Bank Pulse: Perfecting ESG disclosures via the banking book taxonomy alignment ratio

While the banking book taxonomy alignment ratio (BTAR) will offer investors more information on the taxonomy compliance of banks, we believe the green asset ratio (GAR) will, of the two, become the dominant indicator of ESG performance

When it comes to disclosures on taxonomy alignment, the European Banking Authority's (EBA) ESG-related pillar 3 disclosure proposals present a supplementary approach to that of the GAR reporting requirements for banks under the taxonomy regulation. By introducing a separate BTAR alongside the GAR disclosures, the EBA aims to ensure that banks have the opportunity to extend taxonomy eligibility and alignment to smaller corporate exposures not in scope of the Non-Financial Reporting Directive's (NFRD) regime. While we see the BTAR as a valuable additional disclosure metric for investors to assess relative performance, we expect the GAR to be of more importance in this regard.

ESG disclosures under the CRR

On 24 January 2022, the EBA published its final draft implementing technical standards (ITS) on prudential disclosures on ESG risk per Article 449a of the Capital Requirements Regulation (CRR). The CRR requires large institutions with securities traded on a regulated market in any of the EU member states to disclose, from 28 June 2022, information on environmental, social and governance risks, including physical risks and transition risks. In practice, this means credit institutions will publish their first disclosures early in 2023 for full-year 2022, and semi-annually thereafter.

Disclosures on climate change and ESG risks under CRR Article 449a
The EBA's draft ITS provide templates and instructions to banks facilitating the disclose of the relevant quantitative information on climate change-related risks, and additional qualitative information on ESG risks.

The proposed **quantitative disclosures** on climate change include:

1. Disclosures (banking book) on **climate change transition risk**:

- Credit quality of exposures by sector, emission and residual maturity;
- Energy efficiency of the collateral of loans collateralised by immovable property;
- Alignment metrics on relative scope 3 emissions;
- Exposures to the top 20 carbon-intensive firms in the world.

2. Disclosures (banking book) on exposures subject to **climate change physical risk**

3. Information on **mitigation actions**:

- **Green Asset Ratio (GAR)** related disclosures;
- **Banking Book Taxonomy Alignment Ratio (BTAR)** related disclosures;
- Other climate change mitigation actions.

The proposed **qualitative disclosures** include:

1. Qualitative information on environmental risk;
2. Qualitative information on social risk;
3. Qualitative information on governance risk.

BTAR disclosures alongside GAR disclosures

As part of a bank's quantitative evidence of significant contribution to climate change mitigation (CCM) and climate change adaptation (CCA), the EBA not only requires banks to disclose information on their GAR but also to provide additional information for the purpose of calculating a separate BTAR.

The catalyst for the BTAR stems from the fact that exposures to companies not subject to NFRD reporting obligations (SMEs and other non-NFRD corporates) are excluded from the numerator of the GAR. This contrasts with the earlier EBA draft ITS, which had proposed the inclusion of these exposures in the numerator.

Given NFRD requirements only apply to large public-interest entities*, this means a sizeable proportion of the exposures of European banks can never qualify as eligible or aligned for the purposes of the GAR calculation. The soon-to-apply Corporate Sustainability Reporting Directive (CSRD) will extend the scope of the non-financial reporting directive to all large companies and all companies listed on regulated markets (except for micro-enterprises).

Notwithstanding the fact that when CSRD applies, fewer exposures will still be out of scope of the GAR, the EBA has introduced the BTAR into the pillar 3 disclosure framework. The addition of this ratio should give a more complete picture of the taxonomy eligibility and alignment of banks than via a stand-alone GAR.

In the EBA's view, the BTAR will address some important concerns regarding the limited scope of the GAR. This includes, for instance, the potential negative effects on credit flows or the lack of incentive for banks to support the transition process of companies outside the scope of the NRFD. Seemingly, the EBA has acknowledged the GAR disclosures are less meaningful if a substantial part of the banking sectors' exposures is assumed to be taxonomy-ineligible.

* *With a balance sheet total of more than €20m or a net turnover of more than €40m, and with more than 500 employees.*

Data availability will remain an important challenge

For companies not subject to NFRD disclosure requirements, the EBA recommends banks collect information on a bilateral basis via their loan origination and monitoring processes. Alternatively or in conjunction, estimates and proxies can be used. For commercial real estate exposures, EPC labels and the CCM technical screening criteria (TSC) for existing buildings can be considered.

That said, data availability will likely remain a key challenge for banks when meeting the BTAR disclosure requirements, particularly considering the difficulties smaller companies will face in their attempts to provide banks with information on their taxonomy eligible activities and their taxonomy alignment. The EBA, therefore, grants banks the flexibility to disclose BTAR information on a "best efforts" basis. If banks are unable to collect or estimate the relevant information, or if this would excessively overburden them or their counterparties, they are afforded the possibility of excluding these counterparties and explaining this challenge for the applicable portfolios in their disclosures.

With due regard to these data challenges, the EBA also aligned the start date for the GAR disclosures under the pillar 3 framework with the year-end 2023 application date for GAR disclosures under the European Commission's delegated act related to Article 8 of the taxonomy regulation. The BTAR will first become applicable half a year later in June 2024.

The role of the BTAR vis-à-vis the GAR in terms of investor demand

In our view, the BTAR does add value in addition to the GAR as a gauge for the taxonomy status and progress of banks. Even where information on non-NFRD companies is partially based on estimates, the BTAR does offer broader insight into the taxonomy eligibility and alignment of bank balance sheets (than reliance on the GAR alone). It may therefore prove to be an important disclosure metric for investors when distinguishing banks that are more environmentally sustainable from those that may be less sustainable.

That said, when it comes to the taxonomy-related disclosures under the sustainable finance disclosure regulation (SFDR) (applicable per 1 January 2023), the GAR information provided by banks will likely still be the leading metric for portfolio managers. After all, the final draft SFDR regulatory technical standards (RTS), published by the European Supervisory Authorities (ESAs) in October last year, suggest that for financial undertakings the share of taxonomy aligned activities disclosed under Article 8 of the taxonomy regulation (ie, the GAR) should be considered. If that remains the case, the GAR will likely be of more significance as a taxonomy-related performance driver to bank bonds than the BTAR.

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