FIG in Focus

Volume 6 / Dec 2021

Embracing ESG: What will it take?

FIG in Focus is a collection of topical insight pieces from Adeva Partners.

This month's edition will draw your attention to some of the key issues that challenge lenders and investors in their effort to pursue more rigorous ESG policies. For those who invest in bank shares and/ or have credit and counter party exposure to banks, we must learn how to assess ESG risk and the adverse impact it could have which ultimately, could jeopardise our repayment / exit.

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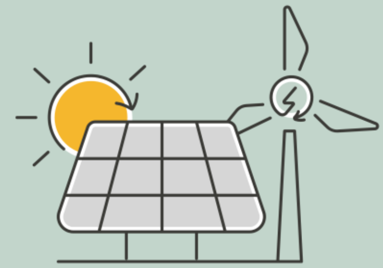
What we will cover:

- Regulation: Can regulators force change?
- Climate-related and environmental risk drivers
- Next steps on Climate-related financial disclosures.

Can regulators force change?



In May 2021 the **European Central Bank (ECB)** completed its first assessment of 112 banks' preparedness to deal with increased climate and environmental risks. Lenders' readiness was found lacking. The ECB has instructed Eurozone banks to improve climate change risk plans or they may, eventually, face higher capital requirements.

What now? ECB has directed banks to stress test the impact of various climate change scenarios on their business and articulate their plans for how they will adapt their business models to address these risks. Earlier this year, the Bank of England required banks to stress test the impact of climate change on their risk profile. Quantifying potential impact this risk has on their capital adequacy; results are not expected until May 2022.

Many banks and investors are pledging to make their portfolios net zero by 2050 and have joined the UN-convened Net Zero Banking Alliance. **Net zero targets** imply a company will achieve a balance between the amount of greenhouse gas emissions produced and the amount removed from the atmosphere by a set date. This allows for carbon offsetting to achieve their targets. Measuring a bank's climate impact requires new data points to be collected (or proxied); methodologies are now being developed and refined. There is a lot of work to be done.

How might lenders suffer loss if they are not more proactive? Consider lending activity to the most energy sensitive sectors, or losses from real estate loans if values of less energy efficient buildings fall.

Below is an extract from a chart produced by the ECB in their May 2021 report on "Mapping climate risk: Main findings from the EU-wide pilot exercise". It shows the most vulnerable sectors exposures to different risks.

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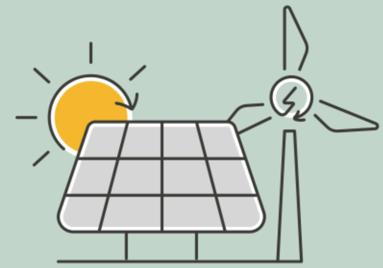
Can regulators force change?



	Fossil Fuel	Utility	Energy Intensive	Buildings	Transportation
Mining	78%		20%		
Manufacturing	10%		50%		18%
Electricity, gas steam	15%	85%			
Construction				60%	15%
Transportation & Storage	3%				90%
Real estate				100%	

% of total exposure

The ECB assessment pointed not only to credit, but also to market and operational risks. On the following page, a table from the ECB Guide on climate-related and environmental risks, highlights the key areas of concern. The ECB report also outlines the regulator's expectations for disclosure, which can be found on page 5.

As you will see, the risks are segmented between physical and transitional. In the context of climate change, transition risk is the risk inherent in changing strategies, policies or investments as society and industry work to reduce its reliance on carbon and impact on the climate.

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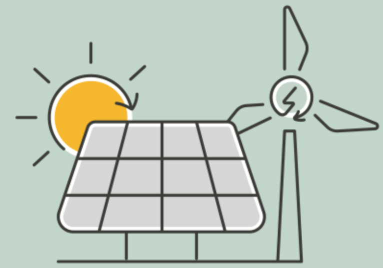
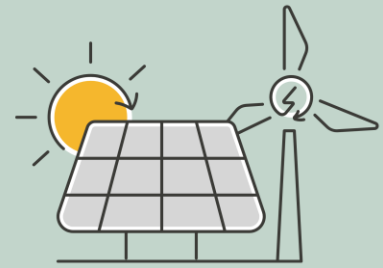
Supervisory expectations relating to risk management and disclosure



Risk Affected	Physical		Transition	
	Climate-related	Environmental	Climate-related	Environmental
	Extreme weather events Chronic weather patterns	Water stress Resource scarcity Biodiversity loss Pollution	Policy & regulation Technology Market sentiment	Policy & regulation Technology Market sentiment
Credit	The probabilities of default (PD) and loss given default (LGD) of exposures within sectors or geographies vulnerable to physical risk may be impacted, for example, through lower collateral valuations in real estate portfolios as a result of increased flood risk.		Energy efficiency standards may trigger substantial adaption costs and lower corporate profitability, which may lead to a higher PD as well as lower collateral values.	
Market	Severe physical events may lead to shifts in market expectations and could result in sudden repricing, higher volatility and losses in asset values on some markets.		Transition risk drivers may generate an abrupt repricing of securities and derivatives, for example for products associated with industries affected by asset standing.	
Operational	The bank's operations may be disrupted due to physical damage to its property, branches and data centres as a result of extreme either events		Changing customer sentiment regarding climate issues can lead to reputational and liability risks for the bank as a result of scandals caused by the financing of environmentally controversial activities.	
Other risk types (liquidity, business model)	Liquidity risk may be affected in the event of clients withdrawing money from their accounts in order to finance damage repairs.		Transition risk drivers may affect the viability of some business lines and lead to strategic risk for specific business models if the necessary adaptation or diversification is not implemented. An abrupt repricing of securities, for instance due to asset stranding, may reduce the value of banks' high quality liquid assets, thereby affecting liquidity buffers.	

Source: ECB Guide on climate-related and environmental risks; Supervisory expectations relating to risk management and disclosure

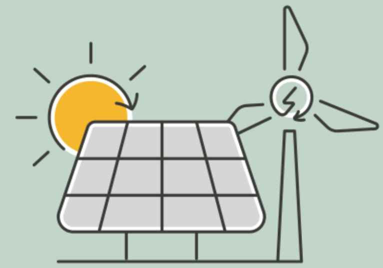
Recommendations of the Task Force on Climate-related Financial Disclosures



Governance	Strategy	Risk Management	Metrics and Targets
Disclose the organisation's governance around climate-related risks and opportunities.	Disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy and financial planning, where such information is material.	Disclose how the organisation identifies, assesses and manages climate-related risks.	Disclose the metrics and targets used to access and manage relevant climate-related risks and opportunities, where such information is material.
Recommended disclosures			
(a) Describe the boards oversight of climate-related risks and opportunities	(a) Describe the climate-related risks and opportunities the organisation has identified over the short, medium and long term	(a) Describe the organisation's processes for identifying and assessing climate-related risks	(a) Disclose the metrics used by the organisations to assess climate-related risks and opportunities in line with its strategy and risk management process
(b) Describe management's role in assessing and managing climate-related risks and opportunities	(b) Describe the impact of climate-related risks and opportunities on the organisation's businesses, strategy and financial planning	(b) Describe the organisation's processes for managing climate-related risks	(b) Disclose Scope 1, Scope 2, and if appropriate, Scope 3 greenhouse gas (GHG) emissions and the related risks
	(c) Describe the resilience of the organisation's strategy, taking into consideration different climate-related scenarios, including a 2oc or lower scenario	(c) Describe how processes for identifying, assessing and managing climate-related risks are integrated into the organisation's overall risk management	(c) Describe the targets used by the organisation to manage climate-related risks and opportunities and performance against targets

Source: TCFD

What will it take to change banks behaviors?



Cynical or realistic: What will it take to change banks behaviors?

> **"Banks are mirroring the real economy; the real economy is not sustainable, so the way banks operate is not sustainable."**
>
> **Sasia Belick, Head of Sustainability at PFA**

Do you believe, as some do, that we should not expect banks to make major improvements to their ESG strategies until they have experienced financial losses? So said Mr Belick.

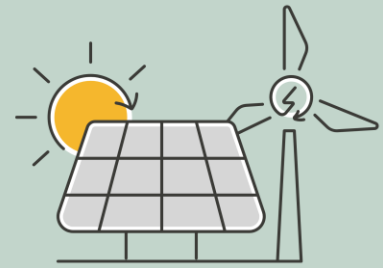
What will work?

Will naming and shaming financial institutions with apparently weak ESG policies be an effective deterrence to curtail lending to companies with harmful environmental practices? Financial Times dedicated two thirds of a page to trying to do just that.

The article focused on deforestation-linked borrowers. The global finance industry raised $119billion to fund companies linked to deforestation. Half of the money raised between 2016 - 2020 to finance these businesses were by way of bond issuance. Fixed income fund managers need to be brought into the fold, if the goal, to starve such companies of access to finance is to succeed. Let us hope that such concerted actions will encourage companies to change their business models.

*Global finance industry sinks $119bn into companies linked to deforestation
https://www.ft.com/content/ff1eccc8-645a-497b-a02d-6eb38efe6219

What will it take to change banks behaviors?



During the Cop 26 climate summit The Sunday Times quoted Mark Carney as saying "If fossil fuel giants don't cut carbon, banks will starve them of cash…. He further went on to say that "The people who make those decisions are the investors… It's a big world and there's many of them."

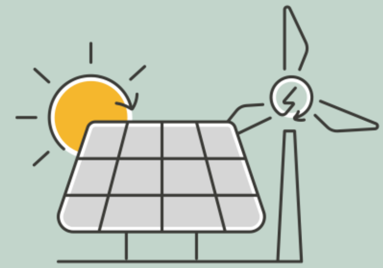
A wise man once said "You don't know a man until you touch his pocket". Quoting ShareAction, FT journalist, John Plender, informed readers that 84% of asset managers had no public policy against purchasing sovereign bonds from countries under international sanction for human rights abuses. Clearly, the search for yield trumps ESG considerations. Will this, can this, change? Perhaps if investors become more diligent in setting ESG criteria for their bond portfolios. Let's hope the pressure is on.

Making up for lost time

Less than a month before the US 2020 election, the U.S. Department of Labor finalized a rule clarifying that pension fund managers must put retirees' financial interests first when allocating investments, rather than other concerns such as climate change or racial justice. The move by the department under the administration of former U.S. President Donald Trump represents one of the President's many efforts to make it harder to use investment assets to address social issues.

This rule is among the first of hundreds of Trump-era measures that are being frozen or rescinded by President Joseph Biden, who has put tackling climate change and social injustice at the forefront of his policy agenda.

Making better informed investments



Standardisation of reporting requirements, across all industries, is needed if we are to gauge a company's track record and measure its performance against its goals. Next year, the International Sustainability Standards Board, part of the IFRS Foundation, will be tasked with creating a single set of standards specifying sustainability disclosure requirements. New standards will inevitably be fraught with challenges and may be a long time in getting implemented but at least we are starting!

The hope is this: with clear key performance criteria available, lenders and fund managers can make better informed decisions.

Things to consider:

1. What tools might regulators use to change bank ESG policies and practices? Disclosure and reporting, stress testing, capital requirements?
2. How will ECG risks be evidenced in a bank's performance? Higher costs of doing business, higher loan loss provisioning?
3. What kind of disclosure might we expect from both banks and companies that operate in the most egregious sectors?

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