Principles for Responsible Investment

PRI RESPONSE

EUROPEAN CENTRAL BANK GUIDE ON CLIMATE-RELATED AND ENVIRONMENTAL RISKS

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ABOUT THE PRI

The Principles for Responsible Investment (PRI) works with its international network of signatories to put the six Principles for Responsible Investment into practice.

Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice.

The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system. This consultation response represents the view of the PRI Association and not necessarily the views of its individual members.

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WHY THE PRI IS RESPONDING TO THIS CONSULTATION

Climate change is the most pressing environmental issue facing the global economy. The PRI's Inevitable Policy Response (IPR) project has demonstrated that a delay in implementing the policies necessary to transitioning our economy would result in an eventual policy response that is forceful, abrupt and disorderly, undermining the value of investments and challenging the stability of the financial system.

The PRI is predominantly focussed on the investment industry. Nonetheless, we welcome the European Central Bank's (ECB) guidance on climate risk for banks for the following reasons:

- Banks are integral to the function of the European and global economy, and as such must be resilient to the consequences of a changing climate;
- Investors require evidence of better-quality management of climate risk, and better disclosure, from the companies in which they invest – this includes financial companies such as banks;
- The Task Force on Climate-related Financial Disclosures' (TCFD) recommendations are recognised as the global gold standard for this and have been widely supported across industry. Although banking and investment have may differences, integration of TCFD into supervisory expectations of banks could provide inspiration or best practice for future integration of TCFD into supervisory expectations of investors.

RECOMMENDATIONS

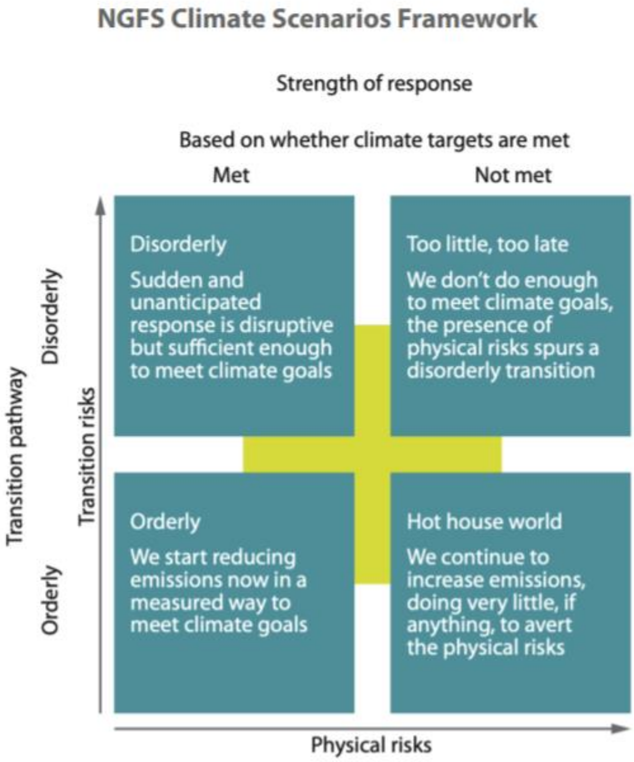
The PRI strongly welcomes the ECB Guidance, which is both necessary and timely. We make the following recommendations for improvement:

1. **Provide greater clarity on the climate scenarios to be used**

In section 6.5, Scenario analysis and stress testing, we believe the second bullet point after '*When conducting scenario analysis and stress testing with respect to climate-related and environmental risks, at least the following aspects are expected to be considered*:' should be replaced by:

"*how climate-related and environmental risks might evolve under various scenarios, taking into account that these risks may not be fully reflected in historical data; a common starting point for analysing climate-related risk and opportunities are provided by The Network of Central Banks and Supervisors for Greening the Financial System (NGFS) which has developed a framework and set of representative scenarios.*"

The Network of Central Banks and Supervisors for Greening the Financial System (NGFS) issued *NGFS Climate Scenarios for central banks and supervisors*[1] in June 2020. The report sets out a climate scenarios framework, which different scenarios of future climate change and climate policy impacts can be mapped to. The framework considers future scenarios ranging from low to high physical and transition risks and considers whether climate targets are met. This is represented in 4 quadrants shown in the figure below[2].



The PRI has done related work on the NGFS' disorderly scenario quadrant as part of the Inevitable Policy Response (IPR) project[3].

As the realities of climate change become increasingly apparent, it is inevitable that governments will be forced to act more decisively than they have so far. The IPR project forecasts a response by 2025 that will be forceful, abrupt, and disorderly because of the delay. Financial markets today have not adequately priced-in these likely near-term policy responses to climate change. The IPR project aims to prepare investors for the associated portfolio risks.

[1] NGFS, NGFS Climate Scenarios for central banks and supervisors, 2020
[2] NGFS, NGFS Climate Scenarios for central banks and supervisors, 2020
[3] PRI, Inevitable Policy Response, 2020

2. Integrate the EU Taxonomy further into the guidelines

The PRI welcomes the ECB's support for the Taxonomy, including the ECB's recent announcement to accept sustainability-linked bonds based on the EU taxonomy as central bank collateral.

The draft guidelines do make reference to the use of taxonomies, but only explicitly describe the EU Taxonomy once in its report.[4]

The Taxonomy regulation requires the EU to establish screening criteria for determining how an activity can avoid significant harm, as well as create a substantial contribution. The delegated acts containing technical screening criteria due by the end of 2020, will embed both “substantial contribution” and “significant harm” criteria. This is closely aligned to recommendation no.6 of the NGFS First Comprehensive Report[5], which called for Members to support the development of taxonomies which contribute to the transition to a low-carbon economy, and those which may be exposed to greater climate-related (physical or transition) risk.

Many banks qualify as undertakings for the purposes of the Taxonomy regulation and will therefore be required to disclose their alignment to the Taxonomy. Therefore the PRI recommends the ECB consider using the Taxonomy further in these guidelines.

In particular, the Taxonomy could be relevant to Expectation 13 regarding key metrics, and supporting expectations: *For the purposes of their regulatory disclosures, institutions are expected to publish meaningful information and key metrics on climate-related and environmental risks that they deem to be material, as a minimum, in line with the European Commission’s Guidelines on non-financial reporting: Supplement on reporting climate-related information.*

Beyond disclosure frameworks, we also encourage the ECB to think of broader benefits the Taxonomy can bring to the banking industry, and the work of supervisory authorities. In full, the Taxonomy will support this industry to:

- Define economically sustainable activities that will be referenced in policy products and instruments
- Enhance disclosures from the banking industry
- Guide and refine banks’ business strategies to align with the SDGs
- Assess ESG and financial-related risk management by banks
- Assess whether a prudential treatment of exposures should be justified

The European Commission has issued several mandates to the European Banking Authority (EBA) to demonstrate that the Taxonomy is embedded in their strategy[6].

As a major EU financial stakeholder, the ECB should consider this future progression of the EBA and increase its use of the Taxonomy, as part of a mix of tools, to guide its own strategy. Therefore, we recommend that the application of the Taxonomy to these guidelines, covering a broad range of areas including and beyond disclosure, be investigated further.

[4] Section 7: Supervisory expectations relating to disclosures states that there is political agreement on the EU Taxonomy and its application to NFRD institutions, and that the EC intends to review the NFRD.
[5] NGFS, First comprehensive report, A call for action, Climate change as a source of financial risk, 2019
[6] EBA, Action Plan on Sustainable Finance, 2019. See section 3: Overview of EBA mandates on sustainable finance, paragraphs 12-14