# Climate risk disclosure requirements not without challenges for European banks

**Banks will be kept busy in 2022 meeting stakeholder demands for improved ESG disclosure. While some disclosures are voluntary, bank-specific or industry-wide, others are binding regulatory initiatives. It is the latter that will set the banks' priorities in the short term, in particular the ECB's climate stress test and the EBA's Pillar 3 package of prudential disclosures, which is being expanded to cover ESG risk indicators.**

The European Banking Authority's primary goal in integrating ESG risks into Pillar 3 disclosures is to improve data collection and transparency, starting with climate change. Its final draft technical standard presented 10 quantitative disclosure templates alongside qualitative templates; and it set the timeline for implementation.

The European Central Bank's 2022 climate stress test, which will run from March to July, is not designed to be a pass or fail exercise, it will feed into the Supervisory Review and Evaluation Process (SREP) and potentially influence Pillar 2 requirements. The ECB makes it clear that the climate stress test metrics have been designed to '*shed light on banks' analytical and data capabilities regarding climate risk*' i.e. an evaluation of banks' readiness.

We believe lack of banks' readiness for these initiatives could lead to soft regulatory actions. Neither the EBA nor the ECB initiatives establish binding financial requirements for banks, such as minimum thresholds. Their main merit is to narrow down nebulous ESG concepts into specific quantitative metrics. The priority is to push banks to put in place data collection capabilities and articulate ESG risk management strategies. Not one bank was close to meeting its supervisory expectations relating to climate-related and environmental risks, the ECB noted in November 2020.

Already, in the absence of regulatory requirements, market perceptions are influencing the speed at which banks are acting on ESG issues. A more transparent screening of credit exposures will facilitate positive and negative impact strategies, either by banks as they transition or by investors (institutional and retail) vis-à-vis the banks they fund. Sensitivity to rising stakeholder demands is already a relevant risk, while the emergence of climate-related risks will span a much longer period.

Coming up with quantitative metrics to measure ESG risks is a major step forward in solving ESG data collection challenges. Regulatory action will provide a major acceleration for defining material ESG factors, even if debate on the topic and the selection of metrics will continue. The regulatory frameworks will also evolve.

This report highlights the nature of the quantitative metrics introduced under the two initiatives and assesses five key issues emerging from them:

1. Banks have become policy tools to transform the economy.
2. Can evasion strategies or moral hazard be avoided?
3. The multiplicity of ESG related EU frameworks is a source of complexity.
4. ESG risks no longer come as complementary extra-financial risks.
5. These are ambitious initiatives but have limitations for credit analysis.


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## 1 Banks as policy tools: greening the economy, and risks attached

The initiatives are designed to help identify risks associated with climate change. Avoiding potential financial losses stemming from climate change is clearly in line with the ambition to preserve financial stability. But by introducing ESG risk indicators to screen banks' balance-sheets and measure their degree of alignment to pre-defined policy objectives, banks have been transformed into policy tools to transform the economy. Banks are being incentivised to lend to certain (green) sectors of the economy but limit their exposure to other (brown) sectors or even exit some of them (i.e. the most polluting, see template 4 in Appendix III).

**Policy alignment is a form of directed lending**

The incentives put in place to act on climate change may be seen as a form of directed lending which is usually only seen with institutions that have a declared policy role, like development or promotional banks, not privately-owned commercial banks.

The reduced investment (lending) universe for banks, disagreement on the definition of green assets, the evolving eligibility criteria (e.g. the possibility to finance nuclear power plants), the clarity of policy objectives or the speed at which stakeholder demand varies, all create new sources of financial risk for banks. Both the ECB and the EBA point to the risks of policy change or technological changes which could negatively impact the credit quality of banks' exposures. Banks must also manage conflicting priorities between risk management and having a positive impact.

## 2 Can evasion strategies or moral hazard be avoided?

**Green or brown are the only options**

Asking banks to screen their balance-sheets to identify which clients or sectors are poorly aligned with some policy objectives will inevitably give rise to evasion strategies. The EBA and ECB initiatives have already attempted to address the issues of categorising general-purpose loan facilities for diversified corporate groups (determining the NACE sector classification for diversified corporate groups) or the classification of holding companies from a climate-friendly perspective.

Pillar 3 disclosures are intended to address issues related to information asymmetry. But with the objective of integrating ESG factors while readiness across the economy is still limited, the risk of moral hazard cannot be ignored. Conduct risk is identified as part of the ECB climate stress test in relation to greenwashing: *liability claims resulting from green products sold with underlying assets that do not match the promoted level of greenness/sustainability*. The possibility offered to rely on proxies to calculate metrics does not address the issue of information asymmetry.

These initiatives will only achieve their goals if they become widely accepted at international level. The exclusion of some clients or sectors may simply lead to the relocation of activities, or recourse to alternative sources of financings outside of banks' balance-sheets, which would impact their business models.

## 3 Multiple EU initiatives a source of complexity

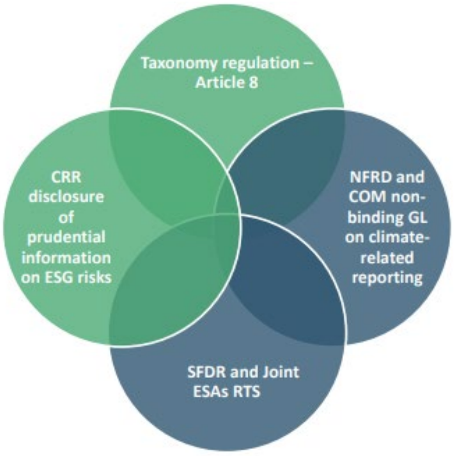
Both initiatives can be seen as a co-ordinated push by the EU authorities to act on climate risk and more generally on sustainability. They do appear aligned with one of the European Commission's medium-term priorities: the European Green Deal, or *how to become the first climate-neutral continent by becoming a neutral resource-efficient economy*.

**EU Directives follow a building block approach**

Reading through the various EU initiatives to understand how they complement each other, or by contrast the extent to which they focus on different goals, scopes or involve different stakeholders according to different timelines is complex. The EBA report on Pillar 3 disclosures points to the issue of partial overlap (figure 1). This is also an important consideration which is supposed to be addressed under the proposed Corporate Sustainability Reporting Directive (CSRD).

This complexity is compounded by the multiplicity of initiatives globally, an area where convergence and consolidation are also making progress (e.g. the formation of a new International Sustainability Standards Board – ISSB).

**Figure 1: EU legislative initiatives on ESG-related disclosures**




Source: EBA final report draft ITS on prudential disclosures on ESG Risks, figure 1 page 8.

## 4 ESG risks no longer complementary extra-financial risks

With the integration of ESG risk indicators into prudential disclosures, the importance of ESG factors has gained full recognition. These risk indicators do not come as a simple addition to the existing framework, but in combination with traditional financial risk metrics. There is a constant focus across the two initiatives to provide information on the credit quality of the various portfolios.

As the EBA stated, this will allow for close monitoring of how ESG-related risks and vulnerabilities might exacerbate other risks in banks' balance sheets. As portfolios will increasingly be seen as being either 'green' or 'brown', it is critical to monitor how this new criterion impacts the credit quality of portfolios.

**Figure 2: How ESG data points combine with asset-quality reporting frameworks**

| Sector/subsector | Gross carrying amount (Mln EUR) | | | | |
|---|---|---|---|---|---|
| | Total | Of which exposures towards companies excluded from EU Paris-aligned Benchmarks (…) | Of which environmentally sustainable (...) | Of which stage 2 exposures | Of which non-performing exposures |
| **Exposures towards sectors that contribute highly to climate change** | | | | | |
| A - Agriculture, forestry and fishing | | | | | |
| B - Mining and quarrying | | | | | |
| *B.05 - Mining of coal and lignite* | | | | | |
| *(…)* | | | | | |

Simplified overview of EBA template 1
Source: Scope Ratings, EBA Annex I -Templates for ESG prudential disclosures

## 5 Ambitious initiatives but limitations for credit analysis

The two initiatives are pioneering. Because they are works in progress with high potential reputational risks for individual banks, there are some limitations around using the frameworks to feed credit analysis and peer benchmarking:

- **The partial risk coverage** and in particular the limited scope in terms of banks' balance-sheet coverage. The focus of the Pillar 3 disclosure initiative is mainly on banking books. Sovereign exposures are not included and it only applies to the largest listed EU banks. It also focuses on climate change, only one of the components of ESG. The intention is to broaden the scope at a later stage. This narrow initial focus is explained by the urgency of the topic, developments taking place at EU and international level and data and methodology challenges.
- **The use of proxies** (e.g. to calculate Scope 3 GHG emissions) or the possibility to opt for different approaches to produce risk indicators (carbon emitters, energy performance).
- **The degree of transparency is insufficient** whenever data aggregation is too high. It relates for instance to the absence of granular geographical breakdowns (e.g. template 2 on energy performance or template 4 on top 20 polluting companies).

## Appendix I: Overview of the 2022 ECB climate stress test exercise

The climate stress test is made up of three modules: a qualitative questionnaire, two main climate risk metrics (overview in Box A) and bottom-up stress tests covering both transition and physical risks. Not all banks will be subject to all three modules, which will limit the data output.

| Focus on climate risk metrics required as part of the 2022 ECB climate stress test exercise | | |
|---|---|---|
| | Metric 1: Measure of a bank's reliance on income stemming from GHG-intensive industries. | Metric 2: Financed greenhouse gas emissions. |
| **Approach** | Measure of interest, fee and commission income from GHG-intensive industries. | Measure a weighted average greenhouse gas (GHG) intensity metric in relation to banks' non-financial corporate portfolios.<br><br>GHG intensity is an estimate of Scope 1,2,3 GHG emissions of a counterparty compared to the average revenue of the counterparty for the last three years. The outcome is weighted according to the share of the bank's exposure to the counterparty compared to the total target portfolio. |
| **Goal** | This metric is intended to provide an indication of the sustainability of a bank's business model.<br><br>Banks should provide information on income but also on the total volumes (e.g. loans) to non-financial corporations which generate interest income and fee and commission income.<br><br>Coverage: as many countries as needed to cover at least 80% of gross interest income and gross fee and commission income, or five countries if the 80% coverage threshold is not achieved with five countries. | The metric is intended to provide an overview of the emissions financed by a bank via its corporate portfolio.<br><br>It shows the extent to which banks are financing emissions and how exposed they are to emission-intensive companies.<br><br>The focus is on the top 15 counterparties by NACE sector (among 22 pre-determined industries). Non-SME exposure within NFC exposure is excluded.<br><br>Banks should also indicate the exposures to counterparties as a percentage of total exposure per NACE sector. |

Source: European Central Bank, Climate risk stress test SSM stress test 2022, October 2021, Scope Ratings.

The scenarios-based stress test will attempt to measure the financial losses an institution may incur because of transition risks (adjustments made towards a low-carbon economy, including a sharp increase in the price of carbon) or physical risks due to a changing climate (like floods, severe droughts and heatwaves).

Transition risk scenario analysis covers mortgage and corporate credit risk exposure. It also includes corporate bonds and equities in the trading book (market risk exposure). For mortgage and corporate credit exposures secured by real estate, banks are required to break down their exposures by EPC (Energy Performance Certificate) rating. Value-added losses by sector and EU country are provided to banks and reflect a pre-defined scenario.

Physical risks associated with drought and heat risk are measured based on the corporate credit risk exposure. Flood risk is assessed according to corporate exposure secured by real estate and mortgage exposure. A flood stress map is provided as a criterion to classify exposures.

## Appendix II: list of industries selected for the ECB climate stress test (annex 5)

| NACE industrial sectors | NACE industrial sector description |
|---|---|
| A01 | Crop and animal production, hunting and related service activities |
| A02-A03 | Forestry and logging; Fishing and aquaculture |
| B | Mining and quarrying |
| C10-C12 | Manufacture of food products, beverages and tobacco products |
| C13-C18 | Manufacture of textiles; Manufacture of wearing apparel; Manufacture of leather and related products; Manufacture of wood and of products of wood and cork, except furniture; manufacture of articles of straw and plaiting materials; Manufacture of paper and paper products; Printing and reproduction of recorded media |
| C19 | Manufacture of coke and refined petroleum products |
| C20 | Manufacture of chemicals and chemical products |
| C21-C22 | Manufacture of basic pharmaceutical products and pharmaceutical preparations; Manufacture of rubber and plastic products |
| C23 | Manufacture of other non-metallic mineral products |
| C24-C25 | Manufacture of basic metals; Manufacture of fabricated metal products, except machinery and equipment |
| C26-C28 | Manufacture of computer, electronic and optical products; Manufacture of electrical equipment; Manufacture of machinery and equipment not elsewhere classified |
| C29-C30 | Manufacture of motor vehicles, trailers and semi-trailers; Manufacture of other transport equipment |
| C31-C33 | Manufacture of furniture; Other manufacturing; Repair and installation of machinery and equipment |
| D | Electricity, gas, steam and air conditioning supply |
| E36-E39 | Water collection, treatment and supply; Sewerage; Waste collection, treatment and disposal activities; Materials recovery; Remediation activities and other waste management services |
| F | Construction |
| G45-47 | Wholesale and retail trade and repair of motor vehicles and motorcycles; Wholesale trade, except of motor vehicles and motorcycles; Retail trade, except of motor vehicles and motorcycles |
| H49 | Land transport and transport via pipelines |
| H50 | Water transport |
| H51 | Air transport |
| H52-H53 | Warehousing and support activities for transportation; Postal and courier activities |
| L | Real estate activities |

Source: ECB Climate risk stress test – Annexes, p.58

## Appendix III: Amended Pillar 3 reporting framework

Pillar 3 disclosure reports are designed to reinforce market discipline by developing a comprehensive framework with consistent and comparable disclosures. They mainly provide information on regulatory requirements such as capital and liquidity positions, but they have also been used to disclose information on Covid-related support measures in the form of moratoriums and State-guaranteed loans.

ESG risk indicators are integrated in the form of 10 quantitative and three qualitative templates; the latter intended to cover dimensions for each ESG factor: governance, business model and strategy, and risk management. Changes to Pillar 3 disclosures on ESG risk indicators only apply to large institutions with securities traded on a regulated market of an EU Member State.

Investors will have access to new data on banks' asset quality, allowing them to differentiate banks' credit portfolios into different shades of green, and track the greening of banks' balance sheets over time. The disclosure of information will be gradual, generally starting early 2023 on end-2022 data for the large banks.

**Overview of the 10 quantitative templates introduced as part of the Pillar 3 Package**

| Templates | Specifications |
|---|---|
| **Template 1: (on credit exposures to GHG emissions by sectors)**<br>Credit exposure to non-financial corporates by sector, scope 1,2,3 GHG emissions and residual maturity. | Transition risk indicator. Applies to banking book only. Exposure to sectors that contribute highly to climate change. |
| **Template 2: (on energy efficiency of credit exposures)**<br>Loans collateralised with immovable property and of repossessed real estate collateral with a breakdown by EPC label of the collateral. | Transition risk indicator. Applies to banking book only. Given the variety of measurement methods, banks are also required to disclose energy consumption ranges. Use of proxies is possible in the absence of an EPC label. |
| **Template 3: (on distance to meet 2050 scenario on CO2 emissions)**<br>Information by relevant sector, alignment metric and estimate of the distance from the current value of the alignment metric to the 2030 projection according to the proposed scenario. | Transition risk indicator. Applies to banking book only. Information on sector exposure, the relative CO2 emissions and the distance to the International Energy Agency (IEA) Sustainable Development NZE2050 Scenario 17 expressed in percentage points. |
| **Template 4: (on credit exposures to top carbon emitters globally)**<br>Exposure to the top 20 carbon-intensive firms in the world. | Transition risk indicator. Applies to banking book only. Intended to complement Template 3. Institutions must explain how they have identified the companies included in the template, and the reasons for omitting information (for instance confidentiality). Only the aggregated amount will be disclosed. |
| **Template 5: (credit exposures to acute physical risks)**<br>Loans to nonfinancial corporates collateralised with immovable property and on repossessed real estate collateral that are exposed to chronic and acute climate-related hazards. | Physical risk indicator. Applies to banking book only. For the identification of geographies prone to specific climate-related hazards, institutions must use dedicated portals and databases. |
| **Template 6: summary of the Green Asset Ratio (GAR)**<br>**Template 7: assets for the calculation of the GAR**<br>**Template 8: Green Asset Ratio (GAR) KPIs** | Applies to banking book only. Gathers information on EU Taxonomy aligned activities.<br>Information on the GAR must be fully aligned with the information that institutions will disclose under Article 8 of the Taxonomy Regulation. |
| **Template 9: (on alignment with EU taxonomy)**<br>Banking Book Taxonomy Alignment Ratio (BTAR). | Applies to banking book. Gathers information on EU Taxonomy aligned activities related to non-financial corporates not subject to NFRD disclosure obligations (excluded from the COM DA GAR).<br>Complements information provided with the GAR. |
| **Template 10: Other climate change mitigating actions** | Complements information provided with the GAR in templates 7 and 8, highlighting additional mitigating actions by type of financial instruments (bonds or loans). |

Source: EBA Final draft implementing technical standards on prudential disclosures on ESG risks in accordance with Article 449a CRR and Annexes; Scope Ratings

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