ESG Risks - CRR3 (Capital requirements regulation)

Vested Impact Data & Analytics statement of alignment and mapping of assessment methodology and data

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V1.0

Contents

Introduction

The Capital Requirements Regulation 3 (CRR3) was developed by the EU alongside the Capital Requirements Directive 6 (CRD6) as part of the implementation of the Basel 3 Standards, a set of international banking regulations aimed at strengthening regulation, supervision, and risk management within the banking sector. CRR3 sets out the technical and quantitative requirements, whereas CRD6 focuses on the qualitative aspects. CRR3 mandates banks to maintain sufficient capital to cover various risks, including ESG risks and those related to their lending and investment activities.

ESG factors can significantly impact a bank's risk profile, potentially affecting credit quality, market valuations, and operational resilience. Integrating ESG risk assessment into the bank's risk management practices helps ensure compliance with regulatory requirements by identifying and addressing material ESG risks. Implementing a ESG risk assessment framework enables banks to systematically identify and assess material ESG risks that may impact their financial performance and reputation, including climate-related risks, social controversies, governance issues, and reputational risks, aligning with the goals of CRR3 i.e. banks to identify and assess risks inherent in their business activities.

CRR3 establishes capital adequacy requirements to ensure banks have enough capital to absorb losses from unexpected risks. Integrating ESG risk assessment helps determine potential financial impacts on capital adequacy, improving capital allocation and risk mitigation strategies. Additionally, ESG offers an external perspective, reducing bias from self-reported data.

CRR3 Key Requirements and Vested Impact Alignment

Article 449a - *Disclosure of environmental, social and governance risks (ESG risks)*

- Institutions shall disclose information on ESG risks, including physical risks and transition risks.
- The information shall be disclosed on an annual basis by small and non-complex institutions and on a semi-annual basis by other institutions.
- EBA shall develop draft implementing technical standards specifying uniform disclosure formats for ESG risks, ensuring that they are consistent with and uphold the principle of proportionality (see below).
- ESG Risks to be disclosed in accordance with Article 434 (Means of Disclosure)

EBA draft guidelines on the management of ESG risk

Section	Sub-Section	Requirement	Vested Impact Alignment
Materiality Assessment	Frequency and Scope	Conduct regular institution specific ESG risk materiality assessments that evaluate the potential effects of ESG risks on all financial risk categories, integrating these assessments into their overall materiality evaluations, including those for ICAAP.	Vested Impact allows for minimum Yearly assessments, with equities being assessed weekly and private assets on demand.
	Time Horizons	Assess the materiality of ESG risks across short (i.e. less than 3 years), medium (3 to 5 years) and long-term time horizons, including a time horizon of at least 10 years.	Vested Impact assesses the short/medium/long term time horizon associated with the realisation of each impact and defines the time horizons with the CSRD and EBA definitions.
	Inputs and Factors	Use of both qualitative and quantitative elements and data	Vested Impact leverages over 200 million academic papers to provide science-based evidence to what individual company activities impact, and over 100 million impact data points to automatically assess and quantify the degree of impact of companies' products, services, and activities.
	Scope	Assess the impact of ESG risks on the most significant activities, services and products	Vested Impact assesses and quantifies the external material impact of a company's activities, services and products, allowing for ranking of significance of the risk based on CSRD-defined scale, score, irremediability and likelihood factors.
	Scope - Environmental Risks	Assess environmental risks by evaluating both transition and physical risk drivers, considering the economic sectors and geographical locations of assets and counterparties, and factoring in policy, technology, market changes, and physical climate events.	Vested Impact assesses ESG impact risks at an activity-level with each risk assessment specific, and leverage sector, activity and geographic specific

			data, to assess the degree of risk factoring in all risk drivers. Vested Impact classifies risk types in terms of: Policy & Legal, Reputational, Market, Operational etc Vested Impact classifies activities as Physical or Transition risks as per the EU Taxonomy classification.
	Risk Assessment Approach	Use risk-based approach that considers the likelihood and the severity of the materialisation of the risks	Vested Impact assesses the likelihood and severity (including scale, scope and irremediable character) of each impact risk; leveraging
	Sectoral Exposure (Climate Risk)	Consider their exposures to sectors that significantly contribute to climate change (sectors listed in Sections A to H and Section L of Annex I to Regulation (EC) No 1893/2006)	Presence of Vested Impact activities assigned as in Appendix 1 Vested can identify/classify companies that derive any revenues from exploration, mining, extraction, distribution or refining of hard coal and lignite; (ii) companies that derive any revenues from the exploration, extraction, distribution (including transportation, storage and trade) or refining of liquid fossil fuels; and (iii) companies that derive any revenues from exploring and extracting fossil gaseous fuels or from their dedicated distribution (including transportation, storage and trade); (Exposure to Fossil fuel sector (%) = activity * weight of security in portfolio)
	Documentation	Document ESG risks materiality assessments, methodologies, and results.	Vested Impact provides materiality assessment at an activity-level for each asset, as well as providing indicators, academic references and underlying data available for each impact assessment. Vested Impact also provides documentation covering the methodology/s utilised.
Identification and measurement of ESG risks	Procedures	Include identification, collection, structuring, and analysis of necessary ESG data in internal procedures	n/a
Data requirements	Businesses' internal procedures must gather current and forward-looking ESG risk data on counterparties, collecting client and asset-level data, including specific information for large	**Environmental:**	
		Geographical location of key assets and exposure to environmental hazards at the level of granularity needed for appropriate physical risk analysis	Vested Impact considers the geographical location of an activity when assessing the impact on environmental factors, and leverages market/country specific indicators to take into account unique and geographic-specific risks and factors.

	corporate counterparties:	Current and forecasted greenhouse gas (GHG) scope 1, 2 and 3 emissions in absolute and/or intensity such as per million-euro revenues or per units of production	n/a
		Material impacts on the environment, including climate change and biodiversity, and related mitigation or adaptation policies	Vested Impact considers the environmental impact of an asset's activities when assessing impact, including impacts on climate change (SDG13) and biodiversity (SDG15), marine (SDG 14) as well as contributing activities impact waste (SDG 12), water (SDG 6). Vested Impact classifies activities as per the EU Taxonomy classification of mitigation or adaptation.
		Dependency on fossil fuels, either in terms of economic factor inputs or revenue base	Vested Impact uses industry classification and NLP to classify/flag assets involved in Share of investments in the extraction, storage, transport or manufacture of fossil fuels Exposure to fossil fuels (%) = activities * weight of revenue/market value
		Energy and water demand and/or consumption, either in terms of economic factor inputs or revenue base	Vested Impact uses industry classification and NLP to classify/flag assets involved in high water extraction and usage (SDG 6.3), high emissions to water (SDG 6.2). The degree of risk of calculated leveraging geographic context data and revenue information from the asset.
		Energy performance certificates and score in kWh/m² for real estate exposures,	n/a
		Adherence to voluntary or mandatory climate and environmental reporting,	n/a
		litigation risk including imminent, pending or completed litigation case related to environmental issues	Vested Impact classifies any negative risks, including against policy, legal and reputational – all of which could imply a risk for future litigation.
		Forward-looking adaptive capacity, including transition plans prepared by non-financial corporates	n/a
		Social and governance risks:	
		Compliance with and due diligence on social standards, such as ILO fundamental conventions or World Bank's Environmental and Social Standards	Vested Impact leverages due diligence standards in its own processes and methodologies, and this provides proxy alignment for organisations leveraging the Vested Impact data and platform. However, Vested Impact cannot ex post assess compliance from the asset.
		Governance practices	n/a
		Adherence to voluntary or mandatory social and governance reporting	n/a

		Negative impact on local communities, including due diligence policies to prevent impacts	Vested Impact assessment covers the impact of a counterparty on local communities (SDG1,3,4,6,8,10,11,16)
		litigation risks including imminent, pending or completed litigation case related to social or governance issues and due diligence policies.	n/a
	Data gaps	Assess gaps in ESG data from counterparties and public sources, document their impacts, and take remedial actions such as using estimates or proxies temporarily and considering third-party data providers	Vested Impact, as a third part data provider, provides an ability to remediate data gaps through its provision of academic and proxy/macro impact data points.
Measurement and assessment principles	Internal Procedures	Develop tools and methodologies for ESG risk identification, mapping, and management	Vested Impact provides a tool and methodology for internal screening, mapping, due diligence and management of ESG risks across over 163 UN SDG targets and supported by independent data points and references.
	Methodologies	Use a combination of methodologies—exposure-based, portfolio-based, and scenario-based—to comprehensively assess ESG risks across different time horizons, aligning them with short-term impacts and medium- to long-term planning.	Vested Impact reporting can assess impact at an asset/company level (exposure based) and at a group level (portfolio-based)
	Quantifying Environmental Risks	Quantify environmental risks by estimating the probabilities and magnitudes of financial impacts, establishing Key Risk Indicators (KRIs) for short-, medium-, and long-term horizons and materially exposed portfolios.	Vested Impact assesses the external impact of a counterparty/asset's activities on environmental factors
	Evaluating Social & Governance Risks	For social and governance risks, start with qualitative evaluations of potential impacts and gradually develop quantitative measures where quantitative information is lacking.	Vested Impact assessments quantify the impact of a counterparty/asset on social and governance risks leveraging over 200 million academic papers to provide science-based evidence and over 100 million impact data points
Main features of reference methodologies for the identification and measurement of ESG risks	Exposure-based	**Exposure-Based Assessment:**	
		Assess counterparties' activities and key assets' exposure to ESG factors, especially environmental and climate change impacts.	Vested Impact assesses impact at an asset activity-level, allowing for each activity to be assessed against its ESG risk to/from over 163 SDG targets across, climate, biodiversity, waste, social and inequalities factors.
		Ensure ESG factors are integrated into internal risk classification, default risk assessments, credit scoring, rating models, and collateral valuation.	Vested Impact provides an automated and comparable approach for ESG impact risk assessment, for assets of all sizes and asset types. This allows for automated and scalable integration of ESG risk assessment and management into loan determination, credit scoring and rating and other asset decisioning tools.
		Environmental Risk Assessment Criteria:	
		Physical Risks: Evaluate vulnerability to acute and chronic physical risks based on geographic location and environmental hazards affecting key assets and physical collateral.	Vested Impact classifies activities as Physical or Transition risks as per the EU Taxonomy classification.

		Transition Risks: Consider technological developments, environmental regulations, current and forecasted GHG emissions, and energy performance for real estate.	Vested Impact classifies activities as Physical or Transition risks as per the EU Taxonomy classification.
		Business Model Disruption: Assess likelihood of disruptions due to biodiversity loss, water stress, or pollution.	Vested Impact assesses the impact on biodiversity (SDG15), water (SDG6) and pollution (SDG3,6,14), and classifies the risk as 'Operational', 'Financial' or 'Market' all of which can materially impact financial business models of the asset.
		Term Structure: Consider the (planned) maturity or term structure of the exposure or asset.	n/a
		Mitigation Opportunities: Evaluate mitigation options, such as insurance coverage, adaptive capacity, and transition planning.	Vested Impact assesses the positive impact that activities have on climate, biodiversity and social factors; including the positive impact of EU Taxonomy classified mitigation activities.
		Data Gaps: Engage with clients to obtain necessary data or use sector-level characteristics as a preliminary step, adjusting for counterparty-specific details when feasible	Vested Impact, as a third part data provider, provides an ability to remediate data gaps through its provision of academic and proxy/macro impact data points.
		Social and Governance Risks:	
		Implement due diligence to verify adherence to social and governance standards, considering company size, legislation, and international principles.	n/a
		Assess potential future social and governance risks over short-, medium-, and long-term horizons due to rising standards or stricter policies.	Vested Impact classifies all ESG impact risk according to the time horizons as defined by the EU CSRD definitions of short, medium and long.
	Portfolio-based	**Portfolio-Level Climate-Related Risk Assessment:**	
		Use portfolio alignment methodologies to assess alignment with climate-related sustainability targets.	Vested Impact reporting can assess impact of a portfolio (i.e. at a sector level or group of assets)
		Implement methodologies to measure potential gaps between existing portfolios and benchmark scenarios, and assess climate-related risks and their impacts.	n/a
		Sectoral Portfolio Alignment:	
		Large institutions with securities traded on regulated markets should measure alignment for specific sectoral portfolios (e.g. power, automotive) to IEA net zero emissions by 2050 scenario or comparable scenarios.	n/a
		Other institutions determine sectoral portfolios for alignment based on portfolio characteristics and materiality assessment	Vested Impact can assess non-climate related ESG factors at a portfolio level, and covers over +25,000 equities and 2.7M private assets, allowing for sector and industry risk comparison.
		Other ESG Factors:	
		Implement additional methodologies for non-climate-related ESG factors at a portfolio level, including heat maps highlighting ESG risks of economic sectors.	Vested Impact can assess non-climate related ESG factors at a portfolio level, and covers over +25,000 equities and 2.7M private assets, allowing for sector and industry risk comparison.
		Additional Measures for Large Institutions:	

		Develop methods to identify natural capital dependencies and measure impacts on achieving UN Sustainable Development Goals, assessing potential financial risks.	Vested Impact assesses the impact of a company's activities at the UN SDG target level
	Scenario-based	Institutions should perform climate/environmental scenario-based analyses, as set out in [to insert reference to future EBA Guidelines addressing letter d of the mandate under article 87a(5) of the CRD20].	n/a