

**DISCLOSURE OF ESG RISKS UNDER THE PILLAR 3 FRAMEWORK. SPANISH BANKS**

In recent years, the risks associated with environmental, social and governance (ESG) factors have gained importance in the financial industry in general and, in particular, in the banking sector.<sup>1</sup> The disclosure of consistent and comparable data on these risks is essential to enable supervisors, investors and other users of this information to understand and correctly assess credit institutions' exposure to ESG risks.

In 2023 H1 European credit institutions began to make their first disclosure of ESG risks, under the prudential disclosure (Pillar 3) framework.<sup>2</sup> These disclosures were made using the templates and following the instructions contained in the EU regulations (hereafter, the Regulation).<sup>3</sup>

The Regulation, applicable to certain types of EU credit institutions,<sup>4</sup> includes qualitative and quantitative information on ESG risks (see Figure 1). The qualitative information addresses each of the ESG aspects and requires that banks disclose how they are incorporating these risks into their strategy and business model, and what are the internal governance and control procedures established in this respect. The quantitative information focuses on climate risks (both transition and physical risks),<sup>5</sup> and also includes mitigating measures.

In the case of **transition risk**, different indicators are reported for exposures to non-financial corporations (NFCs)

held in the banking book<sup>6</sup> and for loans collateralised by immovable property. For exposures to NFCs in the banking book, banks shall disclose the amount of their exposures to sectors that highly contribute to climate change,<sup>7</sup> a concept that covers a considerable number of sectors, including oil, gas, mining and transportation, with different greenhouse gas (GHG) emission levels.

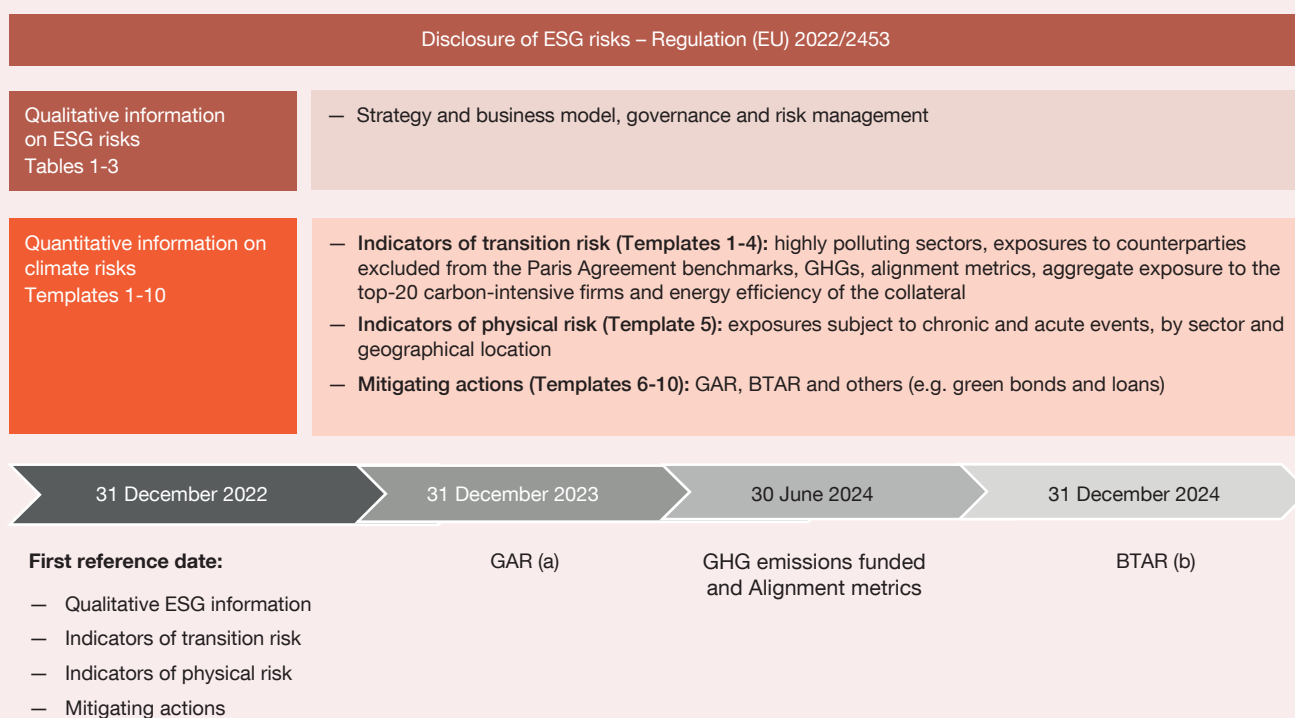
Exposures to counterparties excluded from the Paris-aligned benchmarks<sup>8</sup> (essentially, companies whose activity is related to the extraction and distribution of fossil fuels) shall also be disclosed at sector level, as shall exposures aligned with the goal of mitigating climate change under the Taxonomy Regulation<sup>9</sup> (mainly investments in low carbon activities or in activities that facilitate the transition).

These metrics are complemented with a breakdown by sector of GHG emissions, and with measures to align banks' own decarbonisation targets for key sectors with the Paris Agreement goals.

Banks shall disclose information on the energy efficiency of the portfolio of loans collateralised by immovable property.

As for **physical risk**, banks shall disclose information on exposures that are sensitive to impact from chronic and acute climate change events, with a breakdown by affected sectors and geographical areas.

- 1 EBA. (2023). "Report on the role of environmental and social risks in the prudential framework". This recently published report highlights the importance of environmental and social risks and how they are captured in the current prudential framework. The report makes recommendations for specific improvements, to accelerate their incorporation into minimum capital requirements.
- 2 Pillar 3 or prudential disclosure is one of the three pillars that make up the prudential banking regulations, together with Pillar 1 (minimum capital requirements) and Pillar 2 (supervisory review).
- 3 Commission Implementing Regulation (EU) 2022/2453 of 30 November 2022 amending the implementing technical standards laid down in Commission Implementing Regulation (EU) 2021/637 as regards the disclosure of environmental, social and governance risks.
- 4 Pursuant to current legislation, only large European credit institutions, classed as such under Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms, and that have issued securities that are admitted to trading on a regulated market of any Member State are required to make these disclosures. In the future, this requirement will be extended to all banks, taking into account the principle of proportionality.
- 5 Transition risks are those associated with the transformation to a more sustainable economy, as a consequence of policy, technology and market changes. Physical risks are those associated with the impact of extreme weather events, such as heat waves or flooding (acute events), or gradual long-term shifts in climate patterns, such as changing precipitation patterns or rising sea levels (chronic events).
- 6 These include exposures to NFCs, in the form of loans and debt and equity instruments as defined in the FINREP supervisory reporting framework, that banks hold in their banking book, i.e. excluding assets held in the trading book.
- 7 These sectors are defined in Recital 6 of Commission Delegated Regulation (EU) 2020/1818 of 17 July 2020 supplementing Regulation (EU) 2016/1011 of the European Parliament and of the Council as regards minimum standards for EU Climate Transition Benchmarks and EU Paris-aligned Benchmarks. They include all sectors that contribute significantly to climate change, listed in Sections A to H and Section L of Annex I of Regulation (EC) No 1893/2006 of the European Parliament and of the Council of 20 December 2006 establishing the statistical classification of economic activities NACE Revision 2.
- 8 These counterparties are defined in Article 12 of Commission Delegated Regulation (EU) 2020/1818 of 17 July 2020. Specifically, companies that derive: (i) 1% or more of their revenues from exploration, mining, extraction, distribution or refining of hard coal and lignite; (ii) 10% or more of their revenues from the exploration, extraction, distribution or refining of oil fuels; (iii) 50% or more of their revenues from the exploration, extraction, manufacturing or distribution of gaseous fuels; or (iv) 50% or more of their revenues from electricity generation with a GHG intensity of more than 100g CO<sub>2</sub> e/kWh.
- 9 Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (the European Taxonomy Regulation).

**DISCLOSURE OF ESG RISKS UNDER THE PILLAR 3 FRAMEWORK. SPANISH BANKS (cont'd)**Figure 1  
Disclosure of ESG risks

SOURCE: Banco de España.

- a The Green Asset Ratio (GAR) provides information on the level of alignment of a credit institution's balance sheet with the Taxonomy Regulation. Counterparties not subject to the Non-Financial Reporting Directive must be included in the denominator of the ratio but not in the numerator.
- b The Banking Book Taxonomy Alignment Ratio (BTAR) provides information on the level of alignment of a credit institution's balance sheet with the Taxonomy Regulation. Counterparties not subject to the Non-Financial Reporting Directive must be included both in the denominator and the numerator of the ratio.

Lastly, the Regulation also includes information on mitigation actions for both transition and physical risk, such as the Green Asset Ratio (GAR), which shows the percentage of banks' assets that are aligned with the Taxonomy Regulation.

The first disclosure reference date set in the Regulation is December 2022, although several transitional stages are envisaged, as depicted in Figure 1.

In the case of climate change data, the information disclosed by the ten Spanish credit institutions that are subject to the Regulation<sup>10</sup> can be summarised as follows.

### Transition risks

Chart 1 analyses, at both the aggregate and bank level, the transition risk of exposures to NFCs in the banking book.

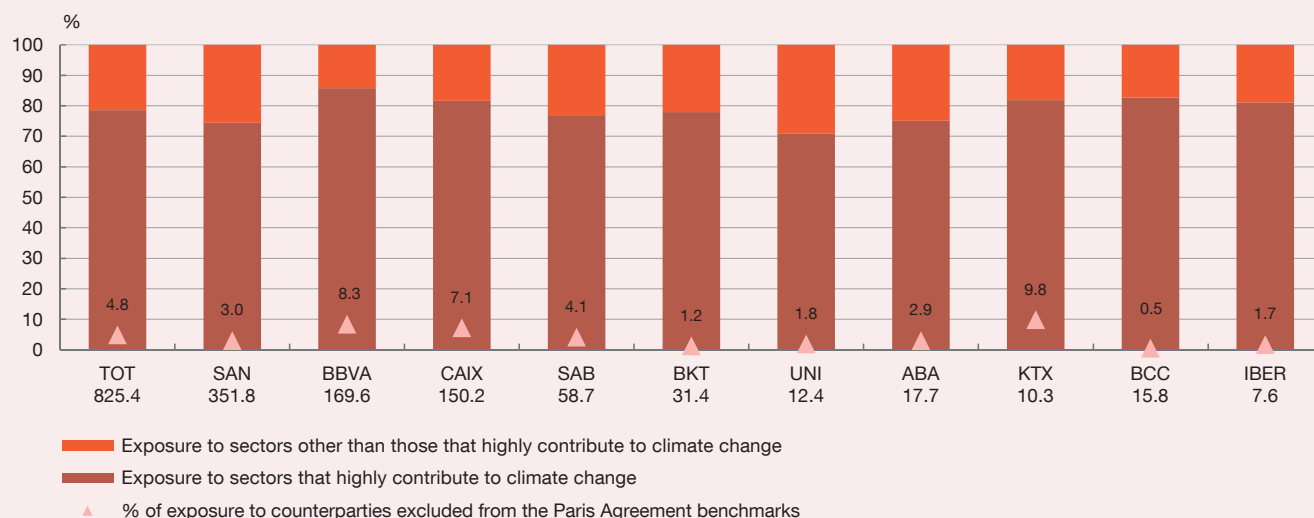
Of the total exposure analysed (€825.4 billion in banks' consolidated balance sheets), approximately 80% is to sectors that highly contribute to climate change.<sup>11</sup> Despite all the caveats arising from the lack of granular data on the situation of individual firms, these sectors must strive harder to decarbonise their activities. Exposures to counterparties excluded from the Paris Agreement are significantly smaller, amounting to €39.9 billion (4.8% of the exposures analysed).

<sup>10</sup> Banco Santander, BBVA, CaixaBank, Banco Sabadell, Bankinter, Unicaja, Abanca, Kutxabank, Banco de Crédito Social Cooperativo and Ibercaja.

<sup>11</sup> This figure differs significantly from that mentioned in Margarita Delgado. (2019). "Energy transition and financial stability. Implications for the Spanish deposit-taking institutions". *Financial Stability Review* – Banco de España, 37, pp. 9-40. This is because, as mentioned above (see note 6), the definition of "carbon-intensive sectors" according to the [Commission Implementing Regulation \(EU\) 2022/2453](#) is particularly broad compared with other taxonomies, such as that used in the article mentioned here, that differentiate more clearly between polluting sectors.

**DISCLOSURE OF ESG RISKS UNDER THE PILLAR 3 FRAMEWORK. SPANISH BANKS (cont'd)**

Chart 1  
Transition risk of exposures to NFCs (a)  
Consolidated data at 31 December 2022



SOURCE: Banco de España.

a Chart 1 indicates (x-axis) the name of each bank and their total exposure amount, in billions (consolidated data at 31 December 2022).

Charts 2 and 3 analyse transition risk associated with the collateral for loans secured by immovable property (residential and commercial) and for the foreclosures portfolio. This risk is measured in terms of the energy efficiency of the collateral. The data comprise the energy performance certificate (EPC)<sup>12</sup> (Chart 2) and energy consumption in kWh/m<sup>2</sup> (Chart 3) of the collateral. Only loans granted within the EU have been analysed, as the data are considered to be of higher quality. Lending analysed under this criterion totals €631.4 billion.

A high percentage of buildings do not yet have an EPC. For loans collateralised with residential immovable property (84% of the total collateralised portfolio analysed), 64% of the collateral lacks an EPC. In the case of mortgages on commercial immovable property (14% of loans in this portfolio), 81% of the collateral has no EPC.<sup>13</sup>

For collateral securing residential immovable property with an EPC, label E is clearly the most prevalent, both at the aggregate level (20% of total collateral in this portfolio) and for each individual bank analysed. The higher EPC labels (A, B and C) account for 4% of total loans collateralised by

residential immovable property. Label E is also the most common in the case of commercial immovable property, although the gap here with the other labels is not as wide, with the higher EPC labels accounting for 8% of the total.

Chart 3 – which incorporates both real and estimated EPC data – shows the effort made by banks to estimate the energy consumption of a significant portion of their immovable property without a certificate. The effort made is particularly evident in the residential sector, with information (real or estimated) on energy efficiency unavailable for just 15% of the immovable property analysed.

### Physical risks

As a last step, the physical risk metrics used by the banks are analysed. It is worth noting that, in line with the high degree of flexibility permitted by the Regulation, the banks have used different methodologies and data sources to identify this risk, which could affect the comparability of information. This, together with the absence of previous such reports, means that the information should be interpreted with due caution.

12 The EPC is an official document that has been compulsory since 2013 in the sale and rental of property, with some exceptions such as garages, storerooms or plots and warehouses not used as office space. This certificate rates a building in terms of its annual consumption of energy from non-renewable sources in kWh/m<sup>2</sup> and its CO<sub>2</sub> emissions. The rating scale comprises seven letters, from A (most efficient) to G (least efficient).

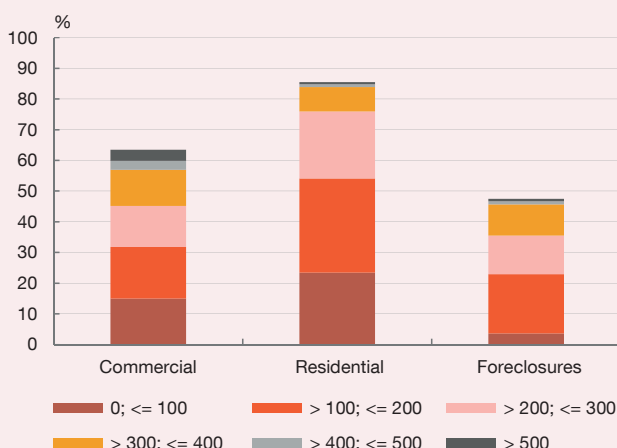
13 The pattern observed in foreclosed properties, which account for a small share of the total portfolio analysed, is similar to that of loans collateralised with residential immovable property.

**DISCLOSURE OF ESG RISKS UNDER THE PILLAR 3 FRAMEWORK. SPANISH BANKS (cont'd)**

**Chart 2**  
Energy efficiency of immovable property used as collateral in loans granted in the EU by Spanish banks. EPC (a) (b) (c)



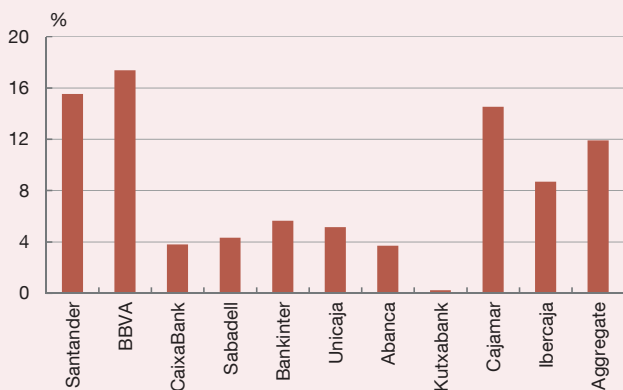
**Chart 3**  
Energy efficiency of immovable property used as collateral in loans granted in the EU by Spanish banks. kWh/m<sup>2</sup> (d)



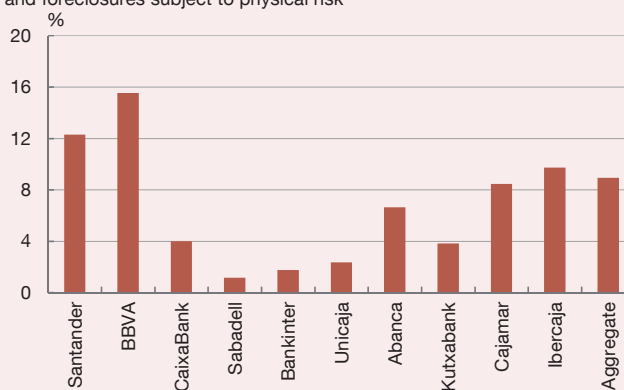
SOURCE: Banco de España.

- a The Energy Performance Certificate (EPC) is an official document that has been compulsory since 2013 in the sale and rental of property, with some exceptions such as garages, storerooms or plots and warehouses not used as office space. This certificate rates a building in terms of its annual consumption of energy from non-renewable sources in kWh/m<sup>2</sup>, and its CO<sub>2</sub> emissions. The rating scale comprises seven letters, from A (most efficient) to G (least efficient).
- b In Chart 2, the percentage of immovable property without an EPC in each portfolio analysed is as follows: 81% of commercial, 64% of residential and 69% of foreclosures.
- c In Chart 2, the share of each energy efficiency label of immovable property (rated from A to G) is calculated relative to the total (with and without an EPC).
- d In Chart 3, the percentage of immovable property with no estimated energy consumption in kWh/m<sup>2</sup> relative to the total is as follows: 37% for commercial, 15% for residential and 53% for foreclosures.

**Chart 4**  
Exposures to NFCs subject to physical risk



**Chart 5**  
Loans collateralised by residential and commercial immovable property and foreclosures subject to physical risk



SOURCE: Banco de España.

Chart 4 compares the physical risk reported by the banks for their exposures to NFCs in the banking book with the total exposure reported for this portfolio, while Chart 5 shows an equivalent comparison for the portfolio of loans collateralised by immovable property and the foreclosures portfolio. As can be seen, the overall exposures to physical risk stand at 11.9% and 8.9%, respectively. These charts also show notable dispersion among banks, with higher

values observed both at the most systemically important institutions and at some smaller banks in the reporting group.

It should be emphasised that this analysis is preliminary and needs to be interpreted with caution. First, because it is the first time that banks have disclosed information in this format, opening up a greater possibility of errors.

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Second, because this information provides an as-yet incomplete vision of exposures to climate risks. A significant part of the data to be disclosed under the Regulation is not available owing to the transitional stages mentioned above.

It should also be borne in mind that the risk exposure categories used are relatively broad, and that there may be considerable heterogeneity in terms of the risks of impact across individual corporations and immovable properties within each category (such as differences between corporations in emission-intensive sectors as regards the level of emissions and the ability to adapt their productive process).

With the application of the Corporate Sustainability Reporting Directive, banks will foreseeably have higher quality data on their counterparties, which will enhance the quality of their Pillar 3 disclosures. With time, the analysis can also be rounded out with the other aspects envisaged in the Regulation and with future developments in the indicators, thus enabling more comprehensive and qualified assessments.

In any event, these disclosures provide previously unavailable quantitative information that points to the importance of climate risk exposures and also to the need for further headway in improving databases to ensure the proper management of such risks.