The growing importance in bank analysis of the 'E' in ESG

The link between ESG factors and a bank's ability to meet contractual financial commitments in a timely manner remains a subject of debate. While 'G' (governance) has long been relevant, the 'S' (social) and especially the 'E' (environmental) can no longer be ignored.

There is growing acknowledgement from central banks and supervisors that climate-related risks are a source of financial risk relevant for financial stability and the soundness of financial institutions. For banks, this will require a shift in thinking – from being a corporate social responsibility issue to addressing the associated risks.

While data, research and models on the impact of climate change may be limited, it is possible to consider how climate-related risks might affect bank credit fundamentals. Risks can manifest broadly in three ways: (i) credit risks via lending and asset portfolios, (ii) funding costs driven by investor expectations, and (iii) capital requirements resulting from supervisory assessments.

Banks do not currently provide enough detailed and consistent information for Scope to systematically incorporate climate-related risks into our rating approach. However, as disclosures improve, and supervisory assessments become a reality (in particular, stress tests) we see climate-related risks becoming a more tangible part of the credit process.

How climate change poses financial risks

It is generally accepted that climate change poses financial risks primarily in two ways: physical and transition risks. Physical risks stem from the increased severity and frequency of climate and weather-related events that can damage property and impair the creditworthiness of borrowers. Transition risks arise from the adjustment to a lower-carbon economy, with changes in policies, customer preferences and technologies potentially leading to a reassessment of the value of assets and companies.

Figure 1: Examples of physical and transition risks

	Credit	Market	Operational
Physical	Increasing flood risk to mortgage portfolios Declining agricultural output increases default rates	Severe weather events lead to re-pricing of sovereign debt	Severe weather events impact business continuity
Transition	Tightening energy efficiency standards impact property exposures Stranded assets impair loan portfolios Disruptive technology leads to auto finance losses	Tightening climate-related policy leads to re-pricing of securities and derivatives	Changing sentiment on climate issues leads to reputational risks

Source: Bank of England

Analyst
Pauline Lambert
p.lambert@scoperatings.com

Associates
Andre Hansen
a.hansen@scoperatings.com

Constantin von Fritsch
c.fritsch@scoperatings.com

Team leader
Dierk Brandenburg
d.brandenburg@scoperatings.com

Scope Ratings GmbH
Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Headquarters
Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Assessing impact of climate change on loan portfolios is not easy

A group of 16 banks, co-ordinated by the Secretariat of the UN Environment Programme Finance Initiative (UNEP FI), is aiming to develop and test a widely applicable scenario-based approach for estimating the impact of climate change on their corporate lending portfolios. This is in line with the Task Force on Climate-related Financial Disclosures (TFCD) recommendations for banks to use scenario analysis to disclose the impact of climate-related risks on their businesses, in addition to how they identify, assess and manage these risks.

The project has identified several items needed to improve the ability of banks to assess physical risks, including location-based borrower data, better climate models and datasets that can be applied to assets and industries. The need to integrate the macroeconomic impacts of climate change into assessments was also noted. On a macroeconomic level, weather events can influence levels of inflation, consumer spending, interest rates and other factors which have a bearing on a borrower's ability to repay or the value of assets held in banks' trading books.

Banks have benefit of time to adjust loan exposures

While the time horizon for transitioning to a low-carbon economy is long compared to the more short-term nature of corporate loans, banks still need time to adapt the exposures and risk profiles of their loan portfolios. This is not straightforward, as there is still limited information on how specific climate-transition scenarios may impact the creditworthiness of specific borrowers and industries. At the same time, there are opportunities for banks to help their clients implement climate-adaptation measures and to finance investments supporting the transition to a lower carbon society.

Growing scrutiny and expectations from bank supervisors

Only two notable absences from NGFS – the US and Brazil

Established in December 2017, the Network for Greening the Financial System (NGFS) has expanded in two years from eight members to over 50 central banks, supervisors and observers across five continents (Figure 2). The coalition's work is focused on three areas: supervision, macro-financial impacts and scaling up green finance.

Figure 2: NGFS members and observers

Source: NGFS

Growing acceptance of climate risks as source of financial risk

In its first progress report, published in October 2018, NGFS members acknowledged that climate-related risks are a source of financial risk and therefore within the mandates of central banks and supervisors to ensure that the financial system is resilient against these risks. This was followed in April 2019 by recommendations for facilitating the role of the financial sector in achieving the objectives of the 2015 Paris Agreement. Of note are the recommendations to integrate climate-related risks into financial-stability monitoring and micro-supervision, and the call for robust and internationally consistent climate and environment-related disclosures.

Central banks and supervisors are acting

While the work of the NGFS may appear academic, it is informative to look at what its members have been doing. Over the last few years, the Dutch central bank (DNB) has conducted studies to examine the implications on the economy-at-large of transitioning to a carbon-neutral society, the physical risks of climate change on the Dutch financial sector, and the impact of a higher tax on carbon emissions for the corporate sector. An energy transition stress test at the macro level was also carried out to gather insight into possible losses under different future scenarios. Currently, the DNB is integrating climate-related risks into its supervision of banks and insurance companies.

The Bank of England (BoE) has also been considering the relevance of climate-related financial risks for some time, starting with the UK insurance sector and more recently with banks. The results of a survey covering 90% of the UK banking sector found that climate-related financial risks were already relevant and that the approach to risk management varied widely between banks: 30% viewed climate change primarily as a corporate social responsibility, another 60% assessed climate change as a financial risk focusing within a three-to-five-year time horizon, while 10% were taking a strategic, forward-looking view driven by the long-term financial interests of the firm.[1]

Consequently, in April 2019, the BoE set out detailed expectations for financial institutions on how they should manage climate risks, covering governance frameworks, risk management, the use of scenario analysis and appropriate disclosure. As part of its stress test of the UK financial system in 2021, the BoE will assess the resilience of UK banks to the physical and transition risks of climate change.

Supervisory scrutiny and additional capital requirements may be on the horizon

There is growing support to include climate risk in assessments of the financial sector and to use available tools for strengthening the resilience of banks against these risks, i.e. capital requirements and macroprudential supervision. The Deutsche Bundesbank recently asserted that a climate stress test should be part of supervisors' toolkits. Valdis Dombrovskis, Vice President of the European Commission, has also stated that the EC will be assessing whether regulatory changes need to be made to ensure better reporting and monitoring of climate-related risks as well as investigating ways to integrate sustainability risks into financial stability monitoring and supervision, such as through stress testing and scenario analysis.

Meanwhile, the DNB has asserted that a lack of climate-related financial regulation has not prevented them from acting. Further, it has concluded that the Dutch financial sector is exposed to other environmental and social challenges such as water scarcity and human rights issues. And therefore, it is also within its mandate to continue broadening its work in these areas.

[1] Prudential Regulatory Authority, September 2018. Transition in thinking: The impact of climate change on the UK banking sector.

The call for disclosure becomes more insistent

There are growing demands from investors and supervisory authorities for banks to improve their disclosures on climate-related risks. The identification of best practices, the development of common frameworks, and clearer expectations should help. An important step is the regulation on environmental, social and governance disclosures of financial institutions which was endorsed by the European Parliament on 18 April 2019.

Investor support could weaken for those banks with poor disclosures

The risk is that funding costs could rise for those banks unable or unwilling to disclose the information the market increasingly wants. As ESG factors become a consideration in more and more investment mandates, banks that rank poorly are likely to face diminished investor support.

In 2015, the Financial Stability Board (FSB) established the TCFD to help identify the information needed by investors, lenders, and insurance underwriters to assess and price climate-related risks. Members of the global 29-member task force were selected by the FSB and come from various organisations, including large banks, insurance companies, asset managers, consulting firms and credit rating agencies.

In June 2017, the TCFD published its recommendations on climate-related financial risk disclosures. Applicable to both non-financial corporates and financial institutions, they are structured around four thematic areas: governance, strategy, risk management, and targets and metrics.

Overall, current disclosures remain insufficient

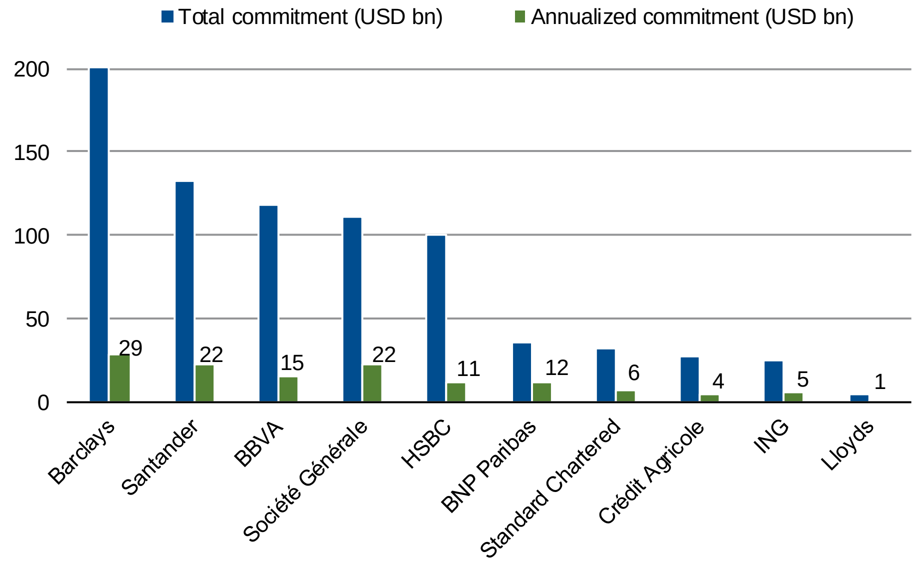
In its 2019 status report, the TCFD concluded that disclosure of climate-related financial information has increased since 2016 but is still insufficient for investors. The area identified as needing the most improvement was disclosure on the potential financial impact of climate-related issues. In the TCFD's review of over 1,100 companies worldwide across eight industries, only around 25% of companies disclosed information in line with more than five of the 11 recommended disclosures and only 4% of companies disclosed information in line with at least 10 of the recommended disclosures.

Overall, the banking sector ranks the best in terms of disclosures. An increasing number of banks disclose information on their boards' oversight of climate-related issues and the integration of related risks and opportunities in their risk management processes (Appendix 1). This is a notable trend as disclosures in these two areas rank amongst the lowest for all companies.

Sustainable finance targets signal support for transition to low carbon future

At a broader level, there are signs that banks are also responding to the need to help the transition to a lower-carbon future. This should be supported by the EC's efforts to develop a classification system for sustainable activities (taxonomy). A World Resources Institute (WRI) study of the world's 50 largest private-sector banks found that half have set sustainable finance targets (Figure 3). For those that have made commitments, however, there is large variation in how they define and describe their targets as well as the time horizon for these activities.

Figure 3: Sustainable finance commitments of selected European banks

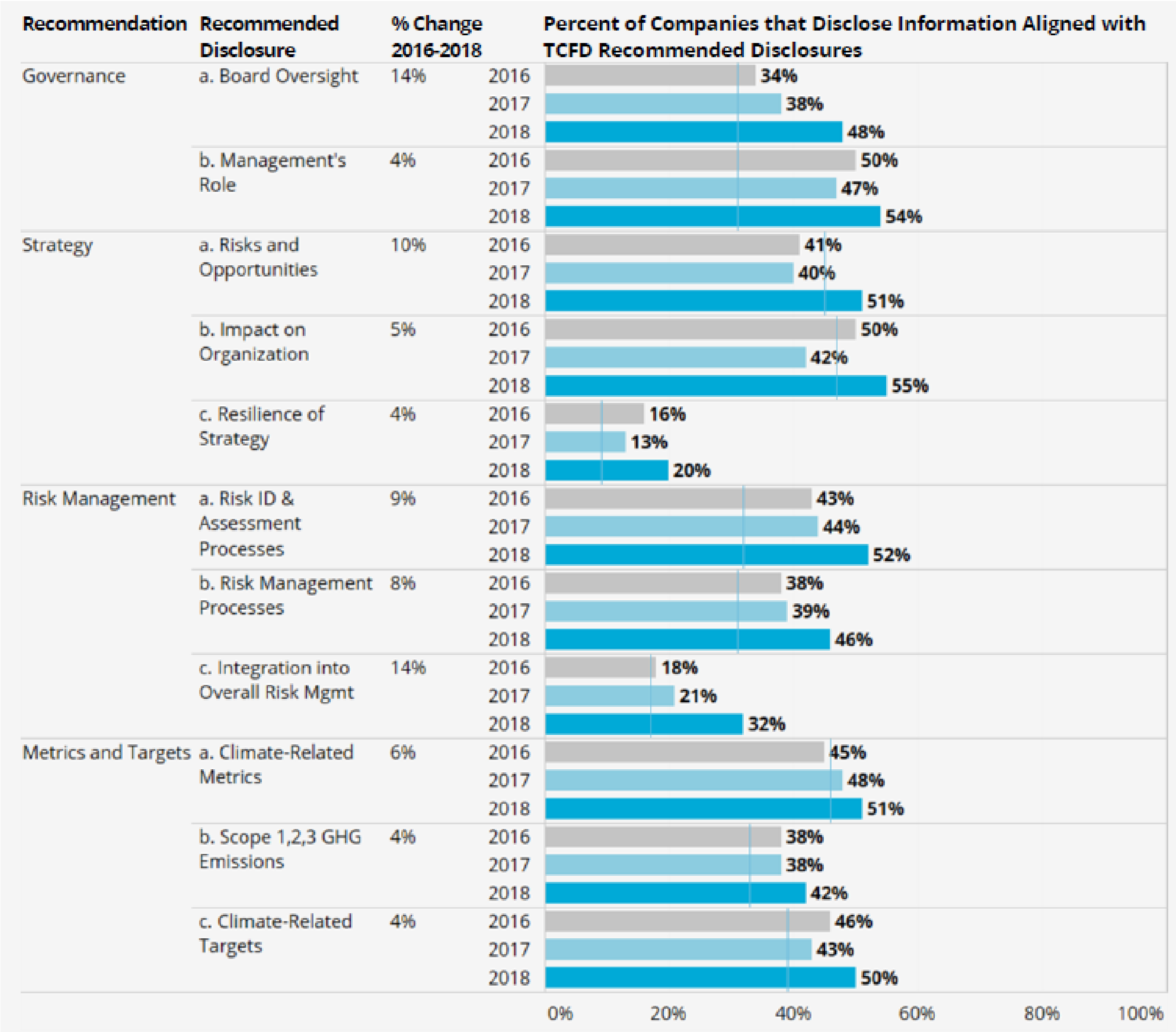


Source: World Resources Institute, Scope Ratings
Note: Data as of 1 July 2019 except for Santander who disclosed their commitment in October 2019.

Banks involved in numerous initiatives to advance sustainability

At the same time, the WRI acknowledges that a public commitment in itself is not proof of a bank’s dedication to sustainability and that the absence of a commitment does not necessarily mean a bank is not involved in sustainable finance. Other ways banks are supporting sustainable finance include: (i) signing up to the UN-backed Principles for Responsible Banking, (ii) aligning lending portfolios with the goals of the COP-21 Paris Agreement on climate change, (iii) aligning investment and lending portfolios with climate-stabilisation pathways under the Science Based Targets initiative, (iv) sourcing 100% of electricity from renewable resources, and (v) pledging to phase out or restrict coal financing.

Appendix I: Banking sector: Disclosures in line with TFCD recommendations



Source: TFCD 2019 status report based on sample of 104 financial institutions in three sub-industries (regional banks, large, diversified banks; and investment and asset management firms, ranging in size from USD 4 trillion to USD 8 billion in assets).

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

London
Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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