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European Parliament Committee Finalizes ESG-Related Financial Sector Risk Reforms

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On January 24, 2023, Members of the European Parliament voted to adopt reforms to banking rules and implement the international Basel III agreement (Basel III). One of the objectives of Basel III is to enhance focus on ESG risks within the prudential framework.

Basel III is a comprehensive set of reform measures in banking prudential regulations, aimed at strengthening the regulation, supervision and risk management of the banking sector, and was introduced by the Basel Committee, a consortium of central banks from 28 countries, formed largely in response to the 2008 global financial crisis. The Basel III framework is designed to mitigate risk by requiring banks to maintain certain capital ratios to cope with market events. When initially proposed, Basel III was largely focused on credit risk, market risk and operational risk. The ESG elements have been introduced following growing awareness of systemic risks presented by climate change and the EU's objective for carbon neutrality by 2050.

Basel III is comprised of three parts, also referred to as pillars. Pillar I addresses minimum requirements for capital and liquidity adequacy; pillar II outlines supervisory monitoring and review standards; and pillar III promotes market discipline through prescribed public disclosures. Climate-related disclosures are included under pillar III. Such disclosures would require approximately 150 European banks to publish on a semi-annual basis qualitative and quantitative information on transition and physical risks, exposure to at-risk sectors and green lending.

The Committee did not approve a so-called "one-for-one" rule, pursuant to which banks would have to add a euro to their regulatory capital for each euro financing fossil fuel exploration or

production in anticipation of future losses on those investments. The Committee did approve proposals that, among other things, would require: (i) regulators to take into account climate transition plans and targets when deciding on regulatory requirements for financial institutions, (ii) banks to adopt "transitional plans to address ESG risks in the short, medium and long term, with a special focus on the EU objective of achieving climate neutrality by 2050," and (iii) banks "to include ESG-related valuation consideration in the obsolescence of collateral." The Committee also mandated the European Banking Authority "to assess whether a dedicated prudential treatment of [ESG] exposures would be warranted. Based on that report the Commission might adopt a legislative proposal in this regard." The Committee will now commence negotiations with member states over a final text of the rule.

Taking the Temperature: The proposed reforms passed by the Committee largely are in line with the direction of travel among global financial industry regulators to require banks to account for and disclose on climate and other ESG-related risks and opportunities. We have reported on similar developments in the U.S., Europe, Australia and elsewhere. The one-for-one rule rejected by the Committee has been controversial. We previously commented that it is not apparent that such a bright-line rule would be an effective method for achieving financial stability. The rule assumes financial risk associated with a particular category of assets in isolation, without considering the particular institution's overall risk exposure based on all applicable material factors, including industry exposure, strategy, and customer base. The rule also runs counter in spirit to the thrust of global prudential regulatory guidance, which is to not seek to compel financial institutions to abandon all emissions financing, but to devote appropriate efforts to assessing climate-related risks and opportunities and disclosing such assessments – a view endorsed by certain financial regulators. In our view, such a nuanced approach makes more sense in that it is tailored to the individual institution and consistent with global regulatory guidance on risk assessment.