EU banks under the spotlight –

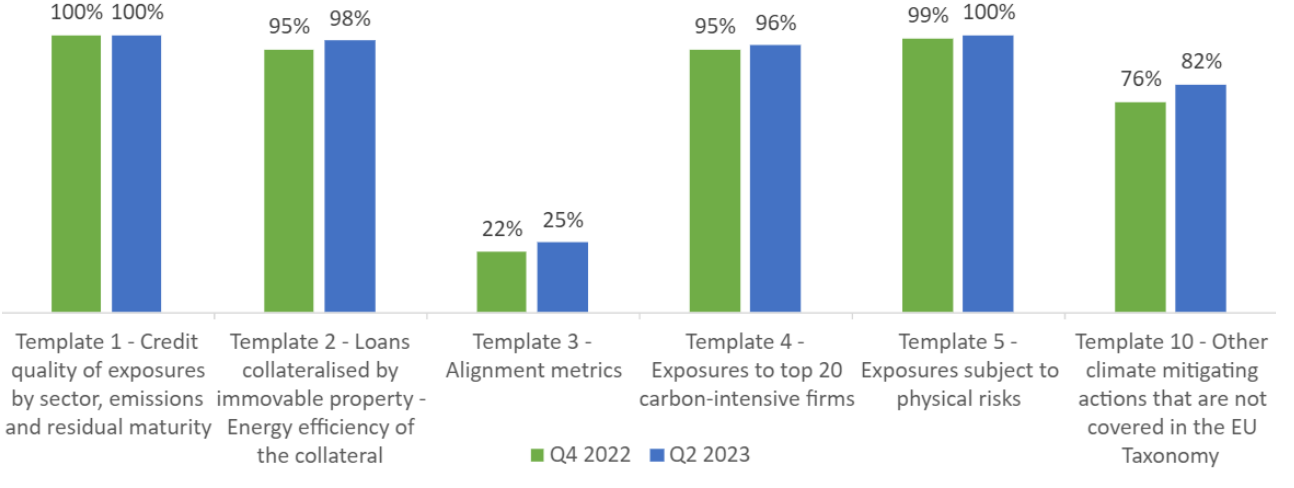
analysis on Q2 2023 Pillar 3 ESG reporting

Pillar 3 disclosures on ESG Risks

This document covers the analysis of the Q2 2023 Pillar 3 reporting on ESG risks of 57 European banks, of which six Dutch banks. All banks in scope are considered large institutions which have issued securities that are admitted to trading on a regulated market of any Member State and are under European Central Bank (ECB) supervision. The Pillar 3 benchmark performed on Q4 2022 disclosures covered a scope of 75 European banks in total. However, unless indicated otherwise, in this analysis the reporting figures of 57 banks are benchmarked to each other, as well as analysed for trends and movements between the two reporting periods. Additionally, there are no scope changes in the set of Pillar 3 templates on ESG risks that are mandatory for banks to report in their Q4 2022 and Q2 2023 disclosures.

In the figure below the frequency of the disclosure of the respective Pillar 3 ESG templates are displayed. Compared to the Q4 2022 disclosures, banks have more frequently disclosed the Pillar 3 ESG templates in Q2 2023.

Figure 1: Pillar 3 disclosures on ESG risks as per Q2 2023 (57 banks in scope) and Q4 2022 (75 banks in scope)

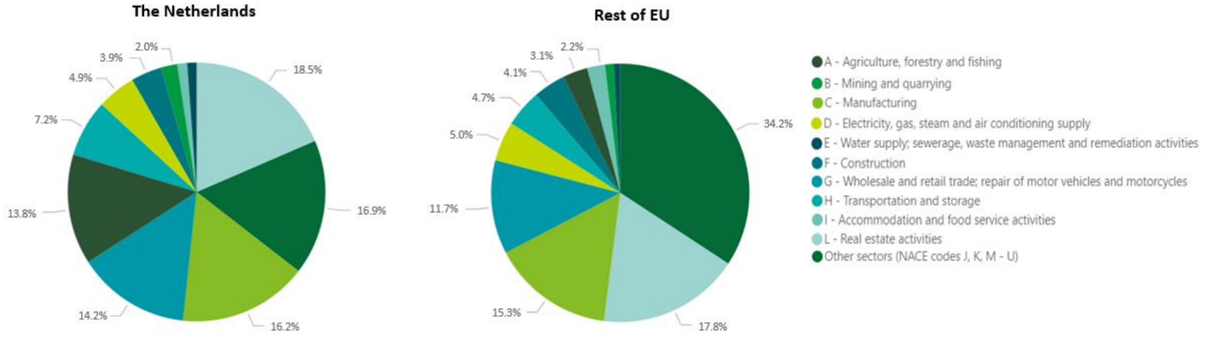


Template 1

Template 1 requires banks to disclose their exposure to sectors that highly contribute to climate change.

In figure 2, it is notable that compared to the rest of Europe, Dutch banks report relatively higher exposures to the agriculture, forestry, and fishing sector (13.8% NL; 3.1% EU). This discrepancy is mainly caused by the figures of one bank in the Netherlands, which accounts for 89% of the total Dutch exposure to this sector. Also remarkable is that the relative exposure to the other sectors (NACE codes J,K,M-U), is significantly lower for Dutch banks compared to other European banks (16.9% NL; 34.2% EU). This suggests that a larger part of the portfolios of Dutch banks is exposed to sectors that are considered sensitive to climate change related risks. Compared to Q4 2022, the average exposure to other, non-climate risk contributions, sectors (NACE codes J,K,M-U) has increased for the European banks (from 24.2% to 34.2%). For the Dutch banks in scope, there are no significant changes between the two periods.

Figure 2: Share of Gross Carrying Amount (GCA) by sector (%) – The Netherlands and the Rest of Europe[1]



Exposures towards companies excluded from Paris-Aligned Benchmarks

In addition to the disclosure of exposure to the sectors that are identified as contributing to climate change, banks are required to disclose whether these exposures are excluded from Paris-Aligned Benchmarks (PAB). Our analysis determined that the relative exposure that banks have towards PAB excluded companies in comparison to the total exposure, increased compared to Q4 2022 for almost all sectors except for the Agriculture, forestry and fishing sector, Water supply, sewerage, waste management and remediation activities sector and the construction sector.

Also interesting to note is that one of the six Dutch banks in scope reports a higher exposure to PAB excluded companies than their total GCA towards that specific sector.

For this analysis it is assumed that the reporting values should be switched.

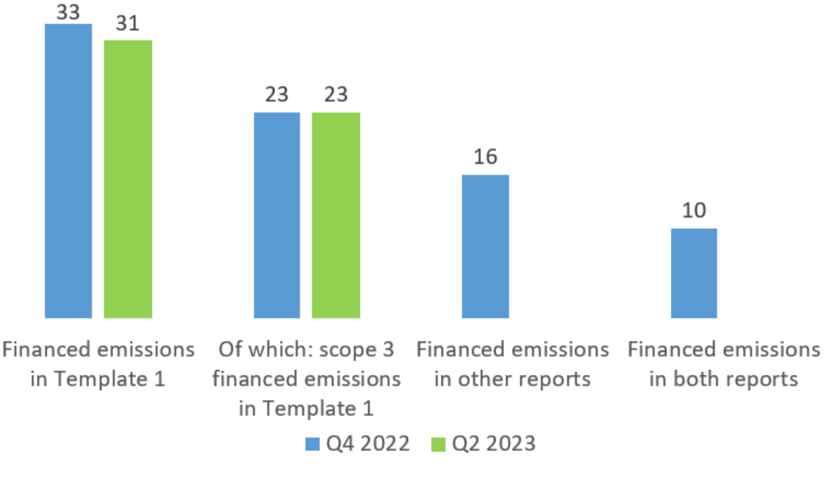
[1] The Rest of Europe group does not include The Netherlands

Figure 3: Exposure of Dutch banks and banks in the rest of EU towards companies excluded from Paris Benchmarks as percentage of GCA

Financed emissions

In template 1, 54% of the banks in scope disclosed their financed emissions and 40% of the banks in scope disclose scope 3 emissions. Additionally, other year-end reports of the banks in scope are assessed, whereas it is concluded that only 28% of the banks in scope also reported on financed emissions in their annual report and/or climate risk report. The limited disclosure of banks suggests that banks do have difficulties or are reluctant to disclose financed emissions. Dutch banks specifically indicate that the lack of data availability from their counterparties interferes with the reporting of scope 3 financed emissions.

Figure 4: Disclosures of financed emissions – by banks in scope based on their Pillar 3 disclosure (Q2 2023 57 banks in scope) and annual report (Q4 2022 75 banks in scope)



Template 2

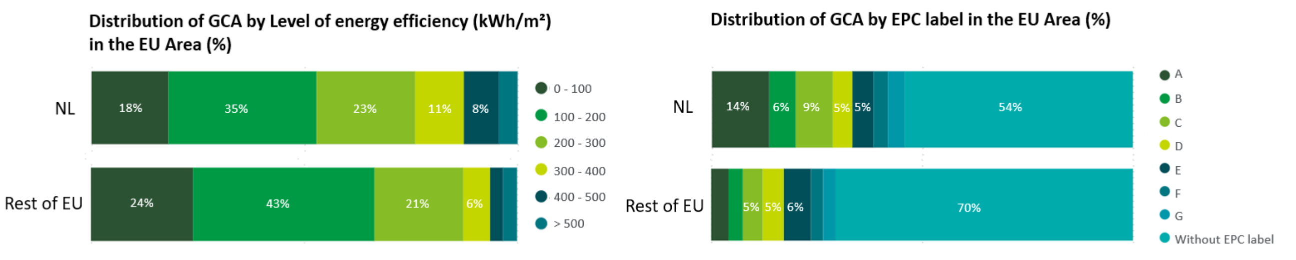
Template 2 discloses information on the loans collateralised with real estate, based on the energy efficiency of the collateral.

Banks have a long way to go with energy efficiency and EPC[2] labels. Figure 5 shows that, on average, Dutch banks report much lower energy efficiencies in their portfolios than the rest of Europe[3] (53% reports energy efficiency ≤ 200kWh/m2 for NL; 67% for EU). From the level of energy efficiencies reported by the banks in scope, more than half of these reports are based on estimations (Q4 2022: 59% and Q2 2023: 54%).

Compared to Q4 2022, Dutch banks have been able to lower the relative amount of GCA without EPC labels (Q4 2022: 61% and Q2 2023: 54%), while the rest of the European banks report a higher share of GCA without EPC labels (Q4 2022: 61% and Q2 2023: 70%). Given the significance of this exposure, it appears that banks throughout Europe still have difficulties determining the EPC labels for the collateral underlying their loans.

It's worth mentioning that the approach for the reporting of EPC-labels varies, whereas some banks disclose the most recently available EPC label, or in the case of multiple available certificates for a single property, the worst EPC label. If the EPC labels are unavailable, some banks use their own estimations – for example, by using specific collateral data – while others only recognise definitive labels. This is one of the examples that indicates that banks apply different approaches for their Pillar 3 reporting, varying from prudent to non-conservative, which makes it harder to compare data between banks.

Figure 5: Distribution of GCA by level of energy efficiency (kWh/m²) and EPC label in the EU-Area as disclosed by Dutch banks and other European banks for Q2 2023



[2] The Energy Performance Certificate (EPC) is an instrument for improving the energy performance of buildings and must be calculated according to a methodology adopted in accordance with the Energy Performance of Buildings Directive 2010/31/EU10 (EPBD).

[3] The Rest of Europe group does not include The Netherlands.

Template 3

Template 3 discloses the distance to the IEA Net Zero Emissions by 2050 Scenario (NZE) regarding GCA by sector. Disclosure of this template is mandatory as of 30 June 2024, but banks that are already estimating their Paris Agreement alignment must disclose the information required by the EBA.

In Q2 2023, from the 57 banks in scope, only 14 disclosed template 3. The banks in scope report a year of reference between 2020 and 2023 for the alignment metrics. Remarkably, four banks, including one Dutch bank, report a negative distance value to NZE for specific sectors. This suggests that these banks are already aligned with the alignment scenario for sectors such as power, automotive, and iron, steel, coal, and metal ore production. Interesting to note is that some banks do disclose their alignment metrics and distance to NZE, but they do not yet indicate their target for three years after the year of reference, suggesting that short-term target setting might not be finalized by banks. For the banks in scope that do disclose their targets, they most often do so for the power sector.

Template 4

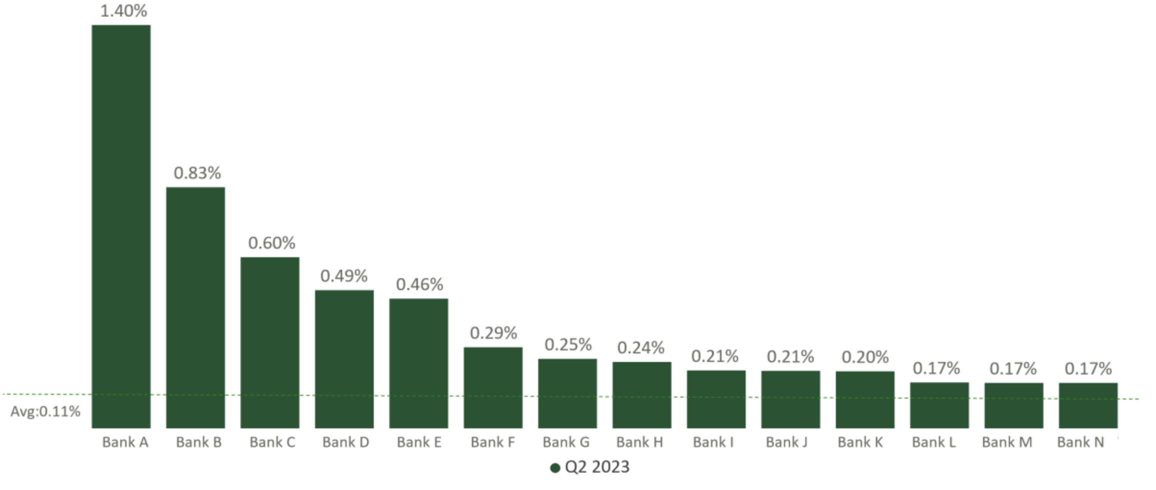
Template 4 shows the exposures in the banking book to the top 20 carbon-intensive companies in the world.

Dutch banks are exposed to some of the worst-polluting companies in the world. Among the 57 banks in scope, a Dutch bank reports the highest exposure to the top 20 carbon-intensive companies relative to total GCA, both in Q2 2023 and Q4 2022 (i.e., respectively 1.4% and 1.6%). Additionally, compared to the rest of Europe, Dutch banks on average report a higher relative exposure towards the top 20 carbon-intensive counterparties (Q2 2023: 0.26% NL; 0.11% EU). However, if the Dutch bank with the highest exposure to the top 20 carbon-intensive companies is excluded, the average relative exposure of the Dutch banks would decrease to 0.03%.

It is also visible, that both the Dutch as the other European banks report lower relative exposure compared to Q4 2022 (Q4 2022: 0.31% NL; 0.21% EU). This suggests that banks are actively taking measures to reduce exposure to the worst-polluting companies.

The general approach to define the largest polluters relies on the Climate Accountability Institute's Carbon Majors Data Set, the Moody's database combined Scope 1 and 2 emissions values, or the CDP's Full GHG Emissions Dataset. The Dutch banks all employ the same benchmark in Q2 2023 as in Q4 2022.

Figure 6: Gross carrying amount towards the top 20 polluting firms compared to total gross carrying amount[4]



[4] Graphs only show banks with exposures to the top 20 polluting firms ≥ 0.17% of total GCA. The average line includes all 57 banks in scope.

Template 5

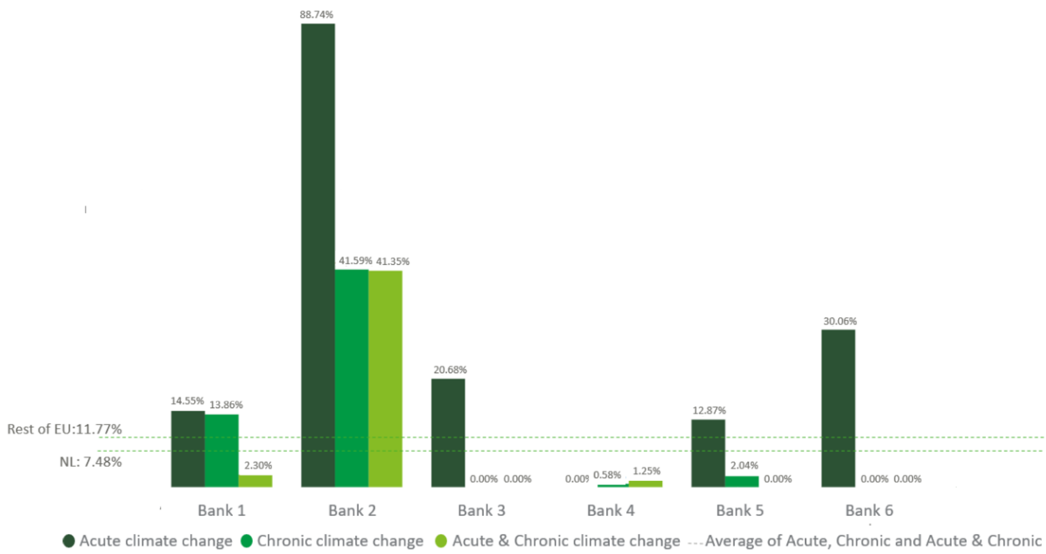
Template 5 discloses acute and chronic climate change physical risk exposure of banks. Banks currently use different methodologies to estimate sensitivity to this risk.

All 57 banks in scope have disclosed template 5, of which eleven banks did report this template for the first time in Q2 2023. The maximum relative exposure towards acute climate risk compared to total GCA is reported by a Dutch bank, being 88.74%, while it was 30.65% in Q4 2022. This increase is explained by an updated methodology for the estimation of climate change sensitivity as implemented by the bank as per Q2 2023 reporting.

Within the scope of banks in this benchmark, a pattern emerges that is worth mentioning: regardless of whether the observed climate change-related risks are acute or chronic, the majority of banks estimate their sensitivity levels to these events to range from 0% to 30%. This slightly increased compared to Q4 2022, where the observed range was between 0% to 25%. Surprisingly, the second most common sensitivity level observed among banks is precisely 0%, indicating a significant number of banks disclose no sensitivity to physical climate change events. Or the banks are potentially not able to identify the type of risk yet.

Figure 7 illustrates the exposure of six Dutch banks to sectors significantly contributing to climate change risk. It can be concluded that all Dutch banks are exposed to either acute or chronic climate risks. Dutch banks predominantly face acute climate risk over chronic climate risk.

Figure 7: Share of GCA (%) sensitive to impact from climate change physical events – Exposures towards sectors that highly contribute to climate change risk of Dutch banks



The methods that banks apply to analyse physical risks seems not to be clearly defined in the Implementing Technical Standards (ITS). As a result, banks have come up with their own methods to estimate physical risks, while analysing different aspects and applying different interpretations of what is considered as a risk. For example, some banks solely base sensitivity on the location of the collateral or counterparty, while others use internal heat maps to define locations and exposures or external sources such as 'Klimaateffectatlas'. One bank even assumes that, due to the nature of its financing activities, the assets exposed to acute events are the same for all sectors. This absence of a standard method makes it difficult to accurately assess and compare the risks among banks. As banks seem to interpret the reporting of the total of sensitivity to acute and chronic climate change in different ways, the share of exposure reported towards these risks does not necessarily mean that these banks have the highest actual risk– it can also highlight a different prudential risk management practice.

Template 10

Template 10 discloses climate change mitigation actions which are not covered in the EU Taxonomy, while still supporting climate change objectives.

In template 10 banks disclose quantitative and qualitative information on their climate change mitigation actions that are not covered in the EU Taxonomy. The number of banks in scope that report template 10 has significantly increased in Q2 2023. From the 57 banks in scope, it is observed that approximately 80% of the actions disclosed in template 10 are focused on the mitigation of climate change transition risks, while 20% is focused on the mitigation of climate change physical risk. The focus on counterparties targeted with the financial product differ as well, whereas bonds are mostly focused on (non-)financial corporations, while loans focus on (non-)financial corporations and households.

Five Dutch banks have submitted template 10. The types of products included in this template by Dutch banks are amongst others: green bonds, specifically contributing to mitigating climate change transition risks and project finance related to renewable energy production in wind power, hydropower, photovoltaic technology, and projects associated with electricity storage and transmission.

Final thoughts

The Pillar 3 reports provide reasonable insights into the banks' ESG risks for regulators, investors and other stakeholders. We will update our benchmarking analysis twice a year to incorporate new data and trends as reporting practices mature. We will also perform specific peer group analyses to offer clients across Europe tailored insights and advice, helping with all aspects ranging from data collection to solution implementation.

While financial institutions prepare for the implementation of new Pillar 3 reporting templates, of which template 6, 7 & 8 are already applicable for FY 2023 reporting, we see potential challenges related to the regulatory interpretation, data availability and quality, the experience to implement all the relevant reporting and disclosure criteria, and the ability to establish the right connections to other reporting requirements (e.g., CSRD, EU Taxonomy, ECB Guide and other imminent future requirements).

We encourage all organisations to take active measures to prepare for consistent and transparent ESG-related reporting. To discuss any of the themes that are discussed in this article, or for help with your own Pillar 3 ESG reporting, please contact Anne-Claire van den Wall Bake-Dijkstra, Eric de Weerdt or your usual Deloitte contact.