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Green asset ratios: What's in store for banks?

Starting next year, banks will have to disclose the extent to which their activities are environmentally sustainable. But specific KPI measures may not always give the complete picture of a bank's actual transitional efforts. Green asset ratios could also end up becoming a bit of a disadvantage for banks that are more exposed to out-of-scope sectors

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Executive summary

Starting next year, banks will have to disclose the extent to which their activities are environmentally sustainable according to the definitions set out in the EU taxonomy regulation.

Recently, the European Banking Authority (EBA) shed further light on what these disclosures could look like for credit institutions under their non-financial reporting obligations. These disclosures should enhance the transparency and comparability of the ESG performance metrics of credit institutions.

As such, they could form a valuable reference for example for central banks aiming to integrate sustainability criteria into their monetary policy framework. That said, key

performance indicators that measure the taxonomy alignment of bank exposures may not always give the full picture of a bank's actual transitional efforts.

After all, the KPIs do not cover all activities. The EBA estimates that its KPI proposals will cover roughly 80% of a bank's financial assets if sovereign and central bank exposures are left out of scope. However, the corporate lending books of European banks are also for roughly 25% comprised of exposures to sectors for which no technical screening criteria are developed at this stage.

To our understanding, these exposures will be part of the green asset ratio calculations. This could entail a GAR disadvantage for banks that are more exposed to the out-of-scope sectors, such as Southern European banks.

Besides, green asset ratios will fail to make transparent those ESG efforts of banks that are crucial but not taxonomy aligned. Bank corporate loan books are for almost a third exposed to sectors that are among the more polluting ones.

Besides, the indirect carbon footprint of banks via their household lending books is also substantial. Not all efforts made by banks to help make the activities of these counterparties more energy efficient will necessarily make them taxonomy aligned.

For example, where a bank would finance the transition of a building from the G EPC label category to the C label category, it would probably contribute to bigger energy efficiency gains than when funding the transition of an already relatively efficient building with a C label to the A label category. The former would not be reflected in the GAR stock or flow information where the latter would.

Maybe the development of a low or negative (brown) taxonomy would make such efforts ultimately more visible. If banks had to publish stock and flow information on both brown asset ratios (BAR) and green asset ratios, their accomplishments in supporting counterparties in becoming environmentally more sustainable, albeit not yet taxonomy aligned, could become more transparent.

However, even this would still carry a risk for the identification of transition assets that are not yet green but are also not brown.

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