REGULATORY DEVELOPMENT:

UNDERSTANDING PILLAR III ESG DISCLOSURES FOR BANKS

SPEED READ

This paper outlines the new disclosure requirements under the European Banking Authority (EBA) draft Implementing Technical Standards (ITS) for Pillar III disclosure and reporting of Environmental, Social and Governance (ESG) Risks under Article 449a[1] of the Capital Requirements Regulation (CRR) and the key challenges and considerations for large reporting institutions.

Disclosure of ESG risk is critical to aid market discipline. The draft technical standards provide a framework for ESG-related quantitative and qualitative disclosures, ensuring stakeholders are more appropriately informed about ESG exposures and strategies to support decision making.

The EBA has developed the consultation paper in parallel with advice from the European (EU) Commission on ESG disclosures under the EU taxonomy.[2]

Firms should prepare for further enhancement to Pillar III ESG disclosures once the taxonomy screening criteria is extended to cover climate change mitigation and adaptation, as well as other environmental risks and objectives.

1. https://www.eba.europa.eu/regulation-and-policy/single-rulebook/interactive-single-rulebook/101565
2. https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en

SUMMARY

The Basel Framework is a set of standards outlined by the Basel Committee on Banking Supervision (BCBS), Pillar III[3] of the Basel Framework outlines a requirement to publicly disclosure information to enable market participants to assess a banks material risks and capital adequacy. Article 449a of the CRR outlines requirements for large institutions (institutions with securities traded on a regulated market of any Member State) to disclose prudential information relating to ESG, including transition and physical risk.

Subsequent to the EU Commission publication in March 2018 of its action plan[4] on financing sustainable growth, the EBA prepared its own work plan to identify key priorities, including considerations on how ESG can be incorporated into the regulatory and supervisory framework of EU credit institutions.

The EBA has now developed Pillar III disclosures on ESG risks by large institutions. On Monday 1st March 2021 the EBA issued a public consultation[5] on draft ITS on public disclosure and supervisory reporting of Pillar III ESG risks.

The ITS proposal outlines how climate change may intensify other risks within reporting institutions balance sheet and the ways institutions are mitigating those risks. The proposal is consistent with the Paris Agreement goals[6] which came into force in 2016 and the UN 2030 Agenda for Sustainable Development[7]. It is worth noting, the Paris Agreement is a global roadmap for climate action to support the reduction of emissions while building climate resilience.

BACKGROUND

THE RISE OF ESG

Capco's paper, The Rise of ESG and Its Implication for Firms outlines key ESG considerations for firms and the importance of ESG in today's market. In the past decade, environmental, social and governance concerns have been placed at the forefront of concern within society. There are increasing demands for wider governments, regulators, supra-national bodies, and value chains to have a much greater empathy and more considered regulatory behavior towards ESG criteria within these institutions. To understand how this has come about, there needs to be a general awareness of what is included in environmental, social and governance factors.

Environmental - Environmental considerations reflect the effects of climate change, such as the tracking of carbon emissions, as

3. https://www.bis.org/fsi/fsisummaries/pillar3_framework.htm#
4. https://ec.europa.eu/info/publications/sustainable-finance-renewed-strategy_en
5. https://www.eba.europa.eu/eba-launches-public-consultation-draft-technical-standards-pillar-3-disclosures-esg-risks
6. https://www.un.org/en/climatechange/paris-agreement
7. https://sustainabledevelopment.un.org/content/documents/21252030%20Agenda%20for%20Sustainable%20Development%20web.pdf

BACKGROUND CONT.

well as broader considerations such as the sustainability of resources and reducing waste.

Social – Perhaps the most nebulous grouping of factors falls under social considerations. These include a range of factors – from implementing diversity targets and monitoring a country's attitude towards human rights, to the rights of consumers and more recently, the treatment of workers in the so-called 'gig economy'.

Governance - Over the years, corporate governance has expanded, and now includes areas such as executive incentives and compensation, the structure of management, and employee relations (such as the ability to form or join a union).

These broader thematic challenges have been brought together under one grouping – ESG. Many of the associated regulations under the ESG framework are enduring and established regulations that have been categorized together under a new framework and are now being considered in a more holistic way as they all have interaction points that are supportive of a wider social narrative and greater good.

The EBA aims to promote transparency on the risks arising from Environmental, Social or Governance (ESG) factors. They encourage institutions to strengthen the management of these risks and promote awareness of their role in the transition to a 'green economy'. Failure to address ESG risks can lead to catastrophic institutional outcomes or failure. There are a number of potential financial risk factors that need to be considered and mitigated against within the financial services industry.

Transition risk - Transition risk is the risk attributed to the cost of shifting values and asset prices when moving towards a less polluting, greener economy. Economic trends related to climate risk could also affect organisations that consume an extensive amount of fossil fuels and use raw materials such as steel and cement in production.

Physical risk - Climate change indicates more frequent or severe weather disasters such as flooding, droughts and storms that bring 'physical risks' that directly impact our society and have the potential to affect the economy. Climate, risk-related insurance claims spread and immediately affect underwiring pricing and insurance premiums.

Litigation risk - Litigation risks relate to the business impact that could arise from parties who have suffered loss and damage from climate change and seek to recover losses from others. The cost may be passed to insurers under third-party contracts.

What is Sustainable Finance?

As a subset of wider ESG thinking, sustainable finance is the financing and related institutional and market arrangements contributing to the attainment of sustainable, balanced, and inclusive growth through direct and indirect support of the framework of the Sustainable Development Goals.[8]

Key objectives of sustainable finance include:

- Mainstreaming sustainability into risk management
- Promoting greater transparency and long-termism
- Redirecting capital flows in the direction of sustainable investment.

Sustainable finance aims at integrating ESG criteria into financial services, to support sustainable economic growth. A fundamental aim of sustainable finance is to increase awareness across the financial services industry about the need to mitigate ESG risks and create a sustainable finance strategy which considers the long-term nature of such risks including the uncertainty of their valuation and pricing.

As part of EU and global sustainable development, financial institutions should consider the financial risks arising from climate change, depletion of resources including environmental degradation and social issues while planning for increased investment in support of greater transparency and long-term sustainability.

8. http://www.g20.utoronto.ca/2018/g20_sustainable_finance_synthesis_report.pdf

BACKGROUND CONT.

What are the ESG disclosure obligations in the EU?

There are four key pillars to support the European Green Deal and aid EU Taxonomy and transparency for financial institutions.

TAXONOMY DISCLOSURES (Taxonomy Regulation)	NON-FINANCIAL STATEMENT Non-Financial Reporting Directive - NFRD)	EBA PRUDENTIAL DISCLOSURES (Capital Requirements Regulation & Investment Firms Regulation)	DISCLOSURE REGULATION (Sustainable Finance Disclosure Regulation)
Establishes a common classification system for environmentally sustainable economic activities at Union level. Article 8 of the Taxonomy Regulation requires firms subject to NFRD to disclose information relating to the how and what their activities are associated with economic activities that qualify as environmentally sustainable. Disclosures are applicable from January 2022 for environmental objectives of climate change and for other environmental objectives to be disclosed from January 2023.	NFRD outlines rules on disclosures of non-financial and diversity information by large companies with more than 500 employees and listed companies, banks, insurance companies and other companies designated by national authorities as public-interest entities. NFRD mandates large companies to include non-financial statements in their annual reports.	CRR outlines disclosure requirements for ESG risks for large institutions. Article 53 of the IFR regulation outlines requirements for class two investment firms to disclose information on ESG risks including physical and transition risks and prudential information similar to that required for large institutions under CRR.	SFDR outlines sustainability related disclosure obligations for fund managers, financial advisers, and certain other regulated firms. In-scope credit institutions are those which provide portfolio management and investment advice services.

CRR DISCLOSURE

Part Eight of the CRR outlines requirements for disclosures by institutions; Article 434a mandates the EBA to develop draft ITS on uniform disclosures on climate related transition and physical risks and exposures towards carbon related assets including assets subject to chronic and acute climate change events. This information should be sufficiently comprehensive and comparable for users of information to appropriately assess the risk profiles of reporting institutions.

The EBA ITS has taken account of the Financial Stability Board Task Force on Climate-related Financial Disclosures (FSB-TCFD), and the EU Commissions non-binding guidelines on climate-change reporting and the EU taxonomy.

PILLAR III ESG DISCLOSURES

The Pillar III prudential disclosure on ESG risks are in accordance with the mandates in Article 449a and Article 434a of the CRR and is a step forward in aligning institutions with sustainability goals.

Furthermore, the draft ITS ESG disclosures align with the EBA strategic objective of defining a single, comprehensive Pillar III framework under CRR as outlined in the EBA Pillar III Roadmap[9] and discussed in Capco's paper[10] on a comprehensive Pillar III disclosure framework.

The draft ITS proposes requirements for both qualitative and quantitative disclosures in table and template format, including:

- Tables for qualitative disclosures on how institutions are embedding ESG risks in their business model, strategy, risk management framework and governance processes
- Templates with quantitative disclosures on climate change transitional risk
- Templates with quantitative information and KPIs on climate change mitigation measures, including the green asset ratio (GAR) on taxonomy-aligned activities and other mitigating actions which align to the Paris Agreement and European Green Deal i.e., mitigation actions towards transition to a carbon neutral economy and in the adaptation of climate change.

9. https://www.eba.europa.eu/eba-publishes-its-roadmap-risk-reduction-measures-package
10. https://www.capco.com/Intelligence/Capco-Intelligence/Finance-Risk-And-Compliance-Policy-Framework-Reform-Comprehensive-Pillar-Iii-Disclosures

CRR DISCLOSURE CONT.

The EBA draft ITS includes templates and instructions[11] to aid reporting institutions implementation of disclosures.

Quantitative and qualitative disclosures are required for the following:

TABLE / TEMPLATE	INFORMATION AREA	ESG RISK CATEGORY
Table 1	Qualitative information on environmental risk	Governance Arrangements Business model and strategy Risk Management
Table 2	Qualitative information on social risk	
Table 3	Qualitative information on governance risk	
Template 1	Banking book- climate change transition risk: Quality of exposures by sector	Climate change transition risk
Template 2	Banking book - climate change transition risk: Exposures towards NACE sectors A to H and L - Maturity buckets	
Template 3	Banking book - CC Transition risk: Loans collateralized by immovable property - Energy efficiency of the collateral	
Template 4	Climate change transition risk - Alignment metrics for the banking book	
Template 5	Exposures in the banking book to top carbon-intensive firms	
Template 6	Climate change transition risk - Trading book portfolio	
Template 7	Exposures in the banking book subject to climate change physical risk	Climate Change Physical risk
Template 7.1	Exposures in the banking book subject to climate change physical risk (simplified version for phase in period)	
Template 7.2	Exposures in the banking book subject to climate change physical risk (extended version for after phase in period)	
Template 8	Assets for the calculation of Green Asset Ratio (GAR)	Mitigating Actions on Climate-Change-related risk
Template 9	GAR KPI	
Template 10	Other climate change mitigating actions	

11. https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Consultations/2021/Consultation%20on%20draft%20ITS%20on%20Pillar%20disclosures%20on%20ESG%20risk/963623/Annex%20II%20-%20EBA%20draft%20ITS%20on%20Pillar%203%20dislcosures%20on%20ESG%20risks%20%28instructions%29.pdf

CRR DISCLOSURE CONT.

The EBA ITS proposes a phased-in approach with transitional arrangements for the disclosure of information in templates eight and nine due to anticipated challenges with data availability, particularly for stock loans. The phase-in period is likely to run until June 2024 (subject to finalization) for the disclosures of information relating to the green asset ratio on stock of assets for those exposures.

To avoid unnecessary disproportional costs to institutions the EBA have taken a practical approach to the disclosure requirements including:

- Transitional periods where disclosures in terms of estimates and proxies are allowed
- Inclusion of certain counterparties (e.g., Sovereign exposures and part of the retail portfolio excluded)
- Limitation of the GAR to only EU exposures
- Sequential approach for the development of requirements (e.g., climate risk prioritized).

TIMELINE

- Phase-in period for qualitative template disclosures (Templates 8 & 9) until June 2024
- Annual disclosure by 31st December 2022
- Pillar III ESG Risk disclosures shall apply from 28th June 2022
- EBA ITS public consultation period is open until 1st June 2021
- Sustainable Finance Disclosure Regulation (SFDR) applicable from 10th March 2021
- EBA ITS Consultation launched 1st March 2021
- EU Commission published a call for advice (CfA) on 15th September 2020
- European Supervisory Authorities (ESA) published final report on draft regulatory technical standards (RTS) on 4th February 2021
- EBA Action Plan on Sustainable Finance published 6th December 2019
- EU Commission published non-binding guidelines on Non-financial reporting in 2017[12]
- One Planet Summit held in December 2017
- High Level Expert Group on Sustainable Finance (HLEG) formed in December 2016
- Paris Agreement entered into force on 4th November 2016
- Paris Agreement adoption on 12th December 2015
- Non-Financial Reporting Directive 2014/95/EU 22nd October 2014[13]

12. https://ec.europa.eu/info/publications/non-financial-reporting-guidelines_en
13. https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0095&from=EN

CHALLENGES

The draft ITS signifies potential costs for reporting institutions to comply with the ESG disclosure requirements. The EBA proposes disclosure information on institutions exposures towards sectors that highly contribute to climate change, breaking down exposures towards fossil fuel and other carbon related sectors and taxonomy aligned exposures, combining information on scope three emissions per sector.

The benefit of an EU taxonomy is a common classification system for sustainable activities, however the EBA acknowledges challenges from a lack of common classifications for environmentally harmful activities including identification of sectors and geographies exposed to climate change physical risk.

Institutions should consider the following challenge areas:

- Granularity of reporting; currently only selected counterparties included
- Additional financial investment to comply with ESG policy
- GAR disclosure requirements
- Over reliance on proxies, fallback solutions, estimate and ranges where reliable data is not currently available, e.g.: economic sectors for SMEs counterparties or aggregate information on energy performance certificates for mortgage portfolio disclosures
- Risk mitigation for ESG risks and associated costs to address those risks including financing activities that reduce carbon emissions
- Difficulty monitoring and measuring exposures to deal with transition and physical risks
- Physical impact of climate change may impact financial performance and assets.

Proportionality

It is interesting to note the EBA's acknowledgement of challenges for institutions to effectively gather and report on the new Pillar III ESG disclosure requirements.

In light of this, the EBA propose various approaches to aid in the preparation of disclosures, in the interest of proportionality which include:

- The introduction of a transition phase-in period until June 2024 for the disclosure of the green asset ratio on stock of assets for those exposures towards retail, and corporates not subject to NFRD disclosure obligations in addition to data gaps, which will require the development of methodologies instead of estimates and proxies which shall be allowed during the phase in period
- Follow a sequential approach for the development of Pillar III ITS
- A proportionate approach for the disclosures relating to the trading book, with a specified threshold to delimit which institutions are in scope to disclose this information
- A proportionate approach for disclosures of information on taxonomy alignment for non-EU exposures, the EBA have provided definitions of which institutions are in scope to provide information for exposures towards non-EU counterparties on a 'best efforts basis' and in relation to estimates and ranges.

It is worth nothing the EBA observation that the data collection process should be easier and faster for counterparties subject to NFDR disclosure obligations which are applicable from January 2022, additionally the transition period should aid firm's ability to comply with the requirements set out in the draft ITS.

14. https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en

CONSIDERATION FOR BANKS

There is currently no common classification system for environmental objectives other than climate change, or for social or governance risks. It is worth noting the taxonomy regulation will be extended by the end of 2021 with the aim of incorporating the other environmental objectives, with the EU Commission reporting by the end of 2021 on whether to extend the taxonomy regulation to cover environmentally harmful or neutral activities and social objectives.

With disclosures applicable from June 2022 on an annual basis for the first reporting year and biannually thereafter, institutions should plan their roadmap to compliance and the availability of granular data to accurately disclose ESG risks.

CONCLUSION

Society's response to climate change has led to the identification of new sources of financial risk. Regulatory and supervisory bodies including the EBA are committed to creating a reporting and disclosure framework which fosters greater transparency to support sustainability in financial and economic activity.

The EBA ITS proposes comparable disclosures and KPIs for reporting institutions as a critical enabler for demonstrating how sustainability considerations are being embedded in risk management, business models and firm's roadmap towards the Paris Agreement goals.

Firms are continuing to navigate through the uncertainty from the global COVID-19 pandemic and careful consideration should be given to the challenges and costs associated with ESG Pillar III disclosure requirements. In-scope reporting institutions should begin their impact assessment, gap analysis, and consider the key disclosure points in the ITS.

CAPCO FINANCE PRACTICE

To support in your understanding and implementation of the latest Pillar III disclosure requirements, Capco's Finance practice has a team of experts in regulatory and accounting change execution. Our team has a wealth of experience in supporting clients to meet regulatory reporting and disclosure requirements in an efficient and compliant way.

Capco's offering is underpinned by capabilities within consulting, digital and technology providing an end-to-end service to unlock value at an enterprise level.

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