

Sustainable Finance

Banks and ESG

“Supervision, Risks & Profitability 2023”

ABI, Associazione Bancaria Italiana

<https://basilea.abieventi.it/>

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Milan - June 7, 2023

AGENDA

Executive Summary

A. Banks and their ESG Role

B. Integrating ESG into Lending Activities

C. ESG Regulations for Banks: Focus on Climate Change

D. What's Next for EU Banks in ESG Integration?

References

EXECUTIVE SUMMARY

ESG Shift in European Banks - Challenges and Opportunities

- From Compliance to Business Focus:
 - ✓ ESG attracts investors, employees, and customers
 - ✓ European banks emerge as key players in ESG transition during the pandemic

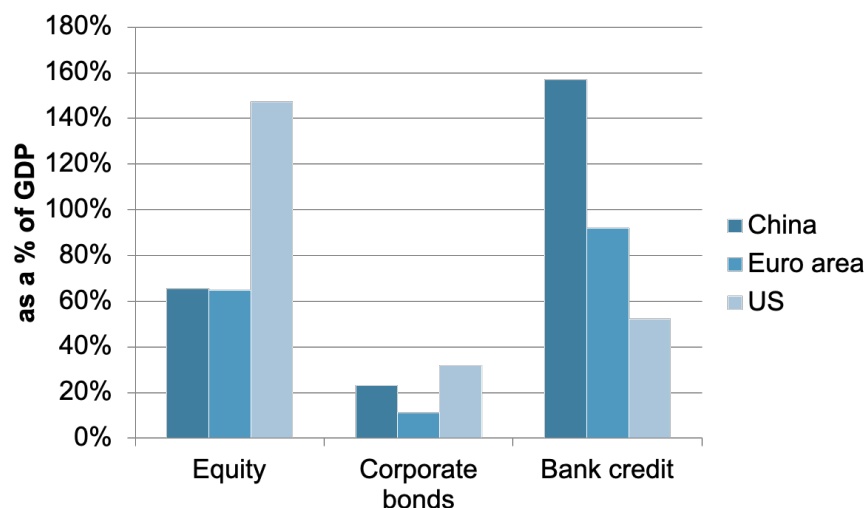
- The EU Green Deal:
 - ✓ Goal: reduce greenhouse gas emissions by at least 55% by 2030
 - ✓ Requires investment in decarbonization, energy efficiency, and sustainable business models
 - ✓ Banks to support green firms and transitioning companies

- Regulatory Priorities:
 - ✓ Align banks with net-zero by 2050
 - ✓ ESG disclosure regulations: EU Taxonomy, CSRD, SFDR, EBA-related rules
 - ✓ Incorporate ESG issues, starting with climate change, into risk management and capital requirements

A. BANKS & ESG

THE ROLE OF BANKS IN CAPITAL MARKETS

- 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 300 banks across 80 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

SASB MATERIALITY MATRIX FOR BANKS

- According to SASB, few ESG factors are financially material for Banks. Let's take a look at these indicators

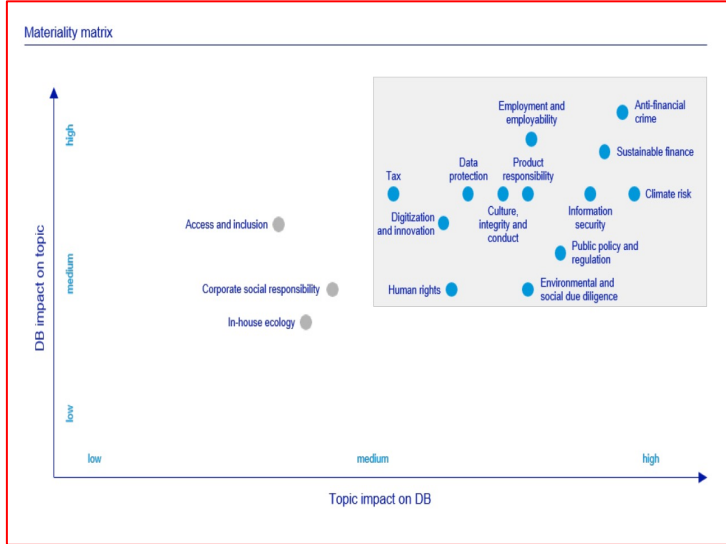
| | | Consumer Goods | Extractives & Minerals Processing | Financials | | | | | | |
|-----------------------------|--|-----------------|-----------------------------------|---------------------------------------|------------------|------------------|-----------|--------------------------------|------------------|--------------------------------|
| Dimension | General Issue Category [Ⓞ] | Click to expand | Click to expand | Asset Management & Custody Activities | Commercial Banks | Consumer Finance | Insurance | Investment Banking & Brokerage | Mortgage Finance | Security & Commodity Exchanges |
| Environment | GHG Emissions | | Material | | | | Material | | | |
| | Air Quality | | Material | | | | Material | | | |
| | Energy Management | Material | Material | | | | Material | | | |
| | Water & Wastewater Management | Material | Material | | | | Material | | | |
| | Waste & Hazardous Materials Management | | Material | | | | Material | | | |
| | Ecological Impacts | | Material | | | | Material | | | |
| Social Capital | Human Rights & Community Relations | | Material | | | | Material | | | |
| | Customer Privacy | Material | | | | Material | Material | | | |
| | Data Security | Material | | | Material | Material | Material | | | |
| | Access & Affordability | | | | Material | | Material | | | |
| | Product Quality & Safety | Material | | | | | Material | | | |
| | Customer Welfare | | | | | | Material | | | |
| | Selling Practices & Product Labeling | Material | Material | Material | Material | Material | Material | Material | Material | Material |
| Human Capital | Labor Practices | Material | Material | | | | Material | | | |
| | Employee Health & Safety | Material | Material | | | | Material | | | |
| | Employee Engagement, Diversity & Inclusion | Material | Material | | | | Material | Material | | |
| Business Model & Innovation | Product Design & Lifecycle Management | Material | Material | | | | Material | Material | | Material |
| | Business Model Resilience | Material | Material | | | | Material | | | |
| | Supply Chain Management | Material | Material | | | | Material | | | |
| | Materials Sourcing & Efficiency | Material | Material | | | | Material | | | |
| | Physical Impacts of Climate Change | | Material | | | | Material | | Material | Material |
| Leadership & Governance | Business Ethics | | Material | Material | Material | | Material | Material | | Material |
| | Competitive Behavior | | Material | Material | Material | | Material | Material | | Material |
| | Management of the Legal & Regulatory Environment | | Material | Material | Material | | Material | Material | | Material |
| | Critical Incident Risk Management | | Material | Material | Material | | Material | Material | | Material |
| | Systemic Risk Management | | Material | Material | Material | | Material | Material | | Material |

Source: <https://materiality.sasb.org/> - SASB Materiality Map

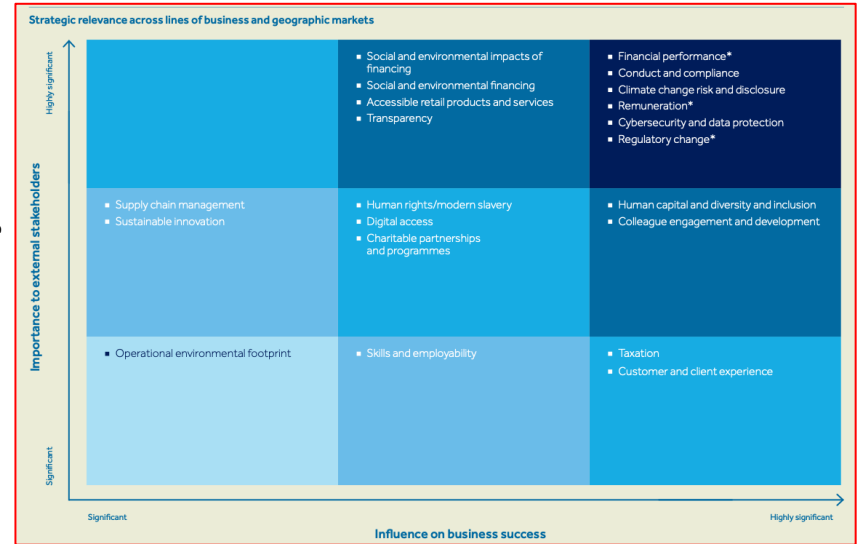
BANKS' MATERIALITY MATRICES

- Following best practices for companies, Banks have started to present a materiality matrix that outlines those sustainability issues that a bank and its stakeholders consider most material

Deutsche Bank



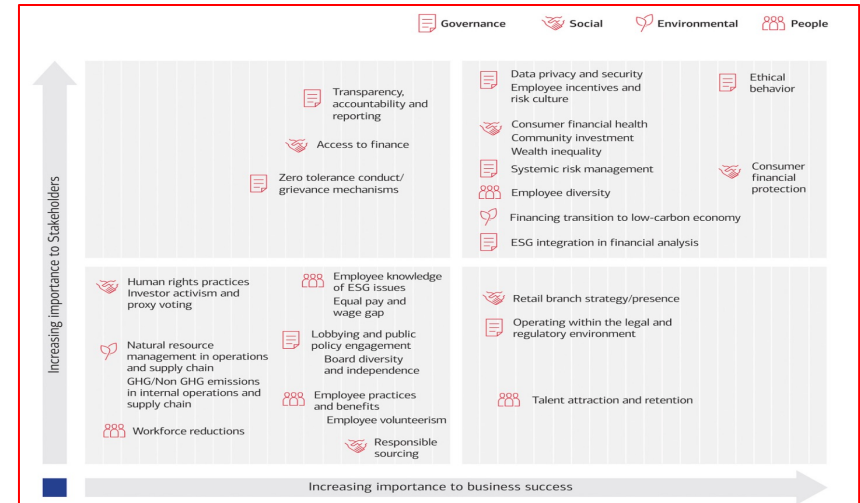
Barclays



ING



Bank of America



B. ESG INTEGRATION INTO LENDING ACTIVITIES

WHY DOES SUSTAINABILITY MATTER TO LENDING?

- In their origination and monitoring role, there is an opportunity for banks to collect more information on firms, including ESG factors and risks. Banks can thus analyze sector-wide sustainability trends and discover best practices
- Banks can in turn transfer these best practices in sustainability back to firms in their advisory role. In that way, banks can help firms with their transition to sustainable business models
- It's therefore important for banks, when granting loans, to consider the full impact of sustainability on a company's business model, because that affects the company's credit risk
 - *What are the transition challenges for the company's sector? How far is the company in the transition of its business model, also in comparison with its sector peers?*
- Sustainability also has an impact on collateral values
 - The energy efficient or real estate is, for example, a key determinant of its future value. Similarly, real estate values are also exposed to physical risk from extreme weather events

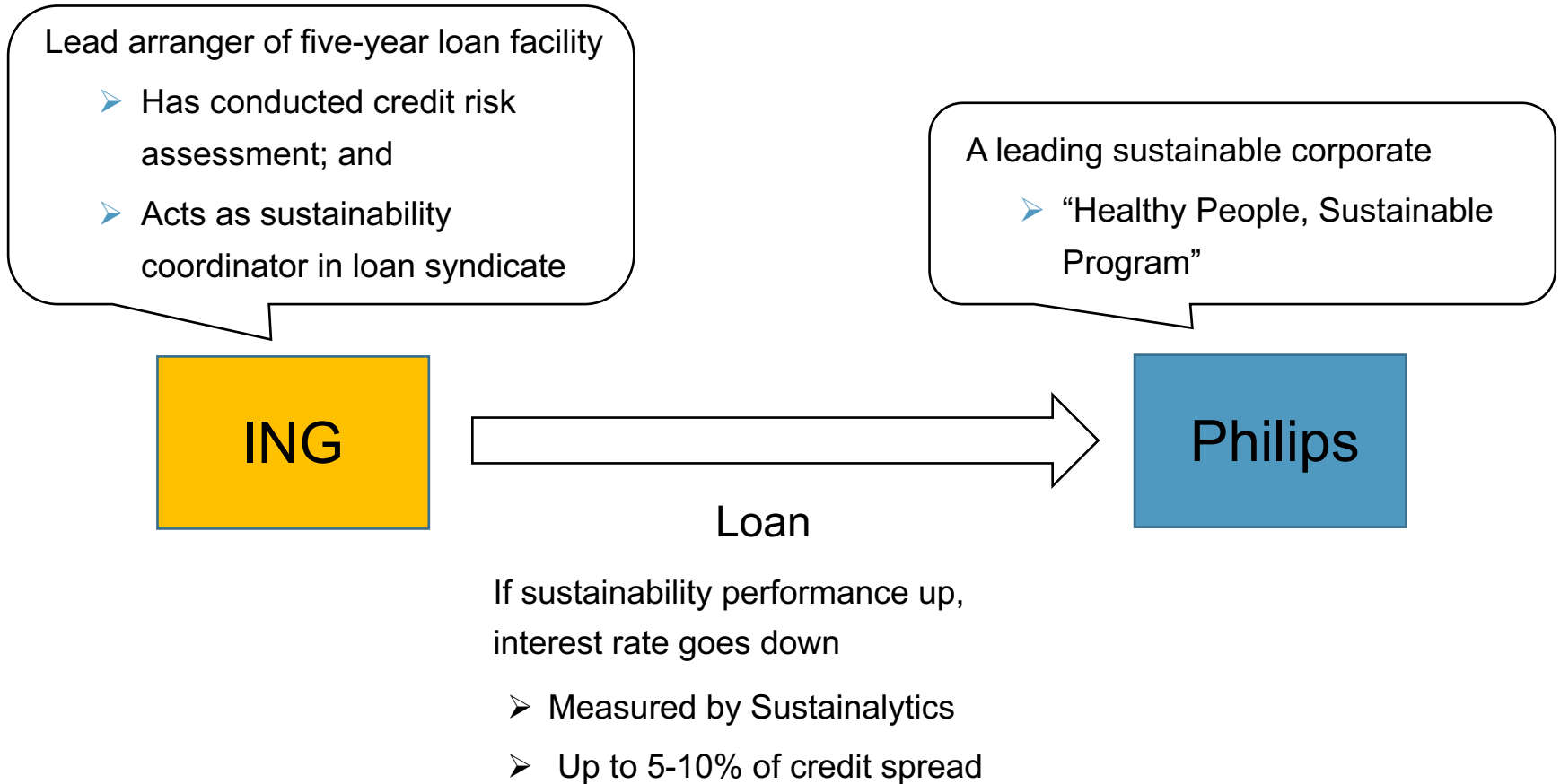
INTEGRATING ESG INTO LENDING ACTIVITIES

- From a risk-based standpoint, various social and environmental factors and risks are included in the credit risk analysis. These risks can affect both the probability of default and the recovery rate
- Academics showed that the inclusion of ESG factors into banks' credit risk scoring systems can improve the outcome of these models:
 - ✓ Weber, Scholz, Michalik (2010): The inclusion of ESG factor into a bank's credit scoring system for private firms improves the prediction of defaults/non-defaults by 5% (Business Strategy and the Environment)
- Researchers also proposed Sustainability Credit Score Systems for banks:
 - ✓ Zeidan, Boechat, Fleury (2015): they developed a credit scoring system that integrates the sustainability of companies and of their industries into a business as usual ratings-based model. They explicitly recognized that sustainability is about the future (Journal of Business Ethics)
- As these credit score models have not yet been widely implemented by banks, there is still no hard evidence that incorporating sustainability into credit score systems leads to less defaults. *The issue is also complicated by the private nature of banks' borrowers: currently available ESG scores and analytics only cover public companies for which sustainability information is available*

INCORPORATING ESG INTO LOAN PRICING

- **Sustainability-linked Loans:** Loans, usually revolving credit facilities, whose interest rate is partially adjusted (a premium or discount is usually applied to the margin) depending on the evolution of the borrower's sustainability performance
 - This sustainability performance may either be assessed based on external ESG ratings or KPIs, on the reaching of internal sustainability targets measured internally or externally
- The first loan of this kind was granted by ING to Royal Philips, a health technology company, who agreed in April 2017 to a revolving credit facility agreement of \$1 billion with a margin linked to the company's sustainability performance improvement, as measured by Sustainalytics' ESG ratings
- The second one, in February 2018, involved Danone who subscribed a €2 billion loan, issued by a banking pool coordinated by BNP Paribas, with an adjustment of margins every 12 months based on both (1) the average of ESG scores as measured by Sustainalytics & Vigeo-Eiris, and (2) its transformation to a B-Corp Certified Group
- Sustainable loans are raised most actively in the European and US markets, making up 76% of the sustainable loan market in 2022 (around \$700 bln, increase > 300% year-on-year from 2020)

THE FIRST SUSTAINABILITY-LINKED LOAN (APRIL 2017)



Philips is then incentivized to improve its sustainability, while ING reduces the sustainability risk of its loan

EXAMPLES OF SUSTAINABILITY-LINKED LOANS (1)

- **Example 1** – Loan to Sun Communities Operating Ltd. Partnership (June 2021)

Section 1.01. Defined Terms (page 17) - **SEC Link**

- *Notwithstanding the foregoing, if at the end of any fiscal year (commencing with the fiscal year ending December 31, 2021) **the Borrower’s Sustainability Rating for such fiscal year is more favorable than its Sustainability Rating for the immediately preceding fiscal year (the “Sustainability Metric”)**, in each case as certified by the Borrower to the Administrative Agent with supporting information as reasonably required by the Administrative Agent, **the Applicable Rate shall decrease by one basis point** (but not to below zero percent (0%) per annum) from the Applicable Rate that would otherwise be applicable; provided that on each annual anniversary of such change to the Applicable Rate, the Applicable Rate shall revert to the original grid set forth above unless and until the Sustainability Metric for the preceding year has been satisfied*
- *“Sustainability Rating” means the environmental social and governance (ESG) rating obtained by the Borrower from Dow Jones, S&P, GRESB or any similar index reasonably approved by the Administrative Agent*

EXAMPLES OF SUSTAINABILITY-LINKED LOANS (2)

- **Example 2** – Loan to Jabil Inc. (April 2021)

Section 1.01. Defined Terms (page 61) - **SEC Link**

- *“Sustainability Margin Adjustment” with respect to any Pricing Certificate for any fiscal year, an amount (whether positive, negative or zero), expressed as a percentage, calculated as the sum of the **adjustments for each KPI Metric, determined as follows:***
 - *an increase of 0.0133% (0.0134% for GHG Emissions Intensity) if the applicable KPI Metric for such fiscal year is worse than the applicable Penalty Threshold set forth for the applicable KPI Metric in the Sustainability Table for such fiscal year*
 - *0.0000% if the applicable KPI Metric for such fiscal year does not surpass the applicable Discount Threshold set forth for the applicable KPI Metric in the Sustainability Table*
 - *a decrease of 0.0133% (0.0134% for GHG Emissions Intensity) if the applicable KPI Metric for such fiscal year surpasses the applicable Discount Threshold set forth for the applicable KPI Metric in the Sustainability Table for such fiscal year*

THE EQUATOR PRINCIPLES IN SUSTAINABLE LENDING

- The **Equator Principles (EPs)**, launched in 2003, provide a due diligence framework for banks to manage the social and environmental risk of financing large projects
- As of February 2022, 138 Financial Institutions in 38 countries have officially adopted the EPs, covering the majority of international project finance debt within developed and emerging markets
- The Principles were originally drawn up to address the sustainability impact of Project Finance. This is a long-term method of financing where lenders are repaid primarily through revenues generated by a specific project – typically large and complex installations such as power plants or mines
- The framework ensures that these projects are developed and operate in accordance with good international environmental and social standards. The signatories will not provide loans to projects where the Client will not, or is unable to, comply with the EPs
- These principles have benefits but also limitations. In fact, there is no mechanism to monitor adherence to the principles by member banks - there is a requirement to report, but the EP Association doesn't verify the contents

THE 10 EQUATOR PRINCIPLES

1. Review and categorization: When a client proposes a project for financing, the bank categorizes the project in one of three categories: A. Projects have potential significant adverse social or environmental impacts that are diverse, irreversible or unprecedented; B. Projects have potentially limited adverse social or environmental impacts that are few in number, generally site-specific, largely reversible and readily addressed through mitigation measures; C. Projects have minimal or no social or environmental impact

2. Environmental and social assessment: A mandatory prerequisite for the client seeking financing and required to be done to the satisfaction of an Equator Principle Financial Institution (EPFI)

3. Applicable environmental and social standards:

The social and environmental assessment would have to be conducted in tune with the socio-environmental standards obtained in the country or jurisdiction of the project. For projects located in countries without a proper regulatory and institutional framework, the IFC (International Financial Corporation) performance standards apply

4. Environmental and social management system: For projects with potential adverse risks, the bank requires the client to develop or maintain an environmental and social management action plan

5. Stakeholder engagement: This is required for category A and B projects. It requires the client, host country or third-party expert to engage with affected communities in a culturally appropriate manner, seeking their free, informed and prior consent about the project

6. Grievance mechanism: The EPs require that the client establish a grievance mechanism appropriate to the level of risks and adverse impacts of the projects and whose existence should be brought to the attention of the affected communities

7. Independent review: The EPs require an “independent expert” – independent of the borrower – to review documents on social and environmental assessment, environmental and social management systems, and environmental performance assessment procedures to inform on the due diligence process

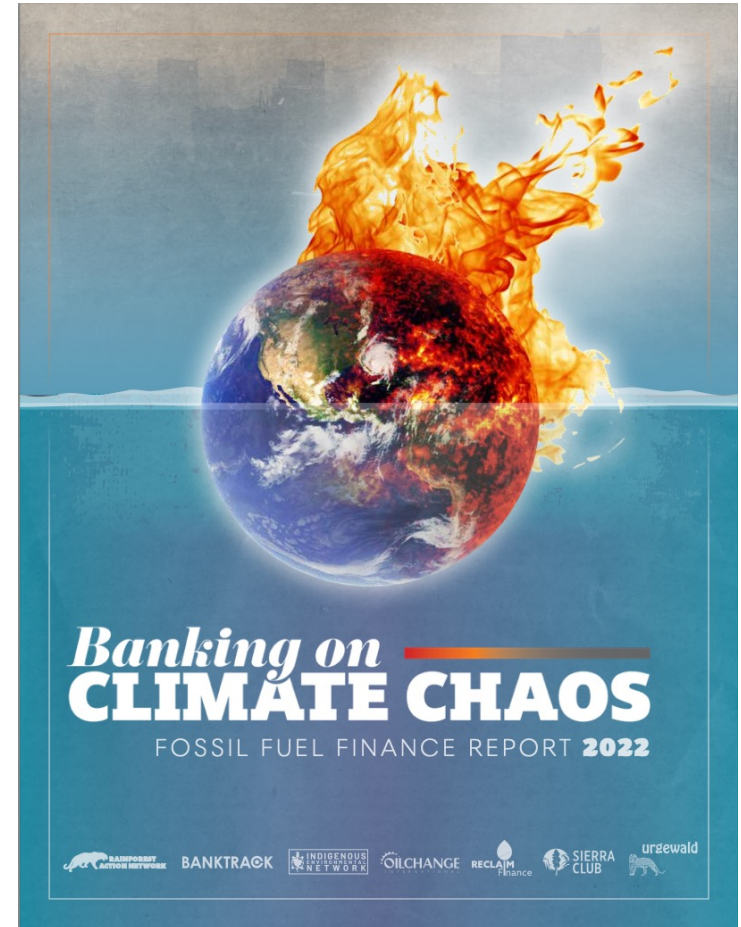
8. Covenants: This refers to covenants with the host country, compliance with the assessment procedure, periodic reports and, where applicable and necessary, a decommissioning plan

9. Independent monitoring and reporting: A client will retain an independent monitoring and reporting expert for category A and B projects where “appropriate”

10. Reporting and transparency: The EPFIs will annually report on their implementation outcomes or report frequently or scaled to the severity of potential risks

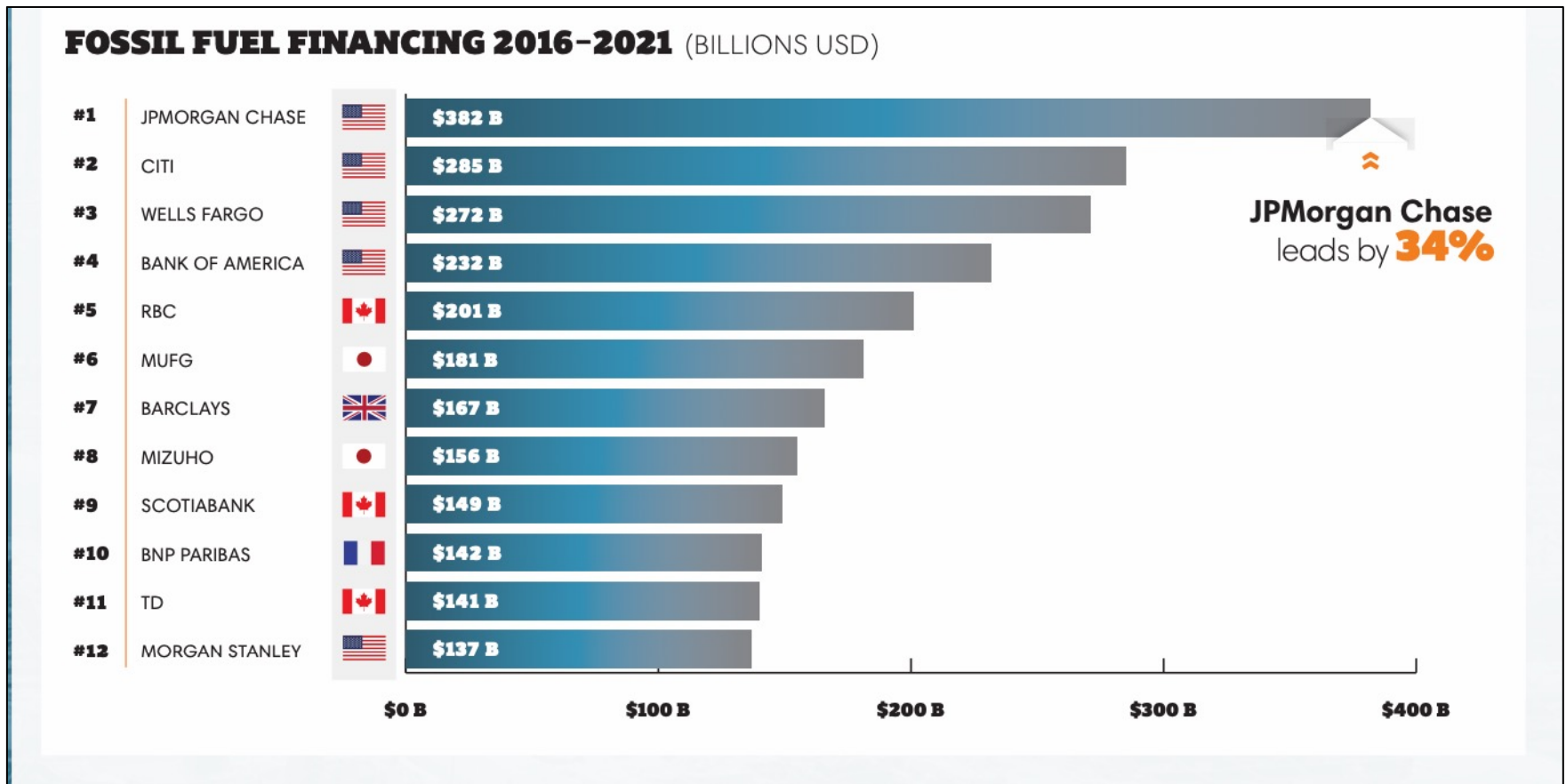
ARE BANKS WALKING THE TALK?

- A recent report shows that many of the world's largest banks, who committed to achieve “net zero” financed emissions, are still active funders of fossil fuels
- Global banks provided \$742bn in financing to coal, oil and gas companies in 2021, despite many having pledged to back the Paris climate accord and cut their funding for fossil fuels
- In total, the world's 60 largest banks have provided \$4.6tn to fossil fuel companies since 2016, when the Paris agreement came into effect
- Even with fossil fuel demand falling during global lockdowns, banks still provided more capital to oil, gas and coal companies in 2021 than they did in 2016 and 2017



ARE BANKS WALKING THE TALK?

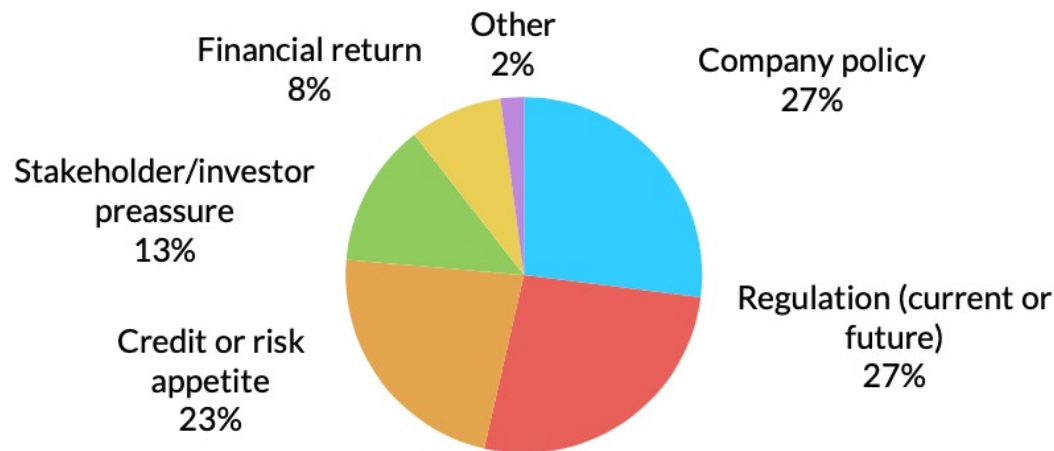
- US banks continue to be the largest financiers of fossil fuel companies
 - *JPMorgan Chase remained the leading player with \$382bn of funding provided through lending and underwriting since 2016. In 2021, JPM increased the amount of financing by around \$10bn*



FACTORS DRIVING USE OF ESG IN BANK LENDING

- According to a recent survey by Fitch, company policies and regulation were jointly the most important drivers behind incorporating ESG into banks' lending activities. This reflects in part the view that banks are increasingly taking the issue seriously and that pressure from potential regulatory changes is increasing
- Whereas banks in Europe, Asia and Latin American highlighted the role of regulations as a driver for ESG incorporation into lending, their peers in North America saw credit or risk appetite as the most important driver for ESG integration

Most relevant factors driving ESG

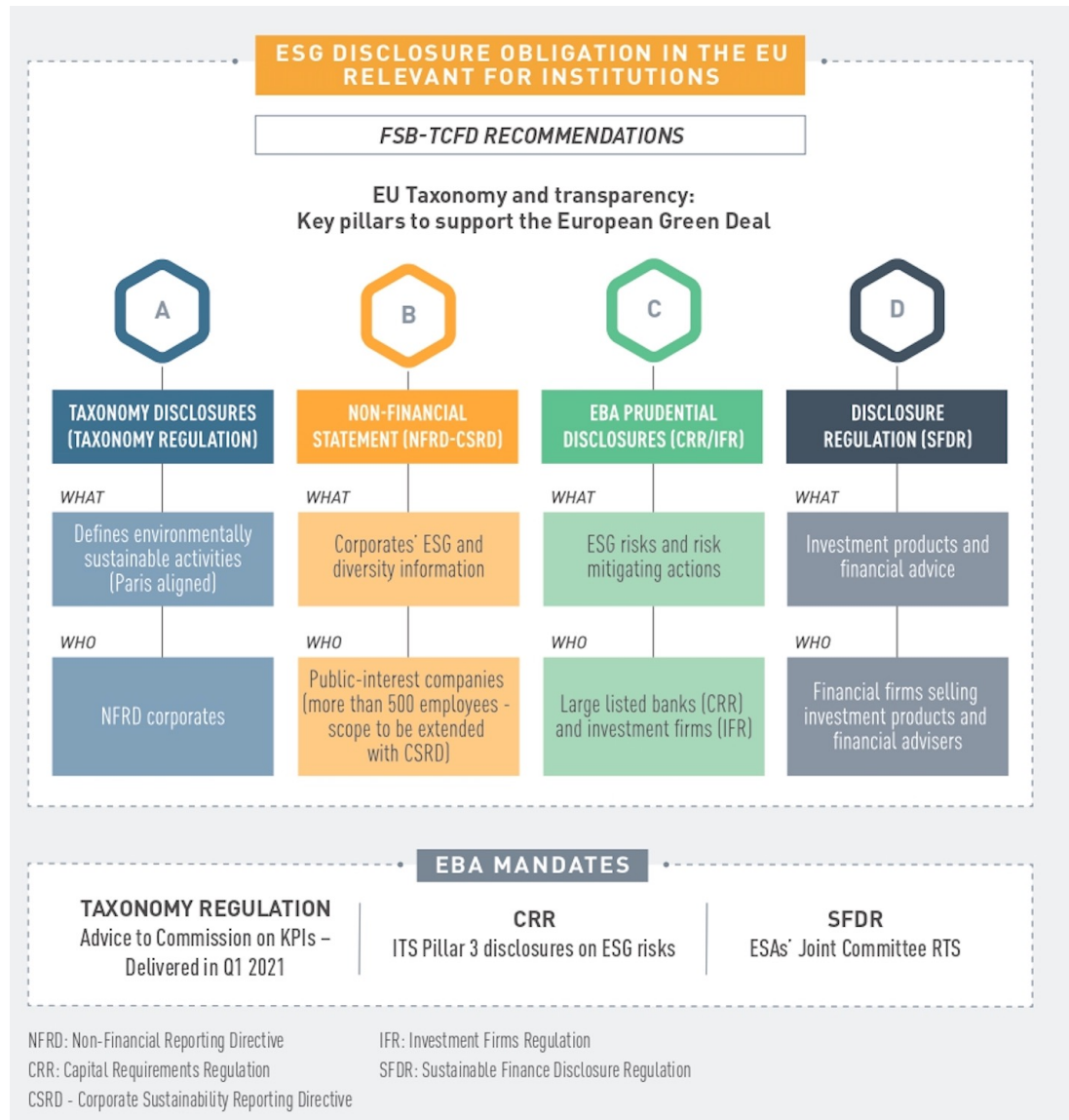


BARRIERS TO SUSTAINABLE LENDING

- **Banks need to train their Account Managers** to understand social and environmental risks and also to include ESG in due diligence and calculation of credit risk premium
- **Status quo of existing Clients** – Clients may not appreciate a higher risk premium due to unsustainable activities. Account managers may be reluctant to fully impose such premiums on clients with whom they have a long-standing relationship
 - A solution taken by banks is to ban unsustainable activities. For example, in November 2017 BNP Paribas pulled back from lending to tobacco companies due to the health negative impact on the health of its customers: <https://group.bnpparibas/en/press-release/bnp-paribas-announces-measures-financing-tobacco-companies>
- **Maturity of Bank Loans is typically < 10 years**, while ESG factors play out over longer term (but may materialize much sooner than expected).
 - Bankers may thus ignore these risks in their short to medium term credit decisions

C. ESG REGULATIONS FOR BANKS: FOCUS ON CLIMATE CHANGE

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 do 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 |

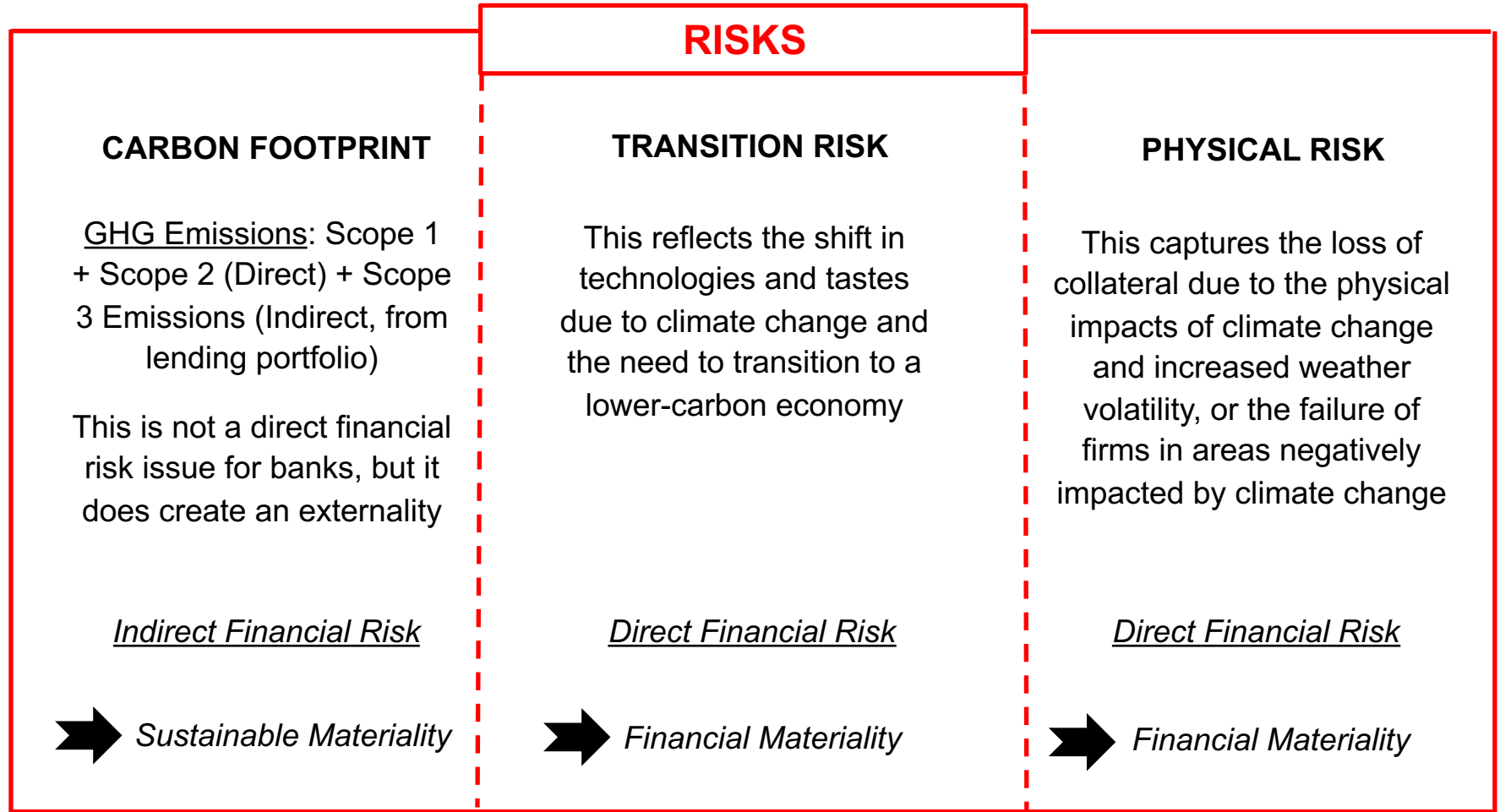
- Among the various ESG disclosures, EU Banks will have to disclose the Green Asset Ratio (GAR) in their Pillar 3
- The GAR aims to show the alignment of banks' balance sheets with the EU taxonomy
- In formula, the GAR is expressed as green exposures (as defined by the EU-taxonomy) as a % of total exposures
- 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)

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 launched a stress test on Climate Changes for several European Banks. The Fed will run a similar stress test in 2023 for 6 large US Banks
- As a result, Bank Regulators appear to be preparing to raise the amount of capital required for lenders with disproportionately high levels of climate risk on their balance sheets
- However, **current ESG regulations remain limited to disclosure requirements**

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

EUROPE – THE ECB’S BANK STRESS TEST

The ECB launched the first Climate Stress Test on Banks in March 2022 and then published the results in July

- The ECB proposed a three-module climate stress test, with 104 banks involved in Modules 1 and 2, and 41 in Module 3:
 - ✓ Module 1: **Questionnaire** on banks' ability to conduct climate stress tests, covering frameworks, governance, scenarios, and whether or not climate risk stress test results are integrated into business strategy decisions.
 - ✓ Module 2: **Benchmark study** to provide insights into the sensitivity of banks' income to transition risk and their exposure to carbon emission-intensive industries.
 - ✓ Module 3: **Bottom-up stress test using scenario analysis**. As part of this approach, the ECB developed two broad types of risk scenarios: those focusing on the **long-term** (what happens to banks' balance sheets over the course of the next thirty years) and those focusing on the **short-term** (the next one-to-three years)

EUROPE – THE ECB’S BANK STRESS TEST

Focus on Module 3: Bottom up stress test using scenario analysis

Climate Change scenarios

Key Outcomes

| <i>Long-term</i> | Orderly Transition | Disorderly Transition | Hot House World |
|--|---|---|--|
| Average increase in global temperature | 1.5°C | 2°C | 3°C |
| Amount of CO2 emissions | Global net zero CO2 emissions reached around 2050 | Global net zero CO2 emissions reached around 2050 | Global CO2 emissions remain relatively constant until 2050 |
| Level of Transition Risk | Relatively low | High | Relatively low |
| Level of Physical Risk | Relatively low | Relatively low | Increase until the end of the century |

- Banks are vulnerable to an increase in transition risk in the short-term which could lead to material increase in credit risk impairments
- Cumulatively, credit and market losses are estimated to c.EUR70bn for aggregate of 41 banks in the short-term disorderly transition and the two physical risk scenarios
- Over the long-term transition (30-year horizon) the losses are notably lower in orderly transition scenario vs. where transition policies are phased in late (disorderly) or not at all (hot house world)

| <i>Short-Term</i> | Transition Risk | Physical Risk | |
|-------------------|---|---------------------------------|-----------------------|
| | <i>Carbon Tax</i> | <i>Drought & Heat Risk</i> | <i>Flood Risk</i> |
| Horizon | 3 years (2022-2024) | 1 year (2022) | 1 year (2022) |
| Credit Risk | Corporate Loans (including SME, CRE) + Mortgages | Corporate Loans (including SME) | Mortgages + CRE loans |
| Market Risk | Bonds + Stocks issued by non-financial companies | Not covered | Not covered |
| Operational Risk | Operational and Reputational risks assessed via a qualitative questionnaire | | |

USA – THE FED’S BANK STRESS TEST

- The Federal Reserve announced in September 2022 that six large banks would participate in a pilot climate scenario analysis exercise designed to enhance the ability of supervisors and firms to measure and manage climate-related financial risks
- During 2023, the Fed will kick off the analysis and the six banks, **JPMorgan, Bank of America, Citigroup, Goldman Sachs, Morgan Stanley, and Wells Fargo**, will analyse the impact of the scenarios on specific portfolios and business strategies
- **This will be the Fed's first public effort to evaluate the level and management of risks for banks as it relates to climate change**, which could inform a process for how banks lend and manage risk in the future
- However, the caveat is that the test is "exploratory in nature", meaning that it will not have capital or supervisory consequences, and will not result in firm-specific information being published but rather aggregate findings.

SEC: CLIMATE-RELATED DISCLOSURES IN THE USA

Listed US Banks will be impacted

- On March 21st, the Securities and Exchange Commission issued a proposal on Climate-related disclosures - [LINK](#)
- On January 4 2023, the SEC updated its 2023 rule-making agenda, setting Q2 2023 as the release date of its final climate-related disclosure rule
- Under the proposed guidelines, publicly traded companies would need to disclose the following climate information in their 10-K:
 - Overarching discussion about the prospective risks and material impacts on the business, strategy and outlook caused by climate change, in line with the Task Force on Climate-Related Financial Disclosures (TCFD) disclosures
 - Scope 1 and 2 greenhouse gas emissions and material Scope 3 emissions
 - Additional qualitative and quantitative climate risk disclosures, including the financial impacts
 - Governance of climate-related risks and risk-management processes
 - Requirement to support plans to comply with companies' advertised environmental claims (e.g., net-zero commitments)

SEC: CLIMATE-RELATED DISCLOSURES IN THE USA

Key Quantitative Requirements

- **Scope 1** (direct emissions from owned or controlled sources) and **Scope 2** (indirect emissions from purchased electricity, steam, heat and cooling consumed by the reporting company) GHG emissions, broken out by GHG, in the aggregate, and in absolute (not including offsets) and intensity terms
 - ✓ Accelerated or large accelerated filers must obtain an attestation report from an independent attestation service provider covering, at minimum, Scope 1 & 2 GHG emissions disclosures
- **Scope 3** (all other indirect emissions occurring in a company's value chain; up & downstream) GHG emissions, only to be disclosed if material, or if the registrant has set a GHG emissions target/goal that includes Scope 3 (the proposed rule includes a safe harbor for liability for this disclosure)
 - Smaller reporting companies (those with <\$250 million in public float) are exempted from Scope 3 disclosures
 - The SEC will follow the standards of the **Greenhouse Gas Protocol**, the most widely accepted GHG accounting standards

ESG BACKLASH (JUST IN THE USA...)

What Next for Purpose-Driven Companies?

- While there's a wealth of evidence supporting the critical role of ESG factors in Capital Markets, not all parties see eye to eye on this issue
- Currently, the United States is experiencing a counter-current, with various conservative states mounting a backlash against ESG
- Critics argue that investors do not need access to all material information about companies to ensure they are investing responsibly. I think they should. Disclosure is not political; it is a tool to make sure markets work properly
- Just few days ago (May 23, 2023), I joined forces with a team of 130 professors from leading American universities to publish a letter expressing our collective concern over this unfolding situation:
<https://www.freedomtoinvest.org/academic-signatories/>

Key Takeaways of our Academic Letter

1. **ESG Attacks:** We express concern over attacks on ESG screening, sustainable investing, and stakeholder capitalism. We advocate for investor access to ESG information
2. **Disclosure:** Disclosure is viewed not as political, but as a tool for market functionality and protection against risks like climate change, water scarcity, and economic inequality
3. **ESG Framework:** ESG is a framework for assessing impacts on a company's bottom line, protecting against risk, and identifying new business opportunities
4. **Corporate Claims:** The letter acknowledges criticisms of corporate ESG performance claims. It notes ongoing regulatory work to ensure credibility and vetting of these claims
5. **Science-Based Efforts:** The need for science-based efforts is stressed to ensure asset managers fulfill their fiduciary duty, particularly in light of global challenges like climate change, water scarcity, and poverty
6. **Academic Work:** Links to academic work on ESG are provided to aid understanding of its strengths and weaknesses

**D. WRAP-UP:
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**
- While the potential introduction of new capital requirements in response to ESG risks is a key challenge for banks, **the current quality of ESG data is subpar**, delaying any imminent implementation
- **ESG issues not only pose new risks but also offer fresh business opportunities for banks**

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Q&As