Answer to the EBA Consultation Paper

THE IMPACT OF DRAFT ITS ON PRUDENTIAL DISCLOSURE ON ESG RISKS: AN ANALYSIS

in accordance with Article 449a CRR II

1. Authors

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She worked on the Climate-Related Risks by elaborating a Regulatory Monitoring in order to understand its impact on the banking sector.

CONTEXT

The European Banking Authority (hereafter “EBA”) introduced a consultation paper on the 1st of March 2021 regarding draft Implementing Technical Standard (hereafter ITS) for disclosures on Environmental, Social and Governance (hereafter “ESG”), and climate change related risks.[1]

Those ITSs related to ESG risks, complete the ITS from the Pillar 3 disclosure framework which aim to support market discipline by communicating comparable statements to inform stakeholders on the institutions’ risk profiles (see figure 1)[2]. In parallel to its mandate to develop ITS as part of the Pillar 3 scope, the EBA designed a framework around ESG disclosures with the objective to promote transparency on ESG risks and to encourage institutions to support ESG risks management.[3]

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[1] European Banking Authority, 2021, Consultation Paper, Draft Implementing Standards on prudential disclosures on ESG risks in accordance with Article 449 CRR, p 5, Consultation paper on draft ITS on Pillar 3 disclosures on ESG risks.pdf (europa.eu)

[2] Implementing Technical Standards on institutions’ public disclosures of the information referred to in Titles II and III of Part Eight of Regulation (EU) No 575/2013 | European Banking Authority (europa.eu)

[3] Transparency and Pillar 3 | European Banking Authority (europa.eu)

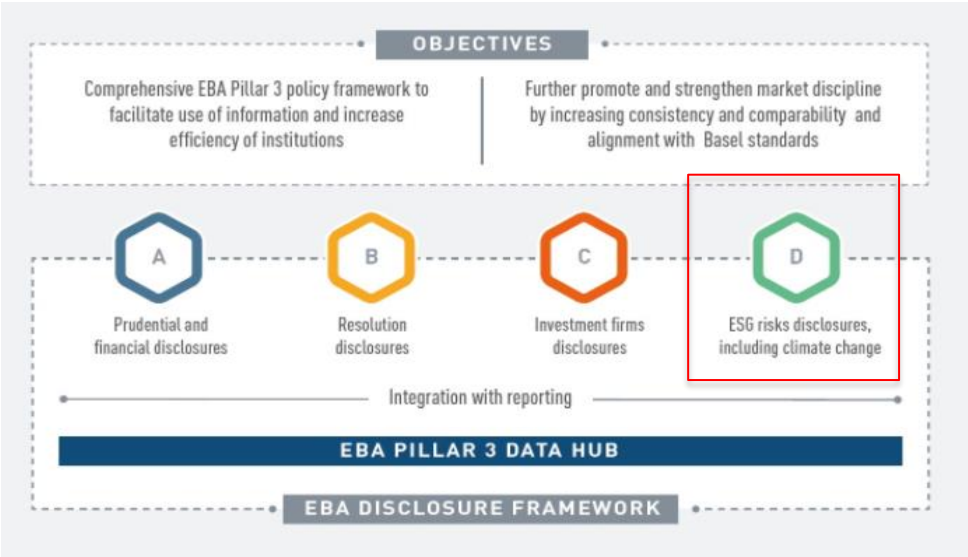

Figure 1: Transparency and Pillar 3 | European Banking Authority (europa.eu)

The purpose of the EBA consultation paper is to propose comparable quantitative disclosures where the impact of climate change on the institutions' balance sheet has materialized ; to propose quantitative disclosures and KPIs which reflect the way institutions' mitigate those risks (including the Green Asset Ratio on taxonomy aligned activities) and to discuss qualitative disclosures on ESG risks. To support this paper, the EBA has included tables, templates and instructions for disclosures to be comprehensive and comparable.[4]

Those disclosure requirements are applicable from June 2022 and apply to large institutions with traded securities in any Member State's regulated market[5].

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[4] European Banking Authority, 2021, Consultation Paper, Draft Implementing Standards on prudential disclosures on ESG risks in accordance with Article 449 CRR, p 5, Consultation paper on draft ITS on Pillar 3 disclosures on ESG risks.pdf (europa.eu)

[5] The criteria to define large institutions is defined in REGULATION (EU) No 575/2013 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Article 142 : large financial sector entity· means any financial sector entity, other than those referred to in point (27)(j) of Article 4(1), which meets the following conditions:

(a) its total assets, calculated on an individual or consolidated basis, are greater than or equal to a EUR 70 billion threshold, using the most recent audited financial statement or consolidated financial statement in order to determine asset size; and

As a stakeholder in the Financial Services Industry, Avantage Reply has decided to respond to this consultation available on the EBA's website. Avantage Reply is a consultancy firm acting across Europe specializing in Finance, Risk, Compliance and Treasury with high regulatory capabilities, focusing on Strategic, Business and IT changes.

THE RELATIVE LIMITATIONS OF AN EMERGING TOPIC OF PRUDENTIAL REGULATION

The proposed tools provided in addendum to the consultation are one of the first reporting propositions formulated by the European Supervisory Authorities in terms of sustainable prudential reporting. It illustrates the start of a compulsory regulatory reporting scheme for the following topics:

- Qualitative information on Environmental, Social and Governance risks;
- Quantitative information on exposure to transition risk: level of exposures of the institution and energy efficiency of the collaterals (exposures towards companies excluded from EU Paris-aligned Benchmarks, other carbon-related sectors, and carbon emissions of the portfolio);
- Quantitative information on exposure to climate change physical risk (exposures prone to impact from climate change events);
- Calculation of the Green Asset Ratio (proportion of the eligible bank's assets funding the taxonomy objectives of Climate Change Mitigation and Climate Change Adaptation).

Following a series of non-binding reporting principles and financial tools built to orient investment through low carbon activities, the regulator is now implementing a series of prudential qualitative and quantitative requirements for financial institutions (i.e. the proposed set of 15 tables under consultation). To be compliant, financial institutions shall allocate the ESG topic to their risk

(b) it is, or one of its subsidiaries is, subject to prudential regulation in the Union or to the laws of a third country which applies prudential supervisory and regulatory requirements at least equivalent to those applied in the Union;
https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32013R0575&from=fr

assessment, lending, accounting and reporting strategies and business lines.

Outside of these business lines, in terms of data management, the requirements in terms of counterparty data and facility sourcing are bringing some substantial strategic and practical challenges to financial institutions - who have never experienced such level of exposure..

Therefore, it is expected that further guidance on client mapping, data sourcing, scoping thresholds and client weighting will be provided. However, at this stage it is difficult to foresee any comparability of the clients from the carbon intensive sectors in terms of emissions.

Template 4: Climate change transition risk - Alignment metrics for the banking book

			a	b	c
	Sector	Nace Sector	Portfolio gross carrying amount (Mn EUR)	Alignment metric	Distance to IEA Sustainable Development Scenario 2 degrees (point in time) in %
1	Power	D - Electricity, gas, steam and air conditioning supply		*Average tonnes of CO2 per MWh*	
				Average share of high carbon technologies (oil, gas, coal).	
2	Fossil fuel cobustion	D.35 - Electric power generation, transmission and distribution		*Average tons pf CO2 per GJ.*	
				Average share of high carbon technologies (coal).	
3	Transportation	H49.3 - Other passenger land transport		*Average tonnes of CO2 per passenger-km*	
				Average share of high carbon technologies (ICE).	
4	Cement, clinker and lime production	C.23.5 - Manufacture of cement, lime and plaster C-23.6 - Manufacture of concrete products for construction purposes		*Average tons of CO2 per tonne cement*	
5	Iron and steel, coke, and metal ore production	C.19.1 - Manufacture of coke oven products B.07 - Mining of metal ores C.24 - Manufacture of basic metals		*Average tonnes of CO2 per tonne steel*	
...	...potential additions...			*tbd*	

Figure 2: Template of alignment metrics for the banking book - climate change transition risk exposure. The column b consolidates average CO2 emissions per sector. However, at this stage, neither the methodology nor the data sources to fill such requirements seems to be made available.

Due to the above-mentioned elements, the implementation of these requirements present the following challenges:

1. Comply or Explain principle: even if requirement is not applicable until June 2022, it seems that the eligible institutions are not bound to report as long as they provide rationales for non-compliance (i.e. non-materiality assessment made by banks, raising of technical burden

issues, non consistency with business model);

2. Free-format is present on the 3 first tables - giving some freedom to the institutions on their qualitative information on ESG risks;

It is to be expected that institutions may be inclined to comply with the requirements not by supervisory pressure but rather by pressure from peer and stakeholders. In any case, future guidance provided by the regulator or market practice creation may be expected in order to help with regulatory implementation.

CASE STUDY: LIMITATIONS OF TRANSITION RISK - LOANS COLLATERALISED BY IMMOVABLE PROPERTY - ENERGY EFFICIENCY OF THE COLLATERAL TABLE

The elements in this paragraph are related to “Template 3: Banking book - CC Transition risk: Loans collateralised by immovable property - Energy efficiency of the collateral”, available in appendix of this document.

The table is supposed to illustrate the level of exposure of the institution to transition risk through the ranking of its immovable property loans energy efficiency.

In the rows, institutions are called to list the level of their loans by country and per type (e.g. Loans collateralised by commercial immovable property, Loans collateralised by residential immovable property and Collateral obtained by taking possession: residential and commercial immovable properties). The columns represent total gross carrying amount per EPC (Energy Performance Certificate) label of the collaterals. The average energy performance and the CO2 emissions of the collaterals.

It is interesting to focus on one table in order to point out several practical reporting challenges for institutions. In this one, the following can be noticed:

- The choice to prioritize a classification per EPC label instead of specific criteria (e.g. heater type, energy emission, deperdition superficy) creates a bias in the risk assessment as EPC criteria are not homogeneous across Europe or across countries. For example, in Belgium, 3 different EPC criteria coexist);
- In Belgium, the determination of an EPC certificate is performed at the construction of a change of owner. After 2011, an EPC certificate is available for property that has been subject to a renovation;
- EPC are valid for 10 years, however the certification gets progressively stricter over the years. Two buildings with similar EPC can have very different energy efficiency if their labels have been set in a different year;

Additionally it can be noticed that the regulator follows the principle that a portfolio including a majority of loans set on high EPC labels is considered to have a higher performance in terms of transition risk than a portfolio including a majority of loans set on low EPC labels. It would be interesting to consider a contrary approach within institutions, where an incentive to valorize and renovate buildings with low EPC label is more valuable and opportunity-creator than the selection of top buildings in terms of energy efficiency;

CONCLUSION

These draft ITS are indeed still perfectible because the format and the constraints of the Pillar III model have some inherent flaws including : a difficulty to compare in a cost effective way, a capacity to opt out of certain requirements, and a substantial quantity of new indicators to collect. However, Avantage Reply firmly believes they are a step in the right direction, as they will increase the information available on the sustainability of the portfolios of large institutions, as well as provide forward and backward-looking information. In addition, the publication of the qualitative information around climate risk management can contribute to the availability of best practices across the industry.

Appendix: Template 3: Banking book - CC Transition risk: Loans collateralised by immovable property - Energy efficiency of the collateral

Template 3: Banking book - CC Transition risk: Loans collateralised by immovable property - Energy efficiency of the collateral

		a	b	c	d	e	f	g	h	i	j	k
		Total gross carrying amount (in MEUR)									Average energy Performance	CO2 emissions
			Level of energy efficiency (EPC label of collateral)							Whithout EPC label of collateral		
			A	B	C	D	E	F	G			
1	**TOTAL**											
1,1	**Loans collateralised by commercial immovable property**											
1,2	**Loans collateralised by residential immovable property**											
1,3	**Collateral obtained by taking possession: residential and commercial immovable properties**											
2	EU Country 1											
2,1	Loans collateralised by commercial immovable property											
2,2	Loans collateralised by residential immovable property											
2,3	Collateral obtained by taking possession: residential and commercial immovable properties											
2,4	EPC label description (energy performance for each label in the relevant country)											
3	EU Country 2											
3,1	Loans collateralised by commercial immovable property											
3,2	Loans collateralised by residential immovable property											
3,3	Collateral obtained by taking possession: residential and commercial immovable properties											
3,4	EPC label description (energy performance for each label in the relevant country)											
3	EU Country 3											
3,1	Loans collateralised by commercial immovable property											
3,2	Loans collateralised by residential immovable property											
4,3	Collateral obtained by taking possession: residential and commercial immovable properties											
4,4	EPC label description (energy performance for each label in the relevant country)											
...	....											