1.5 ESRS4 CONSUMERS AND END-USERS – A CALL FOR NEW PERSPECTIVES

By Per Törnqvist, Danske Bank A/S, Sabrina Miehs, Association of German Pfandbrief Banks, Larissa de Barros Fritz, ABN AMRO

Since the European Commission launched its Sustainable Finance Action Plan in 2018, a string of initiatives focused on sustainability risk and analysis have been launched. This includes the Corporate Sustainability Reporting Directive (CSRD) and its corresponding reporting standard, the European Sustainability Reporting Standards (ESRS).

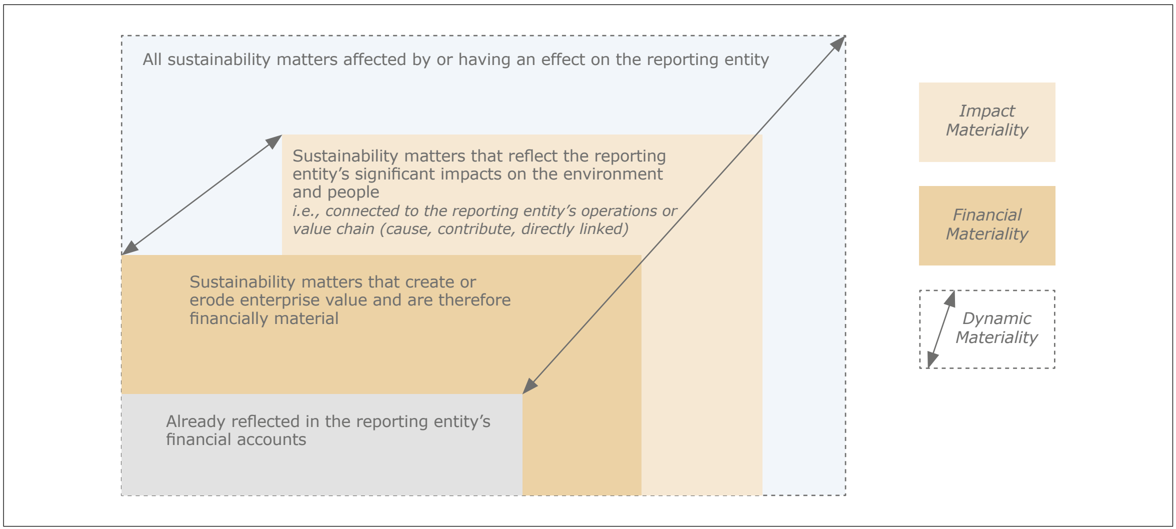
The CSRD/ESRS framework is built on three layers of standards; agnostic standards applicable to all, sector standards, that provide specific application guidelines and disclosures for a sector, and entity specific standards that are the responsibility of each company to identify. Since sector standards are yet to be developed all disclosures that material but not part of the agnostic standards are nonetheless required to be disclosed under the entity specific standards.

Although the ESRS S4 Consumers and End-users is a standard that is very relevant to Financial Services undertakings, it is at the same time not particularly tailored to the industry. Thus, in this article we discuss some of the potential disclosures under ESRS S4 that is specifically related to banks and, more specifically, mortgage lending. This will in turn have a direct impact on covered bond issuers.

The ESRS

Sustainability reporting in the EU is based on the concept of double materiality. This means that a company should account both for material financial effects that sustainability matters result in ("outside in") as well as the material impact on the individual, society and the environment that result from its operations ("inside out"). In the ESRS the "outside in" perspective is represented by Risk, the "inside out" perspective by Impacts and any positive potential effects from the transition to a sustainable economy by Opportunities. Together they are referred to as IRO.

> FIGURE 1: THE CONCEPT OF DOUBLE MATERIALITY



Source: EFRAG Final Report on the Proposals for a relevant and dynamic EU Sustainability Reporting Standard-setting, ABN AMRO Group Economics

Entities reporting according to the ESRS need to disclose IROs related to sustainability matters. These are generally broadly defined as: "environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters".

The ESRS as a starting point is based on a materiality assessment, where only material IROs need to be disclosed. That being said, the responsibility for the identification of material IROs lays with the reporting entity and not the standards. However, it also contains certain mandatory disclosures which companies need to provide regardless of whether these are deemed material or not. These mandatory disclosures belong to the fields of due diligence processes, principal adverse impacts, incentive schemes linked to sustainability matters and provisions for value chain information. Hence, the information about material IROs is extended to cover not only the scope of own operations, but also to the value chain (upstream and downstream – including therefore products, services, business relationships and supply chain).

The ESRS is built on three layers of standards:

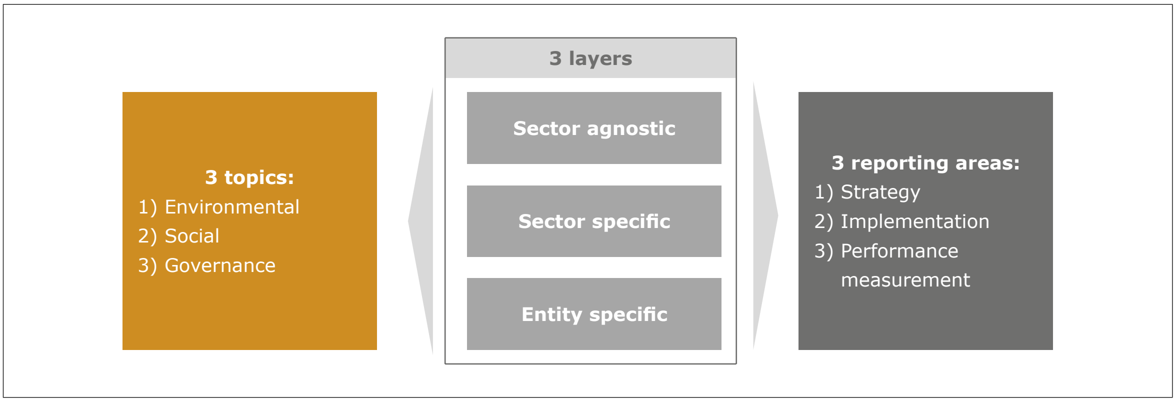
(i) sector agnostic, that apply to all;

(ii) sector specific, that both details specific application of agnostic standards and adds additional disclosure requirements relevant for the specific sector; and finally;

(iii) entity level, which is supposed to capture any material IROs that are not captured by the other two layers of standards.

Each layer also covers all three sustainability matters (E, S and G) and reflects reporting areas under three key management dimensions: strategy, implementation, and performance measurement.

> Figure 2: The ESRS' architecture



Sources: EFRAG Final Report on the Proposals for a relevant and dynamic EU Sustainability Reporting Standard-setting, ABN AMRO Group Economics

A first set of drafts covering the first layer and the principles for the third layer have been developed by the European Financial Reporting Advisory Group (EFRAG). These were issued in the form of Delegated Acts on July 31, 2023. Sector specific standards are at present being developed.

CSRD/ESRS puts the responsibility of the identification of all material sustainability IROs on the board of directors, which is required to identify, measure, act upon, and report on them in the annual report. ESRS is, in short, a comprehensive remodelling of sustainability reporting aiming at high quality data, greater standardisation, and accountability.

In the following, we look at ESRS S4 Consumers and End users–(hereinafter referred to as consumers) – and why mortgage lending can be seen as having a material impact on consumers, and what possible entity-specific topics and disclosures. We also identify arguments why mortgage lending plays an important role in society, both positively and negatively, and how this can be measured.

ESRS S4 Consumers and End-users

The ESRS S4 addresses three critical areas that affect consumers: information-related impacts, personal safety and social inclusion. Companies are required to explain their general approaches to manage actual and potential, negative and positive impacts on consumers in relation to such sub-topics. Each of these areas is broken down into further sub-sub-topics and provides a detailed approach to sustainability reporting.

For **mortgage lending** we think of a number of entity-specific topics (as described below) that could have a clear positive or negative social impact on consumers corresponding to the sub-topics of personal safety and social inclusion and the relevant sub-sub-topics such as health and safety or non-discrimination.

Access to housing is a key requirement in a modern society. Housing also plays an important role for social cohesion, well-fare and financial security. Furthermore there are also social benefits to owning your own home.

As a result, banks are required to assess and, if deemed material, to also disclose on their approaches to managing, among others, the following **examples of entity-specific topics**:

> product safety, i.e. providing the right mortgage loan to the right customer and avoiding mis-selling, i.e. taking into account the borrower's financial situation and the features and terms of the product to ensure that borrowers don't end up in a financial situation where they are unable to repay the loan. (For example, the sale of endowment mortgages in e.g. the UK at the end of the last century was much criticised because many endowments could not generate sufficient returns to pay off the mortgage balances which they were intended to cover.) As product safety is multi-faceted, this topic could fall under any of the sub-topics depending on the critical area being addressed, i.e. clear loan documentation, security of a person's financial situation or marketing practices.

> healthy and climate-adapted properties: When financing products that enable customers to buy or renovate their homes or to build or renovate workplaces, banks could have a positive impact on customers' health and safety, by financing healthy (e.g. allergy-friendly buildings) and climate-adapted properties for living and working. For example, mortgage lenders could be required to report on measures taken to ensure the physical well-being of consumers.

> access to loans against objective criteria: This is an important social impact of mortgage lending. Access or lack of access to mortgage loans determines life chances. Objective lending criteria and objective risk requirements are key sustainability issues in relation to mortgage lending. Failure to provide these could put the bank at risk of not treating customers fairly.

> FIGURE 3: ESRS S4 CONSUMERS AND END-USERS DISCLOSURE REQUIREMENTS ADDRESS 3 CRITICAL TOPICS

ESRS S4 sub- and sub-sub-topics as well as suggested specific topics for mortgage lending

Sub-Topic	Sub-sub-topics (examples as per ESRS S4)	Entity Specific topic – Mortgage lending (suggested examples)
"Information-related impacts"	Privacy Freedom of expression Access to (quality) information	> objective and transparent product & service information
Personal safety	Health and safety Security of a person Protection of children	> product safety (right loan to the right customer) > healthy and climate adapted properties for living and working
Social inclusion	Non-discrimination Access to products and services Responsible markting practices	> access to loans against objective criteria > loan terms and conditions based on objective criteria

Sources: EU 2023/2772 of 31 July 2023, Association of German Pfandbrief Banks

Although this article does not cover the assessments required by the sustainability reporting standards with regard to climate change (ESRS E1) we would like to highlight that there are interactions between ESRS S4 and ESRS E1. For example, environmental impact resulting from the provision of a variety of tailored products, e.g. green mortgage loans can improve the resilience of the property, but also positively impact the lives of borrowers.

To ensure transparency about how companies manage potential negative impacts and exploit opportunities to achieve positive outcomes, ESRS S4 requires them to disclose their policies to consumers, particularly in relation to their impact management and engagement processes.

> Figure 4: S4 Disclosure requirement – an overview

Strategy
SBM-2 Interests and views of stakeholders
SBM-3 Material impacts, risks and opportunities and their interaction with strategy and business model
Impacts, risks and opportunities (IRO)
S4-1 Policies related to consumers and end-users
S4-2 Processes for engaging with consumers and end-users
S4-3 Processes to remediate negative impacts and channels for consumers and end-users to raise concerns
S4-4 Taking action on material impacts on consumers and end-users and approaches to mitigatin material risks and pursuing material opportunities related to consumers and end-users, and effectiveness of those actions
Metrics and targets
S4-5 Targets related to managing material negative impacts, advancing positive impacts and managing material risks and opportunities

Sources: EU 2023/2772 of 31 July 2023, Association of German Pfandbrief Banks

With regard to IRO **management**: The standard requires companies to describe their strategies for managing risks and opportunities related to their impacts on consumers and end-users. This includes a description of policies, stakeholder engagement processes and methods for remediating negative impacts.

In addition, with regard to **metrics and targets**, setting clear, outcome-based objectives is critical under ESRS S4. Organisations need to outline how they intend to reduce negative impacts while increasing positive impacts on their consumers and end users.

Entity specific disclosures

Mortgage lending is a data rich business line. Data on properties and customers alike have been collected for many years and banks have rich databases to mine when designing its relevant entity specific data points. In this section we present a few examples that illustrate what such disclosures could look like and what topics they could cover.

1. Underwriting

In its underwriting, a financial institution defines the criteria under which a customer may borrow money. This, in turn, usually is a requirement for access to the property market. Standard mortgage market practices vary across Europe and the European Union. However, the principal components are similar: debt-to-income, loan-to-value, interest expense to income, the number of persons reliant on total income as well as assessments of other financial assets. These factors and others form the basis for credit decisions with the aim to maximize the commercial potential given a desired risk appetite.

While bankers and regulators tend to consider these components as part of portfolio risk management and capital adequacy, they are at the same time key aspects of access to products and services. Under the agnostic ESRS standards there is the general reference to access to products and services, but no specific disclosure requirements related to financial services. However, as we previously stated, ESRS 1 clearly states that it is the preparers responsibility to identify all material IROs and to complement with any relevant matter and/or disclosures as relevant.

Importantly, prudent underwriting is a balancing act where there are measurable positive and negative impacts that are material for most major credit institutions and that motivate both qualitative and quantitative additional disclosures.

> Figure 5: Metrics that capture underwriting criteria

Underwriting	Max loan-to-value ratio (%) Minimum down payment requirement (%) Max debt to income ratio (times) Expected loss (bps) Share of new borrowers under the age of 30 (%) Share of borrowers over the age of 65 (%) Share of low-income customers (%) Lending by type of customer (single borrower, families, families with children, singles with children ...

2. Positive impact

In a seminal paper titled 'The Return on Everything 1870 to 2015' (Jordà, Knoll, Kuvshinov, Schularick & Taylor 2017), housing is identified as one of the best performing assets with an average annual return of about 7%. This implies that having access to financial services is key to also having the possibility to reap the reward of being a homeowner. There is evidence of a material social impact affecting both the individual and society at large. For large systemically important financial institutions this may have impacts that are defining for society.

There are of course other benefits from owning one's home, such as: security, the fact that it is a key building block for a good life, and it related to the stage where large parts of our lives take place. Those benefits are indirectly linked to the provision of financial services, such as a mortgage loan. However, the financial product is the most direct and resulting aspect from the provision of a loan. While the positive impact outweighs the negative with a wide margin, perhaps illustrated by the short period in which property prices contract compared to the protracted periods of rising values, negative impacts are potentially severe and undoubtedly important.

> Figure 6: Metrics that capture positive impact

Positive Impact	Number of financed properties Number of property purchases Number of properties sold Change in market value of financed properties Average annual return on loan portfolio Customer satisfaction Share of low-income customers (%) Lending by type of customer (single borrower, families, families with children, singles with children ...

3. Negative impact

Two observations are important to state: banks only incur significant impairment losses in systemic financial crises and such crises tend to have important and often authoritarian consequences. While residential mortgage lending in general tends to result in low impairments, the social consequences of a systemic financial crisis are still significant. In Greece, Iceland, Great Britain, Spain and other European countries experienced severe and costly consequences from the Great Recession that began in 2007. In certain ways the repercussions are still felt from that crisis 15 years later.

Not just in the Great Recession but also in other financial crises have mortgage lending and property investments more broadly been an important contributing factor, resulting in not just impairments for financial institutions but also rising foreclosures and forced auctions. This, in turn, resulted in often severe social implications for affected individuals as well as cost to society at large. Post the Great Recession the regulatory agenda has been focused on securing prudent underwriting and avoiding over-indebtedness.

> Figure 7: Metrics that capture negative impact[1]

Negative Impact	Customers with a debt-to-income ratio above 3 Mortgage loans with an LTV above 80% Arrears past due +75 days Number of foreclosed/repossessed properties Stock of foreclosed properties …

As financial institutions start to report and better assess IROs of their mortgage portfolios, reporting on sustainability for covered bonds will also have to evolve. Given the role and position of the ECBC's **harmonized transparency template (HTT)**, it is well suited to play a key role also in future sustainability reporting, including on the social dimension.

The harmonized transparency template (HTT) is the worldwide standardised, Excel-based form that issuers who have been granted the Covered Bond Label use to disclose information on their covered bond programs in a standardized way (For further details – see section Covered Bond Label). It is aligned with the transparency requirements of Article 14 of the Covered Bond Directive[1] asking issuers to regularly publish a set of information to enable investors to analyse the cover pool. In that context it undergoes constant review to be always up to date with regulatory and market requirements.

In the course of the past HTT revisions, various datapoints on the sustainability dimension of green mortgage assets have entered into the template taking into account the growing issuance of green and social covered bonds. While the completion of the sustainability data section in the HTT is voluntary, it is currently filled out in whole or in part for already almost 40% of the cover pools with at least one sustainable covered bond (i.e. covered bonds marked with a green leaf).

Although the HTT does not yet request much data to assess actual and potential, negative and positive impacts on consumers, i.e. borrowers of the mortgage cover assets, it is not unlikely that with the approaching regulatory requirements for financial institutions and unfolding market practices, not only the sustainability section of the HTT will evolve but the ratio of issuers providing sustainability data will rise as well.

As the disclosure and reporting templates of the Energy Efficient Mortgage Label (For further details – see section A Sustainable Housing Market), i.e. the Harmonized Disclosure Template (HDT) and the Harmonized Reporting Template (HRTI) are inspired by the HTT and efforts have been undertaken to align the HRT and the HDT as much as possible. It is therefore not unlikely that also these templates will evolve with respect to the social dimension.

CONCLUSION

ESRS S4 require financial services to reassess its classic disclosures and may in the process discover new insights from existing businesses. This in turn may lead to adjustments of strategies and business models. It is also a good illustration of the fact that the CSRD/ESRS framework is about much more than just reporting.

1 The disclosures and metrics that are referenced here are by no mean an exhaustive list of topics. They only serve as inspiration for the direction of travel that financial institutions, with mortgage lending activities should consider when analysing the entity specific disclosures that may result from their operations.

It is important to note that much of the data required to be reported is already for part of the data pool that banking operations collect hold and process, which sets this standard out from other standards under ESRS, which require the collection of information that currently is not automatically collected.

The type of data that address ESRS S4 Consumers and End-users is also well suited to be incorporated in the HTT framework over time.