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BANKING STAKEHOLDER GROUP

BSG response to EBA Consultation Paper: Draft ITS on Pillar disclosures on ESG risk

Background and connection to other initiatives of the EU

In March 2018 the EU presented the new Action Plan on Sustainable Finance to re-orient capital flows towards sustainable investments, mainstream sustainability risk into risk management, foster transparency and long-termism in markets. By the end of 2020 a renewed sustainable finance strategy has been published. Additional and supporting initiatives have taken place of which the Taxonomy Regulation and the Non-financial Reporting Directive are quite important ones.

The Taxonomy Regulation from 2020 provides market clarity on what economic activities should be considered "sustainable", develops a taxonomy for climate change and environmentally sustainable activities so that the classification system can be used with respect to labels, standards and benchmarks recognizing compliance with environmental standards across the EU and sets criteria for determining if an activity (not a company or asset) is environmentally sustainable, including whether the activity contributes to, or does not significantly harm, one or more specified environmental objectives. It focuses, therefore, on environmental objectives.

The Non-financial Reporting Directive from 2014 sets rules on disclosure of non-financial and diversity information by large public-interested companies – including banks. Information has to be delivered regarding environmental issues, social and employee matters, respect for human rights, anti-corruption and bribery matters. At least six presentation alternatives are offered. Based on the Non-financial Reporting Directive on 21 April 2021 a Proposal for a Corporate Sustainability Reporting Directive was published which should change the before mentioned Reporting Directive. Besides, for example, the requirement to audit the reported information more detailed reporting requirements has been introduced as well as a requirement to report according to mandatory EU sustainability reporting standards, for which EFRAG will be getting the mandate to develop draft standards.

Within this (legal) environment the Pillar 3 Framework aims to promote transparency and market discipline in the banking sector. The main topics are to reduce the asymmetry of information between credit institutions and users of information, to address uncertainties on potential risks and vulnerabilities faced by banks, to allow investors and stakeholders to compare sustainability performance of institutions and their financial activities and specifically, to support institutions in public disclosure of meaningful and comparable information on ESG related risks and vulnerabilities (including transition and physical risks) as well as to provide transparency on how they are mitigating those risks (including information on how they are supporting their customers and counterparties in the adaptation process to e.g. climate change and in the transition towards a more sustainable economy). It is linked to Article 449a of the CRR where disclosure requirements are set up for large institutions with securities traded on a regulated market about prudential information on environmental, social and governance risks, including physical risks and transition risks. Article 434a gives the EBA the mandate to develop draft implementing technical standards (ITS) specifying, uniform formats and associated instructions for the disclosure of this information, in a way that conveys sufficiently comprehensive and comparable information for users of that information to assess the risk profile of institutions. There is a concrete linkage to the EBA Advice to the Commission on KPIs and methodology for disclosures under Article 8 of the Taxonomy Regulation. Therefore, relevant synergies between both mandates and commonalities regarding the information are aimed to be delivered.

The EBA Consultation Paper Draft Implementing Standards on prudential disclosures on ESG risks consists of tables, templates and associated instructions for institutions in order to disclose the relevant qualitative information on ESG risks on climate change and other environmental risks, social risks and governance risks as well as and quantitative information on climate change related risks (including transition and physical risks and mitigating actions, as defined in the report referred to in Article 98(8) of CRD).

The EBA disclosure requirements follow a sequential approach. Disclosure requirements in general have to be delivered from 28 June 2022 onwards (on an annual basis for the first year and semi-annually thereinafter). There is a phase in period until June 2024 for disclosures on institutions' scope 3 emissions. Institutions need to collect information on CO2 emissions from their counterparties and to develop methodologies to estimate their scope 3 emissions. During the transitional period, institutions will have to explain methodologies that they are developing to measure and estimate their scope 3 emissions and sources of data that they plan to use.

There is also a phase in period until June 2024 for disclosures of the green asset ratio on stock of assets for those exposures towards retail, and corporates not subject to NFRD disclosure obligation. This means that institutions need to collect information from their counterparties. The EBA assumes that data collection will be easier and faster for counterparties that are subject to NFRD disclosure obligations. Therefore, it is planned to start disclosing relevant information for 2021 financial year from January 2022 under Article 8 of the Taxonomy Regulation. For the first disclosure reference date (end-of-financial year 2022) institutions to have collect relevant information from their counterparty´s public disclosure when NFRD corporate.

Quantitative disclosures on climate change transition risk

Institutions will have to fill in at least six templates. Climate change transition risks are defined by risks posed by the exposure of institutions to counterparties that may potentially be negatively affected by the transition to a low carbon, climate-resilient or environmentally sustainable economy. Institutions under scope of Article 449a CRR will have to disclose:

- Exposures towards non-financial corporates (NFCs) that operate in sectors that highly contribute to climate change,

- Exposures towards fossil fuel counterparties,
- Exposures towards counterparties that operate in other carbon related sectors.

The reason is according to the EBA, that these counterparties are more likely to be negatively impacted by climate change transition transmission channels, including policy changes, technological changes or related reputational risks, and may involve a negative impact on the credit quality of institutions' related exposures.

Furthermore, institutions should disclose:

- For real estate portfolios, including loans collateralized by commercial and residential real estate, and repossessed real estate collaterals information on the energy efficiency of the underlying real estate collaterals (including distribution of collaterals by energy performance certificate (EPC) label),
- Quantitative data on the credit risk quality of the exposures.

Institutions will have to explain in the narrative accompanying the templates any implications that these exposures may have in terms of operational and liquidity risk for the institution.

Quantitative disclosures on climate change physical risk

One template deals with climate change physical risk. Information have to based on the banking book. (loans and advances, debt securities and equity instruments not held-for-trading and not held-for-sale). Two kinds of information have to be delivered, namely, information by sector of economic activity (NACE classification) as well as information by geography (identified by dedicated portals and databases). Institutions will have to explain in the narrative accompanying the template the sources of information and methodologies used when providing this information. And, two versions have to be disclosed, a simplified and an extended template. The simplified version has to be disclosed during the transitional period – until June 2024. If institutions are ready in collecting the information with higher granularity they will have to start disclosing immediately.

Quantitative disclosures on mitigation actions

Regarding mitigation actions disclosure of information is mandatory on the level of alignment of credit institutions about financial and commercial activities with the taxonomy, especially related to the environmental objectives of climate change mitigation and adaptation. It should be shown the development of the level of alignment over time and targets (evolution). Actions to mitigate climate change transition and physical risk are of essential importance. Therefore, investing in activities and lending to counterparties that are taxonomy-aligned as well as investing in climate adaptation activities are mandatory. The draft includes templates with quantitative information on assets and exposures that are contributing and enabling climate change mitigation and adaptation by supporting institutions' counterparties.

The disclose in one of two templates includes information on:

- Loans and advances,

- Debt securities,
- Equity instruments in the banking book.

A breakdown is mandatory of those exposures that are towards sectors covered by the Taxonomy Regulation and the breakdown of those exposures that are environmentally sustainable, for the objectives of climate change mitigation and climate change adaptation, according to the Taxonomy Regulation.

An estimation has to be delivered of the volume of environmentally sustainable exposures according to specified and very detailed rules.

In the centre of the disclosure on mitigation actions is one template which consists of information that are necessary for the calculation of the green asset ratio (GAR) and other relevant KPIs.

According to the EBA the GAR provides information on the extent to which institutions' activities qualify as environmentally sustainable in accordance with Articles 3 and 9 of Regulation (EU) 2020/852.

The information that should be disclosed in this template is based on the information of the template above. So, it is mandatory to disclose a Green Asset Ratio of the institution, including a breakdown by environmental objective and counterparty, for specialised lending, transitional and enabling activities, and total GAR. Institutions will have to disclose together with GAR, information on the percentage of their total assets covered by the GAR, in order to facilitate comparability of the GAR and of institutions' level of alignment with the Taxonomy Regulation.

In addition, the proposal of the EBA includes a template on other climate change mitigation actions.

Qualitative disclosures

In addition to quantitative disclosures an institution will have to present qualitative disclosures within three tables, namely on environmental, on social and on governance risk. Governance arrangements are described as responsibilities of the management body, the integration on organizational arrangements renumeration policy and other arrangements. Business model and strategy consists of adjustments of the business strategy, of objectives, targets and limits, and of policies and procedures which relate to engagements with customers about ESG. Regarding risk management, information is necessary on processes to identify and monitor risk sensitive sectors and exposures. It also includes information on limits, controls and forward-looking information as well as stress test and scenario analysis.

Questions for consultation

In total, sixteen questions are raised.

Question 1: Are the instructions, tables and templates clear to the respondents?

Question 2: Do the respondents identify any discrepancies between these tables, templates and instructions and the disclosure requirements set out in the underlying regulation?

Question 3: Do the respondents agree that the new draft ITS fits the purpose of the underlying regulation?

Question 4: Do the respondents agree that the tables with qualitative information proposed capture properly the information that institutions should provide?

Question 5: Regarding template 1 – 'Banking book - Climate change transition risk: Quality of exposures by sector', do the respondents agree with the proposals in terms of sector and subsector classification included in the rows of the template and the indentification of the most exposed sectors in columns f to k and p to u?

Question 6: Do the respondents agree with the proposal included in templates 1 and 3 to disclose information on scope 3 emissions and with the transitional period proposed?

Question 7: Do respondents agree that information in terms of maturity buckets by sector proposed in template 2 is relevant to understand the time horizon of when the institution maybe more exposed to climate change transition risk?

Question 8: Do respondents agree that information in terms of alignment metrics and relative scope 3 emissions proposed in template 4 is relevant to understand and compare the transition risk phased by institutions? What are the respondents' considerations with regard to the alignment metrics proposed and the sectors that should be covered by this disclosure? Do respondents agree with the transitional period proposed?

Question 9: Regarding the same template 4, what are the respondents' considerations with respect to the choice of the 2 degrees reference scenario, would respondents opt for a different scenario?

Question 10: Do respondents agree that information proposed in template 5 is relevant to understand the level of climate change transition risk and that information on exposures towards the most polluting companies is a good complement to the sectorial information included in other templates? Specific feedback is sought on possible alternative formats for the presentation of the information required in template 5. In particular, the EBA seeks feedback on whether aggregate information on exposures towards the top 20 polluting companies in the world, at EU level or at member state level, instead of company-by-company information, would be sufficient to understand how climate-change transition risk may exacerbate the exposition of institutions to credit risk. Feedback is also sought on the specific information that a template on aggregate exposures should include to be meaningful, including possible "buckets" of information on exposures (e.g. exposures towards top 5 polluting firms, next top 5 and so on, or other alternative presentations).

Question 11: What are respondents view on the way template 6 reflects how the trading book of institutions may be impacted by climate change transition risk? Do respondents agree that the threshold proposed to determine which institutions have to disclose this template is the appropriate threshold? Feedback on whether there are alternative ways to present information on the trading book that may allow for a better understanding of how climate change transition risk may impact the trading portfolio.

Question 12: Do respondents agree that the information included in template 7 is appropriate to understand how and to what extent the institution may be exposed to climate change physical risk and that the differentiation between a simplified and an extended template is necessary in the short/medium term?

Question 13: Regarding template 7, specific feedback is asked regarding the methodologies and data sources that institutions may use to identify the relevant geographies. Feedback is also required on the content and disclosures proposed in the extended version of the template and on the transitional period proposed.

Question 14: Regarding templates 8 and 9, do respondents consider that this template should be enriched including information not only on assets aligned with the taxonomy but also in the interest income generated by those assets? Do respondents agree with the timeline proposed and transitional period proposed for the disclosure of these templates?

Question 15: Specific feedback is required from respondents on the way template 10 is defined, and on whether there is additional information that should be added. Feedback is sought on alternative disclosure formats that may contribute to a more standardised and comparable disclosure.

Question 16: Finally, respondents feedback on whether the draft ITS should include a specific template on forward looking information and scenario analysis, beyond the qualitative information currently captured in the tables and templates under consultation and the information required in template 4.

Response from the BSG

The BSG welcomes the initiative of the EBA to promote transparency and market discipline also with respect to ESG risks. Furthermore, the BSG welcomes that the EBA ensures some consistency between Art 8 disclosure requirements and Pillar 3.

However, there should also be consistency in the implementation timeline (currently – Art 8 on January 2022 and Pillar 3 report in 2023 based on S2 2022 data), whereas Art 8 deadline will be postponed.

In addition, Pillar 3 requirements go far beyond the already very demanding Art. 8 scope of disclosure. In this respect, the BSG proposes to implement a phase-in with the initial focus on the Green Asset Ratio not only because of the complexity of the process itself but also because it could eventually have effects on financial stability. Notwithstanding the data limitations that all banks face, those that would disclose a lower GAR compared to the average could be subject to market pressures including, among other impacts, an increase in the cost of funding. To prevent undesired effects, the BSG would suggest performing a quantitative impact study (QIS) of the GAR as an adequate exercise to have a better comprehension of the potential impact of the disclosure of such indicators on market participants.

Additionally, the BSG welcomes that the primary focus is on the banking book (lending activities) as it is most meaningful regarding the financing of the real economy. Nevertheless, from a practical point of view the inclusion of borrowers not in NFRD scope will be a challenge, notably SMEs and non-EU corporates. In addition, by including the stock (i.e., past lending) the GAR would be incorporating a static view and a bias towards legacy assets that are less aligned with the EU taxonomy. For that reason, the BSG suggests to focus only on the flow of exposures (GAR of the flow) that are originated under the current bank´s strategy, providing relevant information to market participants on the transition to a greener economy, leaving the GAR on total exposure for a second phase.

The BSG assumes that the main addressees of Green Asset Ratio disclosure will be investors in banks equity and/or debt instruments. They will probably use only one GAR for each issuer, in order to calculate their own GAR. Disclosing separate GAR on other subset of banks' balance sheet don't seem to be necessary, at least at this moment it could be postponed to a second step, with the primary focus on a reliable GAR on the core lending portfolio). In particular, the calculation and disclosure on a GAR on the trading book, AuM, etc. should be postposed to a second phase.

The GAR will be disclosed in sustainability reports and on the company websites of financial institutions as required by SFDR - a development strongly supported by the BSG. However, the GAR is not initially designed for or intended for risk measurement purposes. The GAR is a metric showing the extent of banks' efforts to finance the greenest activities as defined by the Taxonomy.

But the main purpose of the Pillar 3 report is to disclose relevant information with respect to risks. It is questionable how GAR relates to risk. Since the GAR is not designed to reflect prudential risks its inclusion in the Pillar 3 reporting could be misleading for market participants. Therefore, at the very least, the fact that GAR is not a prudential metric needs to acknowledged explicitly in the ITS. The BSG encourages the EBA also to align both general disclosure requirements and the development of a GAR with the development on EU level, namely with the Proposal for a Corporate Sustainability Reporting Directive which was published in April 2021 and which should change the Non-financial Reporting Directive. It is planned that EFRAG will get the mandate to work on detailed reporting requirements, and a requirement to report according to mandatory EU sustainability reporting standards. It is also important to bear in mind that Europe is ice-breaking regulation and implementation of ESG standards -not only on the economic and financial arena-, consequently information related to third-countries, which are lagging behind in adopting international standards, may not be feasible, and should be postponed to a second phase.

According to Art. 8 of the Taxonomy Regulation corporates are required to disclose at least the proportion of their turnover derived from products or services associated with economic activities that qualify as environmentally sustainable, the proportion of their capital expenditure and the proportion of their operating expenditure related to assets or processes associated with economic activities that qualify as environmentally sustainable. The turnover derived from products or services is usually represented by revenues, capital expenditures (CAPEX) are a company's major, long-term expenses while operating expenses (OPEX) are a company's day-to-day expenses. Compared to those key figures, it might have been expected that for a bank operating profits (usually interest income, fee income, maybe, trading income and, maybe, loan loss reserves), investments in long-term securities and investments in loans provided to customers could work as key indicators equivalent to the disclosure requirements for corporates under Art. 8. Therefore, the fundamental principles for the development and the composition of GAR might be explained deeper as well as alternative structures of the GAR that might have been considered in a pre-proposal status.

The BSG would like to take the opportunity for a few remarks regarding other quantitative templates. The BSG fully supports template on alignment metrics, which should be at core of business and risk management strategies. Some templates, however, include confidential client data, more aggregation needed (Top 20 brown exposures). Some templates are premature, in the absence of an agreed methodology and data (exposure to physical risk, by NACE code) and could be, at least temporarily, replaced by more factual data (losses linked with physical risks events incurred in the last period). It has to be taken into account that the Pillar 3 must be subject, at a minimum, to the same level of internal review and internal control processes as the information provided by banks for their financial reporting, which is challenging for proxy or best effort information. Additionally some templates don't seem to include really useful information for stakeholders but rather for regulators. The question is, whether they should rather be included in a "ESG QIS" framework to be implemented (performing/non-performing / stage 2 /average PDs by ESG classification) because the BSG is of the opinion that there is no need for disclosure as this data may be very difficult to interpret, at least at the beginning.