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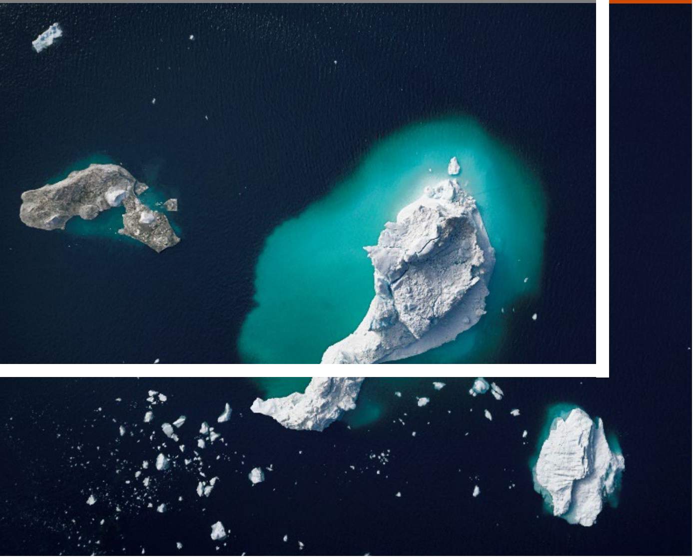
ESG in banking regulation

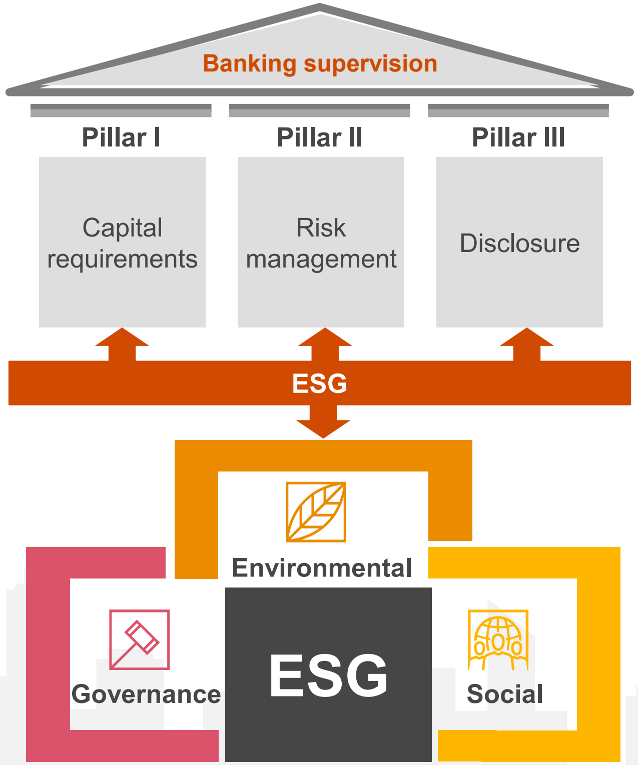
Master ESG regulatory management and disclosure requirements with PwC.



Sustainability in the three pillars of banking supervision

Stronger focus on ESG in the supervisory framework

For the transition to a sustainable economy, **E**nvironmental, **S**ocial and **G**overnance risks will be more strongly integrated into the EU's supervisory framework.



Where does ESG find regulatory consideration?

Pillar I

- Introduced Infrastructure Supporting Factor
- Announced EBA interpretation on possible privileging of sustainable financial products
- Discussions on minimum capital requirements for sustainability risks

Effort € € € € €

Time criticality

Pillar II

- Specific requirements for considering ESG risks in business strategy and organisation, in risk management and in the supervisory review process (SREP)

Effort € € € € €

Time criticality

Pillar III

- Additional disclosure of ESG information in the CRR disclosure report

Effort € € € € €

Time criticality

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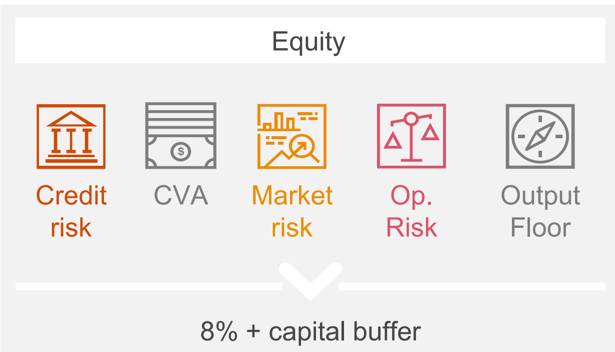
Pillar I
Which ESG minimum capital requirements are under discussion?

Regulatory requirements

The infrastructure supporting factor introduced by CRR II already includes the obligation to analyse impacts on environmental objectives. In Art. 501c CRR III, the EBA is now mandated to submit a report on the supervisory treatment of ESG risks by June 2023. In May 2022, the EBA published a discussion paper on this.

Possible consideration of ESG risks according to the EBA discussion paper



Market risk

- FRTB: Adjustment of risk weights and risk factors under the sensitivity-based approach; use of an ESG residual risks add-on.
- Internal model-based approach: capture of ESG risks through an add-on and inclusion of ESG risks in the stress test.

Credit risk

- SA: Consideration of ESG factors in external ratings, due diligence requirements and collateral valuation.
- IRB approach: integration of ESG aspects in model performance, data representativeness and margin of conservatism.

Operational Risk

- Consideration of ESG factors in existing loss categories.
- Use of data to identify sustainability factors
- Consideration of ESG in strategic and reputational risks in the ICAAP

What are the challenges that emerge?
What solutions does PwC offer?

Challenges

- The currently discussed consideration of ESG risks may lead to increasing risk-weighted assets and thus to increasing minimum capital requirements. An early analysis of the effects is essential to ensure adequate capitalization in the future.
- The integration of ESG risks would lead to a far-reaching methodological revision of risk models. A key success factor here is the availability and provision of data.
- Changes to the methodology for quantifying risks affect all business areas - both in the front office and in the back office.

PwC solutions

- PwC supports you with conducting impact analyses for the regulatory consideration of ESG risks across all risk types. In doing so, we take into account the current proposals of the EBA discussion paper.
- With our experience, we support you in optimising management reporting on ESG minimum capital requirements.

Pillar II
What are your ESG risk management requirements?

Selected regulatory publications on ESG risk assessment

ECB Guide on climate-related and environmental risks

- Contains a total of 13 ECB expectations on the consideration of climate and environmental risks in risk management and disclosures
- Serves as a basis for supervisory dialogue on the treatment of climate and environmental risks by financial institutions

EBA Guidelines on loan origination and monitoring

- Aims to establish prudent lending standards and reduce/limit non-performing loan exposures
- Establishes requirements for loan origination, monitoring and pricing
- Requires incorporation of ESG factors into lending and monitoring practices
- Upcoming implementation in German supervisory practices (7th MaRisk amendment).

BaFin Guidance on Dealing with Sustainability Risks

- Sustainability in relation to ESG
- Describes in detail possible processes of risk identification, management and control, as well as methods and procedures
- Includes implications for stress testing/scenario analyses (transition/impact scenarios)

Regulatory requirements make it necessary to further develop risk management practices in key dimensions

Development of a sustainability strategy or **expansion of the business strategy** and derivation of a consistent **risk strategy** 1

Clear distribution of responsibilities ("three lines of defense") and targeted development of expertise and anchoring ESG in the internal instruction system 2

- Structured **impact analysis**
- Expansion of the **risk appetite** taking into account the **time horizon** (short/medium/long-term) and derivation of **suitable KPIs**

3

- Integration of **management and control processes**
- Expansion of **methodological tools** (e.g. ESG Scoring)

4

Further development of internal and external reporting around sustainability risks – taking **data governance** into account 5

What are the challenges that emerge?
What solutions does PwC offer?

Challenges

- Quantification of ESG risks, e.g. in the context of materiality analyses, stress tests/scenarios
- ESG impact analyses for short-, medium- and especially long-term periods (up to 2050)
- Use of different scenarios (NGFS)
- Expansion of expert knowledge e.g. for physical/transitory risk analysis
- Collection and systematic compilation of climate-relevant data and climate indicators
- Climate strategy projections for long-term scenarios e.g. dynamic balance sheet approach
- Integration of ESG aspects and scenarios into both ICAAP perspectives
- Integration of ESG risks in risk models and consideration in the validation/back-testing process

PwC solutions

- We support you in reacting effectively to regulatory changes regarding ESG – to make you fit for the future.
- Our many years of experience in dealing with ESG from various consultancy projects give us the opportunity to optimally respond to your requirements and develop pragmatic approaches.
- We offer you access to our market and benchmark expertise.
- We look forward to supporting you in the implementation of ESG risks and are convinced that we are a strong and capable partner for you.

Pillar III
What are your ESG disclosure requirements?

Regulatory requirements

- **Art. 449a** of the CRR II already provides the basis for the regulatory disclosure of **ESG risks**, including physical and transitional climate risk.
- On January 24, 2022 the EBA published the final ITS (**EBA ITS 2022/01**) on prudential disclosure on ESG risks, which specifies the disclosure requirement of Art. 449a CRR.
- Large institutions must disclose information on ESG risk in their CRR disclosure report for the first time as of **December 31, 2022**.

Physical risk

As a result of climate change, physical risks are occurring:

Drought | Floods and higher sea level | Warming | Extreme weather events | Wind

Transition risk

On the transition path to a carbon-neutral economy, there are transitional risks:

Technological Innovation | Climate law and regulation | Market

Timeline for the new disclosure requirements

2021

March 2021
Publication of the EBA Consultation Paper on ESG Disclosure Requirements under Art. 449a CRR (EBA/CP/2021/06)

2022

24. January 2022
Publication of the final ITS on ESG disclosure requirements according to Art. 449a CRR (EBA/ITS/2022/01) with **application from 28.06.2022** on a semi-annual basis.

31. December 2022 (light)
First disclosure reference date with reduced disclosure requirements (phase-in approach)

2023

30. June 2023 (light)
Disclosure of half-year figures in the disclosure report with reduced disclosure requirements

(phase-in approach)

31. December 2023 (extended)
Disclosure reference date with extended ESG disclosure requirements

(Phase-in-approach)

- CCM (Temp. 1)
- GAR (Temp. 6, 7 & 8)

2024

30. June 2024 (full disclosure)
Disclosure reference date with extended ESG disclosure requirements and first full disclosure

- Scope 3 emissions (various Temp.)
- Alignment Metrics (Temp. 3)
- BTAR (Temp. 9)

Future
Continuous adaptation/ expansion to include new ESG criteria and expansion of disclosure to include **all six environmental targets**

Gradual expansion of ESG disclosure requirements by June 2024

Full disclosure by June 30, 2024

Pillar III
What templates are there for disclosure of ESG risks?

The templates at a glance

Quantitative data

- Tables 1 through 4 address the **transition risks**, i.e. the risks associated with the transition to a more sustainable economy in quantitative terms.
- Template 5 addresses the **physical risk** caused by climate change. The disclosure of banking book positions affected by acute and chronic climate-related hazards must be disclosed. The positions held are to be broken down into regions affected by chronic and acute events.
- In templates 6 to 10, positions that can be regarded as **risk mitigating measures** must be disclosed**,** such as information on economic activities that are considered environmentally sustainable in the sense of the **Taxonomy Regulation** and on the basis of which the **Green Asset Ratio (GAR)** is calculated. Furthermore, a breakdown of the forms of contribution to CCM (Climate Change Mitigation) and CCA (Climate Change Adaptation) as well as transitional and enabling activities in relation to climate change must be disclosed.
- The **Banking Book Taxonomy Alignment Ratio (BTAR)** is to be disclosed as a new KPI in Template 9. Environmentally compatible exposures to non-financial corporations that are not subject to NFRD disclosure are to be disclosed.

Template 1
Positions vis-à-vis NFC by NACE sectors incl. maturity bands
(banking book)

Template 2
Real estate collateralised loans according to energy efficiency

Template 3
Scope 3 emissions by NACE sectors
(banking book)

Template 4
Positions in relation to top 20 CO_2 emitters worldwide
(banking book)

Template 5
Exposures with physical climate risks

Template 6
Summary of the KPIs for the exposures aligned to the taxonomy

Template 7
Ecologically sustainable positions within the meaning of the Taxonomy Regulation

Template 8
Green Asset Ratio (GAR) based on Template 7

Template 9
Banking book taxonomy alignment ratio (BTAR)

Template 10
Other risk mitigation measures (beyond GAR)

Transitional risks · Physical risks · Risk-mitigating measures

Qualitative information

- In tables 1 to 3 on the qualitative disclosure requirements, information on the three dimensions of sustainability, **Environmental, Social and Governance** risks, must be disclosed.
- Furthermore, under each ESG category, information on the governance, business model and strategy, must be disclosed.

Table 1
Disclosure on environmental risks
E

Table 2
Disclosure on social risks
S

Table 3
Disclosure on governance risks
G

Pillar III
What challenges do you face? Which PwC solutions and tools can you benefit from?

Challenges

- Availability of the requested data
- Continuous development and expansion of regulatory requirements and coherence between different regulations
- Determination or estimation of scope 3 emissions
- Determination of the "distance" to the target values according to the 2 degree scenario
- Classification of contributions to environmental sustainability (CCM and CCA) based on technical screening criteria
- Identification of items exposed to chronic and acute physical risks
- Identification and labeling of regions affected by climate change
- Identification of other mitigating measures beyond the requirements of the Taxonomy Regulation
- Estimations or bilateral counterparty requests

PwC solutions

- PwC offers the necessary holistic view
- PwC has established an integrated Sustainable Finance Workstream that covers both the Pillar III regulatory disclosure requirements outlined here and the non-financial reporting requirements
- Optimisation of disclosure requirements through the analysis of existing data requirements as well as through our extensive experience in the reporting area

PwC ESG Data Tracker Tool

Our PwC ESG Data Tracker Cockpit for identifying new data points and presenting missing data includes:

- Analysis of required data for ESG risk disclosure.
- Efficient identification of the need for action and tracking of project progress
- Optimisation of disclosure requirements

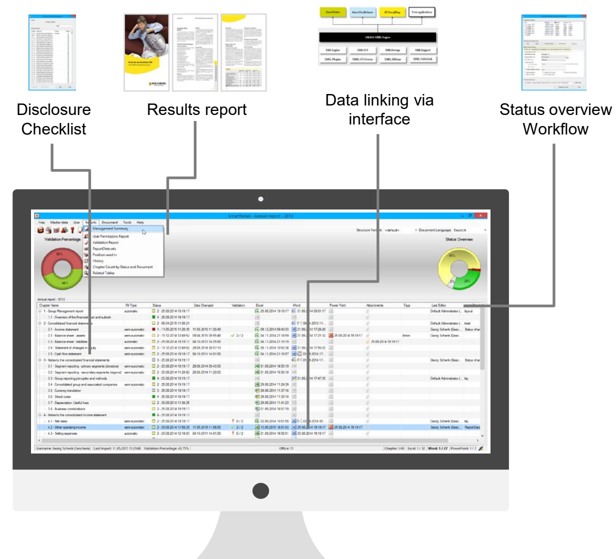
- **Tangible and transparent reporting**
- **Description of the required raw data in a data catalogue**
- **Analysis of data availability**
- **Flexible applicability** in terms of scope
- **Benchmark comparison** to peer group data
- **Flexible extension** in case of new reporting requirements
- **Project-accompanying tool** for planning and tracking purposes

PwC Disclosure Toolbox

Our Disclosure Toolbox to ensure consistency and automation of disclosure tables includes:

- **AD Tool:** The PwC Automated Disclosure Tool to automatically populate and validate disclosure tables.
- Automation possibilities for disclosure with simple implementation of **Robotics Process Automation (RPA)**
- Optimization of disclosure requirements through analysis, design and implementation in **SmartNotes**

SmartNotes



Who are we?

Quality is our benchmark:

Whether in auditing or in legal, tax and strategy consulting, family businesses, medium-sized companies, large corporations, associations, public organisations and NGOs all benefit from the solutions and implementation expertise of PwC Germany. Our clients benefit from the high qualifications of our experts, modern auditing and advisory approaches, reliable process standards and our global PwC network.

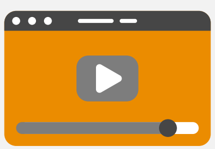
As a pan-European hub within PwC, we offer banks and other financial services providers numerous services relating to regulatory projects and risk management. At PwC Risk & Regulation in Germany, more than 270 people are currently involved in the implementation of new regulatory requirements and the quantification of risks.

PwC Risk & Regulation keeps you up to date, tailored to your needs

PwC Risk & Regulation Youtube Channel

PwC Risk Blog

PwC Regulation Blog



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