



Climate change and the banking sector

The banking sector has a critical role to play in achieving the Paris goals

The banking sector has a critical role to play in keeping global warming below 1.5°C above preindustrial levels and achieving net zero CO₂ emissions by 2050. This was a key message of the investor expectations for the banking sector, which the Institutional Investors Group on Climate Change (IIGCC) published in April 2021 with the support of 35 investors collectively representing US\$11 trillion in assets under management or advice.

The report highlights investor expectations regarding why and how the sector must align with the goals of the Paris Agreement to limit the increase in global average temperature to 1.5°C, as well as to make

financial flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development. It also lays out key action areas for climate risk governance and disclosure. Briefly, investors expect banks to:

- Commit to net zero emissions by 2050 with milestones and clear interim targets;
- When providing financing, set conditions tied to net zero commitments with clear timelines and milestones for clients reducing their emissions;
- Withdraw financing for misaligned activities;
- Scale up green finance;
- Ensure the board of directors is accountable for the bank's strategy, which is aligned with their net zero commitment;
- Include material climate change risks in financial statements;
- Disclose governance, strategy, risk management approach and metrics and targets to be in line with the recommendations of the Task Force for Climate-related Financial Disclosures (TCFD), a global standard for climate-related reporting;
- Disclose greenhouse gas emissions associated with their financing activities, including lending, underwriting and investments; and
- Disclose the ratio of green and non-green financing.

The report concludes that banks need to reduce their financing of fossil fuel and other activities that generate significant levels of CO₂, and increase funding of green finance to facilitate an orderly transition towards net zero emissions by 2050.

In the six years since the Paris Agreement was signed in 2015, fossil fuel financing has increased year-on-year. Between 2016 and 2020, 60 global banks financed fossil fuels in a total amount of US\$3.8 trillion. However, it is expected that the price of renewables and electricity storage will continue to fall, leading to zero-marginal-cost renewable energy and a loss of investor confidence in fossil fuels, particularly in light of recent reports such as the IEA Net Zero Roadmap and IPCC AR6 that emphasise the urgent need to move away from fossil fuels.

This is true for less developed countries as well. For example, a report from Carbon Tracker suggests that between 2020 and 2022 it could be cheaper to build new solar PV than to build new coal capacity in Indonesia, Vietnam and the Philippines. Carbon Tracker also found that new wind and solar will be cheaper than 96% of existing coal power by 2030 and that 42% of the world's coal power plants currently run at a loss. It is foreseeable that thermal coal mining and power plants will become uninsurable in the medium-term.

Central banks are likewise crucial to achieving net zero

Central banks have significant exposure to fossil fuel-intensive and -dependent assets through their monetary policy operations, including their corporate asset purchase schemes (e.g. purchasing corporate bonds, commercial paper or equities) and collateral frameworks. They should set a comprehensive strategy on how they will align their monetary policy portfolios and activities with the Paris goals, with annual updates on progress. They can take steps to reduce those exposures and set an example to drive the low carbon transition in the market, for example by making ineligible for asset purchases or for acceptance as collateral any assets from:

- Carbon-intensive companies that do not adopt a credible Paris-aligned strategy to achieve net zero emissions; and
- Companies whose activities are clearly incompatible with achieving the Paris goals or are associated with high transition risk, such as coal and unconventional oil and gas.

As prudential regulators, they have the ability to take stronger action to promote financial stability, to discourage further or cheap commercial bank lending to fossil fuel-intensive and -dependent companies (e.g. by increasing risk weightings and capital requirements relating to these assets), and to encourage green finance (e.g., through preferential interest rates for banks financing climate change mitigation or adaptation projects).

The Bank of England has called on the banking sector to integrate climate risks

A case study for the integration of climate risks is the Bank of England (BoE). As late as 2011/2012, the BoE was still sceptical about the impacts of climate change for the financial system, with then-governor, Sir Mervyn King, laying out three conditions that would need to exist for climate change to be an issue for the BoE:

- Carbon-intensive exposures at financial institutions are large;
- Climate risks are not priced in; and
- Any asset repricing would be sudden enough to preclude orderly adjustment.

The BoE began to change course around 2014, following the arrival of a new governor, Mark Carney. In a September 2015 speech, Carney characterised climate change as a “tragedy of the horizon” (watch the speech [here](#)). The following year, a staff working paper on climate risk was developed. In 2018, a consultation paper on a draft supervisory statement on banks’ and insurers’ (collectively referred to as firms) climate risk was launched. The statement set out proposed expectations in relation to:

- Governance, where firms are expected to fully embed climate risks with board-level engagement and responsibility for managing those risks;
- Risk management, where firms should address climate change risk through their existing risk management frameworks, in line with their board-approved risk appetite;
- The use of scenario analysis to inform firms’ strategic planning and determine the impact of climate-related financial risks on its business strategy; and
- Appropriate disclosure of information on how climate risks are integrated into governance and risk management processes.

Carney referenced the draft in a [2019](#) speech and concluded that “[t]he more prolific the reporting, the more robust the risk assessment, and the more widespread the return optimisation, the more rapidly [the low-carbon] transition will happen, breaking the Tragedy of the Horizon.”

In 2019, following the consultation paper referenced above, the BoE's Prudential Regulation Authority (the PRA), issued Supervisory Statement 3/19, formalising its expectations for how banks and insurers should address climate-related risks.

Further to the expectations set out above, the PRA also required banks to allocate the responsibility for identifying and managing financial risks from climate change to an individual Senior Manager (who, under the UK's Senior Managers & Certification Regime, can be held individually accountable for failures in that area of responsibility). Boards of directors are expected to play a significant role, including that (1) they should understand and assess the financial risks from climate change and address and oversee those risks within the firm's overall business strategy and risk appetite, and (2) they should ensure there are adequate resources and sufficient skills and expertise devoted to managing the financial risks from climate change.

In 2019, then BoE Governor Mark Carney clearly warned that climate change will require a massive reallocation of capital, and if companies and industries fail to adjust, they will fail to exist. In 2020, the BoE became the first central bank to provide disclosures in line with the TCFD recommendations across its entire operations. The BoE is now in the process of completing a dedicated climate risk stress test across the banking and insurance sectors, the 2021 Biennial Exploratory Scenario (BES), which will explore the resilience of the UK financial system to the physical and transition risks associated with different climate pathways. The 2021 BES also requires banks to explore the risks to their business from climate litigation.

There is significant and growing shareholder support for climate resolutions at bank AGMs

The voting results at numerous annual general meetings (AGMs) of banks in the UK, Japan and the US show strong – and growing – support from shareholders for banks to align their business with the Paris goals by developing credible Paris-aligned strategies.

- At the 2020 Barclays AGM, 99.93% of votes were cast in favour of the board-proposed resolution committing the bank to set an ambition to be net zero by 2050 and to set, disclose, and implement a strategy, with targets, to transition its provision of financial services across all sectors (starting with, but not limited to, the energy and power sectors) to align with the goals and timelines of the Paris Agreement. A more ambitious shareholder resolution had been filed by ShareAction and others, which would have required the bank to set and disclose targets to phase out the provision of financial services to the energy sector and electric and gas utility companies that are not aligned with the Paris Agreement, for which 23.95% of votes were cast in favour.
- At the 2021 HSBC AGM, 99.71% of votes were cast in favour of a board-proposed resolution committing the bank to set, disclose and implement a strategy with short- and medium-term targets to align its provision of finance across all sectors, starting with Oil & Gas and Power & Utilities, with the goals and timelines of the Paris Agreement, and to publish and implement a policy to phase out the financing of coal-fired power and thermal coal mining by 2030 (EU/OECD) and 2040 (other markets). This followed the filing of a shareholder resolution by a US\$2.4 trillion investor group earlier in the year. After months of negotiation with the bank, the investors agreed to back the board-proposed resolution above and withdrew their resolution.

- At the 2020 Mizuho AGM, 34% of votes were cast in favour of a proposal which called on Mizuho to disclose a plan to ensure its investments align with the Paris goals. While this fell short of the two-thirds vote that would have made the proposal binding on the company's management, this level of support indicates increased appetite for shareholder activism in Japan. Notably, the two largest international proxy advisors, Glass Lewis and ISS, both recommended shareholders vote in favour of the resolution.
- At the 2021 MUFG AGM, 23% of the votes were cast in favour of a shareholder proposal requiring the bank to align its business with the Paris goals.
- At the 2020 JPMorgan Chase AGM, 49.6% of votes were cast in favour of a resolution requiring the bank to issue a report outlining how it intends to align its lending activities with the Paris goals.

These trends are expected to continue and to gain momentum in future AGMs, as more investors join the call for banks to align financial flows with Paris-compatible pathways.

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