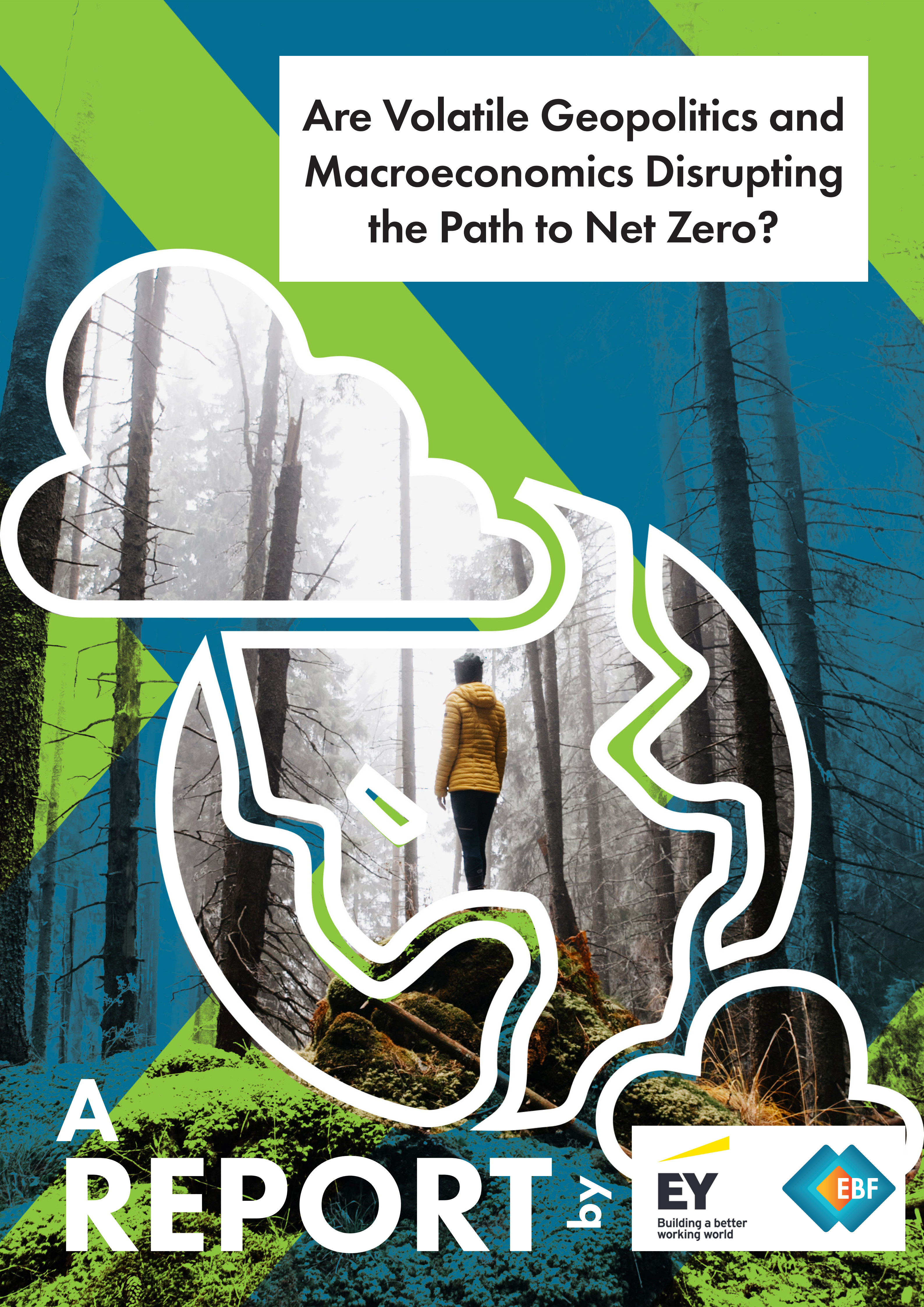
Are Volatile Geopolitics and Macroeconomics Disrupting the Path to Net Zero?



A REPORT by

EY
Building a better working world

EBF

CONTENT

Key findings

1

Most European banks have made net zero commitments, joined climate action initiatives and started to produce climate-related disclosures. Many have begun to embed climate risks into their processes, and to align lending portfolios with their climate commitments.

2

The economic and political volatility triggered by recent shocks are having a significant effect on banks' strategies. In particular, the war in Ukraine has slowed transition agendas.

3

Banks have not changed their overall risk appetite, but sector attitudes have been affected by rapid changes to the economic position of different industries.

4

The greatest effect is on the energy sector, which is overweighted by 50% of our respondents. There is also an increased focus on transportation. In contrast, mining & metals, business services, manufacturing and industrials are comparatively underweighted.

5

Despite the short-term hit to transition agendas, European banks remain fully committed to their net zero goals. This reflects climate science, demand for clean energy and banks' duty to support the transition - reinforced by supervisory, public and political expectations.

6

Banks face major hurdles as they seek to support the real economy while continuing the process of decarbonization. These include inconsistent disclosures, uncertain government policies and the need for sector-by-sector transition pathways.

7

On the upside, many banks see the current crisis as accelerating medium to long-term demand for clean energy finance and infrastructure renewal.

8

Banks' ability to successfully manage their balance sheets while meeting stakeholder expectations will not only depend on macroeconomics, but also on the actions of clients, governments and regulators. Banks can influence these outcomes through thoughtful, collective engagement.

9

It remains to be seen how European banks will stay on the road to net zero while shouldering the burden of two exceptional global crises. Clear measurable transition plans, backed up by effective stakeholder engagement, will be vital to delivering real-world impact.

About this report

The world has changed significantly since European banks began making their net zero commitments. The COVID-19 pandemic and the war in Ukraine have completely altered the operating environment.

Europe is still recovering from the disruption to demand and supply chains caused by the pandemic. Production bottlenecks, increased costs, and reduced supply have had a range of effects on different sectors. European companies are emerging from COVID-19 with significant levels of debt and limited capacity for investment.

At the same time, the war in Ukraine is causing extreme civilian harm and hampering the post-pandemic recovery. Higher oil and gas prices, volatile energy costs, weakened demand and faster inflation are increasing companies' indebtedness, making hedges more costly, and intensifying financial distress.

This new reality poses significant questions for European banks' climate strategies. Net zero remains at the top of the industry's long-term agenda, but over-reliance on fossil fuels - in tandem with recent shocks – is also contributing to short-term economic and social damage that needs to be addressed immediately.

So, how is the current situation impacting the implementation of transition plans? Is short-term noise distracting banks from the decades-long process of decarbonization? Or can banks stay on track to deliver their net zero commitments?

To answer these important questions, the EBF and EY conducted a survey between 9 August and 12 September 2022 of 27 major European banks from 18 jurisdictions with combined total assets of more than USD 16tn[1]. This was followed by workshops involving several institutions, and complemented with desk research.

This report summarizes our key findings. We would like to thank all the institutions and individuals involved for sharing their insights and experiences, which we hope will shed new light on the challenges facing European banks as they work towards net zero.

European banks are advancing their transition agendas

European banks have hugely increased their focus on climate change in recent years. Most have made public net zero commitments, and an increasing number are publishing their 2030 interim targets and sector-specific interim targets.

Many large banks have joined initiatives such as the Net Zero Banking Alliance (NZBA), the Partnership for Carbon Accounting Financials (PCAF) or the Collective Commitment to Climate Action organized by UNEP FI[2]. Last year's COP26 summit saw Europe's leading banks, together with other members of GFANZ[3], commit to aligning $130tn of private capital with Paris Agreement goals. EY's latest Climate Risk Barometer[4] shows that 77% of global banks are producing climate-related disclosures, increasingly based on the recommendations of the TCFD[5].

Our survey and the workshops that followed provide evidence of the progress that European banks have made in integrating climate action into their activities, and of the changes to lending and capital allocation that have already taken place.

For example, almost half (48%) say they have embedded climate risks into certain areas, such as high emitting sectors. This group give themselves a score of 3 on a scale of 1-5. An additional 26% of respondents, mostly comprised of larger banks, score themselves at 4. In contrast a small minority (7%) of banks have yet to start the process.

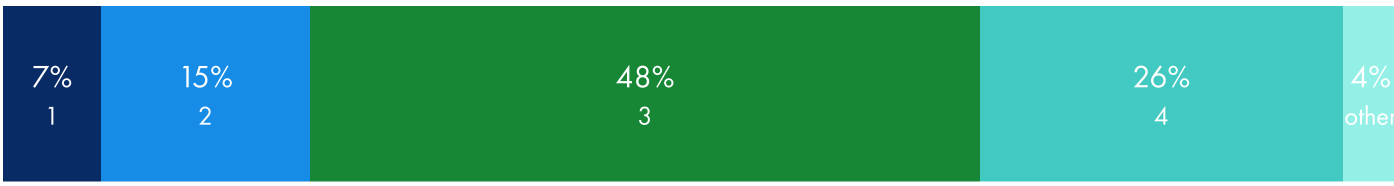
Asked about the scope of their transition plans, lending activities stand out as banks' greatest area of focus. Most banks are aiming to accelerate their **financing of green assets at the same time as gradually reducing their support for high-polluting activities.** Some respondents include all lending in the scope of their transition plans (17%), while others concentrate on selected sectors (28%) – typically the most polluting.

When it comes to aligning portfolios with their climate commitments, the majority of respondents are either in the immature, development stage (44%) or at the first stages of implementation (45%). On average, larger banks are more likely to have begun implementation than their smaller counterparts.

There is much to be done. **To meet net Zero by 2050, the International Energy Agency (IEA) believes that annual global energy investment needs to grow from recent levels of $2tn p.a. to almost $5tn p.a. by 2030.** Most banks still have some way to go; only a minority of respondents (11%) say they are at an advanced stage of maturity and have already met intermediate targets for portfolio alignment.

Figure 1

Extent to which banks embedded climate risk throughout their organisation on a scale of 1 – 5



[1] Sum of total balance sheet assets at 2021 year end | [2] United Nations Environment Programme – Finance Initiative | [3] Glasgow Financial Alliance for Net Zero | [4] Climate Risk Barometer | [5] Taskforce on Climate-related Financial Disclosure

External shocks are affecting banks' climate strategies

Since 2020, European banks' efforts to develop and implement climate transition plans have been impacted by major external sources of disruption. These have often reinforced each other, while also exerting conflicting pressures on banks at times.

First, the COVID-19 pandemic impacted global trade flows and economic prospects. The disruption of supply chains and the subsequent withdrawal from global chains affected individual sectors in very different ways, with prices and profitability rising in some areas but falling in others. These effects were partially reversed in the recovery phase, during which higher consumer demand and a rebound in travel, manufacturing and transportation pushed up energy prices.

Second, the war in Ukraine affected economic prospects in many markets. Food and energy supplies were severely disrupted, with the prices of oil, gas, wheat and other commodities increasing steeply in response to the conflict itself and to sanctions imposed on Russia.

For example, Russian imports accounted for almost 40% of the EU's pre-pandemic natural gas consumption[6].

Third, the economic volatility triggered by the pandemic and the war in Ukraine has acquired a momentum of its own, fueled by the prospect of monetary tightening. Pro-cyclical factors now in play include higher inflation, rising debt burdens and slowing economic activity. GDP growth for the euro area in 2023 is expected to be less than half that of 2021. Further trade disruption or additional economic sanctions could plunge the European economy into recession.

For most European banks, the direct physical risks posed by the war and the pandemic are low. Instead, **the consequences of recent disruption are making themselves felt in two ways:**

- **Economically:** Financial market volatility, rising inflation and higher interest rates are affecting the creditworthiness of governments, businesses and individuals. According to the European Investment Bank's (EIB) early estimates, the share of EU firms losing money has risen from 8% to 15% since the invasion of Ukraine, and the risk of default on their debt has surged from 10% to 17% over the same period. The end of a decade and a half of low yields and ultra-loose monetary policy also has profound implications for banks' balance sheet management.

- **Politically:** The political climate has changed significantly. The desire for banks to support the climate transition is accelerating, but the war in Ukraine has led many governments to reassess their energy security. Banks now face an additional expectation that they will help to secure greater food and energy resilience.

These factors are influencing banks' strategies in three areas:

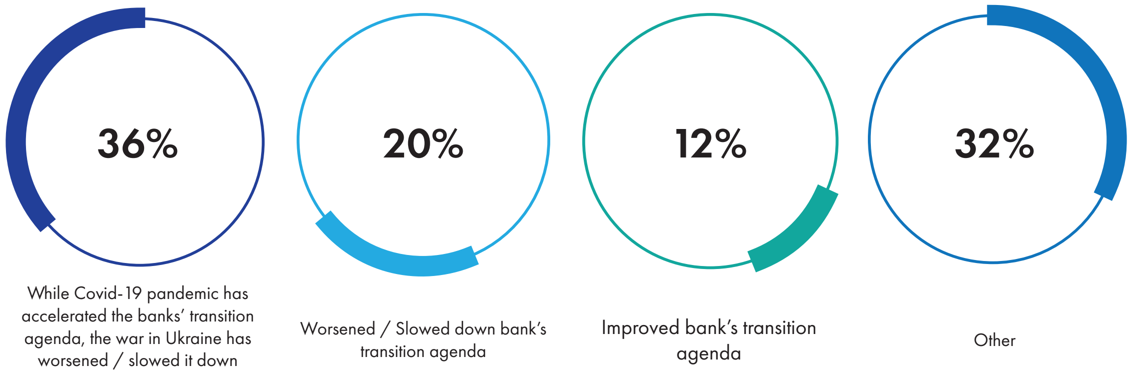
1.Overall business models: The pandemic has had a permanent impact on areas such as online services and remote working, re-shaping business models.

2.Country strategies: Disruption to energy sources and supply chains is affecting each market in different ways, prompting a range of government responses and significantly altering risks and opportunities for European banks.

3.Climate strategies: Our survey (see Figure 2) shows that a majority of respondents see the war in Ukraine as having slowed their transition agenda in recent months, either in conjunction with COVID-19 (20%) or despite the pandemic having helped to strengthen their transition agenda (36%). Only a minority (12%) see the combined impact of recent events as having accelerated their transition agenda, with a further 32% reporting a mixture of greater transition urgency and increasing practical obstacles.

[6] Enerdata Executive Brief – Energy crisis: Opportunity or Threat for the EU's Energy Transition?

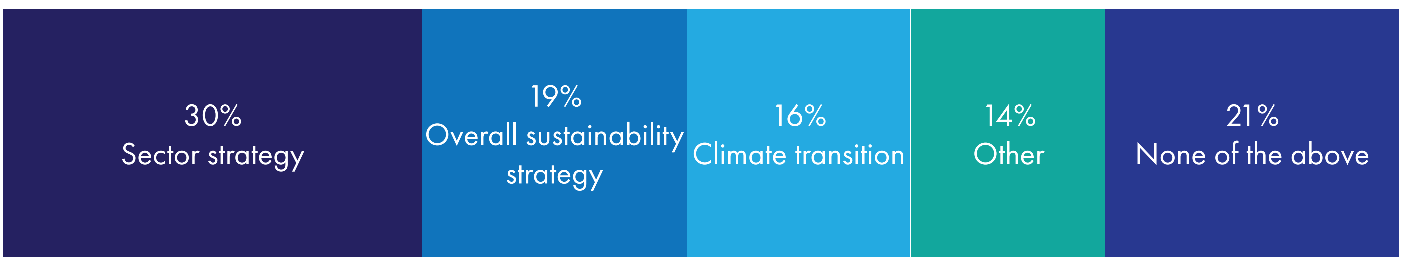
Figure 2
Short term (within a 3-year time horizon) impact of the war in Ukraine and COVID-19 on banks' transition agenda because of related changes to business choices in their portfolio



What does a slowdown of banks' transition agendas look like in practice?

When asked about the areas affected by the pandemic and the war in Ukraine (see Figure 3), survey respondents are most likely to say they have reassessed their sector strategy (30%). It is also notable that a majority (66%) see inflation caused by recent supply chain disruption as having had a negative impact on their sector strategy by reducing commercial opportunities and slowing climate action.

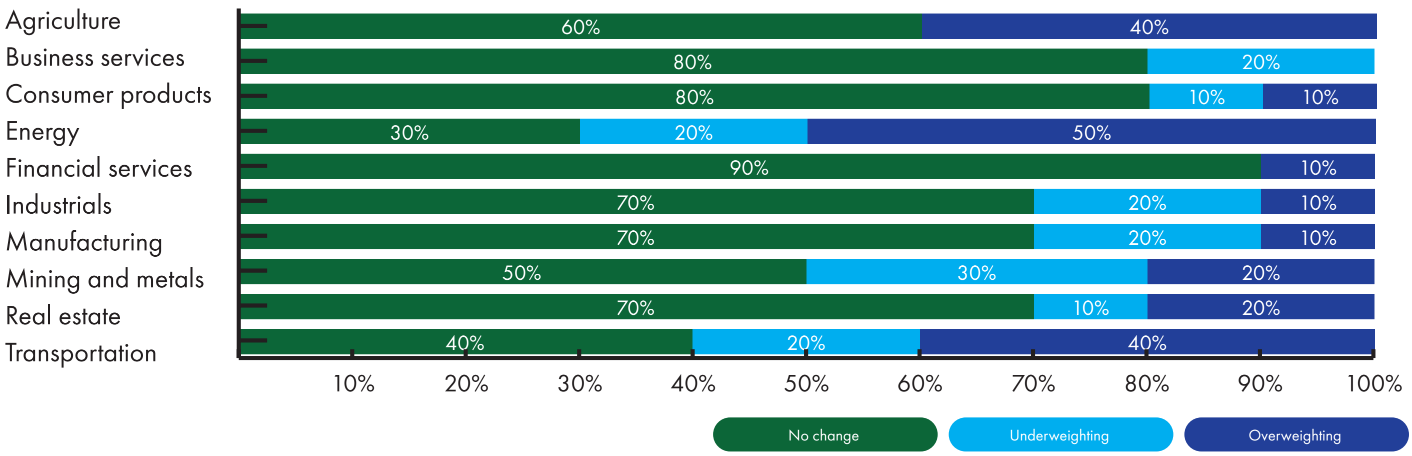
Figure 3
The combined effects of COVID-19 and the war in Ukraine led banks to reassess their approach to:



Fiduciary duties and lengthy lending maturities mean that banks can't simply alter their sector strategies at short notice. There is no indication that overall risk appetite frameworks have suddenly changed; that would go against the business model of commercial banks, which is about long-term relationship management. Even so, it's clear that **European banks' sector positions have been affected by the rapid changes in the real economy and the associated shifts in clients' short-term funding needs.** A closer analysis of the views of respondents reporting changes to their sector positions reveals some clear patterns:

Overall (see Figure 4), the greatest effect of the COVID-19 pandemic and the war in Ukraine has been on the **energy sector,** which is overweighted by 50% of our respondents. That is backed up by the 42% of banks agreeing that the gas supply crisis and increased use of fossil fuels will put them under pressure to reassess their portfolio mix in the next 12 months (only 12% of respondents disagreed).

Figure 4
Macro sectors impacted by the Sector Strategy reassessment (of banks that stated their sector strategy has been reassessed)



These findings reflect rapidly changing sentiment towards the energy sector since the start of the decade. As recently as 2020, COVID-19 appeared to be strengthening public awareness of environmental risks and highlighting the importance of swift and effective action to address the climate emergency. This, coming after relatively low oil and gas prices in the late 2010s, led to comparative **underinvestment in energy infrastructure in the years preceding the pandemic.**

In contrast, 2022 saw **the war in Ukraine dramatically increase the energy sector's need for working capital and fresh investment,** both to satisfy an immediate shortfall in fossil fuel availability and to develop alternative sources of energy.

The scale of these shifts in sentiment is illustrated by market movements. On average, the Markit CDX North America Energy Index was 24% higher in the six months after the start of the war in Ukraine than during the preceding six months, indicating increased risk. However, energy also returned the strongest equity performance of any sector over the first eight months of 2022.

Looking beyond energy, banks are **overweighting agriculture** as they support farmers and food producers working to stabilize disrupted supply chains and develop alternative solutions that will improve long-term food security. Agriculture was one of the only sectors apart from energy to generate a positive equity return during the first eight months of 2022. Banks also report a positive balance of sentiment towards transportation, with those concerned about the impact of an economic slowdown outnumbered by others seeing opportunities to fund new technologies.

In contrast, **mining & metals** are relatively underweighted, with the sector facing a double hit from the economic downturn and lower demand for coal. Concerns over the general economic outlook mean that **business services** are underweighted too. **Manufacturing and industrials** also face slightly negative sentiment, although this conceals contrasting views about the prospects of different sub-sectors. For example, some banks see recent events enhancing the prospects for green hydrogen production.

Despite disruption, banks remain strongly committed to net zero

The disruption of transition agendas and forced changes to sector strategies pose a clear challenge to net zero commitments, especially since energy is a major source of transition risk. Our research (see Figure 5) confirms that the energy crisis has had a negative short-term impact on European banks' transition agendas.

Even so, European banks have not made any formal change to their energy strategies or long-term targets for emissions reductions.

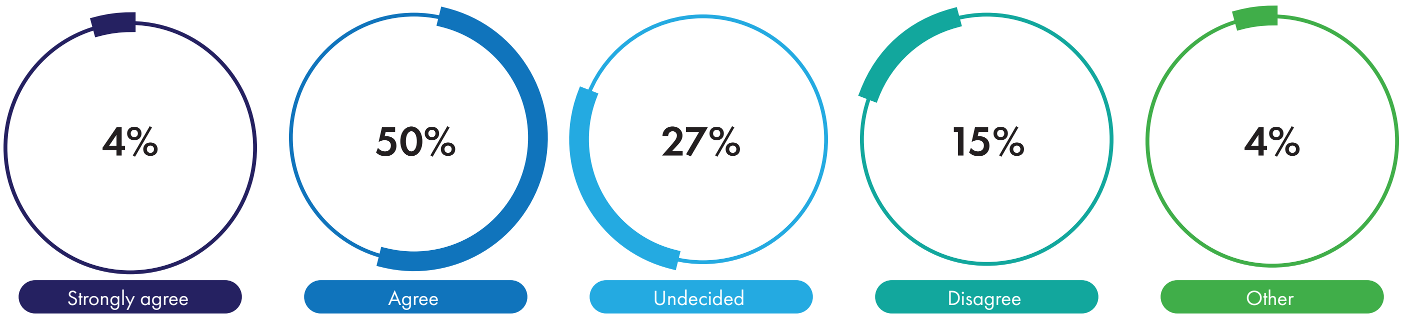
In short, European banks remain firmly committed to net zero despite the disruption that recent events have brought to their own climate strategies. There are a number of reasons for this determination, beginning with several internal factors:

- **Banks are deeply concerned about the impact of the climate crisis.** The context may have changed, but the science has not. Our research confirms that belief in the importance of achieving net zero is sincerely and widely held.

- **The energy crisis is fostering long-term demand for new energy sources** such as biogas and solar – both to decarbonize, and to improve energy security. Opportunities to finance the development of alternative power generation and infrastructure are growing: the IEA expects global clean energy investment to exceed $1.4tn in 2022, accounting for almost three quarters of energy investment growth. Utility-scale wind and solar are now the cheapest power generation sources in many countries.

- Our research shows that **banks have a strong sense of social responsibility.** The industry has a crucial role to play in enabling clients to reduce emissions while continuing to create employment and provide vital goods and services. **Banks would prefer to support clients through this process rather than walk away, although our workshops show that, if necessary, they are willing to end their relationships with companies that fail to develop meaningful transition plans.** The desire to engage, not divest, is particularly strong in emerging markets where energy production often remains heavily reliant on fossil fuels and the withdrawal of finance would trigger huge economic and social disruption.

Figure 5
Agreement with the following statement: 'In the short-term the energy crisis will negatively impact your ability to stay on track with your transition agenda'



These factors are backed by external drivers such as banking regulation, supervisory expectations and pressure from other stakeholders. Together, these provide a tangible incentive to remain focused on decarbonization. But **while banks face clear public expectations to finance the transition, pressure to foster short-term stability in the energy sector is also rising.**

This means it's important for banks to balance authentic, real-world climate transition plans with a continuing commitment to the interests of all their stakeholders. **The ability to engage effectively with stakeholders by communicating plans and demonstrating measurable progress is key.** Protecting the unspoken 'license to operate' is especially important for significant institutions that received explicit or implicit government support during the years of financial crisis between 2007 and 2010.

The practical challenges of meeting stakeholder expectations

European banks face huge practical challenges as they seek to provide continuing post-pandemic credit support to meet the liquidity needs of those affected by the energy crisis, and to support the gradual decarbonization of the whole economy.

This is not just about the unpredictable impact of the war in Ukraine, including its secondary effects such as energy price caps and nationalizations. Nor is it limited to ongoing market volatility. **European banks also face a range of structural obstacles.** Each has the potential to make it harder for banks and, equally importantly, their corporate clients, to execute their long-term transition plans.

Government policies represent one area of uncertainty. Banks are hoping for clearer country-level plans for climate-related policies, tariffs, incentives and investment. Making national plans and sectoral decarbonization pathways more durable – perhaps with the help of industry initiatives – would also be very valuable. Banks would also welcome clearer guidance on the energy transition from multilateral development banks.

In a more strategic sense, **the EU's leadership in climate-related regulation keeps EU banks at the cutting edge of decarbonization.** However – despite emerging regulations in the US and Asia – it raises the possibility of European institutions facing more 'first-mover friction' than their rivals in other regions.

Finally, our workshops show that **approaches to sector-by-sector decarbonization strategies are still maturing.** Reducing financed emissions through client engagement can require difficult trade-offs by banks, especially when conflicting environmental or policy objectives arise – such as comparing the value of land use for agriculture, biodiversity or solar generation.

Banks also need to decide which activities they can finance as part of longer-term decarbonization plans, and for how long.

These challenges mean that **clear sectoral transition pathways are vital.** Smaller banks with limited resources and experience are likely to find engagement particularly difficult. Having an intentional balance sheet management framework, which can be used to appraise external shocks, is therefore important. EY sets out such a framework in a new paper that applies it to energy, agriculture, auto manufacturing and aviation[7].

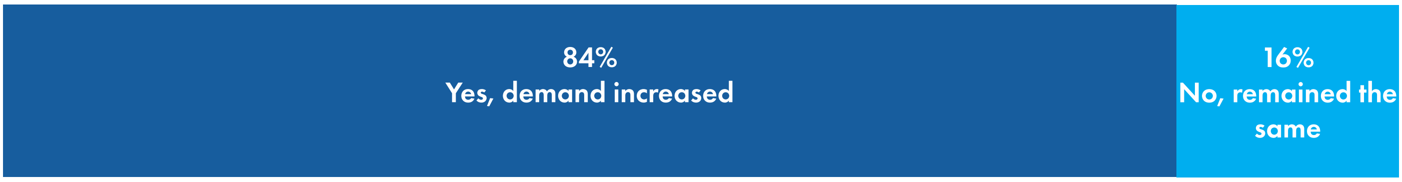
[7] *How can sustainable finance transform 2050 pledges into real-world impact? | EY - Global*

What comes next?

Our research shows that European banks remain firmly committed to their emissions reduction goals. The underlying drivers of this stance, ranging from scientific evidence to regulation, customer preferences, investor demand, risk management, and public opinion, remain largely unchanged by disruption from the COVID-19 pandemic and the war in Ukraine.

In fact, many banks feel that the **current crisis could actually accelerate the global transition over the medium-term**. This is supported by our survey (see Figure 6). A large majority of the banks taking part (84%) see macroeconomic challenges pushing up demand for renewables financing and infrastructure renewal. This view is borne out by the 8.1% rise recorded by the S&P Global Clean Energy Index during the first eight months of 2022. A similar proportion of respondents (77%) agree that recent supply chain disruption will increase the need to finance technology and R&D that could accelerate the transition.

Figure 6
Effect of the worsening macroeconomic conditions, rising inflation, and a shift toward cheaper sources of energy on the demand for the financing of renewable projects



Banks' commitments may not be in doubt, but how can they continue to implement their plans in the current environment?

At the most fundamental level, banks are indivisible from their balance sheets. To succeed in the global market, European banks will need to balance credit, liquidity and maturity risks while delivering a healthy margin. Their ability to do this while meeting stakeholder expectations around pandemic recovery, energy security and decarbonization will depend:

- **In the next 12 to 18 months** - On the extent to which the ongoing political and economic volatility triggered by the COVID-19 pandemic and the war in Ukraine continue to put pressure on banks as they provide support to disrupted sectors of the economy.

- **In the coming 3 to 5 years** - On the extent to which the after-effects of recent crises accelerate or slow banks' climate strategies. In part this is about the impact of external factors such as regulatory activity, government decisions and, most importantly, the choices made by corporates and other institutions. However, banks can also shape the evolution of climate solutions by providing innovative financial support for emerging technologies such as green hydrogen, sustainable aircraft fuel or carbon capture and storage. That might mean partnering with governments, collaborating across the financial ecosystem or, for example, learning from their experience of financing solar and offshore wind power – which are now cheaper than gas-fired energy. Industry-wide initiatives have a critical role to play here.

The last three years have made it clear that European banks' road to net zero will not be linear. That does not mean the destination is unattainable. After all, banks are long-term players and these are 30-year goals. But it remains to be seen how they will stay on course while carrying the additional load brought on by two exceptional global crises. Clear measurable transition plans, backed up by effective stakeholder engagement, will be vital to achieving authentic real-world impact.

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About EY

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Through our four integrated service lines — Assurance, Consulting, Strategy and Transactions, and Tax — and our deep sector knowledge, we help our clients to capitalize on new opportunities and assess and manage risk to deliver responsible growth. Our high-performing, multidisciplinary teams help them fulfil regulatory requirements, keep investors informed and meet stakeholder needs.
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