Pillar 3 ESG Reporting Solution

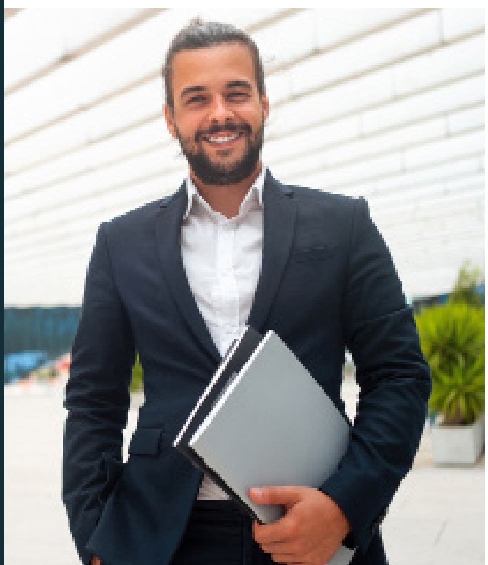
A New Era Of Risk Management

As public attention and efforts on environmental preservation and protection continue to grow, regulators around the world are responding with a host of rules and requirements that impact both financial and non-financial institutions. Previous blogs have covered the effects of the ESG EU Taxonomy – the beginning of a new focus on sustainable investment – on financial institutions.

It is also clear that regulators need to ensure that banks and other financial institutions can withstand the potential impact of a transition to a greener economy on their portfolios. And this is where the European Banking Authority's (EBA) Pillar 3 framework for large credit institutions listed on regulated EEA markets comes into play, highlighting the fact that institutions without a comprehensive environmental, social, and governance (ESG) reporting solution need to examine their overall approach to compliance.

10-Templates – The Pillar 3 Framework

Pillar 3 places particularly strict reporting requirements on credit institutions especially due to their critical role in financing green activities.



Pillar 3 consists of 10 templates that focus on the transitional and physical risks associated with and mitigation of climate change. It allows institutions to clarify ESG-related vulnerabilities and assess transmission channels to the traditional-risk (e.g., credit, market, or operational) framework. It also encourages transparency into the policies and practices of these institutions for the benefit of investors and other stakeholders.

Furthermore, by requiring an assessment of institutions' exposures that finance taxonomy-aligned activities, as part of Pillar 3, the EBA has merged the mitigative risk-management approach to Pillar 3 sustainability with the promotive aspect of the ESG EU Taxonomy.

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What does the confluence of Pillar 3 and EU Taxonomy mean for financial institutions?

This confluence brings several challenges institutions must understand to successfully navigate intersection with the right ESG reporting solution.

NACE Classification

Similar to the ESG EU Taxonomy, Pillar 3 uses the Nomenclature of Economic Activities (NACE) classification system to determine the level of transitional activity undertaken to increase sustainability, thereby providing granularity to climate-risk exposures and standardizing the identification of counterparty activities.

However, there is a key difference. Pillar 3 requires the classification to be done either at NACE code level-1 or -2, not level-4, the most granular of the classification levels.

GAR Calculation

Both Pillar 3 and the ESG EU Taxonomy require credit institutions to disclose their green asset ratios (GAR) – the proportion of an institution's book considered sustainable, in accordance with the EU Taxonomy Technical Screening Criteria (TSC).

Despite the requirement to disclose GAR under both regulations, the calculation methods differ on two fronts.

	ESG EU Taxonomy	Pillar 3
Counterparty Turnover and Capex vs. Counterparty Turnover	The EU Taxonomy requires general-purpose loan calculations to be based on counterparty turnover and capital expenditure (Capex).	Pillar 3 requires assessment based solely on counterparty turnover[1], which presents a more real-time view of the institutions' taxonomy-alignment exposures.
Estimated vs. Reported Data	For the EU Taxonomy, only counterparty reported data is acceptable for the mandatory reporting requirements.	Pillar 3 allows estimated data to be used as part of the GAR calculations.

Finally, Pillar 3 also requires the disclosure of the banking book taxonomy alignment ratio (BTAR), which includes exposures to counterparties not subject to disclosure obligations under the Non-Financial Reporting Directive (NFRD), as well as those currently assessed under alternatives to the European Taxonomy (i.e., other mitigating actions). Although these requirements currently do not exist in the ESG EU Taxonomy regulation, this could change in the future.

Multiple-Collateral/Guarantee Assessment

Under Pillar 3, loans with multiple collateral are assessed differently from those under the EU Taxonomy, specifically for templates 2 and 5. Only immovable collaterals are considered as part of the assessment of collateralized loans in Pillar 3; other types of collateral (e.g., cash) are excluded[2].

On the other hand, there are no specific treatment methods under the ESG EU Taxonomy for collateralized-loan value based on collateral type, as the key assessment priority is of the loan itself, not its collateral.

1. EBA ITS on prudential disclosures on ESG risks, page 22-23.   2. EBA Single Rulebook Q&A: Question ID 2022_6517

What are some of the key functional points of Pillar 3? Qualitative vs. Quantitative

Pillar 3 requires the disclosure of qualitative and quantitative information, broadly divided into four groups:

- ESG risk (qualitative)
- Climate-change transition risk
- Climate-change physical risk
- Mitigating-actions risk

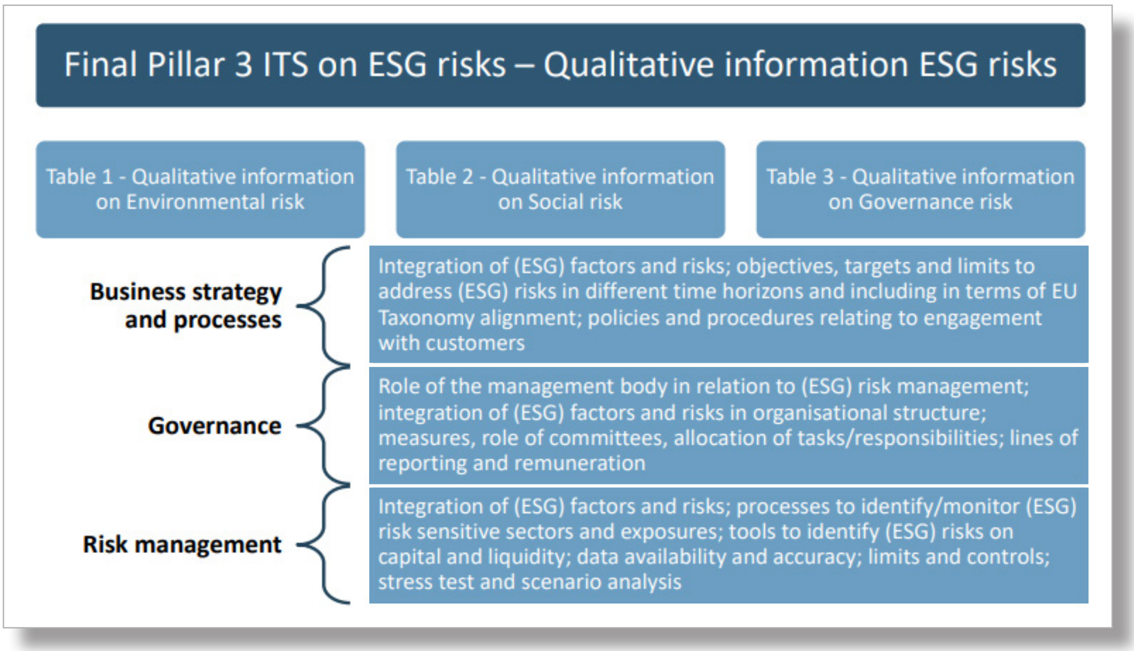
Qualitative information disclosure ensures that each mitigating action has a background and supporting story to explain how it impacts and aids a sustainable economy. **Quantitative transition-risk templates** measure bank exposures to sectors that highly contribute to climate change.

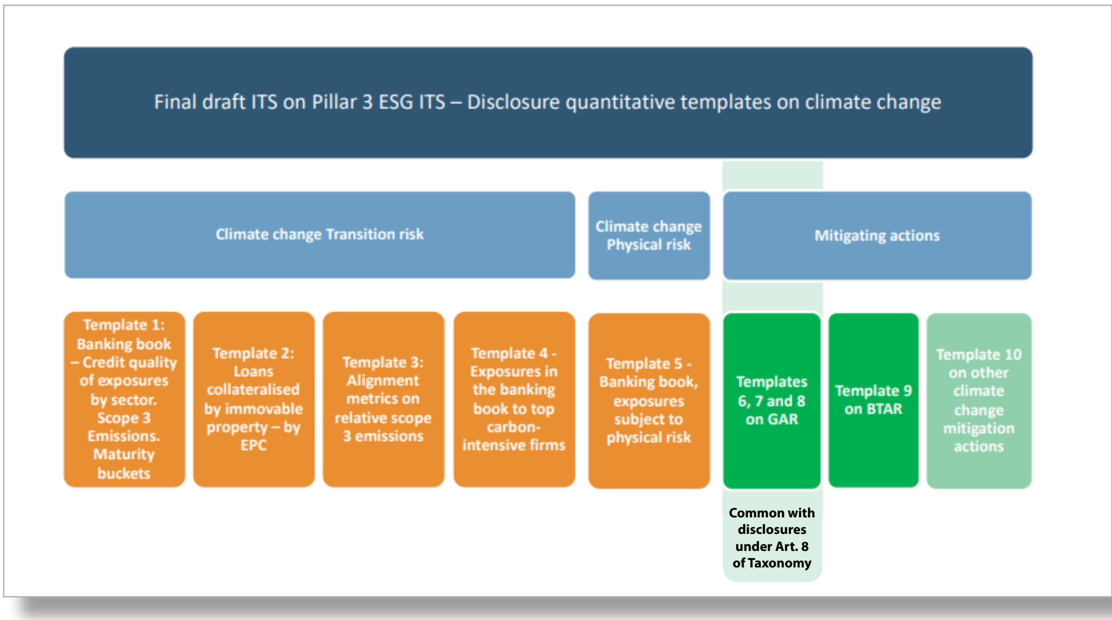
Information on the following items is also required:

- Financed greenhouse gas (GHG) emissions according to the Partnership for Carbon Accounting Financials (PCAF)-based exposures to counterparties
- Whether certain exposures to counterparties are considered "excluded from EU Paris-aligned benchmarks" or not
- Carbon-intensive counterparties exposures
- Energy efficiency real-estate portfolios

Quantitative physical-risk templates allow institutions to measure exposures to sectors and geographies that may be negatively impacted by climate-change events linked to acute and/or chronic physical risks. Once banks have addressed all the potential risks impacting institutions, they can then use template 6 onwards to highlight actions they have taken to mitigate the climate-change-related risks. They can also demonstrate how they embed sustainability considerations in their risk management, with the disclosure of their taxonomy-aligned exposures (GAR and BTAR) and any other non-EU Taxonomy mitigating actions.

The following diagrams provide an overview of the templates required.





How must an ESG reporting solution solve the technical challenges created by Pillar 3?

As is the case with any new regulation, there are both functional and technical challenges under Pillar 3. However, with enough preparation and forethought, there is also always an ESG reporting solution that can accomplish this. Technical challenges include:

Data Collection and Credibility

Data collection and credibility top the list of reporting challenges, for any ESG reporting solution, under Pillar 3. The data required for calculations and reporting is new and very specific. It must also be meaningful and credible – not just for reporting purposes, but also to achieve the institution's own sustainability goals.

It is therefore vital that institutions take a forward-thinking approach to data collection and retention that answers the question: *Do we have the most effective ESG reporting solution in place to flexibly adjust and reuse that data?*

Commonalities between data required for the ESG EU Taxonomy and Pillar 3 regulations can already be seen and so, having a one-stop-shop for all ESG regulations is the best approach.

Evolving Market Practices

Emerging trends and further regulatory developments, within and outside the EU, is another challenge. The International Sustainability Standards Board (ISSB) is currently finalizing requirements for entities to disclose information about their climate-related risks and opportunities. This would require a more advanced view of the information disclosed under Pillar 3 with the introduction of climate-related scenario analysis to the picture.

Outside the EU, Brazil's Social, Environmental and Climate Risks Document (DRSAC) reveals many synergies with the Pillar 3 disclosure requirements in terms of the type of information requested. Again, taking a strategic approach to an ESG reporting solution is key, particularly with respect to the common data required.

These regulations provide a prime opportunity for institutions to collect and analyze non-financial information from their counterparties, paving the way for more sustainable operating and investing. It also allows them to gain a more holistic understanding of their processes, which in turn, may inspire better roadmaps to climate-friendly/neutral economies.

Reconciling with Financial Reporting Regulation?

Although there is some alignment between the ESG Pillar 3 and financial reporting regulation, the reconciliation between the two is not as straightforward as it might appear. The difference in the granularity of the required data (e.g., gross carrying amount for Pillar 3 versus the carrying amount for financial reporting) means that there is no direct match even between the "total" fields across the regulatory templates.

However, institutions that keenly track and absorb any similarities between the results and data of both regulations and put systems in place for an ESG reporting solution is becoming ever more vital.

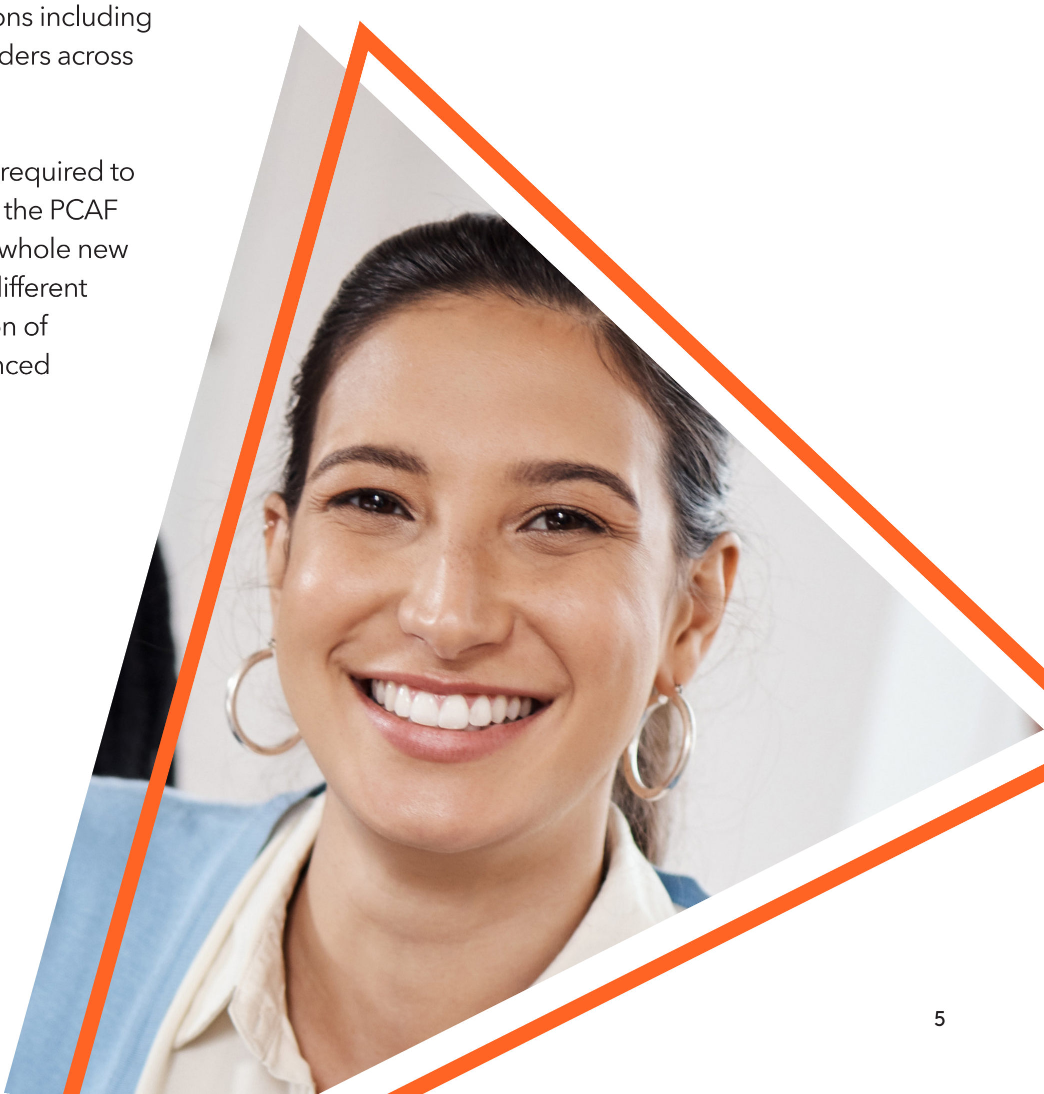
What's next for credit institutions?

Since Pillar 3 is far from the last ESG requirement, such an ESG reporting solution would need to flexibly scale for the future including to address data-intensive and high-computing requirements as well as:

- Technical reporting challenges from the EBA integrating the ESG Pillar 3 module as part of its data-point model and XBRL Taxonomy framework, effective December 2023. Institutions would need technical capabilities to accurately generate and submit these XBRL reports.
- ESG data-collection and reporting obligations. Financial institutions must approach ESG monitoring and disclosure requirements to holistically boost efficiency.

As mentioned earlier, institutions can capitalized on the many similarities among the regulations including the reuse of data attributes and providers across ESG Pillar 3 and ESG EU Taxonomy.

Furthermore, the financed emissions required to be calculated as part of Pillar 3, using the PCAF guidelines as a reference, presents a whole new kettle of fish. The data required and different assessment methods in the calculation of an institutions' Scope 1, 2, and 3 financed emissions provide an extra level of complexity with which their ESG reporting solution must comply.



As with any merger, institutions will face challenges. To successfully navigate this new era of ESG risk management, firms must understand where the regulations align or diverge.

Contact Adenza to start a conversation about how we can help you reconcile Pillar 3 for financial regulatory reporting.

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