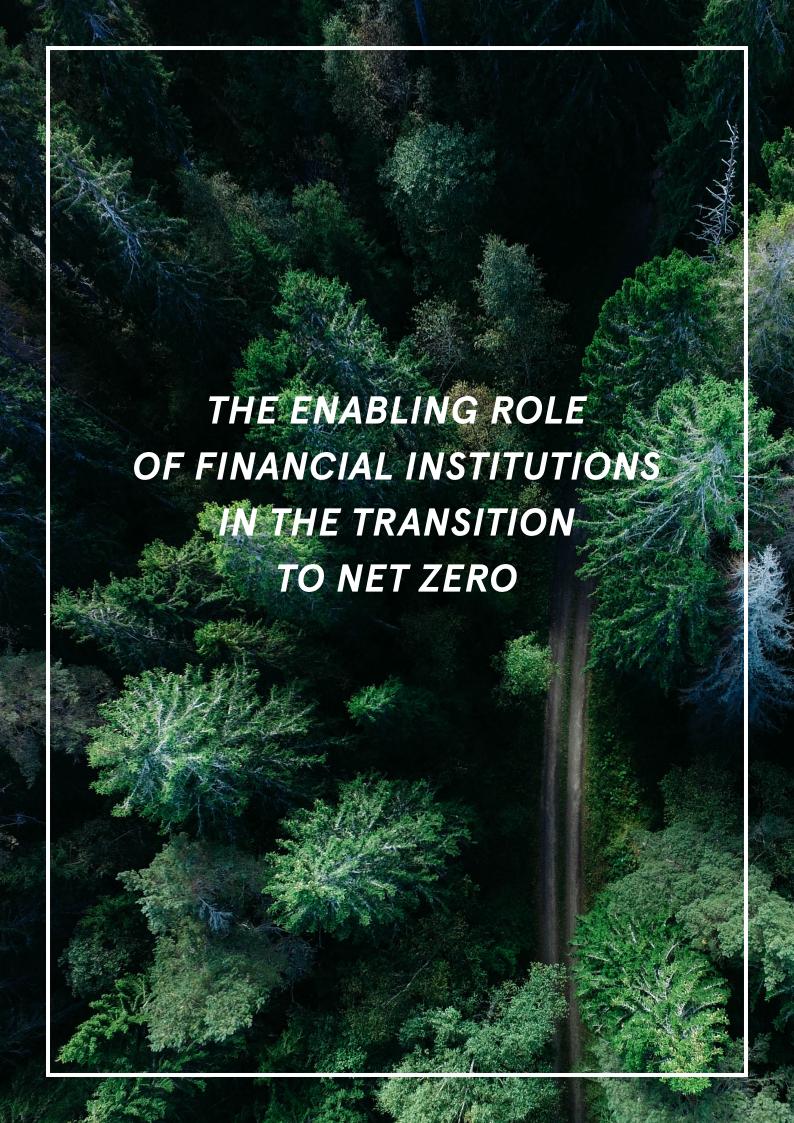
CARBON IMPACT QUARTERLY





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KEY TAKEAWAYS

- For financial institutions today, a central factor in managing climate impact is managing financed emissions arising from lending and investment activity.
- Danks and asset managers must ensure that their portfolios shift in line with established climate scenarios over time.
- New regulation is seeking to define environmental sustainability, by classifying activities based on impact. All preliminary estimates suggest that exposure to both the greenest and the worst emitting assets represents only a small proportion of current financing.
- The zero-carbon transition affects the whole economy. Financial institutions should consider the climate-related risks and opportunities for any given business or sector they finance.
- We present three examples of innovative strategies from European banks to illustrate what a bottom-up approach to financing the transition looks like in practice.
- Central banks are starting to put in place top-down measures to mitigate systemic risk and ensure financial stability in the presence of climate risk.



INTRODUCTION

In April, CDP (formerly, the Carbon Disclosure Project) published a report summarising the findings from the first round of responses to its questionnaire tailored specifically to the financial services sector. The headline figure was that portfolio emissions of global financial institutions are on average over 700x larger than reported operational emissions, and only 25% of disclosing institutions calculate and report these financed emissions.¹

Although this is the first time that this difference has been quantified so starkly, these figures did not come as a surprise. It is through the people, businesses and activities that they choose to support commercially, that financial institutions have the biggest impact and are most exposed to climate-related risks and opportunities.

The difficulty of measuring and managing these financed emissions and the corresponding risks and opportunities lies at the heart of our Carbon Impact approach to financial institutions, which we have developed with many of the topics raised in the CDP report in mind.

As such, the key takeaway which we would like to underline is not those figures themselves – however striking they may be – but rather the message that "on top of providing green finance, the finance sector must become green". As the authors of the report highlight, "While most financial institutions are focused on providing sustainable finance, they are less focused on ensuring that the entirety of their business is aligned with net zero"².

Indeed, this rings true. If 2020 was the year of the net-zero commitment, 2021 is so far proving to be the year of the trillion-dollar pledge, with some of the world's largest banks fighting for the spotlight to showcase their green ambitions. US banks Citi, JP Morgan and Bank of America have all thrown their hat in the ring in recent months, announcing new 10-year sustainable financing targets, matching and indeed surpassing those made by their European counterparts over the last few years.

Yet, at the same time, highlighting so starkly this disconnect to which CDP was referring, the league table of fossil fuel financing compiled each year by the Rainforest Action Network confirmed in March that global banks provided \$750 billion in financing to coal, oil and gas industries in 2020. This brings the total support to \$3.8 trillion in the five years since the Paris Agreement.³ Despite the impact of the pandemic, which reduced global demand and resulted in a roughly 9% reduction in fossil fuel financing across the board, the world's 60 largest banks still increased their financing to the 100 companies most responsible for fossil fuel expansion by over 10%⁴. This stands in glaring contrast to the total overhaul laid out by the International Energy Agency (IEA) in its "Roadmap for the Global Energy Sector" published in May, which calls for all new oil and gas exploration projects to stop as of this year, if we are going to meet the net-zero goal of the Paris Agreement.⁵

Similarly, an analysis by Reclaim Finance and Urgewald of financial flows to all 934 companies on the Global Coal Exit List showed that institutional investors held investments totalling more than \$1 trillion in companies operating along the thermal coal value chain. The report showed that at the start of this year, the world's two largest institutional investors alone had a combined exposure of \$170 billion to the coal industry – accounting for 17% of institutional investments in global coal⁶.

⁽¹⁾ CDP, "The Time to Green Finance"; April 2021

⁽²⁾ CDP; 2021

⁽³⁾ Rainforest Action Network, "Banking of Climate Chaos 2021"; March 2021

⁽⁴⁾ Rainforest Action Network; March 2021

⁽⁵⁾ International Energy Agency, "Net Zero by 2050: A Roadmap for the Global Energy Sector"; May 2021

Ultimately, any carbon impact assessment of a bank or asset manager boils down to the simple question of how it is cleaning up or 'greening' its portfolio, and as these figures so clearly show, it needs to be as much a question of increasing exposure to green activity, as it is about reducing its exposure to 'brown' activity. In our opinion, it is most importantly about actively shifting the scales between the two, by supporting clients in their transition efforts through any levers at their disposal: active engagement, advisory services, green finance, sustainability-linked products, to name but a few. In the following pages we will explore in detail what this looks like in practice.

The figures on either extreme will always be the ones to make headlines, but financial institutions and their investors alike would be wise to take a broader perspective than just those prescribed by prevailing definitions and frameworks and support all efforts to shift the scales and facilitate a reduction in real world emissions.

As positive as a tighter coal policy or a new green financing pledge may be, an isolated commitment on either end – however sizeable – does not guarantee the desired real-world impact on its own. The financial institutions that we rate most highly are not necessarily those with the lowest fossil fuel exposure today, or the largest green financing target, but rather those which demonstrate a fully integrated strategy across all operations and activities, not just detached efforts in particular hotspots of its business.

For the purposes of this publication, we will focus on lending and investment portfolios – excluding underwriting activities. Although insurance companies, both as asset owners and underwriters, undoubtedly have an important role to play in the transition – as all financial firms do – for the sake of simplicity, we apply narrow boundaries for this assessment of financial institutions, and consider only banks and asset managers, and their respective activities which pertain to capital allocation.

1 - THE CHALLENGE FOR FINANCIAL INSTITUTIONS

Since the publication of the European Commission's pivotal Action Plan in 2018, sustainable finance has been creeping ever higher up the European legislative agenda, with a host of new regulation attempting to define what is – and what is not – sustainable. At the heart of the reforms lies the Taxonomy Regulation. Finally signed into law in June last year, the Taxonomy aims to establish a consistent definition of what qualifies as green and is therefore an essential first step towards achieving any underlying goal of reorienting capital flows towards so-called green activities.

To qualify as green under this framework, an activity must meet defined thresholds to show a substantive contribution to one of six environmental objectives, and not compromise or harm the other five.

In the coming years, asset managers and banks, together with non-financial firms, will all be required in different capacities to calculate and report the proportion of their business which is aligned to the criteria set out in the Taxonomy, to give stakeholders an idea of their exposure to these 'greenest' assets, activities and companies.

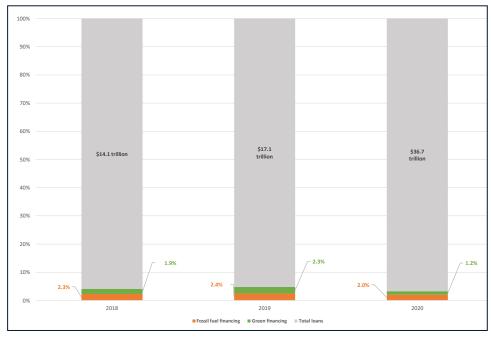
The technical screening criteria are still under review, and reporting requirements are not yet in force, meaning we do not yet have a full set of disclosures from any of these groups. However, one observation remains constant across all early estimates we have seen: only a very small portion of the economy is currently aligned. It seems indisputable that this must grow over time if we are to build a more sustainable economy, but the question of just how high remains open for debate.

Banks and the Green Asset Ratio

For banks, and other credit institutions, the Taxonomy disclosure is expected to take the form of the Green Asset Ratio (GAR). First proposed by the European Banking Authority (EBA) in March 2021, this would require banks to report the share of Taxonomy-aligned loans, advances and debt securities, as a percentage of total balance sheet exposure. Banks will also have to report against similar indicators relating to the share of off-balance sheet exposures, trading operations and fees and commissions from advisory work derived from green activity.

This would bring much needed consistency to a metric which we have been calculating manually in recent years as part of our coverage of the banking sector. We have built a scorecard to track the green and brown financing as a proportion of net loans over time, with a view to understanding the significance of these activities to each bank, in the context of its overall lending activity.

FIGURE 1: Average 'green' and 'brown' financing as a proportion of total annual lending by global banks



Source: La Française Sustainable Investment Research, using data from Factset, Rainforest Action Network (RAN) and company reports. The sample of banks is defined as those covered by the RAN dataset for which we could also source or estimate an annual green financing figure.

The number of banks inscope grew from 14 in 2018, to 19 in 2019 and 39 in 2020.

Note: the figures for 'brown' financing shown on the chart differ from those quoted in the text below. In the chart, banks for which a green financing figure is not available have been excluded.

As a proxy for 'brown' lending, we use the annual dataset compiled by the RAN of bank financing for 2,300 companies active across the fossil fuel life cycle, based on data from Bloomberg and Urgewald.⁷

For 'green' lending, in the absence of a uniform GAR metric, or Taxonomy-alignment figure, we rely on self-reported data. The limitations of this approach are clear: non-uniform and often non-transparent definitions of what constitutes green lending make it prone to inconsistency, as does the lack of granularity in terms of which areas of the business are included – hence our support for improved disclosure requirements such as the GAR. It nonetheless remains useful for illustrative purposes.

Our most recent iteration of the scorecard included over 50 of the biggest global banks, with a collective market cap of over \$4.5 trillion and total assets of over \$78 trillion – representing over 50% of global bank assets.8 Indeed, the numbers are very telling.

No bank reported green financing in 2020 reaching double figures as a percentage of net loans. The average across those banks which reported a figure was only 1.2%. Standard Chartered recorded the highest share, at 7.8%. In absolute terms, Industrial and Commercial Bank of China topped the list (unsurprisingly, given it is also the world's largest bank by assets), adding \$75.8 billion in green credit to its balance sheet last year – 2.7% of net loans. When we consider the likelihood that these self-reported figures adopt a looser interpretation of green than the strict criteria ascribed by the Taxonomy, these low levels feel even starker.

At the opposite end of the spectrum, the story is much the same. Based on the RAN dataset, the average fossil fuel financing of these 50+ banks represented only 2.3% of net loans in 2020. Goldman Sachs and Morgan Stanley stand out as outliers with fossil fuel financing accounting for 16% and 15% of loans respectively, but in both cases, loans account for only 10-15% of total assets – which can then explain the big jump between these two, and the next highest of 7%.

These preliminary figures point to the fact that by far the largest share of activity remains uncategorised. But crucially, 'neutral' does not mean 'carbon neutral'. On the one hand, a diversified global loan book should naturally get greener over time as companies set and deliver against emissions reduction targets. On the other, climate risk will evolve over time, and may well begin to affect industries and activities we currently consider to be neither 'green' nor 'brown'.

Which is to say that, alongside efforts to reduce fossil fuel financing and increase support for green activity, banks should not ignore what lies in between these two extremes. We would encourage banks to take a holistic view of climate-related risks and opportunities and consider the impact of their support for all parts of the economy, not just select sectors and industries.

As a leading example, we may consider the Partnership for Carbon Accounting Financials (PCAF). PCAF is a cross-industry partnership which has developed a methodology to enable financial institutions to start measuring and reporting their scope 3 financed emissions, an exercise which should paint a fuller picture of the true climate impact of their portfolios. This can help banks to contextualise and quantify what the challenge of net-zero actually entails and in turn, will hopefully lead to meaningful and comprehensive emissions reductions targets.

Asset Management and Taxonomy Alignment

The figures for the asset management industry reveal a similar pattern.

Before looking at EU Taxonomy alignment, we might first consider another recent piece of related regulation, the Sustainable Finance Disclosure Regulation (SFDR). The first phase of the SFDR, which came into effect in March, imposed new requirements on asset managers to provide entity-level information on the management of sustainability-related risks – so-called Principal Adverse Impact (PAI) statements – and product-level classifications of funds as either ESG or non-ESG.

The second phase, to be introduced in early 2022, will require mandatory reporting against specific PAI indicators. In many ways, this can be considered as a counterpart to the

Taxonomy. Where the Taxonomy aims to define what is green and measure alignment, the PAI requirements under the SFDR focus on the opposite end of the spectrum, defining and increasing transparency around adverse social and environmental impacts.

In this first stage, funds labelled as ESG must be further categorised into two product types:

- Article 8 (ESG integrated): funds which consider, promote or integrate environmental or social characteristics within the investment process
- Article 9 (positive impact): funds which have an explicit environmental or social objective as part of the core strategy

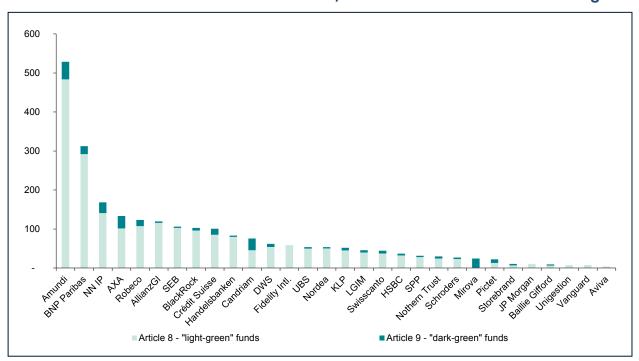
Morningstar carried out a review of initial SFDR disclosures of Luxembourg-domiciled open-ended funds and ETFs representing

roughly 50% of the universe. Their preliminary estimates suggest that 21.6% of reviewed funds, accounting for 25% of AUM, have been classified by the managers as either Article 8 or 9. When extrapolated to the overall European fund market, this indicates a sustainable funds market of up to €2.5 trillion.9

Within that 25% though, only around 10% were given the impact label – in other words, just over 2% of the universe¹⁰. From that angle, it would seem once again that the 'greenest' or most sustainable parts of the economy, remain marginal.

Figure 2 shows these findings at the level of individual asset managers, and we see the same pattern. These impact-related Article 9 funds make up only a very slim fraction of the sustainable investment market.

FIGURE 2: Number of Article 8 and 9 funds, for a selection of 30 asset managers



Source: Exane; April 2021

To return to the EU Taxonomy it will be these funds – both Article 8 and 9 – for which asset managers will have to comply and report alignment.

With that in mind, last year, we took part in a practitioners group coordinated by the

PRI¹¹ alongside 40 other asset managers and owners. The objective was to share feedback on the methods, challenges and solutions we devised and encountered in implementing the Taxonomy in our investment process. As part of this, we provided a case study assessing

⁽⁹⁾ Exane, "ESG: SFDR - The 14 metrics you should know about"; April 2021

⁽¹⁰⁾ Goldman Sachs' Initial observations of ESG fund classifications under SFDR; May 2021

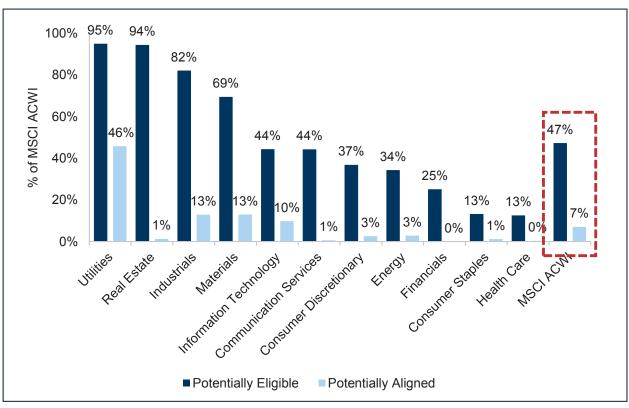
⁽¹¹⁾ UN PRI, "Testing the taxonomy: insights from the PRI Taxonomy Practitioners Group"; September 2020

the initial alignment of one of our own Carbon Impact funds, subsequently classified as Article 9.12 We concluded at the time that 16% of assets in the portfolio were eligible – meaning from companies involved in activities which could contribute to either of the two objectives currently in-scope – and less than 6% were aligned, based on an assessment of the share of revenues of those companies against the criteria defined by the Taxonomy. Most other

participants reported similar findings: single digit alignment figures, even in designated 'green' or 'sustainable' funds.

These results were also consistent with Goldman Sachs' findings in relation to MSCI ACWI companies as shown in Figure 3. Using a proprietary tool, it assessed 47% of companies in the MSCI ACWI to be potentially eligible, and 7% to be potentially aligned.¹³

FIGURE 3: Breakdown by sector of the percentage of MSCI ACWI companies with over 5% revenue potentially eligible and potentially aligned with the EU Taxonomy



Source: Goldman Sachs; April 2021

Financing the transition is a bottom-up activity

Far from being disheartened by the above findings, as we see it, Figure 3 presents two very clear opportunities – or perhaps responsibilities – for financial institutions.

First and foremost, it stands to reason that the gap between eligible assets and aligned assets needs to narrow, which translates into greening the activities that are most highly emitting and scaling up those which enable the transition. It is certainly reassuring to see that the gap between eligibility and alignment was narrower for our dedicated Carbon Impact strategy than for a broader market index, but even so, there is some way to go. Indeed, Goldman Sachs research found that many of the most underweight industries in ESG funds were Taxonomy-eligible, implying an upward opportunity at a fund level to increase alignment from the outset. This includes both high-emitting sectors such as

 $^{(12) \} See \ https://www.unpri.org/eu-taxonomy-alignment-case-studies/eu-taxonomy-alignment-case-study-la-francaise/6256.article$

⁽¹³⁾ Goldman Sachs, The EU Green Taxonomy: Navigating the Journey to Alignment; April 2021

⁽¹⁴⁾ Goldman Sachs; April 2021

automobiles and mining, as well as so-called enabling activities within telecommunication services and industrials.

In many ways, though, low alignment is inevitable. A diversified portfolio, by definition, will only have limited exposure to the sub-industries of the economy currently covered by the Taxonomy - particularly one with a green objective especially, when we consider that criteria have only been developed - if not finalised - for only two of the six environmental objectives. It would follow then that as additional objectives are covered, more economic activities will enter into scope and so too, alignment should naturally increase.

Indeed, one of the recommendations which came out of our exercise with the PRI practitioners' group was to "clarify the role of 'neutral' activities that neither substantially harm nor significantly contribute to environmental objectives", as a way of contextualising the relatively low proportion of alignment".15

But that, in our opinion, misses the point of the second lesson to be drawn from all of this.

The net zero transition is not just relevant to the worst emitters and greenest companies - every sector and every geography is going to be affected. In its pilot EU-wide climate risk exposure exercise, the EBA estimated

that up to threefifths of EU bank financing exposure is in transition risk sectors, whilst no more than 8% could currently be considered 'green'. **Financial institutions** are inescapably and uniquely positioned as a lever to direct

their business model."16 Mark Carney, UN special envoy on climate

action and Finance Advisor to the UK Prime Minister for COP26

"Achieving net zero emissions will require a whole economy transition every company, every bank, every insurer and investor will have to adjust

capital flows as the world strives to lower emissions and achieve its carbon reduction targets.

It is therefore imperative that neither these financial institutions - nor their investors - get hung up on the individual metrics explored above. To do so would be short-sighted and put them at risk of losing their social licence to operate.

As pressure mounts from governments, regulators and investors, the conversation is moving away from the risk to individual financial institutions - though this is material, and seemingly grossly underestimated¹⁷ – towards questions of their real-world impact. Crucially, action in one area cannot compensate for inaction in the other: as ING articulated in their most recent climate report: "risk mitigation doesn't ensure portfolio alignment, and an aligned portfolio is not inherently climate riskfree."18

Though disregarding the worst polluting actors in favour of those which are already green will improve the emissions profile of a portfolio as it stands today, it will do little to reduce realworld emissions tomorrow. Banks and asset managers have a responsibility to ensure the effective allocation of capital to support real economy emissions reductions and adaptation which requires more than just targeted support for green activities. A clear strategy of how to finance the transition is no longer a nice-to -have - it is a commercial imperative, as well as a social obligation.

> Financial institutions must be active change agents and think not about 'green' in isolation, but 'green', 'brown', and everything in between, using the tools at their disposal to tilt the scales. They cannot hide behind

an excuse of only being as Paris-aligned as the economies in which they operate. They must take a leading role in the transition.

⁽¹⁵⁾ UN PRI; September 2020

⁽¹⁶⁾ From speech given by Mark Carney at the Guildhall, London, "The Road to Glasgow" as part of the launch of the COP26 Private Finance Agenda; 27 February 2020

⁽¹⁷⁾ See CDP; April 2021

⁽¹⁸⁾ ING, "Terra progress report 2020", October 2020

2 - WHAT DOES TRANSITION FINANCE LOOK LIKE IN PRACTICE?

All of this means to say that the focus must be on transition finance. For banks and asset managers to deliver on their commitments and targets to align their portfolios with global climate goals, they must work closely with their clients and engage with investee companies, respectively, to support their transition, and the transition of the real economy, not just focus on those which are already low carbon. The critical point to highlight is that the goal must be real-world emissions reduction, not just a decrease in financed portfolio emissions which can be easily achieved through portfolio management and divestment.

For banks, this means tailored green financial products and services to support clients' transition to new technologies, business models and lifestyles. This will mean different things for different banks, depending on the make-up of their client base. To give a few examples:

Corporate lending – both activity-based financing for specific projects geared towards environmental sustainability and behaviour-based KPI-linked loans which tie the rate of interest to specific environmental targets to motivate progress over a given period of time.

- Retail banking e.g., green mortgages offering preferential rates for homes meeting minimum energy efficiency requirements, or credit lines for SMEs to upgrade vehicle fleets with electric models.
- ◆ ESG-advisory services: working with corporate clients to develop a transition roadmap with clear, measurable targets and timelines, and helping them access and/ or raise the capital to meet them through e.g., debt and equity structuring, most obviously green or sustainability-linked bond issuance.

These products and services, and resulting assets and revenues, may not fit nicely into the rigid framework of the Taxonomy as its stands, or be adequately reflected in a Green Asset Ratio – but that does not make them any less important.

Ultimately, beyond any specific client proposition, when assessing the transition efforts of a bank, what we are looking for is evidence that these considerations are spurring innovation and translating into a new way of doing business. As one head of ESG we spoke to declared: "Sustainable banking will become business as usual".

INTEGRATING CLIMATE INTO CREDIT DECISIONS: NATIXIS' GREEN WEIGHTING FACTOR

The Green Weighting Factor is a capital allocation mechanism which aims to direct flows towards transactions with the most positive environmental and climate impact. All financing granted by Natixis' Corporate & Investment Banking is systematically assessed for its environmental and climate impact – both positive and negative – using a sector–specific rating methodology that classifies the deal in question on a scale from brown to green. This then translates into an RWA adjustment which affects the profitability of the financing transaction for the bank – a positive adjustment for green transactions and negative for brown – and directly links the level of internal capital allocation of a given transaction to its climate impact.

OUR VIEW: We see this as a best-in-class example of active balance sheet management to promote the transition to a low-carbon economy, particularly noteworthy in the case of Natixis, given the high concentration of its corporate lending in high-emitting sectors.

SECTOR-SPECIFIC FOCUS: ING'S TERRA APPROACH

The Terra Approach is the strategy launched by the Dutch bank in 2018 to steer its lending towards alignment with the below-2°C goal of the Paris Agreement. It has used science-based scenarios to establish what shifts are required across nine high-emitting sectors to achieve this target and to define sector-level convergence pathways. It can then measure and track progress over time of each of its sector portfolios against these pathways. This approach brings together several industry standards and methodologies, making use of the existing work of initiatives such as PACTA and the Poseidon Principles.

OUR VIEW: We applaud such a granular sector-level approach for its implied emphasis on real-world outcomes. Although the aim is overall portfolio alignment, a single measure of alignment at a collective balance sheet level would not carry the same weight – firstly because the make-up of any given bank's loan book is not necessarily reflective of the wider economy, and secondly, because a single indicator would infer that one sector's transition makes up for another sector's lack, which it does not. All sectors need to transition – as demonstrated by ING's approach.

CORPORATE CULTURE: BBVA'S RESKILLING PROGRAMME

BBVA introduced mandatory sustainability training in 2020 for all employees. This followed the establishment of a Global Sustainability Office, which operates as a 150-person-strong centre of excellence. In recognition that expertise needed to be cultivated across the group – not just in specific designated teams – it rolled out 'practical' training as part of a broader reskilling programme, in an effort to equip all teams to understand and respond to clients' sustainability needs. The group acknowledges that reception and success has been and will be mixed – especially in areas where the business case is less immediately clear – but maintain that it is a necessary investment over the long term.

OUR VIEW: This demonstration of ESG and sustainability as critical to the future of the group as a whole reinforces our view that sustainable – and in particular, transition – financing is not a fringe activity, but central to all business areas and teams.

Clearly, asset managers and owners investing in public market instruments do not have the same capacity as banks to stipulate conditions for how capital is used and raised, meaning at an individual company level, the focus must be on capital allocation and engagement with investee companies.

Asset managers and owners play a vital role in the allocation of capital across the economy, and therefore have an opportunity from the outset, regardless of size, to consider transition financing in product development.

In practice, this implies a necessarily forward-looking investment approach. Strategies geared towards the transition should consider the future trajectory of a given company or holding – its potential for 'greening' itself and lowering its own carbon footprint, or for providing the means to others to do so. Crucially, they must

prioritise this progression over a point-in-time ESG score or rating.

Such strategies will likely only have a slim part of the portfolio eligible under or aligned to the Taxonomy, especially when compared to those strategies which exclude certain sectors, or limit investment to already-green activities but as before, far from being a shortcoming, this highlights the scale of the opportunity for change.

Beyond capital allocation, asset managers and owners should conduct engagements with investee companies, both collectively and individually, and exercise voting rights on climate-related issues. Though the methods are different, the underlying goal is the same: to support and encourage climate change adaptation and climate change mitigation efforts across all sectors and geographies.



3 - THE EVOLVING ROLE OF CENTRAL BANKS

Central banks and supervisors can reinforce transition finance by endorsing climate-related reporting and accounting standards while continuing to promote tools and methodologies for risk assessment. We already observe how supervisory bodies are embracing this link between transition finance and the assessment of climate change as a systemic risk and a factor that could well influence price stability.

In France, for example, the government has just published a revised climate law that includes – among others – a new requirement for financial firms to conduct a climate stress test covering physical and transition risks.¹⁹

In the banking sector, the Bank of England is running the first-of-its-kind climate stress test at an individual bank level. The European Central Bank (ECB) concluded an economy-wide stress test exercise earlier this year. 20 Eurozone banks are already under the spotlight after the central bank published a guide on how it expects them to address climate risks and asked them to submit action plans to achieve it. In the US, the Federal Reserve earlier this year created a new Supervision Climate Committee to strengthen its capacity to identify and assess financial risks from climate change and to develop an appropriate programme to ensure the resilience of the supervised firms to those risks. Even the People's Bank of China has said it will consider including climate risks into its annual stress test of the country's banks.²¹

The Network for Greening the Financial System (NGFS) is "a group of Central Banks and Supervisors willing, on a voluntary basis, to share best practices and contribute to the development of environmental and climate risk management in the financial sector and to mobilize mainstream finance to support the transition towards a sustainable economy".²² Since its creation in 2017, the NGFS has grown its membership from eight to 89 members, and includes the IMF and the Bank for International Settlements as observers, and the US Federal Reserve.

Franck Elderson, Executive Board member of the ECB, was re-appointed chair of the NGFS in September 2020. He explained the overarching supervisory objective in a recent speech: that by compelling banks to adequately assess and manage climate-related risks, the ECB is, in effect, safeguarding the financing of the transition to a low-carbon economy as well. If banks proactively manage climate-related risks, they will not be blindsided by stranded assets, meaning that capital will be preserved and can be used to finance investments in the low-carbon transformation. Climate-related risks being adequately represented on banks' balance sheets will contribute to these risks being appropriately priced.²³

⁽¹⁹⁾ Légifrance, Décret n° 2021-663 du 27 mai 2021 pris en application de l'article L. 533-22-1 du code monétaire et financier. https://www.legifrance.gouv.fr/jorf/id/JORFTEXT000043541738

⁽²⁰⁾ Blog post by Luis de Guindos, Vice-President of the ECB: "Shining a light on climate risks: the ECB's economy-wide climate stress test", Frankfurt am Main, 18 March 2021

⁽²¹⁾ BIS Central Bankers' Speeches: Opening remarks by Mr Yi Gang, Governor of the People's Bank of China, at a High-Level Seminar on "Green Finance and Climate Policy", co-hosted by the People's Bank of China and the International Monetary Fund, 15 April 2021

⁽²²⁾ See www.ngfs.net

⁽²³⁾ Keynote speech by Frank Elderson, at the conference on "The Role of Banks in Greening Our Economies" organised by the EBRD and HNB, Frankfurt, 29 April 2021

CONCLUSION

The ever-increasing roster of regulatory reporting and classification frameworks that are being introduced or considered in the EU – the Taxonomy, SFDR, Green Asset Ratio, Climate Benchmarks – are important and serve a very clear purpose: to put an end to greenwashing and establish a uniform understanding of what is – and what is not – sustainable. They are working to define the two extremes, and to increase transparency around exposure to the greenest assets on one hand and the most harmful assets, activities and companies on the other.

But for financial institutions and their investors, these indicators must be seen as merely a starting point, not an end to be considered in isolation. To do so would be to misrepresent both the full picture of existing transitional efforts and the scale of the opportunity which exists.

Rather than bemoaning or celebrating the relatively small portions of portfolios which meet the criteria set out by regulators, banks and asset managers should focus on how much is left unclassified and see the enormous opportunity – be that commercial or societal – which that poses.

As we see it, the essential role of financial institutions in the collective effort to limit global warming lies not in one extreme or the other, but rather in the shift from one to the other, as well as the dynamic in the middle ground. Through a bottom-up approach, supporting individual clients in pursuit of their own environmental objectives, banks and assets manager can finance and secure the transition to a low carbon economy and in turn, gradually increase their own 'green' exposure and phase out the 'brown'. Moreover, as new risks emerge, and opportunities evolve, a large part of what currently lies uncategorised in the middle, will inevitably be subsumed by one end of the spectrum or the other or at least face intense scrutiny. Financial institutions are uniquely positioned to ensure the direction of travel is positive and ultimately to facilitate the low-carbon transition.

In this report we focus on climate change as its implications are becoming more tangible for financial institutions. The emergence of an accounting standard for financed emissions embedded in portfolios just marks the start for transition finance. It surprises that it took nearly two decades to reach that point since the GHG Protocol was introduced as a guidance for non-financial firms, and which has since become a widely adopted standard.

As climate change has become a priority for most stakeholders of financial institutions, now is the time to act. But the necessary action will not remain limited to climate change adaptation and mitigation. The EU Taxonomy is a transition tool that incorporates not just those two, but four other objectives as well: sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, and protection and restoration of biodiversity and ecosystems. The respective technical screening criteria are already under development.

The much-needed social elements which complement environmental objectives are also moving up the priority list. For example, the European Commission is currently seeking advice on the extension of the Taxonomy to social objectives. The implicit link with the UN's Sustainable Development Goals seems obvious.

The roadmap is clear. Transition finance is a multi-year programme on a massive scale. While today's focus is on climate change the scope is broader. A secular trend manifests itself as an opportunity for the finance sector to play a crucial role as an enabler of a more sustainable economy.

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Published by La Française AM Finance Services, head office located at 128 boulevard Raspail, 75006 Paris, France, a company regulated by the Autorité de Contrôle Prudentiel as an investment services provider, no. 18673 X, a subsidiary of La Française. La Française Asset Management was approved by the AMF under no. GP97076 on 1 July 1997.



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