Users need numbers to track and compare progress towards climate-related goals, but banks are still on a journey

Climate-related risks and their business impacts are the focus of attention for annual report readers like never before.

However, if we look at the annual reports of global banks their progress in disclosing climate-related matters in annual reports has slowed down in 2021.

In phase one of our benchmarking analysis, we look at the climate-related disclosures in the most recent annual reports of 35 major banks. We note significant differences between countries where there is heightened regulation on climate-related disclosures and where that is not (yet) the case. This leads us to believe there is a connection between regulation and disclosures. It appears that where there is regulation (or even regulatory guidance) on the matter, there are enhanced disclosures by banks in annual reports. We will test this finding in phase two of our benchmarking analysis where we look at the climate-related disclosures in other standalone reports.

We also note that while progress overall has slowed down, some jurisdictions where the base level of disclosure in annual reports was historically lower are catching up with jurisdictions that have more advanced disclosures.

The formation of the International Sustainability Standards Board (ISSB™) marks a critical milestone in the journey towards a consistent global baseline of investor-relevant sustainability reporting – including on climate. In anticipation of new IFRS® Sustainability Disclosure Standards (the Standards) from the ISSB, some banks may have taken a wait-and-see approach until they have more clarity about the new Standards.

Our analysis of the major banks’ latest annual reports notes three key findings.

− Banks continue to focus on risk management.
− It’s all about the front part of an annual report – disclosures in the financial statements are less common.
− Metrics and targets remain vague in the annual reports. Banks have made significant commitments to sustainable finance, but without quantitative information on metrics such as financed emissions it is difficult for users to track their progress.
So, what are banks disclosing in their annual reports and what is the impact on their financial statements?

**Banks continue to focus on risk management**

Banks are aware of climate-related risks. We can see this in the disclosures made – particularly when it comes to describing the risks they have identified and how they have set up their governance structures to manage these risks. Given banks’ traditional focus on risk management, it doesn’t come as much of a surprise that most of the banks in our analysis provide detailed disclosure in this area.

77 per cent of the banks disclose that they are integrating climate-related risks into their wider risk management framework and that they are starting to follow the more ‘business as usual’ processes of identification, assessment, management and reporting of climate-related risk.

Many of the banks also acknowledge that climate-related risk is an overarching risk that impacts their other risks. Their most commonly impacted other risks are credit risk, reputational risk, operational risk and compliance risk.

Within risk management, credit risk gets the most attention in the disclosures, with the banks detailing how they are integrating climate-related risks into their credit policies and processes, including borrower credit assessments.

Credit risk management is the section in the annual reports where we see the most qualitative and quantitative disclosures, with some of the banks disclosing details of exposures to carbon-intensive sectors such as oil and gas, or agriculture.

However, while the credit risk disclosures are detailed in the front part of annual reports, very few of the banks are connecting those disclosures with impacts in the financial statements.

And that is in general the case, because…
It’s all about the front part – Disclosures in the financial statements are less common

Users of financial statements are increasingly looking for information about the financial impact of climate-related risks. They want to understand how changes in risk appetite and business strategy filter through into the financial statements. Improving connectivity between the financial statements and the front part of the annual report is key.

However, banks continue to focus on climate-related matters in the front part of their annual reports while disclosures in the financial statements are less common. 37 per cent of the banks in our analysis mention ‘climate’ in the notes to the financial statements. Generally, the nature and extent of information disclosed by these banks is currently minimal – e.g. disclosing in a single statement that climate-related impacts have been considered in the cash flow projections used for goodwill impairment assessments.

Financial risk management (focusing on credit risk) and accounting policies are the two most common notes where climate-related impacts are mentioned.

For banks, the logical place to see discussion of climate-related risks in the financial statements would be in the notes related to measuring expected credit losses (ECLs). Climate-related risks may impact the expected cash flows to be received and, therefore, the banks’ exposure to credit losses. Borrower-specific attributes, physical risks and transition risks, either individually or in combination, may impact not only expected cash flows but also the range of potential future economic scenarios considered in measuring ECLs.

23 per cent of banks in our analysis disclose that they have considered climate-related risks in their measurement of ECLs. We do not see quantitative disclosures other than a minority of banks disclosing that they have assessed the impacts on ECLs as immaterial.

The lack of quantitative disclosure may be due to the shorter time horizon that is generally taken into account in measuring ECLs compared to the longer time horizons often used for climate-related risks.

Even if the impacts to the current period financial position, performance or cash flows are not yet material, it may be important for users to understand the
judgements the bank has made in assessing the impact of climate-related risks on ECLs as well as the key estimation uncertainties that arise from those risks.

The banks have made significant commitments to green or sustainable financing, with some banks earmarking billions over the coming years for such projects. However, in 2021 we have not yet seen these products impacting financial statement disclosures, such as those on accounting policies and estimation uncertainty or financial instruments.

**Metrics and targets are vague in the annual reports**

80 per cent of the banks in our analysis disclose information on their metrics and targets in the annual reports. However, the nature and extent of information disclosed varies significantly.

Generally, the disclosure of metrics and targets is split into three areas:

- financed emissions;
- green or sustainable financing; and
- operational emissions.

In the area of sustainable finance, the banks have disclosed significant targets ranging from a few billion to $1 trillion (USD) by 2030 (or earlier). However, it is unclear where banks see the opportunities in the medium to long term. Also, while the targets are disclosed, the banks are less transparent about progress towards achieving these targets, with 49 per cent providing quantitative disclosures about progress to date.

Similarly, for financed emissions, which for banks is arguably one of the most important aspects of their climate strategy, disclosures remain vague in the annual reports of banks analysed.

*Without quantitative information on metrics such as financed emissions, how can users understand the strategy and whether the bank is on track?*

In the end it’s about the numbers. Metrics need to be quantified, targets further defined and progress tracked. Without the numbers, it is difficult for users of the annual report to understand and assess the extent of the banks’ commitments and progress in achieving them, or to make informed comparisons between the banks.

At this stage it’s not easy to quantify either sustainable financing or financed emissions in a consistent matter, particularly in an environment where there is no single globally-accepted definition and methodology for what sustainable finance or financed emissions encompass or how it should be measured. The standards proposed by the ISSB on climate-related disclosures include disclosures in this area. It will be interesting to see whether that gives a new impetus to increase the disclosure of bank-specific, climate-related metrics.

**And what about auditors’ reports?**

We see that in 2021 the auditors’ reports on the financial statements are starting to mention climate and the impact of climate on the audit of the financial statements with all the auditors’ reports for UK banks mentioning climate and some of the reports for banks in Europe and Australia.

**And now over to you**

The focus on climate-related disclosures is not going away.

In March 2022, the ISSB released two proposed IFRS® Sustainability Disclosure Standards (the proposals) and the US Securities and Exchange Commission (SEC) issued proposed climate reporting rules. The European Financial Reporting Advisory Group (EFRAG) is also developing a suite of standards for EU companies.

The ISSB’s proposals would require the climate-related disclosures to be made as part of a company’s general purpose financial reporting and they emphasise the importance of connectivity between financial statements and other information on climate-related matters. The SEC proposal would require certain metrics and other
disclosures in the Form 10-K and registration statements, including in the audited financial statements.

Now more than ever, it’s critical that institutions take a proactive approach to climate-related disclosures, providing more transparency and consistency for investors and the wider stakeholder community.

Getting ready now is critical even if the final standards are not identical to the proposals – so how do your 2021 disclosures in the annual report line up against our benchmarking analysis? And what are you doing to prepare for the upcoming requirements?

Look out for…

We are now carrying out phase two of our benchmarking analysis on other standalone reports issued by banks in which climate-related matters are featured. We will share more of our findings with you soon.