CLIMATE CHANGE: HOW DOES IT IMPACT THE BANKS?

Key takeaways

- Banks are highly regulated institutions and they are under public scrutiny. They increasingly have to demonstrate that environmental, social, and governance (ESG) subjects are at the top of their agenda.
- We caution that there are perception risks for banks which fail to address such subjects. They could end up with a damaged image and reputation which could in term harm their franchise. We deem the opposite is true for banks which are the most advanced on ESG subjects.
- While we strongly believe that governance is crucial for banks, they also need to address environment and social subjects, notably with the key question of climate change and energy transition financing.
- In this report, we focus on environmental subjects which we deem are relevant for banks. Bearing in mind that banks are also actors in energy transition through their role as lenders to the real economy.
- In a nutshell, when it comes to climate change, we believe banks are more exposed to transition risk rather than physical risk, at least for now:
    - In the short term, we see more risks than opportunities for banks. There is a key question of costs to implement systems designed for measuring and monitoring their exposure to transition risk. This includes the green asset ratio for European banks and its implementation.
    - In the long run, we see opportunities with regard to energy transition financing. We also believe that banks' reputations and image will eventually be at stake should they either successfully address or fail to address these risks.

Introduction: ESG risks and opportunities for banks

We analyse the banking sector on the 3 pillars environment (E), social (S) and governance (G) in order to accurately determine the impact of environmental, social, and governance factors on banks. While we have explained in introduction why environment is an important topic for banks, let us reiterate what social and governance means for them.

Regarding the social pillar, we believe that short-term challenges are related to data protection. In the long term, it is a question of business model transformation and change in banking methods.

We have identified a number of risks for the banking sector in the social pillar. These include the sale of unsuitable products to the customer as well as mis-selling (leading to costs and sanctions, and impact on brand image). Also, migration of customer data induced by regulations, change in banking methods, i.e. online banking with huge IT investments, change in demographics (ageing population and impact on banking product) and finally human capital (capacity to attract talents). The opportunities come down to change in customer patterns: banks advanced in digital transition will benefit from lower operating costs and more industrialized processes.

Concerning the governance pillar, the challenges are related to controversies linked to growing stakeholder ESG awareness: they are less keen to accept misconduct even if the financial impact is immaterial.

The risks identified for the banking sector in the G pillar are also numerous: financial transparency risk (including organization/business complexity), quality and timeliness of financial reporting, lack of or inefficient decision-making process, inadequate checks and balances and litigation risks, and governance of IT systems (cybersecurity and data protection). Concerning the opportunities, good governance is the minimum we want to see for banks. Safe haven banks with solid reputations are best positioned to maintain client trust.

We will now focus on the environmental pillar and its impact on the banking sector.

1. Banks' exposure to transition risk

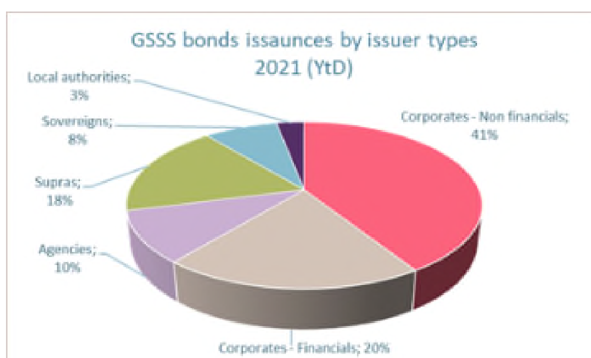
Mainly risks in the short term

Banks are exposed to **transition risk in their loans and investments** on the asset side. A key risk would be to end up with stranded assets on their balance sheet.
This notably includes exposure to carbon intensive sectors and the coal industry. We note however that banks in emerging countries tend to have greater exposure to such assets. Another element we monitor is residual value risk, namely for auto leasing entities exposed to a high share of diesel cars.

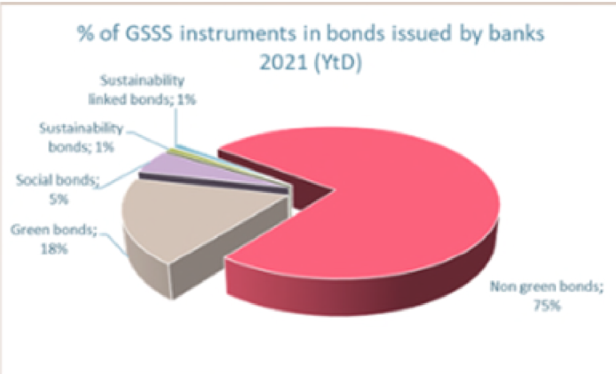
Longer term, banks which are well prepared vis-à-vis climate change will emerge as winners (better image, new opportunities)

In the mid / long run, energy transition will bring **opportunities** namely around the financing of the transition and the growth of the green and sustainable bond market (GSS). Banks could develop new business opportunities for instance in capital market activities with the issuance of GSS bonds.

GSS bond issuances for banks: green bonds account for an increasing share of banks' bond issues and are mainly realized under senior status



Source: CACIB, EBA, ECB, Banktrack, Bank



Source: CACIB, EBA, ECB, Banktrack, Bank

Also, sustainable development could induce **positive change in the loan mix**. With less exposure to stranded assets. For instance, the UN-convened Net Zero Banking Alliance brings together 95 banks from 39 countries, representing 43% of global banking assets (over US$66 trillion) which are committed to align their loans and investments with net zero emissions by 2050. This will entail the run-down of the most climate sensitive exposures (GHG sensitive) with initial targets in 2030. Most European banks have already set an exclusion policy for coal and certain fossil-fuel related sectors.
However, as things head in this particular direction, we would need to watch for potential concentration risk in 'green' industries and monitor the pricing of these loans (which needs to reflect their credit risk).

With growing stakeholder awareness of environmental issues, we also think that banks on top of E subjects will be more able to defend and develop their franchise (better ESG reputation and image).

2. How to measure transition risk? Regulation: European Union green deal and green asset ratio (GAR)

The European regulator is putting in place several **quantitative indicators** to monitor and measure banks' exposure to transition risk. One of these indicators is the **green asset ratio.** In the short term, we caution about **high implementation costs because of a data issue**. In the long run, the GAR will enhance transparency.

Green asset ratio definition

The green asset ratio (GAR) is the main KPI put in place by the European Banking Authority (EBA) and represents the green share of banks' exposures according to EU taxonomy.
It will be reported with 3 different measures (GAR stock: backward looking view, GAR flow more "dynamic" exposures and non-EU GAR for the non-EU exposures).

Deadline:

- Banks should have until end 2022 to report the GARs, based on data at end 2021 (this will apply only to exposures for big corporates).
- June 2024: proposed deadline for reporting a more comprehensive GAR including SMEs.

Quantification of GAR to have an idea of where we stand today and what this would look like:

- An EU-wide pilot exercise was run by the EBA on a sample of 29 volunteer banks from 10 countries, representing 50% of the EU banking sector's total assets.
- The aggregated GAR stands at 7.9% with significant difference amongst the banks.
- The EBA expects a low single-digit GAR to be disclosed by banks by 2022, and also pointed to the importance of focusing on the targeted GAR of banks.

Short-term issues on data and cost

In the short term, there is the question of quality and (un)availability of data as banks are not ready to report under EU taxonomy.
Thus, there will be costs to implement the GAR. This factor will undermine European banks' already low profitability. And this will become even more of a subject for third tier banks with extremely low earnings and limited capacity to meet such requirements.
There are also some limits with regard to the GAR as it does not capture additionality for instance.

Long term: GAR to enhance transparency and help banks manage their transition risk

Longer term opportunities:

- When data issues are resolved, we should have better transparency on banks' assets. This will facilitate the identification of the banks which are more advanced on ESG issues and the ones that are more exposed to risks.
- GAR to become a tool to engage with banks on their exposure to climate risks and how they prepare for this.
- A tool for banks to manage their transition risk.

3. Physical risks

Stressing banks' capital

In short, banks' exposure to physical risk (resulting from damage directly caused by weather and climate phenomena) is generally limited for now. However, it could become more meaningful in case of a disorderly transition with acute climate change risk. This is why we believe the key subject is energy transition financing, with reputation risk for banks which do not address this topic.

- Stress tests: we expect more clarity on how climate related risks will impact banks' balance sheets from 2022 onwards as stress tests are published.
- Climate risks are increasingly under scrutiny and could influence capital requirements.
- However, **exposure to physical risk remains small** for banks as highlighted by the climate stress tests by ACPR and BOE. The key subject is energy transition financing.

Finally, we will conclude this report by highlighting that there are discussions on how the regulator could incentivize banks to finance energy transition (go greener) and penalize banks exposed to brown assets (including financing fossil assets, etc.). This could eventually influence banks' capital ratios. However, we caution that, at this stage, we think it is very complicated to reconcile the public push towards greener assets and the financial stability of the system. As the credit risk of the underlying loans has to (this is crucial!) be considered when calculating banks' capital.

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CONCLUSION

In a nutshell, banks are key actors of climate transition and sustainable development. While exposure to physical risk is small for banks (at least for now), the key subject is energy transition financing, with potential reputation risk. We see long-term opportunities for banks that are well prepared to face ESG challenges. Banks without ESG at the top of their agenda might become laggards.

To analyse banks from an ESG perspective, in-depth knowledge of the sector and each business model is crucial. It requires experience and extensive resources. At Ostrum AM, the credit research team is one of the largest in Europe. 23 credit analysts across 3 continents, including 2 analysts specialised in sustainable bonds, cover 1200 issuers worldwide.
Unique to our credit research approach is that environment (E), social (S) and governance (G) elements are integrated at all stages of our analysis. These factors may affect the sector or the company's business model and may therefore have a material impact on its financial condition today or in the future.
Analysts have a duty to systematically identify any environmental or social elements which may

be relevant for the company and roll them up in the bigger picture of the industry assessment, business model assessment and assess their implication. We have also developed a proprietary methodology to analyse green, social and sustainable bonds. This organisation, with banks' sector-dedicated resources and ESG materiality approach provides an edge in analysing banks to support portfolio managers in their investment decisions.

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Additional notes

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