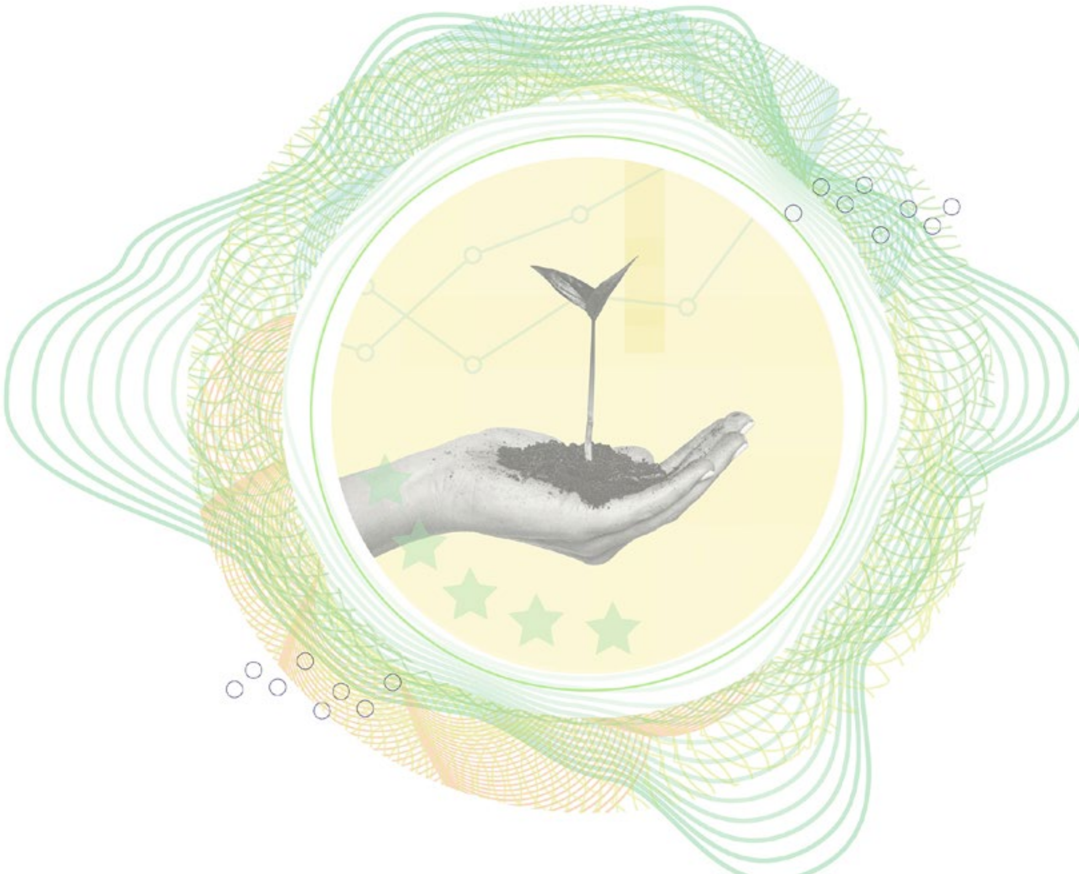


Translating banks' climate commitments into action: Going green isn't always black and white

As the recent United Nations Climate Change Conference (COP26) highlighted, countries and private-sector entities have become more ambitious in their commitments to alter the course of climate change.

Climate pledges are heating up in the global banking industry as well, particularly among the large US banks. For instance, a handful of the largest US banks have collectively agreed to contribute at least $3.5 trillion to sustainable initiatives over the next decade.[1] Not only does this figure represent more than one-third of these five banks' total asset base in 2020, but the sum of these new pledges is roughly five times what the banks spent on climate change programs between 2007 and 2020.[2]

These large US banks also have joined the Net-Zero Banking Alliance, a group committed to "aligning their lending and investment portfolios with net-zero emissions by 2050."[3]

Of course, banks can't alter the trajectory of climate change on their own. Experts estimate that the world needs to invest $131 trillion in the energy transition technologies through 2050 to limit global warming to less than 1.5°C.[4] At COP26, more than 450 global banks, insurers, and asset managers joined the Glasgow Financial Alliance for Net Zero (GFANZ), a coalition capable of generating $130 trillion for green investments over the next three decades.[5]

But the harsh reality is that the planet remains on track to surpass the 1.5°C threshold before 2040.[6] So, more urgent and coordinated action between governments, businesses, and professional associations is needed now.

The banking industry stands out from other sectors in their capacity to help companies transition to a carbon-neutral economy by using their balance sheets for lending, investing, and trading activities. But effecting change at scale will likely require extensive collaboration with clients and regulators. There are some indications of progress on this front: For the first time since the Paris Agreement was signed in 2015, global banks are on track to provide more financing to green projects this year than to oil, gas, and coal companies.[7]

What more are banks doing to fight climate change?

Banks are not just providing capital to firms that are piloting climate change innovation. Other activities include advising clients on the transition to net zero, including mergers and acquisitions of greener companies, asset disposal, and financing of green projects. Institutions also are developing financial instruments that promote environmental initiatives, such as thematic investments and target-linked bonds, as well as new platforms that make it easier to buy and sell carbon credits or participate in carbon markets. Many banks are updating their policies regarding the financing of emission-heavy activities, such as fracking and Arctic drilling.

In addition, US banks are working to catch up to European institutions that tend to be more advanced in green banking practices such as climate-related stress testing, green bond underwriting, and the development of innovative products like sustainability-linked derivatives and exchange-traded instruments. Some banks also have begun to factor in executives' performance on climate and other ESG targets into executive compensation practices.[8]

Another contribution is intellectual capital, which banks have been channeling toward technology that should be made commercially viable, such as hydrogen energy, waste-to-energy, and carbon capture, utilization, and storage (CCUS). Some banks also are leveraging their influence with policymakers to facilitate coordinated action on climate, and press for legislation on carbon taxes and other climate matters. In addition, there is also a movement to bring low-carbon technology onto open platforms. For example, some banks are making the patents they use to reduce emissions at energy-intensive processing sites available to the public,[9] and others have joined coalitions that share tools and datasets that can assist with climate risk modeling and scenario-based predictive analytics.

This article discusses some of the important actions banks should pursue, the challenges they will likely confront, and the questions they should consider to deliver on climate commitments.

The challenge: Lack of standards

While banks' investments in net-zero initiatives are certainly notable, details about how most banks will execute emission-reduction plans remain sparse. While many companies in financial services and other industries have taken strides to share more details about their climate initiatives, the private sector has not yet agreed upon a standard framework for measuring carbon footprint or determining which parts of the value chain should be the focus of decarbonization efforts. As a result, it can be difficult for outsiders to assess how firms are advancing on their climate goals, or compare the progress of peer institutions. This lack of standardization may leave firms vulnerable to accusations of "greenwashing" from a wide range of stakeholders, including consumers, activists, shareholders, investors, regulators, and the press. Many stakeholders are pressuring financial institutions to be more transparent about their plans to phase out of fossil-fuel financing, and in some cases, are demanding banks go beyond the obligations laid out in their climate pledges.

Institutional investors, for example, have launched shareholder campaigns that would compel banks to publish short-term decarbonization targets sooner than they've already committed to and exit certain emission-intensive sectors by a set date. They also are pushing banks to develop a strategy for quantifying their contributions to biodiversity loss and other nature-related risks. Even some courts are pushing for more immediate action. For instance, a German court recently ruled that insufficient interim targets can result in a lion's share of the work being punted down the line instead of being treated with the urgency they require in the near-term.[10] This decision resulted in a law that created stricter reduction targets across public- and private-sector institutions.

Some activists are urging financial institutions to prioritize actions that will reduce and eliminate emissions, instead of just offsetting them to meet net-zero ambitions. These groups point out that banks can meet their targets and still finance fossil-fuel producers, so long as their activities are supplemented with carbon capturing, geoengineering, and other carbon-offsetting technologies. Defending against these claims can be hard when banks have no widely accepted guidelines to fall back on, leaving businesses to point to their own targets for accountability.

How to operationalize banks' climate pledges

There are several areas where more clarity is needed to understand how banks' pledges will be operationalized and reported on, especially in shorter increments over the next decade.

Most large US banks are taking steps to be more accountable on their portfolio goals, in particular by disclosing the methodology they will use to calculate portfolio emissions and deciding which sectors to prioritize for decarbonization. The use of *carbon intensity*, a metric that considers emissions relative to units of output, is emerging as a viable approach to evaluating performance against decarbonization trajectories and revising targets over time. This metric can be more inclusive of smaller companies, since it accounts for growth. But some groups argue that it is not as effective as absolute emissions and suggest that companies can shift resources around to lower emissions intensity without impacting their total production of greenhouse gases.

Banks also can do more to build out nonfinancial disclosures. One step that firms often overlook is quantifying the financial value associated with the expected benefits of financing green projects, despite the benefits it has in boosting reputations by showing the positive externalities of their work.

Partnering on climate-change initiatives

Closing this trust gap is paramount for banks to establish credibility on climate-change initiatives, upholding their social license with the public. Better disclosure is also good for business, as 97% of surveyed institutional investors consider climate-change to be very or somewhat important to their allocation decisions, according to a 2021 survey of global investors with $29 trillion in assets.[11]

Working with nongovernmental organizations (NGOs) can enhance climate reputations, since these groups often have the most up-to-date standards, benchmarks, and leading practices on corporate climate action, according to a recent Deloitte report.[12]

Notable groups, alliances, and partnerships include:

- The Net-Zero Banking Alliance, a coalition that launched in spring 2021 to coordinate strategic and technical work on the United Nations' Race to Zero campaign. The group was visibly active at the COP26 summit in Glasgow.
- The Partnership for Carbon Accounting Financials (PCAF), a global consortium that seeks to develop a common standard for assessing and disclosing climate impacts using science-based targets. Three of the six largest US banks are members of PCAF. Others have voiced support for its efforts but are still evaluating whether they want to take their own approach to developing a carbon accounting program.[13]
- The US Climate Finance Working Group, an association of 11 trade groups that will collaborate on accelerating the transition to a low-carbon economy through market-based policies that support institutions and their work helping clients.[14]
- Science Based Targets initiative (SBTi), a framework for setting and validating decarbonization targets that align with the latest developments in climate science research. Some banks are testing and providing feedback on SBTi methodologies, while others have committed to using its criteria.

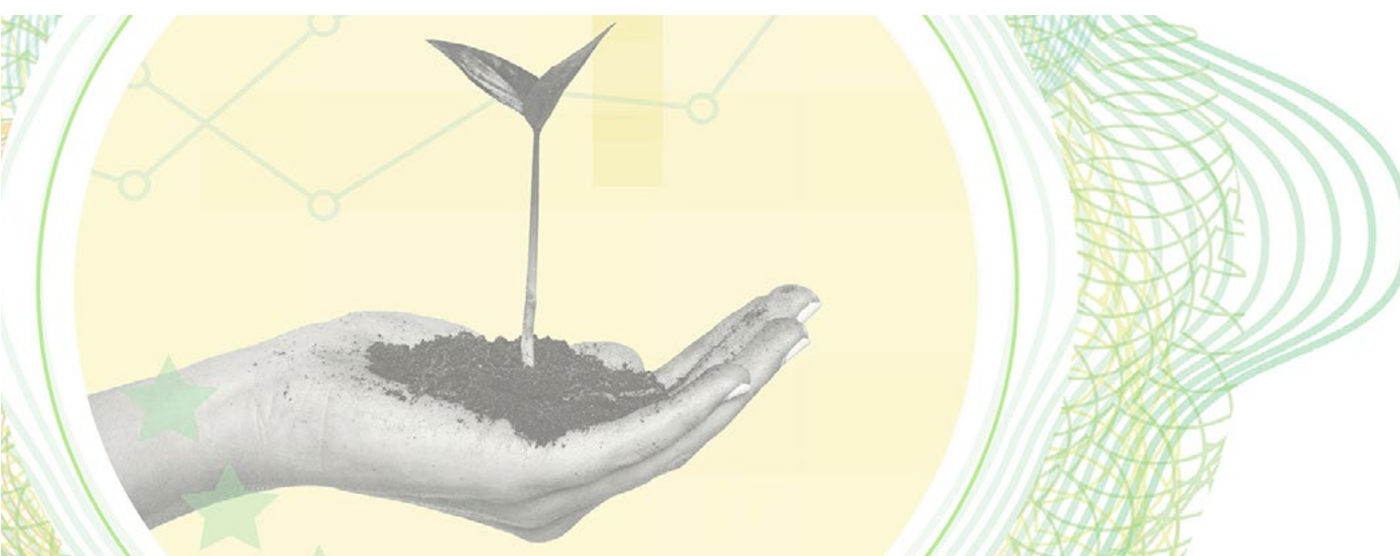
New demands from financial regulators may spur banks to build out their disclosures, too. The Securities and Exchange Commission, for example, wants leaders to reveal how they're managing climate-related risks and opportunities, and incorporating those analyses into corporate strategy.[15] And the Federal Reserve is developing scenario analyses that will model the impact of climate-related risks on individual institutions and the financial system as a whole.[16]

Banks can also refine climate risk reports and do more to incorporate recommendations set forth by the Task Force on Climate-related Financial Disclosures (TCFD) and Sustainability Accounting Standards Board (SASB). These frameworks are widely considered to be the "gold standard"[17] of climate risk reporting, and countries including China, New Zealand, Switzerland, and the United Kingdom have made them mandatory.[18]

US banks have gotten better at embedding TCFD and SASB recommendations in their sustainability reports, but they can do more to make climate communications accurate, complete, and reliable in the heightened attention to net-zero reduction targets. Third-party assurance providers can assist with governance, oversight, and data management processes, and verify that climate reports are market-ready.

As highlighted earlier, banks should confront a wide range of questions to determine how to maximize the impact of their substantial climate commitments, while delivering tangible results that can be measured and tracked. When choosing next steps, they should consider the following:

1. What metrics should be used to establish trajectories and monitor progress toward interim goals?
2. How can reporting be enhanced and/or substantiated to demonstrate accountability and develop safeguards against greenwashing claims?
3. Who within the banks should be tracking financial commitments to climate change, and which external groups should verify that progress reports are accurate?
4. How should financial commitments be revised as new information about climate science comes to the surface? Could pledges be adjusted over time?
5. What financing activities might have the biggest impact on emissions reduction, and how can they be prioritized?
6. Where and how might funding for decarbonization and green investments happen? Will there be an impact on banks' capital and liquidity levels?
7. How can banks better track and measure emissions by their clients/borrowers? And what methodology should be used to determine which sectors should be targeted?
8. What data is still required to track the greenhouse gases emitted by portfolio companies?



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