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Connecting Climate Change and the Law

European Central Bank and European Banking Authority Comment on Revised European Sustainability Reporting Standards

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In January 2023, the European Central Bank (ECB) and the European Banking Authority (EBA) released their opinions on the first set of European Sustainability Reporting Standards (ESRS). As we have **previously discussed**, a revised version of the ESRS was approved by the European Financial Reporting Advisory Group (EFRAG) in November 2022, providing enhanced guidance for companies performing environmental materiality assessments and disclosures of certain sustainability metrics.

The ECB **stated** that the ESRS appear to "substantially" improve the "quantity, quality, reliability and comparability of corporate sustainability disclosures" and will otherwise assist ECB in its efforts to set monetary policy, promote financial stability, and collect a wide range of environmental metrics. In particular, the ECB highlighted how the ESRS rely on quantitative metrics and estimations of physical and transition risks, propose disclosure obligations to promote transition plans in line with the Paris Agreement's goal of limiting global temperature increases to 1.5 degrees Celsius, and include "well-defined" greenhouse-gas emissions targets. The ECB also commented that the ESRS will enhance the ability of financial institutions to gather and disclose information relevant under Basel Pillar III (which sets out disclosure requirements for purposes of permitting market participants to assess an institution's material risks and capital adequacy). As we have **written**, climate-related disclosures under Pillar III would require around 150 European banks to semi-annually publish both qualitative and quantitative information related to climate risks and green-lending. Overall, the ECB praised the ESRS as a "significant improvement compared with the status quo."

Still, the ECB proposed a “limited number” of “beneficial” recommendations. For example, the ECB pointed out that the “materiality assessment would benefit from more granular and clearer guidance on the process to be followed by compilers,” as well as clearer guidance for processing data-compilations, including the appropriate use of estimates and “further specification” for calculations of greenhouse-gas emissions. Additionally, the ECB suggested that the ESRS remove the exemption allowing for subsidiaries to be included in consolidated reporting by the controlling entities and commented that it “firmly” supports revisions focusing the ESRS on specific sectors, and in particular the financial sector due to its “key role...in the transition to a sustainable economy.” The ECB observed that there is an “urgent need” for guidance on the definition of “value chain for financial institutions” and recommended that future revisions to the ESRS take into account the experience of those tasked with preparing disclosure reports to promote a streamlined process in addressing questions and interpretation of ESRS provisions.

The European Banking Authority **echoed** that the ESRS promoted “significant improvement” in climate-related disclosures and demonstrated “overall consistency with international standards and relevant EU Law.” Most notably, the EBA recognized how the ESRS “better align[ed] with the disclosure requirements under the EBA’s Pillar 3 Framework.” Here, the ECB “welcomed” the ESRS’s requirements imposing the “mandatory publication of all indicators and qualitative information needed for banks to comply with the Pillar 3 ESG disclosures.” The ECB also recommended that the ESRS “enhance the alignment” with environmental standards set by the International Sustainability Standards Board (ISSB), including the use of similar terminology and promotion of quantitative disclosures over qualitative ones.

But the EBA also proposed four major technical revisions to the ESRS. First, the ESRS should improve its “interoperability” with other international standards. Second, the materiality assessment should contain additional specific guidance, in particular for how to properly implement the “value chain concept” for financial institutions. Third, in developing standards for specific sectors, ESRS should further increase alignment with the EBA’s Pillar III requirements. Lastly, the ESRS should promote consistency with the accounting and anti-fraud directives in the European Union.

Taking the Temperature: Although noteworthy for any number of reasons, we offer two takeaways from the ECB and EBA comments. First, financial regulators in Europe and elsewhere continue to be integrally involved in the development of standards for assessing climate-related financial risk, collecting and analyzing related data, and making appropriate disclosure. This includes the European Parliament’s recent adoption of proposals to implement Basel III, including as it relates to ESG concerns; the ECB’s publication of “new experimental and analytical indicators” that are intended to help analyze climate-related risks in the finance sector and monitor a green transition; and the Federal Reserve’s pilot climate scenario analysis involving six of the largest banks in the U.S. Second, the ECB and EBA comments highlight the elusive nature of global consensus on these same issues (i.e., climate-related risk assessment, data analysis and disclosure). Notwithstanding the focus on these subjects by financial and other regulators, standard setting organizations and market participants, the EBA in particular remarked on the continuing need to “align” with international standards, including the ISSB, and promote consistency with other EU directives. While a jurisdictional and, to

some extent, global alignment process will continue, it remains to be seen how long it takes and the extent to which consensus ultimately is achieved.