More Risks or More Opportunities?

DOMESTIC AND INTERNATIONAL ENERGY TRANSITION IMPLICATIONS ON THE FIDUCIARY RESPONSIBILITIES OF CORPORATE DIRECTORS IN THE PHILIPPINES

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Transcript

Experiences in Engaging With the European Banking Sector on Directors' Duties in Relation to Climate Risk

Jamie Sawyer
Lawyer, Climate Programme, ClientEarth

My name is Jamie Sawyer, and I am a Lawyer at the Climate team at ClientEarth. For those of you who don't know ClientEarth, we are an international environmental law charity that uses the law to push for systemic change to protect people and the planet. Our Climate team seeks greater accountability and climate action from governments, businesses, and the financial sector, particularly relevant to today's webinar. We also strengthen the financial industries' approach to climate risk and shift financial flow to drive the transition to net-zero.

My work focuses specifically on the banking sector and banking regulation, mainly in the UK and Europe. But I also work with central bank policy such as monetary policy. I am not going to talk about that in detail during this webinar. Still, of course, Central Banks policies can impact bank's operations, one recent example from Asia being the Bank of Japan's announcement that it will provide zero-interest loans to lenders to finance climate change projects.

Today I have been asked to talk about the developments in the European banking sector around climate risks and opportunities and the duties of Bank's Directors regarding climate risk management. First, I talk about the growing pressure from shareholders over the last few years to ensure that banks are correctly managing their climate risks. Their significance in challenging developments has banks having to develop Paris-alignment strategies to transition their business to net-zero emissions. So I will jump right in there and start. Still, then I will move on to discuss the regulatory developments and investor expectations we've seen around climate disclosures, climate risk management, stress tests and scenario analysis, and capital requirements.

So until about two years ago, a key focus of banks and their shareholders when it came to climate risks was on energy policies, which activities they were going to stop financing. These policies tended to start by restricting project finance to new thermal coal activities. Still, now European banks tend to have policies covering a wide range of activities, including oil and gas, fracking, tar sands and Arctic oil.

Over time, following pressure from investors and stakeholders, banks have made these policies progressively more stringent, covering a broader range of activities and a broader range of financial services, so going beyond project-specific finance to general corporate finance and underwriting for fossil fuel companies. Although these policies are necessary, one downside of focusing solely on activity or sector-specific policy is quite a piece-meal approach to managing climate risks. Shareholders want to see banks managing climate risk across their entire business. That's because it's not only the bank's customers in the coal industry, for example, who will face climate change risk. All of their customers will be affected by climate change, and the transition to net-zero brings risk to each bank.

Within the last couple of years, we've seen European banks shift toward developing a strategy to align their entire business with the Paris agreement and reach net-zero emissions before 2050. You might have heard this referred to as the "Paris-aligned" strategy or a Transition plan. This partly comes about through voluntary industry initiatives such as the Collective Commitment to Climate Action under the Principles for Responsible Banking, accelerated by shareholder resolution.

In 2020, we saw the world's first shareholder resolution on this topic, which was a resolution by Barclays bank by a group of investors. The Board of Directors at Barclays then decided to propose its resolution, which would commit banks to start a Paris-aligned strategy with the target, to transition its business to net-zero by 2050. That resolution passed with 99% of shareholders voting in favour. Since then, we've seen similar resolutions at other banks, including HSBC in the UK and Mizuho and MUFG in Japan.

One point to mention here is that, as Ellie discussed, the Directors of banks have fiduciary duties to promote the company's success in many countries. In the Philippines, I understand that one duty is to ensure its long-term viability and profitability. There is a need for fiduciary duty when they are developing a Paris-aligned strategy. I have set out on this slide a few relevant considerations around the long term health and stability of the bank, capitalising on climate-related opportunities that arise because of the transition and reputational risks.

These Paris-alignment strategies generally start by reducing emissions from lending the most emissions-intensive factors because the most significant climate risks are related to being in the near term. Still, the intention is to expand these plans to cover all sectors over time. To cover project financing, corporate financing, underwriting and advisory activities by the bank. This should include short, medium and long term targets on how they will reduce their emissions over time and achieve those emissions reductions. Banks will need to consider whether or not to continue relationships with certain customers going forward. If they do, they should be engaging with their customers to ensure they reduce their emissions. That could, for example, include making lending conditional on the customer putting in place the transition plan within a certain time frame to achieve their emissions reduction.

Moving on to emissions calculations and climate disclosure by banks - as Mark Carney has said, "What gets measured, gets managed." The starting point to banks is to calculate their emissions, which includes their customer's emission as those are banks Scope 3 or financed emissions. Banks could start to plan where and how to reduce their emissions over time. In Europe, shareholder pressure has driven more climate-related financial reporting by banks, often requesting that this align with the TCFD recommendation because shareholders need this information to make investment decisions and fully understand how exposed banks are to climate risks.

Often we've seen this pressure coming in the form of investor engagement with banks, so we've also seen legal action from shareholders against banks. For example, the Commonwealth Bank of Australia was sued in 2017 by two shareholders for failing to disclose climate risks.

The more significant challenge here is for the banks to measure their Scope 3 financed emissions. However, thankfully methodologies are developing and improving steadily. This means that banks can start to report some of their Scope 3 emissions now and then increase that reporting over time as methodologies improve. As I have mentioned before, to report effectively, banks need to engage with their customers to understand their emissions. Still, as climate-related reporting becomes widespread in the real economy, that should become easier for the banks.

We are also seeing regulators and investors assessing their expectations of how banks should manage climate risks. In the UK, for example, the Bank of England expects banks to address climate risks through their existing risk management framework and embed climate risks in their governing processes so that their board is engaged and responsible for managing these risks. Banks in the UK also need a dedicated Senior Manager who takes responsibility for climate risks. They can be held personally accountable by the regulator if climate risk is not managed correctly.

Similarly, investors expect banks to manage their climate risks and be vocal about how they think that should be achieved. For example, the Institutional Investors Group on Climate Change (IIGCC) has published a starter on investor's expectations for banks on their net-zero commitment, climate risk governance, customer engagement and climate disclosures. Banks that are not meeting these expectations can expect to face questions and pressure from their shareholders.

Regarding understanding the impact of climate risks on the bank's business, regulators expect banks to use scenario analysis, essentially looking at how their portfolio will be impacted in a range of hypothetical climate change scenarios. We also see regulators running climate stress tests over the banking sector to see how well the bank would hold up. I set out here European examples on this slide. I want to flag that the Network for Greening the Financial System, which the Philippines' Central Bank is a part of, has put out a guide on climate scenario mapping and has designed a scenario analysis and hypothetical scenario that banks and central banks across the world can use. Ultimately, these exercises will allow banks to understand climate risk exposure better and allow regulators to understand how climate change will affect financial stability.

Related to that, banks need to ensure that climate risk is adequately reflected in their capital requirements calculations to have an adequate capital buffer to withstand shocks to the financial system or their customers stemming from climate change. Banks should already factor in climate risks when calculating the risk weighting for fossil fuel exposures, particularly given how closely linked climate risk is to credit risk. But it's not entirely clear that banks are doing this properly at this stage.

In the UK and Europe, regulators are now coming under pressure to tell banks that specific fossil fuel exposures should be given a risk weighting of 1250%. Essentially, 100% capital is howled against them. Essentially, that would be a penalising factor being applied to fossil fuel exposures, increasing the cost of capital and forcing banks to move away from fossil fuel lending.

To conclude, Directors have a key part to play in ensuring climate risk is adequately managed across their business. And indeed that they are making the most of the opportunities presented by the energy transition. Those who fail to do so may be subjected to pressure from shareholders and stakeholders and face questions such as "Why didn't the bank take action sooner." To ensure the long term viability and profitability of their bank, Directors need to take early and robust steps to integrate climate risks and align bank strategies to the Paris goal. Thank you.

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