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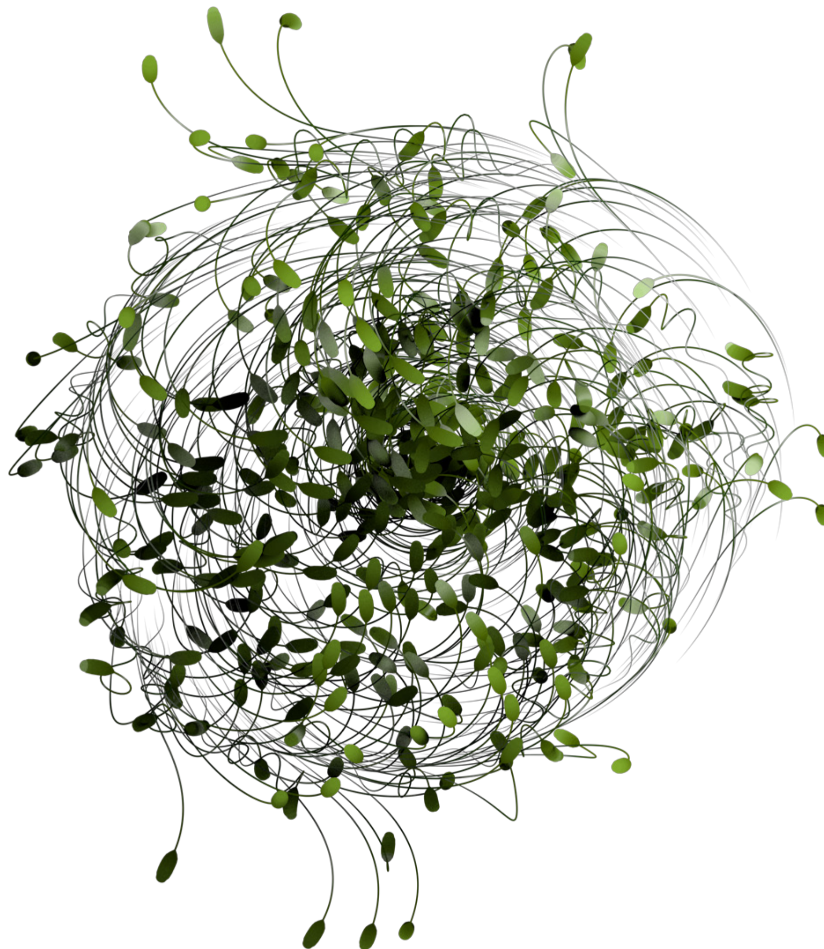

Pillar 3 is evolving: CRR 2 introduces many changes including a focus on ESG

Introduction and Regulatory Context

Transparency and market discipline continue to top the agenda for Irish and European regulatory authorities. The second Capital Requirements Regulation (CRR 2) and recent European Central Bank (ECB) and European Banking Authority (EBA) publications, continue to strengthen the Pillar 3 regulatory framework across Europe and provide challenges to firms in this context. Institutions will be familiar with the majority of data required for the initial CRR 2 Pillar 3 disclosure requirements from June 2021 however future requirements, including the ECB Guide on climate-related and environmental risks[1] and EBA draft implementing technical standards (ITS) on Environmental, Social and Governance (ESG) risk disclosures under the Pillar 3 framework[2], present significant challenges for firms, in particular finance and risk functions and governance fora up to and including the Board.

Motivation

The existing EBA Pillar 3 policy framework is disseminated across a range of regulatory texts, which includes ITS, Regulatory Technical Standards (RTS) and Guidelines on a wide range of disclosures from own funds to non-performing and forborne exposures.

Following the strong mandate included in Article 434a of CRR 2, the EBA is implementing a comprehensive, more standardised approach to Pillar 3 disclosures. This approach is underpinned by several all-inclusive regulatory disclosure products, including the comprehensive final draft ITS on institutions' public disclosures, applicable to all institutions subject to the disclosure requirements under Part Eight of the CRR. This will replace the disclosure requirements included in the existing products and guidelines[3].

Background

The Basel Committee on Banking Supervision (BCBS) integrated a revised Pillar 3 framework in the Basel consolidated framework in December 2019 (subsequently updated in January 2021) which reflects the Committee's Basel III post-crisis regulatory reforms.

1 Guide on climate-related and environmental risks (europa.eu)

2 Consultation paper on draft ITS on Pillar 3 disclosures on ESG risks.pdf (europa.eu)

3 An exception are the guidelines on disclosure requirements of IFRS 9 transitional arrangements, which will continue to apply

CRR 2 significantly amends the CRR in a number of aspects, such as the leverage ratio, the net stable funding ratio (NSFR), requirements for own funds and eligible liabilities. It also introduces some clarifications regarding disclosures on remuneration practices and including new disclosure requirements on performing, non-performing and forborne exposures, and on collateral and financial guarantees received.

To facilitate the comparability of information with international non-EU-active banks, CRR 2 has been developed with the objective of seeking consistency of disclosure formats in alignment with the BCBS Pillar 3 standards.

The final draft ITS covers most of the disclosure requirements included in Titles II and III of CRR 2, with some exceptions which will either be part of a separate ITS or added at a later date to the comprehensive ITS[4]. The EBA has recently launched a consultation paper in relation to the disclosure requirements on ESG risks under Article 449a of CRR 2 and we place a spotlight on this development later in this paper.

Key features of the new disclosure requirements

- **Integration of Pillar 3 disclosure requirements with supervisory reporting.** Given the commonalities of the information that institutions have to report to their supervisors and disclose publicly, the EBA made a strategic decision to maximise the integration with supervisory reporting requirements; including a mapping between the quantitative disclosure templates and supervisory reporting. The benefits of this include:
  - Facilitating institutions' compliance with both sets of requirements, as institutions will be required to use the same data to fulfil their reporting and disclosure obligations.
  - Improving the quality of disclosed information: as the reporting requirements are subject to scrutiny by the supervisor, the mapping of reporting and disclosure data will lead to improvements in the disclosure data, which will benefit all market participants, enabling them to take more informed decisions.

Information relevant for market participants is also relevant to supervisors when carrying out their tasks, thereby emphasising the importance of striving for congruency.

- **Proportionality in Pillar 3 disclosures.** CRR 2 introduced definitions of 'small and less complex institutions' and 'large institutions' to support enhanced proportionality. The revised Pillar 3 framework defines which disclosures are applicable to different institutions, depending on their size, complexity and on whether they are listed or non-listed institutions.
  - Small and non-complex institutions' disclosures will focus on key metrics while large and listed institutions will disclose more detailed information.

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4 Will form a Separate ITS

- Disclosure of own funds and eligible liabilities, in accordance with Article 437a of the CRR. (to be included in ITS on eligible liabilities (TLAC and MREL))

Will be added to the comprehensive ITS

- Disclosure of exposures to interest rate risk on positions not held in the trading book, in accordance with Article 448 of the CRR
- Disclosure of indicators of global systemic importance in accordance with Article 441
- Disclosure of environmental, social and governance risks in accordance with Article 449a

- Proportionality is also reflected in the frequency of disclosures as well as in disclosure formats to ensure that the information provided is sufficient to enable market participants to assess the risk profile of different institutions.
- Additionally, thresholds[5] are introduced to trigger additional disclosures by large banks, based on their risk profiles, to ensure the availability of sufficiently comprehensive and comparable information for users of that information to assess the risk profiles of institutions and their degree of compliance with the regulations.

- **Comparability and consistency of the data disclosed.** Quantitative templates disclosures are mostly based on fixed formats, with some exceptions where standardisation was not feasible. This will further promote comparability and consistency of the data disclosed and facilitate the integration with supervisory reporting.

The Supervisory Agenda

The promotion of market discipline continues to be high on the supervisory agenda and in this context the Basel Pillar 3 framework includes general principles to facilitate users' access to - and understanding of - the information disclosed, as well as comparability across institutions. These principles are reflected in the evolving Pillar 3 framework, for example:

- **Comprehensive and meaningful disclosures** that should include all the information required in the Level 1 text and in the final draft ITS with omissions limited to exceptional cases only (and disclosed).
- **Meaningful, informative qualitative narratives supporting quantitative disclosures** that should be located in close proximity to the related quantitative templates and should not be dispersed throughout the report.
- **Disclosure via single medium and location**, which should be easy to identify and find by users of information.
- **Comprehensive interim reporting** which is comparable with year-end disclosures for all templates and tables, including the qualitative narrative requirements.
- **Internal verification** of information and data to confirm accuracy and consistency.

The requirements of banks to disclose based on the new CRR 2 requirements from June 2021 presents a significant demand on resources with more tables and templates than ever before (maximum 21 tables and 67 templates), coupled with increased disclosure frequencies, reconciliation requirements and detailed narratives. Banks can create efficiencies as the majority of data required will be consistent with what is used in other regulatory reports.

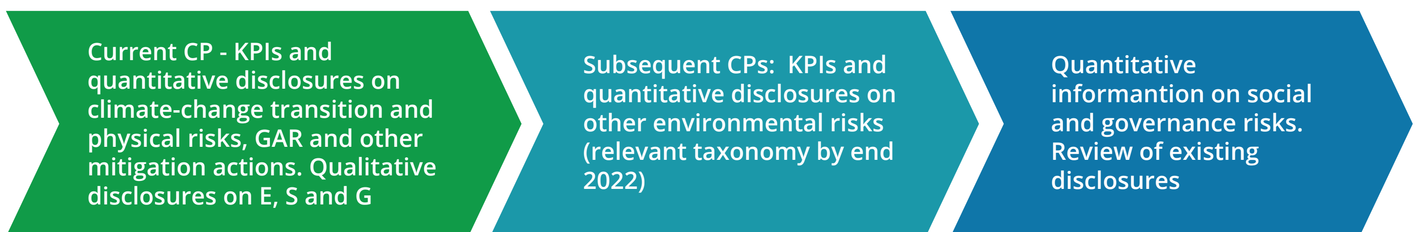
This is not the case for ESG risk disclosures, where internal data will not be readily available at present.

Spotlight on ESG Risk disclosures

From June 2022, the CRR requires disclosures of prudential information on environmental, social and governance (ESG) risks, addressed to large institutions with securities traded on a regulated market of any Member State. The CRR mandates the EBA to develop draft implementing technical standards (ITS) specifying uniform formats and associated instructions for the disclosure of this information. Uniform formats will support the regulatory push for enhanced transparency, market discipline and comparability across market participants.

In March 2021, following on from a detailed ECB guide on climate-related and environmental risks published in late 2020 (more on this later) the EBA launched the first consultation paper[6] which proposes the tables, templates, and associated instructions that institutions must use in order to disclose the relevant ESG information required in line with Article 449a of the CRR. This includes relevant qualitative information on ESG risks, and quantitative information on climate change related risks, including transition and physical risks and mitigating actions.

This consultation paper forms the first part of the EBA's sequential approach for the development of the P3 ESG ITS as follows:



5 Thresholds are introduced for this purpose in the disclosures on credit risk quality (disclosures on non-performing exposures), and in the disclosures on encumbered and unencumbered assets.

6 EBA Consultation paper on ESG risk disclosures

Importance for firms

ESG factors help measure the sustainability and societal impact of business activities that are financed by banks. Their disclosure is a vital tool for market discipline allowing an assessment of banks' environmental risks and their sustainable finance strategy.

Stakeholders from national governments to shareholders to consumers have a legitimate interest in the risks that banks and economies are exposed to from climate change and other ESG risks.

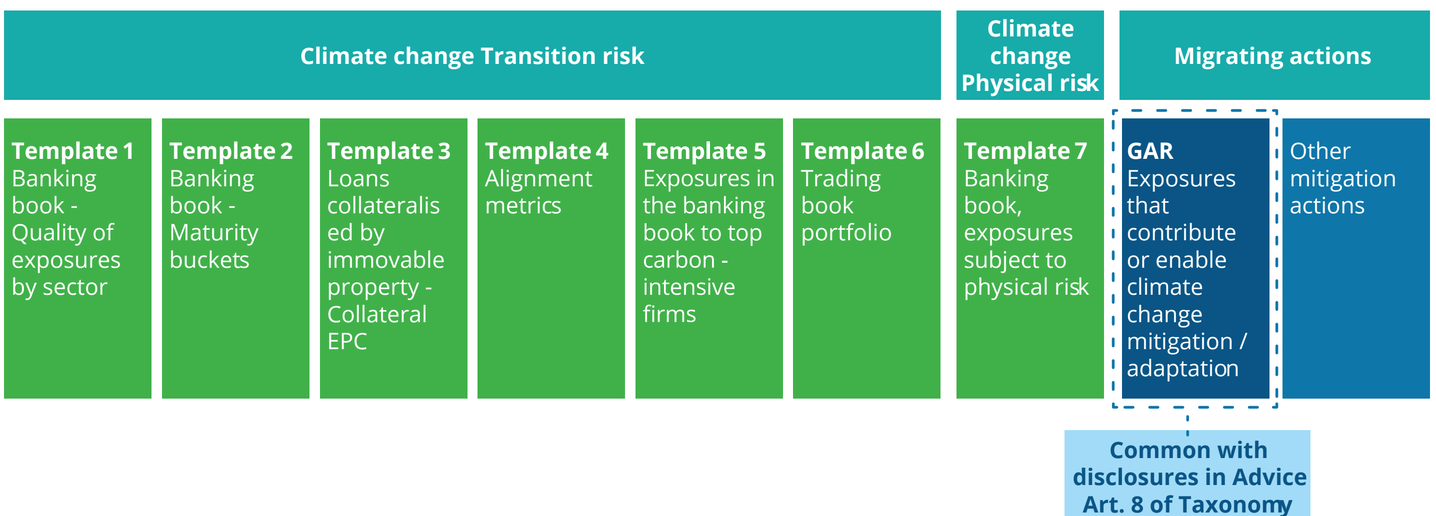
In this context the EBA and other supervisory bodies are asking banks to clearly articulate their strategies, governance and risk management policies in relation to ESG. They also want banks to disclose information on sectors or assets that may highly contribute to climate change, exposures which may be subject to extreme weather events together with details of their mitigation actions.

The Green Asset Ratio (GAR) is a Paris agreement-aligned ratio that can be used to identify whether banks are financing sustainable activities, such as those consistent with the Paris goals. It shows the proportion of assets that are environmentally sustainable and contribute substantially to the objectives of climate change mitigation or climate change adaptation or that enable other activities to contribute substantially to those objectives.

Stakeholders from national governments to shareholders to consumers have a legitimate interest in the risks that banks and economies are exposed to from climate change and other ESG risks.

Summary of ESG disclosure requirements

Firms are required to disclose details on climate change transition risk, climate change physical risk as well as mitigation actions and the Green Asset Ratio as follows:



Data as a driver of the ESG agenda

Pillar 3 disclosure requirements are designed to complement and align with other data-driven requirements including:

- The Non Financial Reporting Directive (NFRD) and Taxonomy Regulation;
- EBA Loan Origination Guidelines; and
- BCBS 239 obligations.

The EBA recognises that it will be difficult to obtain accurate data and allows banks to use proxies, estimates and ranges where reliable data is not yet available. Given the continued scrutiny of data by regulators - in areas such as stress testing, capital planning and resolution planning – the ESG regulatory agenda will place further pressure on banks to improve and enhance data reliability, availability and accuracy.

The EBA expect reliable data for the GAR from December 2022 from counterparties subject to NFRD disclosure obligations; a much longer timeline is accepted (June 2024) for other data including from SMEs, corporates below 500 staff and retail counterparties.

Concluding remarks

The Pillar 3 disclosures framework continues to evolve, with further material changes incoming over the next few years. In addition to the continued regulatory push for increased transparency and more meaningful disclosures on capital, liquidity, credit and governance risks, Irish and European authorities have a clear focus on ensuring emerging ESG risks are properly identified, monitored and disclosed by institutions.

As stated in its Guide to climate-related and environmental risks, the ECB: "expects institutions to consider climate-related and environmental risks – as drivers of existing categories of risk – when formulating and implementing their business strategy and governance and risk management frameworks (...) (and) become more transparent by enhancing their climate-related and environmental disclosures."

Moreover:
"institutions are encouraged to duly consider other relevant publications, such as (...) the Task Force on Climate-related Financial Disclosures (TCFD)"

While many institutions have signed up to the TCFD the ECB notes that
"Only a minority of institutions' disclosures are in line with the recommendations by the TCFD"

In this context, firms will need to integrate the evolving – and overlapping – transparency and ESG agendas into their risk management plans.

The finance, risk and first line functions will be significantly impacted by the new requirements and should consider how their current operating models will be impacted by the ESG data capture and disclosure requirements. Firms should establish/update the necessary policies and procedures in order to be able to meet their disclosure requirements for ESG. Firms should carry out an assessment of the new disclosure templates and address any data gaps. Consideration of existing data programmes, including BCBS 239, should be assessed in this context.

Given the interconnectedness between the Pillar 3 requirements and other EU initiatives mentioned above, banks must understand the overall reporting and disclosure requirement being developed for the EU and take a holistic view when developing their approaches to meeting these. Much of the data requirements for the different initiatives are intertwined. A large amount of the Pillar 3 data will be leveraged from the output of the implementation of the NFRD and the EBA Guidelines on Loan Origination and monitoring, but there will be gaps.

Banks will have to source this data elsewhere, either directly from clients or through third-party data providers. This will present a further set of challenges in areas such as data availability, reliability, timeliness and outsourcing considerations. Banks must also look towards the impact of ESG disclosures on their core businesses and have mitigating action plans in place for instances where the output is not aligned to their strategic plans or market expectations for ESG, even if this is due to data quality issues.

It is imperative that Board members become familiar with the evolving ESG requirements (and broader Pillar 3 changes) and the potential impact it will have on the firm's business, operations and regulatory compliance. In this context, Boards should arrange for training to delve deeper into the new requirements.

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