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European Banking Authority Reports on the Role of Environmental and Social Risks in the Prudential Framework

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In October 2023, the European Banking Authority (EBA) **published a report** addressing the need for a comprehensive prudential framework that adequately considers emerging environmental and social risks. The report is a response to Article 501c of Regulation (EU) No 575/2013 (the Capital Requirements Regulation 2013 (CRR)) and Article 34 of Regulation (EU) 2019/2033 (the Investment Firms Regulation (IFR)), and the EBA initiated its publication through a discussion paper on May 2, 2022. This report signals a series of upcoming reports in line with the CRR.

To address environmental and social risks, the report advocates a holistic approach, suggesting short-term enhancements to the current Basel Pillar 1 framework. These modifications aim to swiftly integrate environmental and social risks, emphasizing risk management/supervision (Pillar 2) and market transparency (Pillar 3). The proposed changes cover both standardized and idiosyncratic approaches, recognizing the efficacy of internal models in capturing new risks. Pillar 1, 2 and 3 requirements were established by Basel II. Pillar 1 establishes minimum capital requirements based on market, credit and operational risks, including environmental risks, and a minimum leverage ratio. Pillar 2 applies in addition to Pillar 1, where this underestimates certain risks. Pillar 3 focuses on transparency through prescribed public disclosures.

Recognizing the link between environmental and social factors and traditional financial risks, the report emphasizes institutions' need to develop techniques for identifying and quantifying these risks. The EBA plans to monitor the incorporation of environment-related information into models and accounting, proposing amendments to supervisory reporting frameworks for enhanced data collection on environmental risks.

Considering data challenges, the EBA explores scenario analysis to enhance the forward-looking elements of the prudential framework. The report acknowledges ongoing developments in the sustainable finance regulatory framework, highlighting the need for future prudential treatments to align with emerging policy tools.

Taking the Temperature: We reported in December 2022 on the EBA's publication of its roadmap on sustainable finance, which outlined the "objectives and timeline for delivering mandates and tasks in the area of sustainable finance and environmental, social and governance (ESG) risks." The roadmap set out the EBA's plan for the next three years to "integrate ESG risks considerations" into the banking framework and to "support the EU's efforts to achieve the transition to a more sustainable economy." The roadmap followed various legislative acts and initiatives that have allocated to the EBA "new mandates and tasks in the area of sustainable finance and ESG risks."

As elements of the European sustainable finance regulatory framework are still evolving, the EBA is set to continue integrating environmental and social risks across all regulatory pillars. This aligns with broader initiatives outside of the prudential framework that aim to contribute to the transition towards a sustainable economy while ensuring the resilience of the banking sector. As we previously reported on June 1, 2023, the EBA articulated a common, high-level definition of greenwashing and outlined greenwashing risks, impacts, proposed mitigation efforts and challenges for the industry. We also reported on the EBA's release of its opinion on the first set of European Sustainability Reporting Standards, in which the EBA stated that the ESRS promoted "significant improvement" in climate-related disclosures and demonstrated "overall consistency with international standards and relevant EU Law." Notably, the EBA recognized how the ESRS "better align[ed] with the disclosure requirements under [the] EBA's Pillar 3 Framework."