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FIA EPTA response to the EBA Discussion Paper on the role of Environmental Risks in the Prudential Framework

Introduction:

The FIA European Principal Traders Association (FIA EPTA) welcomes the opportunity to respond to the European Banking Authority (EBA) Discussion Paper on the role of Environmental Risks in the Prudential Framework.

FIA EPTA represents 24 independent European Principal Trading Firms (PTFs) which deal on own account, using their own money for their own risk, to provide liquidity and immediate risk transfer in exchange-traded and centrally-cleared markets for a wide range of financial instruments, including shares, options, futures, bonds and ETFs. FIA EPTA's members are based in the Czech Republic, Germany, Ireland, The Netherlands, and the UK.

Our members are independent market makers and providers of liquidity and risk transfer on trading venues and to end-investors across Europe. Market making and liquidity provision (also referred to as principal trading or dealing on own account) is a distinct activity that is undertaken by non-systemic investment firms rather than banks, in a highly dispersed and varied ecosystem of independent Principal Trading Firms. These firms operate in an innovative and competitive fashion leading to a vibrant, dynamic and diverse ecosystem which massively reduces interconnectedness and increases substitutability. This fundamentally reduces systemic risk whilst improving market quality and lowering costs for retail and institutional investors alike.

In 2019 FIA EPTA established a Sustainable Finance Committee for its member firms to explore how liquidity providers can contribute to the green transition. It is FIA EPTA's view that sustainable finance offers a great promise in unlocking investment capital that is essential for fighting climate change and mitigating its impact for citizens. To be widely accepted by investors, sustainable finance products need to be embedded in a healthy secondary market environment which ensures liquidity and enables investors to risk-manage their exposures.

FIA EPTA is committed to supporting policymakers and regulators in ensuring the success of the sustainable finance project at all levels of the capital market ecosystem. We would welcome the opportunity to provide further background to the EBA on the issues raised in our response.

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.

FIA EPTA members believe the EBA is correct to start with only incorporating environmental risks in the prudential framework and see, for now, no need to start incorporating social impacts into the prudential framework. In addition, because the EU has strict privacy regulations that make it difficult to disclose employees' information that will make it difficult to measure social risks within the prudential framework. That being said, FIA EPTA members also believe that social impacts and risks are already captured in other legislative initiatives, for example in the AML legislation, the European Employment Strategy, and the EU Taxation legislation in addition to dedicated EU taxonomy regulations e.g. the Corporate Sustainability Reporting Directive (CSRD), and the upcoming Corporate Sustainability Due Diligence Directive (CSDDD) which includes; human rights, including workers' rights, bribery/corruption and taxation. In that regard, FIA EPTA members do not see the necessity to also capture social impacts in the Prudential Framework.

Chapter 4 – Principles, premises and challenges

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

FIA EPTA members believe that there is a significant risk to the clarity and efficiency of investment firms prudential framework in relation to the incorporation of the double materiality concept. As described in the DP by the EBA, there appear to potentially be significant overlaps between the proposed definitions of "outside-in" and "inside-out" risks and the existing IFD concepts of Risks-to-Firm and Risks-to-Market, as well as significant overlap with the definitions of Physical and Transition Risks. FIA EPTA members would caution that any steps towards incorporating a prudential obligation in relation to the double materiality concept need to be based on evidence that demonstrates two principles;

- firms are not inadvertently mandated to capitalize risks that have been capitalized by other parts of the prudential framework
- that any capital requirement in relation to the double-materiality concepts is based on evidence that regulatory capital would in fact be risk-absorbant in relation to the defined risk

FIA EPTA members would further caution that any capitalization based on double-materiality concepts is calibrated to avoid double counting of risks that are capitalized by other requirements.

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?

FIA EPTA members believe that the improvement and availability of meaningful and comparable data are of vital importance for the transparency that is needed for the incorporation of environmental risks in the prudential framework and agrees with the assessment of the EBA in this DP. FIA EPTA members express the hope, therefore, that the EU will continue to be an ambitious standard-setter; also co-operate with other jurisdictions on regulatory approaches to create an effective framework in a global context.

FIA EPTA members believe that all financial market participants need to contribute to the green transition in the amount which is appropriate to their role in the market. For that to function well, FIA EPTA members believe there should be a well-balanced approach in which firms have time to adjust their operations. The underlying data to assess the environmental risks are of pivotal importance and before they can be incorporated, there needs to be a transparent and harmonised approach so that all financial market participants use the same methodologies and objectives to assess the environmental risks in the Prudential Framework.

Chapter 6 – Market risk

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.

FIA EPTA members do not use internal models, however, we believe that environmental risks should only be incorporated into internal models if the underlying data of the environmental risks is improved. FIA EPTA members believe, that in general, the ESG data need to be improved before they will have a meaningful role in the market.

For now, FIA EPTA members observe a large variety of ESG data in the market, due to the absence of standardization and harmonisation of ESG indicators. This is mainly because of measurement divergence, meaning that ESG data agencies measure the same attribute using different indicators. Next to measurement divergence, weight, scope and aggregation of indicators play a role in the lack of correlation between the different ESG ratings. This makes it difficult, if not impossible, to come up with truly meaningful and harmonised ESG assessments of products or risks. FIA EPTA members would like to encourage establishing more standardisation and regulation in ESG data so that the comparability of these ratings increases.

Chapter 7 – Operational risk

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?

FIA EPTA members support a robust prudential regime that increases the resilience of firms and markets. FIA EPTA members also agree with the analysis done by the EBA regarding potential challenges of such an approach namely the uncertainty of the impact of ESG risks on investment firms due to the lack of data and the difference in business models for each firm. FIA EPTA members believe that to the extent that ESG risks are not already captured in the K factors (those being K-DTF or other K factors) the Pillar 2 framework provides an adequate method for firms to assess the impact of ESG risks, when relevant, on their operations. Such an approach would be aligned with the key objective to prevent any double counting and would allow the regulator to take into account the wide diversity of business models of firms subject to the new regime. FIA EPTA members agree that ESG risks may indeed, for some firms, crystalize in the strategic risk or reputational risk as mentioned by the EBA however we would like to provide additional comments:

1) the lack of historical data and the forward-looking nature of ESG risks make it, at this stage, difficult to quantify not only in the K factors (as recognised by the EBA) but also in the Pillar 2 framework and therefore it is not clear how investment firms can attribute a meaningful risk number (be it in strategic risk or reputational risk).
2) the Pillar 2 framework should recognise the fact that it is still unclear to which extent ESG risk as a risk driver is already included in the K-factors, therefore caution should be taken before adding an ESG risk driver in strategic risk or reputational risk.
3) The ESG risk driver may already be included in other Pillar 2 risks accounted for by investment firms (when relevant depending on each business model) and therefore an automatic inclusion in strategic or reputational risk would not be advisable.

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

Taking into account the challenges highlighted by the EBA in assessing and quantifying the impact of ESG risks on both the K-factors and the Pillar 2 framework, FIA EPTA members agree that the existing prudential regime should not be amended at this stage, particularly given the uncertainty in quantifying such risks. FIA EPTA members believe that Investment Firms should instead make, on a best effort basis, an initial qualitative assessment of ESG risks on their operational risks and integrate ESG risk considerations into their governance and risk management framework. Policymakers and regulators could support this assessment by publishing further recommendations, guidelines and additional insight together with appropriate evidence (as and when available) on the impact of environmental factors on operational losses.

Chapter 8 – Concentration risk

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

FIA EPTA members believe that the CRR and IFR framework is not currently calibrated to appropriately assess any necessary capitalization of environmental risks. FIA EPTA members would observe that there is further work to be done to understand whether different environmental risks in different sectors aggregate in the way that the concentration risk regime presupposes.

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?

FIA EPTA members believe that a single hard limit based on the Large Exposures regime may in fact operate to defeat its stated objectives in two ways.

- The LEX regime is not, in its current form, transition-risk sensitive. This is significant in the context of a hard limit, as it could easily become the restricting factor on the ability of the financial services sector to support organisations funding their transition.

- FIA EPTA members also believe that a single hard limit does not incentivize firms to understand, evaluate and capitalise on the tail risks the DP describes. A single hard limit is likely to simply aggregate different sectoral or geographical environmental risks, each with its own different tail event profiles.

Chapter 9 – Investment firms

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

FIA EPTA members, who operate as market makers or also called principal traders do not have a Risk-To-Client contribution. The Risk-to-Firm and Risk-to-Market would be more appropriate categories to capture potential environmental risks. Nevertheless, it is expected for market makers to be affected to a smaller extent than other investment firms as most of the portfolios of market makers are considered liquid (with the exception of commodity and emissions allowance dealers).

The environmental risk contribution to the risk-to-market is expected to be neutral as market makers and liquidity providers are market risk neutral and would normally not be adversely impacted by shocks and an increase in volatility.

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

As described above, FIA EPTA members would consider that a specific inclusion of the environmental risk in the Pillar 1 capital may not be the optimal approach considering the potential translation of environmental risk to financial risk. Those risks will already be priced in the market (in terms of increased volatility, and credit spread widening for contributors with negative Environmental risk impacts).

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

Commodity and emission allowance dealers are key providers of liquidity on markets that are structurally more illiquid and volatile. The inclusion of environmental risk in the regulatory requirement for commodity market makers should take into account the specificity of the commodity market and its participants and not penalize the overall market liquidity. The higher volatility of commodity derivatives will be already included in the Risk-to-Market and to the extent not sufficient, in the Pillar 2 assessment.

Commodity and emission allowance liquidity providers do not take directional positions based on ESG criteria and therefore their portfolios are not directly exposed to environmental risks. Commodity derivatives are also products that enable asset holders to manage their financial risks, which is crucial for discharging their fiduciary duty and for appropriately managing their long-term investments. FIA EPTA members believe that if limitations were imposed on providing liquidity and risk management tools for some sectors, this would not help these sectors in becoming more sustainable.

FIA EPTA members believe, therefore, that any dedicated regime should:

- Be aligned with key objectives outlined in the DP (risk-based approach, no double counting, the presence of different types of business models);

- Be based on evidence that the existing prudential regime needs to be amended;
- Support the transition and market participants that play a key facilitating role, particularly in sectors that do not have low carbon alternatives.

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

Please also see our response to question 34.

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- Support the transition and market participants that play a key facilitating role, particularly in sectors that do not have low carbon alternatives.