

**BNP PARIBAS RESPONSE TO THE EBA DISCUSSION PAPER ON THE ROLE OF ENVIRONMENTAL RISKS
IN THE PRUDENTIAL FRAMEWORK**

BNP Paribas, as a major player in sustainable finance, welcomes the opportunity to comment on the EBA discussion paper on the role of environmental risks in the prudential framework.

BNP Paribas has been committed to a transition toward a sustainable economy since 2011. In 2021, as disclosed in the Universal Reference Document ¹ :

- BNP Paribas committed to a carbon neutral economy by 2050 by signing the Net Zero Banking Alliance (NZBA), the Net Zero Asset Owner Alliance (NZAOA, signed by BNP Paribas Cardif) and the Net Zero Asset Managers initiative (NZAMi, signed by BNP Paribas Asset Management).
- The Group has committed to reducing its credit exposure to oil and gas exploration and production activities by 12% between 2020 and 2025.
- The ESG analysis of counterparties is being deepened thanks to a new risk assessment tool, the ESG Assessment. By 2023, 100% of the Group's large corporate clients will have been analysed in 5 areas (climate, pollution and biodiversity, workers' rights, the rights of local communities and consumers, governance and business ethics).
- BNP Paribas has set up a dashboard comprising 9 CSR indicators to guide its strategy in this area. The monitoring of this CSR dashboard is carried out on an annual basis by the Group's Executive Committee and Board of directors. The achievement of these 9 indicators is included in the calculation of the three-year retention plan for more than 7,000 key Group employees, where they account for 20% of the award conditions.
- As part of the launch of its Strategic Plan for 2022-2025, BNP Paribas has defined new CSR management indicators with commitments by 2025.

BNP Paribas is also fully supportive of the energy and ecological transition

- BNP Paribas has created the Low-Carbon Transition Group, comprising in the long term a total of 250 professionals dedicated to financing the energy transition of its customers.
- BNP Paribas has set a target in funding contributing to the protection of biodiversity by 2025, has strengthened its policy of combating deforestation, has launched with Solar Impulse a fund to support innovative start-ups with high potential in the ecological transition.
- BNP Paribas sits on the Taskforce on Nature-related Financial Disclosure (TNFD). We were co-chair of the Informal Working Group that contributed to the launch of the TNFD.

The BNP Paribas Group is exposed to risks related to climate change, either directly through its own operations or for certain of its assets or indirectly through its financing and investment activities. BNP Paribas monitors the potential impact of these risk factors in the conduct of its business, in that of its counterparties or in its investments on its own behalf or on behalf of third parties. The Group thus integrates these risk factors into its risk management process.

¹ <https://invest.bnpparibas/en/document/universal-registration-document-and-annual-financial-report-2021>

We agree with EBA concluding remark that “Prudential regulation should remain risk-based and evidence-based”. We also agree with EBA proposal that ESG risks are not specific risks, but ‘risk drivers’ that may impact “traditional” categories of risks such as credit, market, operational or strategic risk. We also fully share EBA views that historical data and evidence is not yet available to support adaptation of the Pillar I framework. Before answering the questions raised by EBA in the Discussion Paper, we would like to emphasize the following key views.

Additional capital requirements will hamper EU banks’ ability to finance the transition

- We believe that **increasing banks’ capital requirements is not the right approach** as **banks need to be able to finance the transition of their clients**, in a context of increasing financing needs to support the economy’s transformation shift. This is all the truer in the EU where the financing of companies remains mostly bank-loan based.
- “Front-loading” capital requirements would not necessarily deliver a tangible difference in resilience. Instead, they could constrain capacity to extend credit and investment to key sectors in need of transition finance, which could potentially ‘bring forward’ transition-related disruptions to the economy (e.g., exacerbating inequality by unaffordable energy prices), and negatively impact climate outcomes.
- Banks are part of the solution to achieve the objective of net-zero greenhouse gas (GHG) emissions in the EU economy by 2050 but they should not be the primary enforcers of the EU climate policy. There is a **political responsibility in defining the relevant industrial and tax policies** to ensure an orderly transition and limit transition and physical risk levels. EBA also strengthened in the Discussion Paper that “The primary responsibility and most effective tools for dealing with environmental-risk-related externalities lie within the remit of political authorities”. In this context, the priority is the definition by the European Union of a detailed transition path towards a decarbonized economy by 2050, at a granular level, by industrial sector and by country, considering the industrial implications of a successful transition. This is a key pre-requisite for the European banking supervisors to assess, as part of the Supervisory Review and Evaluation Process (“SREP”), the way banks adapt their climate risk management frameworks, as relevant, to support the financing of these transition paths.
- Last, in a globalised economy, punitive changes to EU banks’ prudential requirements would only result in a substitution of the financing, which will be taken over by **non-EU banks and/or non-bank players**, subject to less stringent regulatory standards. This may put the related risks beyond the reach of EU regulators and supervisors.

The definition of the appropriateness of capital, in terms of nature and calibration, is not mature

- The Regulatory capital framework is designed to cover **unexpected losses with a time horizon of 1 year**, without the intervention of material mitigation and strategic actions. Banks, supervisors and regulators face huge challenges to include the long-term horizon and the forward-looking nature of climate, and more broadly, environmental risk factors.
- We share BCBS’s and EBA’s view that climate factors are not a new category of risk per se: they are ‘risk drivers’ of the existing prudential risk categories, especially credit risk, with a potential

positive or a negative impact. **However, given the nascent nature of the collective understanding of how the climate risk drivers may impact these traditional risks**, it is deemed premature to define a regulatory capital treatment. Indeed, given gaps in the evidence-base, necessary data, and methodology, it is very challenging, at this stage, to calibrate risk parameters such as PDs and LGDs, in credit risk, taking into account climate related risks drivers. **As long as robust risk-based methodologies have not been established and experienced**, reliable counterparty data is not available and the results of supervisory exercises is not stabilised, it would be far too early to foresee any additional capital requirement.

- We also believe that **non-risk-based Pillar 1 adjustments, such as the Brown Penalizing Factor or the Green Supporting Factor (GSF) would be pure political measures**. The underlying objectives should be addressed through public policies or taxes and not through banking regulation. The anchor of the prudential framework must remain risk-based as rightly pointed out by the EBA in its discussion paper. The only consideration of the characteristic of a transaction being sustainable or not does not imply a low or high credit risk.
- The potential interplay between macroeconomic cycles and climate risk factors has not been established, so **the use of macroprudential tools in this area would not be appropriate at this stage**. In February 2022, the Financial Stability Institute ('FSI') highlighted in its Brief No. 16 'The regulatory response to climate risks: some challenges' that applying the macroprudential framework to systemic climate-related financial risks is likely to be ineffective and potentially counterproductive for financial stability. It also notes that 'macroprudential measures aimed at reducing exposures to carbon intensive firms and sectors may not always be conducive to reducing aggregate climate-related financial risks. In particular, a significant increase in capital requirements for brown exposures, by curtailing the availability of credit to carbon intensive industries would increase the vulnerability of those sectors and hinder affected firms from adjusting their business models'. Ultimately, a macroprudential buffer linked to climate could thus delay the financing of transition by banks, delay transition as a result and increase the potentially systemic nature of climate risk and financial stability as a result.

In addition, as highlighted below, proactive work is ongoing to adapt Pillar 2 frameworks, as need be, to capture climate-related impacts if deemed material. Hence, it will be key to ensure that overlap or double counting does not occur over time – as well-acknowledged by the EBA.

Pillar 2 would be the most appropriate framework, but the development of robust climate scenarios, methodologies and data are still globally shared challenges

- **Pillar 2 approaches could be considered, but stress testing is not the right approach to calibrate climate-related Pillar 2 requirements**. Rather, BNP Paribas is supportive of climate scenario analyses, which are by design best suited to apprehend climate risk drivers, given their forward-looking nature. In this context, BNP Paribas has participated in a number of industry-wide exercises, notably the French supervisor, ACPR climate stress test in 2020, which was done on a voluntary basis, and the ECB 2022 Climate stress test. BNP Paribas has also included a climate scenario in its 2021 and 2022 ICAAPs.
- **Climate scenario analyses are useful tools to capture changes in business models that banks will need to undertake** in climate scenarios. Indeed, transition scenarios may result in a rebalancing of

economic activity across sectors and, within sectors, across counterparties. Climate scenarios are not designed, like traditional stress test scenarios, to measure losses, and thus capital, in adverse macro-economic circumstances. Indeed, some sectors or players in sectors can be expected to benefit from climate change. Climate scenarios are designed to anticipate sectoral evolutions that climate change will trigger and to help banks adjust to these changes accordingly. The horizon of climate change and of climate scenarios is also radically different from that of capital sizing stress tests. There are **various initiatives to develop climate scenarios, such as those undertaken by the NGFS² or the IEA³**. However, while welcome, these scenarios are **still incomplete. In particular, they do not offer a complete scenario framework including the modelling and projection of industrial and technological developments, as well as their translation into macro-economic variables. Until this is achieved, scenario analysis will remain exploratory and hypothetical in nature or even unrealistic on short-term horizons and not suited for capital sizing stress testing.**

- BNP Paribas remains engaged to developing climate scenarios which can be used for risk management purposes and allow the Bank to improve its understanding of expected impacts of climate change on its business model. As highlighted above, **BNP Paribas has already integrated climate scenario analyses in its 2021 and 2022 ICAAP** and will keep doing so. Indeed, a key component of the ICAAP is the **Group's business model analysis** and climate scenarios are useful tools to inform such analysis in a forward-looking manner.
- As indicated earlier, **Pillar 2, through SREP assessment, should focus on the quality of banks' risk management framework in supporting well-defined transition plans from public authorities.**
- The results published recently by the ECB of its 2022 climate stress test confirms the **multiple challenges that both supervisors and banks** face in developing reliable and plausible supervisory stress test exercises.
- The ECB notes that while banks make progress in developing climate stress testing infrastructures, many **challenges remain for coherent results** to be produced. Data availability and model developments remain unequal among banks, which is more a reflection of the specificities of climate risk (absence of historical observations, lack of uniform reporting of climate data by clients and, in the case of GHG emissions, lack of a uniform framework to report scope 3 emissions in particular) than banks' reluctance to invest in climate stress testing frameworks.
- The **approach by supervisors of climate scenarios is also widely different**: for example, the ECB transition scenarios included a 3-year scenario, which is not the case of any previous climate stress test exercise; the ECB proposed two physical risk scenarios (flood and drought & heat) while the PRA considered that a "no policy action" scenario constitutes a physical risk scenario. It is very difficult for banks to develop frameworks in the absence of common scenario approaches by supervisors.

In addition, the **time horizon of climate change inherently brings uncertainty to projections in climate scenarios**. The ECB notes in its publication report that, as far as the 30-year transition scenarios are concerned, "it should be borne in mind that the 30-year projections are exploratory and subject to significant uncertainty. Therefore, **these long-term loss projections should be**

² Network for Greening the Financial System

³ International Energy Agency

interpreted as a qualitative yardstick for the direction of travel rather than as a robust quantitative measure.” The ECB also notes that, in the long-term scenarios, “the aggregate pattern of loan loss projections over time is masked by notable differences across banks with respect to projected losses in the long term”. This is particularly true as banks make different assumptions in balance sheet projections under a dynamic balance sheet methodology, which is the preferred option in 2050 projections and the only way to properly capture the business model dimension of climate stress testing.

- Most regulators acknowledge, **the exercises are not robust enough yet in terms of data, scenarios, and methodologies**. A **progressive and iterative development** of such methodologies, scenarios and data would enable **banks to strengthen their risk management frameworks** (for example through the building of risk and IT infrastructure and the development of climate specific scenarios) and effectively continue to include climate drivers in their Pillar 2 frameworks.
- **In the meantime, a climate-related risk concentration framework, leveraging off the existing ones for pillar 2 and/or large exposures, could be useful** to monitor specific areas of concentration and take actions, as relevant, to prevent a small number of financial institutions from unduly accumulating exposures to climate-related risks. However, any potential measure such as concentration limits should be cautiously considered to avoid harming specific regions or sectors and impeding efforts to scale up transition finance to sectors that need it most.
- Irrespective of the sector, **clients demonstrating strong willingness to transition, with solid transition plans and commitments to reach net-zero by 2050 should be supported** and best in class players should have incentives to pursue their transition shift.

Conclusion

- The **focus should remain on bank’s adequate risk management and creating a policy environment that does not create disincentives and impediments to finance the transition**. Tempting to move forward with “precautionary measures” such as capital buffers, would inevitably require a departure from the core risk-based foundations of the prudential framework and introduce subjective choices pertaining to broader policy objectives and potential unintended consequences.
- To cope with the **challenges associated with time horizons, data, and methodologies, we believe that the banking industry together with regulators and supervisors should pursue dialogue and collaboration factoring in** technical work and scientific research benefitting from industrial and sectoral experts.
- **Scenario analysis is an appropriate tool to assess the consequences of climate change in various transition scenarios and anticipate business model changes. However, given the above, it is far too premature to size capital buffers on that basis.**
- Banks should keep their **ability to finance the transformational shift of the economy** and the sizeable needs stemming from the transition plans expected from Public Authorities.



BNP PARIBAS ANSWER TO THE EBA DISCUSSION PAPER ON THE ROLE OF ENVIRONMENTAL RISKS IN THE PRUDENTIAL FRAMEWORK

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.

Social dimension is important to be taken into account in the global strategy of all economical actors and therefore by banks to develop a better and sustainable world. We believe that they should be embedded into the business model and strategy but not be part of the prudential framework for the time being.

We also would like to highlight that in terms of risks, those factors have not been considered by financial authorities as potential systemic risks for the whole financial sector.

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?

BNP Paribas agrees with EBA's views to exclude liquidity and leverage ratios from the scope of their report. Leverage ratio is a non-risk-based measure that does not specifically interact with environmental risks. Liquidity ratios, such as the LCR, are based on short-term indicators whereas the impacts of those drivers of risks are rather medium to long term and it is too premature at this stage to assess impacts if any on liquidity.

Q3: In your view, are environmental risks likely to be pre- dominantly 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?

We believe that increasing banks' capital requirements is not the right approach as banks need to be able to finance the transition of their clients, in a context of increasing financing needs to support the economy's transformation shift. This is all the truer in the EU where the financing of companies remains mostly bank loan based.

Interconnection between sectors and potential impacts of the full value chain are not yet fully understood. Therefore, a significant increase in capital requirements for brown exposures, by curtailing the availability of credit to carbon intensive industries would increase the vulnerability of those sectors and prevent affected firms from adjusting their business models.

In the absence of any fact-based impact of climate risk on bank risks, any Pillar 1 treatment is premature. Equally, any capital treatment via macroprudential buffers is difficult to justify or quantify in the absence of evidence that climate risk increases risks on the banking system. Besides, the potential interplay



between macroeconomic cycles and climate risk factors has yet to be clearly established and so the use of macroprudential tools in this area would not be appropriate at this stage. Finally, such a macroprudential buffer would have the undesirable side effect of disincentivising the financing of transition efforts by corporate clients engaged in documented transition plans and strategies.

Regarding Pillar 2, a key aspect of climate change risk management will be the integration of climate change considerations in client selection and origination processes. Any Pillar 2 treatment of climate risk should thus focus on the way banks' risk management framework and practices support the financing of transition plans defined by public authorities.

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

We agree with the concept of double-materiality, as we think that, in order to finance sustainable activities, it is essential to understand not only the "outside-in" effects of ESG factors on a corporate, but also the "inside-out" effects.

As such, we support the EFRAG proposal for corporate disclosure based on double-materiality concept. However, measuring the impacts of ESG factors (even for climate, which is the most mature one) is still very challenging. Indeed, challenges arise from measuring and managing both in terms of environmental & climate (e.g. GHG emissions) and also in "social" risks, when considering the full value chain in a company's production cycle both upstream and downstream.

A bank can only rely on available information either from corporates or external providers. This information, if and when available, does not meet satisfactory quality yet. For many environmental and social factors (which rely on qualitative standards) there is no methodologies to quantify the inside-out impacts. Relying on proxies in order to bridge data and methodology gaps could be an option, but, for the time being, there is no harmonized proxies/estimates among banks, which could potentially expose banks to liability risks.

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?

BNP Paribas has identified the availability of meaningful and comparable ESG data as a challenge (e.g. no third party audits on data quality, significant variation on data from different providers or from one sector to another, almost no ESG reporting from SMEs, non-standardized reporting, lack of transparency on methodologies...).

We suggest a greater transparency and standardization of methodologies. We are also facing the challenge of collecting data from corporates. We need to find an industrialized way to collect ESG data. The ESG data point currently developed by the EU European Single Access Point (ESAP) will be very helpful, even if it will only cover clients subject to Corporate Sustainability Reporting Directive (CSRD) reporting. International open-source initiatives such as OS-Climate to which BNP Paribas is taking an active part should be further fostered by public bodies as well.

Within the bank, the reporting systems are being adapted with a short-term solution to industrialize regulatory reporting (EU taxonomy eligible and aligned assets, ESG Pillar 3) and ESG monitoring reporting (Sustainable Business Development Plan and risk monitoring).

Moreover, data governance and IT architecture is being upgraded gradually to respond to the new reporting needs.

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.

BNP Paribas agrees with the risk-based approach adopted by the EBA. Prudential framework is to ensure financial stability and should be kept risk-sensitive in order not to distort measurement of banks' solvency. This is further acknowledged through the CRR3 proposal to increase the risk-sensitivity of Standardised Approaches. We strongly believe that understanding and adequately managing the underlying risks of activities, including climate and environmental-risk related drivers, imply a risk-based approach.

Q7: What is your view on the appropriate time horizon (s) to be reflected in the Pillar 1 own funds requirements?

Current framework is one year horizon whereas environmental risk drivers are rather Medium Term to Long Term and therefore do not match. Extending time horizon would not recognize Banks' ability to adjust their balance sheet and business model over time to anticipate and monitor environmental risks.

Q8: Do you have concrete suggestions on how the forward- looking nature of environmental risks could be reflected across the risk categories in the Pillar 1 framework?

At this stage, we consider that the Pillar 2 framework including climate scenario analyses would best fit to capture the forward-looking nature of environmental risks.

The bank has long recognized the importance of climate as a relevant risk topic and, consistent with that, has addressed climate risk in its ICAAP since 2021 and keeps enriching its infrastructure. Accordingly, the climate section of the ICAAP also addresses how climate change is integrated in decision processes and describes initiatives taken by the bank to finance the energy transition. It has reinforced this year the treatment of climate risk in its risk identification process with an expanded number of related risk drivers.

A progressive and iterative development of methodologies and data availability would enable banks to strengthen their risk management frameworks (for example through the building of risk and IT infrastructure and the development of climate specific scenarios) and effectively continue to include climate drivers in their Pillar 2 frameworks.

Chapter 5 – Credit risk

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?

At this stage, BNP Paribas Group is still working on its credit risk assessments framework to better take into consideration ESG factors. For now, the Group cannot provide any conclusion or differentiation of credit risk based on ESG dimensions.

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?

Perceived problems with the methodologies of ratings providers:

- Different approaches, data inconsistencies, lack of comparability of ESG criteria and rating methodologies, as well as inadequate clarity over how ESG integration affects asset allocation are considerable barriers to supporting long-term value and climate-related objectives,
- Unlike credit ratings, which all assess a company's probability of default, ESG ratings are based on a range of factors, which may differ between ratings providers. Methodologies can be focused on risk or impacts, absolute or relative performance, or other criteria. Companies can receive different ESG ratings depending on which provider is rating them, with sometimes little or no transparency on the reasons behind these different methodologies.
- A study by the MIT Sloan Sustainability Initiative found that correlation among traditional credit ratings was 0.92, but for ESG ratings it was much lower at 0.61.
- Many different methodologies and lack of transparency for these methodologies.
- Various ESG ratings providers have differing methodologies, and this can be reflected in low levels of correlation between the ratings they provide.
- More than 600 ESG standards and frameworks data providers, ratings and rankings in 2018 (cf. IRSG paper (International Regulatory Strategy Group)/Accenture (21/02).
- SIA Partners study in 2021 highlighted 30 major actors (« The ESG data market: changes and challenges for financial services players »).
- IOSCO stated in its final report in November 2021 that, according to KPMG study, there was 160 ESG ratings and data products providers worldwide
- This divergence may create confusion for sustainable investors in the absence of supervision and a code of good practices

Q11: Do you see any challenge in broadening due diligence requirements to explicitly integrate environmental risks?

Please refer to answer above to Q10.

With respect to data challenge, the gradual increase in corporates' environmental-risks related disclosures (be it government mandated or voluntary) – and trend towards greater standardization and comparability of disclosed metrics / KPIs – is expected to increase the consistency of the assessment of such risks.

Q12: Do you see any specific aspects of the CRM framework that may warrant a revision to further account for environmental risks?

We believe that environmental risk drivers are already sufficiently captured in the collateral valuation method. Under current framework, banks are required to manage, monitor and reevaluate their collateral by an independent valuer: this means that if the collateral exhibits environmental risks, this will be captured in that framework. Legislators should rather favour the improvement of risk sensitivity of the Standardised Approach rather than introduce environmental criteria if they are not risk-based.

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.

For the time being, Energy Performance Certificates (EPCs) are not the main driver to the asset value. Current CRR3 proposal seems to be adequate as it does not define any increase of the value.

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.

No, we do not consider that high-quality project finance and high-quality object finance exposures introduced in the CRR3 proposal should potentially consider environmental criteria. The benefit of these criteria is that they introduce a more risk sensitive risk weight to such exposure that rely on objective quality criteria, based on the rationale that they imply a lower unexpected loss for such financing (in particular in the context of the future output floor). We think additional environmental criteria should not be added, since the current conditions for benefiting from this factor are risk based. This would introduce non-risk-based criteria that would alter the risk sensitivity of the framework.

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?

For the time being, we do not consider that further risk differentiation in other exposure classes is justified, as risk sensitivity to environmental factors has not been demonstrated yet. In their latest report, NGFS recognized that there is still limited empirical evidence of ex-post green/non-green risk differentials and that conducting such analysis is not straightforward given persistent methodological and data-related challenges.

Q16: Do you have any other proposals on integrating environmental risks within the SA framework?

No, we do not have any other proposals on integrating environmental risks within the SA framework.

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?

For the time being, IRB framework has been based on historical and evidence-based criteria. Therefore, if we want to better capture environmental factors, this will imply changing the approach taken to build internal models by introducing forward looking criteria. For the time being, our institution's internal policies allow for the possibility to upgrade or downgrade by a few notches the intrinsic grade of a counterparty to reflect the ESG risk profile of the counterparty, as need be. Please also refer to answer to Q8.

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?

Please refer to Question 17.

Q19: Do you have any other proposals on integrating environmental risks within the IRB framework?

No, we do not have any other proposals on integrating environmental risks within the IRB framework.

Q20: What are your views on potential strengthening of the environmental criterion for the infrastructure supporting factor? How could this criterion be strengthened?

The infrastructure supporting factor ("ISF") should be maintained as such and be kept risk sensitive. On top, we would like to highlight the fact that we do not think that this ISF should be linked to the

EU taxonomy. As already recognized by the EBA, the EU taxonomy has been developed for disclosure / marketing purposes to foster the decarbonation of the EU and not for risk purposes.

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 believe that increasing banks' capital requirements is not the right approach as banks need to be able to finance the transition of their clients. The definition of the appropriateness of capital, in terms of nature and calibration, is not mature yet. In addition, reflections should be thoroughly debated and agreed upon at international level with the Basel Committee on Banking Supervision (BCBS).

We share BCBS's and EBA's view that climate factors are not a new category of risk per se: they are 'risk drivers' of the existing prudential risk categories, especially credit risk, with a potential positive or a negative impact. Given the nascent nature of the collective understanding how the climate risk drivers will impact the existing prudential risks, it seems premature to define a regulatory capital treatment. Indeed, given gaps in the evidence base, necessary data, and methodology, it is very challenging, at this stage, to calibrate PDs and LGDs, in credit risk taking into account climate related risks drivers.

Moreover, we believe that non-risk-based Pillar 1 adjustments, such as the Brown Penalizing Factor or the Green Supporting Factor (GSF) would be pure political measures. The underlying objectives should be addressed through public policies or taxes and not through banking regulation. The anchor of the prudential framework must remain risk-based as rightly pointed out by the EBA in its discussion paper. The only consideration of the characteristic of a transaction being sustainable or not does not imply a low or high credit risk.

Pillar 2 approaches could be considered, but stress testing is not the right approach to calibrate climate-related Pillar 2 requirements. Rather, BNP Paribas is supportive of climate scenario analyses, which are by design best suited to apprehend climate risk drivers, given their forward-looking nature. In this context, BNP Paribas has participated in number of industry-wide exercises, notably the French supervisor, ACPR climate stress test in 2020, which was done on a voluntary basis, and the ECB 2022 Climate stress test. BNP Paribas has also included a climate scenario in its 2021 and 2022 ICAAPs.

Climate scenario analyses are useful tools to capture changes in business models that banks will need to undertake in climate scenarios. Indeed, transition scenarios may result in a rebalancing of economic activity across sectors and, within sectors, across counterparties. Climate scenarios are not designed, like traditional stress test scenarios, to measure losses, and thus capital, in adverse macro-economic circumstances. Indeed, some sectors or players in sectors can be expected to benefit from climate change. Climate scenarios are designed to anticipate sectoral evolutions that climate change will trigger and to help banks adjust to these changes accordingly. The horizon of climate change and of climate scenarios is also radically different from that of capital sizing stress tests. There are various initiatives to develop climate scenarios, such as those undertaken by the NGFS or the IEA. However, while welcome, these scenarios are still incomplete. In particular, they do not offer a complete scenario framework including the modelling and projection of industrial and technological developments, as well as their translation into macro-economic variables. Until this is achieved, scenario analysis will remain exploratory and hypothetical in nature or even unrealistic on short-term horizons and not suited for capital sizing stress testing.

Moreover, Pillar 2, through SREP assessment, should focus on the quality of banks' risk management framework in supporting well-defined transition plans from public authorities.

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?

We do not support the introduction of adjustment factors to tackle environmental risks.

Q30: What, in your view, are the best ways to address concentration risks stemming from environmental risk drivers?

We believe that the pillar 2 framework and or large exposure one could be leveraged off to monitor concentration on some sectors or asset classes.

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?

In order to enable banks to finance the transition and hence what is not "green" today, Pillar 1-type of measure is not appropriate as it would put a whole sector or asset type with the same treatment whereas it seems crucial to take into consideration transition plans of corporates and leave flexibility to banks to finance corporates with robust transition plans even if in environmentally sensitive sectors. Any sector limit framework will miss the essential point of differentiating counterparties within a sector according to their level of preparation to climate change. This would harm specific regions or sectors and impede efforts to scale up transition finance to sectors that need it most.

Chapter 6 – Market risk

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?

Stress losses created by environmental risk drivers will materialize progressively over time. The key question is to assess if future stressed events would result in higher losses than past ones: for example, events stemming from a new industrial revolution (ex. digitalization), a pandemic (ex. covid-19), political events (ex. war in Ukraine), financial events (e.g 2008 or February 2018) may continue to define the stressed period.

If ordinary volatilities may increase due to environmental events, there is no indication that stressed volatilities would. In the absence of any evidence that the stressed period would increase in magnitude, losses created by environmental risk drivers should be captured within the existing framework. If, in the future, there are clear evidence that stressed events are expected to increase significantly, regulators would have the opportunity to review the risk weights at that time. So far, there are no such evidence and, within the timeframe of market risks (below one year), it is unlikely that there will be.

Potential change of market correlation regime is captured through the Standardised Approach (SA) three correlations scenarios. In SA, regulators may also, in due time if needed, recalibrate the supervisory correlations.

We do not anticipate that environmental risk drivers materialize in additional risk factors. However, in this unlikely event, it may require an update of the SA framework (ex. adding an environment dimension in Sensitivity-Based Method or Residual Risk Add-On). But that could occur only as and when evidence of those new risk factors appears.

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.

Additional losses created by environmental risk drivers will materialize progressively through time and are likely to be captured by the existing prudential IMA framework:

- Increase of volatilities or change of correlation regime created by environmental events will be captured, in part at least, by the frequent recalibration of the current period in particular for affected risk factors that are not part of the reduced set of Risk Factors.
- If environmental drivers materialize in a potential stress market condition worst than in the past, it would result in an update of the Stressed period. There may as well be added Back Testing overshootings that may eventually result in desks being invalidated for IMA and would alert of a change of market condition. Unforeseen extreme stressed losses are to be captured through stress-testing and may result in Pillar 2 added Capital requirements. They are not the object of the Pillar 1 prudential own funds requirements.
- Environmental risks are macro risks that are likely to materialize in the existing risk factors of the FRTB IMA framework (e.g. equity, credit spreads). However, if in the unlikely event, a new risk factor is needed to be introduced within the FRTB IMA framework, that would be demonstrated over time as the desk would fail the P&L attribution test / back testing and the use of IMA would be invalidated with the concerned desk(s) being capitalized under the FRTB SA framework.

Q25: Do you have any other proposals on integrating environmental risks within the market risk framework?

Environmental risks are likely to materialize in additional losses only progressively through time whereas the prudential framework is designed to capture losses occurring in the short term (10 to 120 business days maximum depending on the risk factors, 1 year for default risk within the trading book). As the risks materialize, they should be captured within the existing framework with recalibration.

Chapter 7 – Operational risk

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?

We welcome the initial proposed clarification concerning the linkage between Operational risk and Environmental risks factors through various operational risk loss types (Damage to physical properties or interruptions of the banks' services and communications; Liabilities arising from environmental factors and resulting in legal and conduct risks; Claims emerging from the institution's failure to address its negative impacts on the environment / mis-selling of products "green" whereas they do not comply with the standards for such products...).



The current regulatory operational set-up (with a few additional clarifications on scope and definitions, see answer 29) should be sufficient to understand how environmental risks factors impact bank's operational risk. Most of the time, environmental risks factors are triggers or causes inducing operational risks events and one of the practical challenges will be to be able to identify and collect them on a systematic basis in the operational risk tools. Thus, finding a way to flag the environmental risk factors within the operational risks building blocks (historical incidents, RCSA, Controls, ...) could be a good way to identify their impact on our operational risk profile.

If the loss event type classification would be modified to integrate new categories pertaining to environmental topics, they should really correspond to risk events and not be triggers/cause to ensure a proper representation of the Cause/Event/Effects that is a key element in the operational risk management.

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?

The forward-looking perspective is already embedded in the existing frameworks related to scenario analysis within the current Advanced Management Approach for Operational Risk and Internal Capital approaches, as well as Risk Identification exercise (ICAAP). It will be pursued once CRR3 is finalized. Some new specific scenarios could progressively complete the existing ones, the main challenge remaining the assessment of potential impacts as very few internal and relevant external data can be leveraged on. In our view, the Standardized Measurement Approach (SMA) for Operational Risk calculation should not introduce such a complexity as it is based on financial data.

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?

Yes, we agree that the impact of environmental risk factors on strategic and reputational risk should remain under the scope of the Pillar 2 framework.

Q29: Do you have any other proposals on integrating environmental risks within the operational risk framework?

The current set up should allow to manage most of the situations where operational risks would be linked with environmental risks factors. It would nevertheless be useful to define more precisely what is considered as entering in the operational risk scope thanks to clear definitions without creating overlaps with the existing risk event categories.