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## EBA Consults on Prudential Disclosures on ESG Risks

***The EBA consultation paper calls for the implementation of a Green Asset Ratio to measure banks' sustainability performance.***

Regulators and sustainability-conscious investors increasingly expect banking institutions in the European Union to focus on environmental, social, and governance (ESG) issues and provide quantitative and qualitative disclosures relating to such issues, including climate change risks and the environmental objectives of climate change mitigation and adaptation, from as early as 2022.

These prudential disclosure requirements arise under Article 449a of the Capital Requirements Regulation (CRR) and are included in the Pillar 3 reporting framework, currently designed for disclosure of regulatory capital and risk exposures. On 1 March 2021, the European Banking Authority (EBA) published a [consultation paper](#) relating to the draft implementing technical standards (ITS) on prudential disclosures required from large institutions with securities that are traded on a regulated market of a Member State.

The consultation paper and draft ITS contain proposals for templates and tables detailing:

- *Quantitative disclosures on climate change transitional risk* posed by the exposure of institutions to counterparties that operate in sectors that contribute to climate change or in carbon-related sectors and may be negatively affected by the transition to a low-carbon, climate-resilient, or environmentally sustainable economy<sup>1</sup>
- *Quantitative disclosures on climate change physical risk* related to exposures to sectors or geographies subject to extreme weather events and other climate-related hazards (e.g., heat waves, landslides, floods, wildfires, tropical cyclones, and water scarcity and stress)
- *Quantitative disclosures on mitigating measures* to address climate change risks, including financing activities that reduce carbon emissions
- *Qualitative disclosures on strategy and governance relating to ESG risks* to complement and facilitate the interpretation of the quantitative information

The disclosures are intended to provide investors and stakeholders with sufficiently comprehensive and comparable information to review and compare the ESG performance and risk profile of large institutions, with a spotlight on their financial activities and vulnerabilities and their strategy for supporting the transition towards a more sustainable economy.

## The Green Asset Ratio

The Green Asset Ratio (GAR) is a new metric that aims to measure how banks support and finance their clients' and counterparties' activities that are "environmentally sustainable" according to the EU Taxonomy Regulation,<sup>2</sup> including activities consistent with the goals of the European Green Deal and the Paris Agreement.

The GAR is intended to provide investors and stakeholders with detailed information on what proportion of institutions' exposures contribute to or enable the environmental objectives of climate change mitigation or adaptation in accordance with the EU Taxonomy Regulation or that enable other activities that contribute substantially to those objectives. In particular, institutions are required to disclose:

- Information relating to the assets necessary for the calculation of the GAR, which includes information on loans and advances, debt securities and equity instruments in the banking book (not held-for-trading and not held-for-sale), and the breakdown of exposures that (i) are towards sectors covered by the EU Taxonomy Regulation and (ii) are environmentally sustainable in accordance with the objectives of climate change mitigation and adaptation under the EU Taxonomy Regulation

Certain rules apply in order to estimate the volume of environmentally sustainable exposures per relevant type of exposure, including:

- Specialised lending (if the use of proceeds is known), general purpose lending/funding (if the use of proceeds is unknown), loans collateralised with residential and commercial immovable property towards non-Non-Financial Reporting Directive (NFRD)<sup>3</sup> corporates, repossessed collaterals, and loans to municipalities for house funding, house renovation loans, and motor vehicle loans
- The GAR of the institution building upon the information on exposures above and including the breakdown by environmental objective and counterparty, for specialised lending, transitional and enabling activities, and the total GAR of the institution, together with information on the percentage of total assets covered by the GAR

Institutions shall also provide information on other actions they have implemented to mitigate climate change risks, including detailed explanations of the nature and type of mitigating actions, the risks they aim to mitigate, related counterparties, and the timing of the actions together with an explanation for why these exposures are not taken into account for the purposes of the GAR calculation.

Finally, the qualitative disclosure tables are also relevant to the GAR, since under "Business Model and Strategy" institutions are expected to specify their objectives, targets, and limitations, including in terms of the GAR.

## Policy options for coverage of assets included in the GAR

While the draft ITS and associated templates constitute a key step forward in supporting the EU's efforts to align credit institutions with the sustainability goals of the wider economy and help stakeholders to understand the risks and vulnerabilities that EU credit institutions may face as a consequence of climate change, the requirements will lead to significant changes and new costs. Therefore, the EBA has taken a

pragmatic approach at this stage in order to balance costs against the need for transparency on ESG risks, in particular with regard to assets to be covered by the GAR.

### **Trading book exposures**

The EBA considered whether — in addition to banking book assets — an institution's assets held for trading should be covered for the purposes of the GAR or should be covered only by institutions with trading books above a certain threshold. The latter option was retained. As assets held for trading tend to be of a temporary nature within the portfolio, the EBA considered that disclosure of information on alignment of those exposures with the objectives of climate mitigation and adaptation based on counterparty data may be more challenging than with banking book assets. In addition, as the trading book portfolio is volatile and fast-changing, disclosure of point-in-time information on the composition and alignment of the trading book with the EU Taxonomy Regulation may create undue window dressing.

However, as some institutions have trading books of significant size, the EBA recommends that assets held for trading should be covered only in quantitative disclosures and the GAR by institutions with trading books above a certain threshold<sup>4</sup>. For the GAR, information should be provided on how the institution contributes to the liquidity and trading of EU Taxonomy Regulation-aligned assets. This is in line with the EBA's proposal in its advice to the European Commission on key performance indicators (KPIs) for credit institutions' disclosures under Article 8 of the EU Taxonomy Regulation. In that context, the EBA recommended a KPI that would show how an institution's activities are contributing to the promotion of trading of EU Taxonomy Regulation-aligned instruments by disclosing the absolute volumes of transactions (purchases and sales) relating to debt and equity instruments towards corporates subject to NFRD disclosure obligations compared to total exposures.

### **Non-EU exposures**

The EBA considered whether non-EU exposures should be (i) included and assessed alongside EU exposures in the same GAR, (ii) excluded from the GAR altogether, or (iii) disclosed in a separate "non-EU GAR", on a best-effort basis, by those institutions with subsidiaries outside the EU. As the GAR is based on the EU Taxonomy Regulation, the EBA concluded that institutions will struggle to assess the alignment with the objectives of climate change mitigation and adaptation for non-EU exposures, since they will not receive information from their non-EU counterparties (given that the EU Taxonomy Regulation and the NFRD apply only at the EU-level). As such, it is not possible to include non-EU exposures in the GAR.

However, the EBA acknowledges that disclosure of information on exposures towards non-EU counterparties is necessary, given the high percentage share of exposures to non-EU counterparties held by some EU institutions with non-EU subsidiaries, and in order for investors and stakeholders to receive a comprehensive picture of the overall strategy of an institution with respect to sustainability. Therefore, the EBA has recommended that non-EU exposures should be disclosed in a separate "non-EU GAR", on a best-effort basis, by those institutions with subsidiaries outside the EU, identifying at a minimum lending and equity exposures to non-EU counterparties that pertain to sectors covered by the EU Taxonomy Regulation and using proxies to determine on a best-effort basis the part of those exposures aligned with the EU Taxonomy Regulation.

### **Retail exposures**

The EBA considered whether the GAR should (i) cover the whole retail portfolio, (ii) exclude the whole retail portfolio, or (iii) partially cover the whole retail portfolio (i.e., only retail mortgages and motor vehicle loans). In previous EBA surveys, the industry was in favor of excluding retail exposures from KPIs and

determinations relating to ESG risks altogether. However, the EBA considers that retail exposures account for a substantial part of the balance sheets of EU institutions, and the retail portfolio can play a significant role in driving more sustainable economies.

While the EBA considers that a full coverage of retail loans is not feasible at present, mainly because the EU Taxonomy Regulation does not apply to households, some parts of the retail portfolio should be included where alternatives to using the EU Taxonomy Regulation and to assess the levels of risk are straightforward and practical to apply. Therefore, the EBA proposes that the GAR only cover retail mortgages and motor vehicle loans, since these portfolios already offer existing alternatives for measuring alignment with the EU Taxonomy Regulation for the objective of climate change mitigation, based on the energy performance of the underlying asset as reflected in the energy performance certificate (EPC) and applying the relevant EU Taxonomy Regulation screening criteria.

### **Sovereign exposures**

The EBA considered whether sovereign exposures should be included in the GAR. It is not currently possible for institutions to collect relevant information based on publicly disclosed data, since governments are not subject to disclosure obligations under the EU Taxonomy Regulation. While governments are increasingly issuing green bonds, which could be used as a proxy for governments' EU Taxonomy Regulation alignment, these issuances remain small in comparison to overall government bond issuances, and there is no EU green bond standard yet to facilitate their assessment.

Finally, it is not possible to map a sovereign's economic activities with sectors designated in the Statistical Classification of Economic Activities in the European Community (NACE) and economic activities upon which the EU Taxonomy Regulation screening criteria are built. The EBA has therefore decided that sovereign exposures should be excluded from the GAR at this stage. However, the EBA notes that inclusion of this sector in the GAR should be targeted in the long-term, as the share of sovereign exposure in total financial assets of institutions is not negligible (12.2% in Q3 2020).

### **Timing**

The EBA has designed the GAR disclosure requirements to match the data and timelines, which NFRD corporates are required to produce following Article 8 of the EU Taxonomy Regulation. The EBA expects reliable data for the GAR from December 2022 from counterparties subject to NFRD disclosure obligations. Therefore, large institutions with securities that are traded on a regulated market of a Member State will have to start disclosing this information from 28 June 2022. The first disclosure shall be annual (by 31 December 2022) and semiannual thereafter (by 30 June and 31 December of each year).

Currently, it is envisaged that there will be a phase-in period until June 2024 for the disclosure of the GAR on stock of assets for exposures towards SMEs, corporates with less than 500 personnel, and retail counterparties to ensure that institutions can collect the relevant information from their counterparties. However, this may evolve depending on the negotiations between the European Parliament, Member States, and the Council with respect to the final legislative text relating to the Commission's proposal for the Corporate Sustainability Reporting Directive. Non-EU data is treated separately, and proxies/estimates and ranges may be needed there.

The consultation is seeking comments on whether the GAR should cover interest income generated by EU Taxonomy Regulation-aligned assets, the proposed timeline, and the transitional period. The deadline to submit comments is 1 June 2021.

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**Endnotes**

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- <sup>1</sup> Transition risk factors include:
- a. climate and environment related policy changes, for example as a result of energy efficiency requirements, carbon-pricing mechanisms that increase the price of fossil fuels, or policies to encourage sustainable use of environmental resources;
  - b. technological changes, for example if a technology with a less damaging impact on the climate or the environment replaces a technology that is more damaging, hence making it obsolete;
  - c. behavioural changes, for example if the choices of consumers and investors shift towards products and services that are more sustainable; or if difficulties to attract and retain customers, employees, business partners and investors arise when a counterparty has reputation for damaging the climate and the environment.
- <sup>2</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R0852&from=EN>.
- <sup>3</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0095&from=EN>.

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- <sup>4</sup> Institutions with an on- and off-balance sheet trading-book business that is normally more than 5% of the institution's total assets and €15 million and that always exceeds 6% of the institution's total assets and €20 million (Article 94(1) CRR) or institutions with an on- and off-balance sheet business that is subject to market risk that is more than 10% of the institution's total assets or €500 million (Article 325a(1) CRR).