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Climate risk is financial risk – For banks it's a board-level issue

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What do the latest annual reports reveal about banks' approaches to climate change?

Today's bank boards are addressing climate change right at the top of their organisations, with more empowering their CEOs to take direct responsibility and including climate strategy targets in reward structures.

Disclosures in the most recent financial reports of 25 major global banks clearly show how climate change is becoming embedded in their business strategies. Two years ago, a search for the word "climate" in those banks' annual reports (2018) yielded 36 results; the same search in 2020 provided 99 – a threefold increase.

Our review of those banks' latest annual reports shows three major trends.

- More and better disclosures – a significant increase in disclosures about climate change, in line with recognition that it's a board-level issue.
- Introduction of metrics and targets – the majority of banks have identified and disclosed objectives to increase funding for greener projects and acknowledge their role in shaping and financing a more sustainable future.
- More information in the management commentary, but not (yet) in the financial statements – the banks focus on climate issues in the front half of their annual reports, but there is still little detail on how climate risk will impact existing financial statement disclosures, such as expected credit losses, fair value measurement or impairment.

So, what are banks disclosing in their annual reports and what is the impact on their financial statements?

More and better disclosures

Climate change is a board matter now

We see that in most of the banks' annual reports there is a clear, outlined responsibility for the board of directors to drive forward the climate strategy of the bank.

Responding to climate change will affect the business of a bank in its entirety: deciding which clients to lend to in the future, assessing which businesses to support through investments, determining what type of financial instruments to offer and even deciding how to remunerate staff. A business strategy that addresses climate risk will have real impacts.

So, it's not surprising that the majority of the banks in our benchmarking exercise have said that they see climate change as a matter to be overseen by the board. Indeed, some banks noted that they will review the composition of their boards to

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consider whether they have the appropriate levels of skills and experience in the area of climate change.

The board committees are involved in the more specific aspects, with the risk committee being the one most frequently mentioned as being responsible for assessing and amending the banks' risk frameworks in light of increasing climate-related risks.

And what about management level?

Many banks have created new management roles with responsibility for sustainability and climate change, with titles ranging from global head of climate change to global head of sustainability and a third of the banks in our sample have disclosed that they explicitly made climate change a key responsibility of the CEO.

More and more banks are linking particularly the long-term remuneration of key management to achieving targets in their climate strategy. Our review shows that more than a third of banks have disclosed that targets such as reducing financed emissions (e.g. through reduced lending exposure to high carbon sectors) and sustainable financing are metrics used to assess remuneration.

Climate change is a financial risk

Of the banks that we reviewed, 72 per cent say that climate change is a financial risk and will impact their business in the longer term.

And it's actually considered a material or principal risk by 68 per cent, with one-fifth of the banks disclosing a change in their assessment from an emerging risk to a material risk in 2020.

It's clear that banks are starting to see climate risk as a business-as-usual risk, on par with credit risk or operational risk, as many of the surveyed banks have integrated climate risk into their broader risk frameworks and are starting to follow the established risk processes of identification, assessment, management and reporting to address climate risk.

Scenario analysis – a tool every credit risk expert is very familiar with thanks to IFRS 9 *Financial Instruments* – has also become a popular tool for the assessment of climate risk, with the majority of banks disclosing that they have performed a

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scenario analysis for climate change risk or are in the process of developing such an analysis.

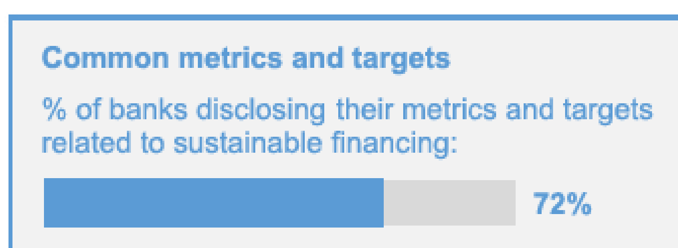
However, there's little detail or disclosure on what scenarios have been used.

Introduction of metrics and targets

Can banks be a catalyst of change to a more sustainable economy?

Most banks have set funding targets to increase sustainable funding. They have also developed metrics to measure their progress towards these targets.

Green and sustainable financing is both an opportunity for banks to increase their business and also a big part of their climate strategy. Most banks are planning a significant expansion of their product offering in these areas, with target amounts ranging from a few billions to one trillion USD by 2030.



As these are the metrics that drive the assessment of pay and bonuses, it's worth noting that there isn't a universal definition used by all banks as to what green financing is, or what a financed emission reduction entails.

More information in the management commentary, but not (yet) in the financial statements

The significant increase in disclosures in the banks' annual reports and the focus of senior management on climate change have yet to filter through to the financial statements. Once products become more prevalent, mature and material, transparent disclosure of accounting impacts and accounting policies will be an important consideration.

This leads to some interesting accounting considerations. What are the accounting considerations for green products? How will the credit risk assessment change? And what is the impact of a change in a lending strategy on a bank's expected credit loss?

Actually, what about credit risk?

If banks are changing their business model to reduce financed emissions, it's likely to affect specific sectors. Some banks have identified these sectors in their commercial loan portfolios, including the oil and gas sector (or a broader energy portfolio), transport sectors, agriculture and real estate.

On the credit risk side, some banks currently limit their disclosures to the impact that climate change will have on their commercial portfolios. Some UK banks have started to disclose the portions of their retail mortgage exposure that are subject to climate risk.

And now over to you

Disclosure of matters related to climate change in banks' annual reports is a journey that has just started, but it has picked up significant momentum. In the UK, as of 2021, premium listed banks will need to comply with the Task Force on Climate-Related Financial Disclosures recommendations or explain why this is not the case. In our benchmarking, based on disclosures in a sample of banks' annual financial reports, the UK banks are currently leading the pack in terms of depth and detail of disclosures. However, other jurisdictions are quickly picking up pace, with discussions ongoing in most major banking hubs about the level of disclosures required.

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With the IFRS Foundation also looking to set up a standard setting body to develop global standards, it's going to be an interesting few years.

So, what are you doing – and how are you measuring up to the benchmark?

Next steps

Armed with this information, we are now carrying out a benchmarking exercise on other reports issued by banks in which climate is featured. We will share more of our findings with you soon.

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