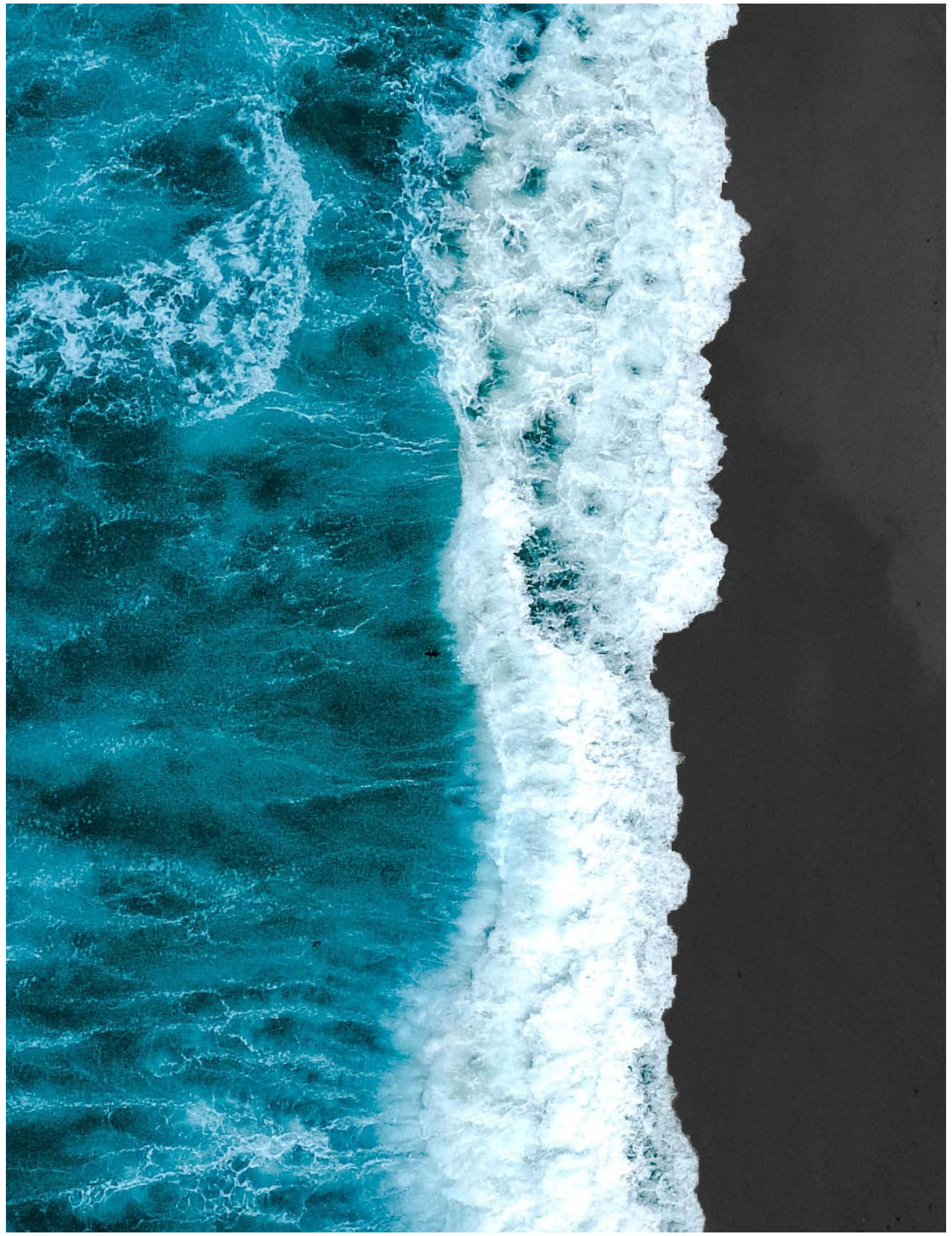
Raising the standard

HOW BANKS CAN IMPROVE THE QUALITY OF CLIMATE-RISK FINANCIAL REPORTING

JUNE 2022

DLA PIPER

Contents



The state of play in climate-related disclosure

Background

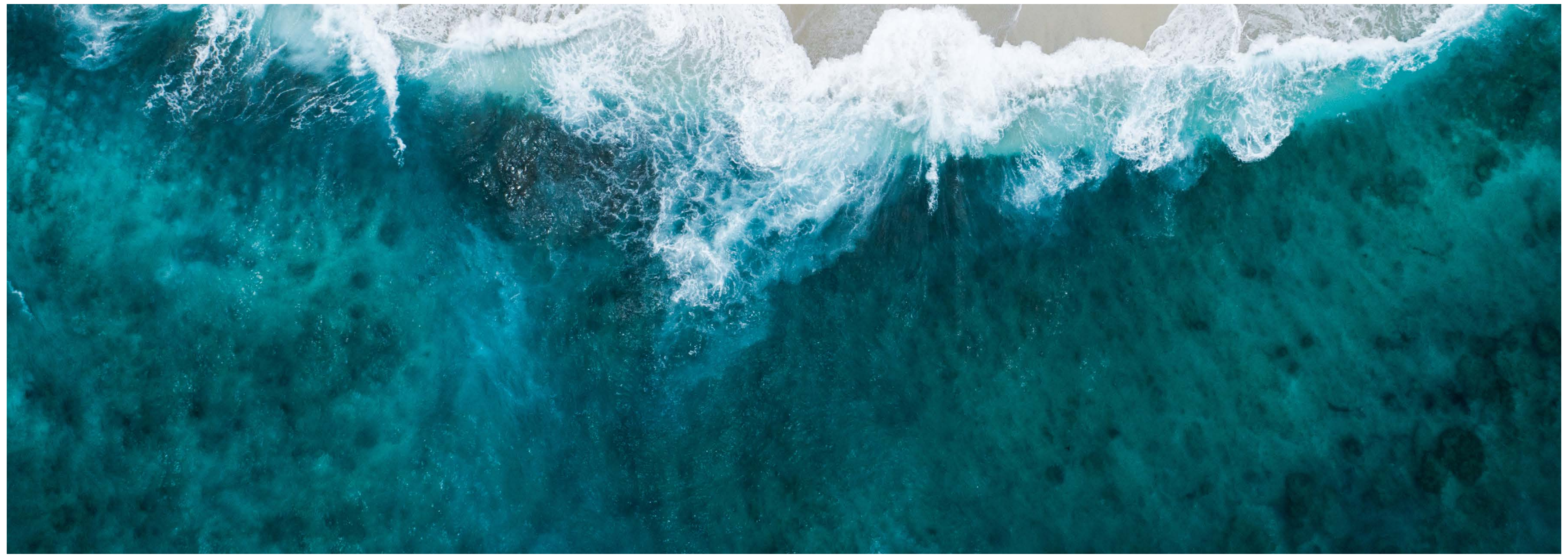
COP21 was an important milestone in the fight against climate change. The resulting Paris Agreement finally reflected a much-anticipated global ambition to collaborate towards a shared goal. The Task Force on Climate-related Financial Disclosures (TCFD), which also launched in Paris, was the first sign of a strategy to make that ambition real.

In 2017, 18 months after the Paris meeting, the TCFD published its recommendations to help companies identify and publish important climate-related information. Greater transparency would in theory help lenders and investors to more accurately price risks and opportunities and ultimately help to direct capital towards more sustainable investments. If polluting companies had a plan to pursue more sustainable strategies, investors could make up their own minds about whether those plans were credible and sufficient.

Crucially, the TCFD chose to rely on the momentum of the market to wean the economy off polluting activity. Instead of direct regulation targeting unsustainable behaviour, the TCFD wanted to raise the overall quality of information, enabling investors and depositors to make the connection between unsustainable behaviour and unsustainable investment, and banks to more accurately evaluate their own risks.

"The physical impacts of climate change are only going to be felt more keenly in the coming years, and with that increased sense of immediacy we'll see an increase in stakeholder attention and pressure on financial institutions. This will go beyond words and platitudes: there will be intense focus on what institutions are doing in terms of their net zero action plans and the implementation of effective strategies to tackle the issue."

– Martijn Boeve, Legal Director, DLA Piper



There's no more room for boardroom debate: climate change is a material risk to financial stability

Severe weather has become a concern for all business stakeholders, disrupting operations, causing material damage to offices and plants, and costing significant sums in insurance. A survey of executives by the World Economic Forum concluded the three greatest risks over the next ten years were 'climate action failure', 'extreme weather', and 'biodiversity loss'.

The material costs of climate change to businesses, communities and individuals continue to rise. From factories affected by wildfire to storms and extreme flooding, properties are being wrecked and people displaced. The Institute for Economics and Peace recently estimated that up to 1.2 billion people could be displaced by the climate crisis by 2050, with the countries most unable to withstand climate threats being among the world's 40 least peaceful.

"Climate change is a material risk to financial stability. In addition to the costs arising from physical impacts, lots of the assets that bank balance sheets are currently exposed to – like coal and oil – will be redundant in 70 years. That risk is now a core part of their business operations, and unless they divest or diversify their assets, what will they actually have in 70 years' time?"

– Steven Gray, Legal Director, DLA Piper

The risk of systemic damage to the banking sector is just as real

Regulators are alert to the potential build-up of large pools of uncatalogued and unsustainable portfolios that risk another sub-prime financial crisis, but this time with green default in place of credit default. G7 finance ministers recently highlighted the risk of fragmented regulation and called for both greater transparency and coordination of climate-related financial disclosure.

In the immediate aftermath of COP26, widely described as "the Finance COP", we've seen increased public and private sector motivation for removing barriers to tackling these risks. Mandatory global reporting frameworks (in the form of mandatory TCFD reporting) and standardised measurement initiatives (such as the International Sustainability Standards Board) come out top of the agenda.

"COP26 led to a number of serious expressions of intent around some reasonably ambitious and, crucially, timed and measurable, carbon reduction targets and outcomes. Multiple institutions and bodies are represented in these commitments, which is important to effect system-wide change."

– Bryony Widdup, Partner, DLA Piper

In financial services, no one has forgotten the long-term damage caused to the sector as a result of public reaction in the aftermath of the 2008 global financial crisis. Many banks prioritise the threat of reputational damage above non-compliance. They know that to keep deposits and investments flowing they need to see each investment decision through the eyes of every stakeholder who might reasonably take a view, from consumers to CEOs.

But without strong, consistent governance, the pressure to issue targets, and to be seen to pursue them, can produce the wrong results. There are many concerns that companies, including financial institutions, promoting their green and broader ESG credentials may be making exaggerated claims, primarily to keep investment flowing. The threat of regulatory enforcement action and even prosecution for so-called greenwashing is steadily growing. But in today's social media-driven world, financial institutions accused directly or indirectly of such practices may suffer trial in the court of public opinion well before litigation catches up.

Despite the risks, some of the larger banks have been inspired to go "beyond compliance." HSBC recently announced it is stopping the funding of coal-fired power stations. NatWest announced last year that it was phasing out coal lending in the UK by 2024 and globally by 2030. And ING announced in March 2022 that it will no longer finance new oil and gas projects.

However, questions remain in the market about whether such pledges will be met and banks will remain exposed whilst their commitments are insufficiently supported due to lack of robust data collection and reporting practices.

Regulation, compliance and progress

We've seen the growing importance of climate change as a threat to the global financial system, and regulators have responded. The Bank of England launched its first climate stress test of banks and insurers in 2021, and in January 2022 the European Central Bank launched a climate stress test of banks in the Eurozone.

Regulators remain concerned about the future of climate-related financial disclosure, on a number of levels. The first concern is that not enough companies are reporting – and those that are, are not reporting sufficiently. According to the TCFD in October 2021, only half of global companies disclosed climate-related risks and opportunities in some form in the four years following the creation of the Task Force, with firms on average responding to only a third of the eleven recommended disclosures. In March 2022 meanwhile, the ECB concluded that, for the second year in a row, virtually none of the banks under its supervision disclose all the basic information on climate-related and environmental risk that would align with all its expectations. Against this backdrop, a number of governments, including the UK, are making disclosure mandatory for an increasing number of companies.

But regulation remains uneven, and the requirements may be moving faster than companies' ability to adapt. Though the ambition to disclose information to the market may exist, there are issues with the lack of a level playing field; the quality of data; the skills to collect and make sense of data; and coordination both inside and outside organisations to publish accurate information.

"Disparity is the big issue. Post-Brexit, we now have a UK regulatory system that can be different from the EU. That's going to create issues."

– Tony Katz, Partner DLA Piper

The reality is that climate-related financial disclosure is too big an undertaking for existing compliance departments to handle alone. In practical terms, all employees with access to pertinent information need to be educated as, in effect, compliance professionals too, with the collective responsibility to identify and assess climate risk and explain the implications of these risks to other stakeholders. This broader view of compliance means that technical, financial, and environmental skills must be present across the organisation, as well as accurate data and the tools to make sense of it. The investment required to enable this is clearly substantial.

In summary, the regulatory landscape for ESG is clearly evolving rapidly, with new requirements on how banks report environmental risks – and this shows no sign of slowing down. We can expect further scrutiny on banks' risk management and reporting frameworks and plans over the coming years.

We conducted the following research to provide an in-depth understanding of the operational and cultural transformation and resourcing requirements financial institutions will need to address in their response to this rapidly growing demand for robust and consistent disclosure.

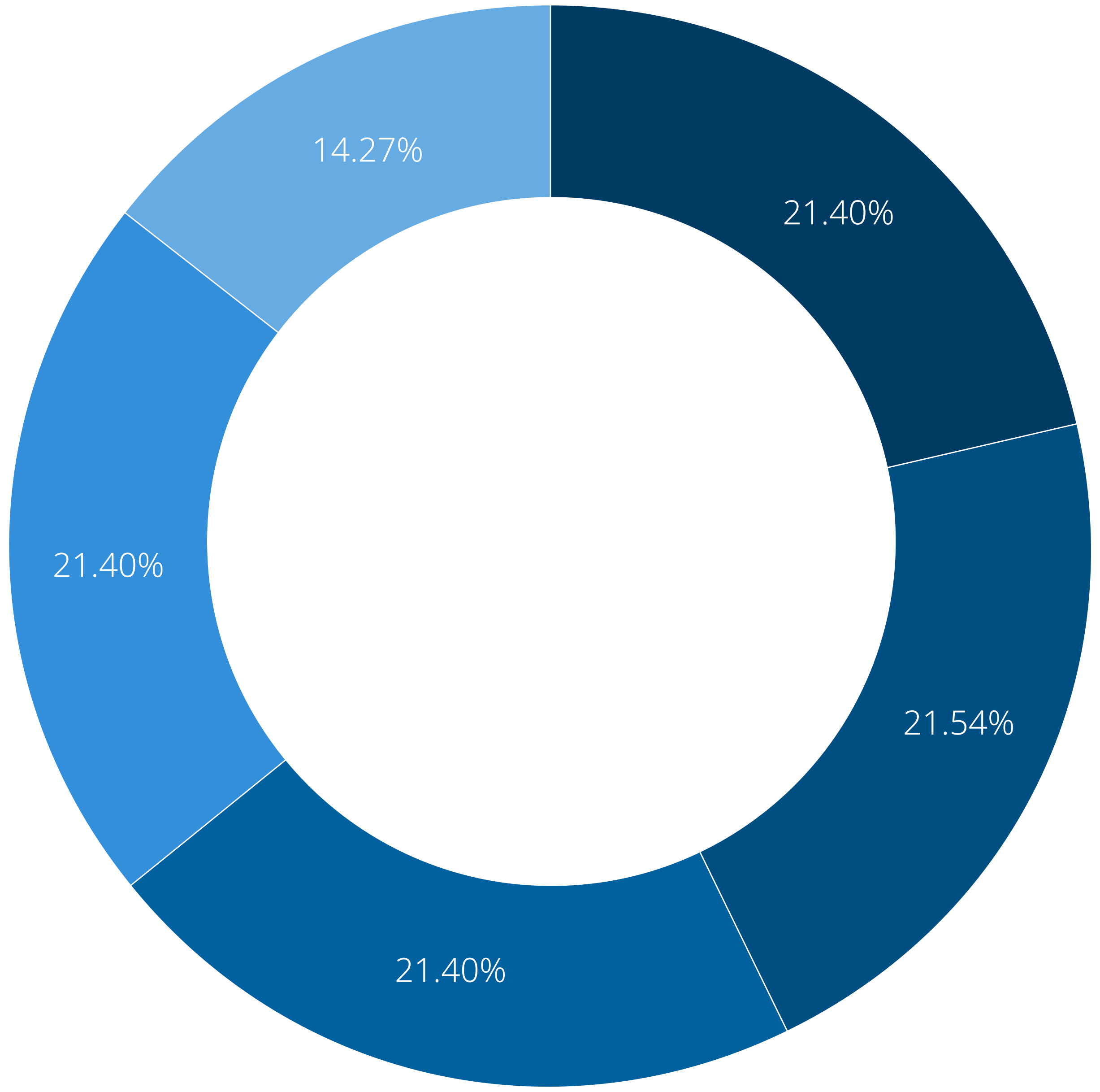
Methodology and sample

To better understand the attitudes of major investment firms and banks about decisions on climate-related financial disclosure, we commissioned a survey of senior decision-makers in banks across five key European finance hubs.

The research was conducted by Censuswide, surveying 701 decision-makers in banks across the UK (150 respondents), Germany (151 respondents), France (150 respondents), Italy (150 respondents) and the Netherlands (100 respondents) between December 2021 – January 2022.

- **UK** (150 RESPONDENTS)
- **GERMANY** (151 RESPONDENTS)
- **FRANCE** (150 RESPONDENTS)
- **ITALY** (150 RESPONDENTS)
- **NETHERLANDS** (100 RESPONDENTS)

Breakdown of survey respondents by location



Overview of key findings

Investing in disclosure: Over four in five senior bankers (86%) say their firm is planning to invest in the improvement of climate-related financial disclosure in 2022, as conversations about ESG rise up the agenda for financial services firms.

- Just over half (52%) of respondents indicated their firm is planning to invest between GBP1-2 million in this area annually, with 15% stating they would be investing GBP2-5 million.
- The primary focus of allocated budget and resource is:
  - building out compliance teams (50%)
  - investing in external advisors and consultants (49%)
  - board initiatives (48%)
  - paying external data providers (45%)

For positively influencing ESG change, senior bankers agreed that key levers at their disposal were:

- **Financial penalties:** 92% of senior bankers agreed that hitting firms with fee, margin or other relevant financial penalties is the best way to deal with clients whose climate risk profile causes significant exposure for a relevant financial institution.
- **Diverting capital:** Nearly nine in ten (88%) senior bankers agree that diverting capital away from environmental polluters is a good way to tackle climate change.
- **Improved reporting:** 90% of respondents agreed that significantly improving climate risk reporting practices for financial services institutions would have a substantive impact on global efforts to reduce climate change.

Lack of reliable data: Though there is ambition to invest in climate-related financial disclosure, barriers remain for financial services firms, who are held back by a critical lack of accurate and reliable data. The three biggest impediments to better climate-related financial disclosure were listed as quality of the data available (36%), reliability of third-party data (36%), and availability of client data (34%).

Greenwashing: Ensuring accurate and reliable data is also central to tackling greenwashing in the sector. Respondents listed improving the technical skills of internal stakeholders and advisors, and improvements in data underpinning disclosures as the two top ways to help minimise the challenges of greenwashing.

Measurement: One of the key challenges facing firms is the lack of agreement on standard metrics and measures for assessing and comparing climate risk and disclosures. And change doesn't seem likely anytime soon. The majority of respondents were sceptical these changes would happen in 2022, with three quarters (75%) estimating it would take longer than a year for the market to create and agree uniform metrics and reliable data and tools specific to climate risk assessment and disclosure. 15% of respondents felt even more pessimistic, predicting it could take more than two years to put these measures in place.

The report

A new operational model for climate-related financial disclosure

The significant operational and cultural transformation required to collect, process and publish the data means some banks are still struggling to match the ambition of the TCFD's recommendations.

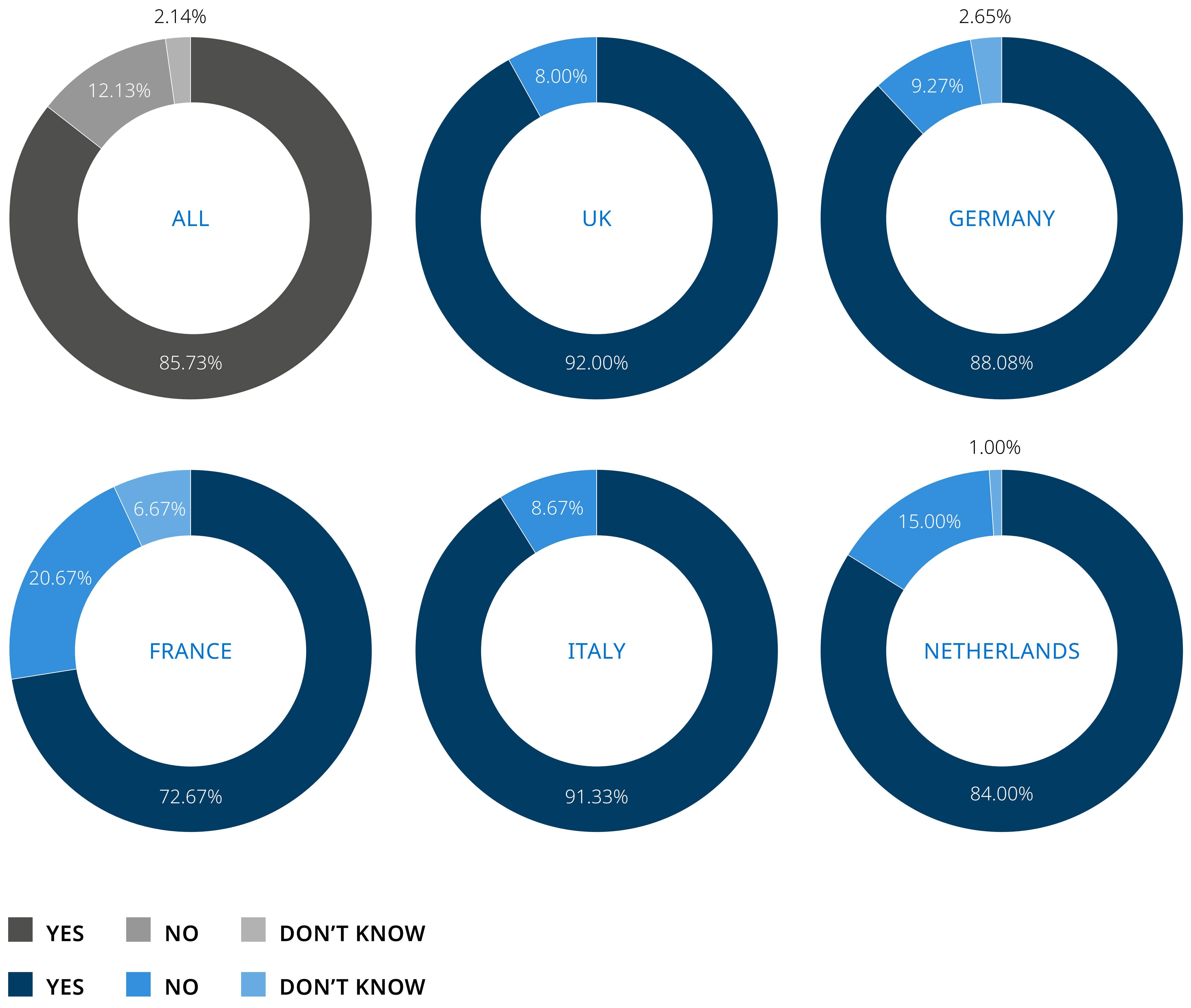
One of the most important TCFD recommendations is that climate-related financial disclosures should appear in public annual financial filings. Any company with public debt or equity operating in a G20 jurisdiction must already disclose all material information in their financial filings. The implication in the TCFD's recommendations is that climate-related issues are also material and should therefore encourage the same governance processes, wider stakeholder engagement and audit review as all existing public financial disclosures.

The recommendations are deliberately forward-looking. But the findings of this report show some banks are concerned about whether the quality of their data will stand up to scrutiny. A TCFD review last year into how companies were responding to the recommendations shows that quantitative data is much less commonly disclosed than qualitative data. This perhaps indicates banks and financial services firms are fearful of being held to standards they can't sustain – or perhaps that they don't trust the underlying data itself.

Investment in climate-related financial disclosure

The majority of banks surveyed for this report are planning to invest in the improvement of climate-related financial disclosure over the next 12 months (see figure 1). Investment plans were most bullish in the UK and Italy, where 92% and 91% of banks said they were planning to increase investment. In France, two out of ten banks said they were not planning to raise the level of investment in disclosure in the coming year.

Figure 1: Are you planning to invest in the improvement of climate-related financial disclosure in the next 12 months?



More than half of banks (52%) said they were planning to invest between GBP1 million and GBP2 million, while 15% said they were planning to spend up to GBP5 million (see figure 2). A significant proportion of this money will be attributed to building out compliance teams (50% of senior decision-makers said this was their bank's focus) and engaging external consultants (49%) to help determine strategy (see figure 3).

There was significant variance between countries. A relatively high proportion of Netherlands banks (61%) said they were focusing on investment in external data providers, compared to German and French banks, where 36% and 35% of decision-makers said external data was an important area of focus.

Figure 2: How much money are you planning to invest annually in the improvement of climate-related financial disclosure in the next 12 months?

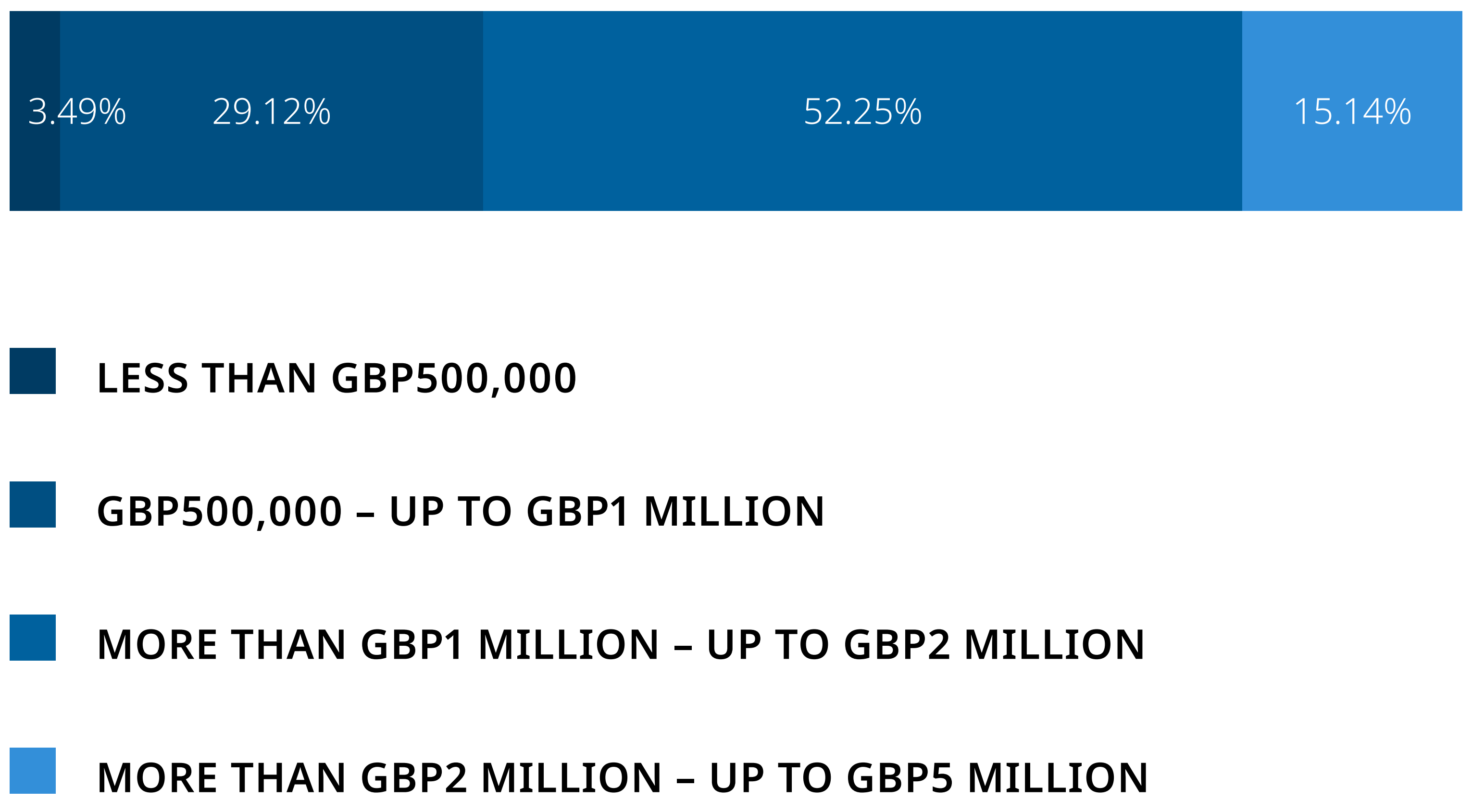
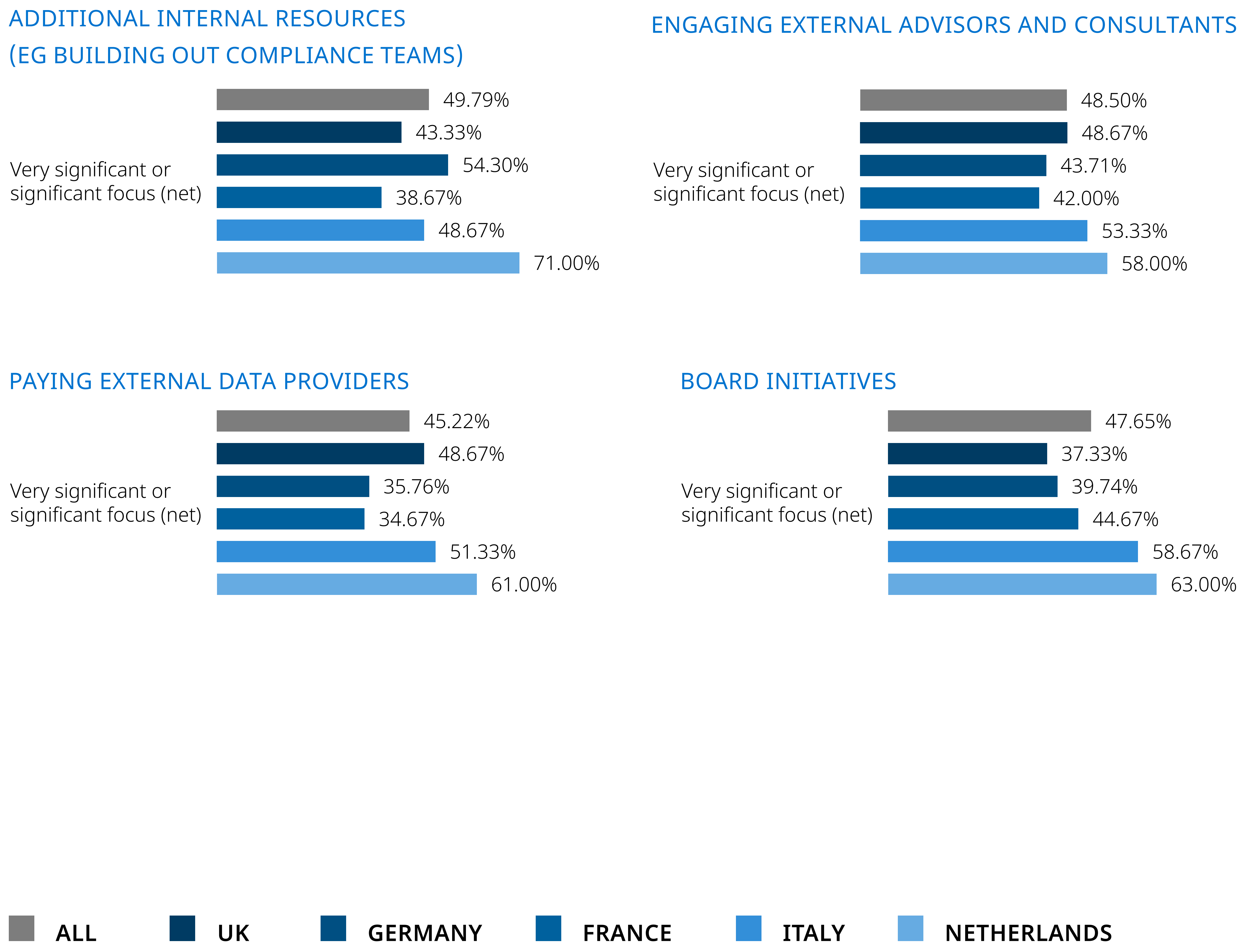


Figure 3: When it comes to your company, how much focus, if any, will be given to this area in terms of allocated budget and resource? (eg building out compliance teams)



The factors preventing better climate-related financial disclosure

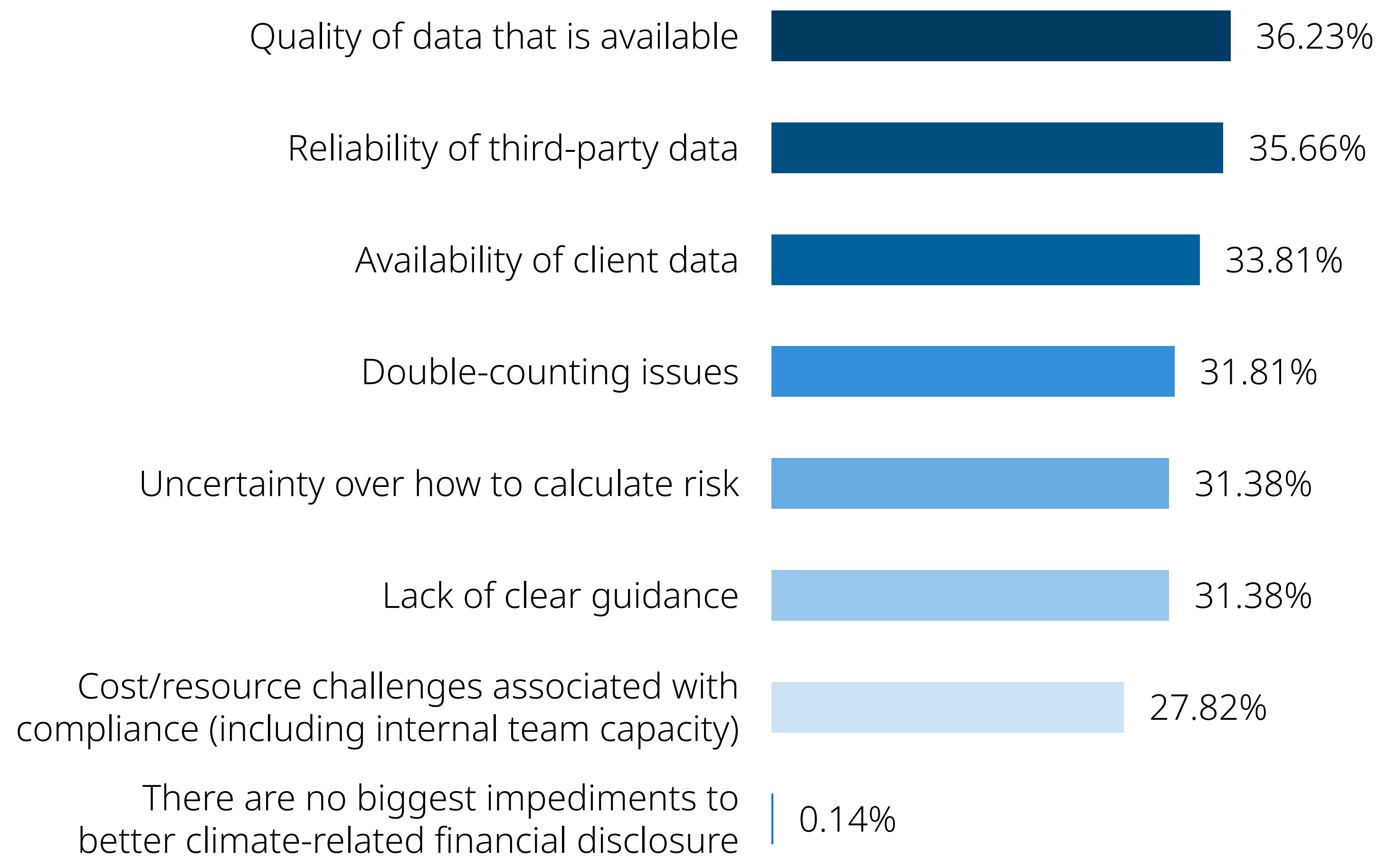
More than a third of bank decision-makers pointed to the quality of available data (36%), the reliability of third-party data (36%) and accessibility to client data (34%) as the biggest impediments to better climate-related financial disclosure (see figure 4).

A significant proportion (32%) of banks said they were concerned about double counting, which could lead to a miscalculation of risk. 31% said they were uncertain about how to calculate risk, which could be attributed to either a lack of resource, skills or dedicated risk analysis tools.

While this is a huge undertaking for all banks, it's clear some are better prepared than others. Certain institutions have been voluntarily disclosing climate-related information for a number of years, which may mean that adapting to a mandatory reporting environment is less threatening. The size of the institution also has a bearing on the sophistication of its disclosure. Banks with large compliance departments may have already invested in the necessary training and tools, and may already possess robust and transparent data for risk analysis.

At a legislative level, there are concerns about whether current systems are working. The majority (84%) of respondents agreed that the TCFD disclosure should be mandatory – signalling a recognition that increased reporting is a good thing. Yet 76% expressed concerns that the establishment of a minimum standard could be counterproductive when it comes to the next step of encouraging beyond-compliance standard climate-related financial disclosure – prompting a race to the bottom to meet the standard rather than push beyond its limits. Pressure will need to be kept on financial services firms to ensure that does not happen, and that those going above and beyond are recognised for their efforts.

Figure 4: What, if any, are the biggest impediments to better climate-related financial disclosure? (choose up to three)



"We're now living in a post COP26 world. The various announcements, commitments, and actions that came from that important conference – as well as recent moves like the creation of the International Sustainability Standards Board – are pushing banks to go further and faster when it comes to climate-related financial disclosures. This includes the recent important shift from voluntary to mandatory disclosure by many bodies."

– Sohail Ali, Partner, DLA Piper

Greenwashing

The ability to distinguish true climate action from greenwashing has the potential to become an important driver for corporate sustainability strategy – and greenhouse gas emissions reduction. For targets to have the desired effect, companies' strategies must be transparent and easily understood by all stakeholders.

Banks are under fire for making tradeoffs between sustainable and unsustainable investments. For example, despite efforts to advise clients on the transition to more sustainable activity, overall direct financing of the fossil fuel industry has totalled between USD63 billion and USD70 billion per year since 2016.

Companies in all sectors risk greater scrutiny over their public statements. A recent report by the New Climate Institute and Carbon Market Watch examined the transparency and integrity of 25 multinational company pledges to reduce emissions. It found that headline emissions reduction targets were often ambiguous. Half of the companies analysed did not go far enough in their explanations of how targets would be met. A significant proportion of the remaining companies made pledges with no specific emission reduction commitment.

Banks are under pressure from environment-conscious investors to direct capital away from companies who make net-zero claims that are detached from concrete plans to execute. The reputation penalties for apparent greenwashing are significant. This goes some way to explaining why the majority of banks surveyed in our report said they believed in the accuracy of sustainable investment funds.

"Consumers are voting with their feet when it comes to the issues close to their heart like the environment. Though banks are at risk from litigation over making false claims, it's the court of public opinion and the reputation damage that will hit just as hard as socially conscious consumers choose to take their business elsewhere.

But greenwashing carries more than just the risk of reputational damage and possible exposure to legislation. There's also an enormous financial exposure. If you have assets which are being classed as having an ESG premium or are in "green funds" that are undermined by hard-to-substantiate ESG claims, the value of those assets will be wiped out overnight."

– Stuart Murdoch, Partner, DLA Piper

Overall, 79% of senior decision-makers in banks said that the marketing of sustainable investment funds was accurate (see figure 5). The proportion among UK banks was 91%. French banks were the least trusting: 17% of senior decision-makers said that the marketing of sustainability funds was inaccurate.

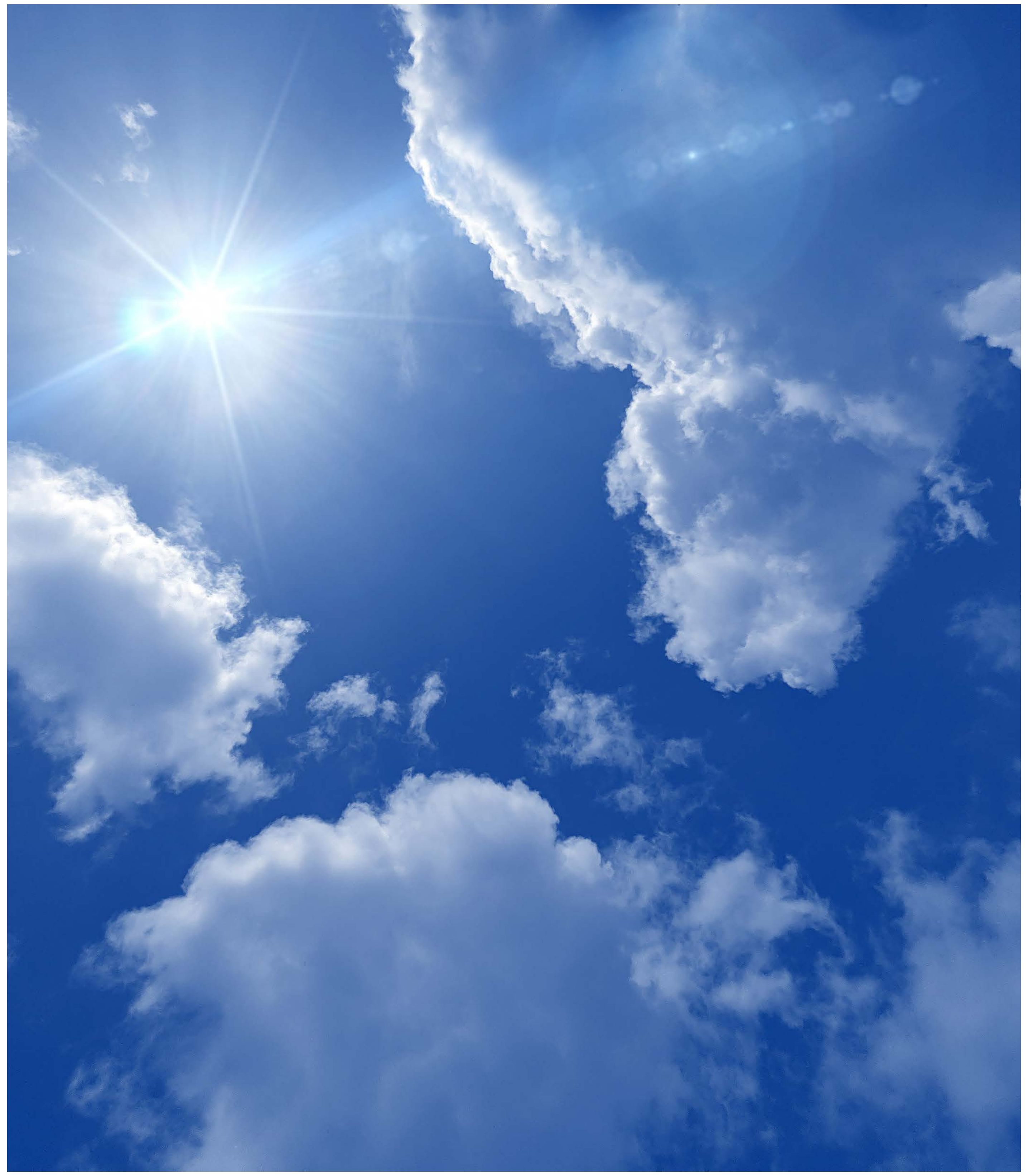
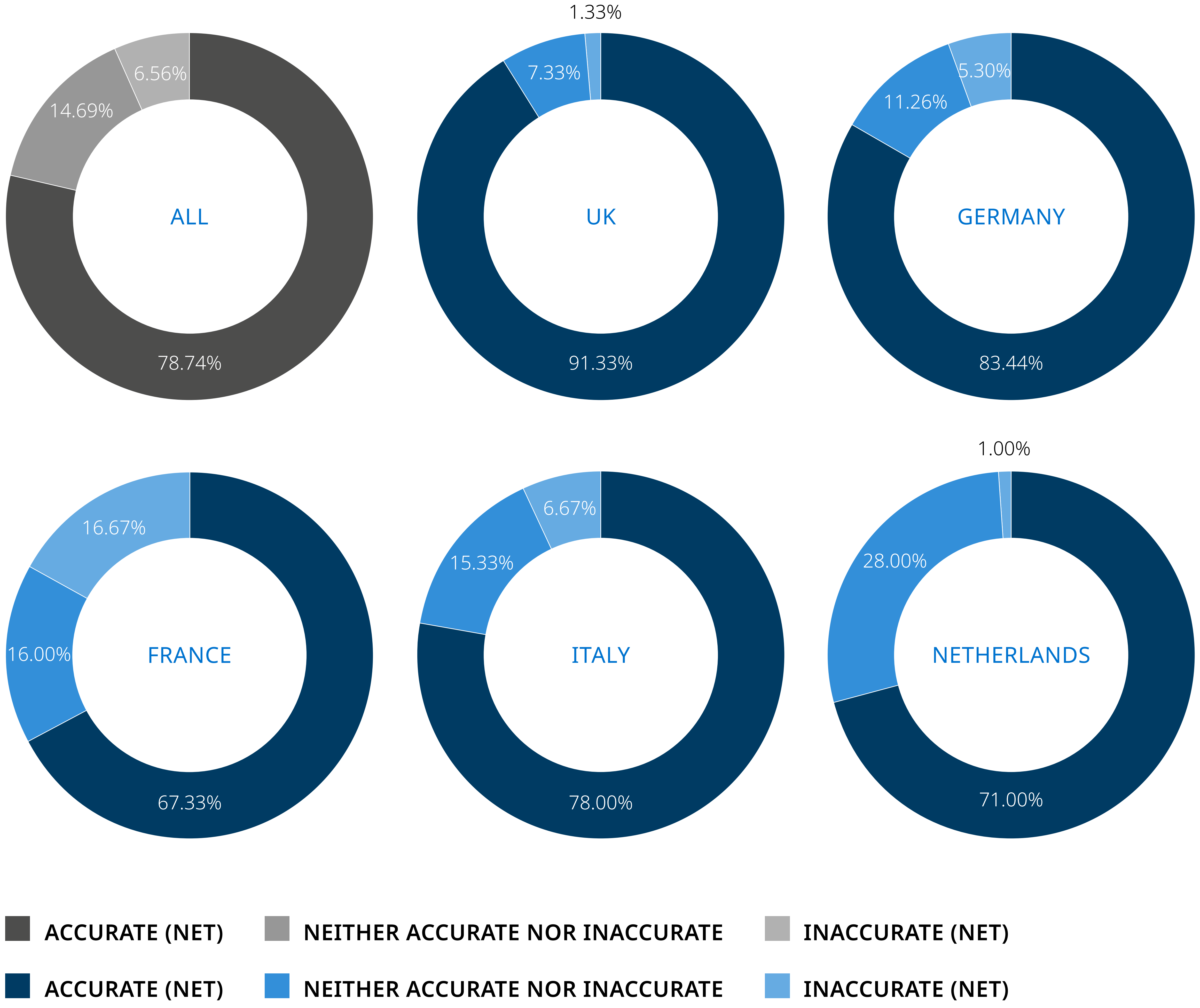


Figure 5: How accurate, if at all, is the marketing of sustainable investment funds today?



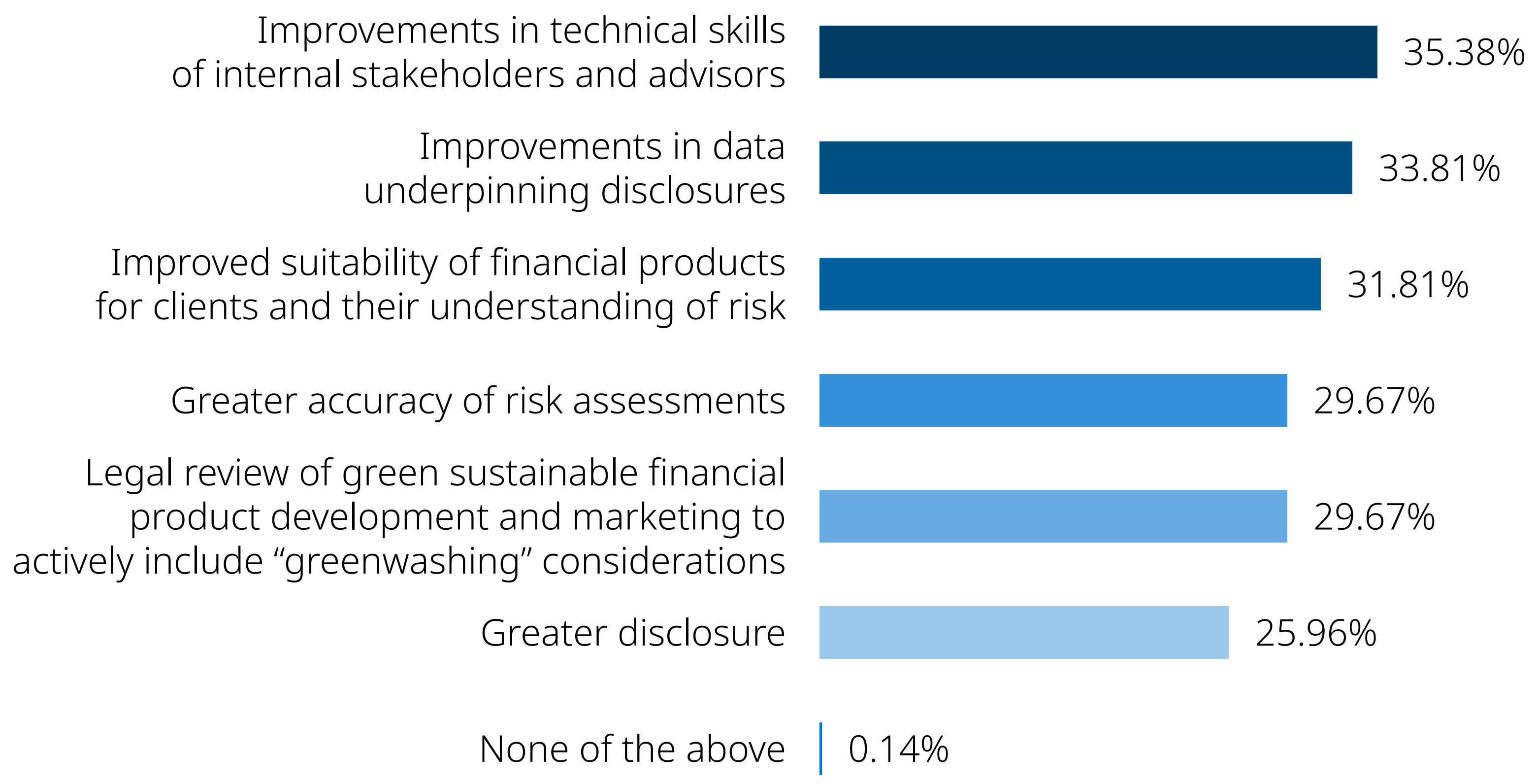
The majority of banks believe greater climate-related financial disclosure forms only part of the solution. Asked which strategies were most likely to minimise the challenges of greenwashing, the two most popular were improvements in technical skills and improvements in data quality (see figure 6). This suggests that banks have faith in their ability to select the right course of action, but rather less confidence in the tools required to make a positive impact on net zero goals.

"We know financial penalties in the context of failure to meet sustainability-linked KPIs are ostensibly low, often just a few basis points, and commentators may speculate as to whether it is sufficiently robust to deter greenwashing. But the surrounding context needs to be added in assessing this. "Failure to deliver" is significantly amplified by the reporting and disclosure framework. Having to specifically and directly disclose that you failed to meet your financing KPIs, even if the financial consequence is small, is a significant concern for businesses."

– Mark Dwyer, Partner, DLA Piper

How should banks manage the dilemma of dealing with clients who either don't respond to calls to transition to sustainable practices, or who fail to keep their promises? 92% of respondents said that the best way to deal with clients whose climate risk profile causes the bank exposure is to use financial penalties (see figure 7, on the next page).

Figure 6: Which two of the following do you feel will most help minimise the challenges of greenwashing, if any?



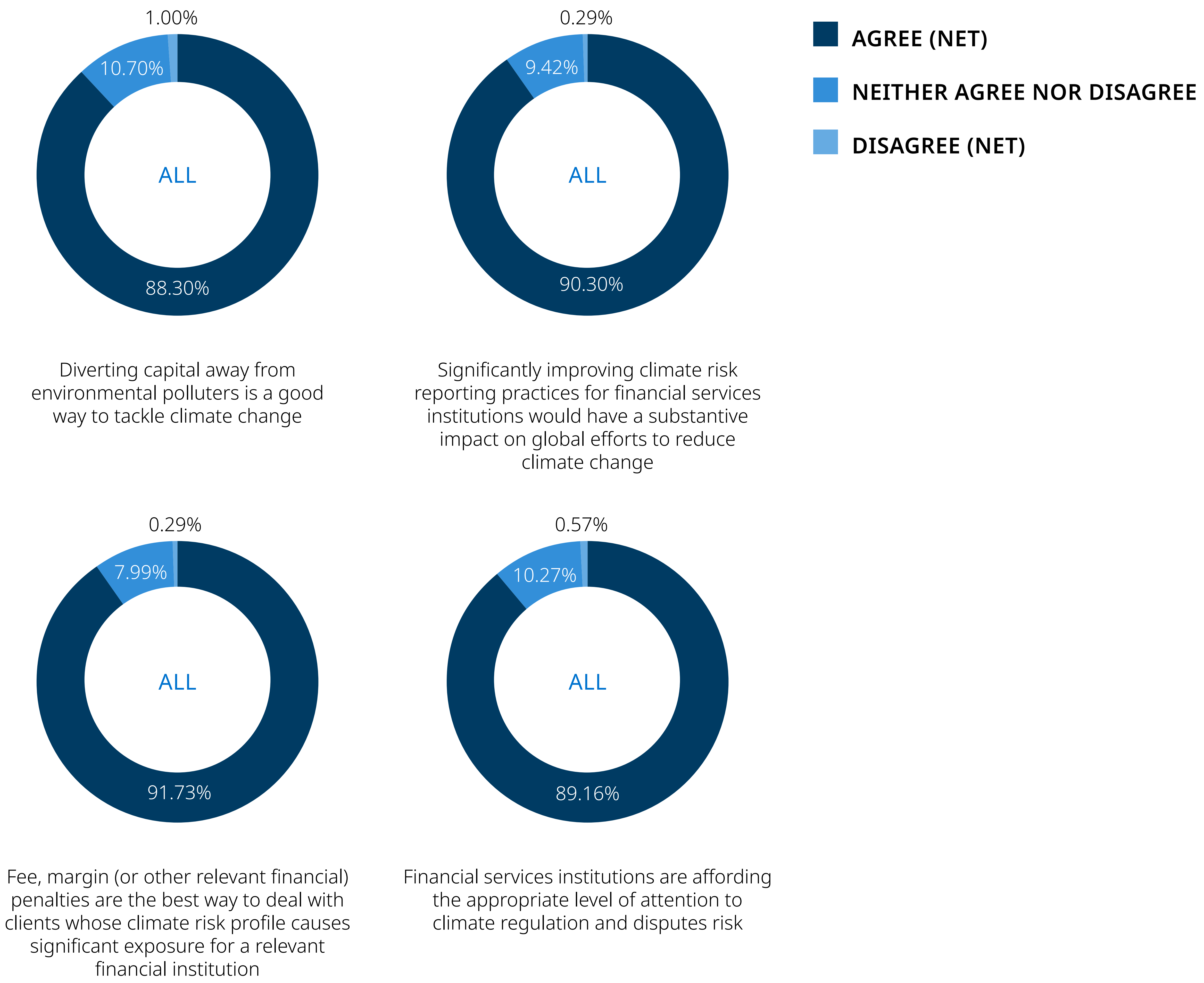
"The easiest and fastest way to green your portfolio is to divest. Full stop. But there is a real argument to say that isn't a responsible strategy. Off-loading a problem so it's no longer your responsibility is just passing the buck to someone else in the chain. It's not creating any meaningful change. There needs to be a real framework put in place to outline what responsible divestment really looks like, and what the conditions and requirements are to meet that bar."

– Steven Gray, Legal Director, DLA Piper

Outside the finance sector, the pressure to divest completely from polluting companies is growing. Activist shareholders, pressure groups, NGOs and even employees are joining a growing chorus of net-zero sceptics, in general unmoved by banks' and their clients' statements of intent. Perhaps that's why 88% of senior decision-makers in banks told us that diverting capital away from environmental polluters is a good way to tackle climate change (see figure 7).

But the argument is more nuanced than that. Divestment frequently transfers emissions to companies that may be less affected by pressure from activists. That may make it harder to induce the lower-polluting behaviour that benefits us all. Institutions that divest such holdings are sometimes rewarded with higher ESG ratings, despite the fact that the underlying behaviours remain unchallenged. Holding on to investments in companies in polluting industries with the intention of funding transition is becoming reputationally toxic. But it is the more responsible action.

Figure 7: To what extent do you agree or disagree with the following statements:



Conclusion

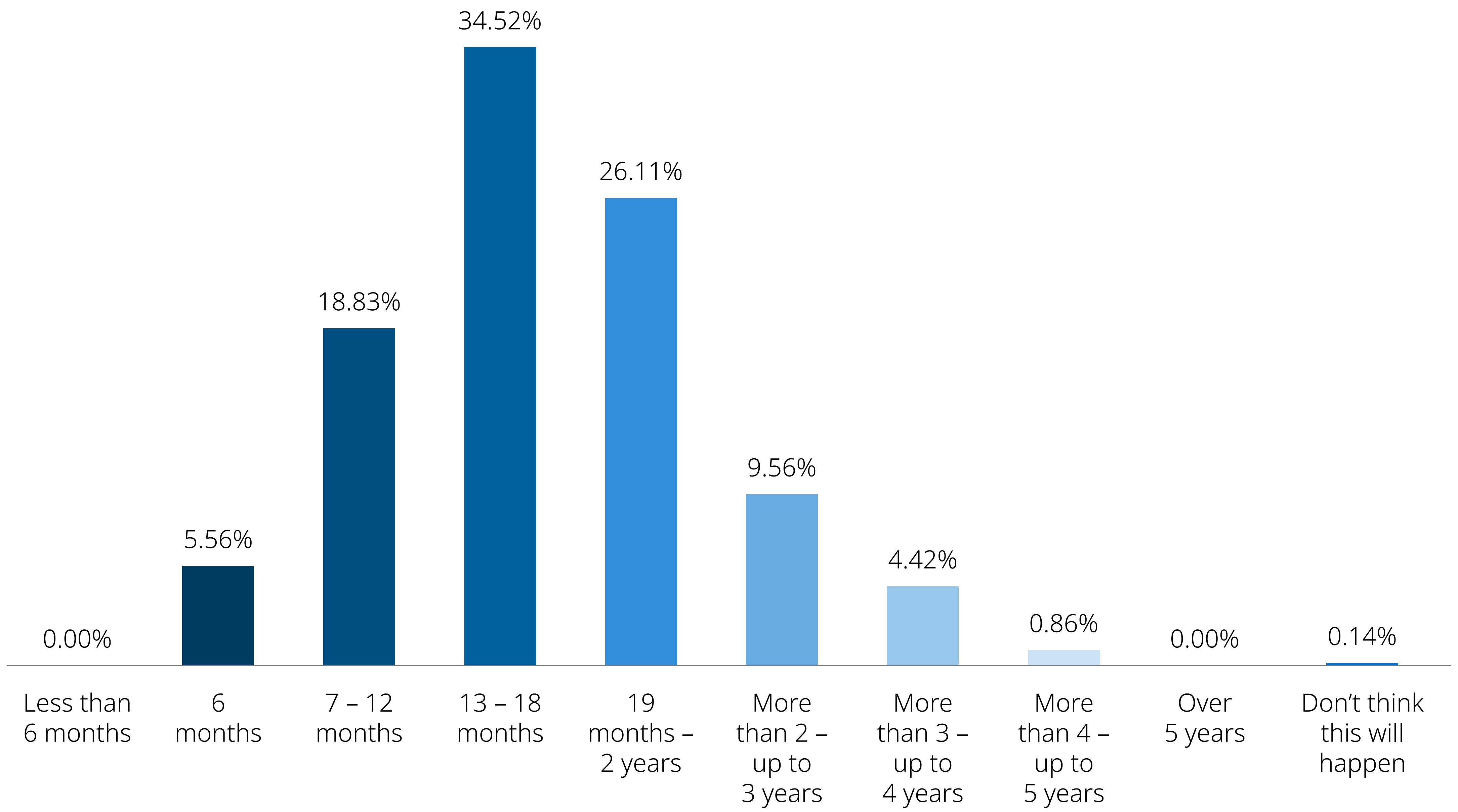
Banking has a crucial role to play in the fight against climate change

Increasing flows of finance to low-carbon initiatives, while reducing flows to less sustainable activity, will enhance the speed and effectiveness of climate action. The greatest impact regulators can have on the financial system is to empower the markets with better information. The greatest impact banks and financial services firms can have is to level up the tools and skills required to collect and publish that information.

Inside the banks, this is as much a cultural transformation as it is operational. But waiting for competitors, customers, regulators or even litigators to act first will put global climate goals out of reach (see figure 8). The time for transformation is now.

What, though, might this transformation look like? We feel there are three key priorities for banks to address in light of our findings.

Figure 8: How long do you estimate it will take for the market to create and agree uniform metrics and reliable data and tools specific to climate risk assessment and disclosure?



Three priorities for banks

DATA MANAGEMENT

Our research has highlighted the indispensability of accurate, consistent and comparable data as banks increase their focus on climate risk assessments and demonstrate clear targets in achieving net zero in the emissions they finance. Banks will only succeed here, however, if their IT infrastructure is fit for purpose in enabling the gathering and managing of data. Banks are already undergoing extensive digital and technological transformation as they seek to maintain competitive advantage in a rapidly changing financial services ecosystem. Effective prioritisation and resourcing of ESG data management will therefore be needed in wider technology transformation initiatives.

TALENT MANAGEMENT

Our findings make clear that talent management will be central to the ways in which banks respond to growing demands of climate reporting and disclosure. As a result, banks may need to consider ESG expertise in their succession planning (including at board level) and hiring activities, including factoring ESG expertise into hiring criteria for new appointments. Banks will also need to ensure their existing workforces are equipped with the right skillset. Regular training of staff in legal and risk functions, for instance, will be critical in ensuring they have the technical knowledge necessary for ESG-related matters.

GOVERNANCE

Our research shows nearly half of respondents plan to allocate budget and resource to board initiatives – reflecting the growing importance of reputational and compliance risks associated with ESG. Bank boards may need to conduct ESG-focused reviews of their product and service offerings.

There will also undoubtedly be technical issues that bank boards will have to address alongside wider operational and strategic transformation initiatives associated with ESG:

- Will bank boards need to establish specialised ESG risk committees?
- Does the existing board risk committee have the necessary knowledge, skills and capacity to understand ESG risks and their impact?

Board directors will need at least a solid understanding of the key ESG risks affecting their banks. So it’s essential that boards are well briefed on ESG issues and any legal risks and consequences for their businesses.

Let’s start talking

If you would like to discuss the insights in this report, or explore how DLA Piper can help you to navigate the sustainable finance space, please contact our financial services sector ESG leads or any of the report contributors.

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