

ESG Integration into Banks' Business Models: New Risks and Opportunities

“Supervision, Risks & Profitability 2022”

ABI, Associazione Bancaria Italiana

Prof. Cristiano Zazzara

Department of Finance and Volatility & Risk Institute (VRI)

NYU Stern School of Business

czazzara@stern.nyu.edu

Milan – June 22, 2022

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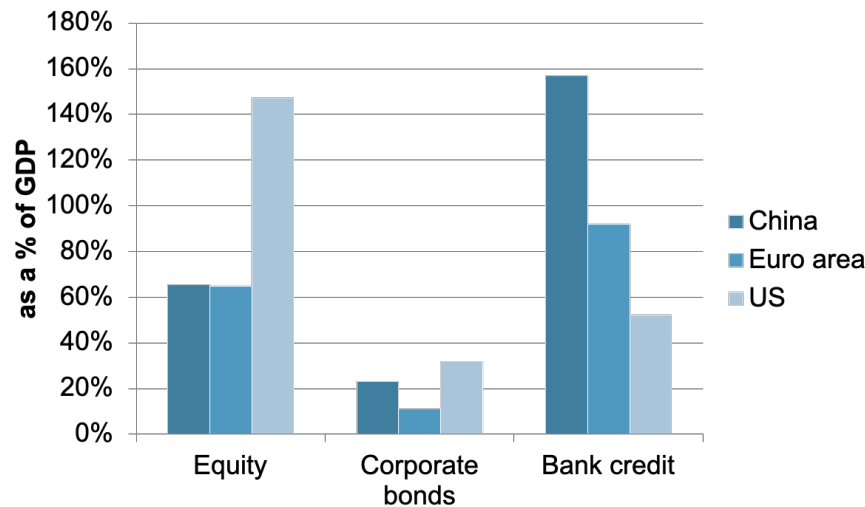
EXECUTIVE SUMMARY

- *Environmental, Social, and Governance (ESG) issues at European banks have shifted from a reputational to a business focus, attracting the attention of not only communities but also investors, employees, and customers, who increasingly use ESG issues as part of their due diligence when selecting financial providers*
- *During the pandemic, European banks have shown great strength in supporting their stakeholders and the economy, establishing themselves as key players in the ESG transition*
- *We take a look at Europeans Banks through an ESG lens and focus on the following key risks and opportunities: 1) Systemic Risk Management, 2) Incorporation of ESG activities, 3) Lending Practices, 4) Customer Privacy & Data Security, 5) Environmental Risk to Mortgage Properties*
- *We analyze how the above ESG issues will impact current banks' business models*

A. BANKS & ESG

EUROPEAN BANKS AND THEIR ESG ROLE

- Banks credit is an important source of finance for the private sector, particularly in Europe and Asia, which are in fact defined as bank-centric markets
- For example, funds provided through bank credit are 157% of GDP in China and 91% in Europe. By contrast, Equity is the most important form of financing for the private sector in the USA at 147% of GDP, while in Europe and China are at around 65%



Source: Bank for International Settlements and World Bank.

Due to the size of banks' balance sheets and their role in financing the economy, European banks have a crucial role to play in the ESG transition

WHY ESG MATTERS FOR BANKS

ENVIRONMENTAL

- Banks do not pollute that much themselves, but through their role of funding the economy their role in the Energy transition is crucial. Banks are accelerating plans to reduce exposures to the most polluting sectors, but a lot more is needed to reach carbon neutrality

SOCIAL


- Banks play a significant role from a social point of view: during Covid-19, they provided a vital support to the economy through moratoria on loan repayments and lending to SMEs, in addition to ensuring other banking services

GOVERNANCE

- In order to align corporate interests with those of society, Banks are starting to reflect their ESG commitments in their Board structures and CEO compensation. Governance is the first step in incorporating ESG into business practices

THE UN PRINCIPLES FOR RESPONSIBLE BANKING

- Launched in 2019, the Principles for Responsible Banking (PRB) provide a voluntary framework for Banks to embed sustainability at the strategic, portfolio and transactional levels, and across all business areas

 <p>PRINCIPLE 1: ALIGNMENT</p> <p>We will align our business strategy to be consistent with and contribute to individuals' needs and society's goals, as expressed in the Sustainable Development Goals, the Paris Climate Agreement and relevant national and regional frameworks.</p>	 <p>PRINCIPLE 2: IMPACT & TARGET SETTING</p> <p>We will continuously increase our positive impacts while reducing the negative impacts on, and managing the risks to, people and environment resulting from our activities, products and services. To this end, we will set and publish targets where we can have the most significant impacts.</p>	 <p>PRINCIPLE 3: CLIENTS & CUSTOMERS</p> <p>We will work responsibly with our clients and our customers to encourage sustainable practices and enable economic activities that create shared prosperity for current and future generations.</p>
 <p>PRINCIPLE 4: STAKEHOLDERS</p> <p>We will proactively and responsibly consult, engage and partner with relevant stakeholders to achieve society's goals.</p>	 <p>PRINCIPLE 5: GOVERNANCE & CULTURE</p> <p>We will implement our commitment to these Principles through effective governance and a culture of responsible banking.</p>	 <p>PRINCIPLE 6: TRANSPARENCY & ACCOUNTABILITY</p> <p>We will periodically review our individual and collective implementation of these Principles and be transparent about and accountable for our positive and negative impacts and our contribution to society's goals.</p>

Source: UN PRI, <https://www.unepfi.org/banking/bankingprinciples/>

- Initially endorsed by 132 banks, currently over 240 banks across 69 countries have signed up for these principles, representing over USD 60 trillion in total assets

BANKS AND SUSTAINABILITY

Key Sustainability topics for Banks can be classified as follows:

- **Bank and its Customers:** satisfied customers; high availability; responsible lending; responsible sales and advisory services; integrity and confidentiality
- **Bank's role in the Community:** local presence; the bank as a taxpayer; financial stability and profitability
- **Bank's Indirect Impact:** responsible credits and investments with regards to human rights, working conditions, environmental concerns, and anti-corruption
- **Bank as an Employer:** responsible employer; working conditions and union rights; employee commitment; leadership and developments; work environment and health; gender equality and diversity
- **Bank's Business Culture:** high ethical standards; salaries and remuneration; anti-corruption and bribery; counteracting money laundering and financing of terrorism
- **Bank as an Investment:** creating value for shareholders and stakeholders, which can only be achieved by simultaneously creating long-term value for its customers and society as a whole

B. ESG RISK & OPPORTUNITIES FOR BANKS

MATERIAL ESG RISKS & OPPORTUNITIES FOR BANKS

- Key Sustainability material issues and opportunities for Banks based on time horizon, probability, and magnitude:

- 1. Systemic Risk Management**

- 2. Incorporation of Environmental, Social, and Governance Factors in Credit Analysis and Investment Banking & Brokerage Activities**

- 3. Lending Practices, Selling Practices & Discriminatory Lending**

- 4. Customer Privacy & Data Security**

- 5. Environmental Risk to Mortgage Properties**

- Let's go through them in greater details

1. SYSTEMIC RISK MANAGEMENT

▪ **Potential incorporation of ESG into regulatory capital requirements**

- ✓ Changes to the regulatory regime, including regulatory capital buffers and calculations by local or supranational regulators
- ✓ How regulators incorporate ESG issues in their existing frameworks, particularly the stress-testing process (for example, the ECB and BOE have included Climate Change aspects in their annual stress-testing process)
 - Systemic changes in the regulatory capital regime, such as changes to the stress-testing process or regulatory capital risk weighting, often require permanent changes to internal risk/compliance/treasury functions, among others. This can lead to higher operating expenses, as banks may have to spend more on an ongoing basis in response to these types of changes.
- ✓ Regulatory capital requirements play a primary role in management decisions over organic/inorganic growth opportunities and capital return considerations
- ✓ However, with European banks generally over-capitalised, introduction of buffers is unlikely to compromise capital return capabilities or banks' ability to take advantage of growth opportunities

2. ESG INTEGRATION INTO BANKS' ACTIVITIES

- **Ability to Manage Opportunities and Risks From ESG Integration into Long-Term Strategies**
 - ✓ The banking sector has not escaped the growing societal pressure for greater corporate action on ESG responsibility. Banks are able to have a distinct positive ESG impact through provisions of both credit and investment banking services
 - ✓ The main focus currently is on the environmental side, specifically on the current non-ESG portfolios that exist in the banks' loan books, as well as on the origination side, continued financing of various non-ESG industries (e.g., non-renewable energy producers), and providing more favourable credit to ESG industries (e.g., green loans and bonds)
 - ✓ In terms of investment banking activities, focus is on disclosure on revenue from underwriting, advisory, and securitization transactions incorporating integration of ESG factors, by industry
- **Environmental concerns will dominate the conversation on ESG impact**
 - ✓ How will banks reduce commercial exposure to non-ESG-friendly industries?
 - ✓ How will they integrate ESG into their business models, specifically on portfolio ESG mix and green financing?

3. LENDING AND SELLING PRACTICES

- **Revenue opportunities and potential non-operating one-off expenses**
 - ✓ With banks' unique and critical role in the economy, banking **consumer protections** are given special consideration. Throughout recent history, questionable lending and selling practices across the banking sector have had material repercussions for the sector. Regulators have imposed significant fines and required customer compensation that have totaled tens of billions of dollars
 - ✓ However, it is not all negatives; on the social impact side, governments are committing greater levels of funding to reduce socioeconomic inequality. Banks are well positioned to benefit from initiatives generally focused on opening up new markets for lending and savings products to previously untouched segments of the markets. Specifically, we are seeing governmental bodies willing to either share credit risk on lending products or fund incentives for savings products to/for these markets
- The key near-term catalysts are any announcements from regulators of any investigations relating to lending/selling practices. On medium- to long-term timescales, comments made by regulators regarding future areas of focus for consumer protections

4. CUSTOMER PRIVACY & DATA SECURITY

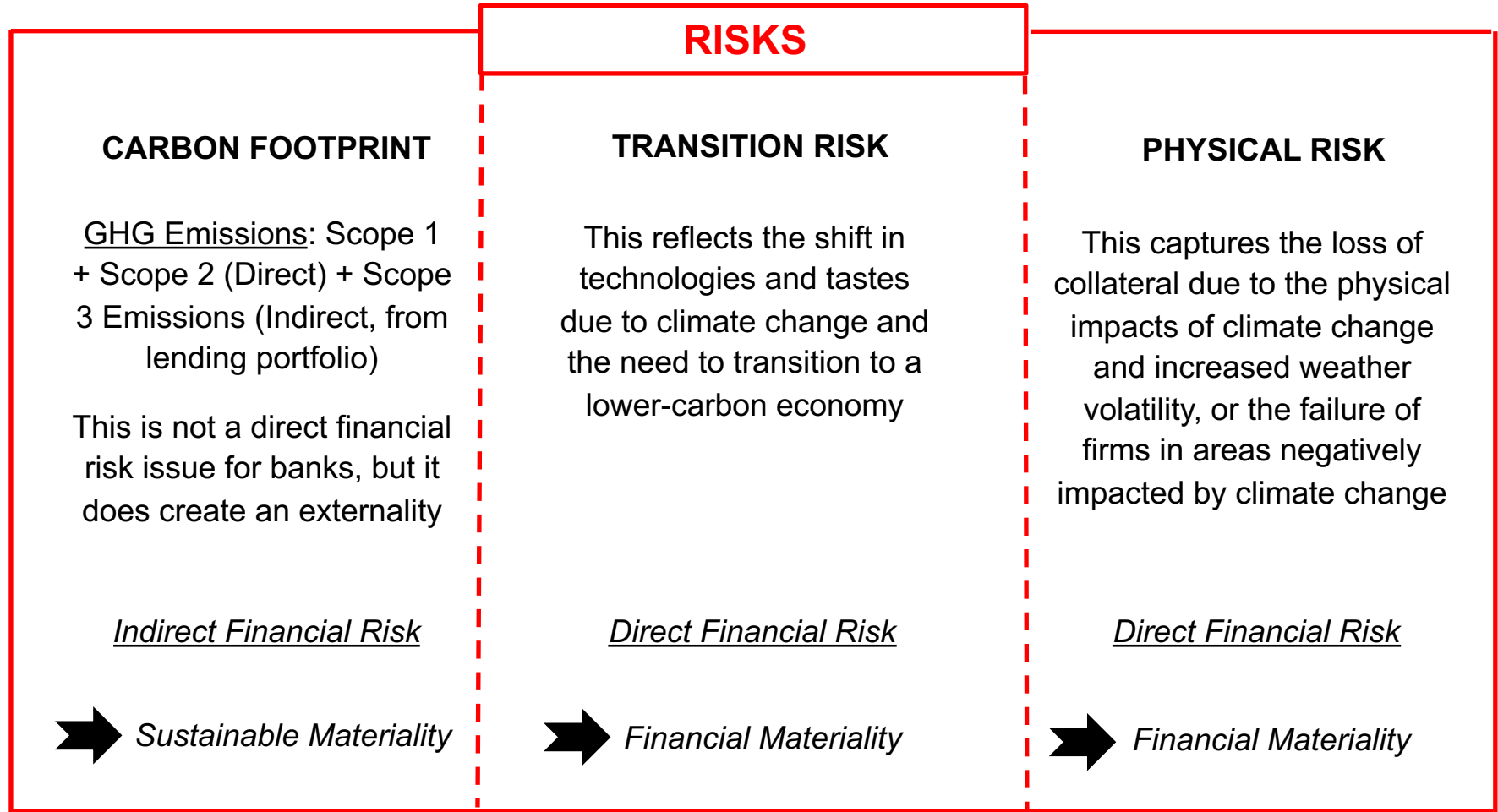
- **Potential risks to revenue, operating expenses, assets, and cost of capital**
 - ✓ With the banking sector adopting greater levels of **digitization, security and privacy of customer data** has also become increasingly important
 - Regulatory scrutiny on protecting customer data (e.g., GDPR) has also increased accordingly
 - ✓ The adoption of **cloud-based infrastructure** has brought exponential computing power, flexibility, and scalability to banking operation and enabled the rollout of digital banking, allowing unparalleled access to customers. However, the benefits have come at the cost of exposing banks to **cyberattacks** at previously unseen scales
 - ✓ With the banks having tremendous amounts of sensitive information on clients, **investing heavily in core tech infrastructure** to defend against continually evolving, sophisticated cyberattacks is just as important as tech investments that improve/expand product capabilities
- **Banks will have to allocate a significant portion of overall technology budgets to areas such as cybersecurity**, as well as current initiatives aimed to ensure that customer data is secure

5. ENVIRONMENTAL RISK TO MORTGAGE PROPERTIES

- **Revenue opportunities and potential risks to operating expenses, assets, and cost of capital**
 - ✓ Mortgage lending generally makes up a significant part of European banks' loan books, with credit secured against real estate
 - ✓ Real estate is particularly susceptible to environmental risks, with weather events driven by climate change able to greatly impair the value of the properties. Under IFRS9, banks are required to take provisions for potential credit losses based on the expected probability of negative scenarios occurring
 - ✓ As environmental risks continue to grow, the probability of negative events are expected to increase, driving higher credit losses for banks holding significant mortgage portfolios
 - ✓ Banks with mortgage exposures in regions with lower environmental risk susceptible to climate change impacts are likely to see lower potential credit loss requirements, as will those banks that have been active in diversifying their geographic concentration risks

C. CLIMATE CHANGE AND ITS IMPACT ON BANKS

CLIMATE CHANGE AND ITS IMPACT ON BANKS



OPPORTUNITIES

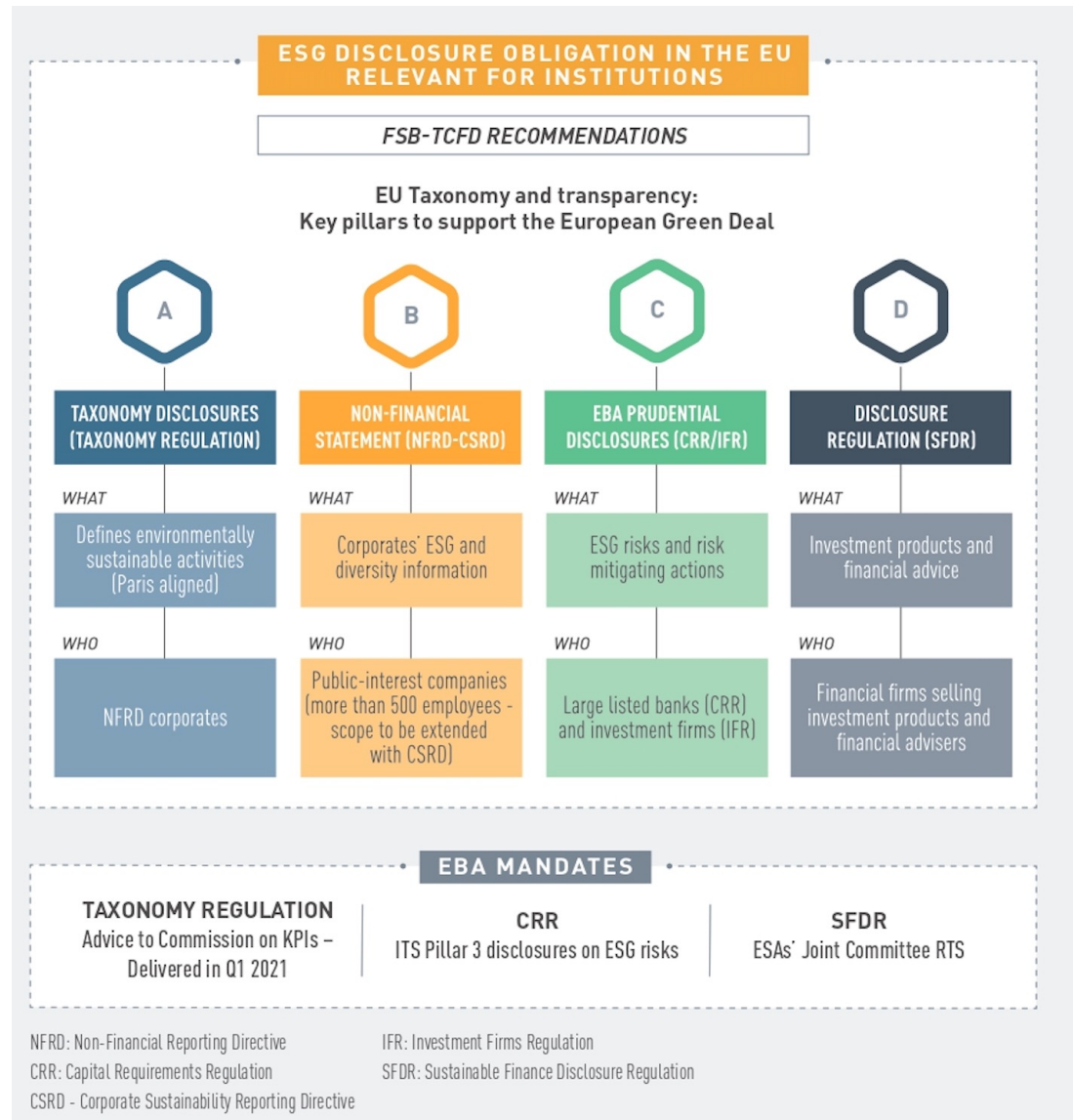
Revenue, New Markets: As demand for credit from ESG-friendly industries increases, banks will see opportunity to expand into these growing markets (e.g., clean energy, sustainable transportation, etc.) — for instance, banks have been increasingly active in the issuance of green bonds, sustainable bonds, and sustainability-linked loans

THE ROLE PLAYED BY BANK REGULATORS

Changes on the horizon for the Basel Capital Accord?

- Climate change is increasingly being examined by regulators including the US Federal Reserve, the Bank of England and the European Central Bank as a material threat to the stability of the global financial system
- As part of the European Action Plan to unleash green financial flows, the European Union Commission declared to be taking a deeper look into introducing a **Green Supporting Factor (GSF)** to amend banks' capital charges to boost sustainable lending. Particularly, the GSF would lower capital requirements for certain climate-friendly loans
- Recently, the ECB said a stress test revealed rising global temperatures are “a major source of systemic risk” because of the probability of mass loan defaults from thousands of corporate borrowers
- As a result, Bank Regulators appear to be preparing to raise the amount of capital required at lenders they considers to have disproportionately high levels of climate risk on their balance sheets

ESG DISCLOSURE REGULATIONS FOR EU BANKS



Source: EBA (2022), “ESG Disclosures in the EU: Financial Institutions”, January,
<https://www.eba.europa.eu/eba-publishes-binding-standards-pillar-3-disclosures-esg-risks>

EBA SUMMARY OF ESG DISCLOSURES-PILLAR 3

	WHAT TO DISCLOSE?	EXAMPLES OF DISCLOSURES
RISK DISCLOSURES	CLIMATE CHANGE TRANSITION RISK Information on exposures to sectors or assets that may highly contribute to climate change	<ul style="list-style-type: none"> ▶ Exposures to fossil fuel companies excluded from sustainable climate benchmarks, and to other carbon-related sectors ▶ For real estate exposures, distribution of the exposures by energy performance of the collateral
	CLIMATE CHANGE PHYSICAL RISK Risk exposures subject to extreme weather events (sector/geography)	<ul style="list-style-type: none"> ▶ Assets subject to impact from chronic climate change events by sector and geography ▶ Assets subject to impact from acute climate change events by sector and geography
MITIGATING ACTIONS	Actions that support counterparties in the transition to a carbon neutral economy but that do not meet taxonomy criteria	▶ Building renovation loans that improve the energy efficiency of the building but do not meet the taxonomy screening criteria
	Actions that support counterparties in the adaptation to climate change but that do not meet taxonomy criteria	▶ Loans to build barriers against flooding, or water management mechanisms against draughts but to not meet the taxonomy screening criteria
GREEN ASSET RATIO	Information on exposures towards NFRD Corporates and Retail financing taxonomy-aligned activities consistent with Paris Agreement goals that contribute substantially to climate change mitigation (CCM) and adaptation (CCA), including information on transitional and enabling activities.	<ul style="list-style-type: none"> ▶ Contributing to CCM: Generation of renewable energy ▶ Enabling CCM: Manufacture of renewable energy technologies ▶ Contributing to CCA: Afforestation ▶ Enabling CCA: Engineering activities for adaptation to climate change
BANKING BOOK TAXONOMY ALIGNMENT RATIO	Information on exposures towards non-NFRD corporates not assessed in the GAR financing taxonomy-aligned activities consistent with Paris Agreement goals, contributing substantially to CCM and CCA. Simplified assessment, based on bilateral information and estimates.	
QUALITATIVE DISCLOSURES	Qualitative information on environmental, social and governance risks	<ul style="list-style-type: none"> ▶ Governance arrangements ▶ Business model and strategy ▶ Risk management

- Among the various ESG disclosures, EU Banks will have to disclose the Green Asset Ratio (GAR) in their Pillar 3
- The GAR aims to show the alignment of banks' balance sheets with the EU taxonomy
- In formula, the GAR is expressed as green exposures (as defined by the EU-taxonomy) as a % of total exposures
- On January 24, 2022, EBA delayed the date of application of the GAR disclosure by one year, until 2024 for data as of end-2023
- Financial Materiality: The GAR can have an impact on Banks' cost of funding (both debt and equity)

D. WHAT'S NEXT FOR EU BANKS IN ESG INTEGRATION?

ESG INTEGRATION: WHAT'S NEXT FOR EU BANKS?

- **Banks play a crucial role in the financing of business**, both of SMEs and larger companies. In the credit evaluation process, borrowers will have to provide banks with **ESG-related information**
- **Banks will have to work with companies to create and standardize information in order to address ESG data gaps**, particularly with respect to unlisted counterparties and SMEs
 - ✓ The revision of the Non-Financial Reporting Directive (NFRD) will provide a stimulus in this regard: the new scope will extend the reporting requirements to unlisted companies (and, in the future, to SMEs)
- **ESG data & metrics will therefore play an important role in the lending process**, and their integration will have a major **influence on Banks' IT infrastructures**
- In this context, the **adoption of organized and automated procedures** that allow for the timely collection and analysis of data appears to be a **prerequisite for a successful ESG integration**

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