, "*the criteria, parameters and metrics by means of which supervisors and investment firms can assess the impact of short-, medium- and long-term ESG risks for the purposes of the supervisory review and evaluation process*".

3. As explained in the Report of June 2021, the EBA had put on hold temporarily the section on the supervision of investment firms in the area of ESG risks and addressing point (d) of Article 35 of IFD. At the time of developing the Report of June 2021, the supervisory review and evaluation process (SREP) framework for investment firms was not yet fully established. In particular, it was not meaningful to address point (d) of Article 35 of IFD before finalising the EBA Guidelines on common procedures and methodologies for the supervisory review and evaluation process under IFD (SREP Guidelines)[1] and before entry into force of the Commission Delegated Regulation (EU) 2021/1253 on the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms[2].

4. In line with the mandate, this report assesses the potential inclusion of ESG risks in SREP performed by competent authorities on investment firms subject to prudential requirements set out in Regulation (EU) 2019/2033, i.e. Investment Firms Regulation (IFR) and in IFD. It has been developed to complement the EBA Report of June 2021 addressing the aspects related to the ESG factors and risks in the supervision of investment firms.

[1] EBA/GL/2022/09

[2] OJ L 277, 2.8.2021, p. 1–5

1.1 General considerations

5. The EBA considers that most of the reasoning and principles set out in the EBA Report of June 2021 can also be applied to those investment firms that are subject to IFD/IFR. These principles are taken into account in this report, with a view to ensure consistency while at the same time reflecting specificities of investment firms and their prudential framework, as well as ensuring appropriate application of the principle of proportionality. Similar to credit institutions, the assessment of ESG factors and risks should be integrated into the existing SREP elements, rather than be performed separately.

6. Consistent with the EBA report of June 2021, it is recommended that competent authorities follow a sequential approach also in the supervision of investment firms, giving more prominence to climate-related and other environmental risks first and extending the assessment to social and governance risks in the future. This approach mirrors the progress in sustainable finance legislative framework, such as the development of the EU taxonomy. Furthermore, the integration of ESG risks into the supervisory review could be implemented gradually, prioritising the recognition of such risks in investment firms' strategies, as part of the business model analysis, as well as in their overall internal governance arrangements, including the corporate and risk culture, and the risk management frameworks. At a later stage, especially where additional ESG data and tools to assess their quantitative impact on financial risks will become available, the supervisory assessment could provide more comprehensive coverage of ESG risks in their assessments of risks to capital and liquidity.

7. In their assessment, competent authorities may rely on qualitative and quantitative information. Quantification methodologies are currently at a nascent stage and expected to develop and improve in the future. Especially until the available quantification methodologies reach a more mature level, the use of proxies or approximation methodologies may be beneficial to establish a dialogue with investment firms that are materially exposed to ESG risks.

8. The report recognises that investment firms that are not systemic and do not have large portfolios on their balance sheets are different from credit institutions in terms of their economic activities, risk profiles, and overall risks they pose to the financial system. In accordance with the principle of proportionality and to ensure effective use of supervisory resources, this may justify a simplified analysis of non-systemic investment firms as compared to credit institutions. However, when incorporating ESG factors in the supervisory review process, it is relevant that competent authorities take into account not only the size and complexity of the investment firm, but also the materiality of its exposures to ESG factors and risks.

9. ESG factors and risks could cause material negative impacts on the value of the asset/portfolio. The impact would be different, for example, if the investment firm is dealing on own account or on behalf of clients. When dealing on own account (on own behalf), ESG factors and risks would directly impact the investment firms' balance sheet through market risk, notably due to price levels and volatility. When dealing on behalf of clients, ESG factors and risks would affect the balance sheet indirectly through potentially decreasing financial performance of their clients' portfolios as well as their profitability

through decreasing fees, commissions, and other monetary gains the firms are generating from this activity.[3]

10. IFR and IFD already incorporate proportionality towards small and non-interconnected investment firms meeting the criteria set out in Article 12(1) of IFR. Consequently, Article 35 of IFD only applies to investment firms that are not meeting these conditions. For small and non-interconnected investment firms, competent authorities should decide on a case-by-case basis in which form the SREP is to be carried out, including considerations of ESG factors and risks to the extent relevant.

11. This report provides an analysis of how ESG factors and risks can be incorporated within the SREP elements, as specified in the SREP Guidelines. While the report provides a broad overview of possible assessment criteria, it is up to the competent authorities to determine which of them are the most relevant for the investment firm under review.

1.2 General conclusions and policy recommendations

- **To ensure appropriate integration of ESG considerations into the supervisory framework, the EBA sees the need to embed ESG factors and risks in the scope of the supervisory review. The ESG considerations should be incorporated in the supervisory processes in a proportionate manner, taking into account the investment firm's business model, size, internal organisation and the nature, scale, and complexity of its services and activities, as well as the materiality of its exposure to ESG risks. The granularity of assessment should also align with the categorisation of investment firms as set out in SREP Guidelines.**

- **The integration of ESG risks into supervisory review should be implemented gradually. In the short-term, competent authorities should focus on the integration of ESG risks in the investment firms' strategy, as part of the business model analysis, and in their internal governance arrangements. In terms of risk management, competent authorities should assess how investment firms identify, assess, and manage their exposures subject to ESG risks, including any concentration in investment activities that are vulnerable to ESG risks. Subsequently, the supervisory assessment could provide more comprehensive coverage of risks to capital and liquidity risk, which is expected to be facilitated by the development of methodologies and access to reliable data.**

- **Data and quantification methodologies are at a nascent stage and expected to develop and improve in the future. Until the available quantification methodologies reach a more mature level, the use of proxies or approximation methodologies may be beneficial to establish a dialogue with investment firms that are materially exposed to ESG risks. As part of the supervisory review, competent authorities should monitor investment firms' efforts to put in place necessary internal infrastructure and processes to increase coverage and collection of ESG data.**

[3] See section 4.4 of EBA/REP/2021/18

2. Business model analysis

12. Chapter 4 of the EBA report of June 2021 encourages investment firms to integrate consideration of ESG factors and risks into their business and investment decisions, where appropriate over the long-term. Equally, it is important that the ESG factors and risks should be part of the assessment of the viability and sustainability of the business model. Such analysis could be extended to include the assessment of the long-term resilience of an investment firm, where a time horizon of at least 10 years could be considered.

13. Investment firms can follow different business models and provide a variety of activities and services whose particularities should be taken into account while performing an assessment of ESG factors and risks. It is important that supervisory assessment covers all services and activities carried out by investment firms to the extent that they are subject to ESG factors and risks.

2.1 Assessing the investment firm and its business environment from an ESG perspective

14. The SREP Guidelines set out the principles for competent authorities to analyse the business model of investment firms in the context of their specific business environment. In this context, there is a need for competent authorities to form a view on the plausibility of the investment firm's strategic assumptions from an ESG-perspective. To this end, competent authorities could analyse the business environment, in which an investment firm, its clients and other market participants and elements operate, taking into consideration the current and the longer-term conditions including macroeconomic, political and market trends, availability of ESG-related financial products, and the investors' preferences, including, in particular, their willingness to invest sustainably.

15. Building on the business environment analysis, competent authorities could further consider ESG factors and risks in their assessment of the investment firm's main activities, geographic presence and market positions to identify the investment firm's business lines, portfolios and investment products that are sensitive to ESG factors and therefore subject to ESG risks, and their level of concentration in ESG-sensitive sectors and geographies.

16. In accordance with paragraph 74 of the SREP Guidelines, when analysing the business model of certain investment firms, competent authorities should conduct both a quantitative analysis, to understand investment firm's financial performance, and a qualitative analysis, to understand the success drivers and key dependencies of its business model. Such analyses could incorporate ESG considerations, supporting competent authorities in assessing the materiality of ESG factors and risks the investment firm may be exposed to or may pose to others, and how these could further affect its clients and markets in which it operates.

17. When analysing key quantitative features of the investment firms' current business model, competent authorities could consider ESG factors and risks within the following areas:

a. risk appetite: whether ESG risk considerations are appropriately taken into account in the limits and formal targets set by the investment firm and are consistent with the (ESG) risks the investment firm is willing to take to achieve its strategic (ESG) objectives;

b. balance sheet and assets under management: whether changes in the book value of asset are (partially) caused by ESG risk drivers and how this is assessed and quantified by the investment firm;

c. portfolio-specific analysis: whether ESG risk drivers could force the investment firm to adjust their forecasting, financial ratios or portfolio composition;

d. concentrations: whether the balance sheet or the assets under management reveal concentration in regions, sectors, industries, or products highly exposed to ESG factors and risks; and

e. profit and loss: whether the investment firm derives a significant portion of its profitability from assets that are significantly exposed to ESG risks.

18. While performing the qualitative analysis, competent authorities could consider ESG factors and risks in the following areas:

a. key external dependencies: the impact of regulatory changes on the market values of investee companies, such as carbon-pricing, minimum environmental or labour standards or an outright ban of certain activities;

b. key internal dependencies: soundness of the methodologies and IT tools used by the investment firm to identify and evaluate ESG risks;

c. level of engagement: the extent to which the investment firm directly (e.g. exercising voting rights) or indirectly (e.g. public communication) engages with investee companies;

d. attractiveness for clients: the ability of the investment firms to align with investors' preferences regarding ESG factors, i.e. the ability to provide, validate and monitor sustainable funds or sustainable investment strategies;

e. areas of competitive advantage over peers: these areas could include investment in sustainable offering, quality and transparency of the investment firm's methodology to evaluate the degree of sustainability of its products/investments offering.

2.2 Analysis of the strategy and financial plans

19. In a forward-looking manner, as per paragraph 87 of SREP Guidelines, competent authorities should analyse the investment firm's financial projections and strategic plans, including the main quantitative and qualitative strategic objectives, the investment firm's projected financial performance, the plausibility and consistency of the investment firm's assumptions, and its ability to effectively execute them. This could include the analysis of

whether and how ESG factors and risks can affect such strategic objectives and projected financial performance.

20. When analysing the strategy and financial plans of investment firms, competent authorities could consider the following aspects:

    a. Strategy: the impact of ESG factors and risks on the investment firm's objectives, the level of ambition and feasibility of strategic ESG objectives compared to the overall strategy and challenges the investment firm may face;

    b. Investment strategy and advice: the investment firm's ability to realise informed sustainable investment on its own account – if the investment firm is dealing on its own account – based on its risk appetite or on the account of its clients based on clients' (sustainability) preferences (while acknowledging that sustainability objectives for investment on behalf of clients should be agreed by the clients) and to proactively monitor such investments;

    c. Projected financial performance: where the investment firm aims to align with ESG criteria, how such alignment may impact the overall financial performance;

    d. Drivers of the strategy and financial plan: ESG risk considerations related to short-, medium- and long-term objectives, sustainable products, investment offers in light of clients' preferences and alignment with the transition to a sustainable economy; and

    e. Assumptions for financial planning: whether the investment firm integrates ESG considerations into financial planning, such as the impact of transitioning to a sustainable and a low carbon economy.

21. Competent authorities are expected to challenge investment firms on how they reflect ESG considerations in their business strategy, taking into account the already existing investors' appetite for sustainable products and the transition to a sustainable and low carbon economy.

2.3 Assessing business model viability and sustainability

22. In accordance with sections 4.7 and 4.8 of SREP Guidelines, building on the analyses of the business environment and the investment firm's strategy, competent authorities should assess short-term viability and medium-term sustainability of the business model.

23. In order to take a forward-looking perspective, competent authorities should evaluate over at least the following three years whether the investment firm is able to generate acceptable returns given its strategy, forecasts, and business environment. Competent authorities could incorporate ESG factors and risks in this analysis by assessing elements such as:

    a. the implications for the business environment in which the investment firm operates coming from existing and forthcoming public policies such as the EU Green Deal, comprising the Climate Law, national climate and environment protection acts, carbon taxes or schemes, and actions to address social issues;

b. whether and how the investment firm integrates such implications into its assumptions, investment strategies and projected financial performance, for instance based on ESG-related scenario analyses (this can include assessment of the treatment of historical returns and losses from instance carbon-intensive industries, as these may require some adjustments in the projections); or

c. whether the investment firm runs a higher strategic risk by failing to transition to a sustainable and low carbon economy due to its operations in activities highly exposed to ESG factors and risks.

24. In accordance with paragraph 94 of SREP Guidelines, as a minimum, competent authorities should assess the key vulnerabilities to which the investment firm's business model and strategy are exposed to, considering ESG risks and their impact on the viability and sustainability of the business model and long-term resilience of the investment firm. Such key vulnerabilities could encompass (i) the reliance on an unrealistic long-term investment strategy, (ii) excessive concentration in ESG-sensitive portfolios or assets, (iii) exposure to significant external developments such as changes in regulatory landscape or in clients' preferences, or (iv) exposure to greenwashing events, such as when investment firms' practices are not aligned with their public (ESG) statements or making false or misleading claims on ESG credentials of their financial products or in their financial advice.

2.4 ESG considerations for the longer-term resilience of investment firms

25. With the above assessments of the viability and sustainability of the business model, some ESG factors could be captured, and related vulnerabilities could be identified. However, it is reasonable to assume that the existing assessment would not sufficiently enable competent authorities to understand the longer-term breadth and magnitude of the impact of ESG risks on future performance and longer-term vulnerabilities of the investment firm. Therefore, it would be beneficial to extend the analysis to a longer-term resilience of the investment firm over a period of at least 10 years. This analysis could be designed in a qualitative manner and using different scenarios, as any quantitative projections of the risks over such long-term would necessarily come with increasing uncertainties.

26. Where materially exposed to ESG risks, competent authorities could consider conducting an analysis of investment firm's longer-term resilience whose outcome may support competent authorities, where relevant, in issuing recommendations or in the application of qualitative supervisory measures. Such analysis would be particularly relevant for larger investment firms, especially those classified as category 1 in accordance with paragraph 15 of SREP Guidelines[4].

[4] Category 1 investment firms include firms whose value of total assets and off-balance sheet exposures are equal or exceed EUR 1 billion, or whose value of the total assets and off-balance sheet exposures is equal to or exceeds EUR 250 million and they perform activities referred to in point (3) or (6) of Section A of Annex I to Directive 2014/65/EU (*OJ L 173, 12.6.2014, p. 349–496)* or for those that are considered significant based on supervisory judgment of the competent authority

27. While performing this longer-term analysis, competent authorities could consider the projected longer-term changes to the business environment proposed by the investment firm and question how its business strategy responds to these changes. In doing so, it is important that competent authorities challenge the investment firm's assumptions, considering plausible future states of the economy and various possible transition paths by taking into account how ESG risk drivers may impact the firm's activities, their potential impact on the business model, and the vulnerabilities they may create.

2.5 Conclusions and policy recommendations on business model analysis

- **To appropriately reflect ESG factors and risks in the supervisory evaluation, the EBA sees a need to proportionately incorporate them into the business model analysis.**
- **Where competent authorities consider the investment firm is materially exposed to ESG risks, the viability and sustainability assessment under existing SREP Guidelines might not sufficiently enable competent authorities to understand the longer-term impact of ESG risk drivers on the firm's business model. In this context, a qualitative longer-term analysis of the investment firm's resilience in light of ESG risk drivers should be introduced. This analysis could be particularly relevant for investment firms classified as category 1 in accordance with paragraph 15 of SREP Guidelines[5].**

[5] Category 1 investment firms include firms whose value of total assets and off-balance sheet exposures are equal or exceed EUR 1 billion, or whose value of the total assets and off-balance sheet exposures is equal to or exceeds EUR 250 million and they perform activities referred to in point (3) or (6) of Section A of Annex I to Directive 2014/65/EU (*OJ L 173, 12.6.2014, p. 349–496)* or for those that are considered significant based on supervisory judgment of the competent authority

3. Assessment of internal governance and risk management

28. SREP Guidelines set out criteria that competent authorities should use when assessing internal governance and investment firm-wide controls. The EBA is of the view that this assessment should incorporate ESG-related considerations to ensure a sound risk management, appropriate internal controls, and oversight.

29. Competent authorities should account for the principle of proportionality with a view to ensure that the internal governance arrangements established by the investment firm with regard to ESG factors and risks are proportionate to their size, internal organisation, business model, and suitable for the nature, scale, and complexity of their activities. They should also consider whether the investment firm is materially exposed to ESG risks.

30. In this context, as per Article 68 of Directive 2014/65/EU, it is important that the competent authorities cooperate with competent authorities designated to carry out the duties provided under that Directive. Such cooperation may cover, amongst other aspects, (i) investor protection, especially ensuring that investors' preferences in terms of ESG criteria are adequately considered, and (ii) that investment firms' commercial products are appropriately designed.

31. In November 2021, the EBA has published Guidelines on internal governance under IFD[6]. These guidelines require the incorporation of ESG factors and risks in the firms' risk management framework and in internal governance arrangements, including the functioning of the management body and its committees.

3.1 Overall internal governance framework

32. To the extent that investment firms are subject to similar requirements as credit institutions with regard to internal governance arrangements, similar guidance can be provided to competent authorities on how to incorporate ESG considerations in their assessment as described in Chapter 4 of the EBA Report of June 2021. Where relevant, it is important that competent authorities consider how ESG factors and ESG risks management have been incorporated into the overall internal governance framework in the following areas:

    a. suitable and transparent organisation and operational structure with clearly defined and allocated responsibilities regarding ESG factors and risks monitoring, including those of the management body and its committees;

    b. sound internal governance framework including an internal control framework that considers ESG factors and risks, including by the compliance function and, where

[6] Guidelines on internal governance under Directive (EU) 2019/2034 (EBA/GL/2021/14)

appropriate and proportionate, an internal risk management and internal audit function;

c. effective provision of services in the field of ESG investment, with sufficient human and technical resources;

d. consideration of ESG factors and risks in the investment firms' business and risk strategy and risk appetite; and

e. effective policies and processes to identify, assess, manage and mitigate ESG factors and risks, appropriately reflecting specificities of ESG risk drivers and their impact.

3.2 Management body, corporate and risk culture

33. In accordance with EBA Guidelines on internal governance under Directive (EU) 2019/2034[7], it is expected that the role of the management body to implement, monitor and oversee the investment firms' strategies, strategic objectives, risk strategy and internal governance arrangements applies also in the context of ESG considerations.

34. When assessing the organisation and functioning of the management body, particular aspects that could be relevant for the supervisory assessment of investment firms' internal controls of ESG risks include verification whether:

    a. the management body, in its management function, adequately defines a strategy to address ESG risk drivers, sets objectives and appropriate limits given identified risks;

    b. the management body, in its management function, appropriately directs the investment firm, considering its defined ESG risk-related strategy;

    c. the management body, in its supervisory function, adequately oversees and monitors management decision-making and actions, considering the objectives and limits implemented to address ESG risks;

    d. the management body allocates responsibilities for ensuring adequate identification and monitoring of ESG factors and risks to the most appropriate function depending on the firm organisational structure and risk profile;

    e. the management body has sufficient skills, expertise and knowledge, while developing its experience related to the management of ESG risks; and

    f. the presence of a sound and consistent risk culture within the organisation promotes sufficient awareness of ESG considerations and helps ensure appropriate and effective management of risks.

3.3 Remuneration policies and practices

[7] Guidelines on internal governance under Directive (EU) 2019/2034 (EBA/GL/2021/14)

35. In accordance with paragraph 16 of EBA Guidelines on sound remuneration policies under Directive (EU) 2019/2034, investment firms are expected to align their remuneration policies for all staff with their business and risk strategy, including ESG-related objectives, corporate culture and values, risk culture, including with regard to ESG risks, long-term interests of the investment firm, and the measures used to avoid conflicts of interest, encourage prudent risk taking and responsible business conduct. Due to the long-term effect of ESG factors and risks on investment decisions, especially where the impact of these factors and risks are likely to be material, competent authorities should ensure that such factors and risks are considered in the investment firm's remuneration policies.

36. The impact of the remuneration policies on the achievement of sound and effective long-term risk management objectives from the point of view of ESG considerations may be especially relevant when it comes to the variable remuneration of categories of staff whose professional activities have a material impact on the institution's risk profile given their organisational roles and responsibilities.

3.4 Internal control framework

37. The main elements for the assessment of the investment firm's internal control framework as set out in the SREP Guidelines, including the management body's responsibilities and tasks, and the activities of all business lines and internal units, are equally relevant with regard to ESG-related strategies, policies, and procedures. Specific ESG considerations could be integrated when evaluating the functioning of the 'lines of defence' model, to ensure consistency in the implementation of ESG-related objectives and limits.

3.5 Risk management framework

38. Competent authorities should ensure that ESG considerations are adequately and sufficiently integrated into the investment firms' risk management framework, as indicated in paragraph 139 of EBA Guidelines on internal governance under Directive 2019/2034. When performing their assessment, competent authorities could verify whether:

    a. the investment firm has a proportionate and consistent risk strategy, risk appetite and risk management framework which also addresses ESG factors and risks as they pertain to the sufficiency of capital and liquidity;

    b. where ESG factors and risks are material, the investment firm sufficiently reflects these in its risk appetite framework;

    c. the investment firm has adequate policies and procedures in place to appropriately address ESG risk driven by ESG factors;

    d. the investment firm establishes and maintains adequate internal control policies, mechanisms and procedures identifying and monitoring ESG factors and risks, and their impacts on the investment firm, its clients and markets in which it operates;

e. where ESG factors and risks are deemed material, and where the investment firm has an internal capital adequacy and risk assessment process (ICARAP)[8] in place, the investment firm appropriately considers ESG factors and risks, and evaluates their potential transmission into financial risks within its ICARAP.

3.6 Information and communication technologies

39. As part of their assessment of internal governance framework, competent authorities should evaluate whether the investment firm has effective and reliable information and communication systems. In the context of ESG factors and risks, competent authorities could assess whether these systems and related processes ensure appropriate data aggregation capabilities and are sufficient to allow the investment firm to identify, quantify and monitor ESG risks.

3.7 Conclusions and policy recommendations on internal governance

- **The ESG considerations should be proportionately incorporated in the assessment of the investment firm's internal governance and firm-wide controls, including the assessment of how ESG factors and risks are incorporated into internal governance, the functioning of the management body, the risk culture, remuneration policies and practices, risk management, information systems and internal controls.**

[8] As defined in paragraph 11 of SREP Guidelines

4. Assessment of risks

40. The SREP Guidelines set out the criteria for competent authorities when assessing risks to capital (risk-to-client, risk-to-firm, risk-to-market and other risks related to ongoing activities of investment firm, as well as the risk of unorderly wind-down) and risk to liquidity, into which, competent authorities may decide to incorporate ESG considerations, where such risks are material.

41. It is expected that ESG risks would manifest differently on investment firms' balance sheet or profit and loss statements depending on the types of the services and activities they conduct. Therefore, it is important that the ESG considerations in supervisory assessment are tailored to the services and activities these investment firms offer.

4.1 Assessment of risk-to-client

42. Competent authorities should assess risk-to-client arising from investment firms' assets under management, client money held, assets safeguarded and administered, and client orders handled, as set out in section 6.3 of SREP Guidelines. Through the assessment of risk-to-client, competent authorities should determine the main drivers of the investment firm's risk-to-client K-factor amounts and evaluate the significance of the impact of this risk on investment firm's own funds.

43. ESG factors can drive risk-to-client, depending on the activities and services of the investment firm. It is reasonable to argue that while it is possible to establish a link between ESG factors and investment firms' assets under management, ESG considerations are not assumed to significantly impact the operational risk addressed through other K-factors such as client orders handled, client money held, assets safeguarding and administering client assets.[9] Hence, the discussion below focuses on the former only.

44. K-factor for assets under management (K-AUM) is relevant for investment firms offering discretionary portfolio management and nondiscretionary investment advice following their clients' mandates. Competent authorities are expected to assess the risk of incurring a loss due to mismanagement of clients' assets under management, notably due to a breach of mandate or contractual terms, which can impact investment firm's capital position but also its ongoing viability. ESG factors may drive such risks for example through breach of contractual terms related to a (complex) ESG product and, depending on the materiality of such products, competent authorities could look at the complexity of mandates and strategies.

4.2 Assessment of risk-to-firm

45. In line with section 6.5 of SREP Guidelines, competent authorities should assess risk-to-firm arising from different risk factors such as exposure to the default of trading counterparties, operational risk from daily trading flow, and concentration risk due to large exposures. In their assessment, competent authorities are expected to also consider material sources of

[9] For a related discussion, see Section 9 of EBA/DP/2022/02

risk to the investment firms such as changes in the book value of assets, the failure of counterparties, the positions in financial instruments and commodities. Through the assessment of risk-to-firm, competent authorities should determine the main drivers of the investment firm's risk-to-firm K-factor amounts and evaluate the significance of the impact of this risk on investment firm's own funds.

46. ESG factors can drive risk-to-firm depending on the activities and services of the investment firm. Risk aspects related to investment firms' dealing on own account activities including counterparty credit risk and concentration risk may have a direct link with ESG factors. As such relationship is less apparent with investment firm's daily trading flow, this aspect is not covered in the further analysis.[10]

47. The K-factor for trading counterparty default (K-TCD) reflects the features of the counterparty credit risk module for credit institutions.[11] ESG factors may drive trading counterparty default risk and competent authorities would need to assess this risk arising from the current or prospective impact of ESG risks on investment firms' counterparties, should they become material.

48. Similarly, K-factor for concentration (K-CON) captures concentration risk in relation to individual or connected counterparties to which investment firms have exposures above certain thresholds. It is important that the competent authorities form a view on the degree of concentration in exposures vulnerable to ESG factors and risks and assess to what extent the existing requirement is adequate to cover them. The risks related to potentially highly concentrated investments in ESG-sensitive clients or groups of connected clients, products, sectors, or geographical locations, reducing the benefits of portfolio diversification, may result in more volatile portfolio, especially where these assets are subject to abrupt changes in ESG factors. Such assessment is, for example, particularly recommended for investment firms specialised in commodity derivatives trading due to underlying assets, particularly sensitive to ESG factors and risks. To that aim, it is also important for competent authorities to assess investment firms' policies and procedures to appropriately manage concentration in such exposures.

49. Additionally, competent authorities could form a view on other sources of risks-to-firm potentially driven by ESG factors, including the following:

    a. ESG factors may negatively impact investment firms' own funds arising from material changes in the book value of assets, including off-balance sheet items, where these assets are realised below book value, subject to impairments due to revaluation, write-off due to non-recoverability or other operational events.

    b. ESG factors may drive adverse movements in investment firms' positions in financial instruments. In this context, risk of losses from adverse movements largely depends on the ESG-sensitive nature of these instruments in which investment firms take positions.

    c. ESG factors may cause counterparty failure from a number of investment firm's ancillary activities such as granting loans to allow a client to carry out a transaction,

[10] For a related discussion, see Section 9 of EBA/DP/2022/02

[11] See section 5.5.1 of EBA/REP/2021/18

direct loans to staff intraday credit risk due to overdraft, guarantee and contingent credit, exposures, hold to maturity or illiquid bond positions, margin loans to clients, accruing/unpaid fees and commissions, direct credit exposures to their managed funds via loans, seed investments and guarantees. In this context it may be relevant for competent authorities to assess the impact of ESG factors and risks on the creditworthiness and potential default of a client or counterparty, ESG-related changes market conditions, effectiveness of collateral, as well as possible concentrations.

d. Credit risk may also occur from other sources such as the impairment or depreciation of assets outside the trading book that is not captured by K-TCD. At this point, supervisory assessment could play a key role to form a comprehensive understanding of the investment firm's risk profile taking into account ESG risks as drivers of credit risk.

4.3 Assessment of risk-to-market

50. Competent authorities should assess risk-to-market arising from exposures on the trading book of an investment firm dealing on own account. In the framework of market risk, the assessment of the impact of ESG factors and risks on net position risks is similar to that of credit institutions, as described in section 5.5.3 of the Report (EBA/REP/2021/18), while the impact of ESG risks on clearing margins given could be assessed separately. Therefore, it is important that the competent authorities, where applicable, consider ESG factors in their supervisory assessment including the following elements:

    a. The nature and composition of the investment firm's exposures to market risk where they are or can be driven by ESG factors. It is important to assess how market risk exposures may be affected by ESG factors, impacting their liquidity and profitability.

    b. Profitability of the investment firm and how this may be impacted by the assets and financial instruments subject to ESG factors.

    c. Market concentration risk with a focus on complex and illiquid products where ESG factors can act as drivers for such risks.

51. Additionally, while performing their assessment, competent authorities could review whether investment firms:

    a. considered ESG risks in their market risk strategy and investment decisions;

    b. outlined an adequate set of controls identifying the emergence of ESG risks;

    c. introduced ESG-related targets and risk limits; and

    d. where applicable, have in place policies on the integration of ESG considerations in their prudential valuation and internal models.

4.4 Assessment of other risks

52. Section 6.6 of SREP Guidelines sets out several other potential risks which investment firms may be exposed to but that are not covered by capital requirements. ESG factors may also drive such risks.

53. It is important that competent authorities assess whether investment firms account for these risks considering ESG factors as their drivers and take necessary measures to mitigate them. This could include the assessment of:

    a. **Conduct risk:** whether investment firms account for potential financial losses they may face due to damage claims or litigations with a client due to failure to meet certain ESG criteria, mis-selling cases, including greenwashing, or non-compliance with relevant laws and regulations such as the EU disclosure standards under Sustainable Finance Disclosure Regulation (SFDR)[12].

    b. **Regulatory, legal and fiscal risks**: whether investment firms comply with the existing laws and regulations in the area of ESG criteria and consider potential litigation and penalties due to non-compliance with binding standards.

    c. **Reputational risk**: whether the investment firms' activities violate ESG criteria and policy objectives in transitioning to a sustainable economy that can lead to reputational damage, and actions they take to mitigate such damages.

4.5 Assessment of liquidity risk

54. Furthermore, competent authorities could also consider ESG factors in their assessment of the investment firm's liquidity risk. In particular, for investment firms classified as category 1[13], competent authorities should consider assessing the potential impact of one or more ESG shocks on the investment firms' quality and amount of liquidity resources depending on the scope, nature and complexity of investment firms' activities.

55. While performing their assessment of investment firms' liquidity management, competent authorities could particularly focus on the following elements:

    a. the potential consequences of an ESG-related shock, such as acceleration of outflows from margin calls, losses from dealing on own account and reduction of funds, from which an investment firm generates fees and commission income to manage its liquidity position;

    b. the impact of an ESG-related shock on the investment firms' ability to monetise its liquidity resources, especially in cases where liquid assets are highly concentrated in counterparties, sectors and geographies that are vulnerable to ESG risks, which

[12] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32019R2088

[13] In accordance with paragraph 15 of EBA SREP Guidelines, category 1 investment firms include firms whose value of total assets and off-balance sheet exposures are equal or exceed EUR 1 billion, or whose value of the total assets and off-balance sheet exposures is equal to or exceeds EUR 250 million and they perform activities referred to in point (3) or (6) of Section A of Annex I to Directive 2014/65/EU or for those that are considered significant based on supervisory judgment of the competent authority

could affect timely monetisation or loss absorption capacity of the assets when converting them into cash during stress periods;

c. the sustainability of the investment firms' funding profile, in particular whether ESG factors could imply material changes to the types and characteristics of funding sources given changing market environment.

56. Competent authorities should also ensure a sufficiently sound risk management framework to address liquidity risk, including an adequate strategy, with certain limits and tolerances. In this context competent authorities could also verify whether these strategies and liquidity risk management practices take into consideration the sensitivity of liquid assets to ESG factors and risks.

4.6 Conclusions and policy recommendations on risk to capital and liquidity

- **ESG risks can materialise in the form of existing risks to capital or liquidity risk. The way in which ESG factors may drive such risks and may manifest on investment firm's balance sheet and/or income statement significantly depends on the services and activities of the investment firm. Where ESG factors and risks are relevant and material for an investment firm, they should be progressively and proportionately integrated into the supervisory assessment of investment firms' risk to capital and liquidity risk. The assessment should capture both the level of inherent risk and the review of risk-specific controls.**
- **The assessment of ESG factors and risks, if deemed material by competent authorities, should progressively and proportionally be incorporated into the supervisory capital assessment to evaluate whether additional own funds are required to cover material risks that are not sufficiently covered by Part Three or Four of Regulation (EU) 2019/2034, and similarly, into the evaluation of specific liquidity measures in accordance with Article 42 of Directive (EU) 2019/2034. Such assessment should be proportionate to the business model, size, and complexity of the investment firm, and the cost of implementation such assessment would put on investment firms and competent authorities.**

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