Focus

ESG revolution: between technical challenge and opportunity for European banks

Part I - A plethora of regulations

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<u>*Summary:*</u>

In Europe, new regulations will come into force in the next few years to standardize the way banks take into account the sustainability risks of the activities they finance. Institutions will have to calculate and publish their "green asset ratios" and assets subject to physical or transition risks, but could also take into account a "Green Supporting Factor" and a "Brown Penalty Factor", which would have an impact on their capital calculation. The goal is to encourage banks to gradually reduce their "scope 3" carbon emissions.

In the near future, European banks with more than 500 employees will have to comply with a new set of rules to classify their loan portfolio according to Environmental, Social and Governance (ESG) criteria. This simple idea hides significant difficulties in assessing the sustainability of projects for both individual and professional borrowers. However, this new framework could offer solutions to ethical banks to benefit from more flexible capital requirements.

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Green Supporting Factor / Brown Penalty Factor

Pillar 1 – Calculation of their own risks

On July 6, the European Commission unveiled its new strategy to finance the transition to a sustainable economy. In this context, the institution stated that it was considering amending the banking capital regulatory framework (CRR/CRD) to ensure that ESG factors are included in the risk management processes. The Commission mandated the European Banking Authority (EBA) to provide a proposal in 2023.

Two possibilities are currently being considered:

- A **"Green Supporting Factor" (GSF) would allow** banks to consider loans that meet "sustainable" criteria by reducing the weighting of these loans in their Risk-Weighted Assets (RWA) calculation. As a reminder, this calculation requires banks to mobilize capital reserves in relation to the assets they hold, according to their risks.
- On the other hand, **a Brown Penalty Factor (BPF)** could penalize brown loans in this calculation, particularly those associated with low-environmental property or projects.

The banking supervisor may be able to incorporate ESG risks into the Supervisory Review and Evaluation Process (SREP) in 2023. This means **that ESG risks could influence capital requirements beginning January 1, 2024**.

In the shorter term, under these new regulations, banks will already be **subject to limited disclosures in 2022, until December 2023**. Only the portion of assets eligible for European taxonomy, with certain qualitative requirements, will be communicated as soon as next year.

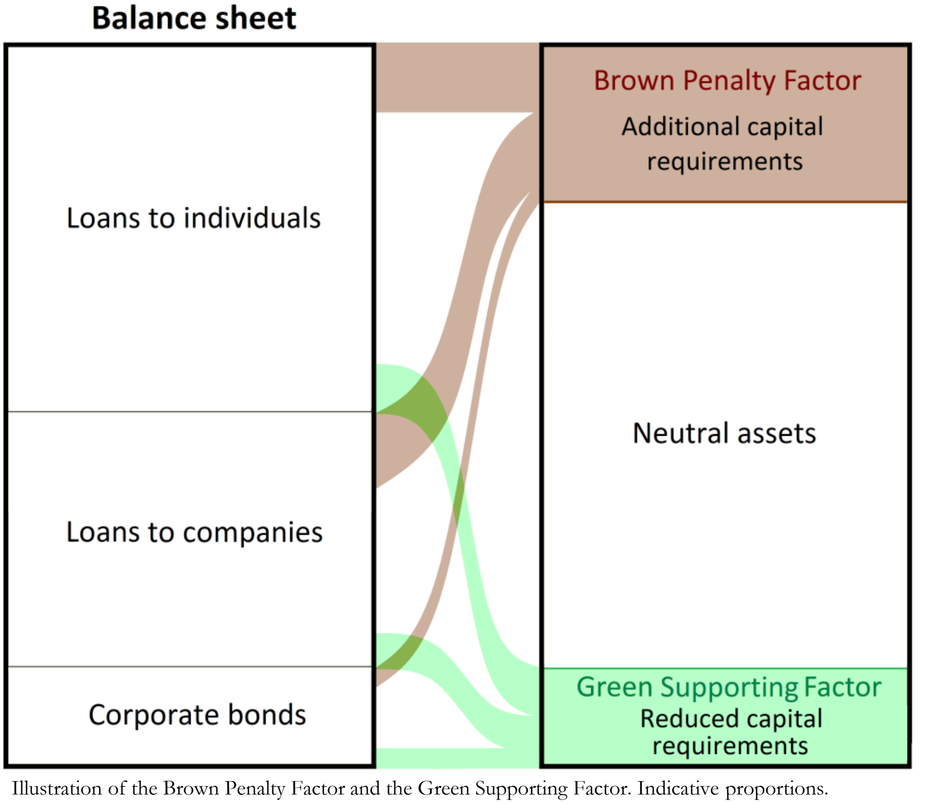

Illustration of the Brown Penalty Factor and the Green Supporting Factor. Indicative proportions.
Source: Lazard Frères Gestion.

Managing physical and transition risks: a data-based approach

Pillar 2 - Integration of climate risks

As part of the climate stress tests that the ECB will publish in July 2022, some of the identified risks could also be included in the specific capital requirements that banks will have to comply with under Pillar 2.
As such, banks will have to understand:

- **physical risks**: what would be the impact of climate change on the value of collateral or guarantees provided by clients?

- **transition risks:** the transition to a "decarbonized" economy poses a risk of loss of value for certain companies/assets and the additional costs associated with this transition, thus lower profitability.

Over the coming years, banks will therefore have a great need for data to be able to classify their balance sheet assets according to the EU green taxonomy and identify their climate risks in order to manage them.

Detailed data on borrowers and their projects will therefore be needed for banks to progressively green their loan portfolio.

The European Union is seeking to meet this parallel challenge through its CSRD (Corporate Sustainable Reporting Directive), which aims to ensure the homogenization, reliability and transparency of the ESG performance of European companies.

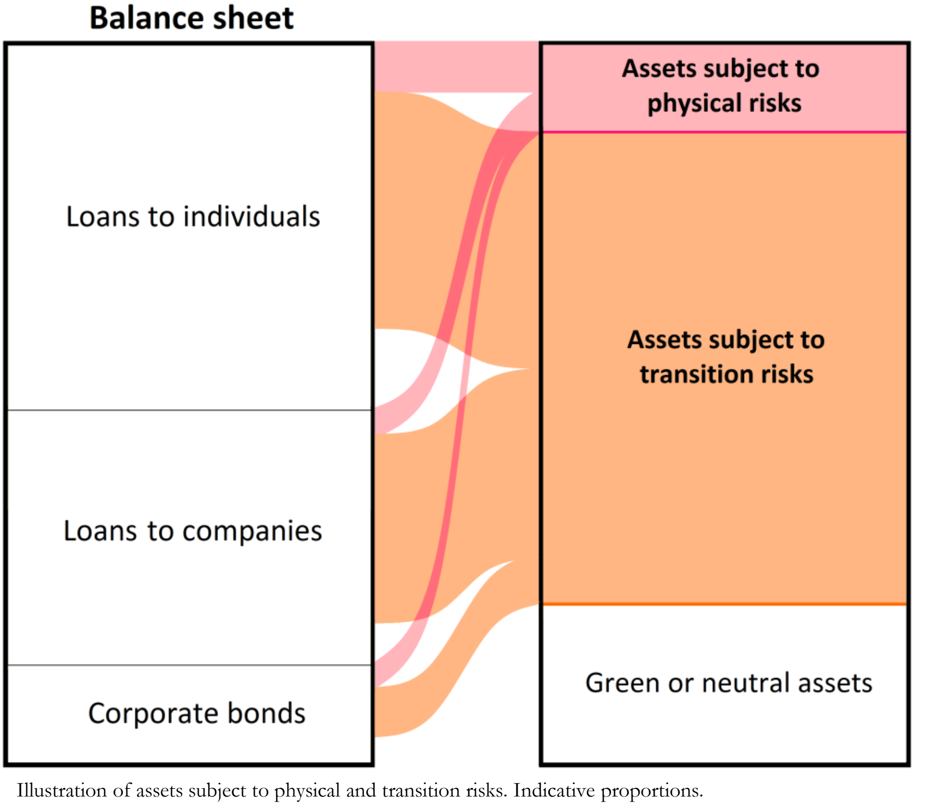

Illustration of assets subject to physical and transition risks. Indicative proportions.
Source: Lazard Frères Gestion.

Green Asset Ratios

Pillar 3 – Communication and transparency

Lastly, in the spring of 2021, the European Banking Authority (EBA) published its Pillar 3 publication recommendations and defined five key indicators (the so-called "KPIs") that banks will need to calculate and publish in the future to report on their implications for green finance.

GAR stock:

1. The calculation of a **Green Asset Ratio (GAR)** is one of the 5 KPIs used by the European Commission in its final delegated act specifying the disclosure requirements of credit institutions. This ratio will reflect, for each institution, the proportion of loans, bonds, equities or repossessions of "green" collateral held in relation to total balance sheet assets. Their classification will be based on EU taxonomy, after the deduction of commitments to Governments and central banks. Effective date: **January 1, 2024.**

GAR flows:

From 2024 to 2026, **four other Green Asset Ratios** will also have to be calculated by banks, this time focusing on flows, and not only on balance sheet inventories.

These ESG indicators will apply to assets under management, off-balance sheet exposures (financial guarantees), trading portfolios and revenues (fees and commissions).

2. KPIs on assets under management: effective **beginning 2024**
3. KPIs on off-balance sheet exposures (financial guarantees): effective **beginning 2024**
4. KPIs on the trading portfolio (debt and equities): effective **beginning 2026**
5. KPIs on fee and commission income: effective **beginning 2026.**

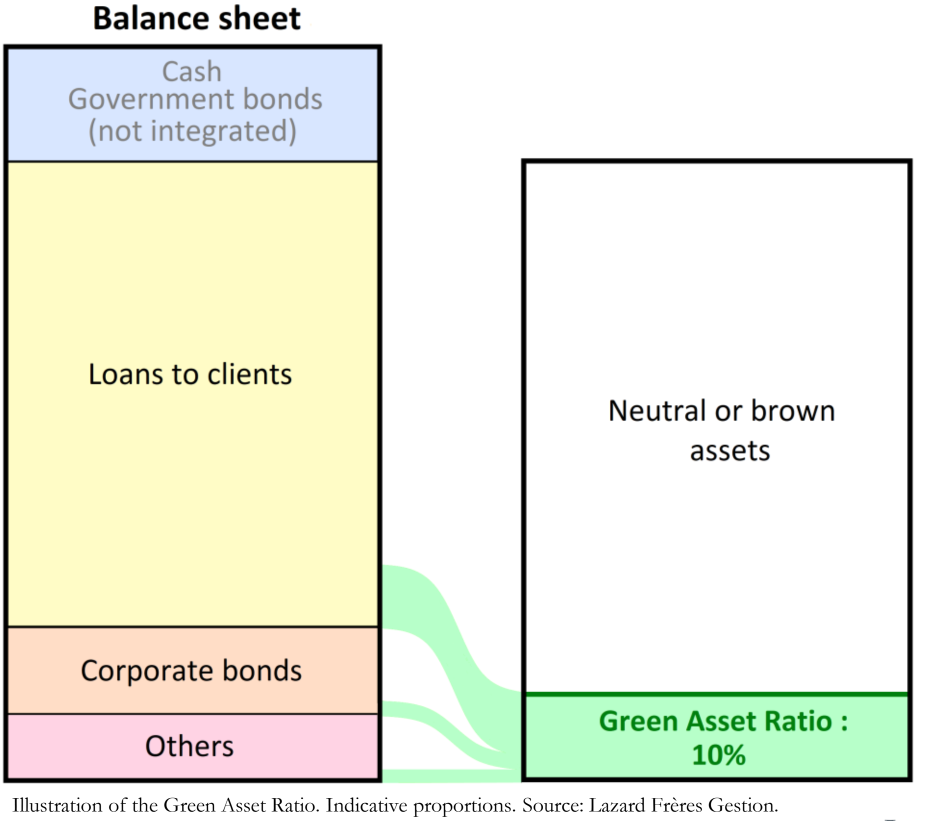

Illustration of the Green Asset Ratio. Indicative proportions. Source: Lazard Frères Gestion.

Being able to assess "scope 3" emissions

The calculation of the above-mentioned ratios is far from insignificant for the banking sector. This is an essential step for institutions to calculate and report on their **"scope 3 emissions,"** in other words, the greenhouse gas emissions they generate indirectly through the activities they finance.

As a reminder, "scope 1" emissions refers to "direct" carbon emissions from a company. "Scope 2" corresponds to indirect emissions related to the way energy consumed was produced (coal, oil, gas, renewable energy, etc.). Lastly, "scope 3" takes into account indirect emissions across the entire value chain linked to its activity, including suppliers, clients and service providers.

Within scope 3, category 15 brings together all the investments and lending activities of financial institutions. Its weighting is, of course, not shared with categories 1 to 14 as illustrated in the table below provided by Piraeus Bank in 2021.

Scope 1-2-3 $CO_{2,eq}$ emissions (in tonnes)	**2019**	**2020**	**Δ%**
Scope-1	2,946	2,820	-4%
Scope-2 [GHG market based]	4,934	0	-100%
Scope 3 [categories 1-14]	24,473	18,351	-25%
Scope 3 [category 15 - participations & mortgages]	756,166	368,636	-51%
Total	**788,519**	**389,807**	**-51%**

Source: Piraeus Bank, November 2021

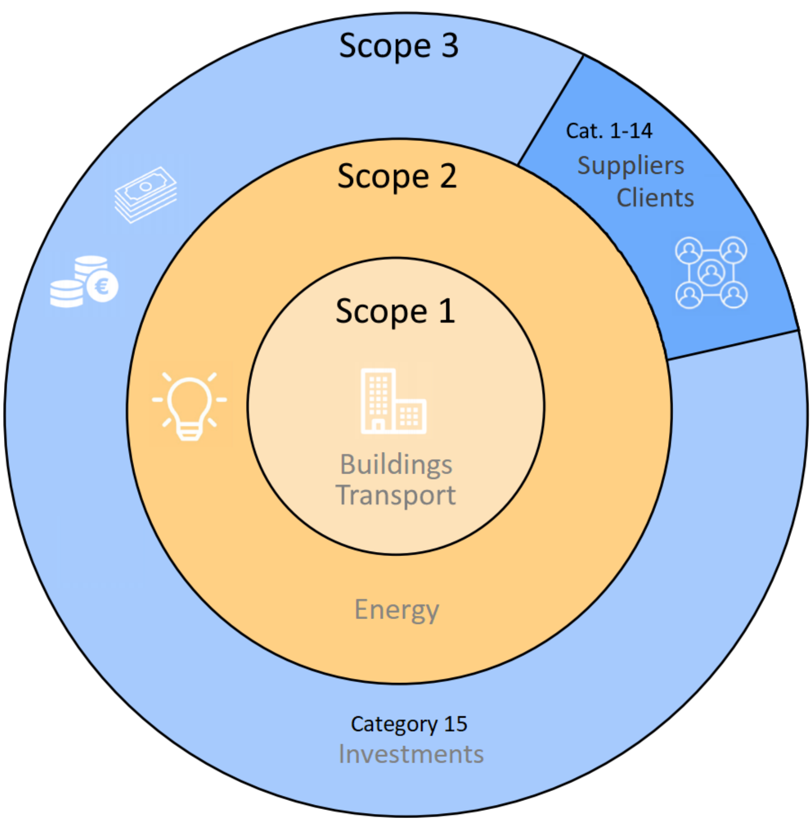

Illustration of scopes 1, 2 and 3. In the banking sector, scope 3 carbon emissions are dominated by category 15 dedicated to investments. Source: Lazard Frères Gestion.

Conclusion

In short, banks will have to **be able to answer three questions to classify their loans to businesses in the future** and define their origination policy and credit pricing:

1. Which sectors/companies are to be financed or not?
2. What should be the purpose of a loan for it to be considered green or brown?
3. How do you qualify the collateral (green or brown) of a loan granted?

The difficulty has to do with multiple angle to the qualification of a loan according to the sector to which the company belongs (green or brown), the use that will be made of it (green or brown) and the type of collateral/guarantee associated with the loan (green or brown): a loan to a brown sector company could be "green" if it finances a project to reduce its carbon emissions and/or is associated with a green collateral.

For example, an oil company will be considered to be part of a "brown" sector, but its renewable energy projects will be classified as "green". As such, they should thus be included in the calculation of the Green Asset Ratios, the Green Supporting Factor, and excluded from transition risk assets.

The European Union's new rules on green finance will represent a **profound change in the banking sector. Acceptance of a bank loan will now require a review of the compliance of each project with the principles of sustainable development**.

For investors, these regulations will provide some advantages. The classification of borrowers and their climate risks, which may be complex for banks, will be particularly **useful for professional investors to have a solid non-financial analysis base**.

Each institution's sustainable development strategy will become more transparent. **This information will therefore enhance the quality of the ESG data available to facilitate responsible investment within the banking sector.**

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