ESG Viewpoint

Climate risk management in the banking sector

May 2021

Influencing financial intuitions for the future

- Banks are under increasing regulatory and commercial pressure to protect their balance sheets from the impacts of climate change, and to contribute to the achievement of net zero greenhouse gas emissions by 2050 or earlier.
- We targeted 30 global and regional financial institutions for engagement around gaps in their approach to integrating climate change in the areas of governance, risk management, scenario analysis and disclosures.
- In 2020, we introduced a dedicated climate voting policy covering companies in high-impact industries. Under this policy, we will vote against selected management resolutions at companies that fail to meet our minimum standards.
- Going forward, we will incorporate the lessons learnt from our engagement to hold increasingly informed discussions with a wider range of financial institutions. Ultimately, we want to help boards drive long-term sustainable differentiation in the marketplace for their firms, meet evolving stakeholder expectations, and manage climate risks and opportunities effectively.

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Our engagement expectations

Banks are under increasing regulatory and commercial pressure to protect their balance sheets from the impacts of climate change, and to contribute to the achievement of net zero greenhouse gas emissions by 2050 or earlier. They must act to embed climate-related risks in their business operations and risk management frameworks. Doing so will not only help them mitigate transition and physical risks to their own operations and portfolios, but also identify opportunities to finance the transition to a low-carbon economy.

As part of a dedicated engagement project, we targeted 30 global and regional financial institutions for engagement (24 based in developed markets and 6 in emerging markets) – mostly banks but also a handful of insurance companies. We sought to encourage firms to address gaps in their approach to integrating climate change in the areas of governance, risk management, scenario analysis and disclosures.

In our engagement, we asked companies to:

- **Implement robust climate change governance frameworks**: Boards of directors are crucial in the governance of climate-related risks and opportunities. We have encouraged firms to designate clear accountability for climate within the board, and to ensure that their boards have the right knowledge and tools to discharge this duty.
- **Enhance climate risk management**: We asked banks to integrate climate considerations into their financial risk management policies and frameworks, covering both lending and underwriting activities. We also expect banks and insurers to conduct climate scenario analysis and stress testing to help assess their resilience to climate change, and inform their climate risk management and wider strategic planning.
- **Provide robust disclosure**: we strongly encourage firms to report on their approach to managing climate risks and opportunities using the Taskforce for Climate-related Financial Disclosures (TCFD) framework.

Discussions about firms' approach to fossil fuel financing were an essential part of our engagement. According to a report by the Rainforest Action Network, **the world's 60 largest banks have provided $3.8tn to fossil fuel companies since 2016, when the Paris agreement came into effect**. The scale of continued lending presents a potential systemic financial risk, as fossil fuel assets could become stranded, leaving the banks exposed to bad debt.

Most of our engagement has been on a one-to-one basis, but we have collaborated where we have seen this has more impact and is in line with our objectives. We joined an investor collaboration led by specialists Asia Research and Engagement to engage Japanese and Chinese banks, and became active members of the banking workstream within the Institutional Investors Group on Climate Change (IIGCC) that will engage with over 25 banks in North America, Europe and Asia to encourage alignment with the goals of the Paris Agreement.

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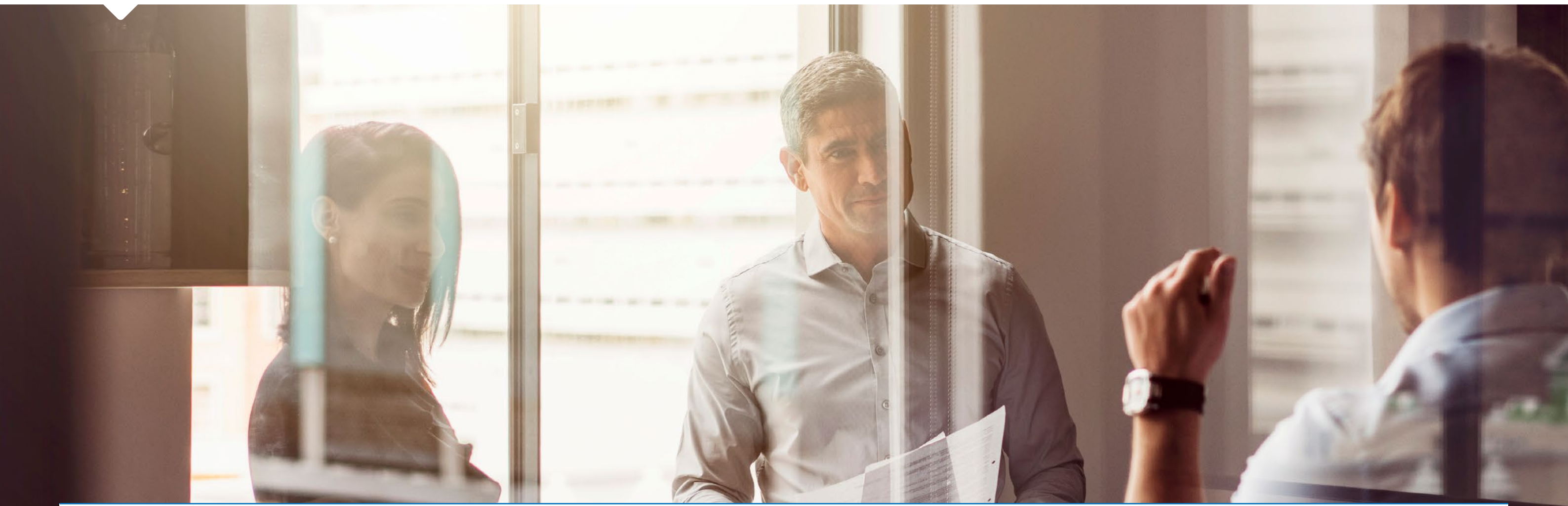


Key findings

We have engaged banks and other financial institutions on climate risk management for over 10 years. However, the focus achieved by developing and executing a dedicated engagement project has helped accelerate progress.

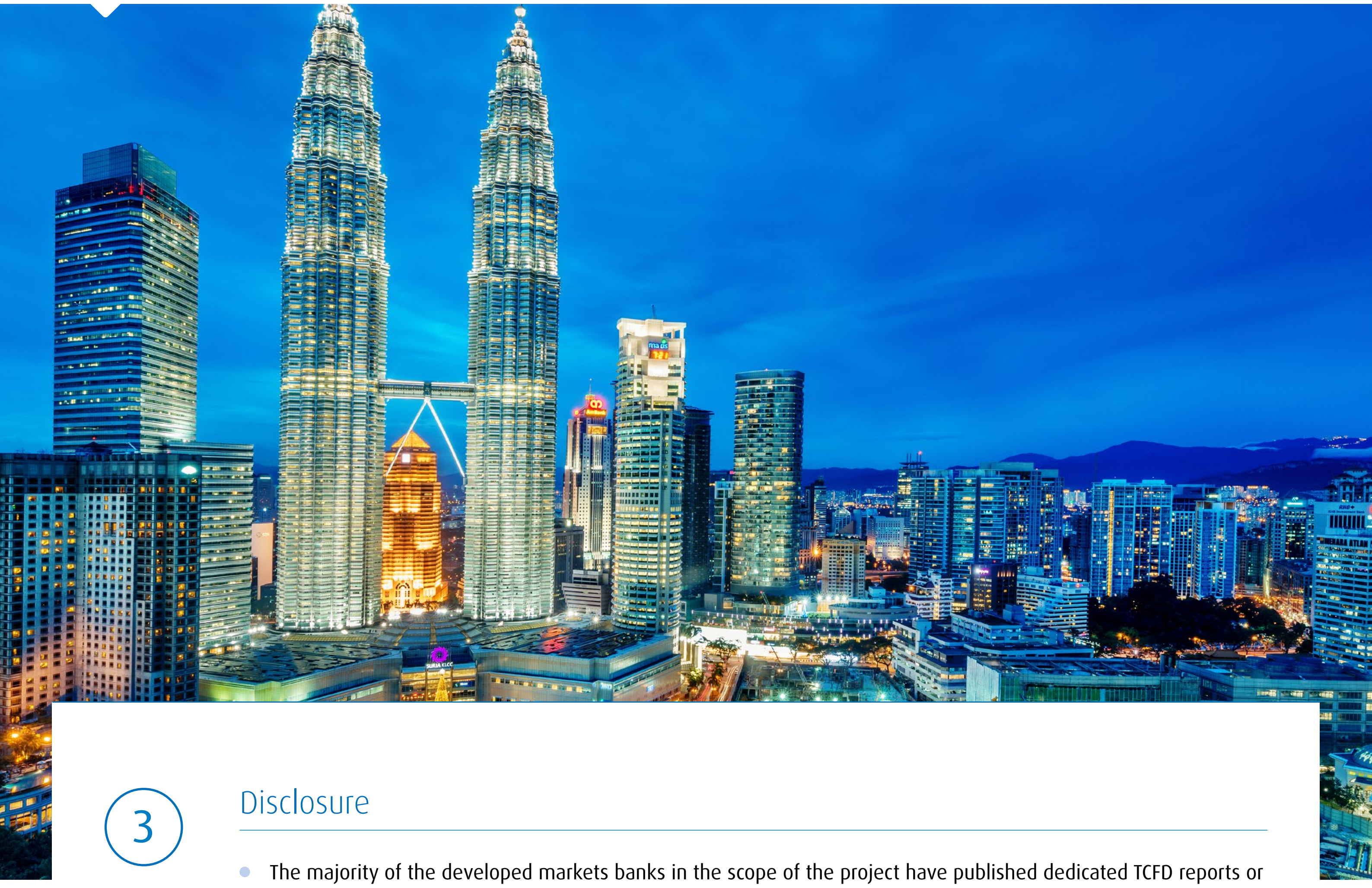
1 Governance frameworks

- A growing number of banks confirm that their boards have responsibility for overseeing management of climate-related issues.
- Increased attention to climate issues has resulted in the creation of executive committees or new roles to oversee climate risk management activities at a handful of banks, including **Barclays**, **HSBC**, **Citigroup** and **ING**.
- However, bar a few exceptions such as **UBS**, there is still significant room for improvement in implementation in terms of accountability, capacity building, transparency and disclosure, and incentivisation.
- The success of the Say on Climate campaign has caught the eye of a few banks that we have engaged with. We encouraged them to consider preparing and submitting their climate plans to a shareholder vote.

2 Risk management

- Environmental risk due diligence processes, including climate change, broadly focus on lending and project financing activities, with clear gaps regarding risks stemming from underwriting or trade finance. Again, UBS is leading the pack in this regard, fully integrating environmental and social risk management process across business lines.
- Banks are increasingly performing climate change stress testing and scenario analysis, but scope tends to be limited. These assessments are generally performed for one or two high-impact sectors, and little detail on assumptions used or outcomes is provided. We acknowledge this is a complex process, and that banks are still building capacity, but expect efforts to accelerate and disclosure to improve in the coming years. We welcome the work of industry initiatives such as the UNEP FI[1] TCFD Task Force to advance the development and implementation of climate change related stress testing. **Barclays**, **Santander** and **Mizuho**, among others, are active members of the Task Force.

[1] The UNEP FI (United Nations Environment Programme Finance Initiative) seeks to bring together banks, insurers and investors to create a sustainable finance sector



3 Disclosure

- The majority of the developed markets banks in the scope of the project have published dedicated TCFD reports or included TCFD-aligned reporting in their annual or sustainability reporting. We support such progress but note that reports are usually missing sufficient details on climate-related implications for strategy and financial planning, as well as on metrics and targets used to assess and manage relevant climate-related issues. We highlight the TCFD reports from **Societe Generale**, **Banco Santander** and **UBS** as examples of good practice – they provide extensive information on practices along the four key areas of governance, strategy, risk management and metrics & targets. **Barclays**' climate dashboard – which also references underwriting – can be considered industry-leading. We expect that developments around making TCFD reporting and underlying practices mandatory in various markets (such as the UK), will force banks to accelerate their efforts.

4 Banks in emerging markets

- Banks in emerging markets significantly lag their peers in developed economies. All the firms we spoke to in these markets are aware of the risks they face from climate change, and some have already explicitly included climate in their risk factors. However, most of them have not yet set up appropriate governance frameworks or developed robust strategies, which leads to their climate-related disclosures being very limited. We note that their focus seems to be on climate opportunities, i.e. helping finance the transition to a low carbon economy, more than on risks. Chinese banks in particular have ambitious green finance objectives.
- Our engagement, individual or collaborative, has unfortunately not led to substantial movement in climate risk management at banks in emerging markets. That said, we have seen some banks take meaningful steps in the right direction, notably Malaysia's **CIMB**, which announced its decision to exit coal financing by 2040, and Thailand's **Kasikornbank**, which has performed and published climate scenario analyses for high impact industries in its lending portfolios.

> Net zero commitments are a welcome development, but they need to be supported by clear emissions reduction pathways.

Our take on net zero

We have seen a wealth of commitments to net zero financed emissions (referring to those greenhouse gases emitted by entities that receive financial services, such as loans). The six largest US banks[2] have now committed to net zero, and so have most of the major European banks. Most pledges are around having "net zero financed emissions by 2050".

We welcome these pledges, but have concerns that long-term ambitions, on their own, are insufficient to address the scale and urgency of the challenge. Net zero commitments need to be supported by clear emissions reduction pathways that feature short and medium-term science-based targets; considerations around capital markets businesses, such as underwriting; and strategies to exit coal financing, and review continued support for the wider fossil fuels industry. We also expect reporting, in line with the Task Force on Climate-related Financial Disclosures. Finally, we support the introduction of "Say on Climate" votes, which help investors hold companies to account on the quality of their strategies.

[2] JP Morgan Chase, Bank of America, Goldman Sachs, Wells Fargo, Citigroup and Morgan Stanley

HSBC was receptive to engagement, though it took a considerable amount of investor pressure through collaborative initiatives, and a separate shareholder resolution, to achieve meaningful progress.

Case study:
HSBC and coal financing

As one of the largest banks globally with a substantial footprint in Asia, HSBC is a crucial actor for climate risk management and financing the energy transition. Its strategy has lagged behind its peers and general market development, only issuing an inaugural climate strategy in 2020, which did not include underwriting targets or a comprehensive coal exit commitment.

Over the course of 2020 and early 2021, we had seven interactions with the bank, including several meetings with the Chair, the CEO and the Head of Sustainable Finance, as well as extensive exchanges with Investor Relations. We discussed the bank's climate strategy, and its hesitation to stop coal financing.

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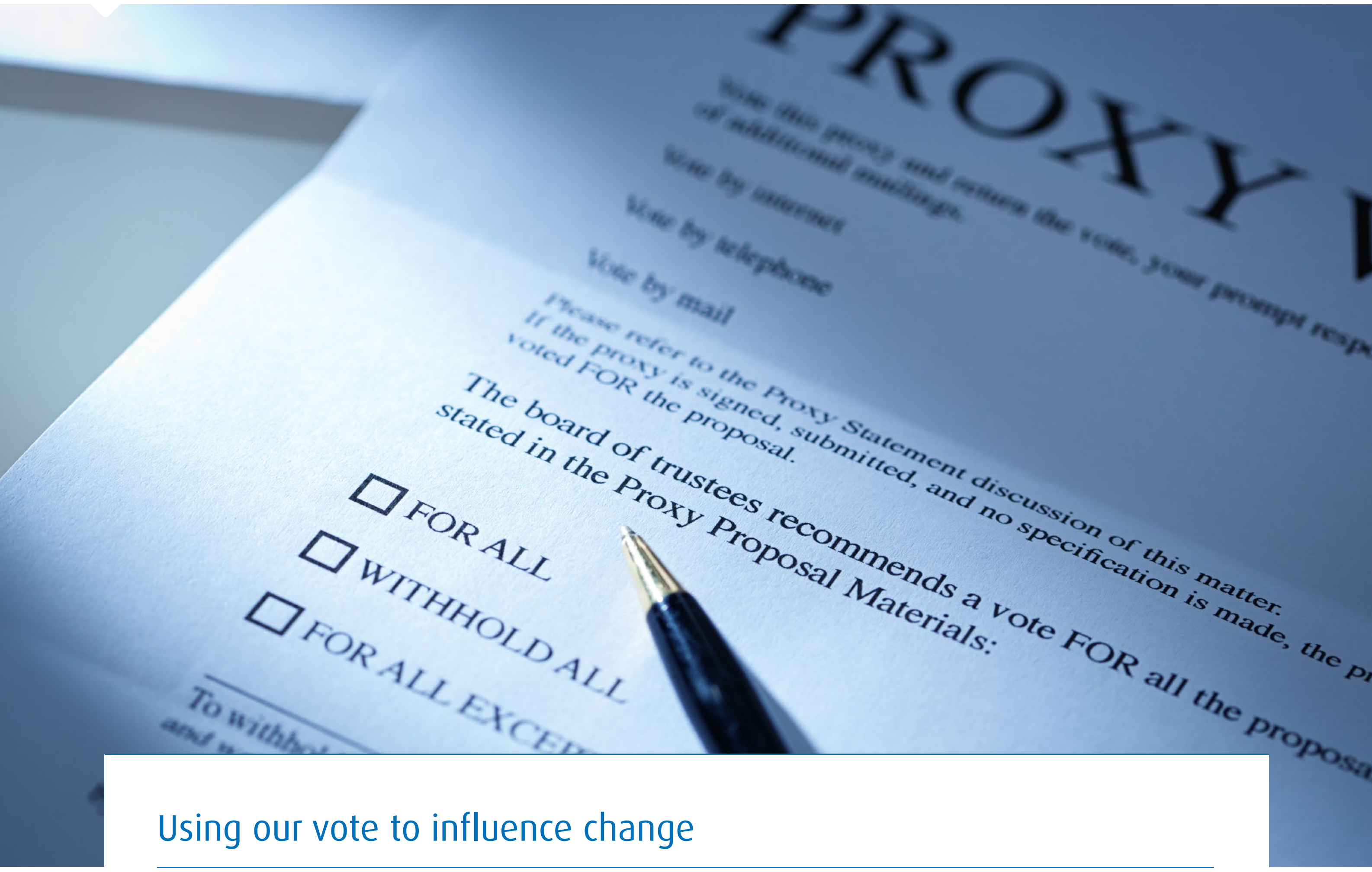
In early 2021, HSBC committed to phase out financing (including project finance, corporate finance and underwriting) of coal-fired power and thermal coal mining in the EU and OECD countries by 2030 and other regions by 2040. We will closely monitor the implementation of this commitment.



Using our vote to influence change

In 2020, we introduced a dedicated climate voting policy covering companies in high-impact industries, including financials. Under this policy, we will vote against selected management resolutions at companies that fail to meet our minimum standards.

For the top 100 banks and insurance companies (based on market capitalisation), we require them to:

(A) Acknowledge climate change has an impact on their business. This can be done e.g. by listing climate change as a risk factor in the annual report or their 10-K filing.

(B) Annually report against the CDP framework[3].

If our research shows that a bank has both a robust exit strategy regarding coal financing and adequate public TCFD-aligned reporting, then we may judge this acceptable even if the above criteria are not met. Otherwise, we will cast a vote against an appropriate resolution.

As a consequence of implementing our policy, in 2020 we voted against 61 management resolutions, such as the re-election of directors, at 58 companies in the financials, oil & gas, utilities and mining sectors.

We will evaluate dedicated shareholder proposals for financial institutions on climate change, climate risk management, enhanced reporting or linked topics on a case by case basis.

In 2021 we further enhanced the scope of the policy, looking at the top 150 banks and insurers by market capitalisation, and at financial institutions where BMO GAM has a substantial holding. We also introduced a deforestation filter for banks that score "0" at Forest500's evaluation. We consider this relevant as deforestation plays a crucial role for climate change and, therefore, will push firms to develop as part of their climate risk management strategies lending and underwriting due diligence criteria for clients or transactions that are potentially contributing to deforestation (e.g. forestry, palm oil, soy, cattle/dairy farming).

[3] If considered in scope by CDP, i.e. asked to report.

Next steps

Sustainable finance, including robust climate risk and opportunity management, is expected to be a crucial factor in the post Covid-19 economic recovery period. Going forward, we will incorporate the lessons learnt from our engagement so far to hold increasingly informed discussions with the firms under the scope of this project and with a wider range of companies – especially those still at the beginning of their climate change risk management journey. We look forward to continuing to collaborate with like-minded investors to encourage the industry align its various activities with the goals of the Paris Agreement, as well as to push for a more conducive regulatory environment.

Ultimately, we want to help boards drive long-term sustainable differentiation in the marketplace for their firms, meet evolving stakeholder expectations, and manage climate risks and opportunities effectively.

Responsible Investment – a glossary of terms

Its wide-ranging nature means that responsible investment involves a host of associated language and jargon. Here we explain some of the most commonly used terms.

Explore our glossary

Get to know the authors

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