European Banks Lead on Financing Sustainability

Le banche europee guidano il finanziamento della sostenibilità

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To avoid the most dangerous consequences of climate change, global greenhouse gas emissions must drop by 50% over the next decade. The European banking sector is in a unique position as it is not only directly impacted by risks linked to climate change, but also plays a crucial role in financing the transition towards a low-carbon economy through its allocation of resources, including corporate and retail lending, financial markets intermediation, and asset management. Climate change is at the top of banks' sustainability concerns and banks across the Eu are committing to sustainable banking. However, moving forward, governments will need to deliver on their policy objectives and the solution will have to be global if we want to accelerate the transition and ensure a safe environment for future generations.

Per evitare le conseguenze più pericolose del cambiamento climatico, le emissioni di gas serra globali devono diminuire del 50% nel prossimo decennio. Il settore bancario europeo è in una posizione unica non solo perché direttamente interessato dai rischi legati al cambiamento climatico, ma anche perché svolge un ruolo cruciale nel finanziamento della transizione verso un'economia a basse emissioni di carbonio, attraverso l'allocazione di risorse, compresi prestiti alle imprese e al dettaglio, l'intermediazione sui mercati e la gestione patrimoniale. Il cambiamento climatico è al primo posto nell'impegno delle banche per la sostenibilità in tutta l'Ue. I governi dovranno perseguire i propri obiettivi di policy e la soluzione dovrà essere globale per accelerare la transizione e garantire un ambiente sicuro per le generazioni future.

1. Introduction

The European Banking Federation is the voice of the European banking sector, uniting 32 national banking associations in Europe that together represent nearly 3,500 banks – large and small, wholesale and retail, local and international – employing more than 2 million people. ABI is a member of the Ebf; representatives of both ABI and its member banks participate actively in the work of the Ebf in all areas, including sustainable finance. In fact, the strategic group overseeing the Ebf's work on inclusive and sustainable growth – steering the banks' financing of the economy through corporate finance, financial markets and sustainable finance – is currently chaired by the Director General of ABI, Giovanni Sabatini. In addition, several of the expert groups and task forces reporting to this group are also chaired by members of the Italian banking community (including export finance, primary markets, post-trading and sustainable disclosures). Hence the views expressed in this article reflect the experiences and contributions of the Italian banking sector as well.

2. Climate change: what is at stake?

The new Ipcc report states that «global surface temperature will continue to increase until at least the mid-century under all emissions scenarios considered. Global warming of 1.5°C and 2°C will be exceeded during the 21st century unless deep reductions in carbon dioxide and other greenhouse gas emissions occur in the coming decades».

This report published by scientists observing changes in the Earth's climate in every region and across the whole climate system warns that many of the changes observed in the climate are unprecedented in thousands, if not hundreds of thousands of years, and some of the changes already set in motion – such as continued sea level rise – are irreversible over hundreds to thousands of years. While benefits for air quality would come quickly, it could take 20-30 years to see global temperatures stabilize. The report warns that unless there are immediate, rapid and large-scale reductions in greenhouse gas emissions, limiting warming to close to 1.5°C or even 2°C will be beyond reach. Every region will be affected in terms of not just temperature but water cycles, rainfall patterns, sea level rise, and ecosystems. For example, extreme sea level events that previously occurred once in 100 years could happen every year by the end of this century.

To avoid the most dangerous consequences of climate change, global greenhouse gas emissions must drop by 50% over the next decade. Emissions must fall by at least 7% per annum over the course of this decade. Last year we met this high bar but only because large parts of the global economy were shut down. With currently implemented policies, central case (postpandemic) projections suggest global CO_2 emissions will rise from around 30 billion tons in 2020 to 37 billion by 2030. Illustrative pathways suggest that containing warming to «well below» 2°C and ideally towards 1.5°C above pre-industrial levels requires global CO_2 emissions in 2030 to be limited to about 15 to 25 billion tons. Without these reductions, the likelihood of stabilizing the climate will decline rapidly, especially if there is lock-in of long-lived fossil fuel capital (for example, coal plants).

The events of the summer of 2021 served to illustrate, most vividly, the seriousness of the risks faced by our planet and people. As one example, in July in China, where we saw harrowing images of urban metros being inundated, the city of Zhengzhou received a whole year's worth of rain in just three days. Climate experts explained this phenomenon as the result of reduced jet currents at high atmospheric levels which then resulted in rain-laden clouds 'sitting' in one focused area, instead of being dispersed, as would have been the case before. Complex similar phenomena – all traceable to climate change – are behind the dramatic events in Belgium, Germany, the Netherlands, and others in Europe and in the Us and beyond – leading to inundation, fires, drought – reflecting the same kind of previously unimaginable and largely unplannable scale of natural disasters.

Indeed, climate change means that we may face more frequent or severe weather events, such as floods, droughts, and typhoons if action is not taken. These events bring so-called 'physical risks' that can have a negative impact on businesses and the overall economy. At the same time, steps taken to help alleviate climate change can result in «transition risks», as carbon taxes and other policies add new operating costs and may generate abrupt changes in consumption or production. In other words, climate change generates risks both in terms of physical damage and major changes to economic structures. There is a complex interplay between physical and transition risks that can impact the operational stability, creditworthiness, and financial performance of firms and, by extension, the banks.

These changes are going to have devastating effects on people around the world. According to the Basel Committee, «These changes could result in higher levels of migration and the increased risk of humanitarian crises. The World Bank (2018) estimates that by 2050, in Latin America, South Asia and sub-Saharan Africa about 140 million people could migrate within their own countries from areas with less water availability and reduced crop yields. Another study conducted by the Mckinsey Global Institute (2020) projects that under a severe increase in temperature, and without adaptation responses, up to 200 million people in India could live in areas with a chance of experiencing deadly heatwaves. The Ipcc also warns that higher temperatures will accelerate the melting of ice sheets and glaciers, raising sea levels (Ipcc, 2019). This may generate endemic (or even permanent) inundations of, and erosion of, coastal cities, islands and lowlying regions».

3. How will climate change impact the Eu?

According to the Jrc Peseta project (Projection of Economic impacts of climate change in Sectors of the European Union based on bottom-up Analysis, part I and II), if no further action is taken and global temperature increases by 3.5°C, climate damages in the Eu could amount to at least €190 billion, a net welfare loss of 1.8% of its current Gdp. Several weather-related extremes could roughly double their average frequency. As a consequence, heat-related deaths could reach about 200 000, the cost of river flood damages could exceed €10 billion and 8000 km^2 of forest could burn in southern Europe. The number of people affected by droughts could increase by a factor of seven and coastal damage, due to sea-level rise, could more than triple. These economic assessments are based on scenarios where the climate expected by the end of the century (2080s) occurs in the current population and economic landscape.

Other studies also confirm the devastating risks for the Eu. The recent Ecb publication of the results of its first economy-wide climate stress test revealed that, by the end of the century, more frequent and severe natural disasters could shrink the region's economy by 10% if no new policies to mitigate climate change are introduced. By comparison, the costs of transition would be no more than 2% of gross domestic product. «The short-term costs of transition pale in comparison with the costs of unfettered climate change in the medium to long term», the report said.

4. How do banks approach sustainability?

Banks are impacted by climate change, and, as financiers of the economy through corporate and retail lending, financial markets intermediation and asset management, they have a unique opportunity to accelerate shifting private resources to purposes that are consistent with a livable planet. Not surprisingly, climate change is receiving top attention from banks. To understand how banks approach climate change, let us first look at the broader context of banks' sustainability efforts.

In June 2021, the European Banking Federation, together with Kpmg Spain, published a report which outlines European bank practices in supporting and implementing the Un Sustainable Development Goals (Sdgs). The study provides an overview of best practices and main challenges for the banking industry in implementing the 17 global goals more than five years after their adoption.

The European banking sector plays an important role in achieving the 2030 Agenda due to its capacity to provide and channel resources towards sustainable initiatives that contribute to the implementation of the Sdgs. To achieve this goal, most banks are identifying ways in which their activities can contribute to delivering the global sustainable development agenda, with about half of survey respondents reporting the use of indicators and targets aligned with the Sdgs.

According to the study, banks give priority to Sdgs on which their financing activities can make the biggest impact, as opposed to areas where their influence would come from their role as employers or purchasers of products or services. While all Sdgs receive some attention, the Sdgs that receive the greatest bank focus are those related to economic growth and decent work (Sdg 8), climate action (Sdg 13), clean energy (Sdg 7), sustainable cities and communities (Sdg 11) and responsible consumption and production (Sdg 12). Sustainable-focused products have high potential as a source of Sdg financing. 63.3% of banks surveyed in the study have already launched products, services or commercial initiatives based on the Sdgs. For bank customers, these mostly include bonds and investment funds aligned with the Sdgs. At the retail level, banks are developing products and services that promote a transition to a low-carbon economy, ranging from green mortgages to loans for the purchase of eco-friendly vehicles. Some products also promote other topics such as entrepreneurship or gender equality.

Establishing sustainable financing frameworks also enables the banks to identify activities that can channel funding into projects aligned with the Sdgs. In terms of portfolio evaluation to measure alignment with the Sdgs, progress has thus far been uneven, with most banks reporting that little head-

way has been made in integrating these aspects into the business. The same trend is observed in terms of defining objectives and metrics suitable for monitoring. According to the study, this is largely due to the lack of a methodology to facilitate these tasks, and the need to engage in strategic business thinking that considers Sdgs from the initial stage.
This unique report provides a first snapshot of the current landscape when it comes to banks' contributions to Sdg implementation. An increasing number of banks are already working on aligning their strategies and lending practices to the Sdgs, even though there is still lots to do. Giving them standardized methodologies and working further on targets and Kpis to assess implementation, are some of the next steps that should be taken.

5. How are banks impacted by climate change?

As reflected in the report cited above, climate change is among the Sdgs that receive the greatest focus of banks. This reflects not only the realization that banks are impacted by climate change but also that they can influence climate change through what they finance and what they don't finance. Before going into how banks deliver on this responsibility, let us review how climate change affects banks.
As explained by the Basel Committee earlier this year, banks and the banking system are exposed to climate change through macro- and microeconomic transmission channels that arise from two distinct types of climate risk drivers. First, they may suffer from the economic costs and financial losses resulting from the increasing severity and frequency of physical climate risk drivers. Physical risk drivers are changes in both weather and climate that impact economies. They can be categorised as acute risks, which are related to extreme weather events, or chronic risks associated with gradual shifts in climate (Ngfs, 2019a; McKinsey Global Institute, 2020).
Second, as economies seek to reduce carbon dioxide emissions, which make up the vast majority of greenhouse gas (Ghg) emissions, these efforts generate transition risk drivers. These arise through changes in government policies, technological developments, or investor and consumer sentiment. They may also generate significant costs and losses for banks and the banking system.
In other words, the process of adjusting to a low-carbon economy can also lead to losses, and therefore it matters how that process is managed. According to the Ecb, a smooth and orderly transition is the best way to reduce the risks of climate change while also allowing producers and consumers to adjust to a low-carbon economy, thereby avoiding the high costs of either no-action or abrupt and unplanned action. The Ecb's Eu wide exercise showed that the «too much too early» path could be as disruptive for the economy as «too little too late» path. It is a delicate balancing act to get the policy and regulatory frameworks right.
In this context, it is also important to note that exit strategies must be thought out carefully. The Ecb noted, in remarks about its asset purchase program, that excluding certain sectors or firms from financing could be counterproductive. In the Ecb's words, «In order to lower emissions, firms with high levels of carbon emissions are extremely important because they offer scope for making the most progress. If these firms want to become climate-neutral, they are dependent on favourable financial conditions».
Putting all this together, banks have a strong interest in:

1. taking individual and collective action to reduce the physical risks of climate change by shifting their financing towards «green» activities; and
2. contributing to a smooth and orderly transition that accelerates the «greening» of the economy.

6. What are european banks doing about climate change?

Banks are increasingly under pressure from investors and other stakeholders to address climate change. This will have increasing impact on lending, investment decisions as well as risk management, as banks will seek to maintain profitability and performance and reduce transition risks.
Many banks are committing to align their portfolios with the objectives of Paris Agreement. This could be seen as risk mit-

igatory and help integration of Esg into governance and risk structures. These efforts are done both individually – as when individual banks publish commitments to invest or divest in certain sectors – and collectively – as when a group of banks act together to commit to a set of climate change goals.

One of the best and most comprehensive examples of that is the banks' commitment to the Principles for Responsible Banking. The Ebf was among the first associations to endorse the Prbs, which are the first comprehensive principles applicable globally to provide a framework for sustainable banking. The latest collective initiative – again with strong backing of the Ebf – is the Net Zero Banking Alliance.

Through the Nzba, banks are committing to transition the Ghg emissions out of their lending and investment portfolios to align with pathways to net-zero. They are also setting intermediary targets, focusing on priority sectors where the bank can have the most significant impact in a transparent and publicly accountable way.

Today, we have more than 50 signatory banks, including the 3 European banks with most exposure to fossil fuels, committing to align their lending and investment portfolios with net-zero. I mentioned the 3 banks as in fact, there are less then 5% of banks accounting for 45% of overall emissions. Such initiatives also contribute to risk mitigation as they aim at aligning with Paris objectives, thus decreasing the transition risk.

Next year, the Ecb will conduct a full supervisory review of banks' practices. Ecb will take concrete follow-up measures, in particular where banks do not show sufficient progress to meet supervisory expectations. The Ecb will also conduct the stress test that will help us to better understand the capacity of Eu banks to withstand even severe scenario and possible risks to financial stability. At individual bank level, not only the results of the stress tests but also the preparations for the stress tests are also expected to impact and accelerate the integration of Esg factors in banks risk management and business decision as banks will have to analyze their portfolios and improve data gathering.

Beyond the banks' individual and collective commitments to fight climate change, banks also contribute to the transition to a low-carbon economy by providing ideas and solutions. Banks' input to the sustainable finance and related regulatory framework has been constructive from the start, committing to an open cooperation with the policymakers and supervisors. Banks and their associations also promote best practices and coordinate with other sectors (Smes, industrial sectors, Ngos). Finally, European banks contribute to global coordination, which is important especially as the Eu has had the regulatory lead in this topic. European banks want to help the Eu to maintain this lead while ensuring a level playing field for banks that are globally active and maintain the costs of capital for the European economy competitive with other regions. This means that global standards should be convergent. Towards this goal, the Ebf plays an active role in various fora, including the IbFed.

7. What do banks need to accelerate their efforts?

At the most basic level, it should be recognized that climate change cannot be solved through sustainable finance policies alone. As long as the incentives for the underlying economic patterns do not change, there is a limit to how much can be achieved through the regulatory policies designed to channel financing towards a low-carbon economy. This does not mean that banks (and other financial sector players) can wait until the economic structures are fully re-designed before playing their role. There is a lot that banks can do – as we have seen above – that could accelerate the transition to a low-carbon economy. However, one must be realistic about the limits of banks' efforts and take the necessary steps to put into place the overall economic framework needed for a low-carbon economy.

This is why, already three years ago, the Ebf published a comprehensive overview of the economic incentives needed to shift private resources to sustainable purposes. Ideas contained in this report have been echoed elsewhere since. Most recently, Mark Carney, the former Bank of England governor and current Un special envoy on climate action and finance, stated that governments must step up their

regulation of businesses to tackle the climate crisis, noting that, for the world to meet its climate goals, governments would have to force industries to follow clear rules, on everything from energy generation to construction and transport, and set carbon prices that would drive investment towards green ends and close down fossil fuels.
Secondly, on the financial sector regulatory framework, policymakers must strike the right balance between ambition and practicality. This means clear, consistent, practicable rules that allow the private markets to channel the funds needed for transition. So far, the open and consultative processes used by the Eu have been instrumental in creating a regulatory framework that is purpose-driven and fact-based. In this context, there are two issues that merit special attention. The first is the prudential framework. We fully recognize that climate change and other environmental factors could be a source of financial risk. We support the ongoing efforts of banks and regulators to ensure risks are properly identified, understood and managed, including the current review of the Basel Committee on Banking Supervision. It is however crucial that the prudential framework remains risk based and should not be used to channel political decisions, to substitute for the lack of direct mechanisms such as taxes or industrial measures. We need supportive capital adequacy regulations which are risk-sensitive, which do not penalize entire sectors, and which are sensitive to the transition ambitions of the companies setting ambitious carbon reduction targets, since this will positively impact the risk profile of the banks. The Eu should also avoid any capital surcharges decided at the Eu level. A unilateral move by the Eu would undermine the competitiveness of both the Eu industry and financial sector *vis-à-vis* the non-Eu economies.
The lack of data is not an excuse for lack of action. However, it is an important challenge to be addressed. Standardized methodologies and further work on targets and Kpis are needed to put Esg strategies into action. To scale up and accelerate the work, it would be extremely useful if the public sector develops public databases, shares data, proxies, estimates and methodologies that can be commonly used as corporate disclosures improve over time. A common set of Kpis and sharing methodologies, data and estimates would be extremely useful as both banks and supervisors need to strengthen the capacity building.
Finally, effective policy in this area should also make the right distinctions among political levels, i.e. concerning what needs to be standardized globally, what needs to be standardized at Eu level and what can/should be left to national choices.

8. Conclusion

The world has made progress since the Paris agreement, in particular thanks to European leadership, but this progress is not enough. Globally, we need to accelerate our reduction of emissions, because:
- Even if we assume that everybody will implement their existing Paris pledges, the temperature rise will still be 3 degrees Celsius.
- Extreme weather events of the summer have shown that the impact of climate change has already started, and made it very concrete for all of us to see how difficult it will be to protect lives against the damages.
- Also in the summer, we we were warned by the Intergovernmental Panel on Climate Change that unless there are immediate, rapid and large- scale reductions in greenhouse gas emissions, limiting warming to close to 1.5°C or even 2°C will be beyond reach.
- And in all of this, the financing plays a big role. We must invest and grow to get to net zero. We need to double energy infrastructure investment with somewhere between 3.5 trillion and 5.5 trillion Euro per year.
- 50 banks representing almost a quarter of global banking assets committed to net-zero by 2050 (launched in April 2021), consistent with a maximum temperature rise of 1.5°C above pre-industrial levels by 2100.
- Almost 250 banks representing 40% of banking assets worldwide have signed on to the Principles for Responsible Banking.

While banks' shifting of resources towards a low-carbon economy and engagement with customers are key in financing the transition and banks will play their role, it is not realistic to expect finance to make this shift in the absence of a major change in the incentives of the underlying economy. Banks should not be put in the position of being the primary enforcers of climate policy. This is both an inappropriate delegation of responsibility and one which many banks are in no position to assume. We need greater national political ambition to align the underlying economic incentives with the Paris Agreement.

Climate change is a global issue and requires global solutions. The Eu contribution to global carbon emissions is around 8%. While essential and fully supported, the decarbonisation of Eu economy will not have a material effect on climate change by itself. We therefore need to turn our focus outside and provide expertise and resources if we are to guide and lead the transition to net zero.

Nearly a quarter of Eu banks' exposures are to entities outside of the Eu. In this context, the Cop26 was an important opportunity to discuss how international harmonization and standardization can be achieved to facilitate the flow of capital where most needed. Companies need to start disclosing their transition plans and other relevant forward-looking information. Governments need to define official underlying transition paths, which are per sector and geography-based, on which banks (private and multilateral) can evaluate the robustness and credibility of companies transition plans to provide the essential finance including in third countries.

The banking industry has an important role to play in delivering the 2030 Agenda and it is hoped that these findings can promote best practices in implementing Sdgs across our industry as well as help identify and solve challenges faced by banks in this area. Climate change is at the top of banks' sustainability concerns. As the representative of European banks, we will continue to help with their efforts to accelerate the transition to a low-carbon economy that serves the people and the planet for generations to come.