COLUMBIA THREADNEEDLE INVESTMENTS

A unique lens on banks and net zero

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- **We want to gauge how financial institutions are embracing the energy transition, managing climate change risks, and looking at the opportunities presented by the decarbonisation process**
- **We discovered climate risk management functions and reporting standards have improved, but climate risk processes are not yet operationally mature**
- **This is a great example of how we integrate RI into our investment process, showcasing our research intensity and collaboration, and our deep understanding of climate issues**

Over the past six months the Credit Analysts team at Columbia Threadneedle Investments has conducted its second net zero engagement exercise for the banking sector. Our objective is to gauge how institutions are embracing the energy transition, how they are managing climate change risks, as well as seizing the opportunities from the decarbonisation process – something we have been interested in for some time[1].

We held meetings with 47 banks from 18 countries across Europe and Asia, talking to representatives from management, investor relations and the climate and sustainability risk departments. We asked a list of tailored questions[2], designed in collaboration with our Responsible Investment (RI) Thematic Research team, to assess whether each company's lending and investment policies are aligned with a forward-looking net zero pathway. The questions are aimed at understanding the most financial material issues resulting from a net-zero transition to the banking sector.

This exercise is a great example of how we integrate RI into our investment process, showcasing our research intensity and collaboration as well as our deep understanding of climate issues from a fundamental and investment perspective.

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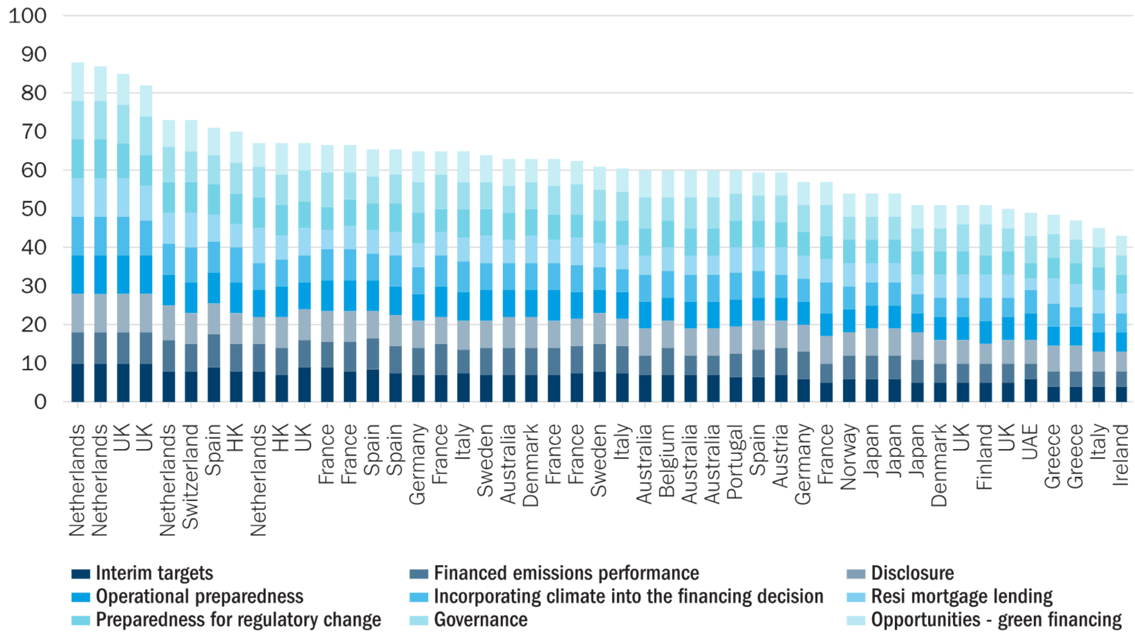
[1] Columbia Threadneedle Investments, Climate change to bear upon banks' financial performance, September 2021

[2] See Appendix

We found that most banks have made changes at the top of their organisations to implement net zero targets, and almost all have set targets both for green financing and for the reduction of financed emissions. The majority are doing well on the former but only a small proportion have made any real progress in the latter.

In general, climate risk management functions are being beefed up and reporting standards have improved, but climate risk processes are not yet operationally mature (Figure 1). However, we do feel the building blocks are in place, and we expect meaningful progress over the next few years.

Figure 1: how the banks are shaping up at a country-level



Source: Columbia Threadneedle Investment's analysis, May 2023

Interim net zero targets for financed emissions

Banks are essentially made up of people, computers and office buildings which collectively produce few direct emissions. These are known as scope 1 and 2 emissions: scope 1 are emissions a company makes directly, through the vehicles it uses, for example; and scope 2 are emissions from the electricity or energy it buys to heat its buildings. However, banks provide the financing for companies or properties which do produce emissions (scope 3), on a scale of minor to vast. We call these "financed emissions", and this is where the focus of our engagement lay. High-level climate pledges are no longer enough. Banks are facing pressure from investors, customers, NGOs and regulators to put credible net zero plans in place for financed emissions.

Almost all the banks we met with are members of the Net-Zero Banking Alliance (NZBA). NZBA member banks are required to set targets to reduce lending to carbon-intensive industries. Most have set sectoral targets for oil and gas and power, and the more advanced lenders are incorporating other sectors such as cement, autos, aviation and commercial real estate. Targeted reductions are between 30% and 60% by 2030. Typically, a credible net zero scenario such as the International Energy Agency's Net Zero Emissions by 2050 Scenario (NZE) is used, and targets are validated by an external party. If the sector delivers on these commitments, it will make a meaningful contribution towards cutting greenhouse gas emissions.

Current performance relative to interim financed emissions targets

Exposure to fossil fuels has started to decline among financial institutions, but we are yet to see real progress on other emissions intensive sectors. On average, around 10% of a bank's loan book is to energy, utilities and mining, autos, chemicals and agriculture sectors[3]. That hasn't reduced much since our last net zero engagement exercise in 2021. However, the banking sector's involvement in the underwriting of bonds and syndicated loans to carbon intensive industries has improved. We expect meaningful progress over the next few years as operational change is implemented.

Disclosure of financed emissions

Disclosure of financed emissions has come on leaps and bounds over the past couple of years, but there is plenty of room for improvement. Most of the banks we spoke to are now reporting in accordance with TCFD (Task Force on Climate-Related Financial Disclosures) recommendations; the market leaders have been using TCFD for several years. Climate reports produced by the banks have grown from a handful of pages to more than 100 pages. We applaud ING[4], NatWest, BBVA and Barclays on this front. All four provide clear numbers allowing analysts to track year-on-year progress.

There is still work to do, however. Disclosure remains inconsistent. Some banks report absolute emissions, others use emissions intensity. Some use drawn loans and others include off-balance sheet undrawn commitments and bond underwriting. Only the more advanced companies such as HSBC and NatWest provide a view on the quality of the data they provide, based on the PCAF 1-5 scale (the Partnership for Carbon Accounting Financials is perhaps the leading global standard for measuring and reporting financed emissions). All of this means that comparing banks' net zero targets isn't easy. The sector is due to report the Green Asset Ratio, which measures what proportion of assets are aligned to the EU taxonomy, with the 2023 full year numbers. We encouraged the investor relations and risk managers we met to use this as a catalyst to start publishing readily comparable information.

Operational preparedness

There is much operational change taking place. The majority of banks told us they want to take things slowly to get it right. We have some sympathy for this – it's a steep learning curve. Climate risk data tools are being created, using a combination of internal and external data. Banks are leveraging what's available from PCAF, PACTA (The Paris Agreement Capital Transition Assessment) and SBTi (Science Based Targets initiative), as well as partnering with consultants. ESG risk and sustainability departments are also being beefed up – for example, Standard Chartered has built a sizable team of specialists in Poland and India. This new generation of "climate bankers" are in short supply, so new recruits are being sought from industry (mining and other heavy emitters) or from consultancies.

There is also a focus on upskilling existing staff. Some banks, such as ING, are using universities. For others the training is mostly in-house (Deutsche, for example). For front line staff the training tends to be classroom based, for the wider workforce it is often online modules which we felt could be a bit flimsy – such as the ones Commerzbank described.

[3] Columbia Threadneedle Investments' analysis of company reports, May 2023

[4] Mention of specific institutions should not be taken as a recommendation

Incorporating climate into the financing decision

Lending now needs to be in line with banks' own net zero transition targets. To make the assessment, internal climate experts work with relationship managers using new tools to understand the transition pathway of the corporate borrower. Often this isn't an easy process given the lack of data in published accounts. The problem only intensifies with lending to small and medium-sized enterprises. Tricky cases are reviewed by a bank's risk committee or a similar specialist committee, such as Deutsche Bank's Net Zero Alignment Forum. Outside of a select few, such as ING and Triodos, these processes are not operationally mature. We only found a handful of lenders currently willing to reduce exposure to polluters. Most banks are still putting the building blocks for this in place, establishing dialogues and informing clients that lending may not be renewed in 2025 unless a credible transition plan is put in place. Management teams were keen to emphasise here that they take a longer view than the tenor of the financing, which is typically short dated.

Residential mortgage lending

European and Asian bank loan books are heavily skewed towards residential mortgages. For many lenders the mortgage portfolio is the largest source of financed emissions. Large gains could be made here by decarbonising the power grid but reducing the footprint of individual homes is tricky. Householders need to retrofit their homes. Some banks are offering innovative, lower margin products to incentivise such change – Triodos for example – but the institutions we spoke to unanimously felt that governments need to lead the way with subsidies and incentives, such as the SBCI (Strategic Banking Corporation of Ireland) scheme involving government guaranteed lending for energy efficiency projects. However, without concrete commitments from governments, only a handful of banks including NatWest and UBS have been confident enough to set a 2030 net zero target for their residential mortgage portfolios.

Preparing for regulatory change

Climate stress tests are here to stay. Most banks are running climate-related scenario testing. Those that are most advanced operationally, especially on the data front, are best prepared. Banks with large exposures to carbon-intensive industries are likely to have larger capital drawdowns in the tests and will therefore have to hold more capital. We expect regulators to demand an additional 50-100bp of buffers over the next few years to cover climate risks. As such, lending to high emissions industries or where there is higher physical risk will become more capital intensive and more expensive. Some banks are already increasing the internal cost of funding for high emitters and reducing it for green lending — we congratulate Nordic bank SEB & French bank Natixis (BPCE Group) here on their approach.

Governance

For effective change to occur, climate risk awareness needs to start at the top and permeate throughout the entire organisation – a complete culture change is required. Banks are exposed to several risks, traditionally credit, market, treasury, operational and legal risks. Now, climate risk has been elevated to a principal risk to the banking business. Institutions must now consider whether the financing they provide is congruent with the bank's own net zero commitments. We wondered whether management teams were appropriately incentivised to make this change and duly found that CEO compensation is often only indirectly linked to net zero targets with less than 20% of the banks we quizzed having a clear link between net zero targets and CEO pay.

We also questioned whether there is enough expertise at the top to manage the transition. A few banks had some relevant transition experience on the board – we would highlight Australian institutions here with their mining industry experience – but overall we did not find a wealth of relevant experience in the most senior roles. However, most of the banks have now created a Chief Climate Officer (CCO) role. This sometimes reports to the CEO, but more often to the Chief Risk Officer.

Opportunities

Most banks now have multi-year targets for green financing. In aggregate, the banks we spoke to are hitting and increasing targets year-on-year. Interestingly, the sector is already doing more green financing than fossil fuel financing! However, a lot more is required. The aggregate green financing for our coverage universe is about $1 trillion a year. This is only 25% of the estimated annual green financing requirement[5]. This represents a huge opportunity and banks are only just making a start to lay out the revenue potential, with Standard Chartered and Deutsche Bank having made some great progress here.

Conclusions and positioning

The leading banks in Europe and Asia have made good progress over the past year on a path to net zero, but it is clear from our conversations that some are more aligned than others. We don't believe this difference is reflected in the pricing of fixed income instruments – ie, it is not something that is yet impacting banks' earnings or capital requirements.

However, we believe net zero alignment of banks will become increasingly important in the coming years. At Columbia Threadneedle we incorporate the learnings of these net zero engagements with banks into our analysis and portfolio construction. Banks scoring well have seen a positive impact on their fundamental score in our model, including some UK, Dutch, Spanish and French banks; the opposite is true for banks that performed less well. Our fundamental scoring feeds directly into our pricing expectations for credits. All else being equal, we believe net zero-aligned banks should have a lower cost of funding than those which are not aligned.

[5] Columbia Threadneedle analysis of company reports and Global Financial Markets Association and Boston Consulting Group, June 2021

Appendix

The categories and questions we put to the banks:

Interim net zero targets for financed emissions

• Can you describe your interim targets?

• Have these targets been validated by an external party?

• Does the bank have a policy demonstrating a carefully managed withdrawal from existing coal lending and underwriting and prohibition of new coal (generation/mining) , as well as oil and gas infrastructure linked lending and underwriting?

Provide robust disclosure

• Has the company reported on their approach to managing climate risks and opportunities?

Enhance climate risk management

• How are climate considerations integrated into financial risk management policies and frameworks, across both lending and underwriting?

• Specific examples of investing in people and tech for climate risk purposes.

• How much are you investing in climate risk? (Please provide $ figures if possible).

• Practically how do you engage to understand a company's decarbonisation plan? How often do you have these conversations? Which people have these conversations? Where do you recruit the people with the skillsets to have these conversations?

• Would you reduce funding or shorten maturities if companies are not decarbonising quickly enough? Practically, how do you choose to fund one company and not the other? Please provide a few examples here.

Residential mortgage lending

• How are you thinking about improving the EPC rating of the homes you finance?

• Are you considering different rates for different EPC ratings?

• Are you financing the greening of the housing stock, eg a green mortgage to upgrade from EPC rating D to B?

Preparedness for regulatory change

• Does the bank conduct climate scenario analysis and stress testing across all sectors they are exposed to?

• How are you preparing for central bank stress tests?

• Are deforestation and broader biodiversity risks considered in methodologies?

• How do you think about the internal cost of funding for lending to green/polluting companies?

Implement robust climate change governance frameworks

• Is there clear accountability for climate within the board?

• Does the board have sufficient climate expertise to manage the transition?

• Do you have a Chief Climate Officer. Who does the CCO report to?

• Is executive remuneration directly linked to the implementation of the climate strategy?

Opportunities – green financing

• Advisory, funding, lending

• Targets and progress against targets

• How are you looking to capitalise on the opportunity?

• When will you put numbers around the revenue opportunity?