Discussion Paper

FINANCE-FIT-FOR PARIS (3FP) - BANKS

Technical handbook on aligning commercial banks with the Paris Agreement

28 September 2020

Frankfurt School - UNEP Collaborating Centre for Climate & Sustainable Energy Finance

Frankfurt School

Authors: Sebastian Rink, Henriette Jahns, Mathilde Bossut and Felicitas Koch

Supported by the European Climate Foundation

Table of Contents

Table of Figures

Abbreviations

3fP - Finance Fit For Paris

CEO - Chief Executive Officer

CSR - Corporate Social Responsibility

EBA - European Banking Authority

ECB - European Central Bank

EIB - European Investment Bank

ESA - European Supervisory Authorities

ESG - Environmental, Social and Governance

EU - European Union

GRI - Global Reporting Initiative

IEA - International Energy Agency

IPO - Initial Public Offering

KPI - Key Performance Indicator

kWh - Kilowatt-hour

M&A - mergers and acquisition

NFRD - Non-financial Reporting Directive

NGFS - Network for Greening the Financial System

PACTA - Paris Agreement Capital Transition Assessment

PCAF - Partnership for Carbon Accounting Financials

PRB - Principle for Responsible Banking

RTS - Regulatory Technical Standards

SBTi SDA- Science Based Target Initiative’s Sectoral Decarbonisation Approach

SME - Small and Medium-Sized Enterprises

SSM– Single Supervisory Mechanism

TCFD - Taskforce for Climate-related Financial Disclosures

TPI - Transition Pathway Initiative

UNEP FI - United Nations Environmental Programme Financial Initiative

Introduction to 3fP Banks

The climate crisis poses huge challenges to our economies and societies. Taking climate action to fight the adverse consequences of climate change has become a major driver for the transformation of both our economies and financial systems.

The transformation of the European economy towards net-zero greenhouse gas emissions and climate resilience is in full swing, guided by the EU's Green Deal for a sustainable economic development. The president of the European Commission, Ursula von der Leyen, has just announced the 2030 EU emission reduction target of 55% relative to 1990 levels. To achieve this target, the EU's economy will undergo a major transformation that will include major technology, policy, and demand shifts and innovation over the next ten years. A supportive financial system is necessary to redirect capital flows towards this transformation and to ensure that the European financial system becomes a strong partner for the European economy in financing the transition, while building up sufficient resilience against climate change related risks in the financial sector to ensure the financial system's stability.

The Paris Agreement provides the framework, which guides a future that aims to limit adverse consequences from climate change. Article 2.1.c) of the Paris Agreement stipulates that all financial flows should be made consistent with a low-carbon and climate resilient economic development. Financial institutions and financial regulatory bodies around the globe are acting upon it. Banks are at the core of any financial system and have started to act as well.

Banks play a critical role in supporting the transformation. They are the central providers of capital to the real economy and as the key financier for SMEs[i]. Based on their capital provision, banks can advise on and steer the transformation of European economies towards sustainable development. This entails being a manager of both climate risks and opportunities, an advisor on climate impact, an intermediary for climate-related financing opportunities, and a communicator on progress and investment needs. Faced with growing customer awareness, banks will need to position themselves internally and externally as to where they stand in the sustainability transformation.

The transformation will not occur overnight, but it has started and sustainability leaders have started acting already. Therefore, banks should embark on a long-term strategy and become long-term partners for the real economy in financing the transformation. Instead of binary approaches of divestment versus investment, it will be important to develop processes and pathways in collaboration with the real economy that allow for a targeted, just, inclusive and effective transformation.

The transformation will not be purely market-driven but will be guided by major policy frameworks such as the European Green Deal that set targets and the boundaries, act as an enabler and provide a long-term predictive and credible policy environment for investments into the transformation. The European policy agenda on sustainable finance pushed forward by the EU and many European governments shows that governments have started to take on their role. Banks should assume at least two roles within the public sphere: (i) Banks will need to operationalise regulatory action in the field of sustainability and climate change, and (ii) should become a partner for regulators and governments so that they can jointly work towards feasible solutions. This requires thinking ahead and pro-actively developing visions, ideas, solutions, methods and tools.

The aim of the finance fit for Paris (3fP) Banks Handbook is to support the commercial banking sector in finding a pro-active and constructive role in the transformation of the European economy. To this end, the 3fP Banks Handbook provides a collection of current knowledge. It is a guiding document on how commercial banks can align their operations with the objectives of the Paris Agreement, structured along ten key areas of action for 3fP-Banks. Building on the formulation of a vision of what a Paris aligned Bank could look like the Handbook particularly intends to assist commercial banks in learning about:

- Existing tools and methods for commercial banks to align with the Paris Agreement,
- Practical steps towards implementing respective methods and tools,
- The status quo amongst European banks in aligning with the Paris Agreement, and
- Good practices observed in the market.

This working paper is intended to ignite first discussions, particularly with a view to the European Sustainable Finance Summit. The final 3fP-Banks Handbook and a market assessment will be published later this year.

We invite commercial banks and all interested stakeholders to use this working paper as a starter for discussions, a “shopping list” for action, an enabler for climate impact, and as a kick-starter for joint collaboration on supporting the transformation.

Banks fit for Paris? The vision for a Paris-aligned commercial bank

A Paris-aligned commercial bank tackles the climate crisis on various levels using a wide range of methods and tools in a holistic manner. In the following, we outline a vision for a Paris-aligned bank. This visionary statement does not claim to be comprehensive and should be regarded as an opener for discussion and a guide to the development of the 3fP-Banks areas of action.

A Paris-aligned commercial bank integrates climate action holistically in its core business strategy. The corporate strategy reflects the perspective through commitments to climate goals and the respective integration into its own targets. The bank takes a role as steward for climate action. Reorienting capital flows towards the Paris climate goals represents a key target on the agenda. While C-level management sets the tone from the top, the organization-wide process integration ensures that climate considerations form part of daily operations. A spirit of transformational and forward-looking thinking is encouraged. A long-term perspective is the foundation for decision-making processes, underpinned by a science-based vision for sector-specific decarbonization pathways.

A Paris-aligned commercial bank creates climate-related opportunities and impact. Its product portfolio contains a strong track-record in climate finance and a variety of Paris-aligned financial products. A continuous effort to grow the project pipeline and portfolio ensures that increasing customer demand is satisfied with adequate products and services. A sufficiently developed entrepreneurial culture allows testing of new ideas. A solution and innovation-oriented position places the bank as a thought leader and as an institution recognised for its pioneering practices. The development of frameworks, tools and new structures is ongoing in all departments.

A Paris-aligned commercial bank fully comprehends its business environment and its investees. It aims to increase the climate resilience of the financial system and this support financial stability. Its efforts in understanding and measuring the impacts of its business activities on the climate and vice versa forms part of an iterative decision-making processes. Climate risk management is understood to be a central pillar adapting risk management in a transforming world. Forward-looking approaches entail the inclusion of all relevant internal actors as well as the use of climate scenario analyses, which contribute to a comprehensive and decision-useful risk assessment.

A Paris-aligned commercial bank shares information on its business activities, its research and its strategic views with the outside world. Transparency is sought wherever possible and where not resulting in competitive disadvantages. A Paris-aligned bank "walks the talk" and discloses on its progress towards achieving the Paris climate goal in its business as well as on its positive and negative impacts and on achievements (methodological, technological, etc.). In dialogue with academia, policymakers, the civil society, peers and investees information is shared, action demanded and room for joint initiatives evaluated.

A Paris-aligned commercial bank actively helps raising awareness and shifting societal and economic activities towards the achievement of the Paris climate goals. In an advising role, (i) customers are made aware of climate impacts resulting from investment decisions, (ii) investees are presented with options to green activities and (iii) employees are encouraged to take action themselves. The bank becomes an agent of change.

Paris-aligned commercial banks follows a gradual process in translating those attributes into action. This indicative timeline should provide a sense of what this process could look like.

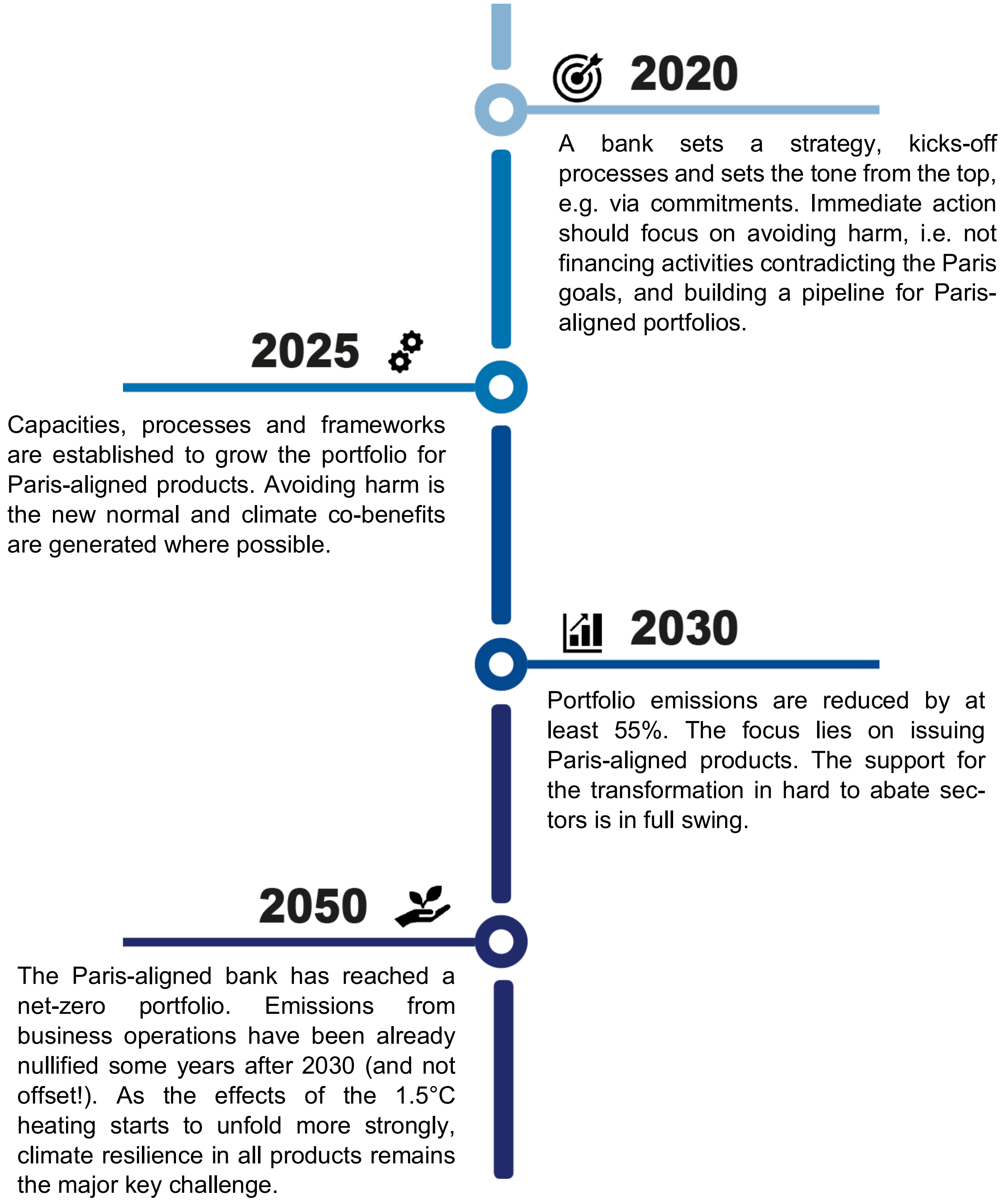

Figure 1 - Timeline for the Paris-alignment of banks

Are 3fP banks the vision to go for? The business case for Paris-aligned banks

Good business sense is driving action on climate change amongst banks. Many banks have already realised that they can seize market opportunities and gain a competitive edge when going beyond regulatory requirements. The nature of the bank's business allows it to take on a vital role in financing the sustainability transformation while renewing and strengthening its business models. Four key elements of the business opportunity for banks are outlined in Figure 2.

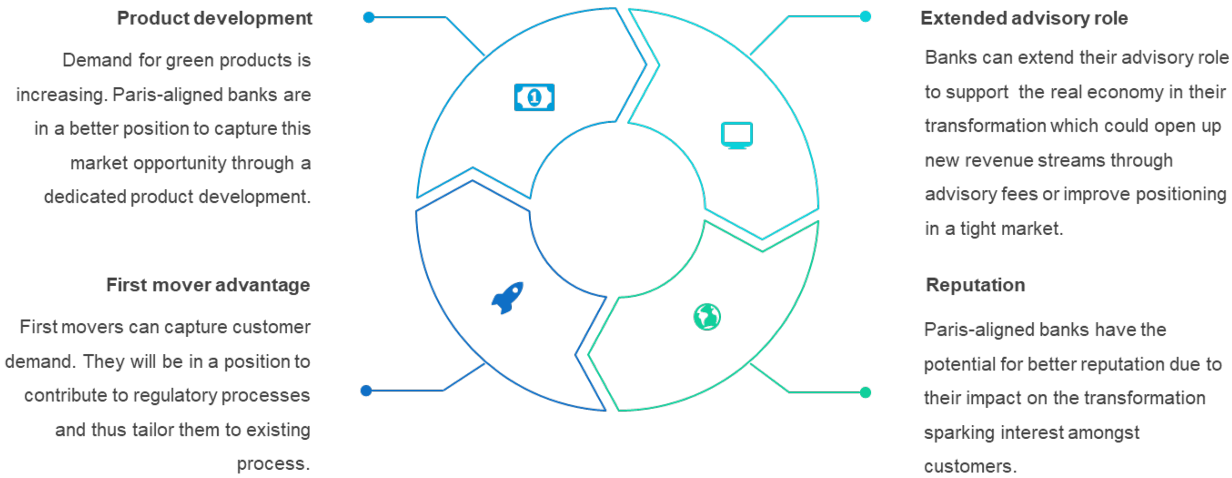

Figure 2 - Climate as business opportunities for banks

Product development will allow banks to benefit from the growing sustainable finance market segments. Demand for and supply of green bonds, green loans, sustainability-linked bonds, sustainability-linked loans and other green instruments are rapidly growing. These green financial products have an important role in enabling a sustainable transformation. Space for product innovation still exists, providing banks with the opportunity to further develop their product portfolio. This action point is further discussed under the section Products, page 16.

An **extended advisory role** by banks can support key industries in their green transformation opening up new revenue streams and allow for stronger positioning. Banks can use their sector and macroeconomic knowledge as well as their method and tools to support corporates throughout the economic value chain in their transformation. Banks can in particular support Small and Medium-Sized Enterprises (SMEs) in implementing sustainability aligned business operations and in collecting climate-related data.

If banks act now and ahead of upcoming climate regulation, they can gain a **first-mover advantage**. First moving banks currently seem to be in a better position to contribute to regulatory processes. By developing ideas in-house, banks can react to the rather open requirements by regulators and therefore help shape upcoming or stricter regulation throughout their processes and needs. On the market side, first moving banks are in a better position to advise clients and to supply the market demand for green products, which could result in the growth of the business model or their respective market shares.

Sustainability has long been a **reputational factor**. The reputational aspect is gaining ever more importance much beyond corporate CSR functions. Acting upon climate change and sustainability across the entire business of banks is increasingly expected and recognized by clients and customers. Through real impact on the transformation, banks can position well with customers. This will help to sustain a successful business in the medium- to long-term.

A look in the future	Discussions on the risk of green and brown assets are ever-present among regulators and financial market actors. At one point, regulatory authorities may find evidence for higher risk of brown assets, which would put them in the position to adjust capital requirements accordingly. Regulatory authorities might furthermore decide to use capital requirements as an incentive tool (as is the case for SMEs today already) to push investments out of brown activities or into green activities. By adjusting their business models today, banks would be able to benefit from such measures immediately

The status quo of Paris-aligning banks

Compared to institutional investors or insurance companies in the context of entire financial system, banks were usually perceived as being less advanced on aligning with the Paris Agreement. Various aspects might be the reason for this situation such as a common shorter time horizon within the banking business or more recent and less advanced development of regulatory requirements on climate change for banks as compared to other parts of the financial sector, e.g. on the use of the EU Taxonomy. However, the situation is currently changing drastically. Four key drivers of change are displayed in Figure 3.

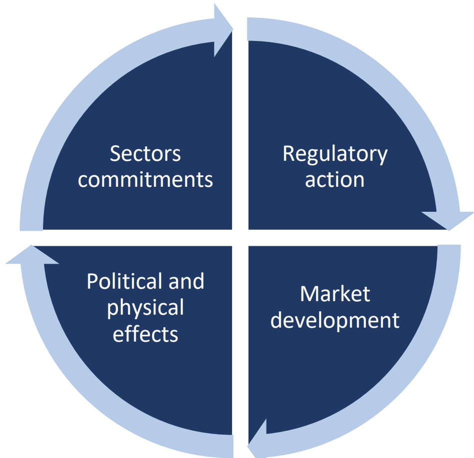

Figure 3 - Four key drivers of change towards Paris-alignment

Sector commitments by the banking industry in Spain, Germany and the Netherlands will move the markets on a voluntary basis. Signatories to those sector commitments will align their portfolios with the Paris Agreement over the coming years. Currently, the sectors in those countries seek agreed technical solutions to measure progress towards the target. Banks throughout Europe have signed up to the Principles for Responsible Banking (PRB) by UNEP FI[ii] since its launch in 2019.

Regulatory action on the EU and the national level has become a driving force in moving the entire EU banking market. A recent publication of the draft ECB Guide on climate-related and environmental risk[iii] as well as the EBA sustainable finance action plan[iv] show that climate-related banking regulation at the EU level is rapidly evolving. National regulators e.g. in France or Germany are complementing this action by becoming role models or publishing guiding documents on their own or as part of international networks such as the Network for Greening the Financial System (NGFS). The introduction of further EU regulation resulting from the EU Action Plan on Financing Sustainable Growth is integrating the European sustainable finance market, including the EU Taxonomy, the Sustainable Finance Disclosure Regulation incl. the European Supervisory Authorities' Regulatory Technical Standards (RTS) or the EU Green Bond Standard.

A **market-driven development** mainly results from changing customer demand patterns and the move by competitors. Conversations with the banking industry show that retail and corporate clients increasingly ask for green and sustainable financial solutions, including advisory as well as financial incentives. Many banks, and particularly front-runners, are aware of this trend and adapting their business model. This creates pressure on the entire market to move if actors do not want to run the risk of losing out.

Actual physical effects related to the climate crisis are increasingly felt and trigger societal (e.g. Fridays for Future or Extinction Rebellion) and policy (e.g. EU climate targets) reactions. Supranational, national, regional and city governments are increasingly taking action on the climate crisis, which changes the business cases for many technologies (i.e. green activities become financially viable while some brown activities become stranded assets). This will have a strong impact on the real economy and therefore indirect impacts on the financial system. Over the last years, the effects of the climate crisis became more frequent, e.g. flooding in Bangladesh, wildfires in California and Australia, water scarcity in Germany. The increased frequency of those events forces banks to take action in some cases already today. The physical climate effects result from increasing temperatures. In the last ten years, the world saw eight out of the ten hottest years on record[v].

Challenges

The ongoing efforts by European banks to align with the Paris Agreement have already unearthed some key challenges in operationalising the 3fP Banks vision. From the dialogue with banks, three challenges stand out:

Climate data gap: a Paris-aligned bank will need to process many climate-related data in order to assess progress towards the great transformation, climate risks and impacts, sustainability of existing business models, level of Paris-alignment of products and portfolios, etc… Data is currently not readily available at the scale necessary. Data providers and disclosure obligations can help to reduce the climate data gap. Much of the data relevant to banks, however, will need to be provided by SMEs, which are currently not obliged to disclose under existing disclosure regimes and often are too small for data providers to be attractive for analysis. Therefore, the climate data gap persists, and banks will need to fill the data gap themselves or request assistance from public authorities.

Harmonisation and standardisation of methods and tools: Paris-alignment of banks is an ongoing challenge and therefore harmonised and standardised approaches are just starting to evolve. Regulators often provide methodological freedom to a certain degree to allow banks to develop methods and tools that best fit their operations and to let the market develop tools. However, this approach reduces appetite to invest too heavily in those methods and tools as the regulator or other standardisation bodies might set a different method or tool as the standard in the future. Therefore, pre-competitive formats or cooperation between regulators and banks should be sought to increase the pace of harmonisation and standardisation of methods and tools. This could increase efficiency in the process. Cases for this would involve:

- The development of a standard scenario for climate risk assessment
- A joint development of tools to measure portfolio impacts
- Setting up of standardised reporting templates and data flows from SMEs to banks

Capacities: a successful steering of the transformation requires new skills and capacities within banks and amongst clients and other stakeholders of banks. From the front desk to the back end, from the retail client to the treasurer at a large corporate and from the supervisor to the reporting team, all actors need to acquire the capacities to fulfil their role in the transformation, to interact with other stakeholders and to ask the right questions. This process will take time and will require efforts by all sides. Early results of this study show that most banks have actively started to educate their employees, while some have integrated respective governance and remuneration structures and only few educate their clients. In order to overcome this challenge, public agents, civil society and banks alike will need to get active and support this capacity building process.

The 3fP-Banks areas for action

Ten 3fP-Banks areas for action should guide commercial banks in aligning their business model with the Paris Agreement, see Figure 4 for an overview of the areas. The 3fP-Banks areas for action should cover all relevant aspects of a commercial bank's operations with a high proximity to the real economy. Within each area of action, fields of action, single actions and necessary methodologies and tools are defined. Those will be published in the final 3fP-Banks handbook in more depth.

Figure 4 – Overview of the ten areas of actions

In the following chapters, a brief introduction to each area of action is provided. It contains a short explanation of why this area of action is important for the alignment of commercial banks with the Paris Agreement. Moreover, key steps to taking action and a good practice example[1] are briefly outlined.

[1] Please note that only good practice examples from non-participating banks are displayed. Good practice examples from participating banks will be developed in more depth for the final 3fP-Banks handbook.

Strategy

In the World Economic Forums' long-term risk outlook, five of the ten most likely and most impactful global risks are related to climate change[vi]. The Network of Central Banks and Supervisors for Greening the Financial System (NGFS) warns that climate change is threatening financial stability. In 2018, climate risks became part of the ECB SSM Risk map[vii]. Climate change mitigation and adaptation offers market opportunities. Against this backdrop, banks considering environmental variables when developing their strategy will benefit from advantages to be competitive in the world of today and tomorrow.

The alignment of a bank with the Paris agreement should be a strategic element of banks' agendas and should focus on the consistency of financing and investing operations "*with a pathway towards low greenhouse gas emissions and climate-resilient development*"[viii]. Adopting a consistent climate strategy will allow banks to contribute to the reshaping of the banking sector and indirectly the real economy, which would show future-oriented leadership. First movers will not only benefit from reputational gains but also from reduced financial risk exposure due to a greater understanding of the challenges of a transition towards a low-carbon and climate-resilient economy. Considering climate-related variables in strategical developments requires to adopt a longer time horizon, which by anticipating market movements and new regulatory requirements will improve decision-making and the long-term sustainability and viability of banks.

A Paris-alignment strategy should consist of:

- **Quantifying higher ambitions** by setting up targets for increasing financing on climate mitigation and adaptation activities and for decreasing financing in activities not aligned with the objectives of the Paris Agreement;
- **Improving processes with regard to climate change**, in particular to improve the understanding of climate-related risks and opportunities and enhance the transparency towards investors for example by steering and disclosing the climate footprint of the bank's portfolio;
- **Communicating ambition*:*** by joining industry, policy and civil society forums to present the strategy and jointly work towards an environment that rewards climate strategies;
- **Complying with and anticipating an evolving regulatory environment**

The European Investment Bank (EIB) becomes a green bank

In 2019, the European Investment Bank announced it will end financing for fossil fuel energy projects from end of 2021 and to align all financing activities with the goals of the Paris Agreement from the end of 2020. With its new Emissions Performance Standard of 250g of CO_2 per Kilowatt-hour (kWh), future financing will accelerate clean energy innovation, energy efficiency and renewables. The EIB will also unlock EUR 1 trillion of climate action and environmental, sustainable investment between 2020 and 2030 and will develop financing mechanism to assist the energy transition in Europe with the Just Transition Fund. With its climate strategy, the EIB became the first European green bank. Although EIB is not a commercial bank, its first mover behaviour should have a lighthouse effect for the entire European financial industry.

Data solutions

The availability of relevant and consistent data on climate-related variables is a prerequisite for the alignment of commercial banks with the Paris-agreement. For financial market actors, the accessibility and quality of data on sustainable finance is critical for the measurement of climate risks and their potential impact on the long-term performance of financial assets as well as for the quantification of the environmental footprint of financing and investing activities. Furthermore, many climate-related financial products require the measurability of impact or progress.

Commercial banks should be able to measure financial flows and their alignment with the climate targets of the Paris Agreement by:

- **Ensuring the availability of climate-related data**: banks could undertake an analysis on accessible and missing climate-related information, engage with their clients and investees on the communication of climate data and cooperate with ESG-data providers;
- **Defining climate variables and KPIs** in order to ensure standardization, comparability and coherence between collected data at the bank-level to steer the progress on sustainable finance and seize further developments;
- **Defining reference framework** to interpret data and benchmarking them against good practices, sectors climate standards or climate trajectories;
- **Ensuring the adequate collection and application of data** by offering guidance and training to clients on the communication of climate information and employees on their collection and use as well as providing tools with a high level of usability;
- **Reviewing methodologies** to include climate information in processes, assessment models and diverse algorithms in order to consider climate issues.

Commercial banks can seize opportunities of the digital transformation to systematically assess their risk exposure to climate change and the transition towards a low-carbon and climate-resilient economy as well as consider the environmental performance of their assets.

Good example: A blockchain-powered green bond

The biggest challenge in issuing a green bond is to ensure credibility of the climate purposes of the bonds revenues, to guarantee transparency on their use and to limit additional cost resulting from these challenges. In 2019, BBVA and the Spanish insurance company *Mapfre* partnered to arrange the issue of the first blockchain sustainable bond. The use of blockchain reinforces confidence on the “green-ness” of the selected projects as transactions are validated through mathematical algorithms and cryptography while machine learning and artificial intelligence allow monitoring the impact in the real-time. Such technologies alleviate the administrative burden and therefore could partly reduce the cost linked to green bond issuances.

Products

Green bonds, with an USD 258.9 bn issuance in 2019, which is more than 5 times the issuances in 2015, are the symbol of sustainable finance. Since the first green bond issuance in 2008, multiple new green financial products have been created: green loans, green deposits, green mortgage, sustainability-linked loans, etc. Green financial products are a way for commercial banks to redirect financial flows towards their climate targets but also to seize new business opportunities arising from the transition towards a low-carbon and climate-resilient economy. Developing green financial products also:

- Enables the **adaptation of well-known financial products** to new climate challenges and ensure trust and reliability of products;
- **Creates new product categories** to attract the rising demand for sustainable finance and tap into a new class of investors;
- **Facilitates the tracking of green financing** and the steering financing and lending portfolio toward the alignment with the Paris Agreement.

In order to develop a green financial products consistent with the Paris Agreement, commercial banks should consider:

- **Developing a green finance framework consistent with the Paris Agreement,** defining inclusion criteria for green and climate-resilient projects and exclusion criteria for projects, activities and sectors not compliant with the 1.5°C objective. These criteria should be aligned with national and international regulation. European banks could use the EU Taxonomy as an underlying framework;
- **Complying with existing regulation** when relevant – this is for example the case for the EU Green Bond Standards in the EU;
- **Requiring external review and second party opinion** to ensure the "green-ness" of the financed green projects;
- **Proposing valorising financial terms** with for example interest rate depending on the sustainability performance of the client;
- **Studying currently available offers from public authorities** that could be adopt by commercial banks, for example preferential interest rate for energy retrofit subsidized by governments or state agencies.

Retail Banking	Corporate Banking
Green mortgage	Green Project Finance
Green Home Equity Loan	Green Securitization
Green Commercial Building Loan	Green Venture Capital
Green Car Loan	Carbon Finance
Credit Card	Green property investment
Energy equity loan	Green Technology Leasing
Green deposit	Sustainability Improvement Loan

Figure 5 - Existing green banking products

Incentivisation

Rewards and incentivisation schemes, often in the form of financial remuneration and bonuses, are a powerful tool for banks to institutionalise their Paris-aligned strategy throughout business and cultural aspects. Therefore, commercial banks worldwide are in the process of adjusting their remuneration structure to reward longer-term success by means of deferring compensation to future years or paying bonuses in bonds or stocks[ix].

The European Central Bank (ECB) underlines the importance of incentivisation in its draft guide on climate-related and environmental risks[x], which states that *"institutions are expected to ensure that their remuneration policy and practices stimulate behaviour consistent with their climate-related and environmental (risk) approach, as well as with voluntarily commitments made by the institution".* Hence, the ECB recommends developing remuneration policies, which are in accordance with the bank's strategy and long-term business goals, risk appetite and the long-term objectives.

As part of a Paris-aligned strategy, commercial banks should establish remuneration schemes, which focus on long-term success rather than financial performance of a single year to promote sustainable business growth of the bank. Financial and non-financial incentivisation should be considered.

- **Financial incentives**: Banks could develop, communicate and establish a financial incentive policy. Such a policy will take into account specific quantitative and qualitative targets on aligning behavior and decision-making with the Paris goals. Such incentive schemes are oftentimes established at the top of the institutions and then diffuse through the banks hierarchy, which is important to incentivize all employees.
- **Non-financial incentives**: Banks could additionally develop, communicate and establish a non-financial incentive system using both qualitative and quantitative factors. Those could include promotions based on performances along climate targets, rewards such as additional days off, public transportation passes, etc. Furthermore, competitions for employees to develop and present their own low-carbon project or ideas for the bank could encourage action.

Good practice – the Société Générale's remuneration policy

A good practice example for climate-related incentivisation is Société Générale's remuneration policy for CEOs and employees. As transparently outlined in their 2019 TCFD report, Société Générale's remuneration policy for CEOs is based on three pillars, see Figure 6.

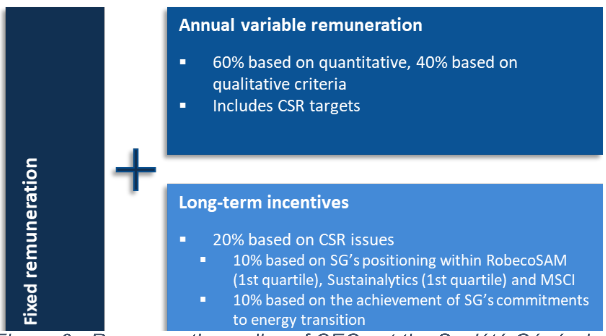

Figure 6 - Remuneration policy of CEOs at the Société Générale

According to RobecaSAM, the long-term incentives pillar includes a 15% weighting on climate-related issues. For its French operations, Société Générale states that out of the total amount of profit-sharing and incentives paid to their employees in 2018, 4% was with regards to CSR objectives. In the 2019 TCFD disclosure, Société Générale further points out that employee remuneration is not linked to climate-related matters leaving some room to improve this good practice example.

Governance

The governance of financial corporations is of high importance as it directs and controls the strategic decisions and actions of the bank. The governance has an impact on the management of interests by stakeholders and the interaction between different units in the bank.[xi] A strong climate governance can therefore result in new opportunities for growth thanks to a stronger climate portfolio. The Finance Initiative of the United Nations Environmental Programme (UNEP FI) has proposed a new governance model, the so-called *Integrated Governance*. It brings the oversight of climate-related and sustainability issues to boardrooms and expresses an end state of government practices.[xii] Such an approach can lead to:

- A holistic and strong governance system can improve the effectiveness of other climate-related actions and measures;
- Identification of synergies between bank units can reduce organisational silos;
- Strong governance structures enable banks to address climate issues within their portfolios early on to stay ahead of the curve.

Banks should take decisive actions in order to ensure a structured and stringent climate-related governance. Banks may start by integrating climate-related elements into committees, which are responsible for, inter alia, strategy, risk management and incentive setting. These working groups should develop a holistic governance approach that:

- Establishes **formal mandates, responsibilities and tasks at board level, management level and division level**;
- Includes a step-by-step process that ensure structure and stringency, for instance, when measuring impact performance or guiding decision-making processes;
- Align management practices with international good practices and standards, such as the Principles for Responsible Banking.

The governance shall ensure that climate-related aspects are mainstreamed and a cultural shift within the organization is triggered. A long-term perspective in decision-making appears to be a factor along with clear mandates and responsibility for (senior) management. Paris-aligned targets and objectives throughout the organisation ensure that long-term objectives become tangible. The awareness and the capacity amongst employees can be increased by addressing climate-related matters regularly. This allows management to establish a bank-wide, internal community of employees who provide concrete contribution and take on responsibility for climate-related matters. Employee engagement could further be strengthened through dedicated events, webinars, meetings, seminars, newsletters, workshops or public recognition for “Paris-aligned champions” within the bank. It is important to note that an adequate resource allocation is required.

Good climate governance is characterised by a solid monitoring, reporting and verification mechanism. This involves the monitoring of the bank’s progress towards climate goals. The monitoring should be established throughout the bank to align and coordinate action by all divisions. The coordination can be further strengthened by establishing a direct reporting line from the coordinating head to a board member. The board should have the capacity and mandate to take action if climate goals and targets are about to be missed. Finally, governance disclosure processes should be transparent and a regular audit by internal and/or external auditors should ensure quality and stringency.

Portfolio management

Banks' core business activities include their lending activities to corporates, which can have both positive and negative effects on climate change mitigation and adaptation as well as their underwriting of securities with underlying "brown" or "green" assets.[xiii] Banks' activities are reflected in the their portfolios, which makes portfolio management a central element when aligning activities with the Paris Agreement.

Aligning banks' portfolios to the Paris Agreement will support a more resilient business model that integrates climate-related risks and opportunities. It will facilitate the operationalisation of disclosure obligations such as the upcoming disclosure according to the EU Taxonomy. Aligning a portfolio with the Paris Agreement means to mathematically measure the difference between the climate performance of the respective portfolio and temperature benchmarks or trajectories such as the IEA Sustainable Development Scenario.[xiv]

For a Paris aligned portfolio management, banks should:

- **Integrate climate metrics across its overall portfolio management process** to ensure that the effects of climate-related risks and opportunities on the portfolio performance are well understood. Integrating climate metrics includes the definition of scope (e.g. sectoral approach) and targets (e.g. volume or output based) and the use of and reference to appropriate tools and methodologies.
- **Manage Paris-aligned portfolios** by relying on methodologies, tools, certificates and labels to categorise products in the individual portfolios and take lending decisions based on this information. Industry and sector data is again central for applying these portfolio management tools, as is a forward-looking approach towards the climate alignment of assets/companies. Methodologies provided by e.g. PACTA's tool for corporate lending portfolios[xv] or UNEP FI's Portfolio Impact Analysis Tool[xvi] are evolving and may support these efforts.
- **Apply carbon accounting**, based on the relevance of GHG scope 3 emissions (indirect emissions) for banks, which themselves do not produce goods nor consume much energy relative to corporates in the real economy. Indirect GHG emissions through their financing are referred to in internal carbon accounting frameworks in alignment with (international) regulations, standards or principles such as the Partnership for Carbon Accounting Financials (PCAF)[xvii]. These carbon accounting frameworks should be applied throughout the portfolio management process.

Good practice - ING's Terra approach:

"Terra is an inclusive, science-based, forward-looking and engagement-driven approach. With Terra we focus on the sectors in our loan book generating the most climate impact. Drawing upon two main methodologies for target-setting, namely the Paris Alignment Capital Transition Assessment (PACTA) and the Science Based Target Initiative's Sectoral Decarbonisation Approach (SBTi SDA), Terra adheres to a number of underlying principles. Perhaps the most critical principle is that we steer our portfolio per sector. This sector-based approach respects the fact that each sector has its own transition pathway, or 'technology roadmap', for it to contribute to a low-carbon, below-two-degree world." (Source ING 2019 Terra Progress Report)

Risks management

Risk management is at the core of banks' businesses and aims to identify, assess and manage risks that are or may become material for the bank. Climate-related risks directly affect a bank's operations (e.g. through physical events damaging the bank's premises) and a bank's client activities through the exposure of its clients to climate-related risks, influencing clients' creditworthiness and underlying asset values.

In an assessment of 46 banks' portfolios in the European Union, 15% of portfolios are subject to high physical and transition risks due to climate change.[xviii] A similar study shows that 43% of major global banks do not explicitly capture climate risks in their credit rating processes to corporate clients.[xix] Climate risk management was also among the weakest areas in a recent assessment of 20 large European banks.[xx] Integrating climate-related risks into banks' overall risk management is a key building block in order to develop more robust lending strategies given that a wider range of uncertain future conditions must be taken into account.[xxi]

Towards a Paris-aligned risk management, banks should:

- **Build a comprehensive framework for assessing and managing climate-related risks of clients** by making use of risk assessment and management tools. With the growing importance of the impacts of climate risks on corporate's financial performance, and thus on banks credit default risk, a variety of impact assessment tools has been developed. Tools cover transition and physical risks (e.g. CD, 427 – overview to be included in Handbook), scenario analyses for different levels of global heating, differing levels on which the impact is assessed (e.g. portfolio, company, site, asset, etc.) as well as different parameters and the corresponding exposure, sensitivity and adaptive capacity;
- **Consider managing bank's own operational risk** related to climate change, which for instance can refer to operational, reputational, legal and policy risk;
- **Make use of scenario analysis and stress tests to explore possible futures** to reflect that timing and magnitude of the effect of climate risks are often uncertain and be long-term. Climate-related scenario analyses test the portfolio's resilience against climate change risks, based on different assumptions and constraints. There is guidance e.g. based on the TCFD by UNEP FI[xxii] or the NGFS, as well as tools such as the Transition Pathway Initiative (TPI) and PACTA;
- **Comprehensively integrate climate risk management into the banks' overall risk management**, including a strong climate-risk governance function, the alignment with overall credit and capital allocation strategies and the integration into overall risk processes.[xxiii] This may cover target setting for managing climate exposure in the bank's overall portfolio as well as transition/phase out/exclusion policies for carbon-intensive sectors.

Good practice

The ECB formulates its expectation on banks' risk management: *"Institutions are expected to incorporate climate-related and environmental risks as drivers of established risk categories into their existing risk management framework, with a view to managing and monitoring these over a sufficiently long-term horizon, and to review their arrangements on a regular basis. Institutions are expected to identify and quantify these risks within their overall process of ensuring capital adequacy."* (ECB Guide on climate-related and environmental risks, May 2020).

Financial advisory

The successful alignment of a bank with the Paris Agreement is highly dependent on the underlying portfolio and asset distribution. The transformation of the real economy must deliver appropriate assets to be financed. This opens new business opportunities for banks in the role of a financial advisor who is not only in the position to provide green financial products to corporates but also understands the transformation of the sector and can therefore provide additional advisory services. The analysis of climate aspects (see chapters on portfolio and risk management) will enable banks to identify "green" opportunities in corporate business models. Advice from banks will be of particular relevance for SMEs who usually do not have the capacities to hire dedicated experts to assess the impact and potential courses for action in the climate transformation.

Many banks have already realized the need for Sustainability Advisory teams. Often integrated in the Corporate Finance or Advisory division, such Sustainability Advisors have a particular focus on supporting clients in integrating climate-related aspects. Tasks of those divisions might include:

- **Utilising internal knowledge on climate change** and the client's sector to advise on climate strategies;
- **Advisory on climate risk management, operations, regulatory and general (financial) management services** as well as analyses on industry and geographic specific aspects. This might extend to assessments on reputational and regulatory climate-related matters of the company and advisory services on disclosure practices, e.g. use of the TCFD recommendations and the application of scenario analyses;
- **Preparation of companies for the issuance of green instruments** such as green- and sustainability-linked bonds or provision of green- and sustainability-linked loans;
- **Build capacities amongst corporate clients** to raise awareness for the need to act in the transformation. This involves providing information on the changes to the sector, highlighting the benefits of green financing options and the downsides of inaction.

Providing such services, banks usually need to establish tools and service models. To develop green advisory processes and products for corporate clients, banks should align advisory products and processes, such as M&A, Debt Advisory or IPOs (due diligence practices, etc.) with climate-related aspects. At the end of this process, advisory products include, inter alia, regulatory product frameworks, impact assessment tools and climate-related risk scenario assessment.

Employees need to be empowered and enabled to promote climate action in advisory processes through internal capacity building. Banks should educate financial advisors on climate-related issues that are relevant for corporate clients as well as their climate impact and their (financial) risk profile. This includes educational elements on regulatory, reputational, risk-related, operation-related, geographical and industry specific climate matters. Financial advisors should further receive education on the range of "green" financial products offered and how these incorporate climate-related risks and account for adverse impacts on climate change.

Initial findings from this project's interviews show that banks take different approaches in developing relevant services and capacities. Some banks have already rolled out trainings for their entire front desk teams. Others have hired dedicated experts who support front desks in client interactions upon request. The mode of interaction seems to vary between actively raising climate-related aspects in every client interaction as compared to being able to respond to client's inquiries and demand for green products. This is also reflected in the data collection for such proposes, which already forms part of a standard questionnaire at some banks while others are still in the process of setting up such procedures.

Disclosure

The lack of available information on climate impact or exposure of assets to climate risks constrains participants in their investment decision making. Increasing and enhancing climate-related disclosure of relevant and useful information leads to greater transparency and would stimulate behavioural change. Transparent financial markets would allow financiers and investors to adapt their investment decision with climate information.

Improving transparency on climate information is also crucial for commercial banks as the regulatory landscape, in particular in the EU, increasingly requires companies to disclose non-financial information. Since 2018, large companies are required to disclose information on their business models, policies, risks and outcomes as regards to environmental and social matters under the Non-Financial Reporting Directive (NFRD)[xxiv]. The NFRD has been enhanced in 2017 and as a part of the European Green Deal, the European Commission plans to strengthen the requirements in 2021. Beyond compliance, commercial banks could have a strong interest in disclosing non-financial information as it could be a competitive advantage with regard to the rising demand of retail and corporate clients and a basis for further strategical development in sustainable finance. The European framework for sustainable finance also offers an enabling environment as banks can profit from accessibility to information on the sustainability of large European companies. As of this writing, information on SMEs remain largely inaccessible through European disclosure requirements.

In their disclosures, banks should consider climate-related aspects such as climate footprint of the bank's financial assets with for example the CO_2 emissions being emitted or avoided by the bank's financing. Additionally, the positioning of sector-specific portfolio in comparison the sector (e.g. energy mix in energy portfolio vs. energy mix in an average country portfolio) and to the exposure to climate-related risks should be disclosed. Numerous frameworks exist for climate-related disclosures, for instance, the frameworks of the Global Reporting Initiative (GRI) and of the Taskforce for Climate-related Financial Disclosures (TCFD). Optimal environmental disclosure management would:

- **Ensure a close collaboration and dialogue between disclosure, strategy and risks management divisions** to properly develop climate-related disclosure but also plan necessary training, education, make sure that top managers are aware of gathered knowledge and that links are established between climate information and risk management planning;
- **Define environmental Key Performance Indicators** to assess on a year-to-year basis the development of green finance and the alignment with the Paris Agreement and enable comparability and consistency;
- **Be verified by external reviewers and Second Party Opinion providers** to ensure transparency and veracity of non-financial information.

Commitment & Communication

Half of all major banks globally have issued a sustainable finance commitment by mid 2019, with more banks followed thereafter. This trend will not only change the way the banking sector is operating but will have a major impact on the climate. Committing to the Paris Agreement and communicating the commitment in an effective way can, first, raise awareness within the banking sector, second, lead to transformative actions, and third, change both internal and external cultural aspects.[xxv]

The bank's image, brand and reputation are important factors when it comes to investor relations, regulatory communication, acquisition of new or retainment of existing clients, and attracting top talents. Therefore, climate action and the open communication of targets, progress and achievements increasingly become competitive factors. Commitments are a key piece of communication that is currently used more frequently. Turnkey commitments for the European banking sector include:

- The **Katowice commitment**: Five leading banks, namely BBVA, BNP Paribas, Société Générale, Standard Chartered and ING, have issued a commitment to the global climate goals for COP24 in 2018. The banks commit to "*measure the climate alignment of our lending portfolio, and to explore ways to progressively steer financial flows through our core lending towards the goals of the Paris Agreement*" and support Article 2.1c) of the Paris Agreement[xxvi];
- The German **Klimaschutz-Selbstverpflichtung des Finanzsektors** (climate protection self-commitment by the financial sector): On 30 June 2020, 16 German financial institutions signed the commitment in which they aim to keep global heating below 1.5°C. *"In concrete terms, this means that by the end of 2022 each signatory will develop and implement mutually accepted methods for measuring the climate impact of its credit and investment portfolios and then manage them in line with national and international climate targets*"[xxvii];
- During COP25, the main Spanish banks signed the **Spanish Commitment** to reduce the carbon footprint in their credit portfolios, in a way that can be measured with internationally approved criteria and in line with the objectives set out in the Paris Agreement. The commitment represents more than 95% of the Spanish banking sector. Under this agreement, the signatory banks included a milestone in relation to establish and publish the specific objectives of the sector, based on scenarios for the portfolios' alignment with the objectives of the Paris Agreement within a maximum period of three years;
- The **Principles for Responsible Banking** by UNEP FI: The Principles for Responsible Banking (PRB), initiated by UNEP FI, are a framework for a sustainable banking system and ensure that the strategy and action of a signatory bank is aligned with the Paris Agreement and the UN SDGs. By signing the PRB, the bank commits to set targets, report its impact and provide information on the implementation of the PRB in the annual report or other public reporting.[xxviii]

Beyond signing up to a climate commitment, banks should communicate their climate actions, ambitions, targets and needs in a variety of settings. This will allow customers and clients, regulators, policy makers and the market to move together more efficiently. It is important to identify the different information needs of targeted stakeholders, including corporate clients, supervisory authorities and central banks, politics (governments) and public institutions and civil society, academia and NGOs. The identification will allow banks to engage in consultation processes, collaborate with stakeholders and publish joint ambition statements. This approach may lead to innovative Paris-aligned products, regulation that can be easily operationalised or the development of joint disclosure approaches within the banking sector.

The way forward

The momentum for climate action at European commercial banks is prevalent. Commitments from sectors at the country-level and single organisations are increasingly observable while regulators are increasingly active as well. In a next step, commitments and regulatory requirements need to become operationalised. In order to ensure efficiency in the operationalisation, the banking sector should:

- **Utilise existing knowledge**: methodological approaches and first mover action exists already for many of the challenges that banks face today. Commercial banks should build upon this knowledge when operationalising commitments and regulatory requirements.
- **Close methodological gaps**: in the technical translation, methodological gaps such as effective climate risk reporting by SMEs or joint measurement of progress towards targets of commitments are still existing. Banks should cooperate on closing these gaps in order to utilise resources more efficiently and start building harmonised industry views.
- **Engage in peer learning**: first results of the interviews for the 3fP-Banks handbook show that different banks have built leading knowledge on different challenges. Banks should engage in pre-competitive peer learning to ensure knowledge is applied effectively and that further industry harmonisation is reached.

With the publication of the final 3fP-Banks handbook by the end of fall 2020, we hope to contribute to moving the banking sector forward in aligning with the Paris Agreement and to enable knowledge sharing, methodological progress and peer learning. We would like to acknowledge the great contributions that European banks have already provided in the development of the 3fP-Banks handbook.

This discussion paper is meant to provide a first glimpse at the upcoming 3fP-Banks handbook as an input for discussions during the European Sustainable Finance Summit 2020. We look forward to discussing this paper with you.

Annex

Methodology of the technical handbook

The aim of the 3fP-Banks handbook is to provide a technical input into the ongoing operationalisation of Paris-aligning banks and to increase transparency with respect to the status quo of the operationalisation at European banks. From this analysis, persisting methodological and policy gaps are derived. This framing is particularly geared at translating the banking commitments into measurable actions and at encouraging further commitments by showing that technical solutions exist already.

The 3fP-Banks handbook focuses on banking activities with a high proximity to the real economy. This implies a strong bias towards lending activities to corporate clients. This focus was chosen to maximise the impact on the transformation of the real economy. While other banking activities will most certainly have an impact on the real economy as well, lending activities seem to have largest coverage as it includes the SME sector most strongly. Please, see the envisaged mechanism for impact depicted in Figure 7.

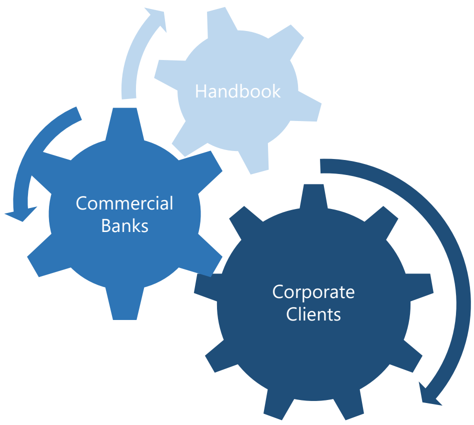

Figure 7 - Approach of the 3fP Bank handbook

The methodology to develop the 3fP-Banks handbooks follows a three-phase approach (see Figure 8).

1. **Desk-based research:** at the beginning, all relevant existing literature and publicly available information is collected. From this research, the ten 3fP-Banks areas for action are derived and a preliminary assessment of the status quo of Paris-aligning commercial banks in Europe is conducted.

2. **In-depth dialogue:** an in-depth dialogue with European commercial banks is conducted to confirm the preliminary assessment, close knowledge gaps and ensure needs by banks are adequately reflected in the handbook. For those conversations, a questionnaire containing 100 questions along the ten 3fP-Banks areas for action is used.

3. **Identification of good practices**: through the research on European banks, good practice case studies are identified. Those will be presented in the final 3fP-Banks handbook to show practical steps towards operationalising Paris-alignment at banks. Good practice case studies are jointly developed with respective banks.

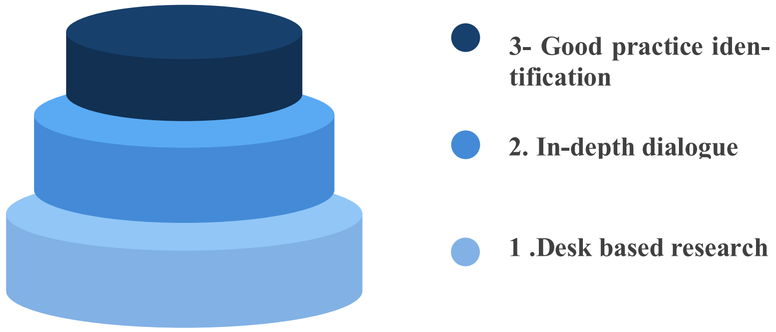

Figure 8 – Three-phase approach of the 3fP-Bank handbook's development

Literature

In the development of the technical 3fP-Banks handbook prior work in the field is largely included.

- Cambridge Institute for Sustainable Leadership, "Bank 2030: Accelerating the transition to a low carbon economy", 2020
- ShareAction, "Banking on a low carbon future", 2020
- UNEP FI, "Guide to Banking and Sustainability", 2016
- UNEP FI, "Changing Course: a comprehensive investor guide to scenario-based methods for climate risk assessment, in response to the TCFD", 2019
- WWF, "Bankenrating", 2020

End notes

---

[i] ECB (2018).Speech: Financing the economy - SMEs, banks and capital markets https://www.bankingsupervision.europa.eu/press/speeches/date/2018/html/ssm.sp180706.en.html

[ii] UNEP FI (2019). Principles for Responsible Banking. https://www.unepfi.org/banking/bankingprinciples/

[iii] ECB (2020).Public Consultation on the draft ECB Guide on climate-related and environmental risks https://www.bankingsupervision.europa.eu/legalframework/publiccons/html/climate-related_risks.en.html

[iv] EBA (2019). EBA Sustainable Finance Action Plan. https://eba.europa.eu/sites/default/documents/files/document_library//EBA%20Action%20plan%20on%20sustainable%20finance.pdf

[v] Climate Central (2020). Data on hottest years on record. https://www.climatecentral.org/gallery/graphics/10-warmest-years-globally

[vi] WEF (2020) Global risks report, http://reports.weforum.org/global-risks-report-2020/shareable-infographics/

[vii] ECB (2020). SSM Risk Map https://www.bankingsupervision.europa.eu/banking/priorities/risk_assessment/html/index.en.html

[viii] UNFCCC (2015). Paris Agreement.

[ix] Bloomberg (2019). Banker bonuses https://www.bloomberg.com/quicktake/banker-bonuses

[x] ECB (May 2020), Guide on climate-related and environmental risks, supervisory expectations relating to risk management and disclosure https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/climate-related_risks/ssm.202005_draft_guide_on_climate-related_and_environmental_risks.en.pdf

[xi] UNEP FI (2015). Integrated Governance. https://www.unepfi.org/fileadmin/documents/UNEPFI_IntegratedGovernance.pdf

[xii] UNEP FI (2015). Integrated Governance. https://www.unepfi.org/fileadmin/documents/UNEPFI_IntegratedGovernance.pdf

[xiii] WRI. Exploring metrics to measure the climate progress of banks, available at https://files.wri.org/s3fs-public/exploring-metrics-to-measure-the-climate-progress-of-banks.pdf

[xiv] IEA (2019). World Energy Outlook/The Sustainable Development Scenario, see https://www.iea.org/reports/world-energy-model/sustainable-development-scenario

[xv] PACTA (2020). PACTA for Banks, available at: https://www.transitionmonitor.com/pacta-for-banks-2020/

[xvi]UNEP FI (2020). The Portfolio Impact Analysis Tool for Banks, available at: https://www.unepfi.org/publications/positive-impact-publications/portfolio-impact-tool-for-banks/

xvii PCAF (2020). Public Consultation on the draft Global Carbon Accounting Standard for the financial industry, available at: https://carbonaccountingfinancials.com/consultation-signup

[xviii] McKinsey & Company (2020). Banking imperatives for managing climate risks, available at

[xix] Oliver Wyman (2019). Climate Change – Managing a new financial risk

[xx] ShareAction (2020). Banking on a low-carbon future II. Available at: https://shareaction.org/research-resources/banking-on-a-low-carbon-future-ii/

[xxi] TCFD (2017). Final report, available at https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-2017-TCFD-Report-11052018.pdf

xxiiUNEP FI (2019). CHANGING COURSE: A COMPREHENSIVE INVESTOR GUIDE TO SCENARIO-BASED METHODS FOR CLIMATE RISK ASSESSMENT, IN RESPONSE TO THE TCFD, available at https://www.unepfi.org/publications/investment-publications/changing-course-a-comprehensive-investor-guide-to-scenario-based-methods-for-climate-risk-assessment-in-response-to-the-tcfd/

[xxiii] Compare McKinsey & Company (2020). Banking imperatives for managing climate risks, available at https://www.mckinsey.com/business-functions/risk/our-insights/banking-imperatives-for-managing-climate-risk

[xxiv] European Commission (2020). Non-financial reporting https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en

[xxv] UNEP FI (2016). Guide to Banking & Sustainability

[xxvi] Katowice Commitment, published by BNP Paribas

[xxvii] Klima-Selbstverpflichtung des Finanzsektors (2020). https://www.klima-selbstverpflichtung-finanzsektor.de/

[xxviii] UNEP FI. Principles for Responsible Reporting

For further information, please contact:

Sebastian Rink

Green and Sustainable Finance Expert

Frankfurt School - UNEP Collaborating Centre for Climate & Sustainable Energy Finance

E-Mail: s.rink@fs.de

Henriette Jahns

Senior Project Manager

Frankfurt School - UNEP Collaborating Centre for Climate & Sustainable Energy Finance

E-Mail: h.jahns@fs.de

Frankfurt School - UNEP Collaborating Centre for Climate & Sustainable Energy Finance

Adickesallee 32-34
60322 Frankfurt am Main

https://www.fs-unep-centre.org

Frankfurt School