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The EU’s ESG reporting requirements turn up the heat on financial institutions there

Article

The news: The EU is taking the lead in implementing ESG reporting regulations—striving to achieve carbon neutrality by 2050. As part of this effort, **the European Banking Authority**

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(EBA) is changing capital requirements for lenders—factoring environmental and social risks into the equation.

- As this trend gains momentum and influence, leaders in financial institutions (FIs) around the globe are watching how their European counterparts navigate this new landscape—as they could be next.

Breaking down the change: While Tier 1 institutions already face enforcement for these changes, certain aspects of this framework will affect all FIs in the EU by 2025.

- FIs will need to adapt their **risk assessment processes** to account for environmental and social risks, impacting client creditworthiness and risk profiles.
- They'll need to **assess default and loss probabilities for client accounts**, particularly considering how ESG factors may affect the likelihood of clients defaulting.
- They must also **adjust risk weights for client accounts**, potentially requiring the allocation of more capital for clients influenced by ESG factors, with a focus on high-emission sectors.

The regulatory trend: ESG requirements are chasing the tailwind of the EU's Green Deal.

- Most FIs in the EU already use ESG data when making strategic decisions.
- But concern about the growing "red tape" businesses in the EU face has led more than 40 European Parliament leaders to fight this new guidance.
- Pressure is mounting on Europe's biggest FIs to reconsider financially supporting fossil fuel companies.

However, in PwC's 2023 Annual Corporate Directors Survey of 600 public companies around the world, **46% of respondents don't see the link between ESG and corporate strategies,** suggesting **there's a disconnect between the regulations and those they impact.**

Greenwashing remains a problem: Some companies have taken to exaggerating ESG-related accomplishments as they try to keep up with greener competitors, strengthen their reputation, appease consumers, and attract investment.

- As a result, European lawmakers regularly investigate EU-based companies' ESG claims.
- European companies may no longer claim they're "environmentally friendly" or "climate neutral" without proof.

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- Since 2012, the EBA has seen the number of potential greenwashing cases against European FIs skyrocket.

Can non-EU FIs escape this regulatory fate? While the new reporting requirements just affect European FIs, FIs around the globe face scrutiny for greenwashing.

- The US Securities and Exchange Commission (SEC) has introduced a rule targeting greenwashing—reflecting a global crackdown on such practices.
- FIs in the US face pressure from consumers to adopt ESG practices despite strong economic ties to fossil fuels.
- Gen Z places a high priority on sustainability when choosing where to bank, and they'll be quick to cancel a brand that makes false ESG claims.

Key takeaways: While US FIs may not see similar regulations hitting their market any time soon, consumers may force FIs in a greener direction before the regulators do.

- Strategic leaders should adopt a framework for accurately tracking ESG-related activities.
- To create meaningful relationships with Gen Z and Gen Alpha, FIs should promote their sustainable practices and be transparent about them. But first FIs must be certain their claims are accurate.

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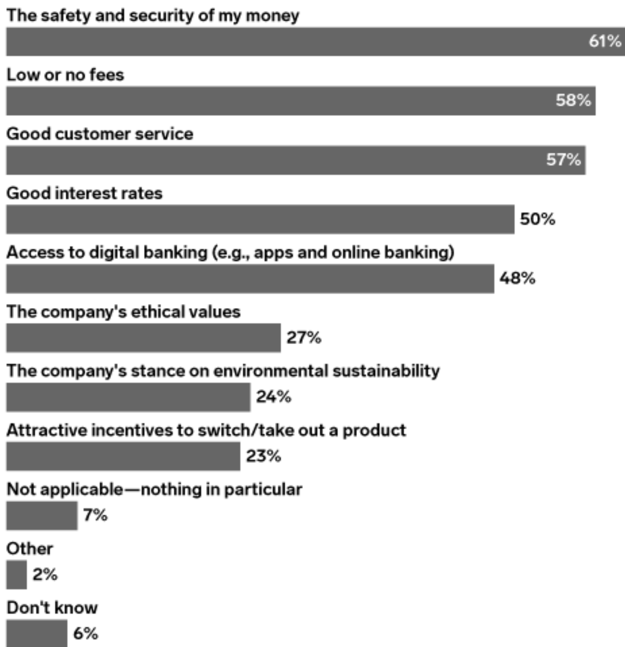

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