

Bank Governance Leadership Network

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BGLN

VIEWPOINTS

Charting a path to net zero in banking

We now have the essential plumbing in place to move climate change from the fringes to the forefront of finance so that every financial decision takes climate change into account.

— Mark Carney, UN Special Envoy for Climate Action and Finance¹

Climate change has been described as the single greatest challenge facing humanity. Banks are being asked to play a critical role in managing what some expect will require the largest economic transition since the industrial revolution, and perhaps the biggest reallocation of capital in history. Defining their approaches to climate transition and developing strategies to transform their businesses and their balance sheets is now one of the defining challenges facing bank boards and management.

According to the *Economist*, “Politicians, consumers and companies are on a journey of discovery about climate change and the energy business. The first stage, in the early 2010s, was characterized by indifference. The second phase, in the past few years, has involved setting idealistic emissions-cutting targets far in the future that cost little today. In 2022 the third stage of the journey will get under way, amid dangerously volatile energy prices, fears of greenflation and rising geopolitical risks. It will require realism about the task ahead.”² Bank leaders are indeed realistic about the scale of the challenge ahead; having made public commitments to transition their businesses, they are now faced with defining the path to achieving them.

As of the end of the UN Climate Change Conference (COP26) in November 2021, more than 1,000 companies had set 1.5°C-aligned science-based targets,³ and, to date, 97 banks from 39 countries—representing \$66 trillion in total assets, or 43% of all banking assets globally—have joined the Net-Zero Banking Alliance.⁴ While these public commitments represent a clear signal of intent, bank leaders acknowledge that many of their institutions are a long way from outlining a concrete path to achieve net zero by 2050 or identifying intermediate targets along the way. There are many variables outside the banks’ control, and government policy must be supportive for banks’ efforts to be meaningful. Having made these commitments, however, bank leaders also recognize the need to get on with their part. Acknowledging the strategic

implications for their institutions, boards are delving into the details of their transition plans and the potential implications for customers, employees, and business models.

This *ViewPoints* synthesizes discussions with participants in the Bank Governance Leadership Network (BGLN) in the second half of 2021, including a meeting on November 18 in London, on how their institutions are approaching net-zero commitments, the implications for banks emerging from COP26, and the challenges for banks, their investors, and policymakers in advancing climate transition strategies.⁵ *For a list of discussion participants, see Appendix.*

The following themes emerged from the discussions:

- **Banks are expected to play a central role in addressing climate risk**
- **Refining transition strategies will take time**
- **Effectively engaging with clients will be essential**
- **Investors are looking for evidence that banks are acting on commitments**
- **Banks are but one part of a complex financial system**

Banks are expected to play a central role in addressing climate risk

Banks are viewed as an important transition mechanism for the broader economy. Governments, investors, and activists are putting pressure on bank leaders to define how they will transition their balance sheets from brown assets to green, to reduce funding for carbon-intensive activities and expand investment in sustainable ones. Bank leaders increasingly recognize the risks from climate change—both physical and transition risks—and acknowledge the need to adapt their businesses accordingly. A recent EY survey found that 91% of bank chief risk officers now view climate change as the top emerging risk over the next five years, and 49% now view climate change as a top risk requiring their attention in the next 12 months—up from 17% in 2019.⁶ But bank leaders also see the need for policy to lead the way, to define standards and coordinate efforts across the financial system and across sectors if the steps that banks take are to have a meaningful effect.

COP26 marked an inflection point regarding private-sector engagement in climate policy

“Governments will be increasingly looking at private finance to provide for this agenda.”

– Participant

Although the annual UN Climate Conference is largely a policy forum, COP26 included the conference’s first “finance day,” spearheaded by Mark Carney, UN special envoy on climate action and finance and former governor of the Bank of England. A BGLN participant who attended COP26 noted the expanded expectations for financial services in supporting investment in climate transition: *“Governments will be increasingly looking at private finance to provide for this agenda. I’ve been to quite a few of these, and I’ve never seen the finance sector show up in the way it did this time.”* Another participant observed, *“One of the main things emerging from COP26 was ‘climate change goes mainstream.’ The language of it, the education on it that business leaders need to have now is immense.”*

One participant suggested that the presence of finance ministers and heads of treasury, in addition to business and finance leaders, was another signal of the seriousness with which climate transition in the financial system is now being taken. US treasury secretary and former Federal Reserve Board chair Janet Yellen was quoted at COP26 saying, “The reason I am here is because climate change is not just an environmental issue. It is not just an energy issue. It is an economic, development and market-destabilizing issue, and I would not be doing my job if I did not treat it with the seriousness warranted.”⁷

During COP26, banks, insurers, and investors with a combined \$130 trillion in assets, or around 40% of the world’s capital, committed to assuming a “fair share” of the effort to wean the world off fossil fuels as part of the Glasgow Financial Alliance for Net Zero (GFANZ).⁸ Though these commitments were welcomed by climate activists, some questioned their practical implications. As one participant noted, *“Those assets do not represent a war chest, so there is much work to be done in driving investment into sustainable finance.”* Still, another participant countered cynics by saying, *“I think those criticisms are misplaced. It’s an enormous signal of appetite, enormous signal of where this sits now on the priority list of boards.”*

To ensure sustainable finance is directed properly, the UN confirmed it is going to set up a *“greenwashing watchdog.”* A member of the Global Steering Committee of the UN Environment Program Finance Initiative described the plan: *“We will convene a group of experts over the next six months to develop a framework that the entire private sector can follow.”*

Evaluating the relative success of COP26, a participant said, *“The takeaway is a sense of relief rather than celebration. Many did not think COP26 would be successful partly due to COVID and partly due to politics.”* The participant noted that the renewed sense of urgency and energy around climate action *“is happening at the same time as rising concerns about cost of living, especially with regard to things like heating and energy bills.”*

“There’s a significant role that the financial sector can play to help new clients, developing nations in this process who don’t know the language of finance.”

– Participant

Participants discussed two trends emerging from COP26 with implications for banking:

- **Facilitating finance for less-developed countries and small island nations.** Wealthy nations failed to meet their prior commitments to financing climate adaptation and transition initiatives in less-developed countries but recommitted in Glasgow. According to one BGLN participant who attended COP26, the leaders of many of those less-developed countries are asking, *“Where’s the money and how do we access it?”* This could present an opportunity for banks in facilitating that financing, much of which will be needed to adapt to the current realities of climate change facing some of these countries, particularly small island states. A director cautioned, *“All the expert opinions in the last six to 12 months suggest that even if every NGO gets all of their wishes, which will not happen, it wouldn’t influence the next 10 years. We are beyond the ability to affect the next 10 years. The impact of climate change is here.”* As a result, another participant said, *“Adaptation: there’s a significant role that the financial sector can play to help new clients, developing nations, in this process who don’t know the language of finance, to help the groups taking advantage of the trillions of dollars of capital being moved around. As the tide goes out on fossil fuels, there will be a tide coming in of a whole new group of clients who want to take advantage of this transition and put this capital to work. They might not know the language of finance, but they’ve heard this money is out there.”*
- **Shifting focus to biodiversity and natural capital.** While addressing future climate change will continue to be a priority, it will be accompanied by not only a focus on adaptation but also a shift to more discussion on natural capital and biodiversity. A participant observed, *“Natural capital is going to become an increasing focus. The new organization in town is the Task Force for Natural Capital Financial Disclosures [TNFD]. The impact of banks’ financing and other activities on natural capital will be the next area of focus. TNFD: if that’s not part of your boardroom education yet, as maybe TCFD [Task Force on Climate-Related Financial Disclosures]*

wasn't a few years ago, I'd suggest putting that on your list as soon as possible. It's a new dialogue."

Mobilizing sustainable finance will require engagement and support from policymakers

"Green willingness in the private sector, in the bank, is not going to make up for lack of policy action in the government."

– Participant

A bank executive observed, *"Often, the discussion is defensive; it feels like this is being done to the banks. But there is an argument that sustainable finance is the only growth game in town for some banks. We should be taking hold of this."* Massive investment will be required for economies to improve sustainability and achieve internationally agreed-upon goals. Another participant asserted, *"If we do this right, all finance will be green, barring a bit of carbon sequestration going on separately. We need to make this mainstream."*

But others emphasized the need for policy interventions, including more investment from governments, to set standards and de-risk private investments in sustainable energy and other efforts to reduce carbon emissions. There remain areas of misalignment between market forces and economics and the desire to go green. A participant noted, *"The lack of economic payback for those taking out mortgages or buying an electric car, of going green, is not going to be addressed by banks. Green willingness in the private sector, in the bank, is not going to make up for lack of policy action in the government."* A similar misalignment of incentives still needs to be overcome in the banking sector, as another participant explained: *"The commercial banks are asking, 'Am I really being asked to pass up the opportunity to finance something low risk and high return for something that is high risk and where the return is questionable?' We need to bridge that market-forces gap."*

"There is a capability gap and a risk appetite gap to make the pivot required."

– Participant

Bridging that gap, another participant contended, will require *"a big mindset shift in treasury and governments around the need to de-risk and catalyze private capital. There is a capability gap and a risk appetite gap to make the pivot required."* Although governments have made substantial commitments to funding climate adaptation and transition, a bank executive noted that *"\$100 billion is peanuts for the financial system as a whole."* A director expressed skepticism that governments could afford to step in and fill the gap: *"There are trillions of dollars of unfunded public pensions. Which democratic governments are going to take this on?"*

While it is unclear how much green finance will require some form of government subsidy, and despite the challenges in governments expanding commitments, a participant proposed, *"Let's use government balance sheets*

in a smarter way. Where there are business cases that are valid, no money should be given as grants, ever; they should go out as guarantees. We've all signed up for net zero, to find ways of making money in a different way. There are plenty of examples where government money can be leveraged far more effectively."

"The financial sector is there, so governments have to take action. They can't say, 'Finance won't be there,' because we are ready to go."

– Executive

Bank leaders need to actively engage with governments and policymakers to ensure there is sufficient understanding of what will be required. *"It's our job to point these things out, to say we need policy action, subsidies, whatever it is,"* a participant said, *"because we cannot go to shareholders and say we want to finance green if we are lacking the hundreds of billions of dollars of policy action that needs to go in."* Another observed, *"We have a role to play in helping to shape that dialogue and demonstrating we will turn up. It's not just about policy; it's about intervention of financial mechanisms, and we know how to do that."* According to a bank executive, governments are prepared to engage: *"Governments see what the private sector is doing, that we are serious, and they are starting to figure out how they can connect policy to the private sector. The financial sector is there, so governments have to take action. They can't say, 'Finance won't be there,' because we are ready to go."*

Governments and regulators need to establish standards and ensure a just transition

Some bank leaders feel they are being asked to make decisions that are better made by elected officials. One director said, *"Brussels cannot determine and decide whether nuclear is sustainable or not, so as a bank, what do I do? Do I determine if nuclear is sustainable? It is not for me to decide."* Policymakers and regulators need to establish standards and level the playing field to accelerate progress.

Financial services regulators may have an expanded role to play. While some are already conducting climate stress tests and scenario analyses, participants suggest they could do more to help set standards—for example, by *"blessing a single approach"*—and helping banks to prioritize their efforts. But regulators may be cautious about pressing financial institutions on business decisions: *"As a regulator, if you force a financial institution to do something subeconomic, you get into muddy waters in terms of your statutory authority; you have to be very careful,"* cautioned one participant.

Policymakers also need to coordinate efforts across the public and private sectors to ensure that vulnerable people are at least somewhat insulated from unintended consequences, like high energy prices. *"I think we've*

walked into a very difficult period to do this. We're going to get brownouts and blackouts. There are a lot of people that cannot afford to wait for paybacks; they need to get through the next week." Standard Chartered CEO Bill Winters, one of the more outspoken banking leaders on climate transition, noted recently that transitioning to a net-zero economy

requires agreement on practical solutions governed by principles of fairness ... [T]hese actions must address both the urgent need to transition to a net-zero economy *and* the need to support ongoing economic development ... Green technologies and renewable energy sources are coming along very quickly, but they can't replace fossil-fuel use overnight and to urge that as a policy prescription is not only unrealistic, it implicitly condemns hundreds of millions of people to a life of poverty without power and greatly diminished economic opportunities. This is neither just nor practical.⁹

"If the objective is net zero for the world, then we need to figure out how to do that in a way that does not leave people without access to affordable energy solutions."

– Director

Several participants echoed these comments, including one director who said, *"If the objective is net zero for the world, then we need to figure out how to do that in a way that does not leave people without access to affordable energy solutions, as we're already seeing roll across the world. If we don't do this properly, the harm that can be done to humanity here is quite significant."*

Refining transition strategies will take time

Having made net-zero commitments, many of the largest banks in the world are working through the implications. Boards are actively engaging with management in multiyear processes to define a methodology and begin to translate high-level commitments into specific implications for businesses. Given the challenges around definitions, data and metrics, and changing policy and reporting standards, banks will continue to refine and adapt plans over the coming years.

Banks are increasingly expected to articulate a path to achieving commitments

As pressure has grown, more and more banks have made sustainability commitments, particularly net-zero goals. Setting these goals, which are intended to align banks with the target of the Paris Agreement, is easier than identifying the path to achieving them. One director admitted, *"A lot of people are saying, 'Net zero by 2050,' with no clue how to get there. That has different meanings from a strategic perspective. I hate to say we are building the bike while riding it, but it's a huge body of work."* One study found that

57% of banks that have made commitments do not publicly disclose their accounting methodology, and a third do not have plans to report on the progress of keeping their commitments.¹⁰

“For the board of a global bank to be talking about intensity metrics by sector shows how real this is. It’s not marketing; this is changing strategy.”

– Executive

In October 2021, the Sustainable Markets Initiative published a “practitioner’s guide” to net zero for banks, which provides a framework for how banks can approach development of net-zero strategies. The guide notes, “Many banks have made net zero commitments in recent years, acknowledging that they have a role to play in the climate transition. What is needed now is clarity for banks on how to build their net zero strategies, demonstrating that banks have a robust approach and enabling external stakeholders to keep track of progress.”¹¹

An executive admitted, *“We actually did not want to join net zero. Frankly, I do not think it’s clear what it is or how to get there. Eventually, we joined simply because you cannot be the last bank remaining that has not joined, so we might as well join and then we can all try to figure this out together.”* A director conceded, *“It’s not easy, and in some parts of the plan we don’t know what to do,”* but added, *“The fact is, we do have our business behind this and that’s exciting. We’re convinced it’s our duty.”*

Boards are engaging in the details

“Boardrooms having fluency in climate change is now table stakes.”

– Participant

To effectively review and challenge net-zero and climate-transition plans, many bank boards are getting into technical details—for example, one said their board debated whether limits on coal should extend to all forms of coal or exclude metallurgic coal. An executive said, *“For the board of a global bank to be talking about intensity metrics by sector shows how real this is. It’s not marketing; this is changing strategy.”* Engaging in these details, however, isn’t always easy, as one participant noted: *“It takes quite a while to get comfortable with the language. Even defining ‘net zero’ is complicated.”* Nevertheless, a participant observed, *“The fluency that CEOs, board chairs, and non-executive directors now need to have on this topic has gone through the roof. Boardrooms having fluency in climate change is now table stakes.”*

Given the strategic and long-term implications of these commitments, the full board must ultimately approve transition plans; however, some banks have established sustainability, corporate responsibility, or equivalent committees, which are taking the lead with management on the initial work of developing plans, while a combination of nominating and governance committees, audit committees, and risk committees are continuing to review relevant aspects of the plans.

“That’s the new reality for directors: you are going to have to get immersed in this the way we have had to get immersed in other things.”

– Director

The scale of this transition also raises questions about board competency. If boards are to understand the opportunities, risks, and trade-offs inherent in climate-transition planning, an executive said they need to ask, *“How can you become a climate-competent board, an ESG-competent board? That should be top of mind for every major bank right now.”* Some participants said they have considered whether adding directors with more expertise in sustainability would be wise but that finding the right person is difficult. A director said, *“A lot of businesses are trying to do that, but I always wonder if the person even exists in the world today to be the expert on all the things you need for this and be a competent director? It’s so new and dynamic, I do not think that person is really out there.”* Another said, *“Just like financial literacy, I think we’ll need environmental literacy or environmental transition literacy in the makeup of your board. The duration of this is so long and chapters of this so many, I’d be very skeptical if there is a person out there for every board who can provide answers to this question. That’s the new reality for directors: you are going to have to get immersed in this the way we have had to get immersed in other things.”*

Plans will evolve over time

Even banks that are furthest along in articulating their transition plans acknowledge that a series of open questions will continue to challenge their efforts. Shifting standards, improving their ability to access and use climate data, and understanding the implications for business strategy, for employees, and for customers, will take time and require agility to adapt plans as needed.

Linking climate transition to purpose and culture

“[Net zero] didn’t come out of nowhere; it was something we were likely to do anyway, but the zeitgeist encouraged us to move as quickly as we can.”

– Director

While some banks are still hesitant to commit to net zero, others have been developing their approach to climate transition over years. A director reported, *“The important thing for us is this has been a long gestation, an incubation. It didn’t come out of nowhere; it was something we were likely to do anyway, but the zeitgeist encouraged us to move as quickly as we can in recent years.”*

Transition plans need to be linked to the bank’s purpose and strategy and embedded into the culture of the organization. A participant emphasized the importance of *“having the key people engaged,”* explaining, *“We had a CEO join the bank who was interested in the agenda, a chairman who was fluent on these issues, and the chair of the culture and sustainability committee, and we added someone to the board with additional expertise.”* The same participant suggested the process required a holistic approach: *“It wasn’t*

done in isolation; we didn't go on a green journey, as it were. It was more that we looked at all of the elements, a journey around the purpose of the business, articulating that and engaging with staff around the world on it—making sure culture dovetailed with the strategy. This all helped prepare the ground for net zero.”

Setting targets amid a range of unknowns

“We thought about pushing it out until we had better data, but realized we'll never have perfect data on this.”

– Director

In some instances, banks are having to make best guesses about their existing exposures and make a range of assumptions about the future. Determining banks' current financed emissions—included as part of scope 3 emissions calculations—is complex. Data availability remains challenging: *“You can't do more until you get the information. Until then, you're sort of a second or third derivative from it. It's a big chunk of information that's still not there, but someone still needs to work that out. It is clearly a big hole in the whole thing,”* one director said. Another asked, *“Customers and counterparties are included: do we rely on their disclosures and attestations or just focus on corporate book of business for now?”*

Many banks have decided they need to get on with planning based on the information they have, making necessary assumptions along the way. One director reported, *“Looking at financed emissions, we committed to 2050 pretty much on a work-back basis rather than work-forward basis. We thought about pushing it out until we had better data, but realized we'll never have perfect data on this. A lot is based on assumptions, but that's what you have to do.”*

Considering other aspects of transition planning

Other considerations banks are addressing as they refine their plans include the following:

- **Setting absolute or relative targets.** Some banks are still determining whether to set specific targets for reductions in financed emissions by specific dates and whether those should be absolute targets or intensity targets (i.e., relative targets). One participant reported, *“We did set specific targets, but I have to admit they are mainly intensity targets. We know that's contentious, and we will be pushed on absolute targets—we did do that for coal—but for now the rest are intensity targets. We want to switch to absolute targets in due course.”*
- **Adjusting risk limits.** A participant said, *“If you want to change a bank, you have to change risk management. If you change risk management, you change the bank. You have to embed climate and sustainability into*

your risk management, risk appetite, and frameworks.” Banks are identifying practices for doing so, aligning limit structures with climate objectives. Some banks are adjusting risk-weighting of assets to take a view on the risk from climate change. Regulators may adopt a similar approach for capital adequacy assessments. Another approach is carbon budgeting. A bank executive reported, “On execution, we used to think of things like rationing capital, and this is effectively rationing carbon in the business. How do you think of that internally and build a business that is lower carbon? It’s a multiyear journey. And that’s exactly how our clients are thinking of their own businesses: how do I do this with less carbon? So, if you think of this as a resource that needs to be used scarcely, it becomes more intuitive and natural.”

- **Assessing real-world impacts.** With so much emphasis on mapping a path to net zero, one director said, “One question is methodological: do you believe you know enough about the input/output analysis in terms of the effect on climate change to actually say we’ve identified the things that matter?” Some degree of prioritization will be required if banks want their plans to address business decisions in ways that will achieve the desired effect—for example, focusing on the largest emitting sectors. Given the scale of the challenge, some participants called for prioritization: “Where to start? I think power is really critical; decarbonizing power is critical to electric, heating, cement, etcetera. It’s an important place to start.” Another noted that a few sectors represent a disproportionate share of emissions—for example, construction and homes, energy, and automobiles—and focusing first on those could make a material difference.
- **Understanding the implications for customers and employees.** A director said, “We set subsector targets by 2030. Clients are starting to ask, ‘What does this mean for me?’” Customers, especially those in carbon-intensive sectors, will want to know how their banking relationship and their broader access to and cost of capital is likely to be affected. Employees who serve these sectors will also want to know, as another participant explained: “Colleagues will be asking what this means for them and for success at their job, and what they’ll be measured against. The consequences—that’s the next bit.” Developing specific targets could make teams, like those focused on coal, redundant, so considering how to retrain and repurpose existing employees and what new skills will be needed will be another challenge. A director noted, “The external

“We set subsector targets by 2030. Clients are starting to ask, ‘What does this mean for me?’”

– Director

challenge is mindboggling enough, but actually the complete rewiring of banks and what business gets done is quite intense.”

- **Preparing to adapt.** These plans will be iterative. *“The world is moving very fast,”* a director noted, and the assumptions used to create plans today could change rapidly, requiring the plans and approaches to implementing them to adapt accordingly. A director reported, *“We’ve now got a team focused on this, so we have the capacity, and the committees have the space to look at it on a regular basis.”*

Achieving goals will require some trade-offs in the short term

“The really hard-hitting questions are going to be ... where are the opportunities that your people are seizing to genuinely do green financing, and where are the areas where people are genuinely forgoing profit?”

– Participant

A director observed, *“It strikes me that we are still so early in this process. It’s still about inputs, not outputs: methodology, getting the shareholder advisory vote, our pathways to get to 2050, etcetera. That’s all fine, but the really hard-hitting questions are going to be, where in your bank are the examples of companies in the energy sector or whatever it may be who are really transitioning, and where are the opportunities that your people are seizing to genuinely do green financing, and where are the areas where people are genuinely forgoing profit?”* Forgoing some profit is inevitable, as another participant explained: *“Christine Lagarde [president of the European Central Bank] said, ‘We politicians know what needs to be done, just not how to do it and be reelected.’ Applied to CEOs, they know, or will know soon, what needs to be done but won’t know how to do it while still delivering quarterly earnings. You look at debt, equity, profit margins, you look at the balance sheet and what you inherit, you realize it’s a major challenge.”*

According to Bloomberg, since the Paris Agreement near the end of 2015, banks have generated \$17.8 billion in fees from extending financing of almost \$4 trillion to fossil fuel companies.¹² Transitioning away from fossil fuels puts some of that revenue at risk at a time when other revenue streams are under pressure. A director explained, *“Financing natural gas for European banks is one of the core franchises. Should we give it up? The American banks will say, ‘Just give it up.’ They’re happy to let us do that. And I have these conversations with the European Central Bank and on the one hand they are pushing us to be more profitable, but then they said, ‘Yes, you should give it up.’”* Green finance will clearly play a role in replacing some of these revenues, but it will take time, and alternatives are not yet at scale. Since 2015, green debt, for instance, has only generated \$8.9 billion in fees.¹³

“A very long-term plan is five years. Climate requires thinking out 30 and 50 years, and banks traditionally have not done that.”

– Director

A participant suggested this tension between short-term and long-term performance may require reassessing the very purpose and objectives of banks: *“It’s about getting the smartest people in the sector and figuring out the structures that work for them and asking, At what point does it make sense to take a different, longer-term view of your returns? Just generally being more considered in how your returns are calculated.”* A director said, *“In banks, at least the ones I’ve worked at in my career, the planning horizon has always been typically three years. A very long-term plan is five years. Climate requires thinking out 30 and 50 years, and banks traditionally have not done that and are not good at it.”* That time horizon requires thinking beyond traditional risk management and beyond the careers of those currently leading these institutions. And some banks may be better positioned to do so than others noted one director: *“If you are a capital-rich company that can afford to say, ‘We take on loss-making business to begin with because we are building our reputation and connections,’ then you can look ahead to the point at which more green lending is going to be profitable. But there is a bridge between now and the long term where there is a role for government subsidies and indeed legislation to change habits.”*

Effectively engaging with clients will be essential

“Those sharing an unwillingness to transition are the ones we exit; the ones sharing ‘transitional journeys,’... are the ones we will work with.”

– Participant

Banks’ biggest challenge in achieving net-zero commitments is through their financing activities and addressing scope 3 emissions. They are expected to reduce their exposures to carbon-intensive activities, but participants emphasize that they cannot simply divest. Therefore, they must work with clients to understand and assess their transition plans and, in some cases, encourage those transitions through a combination of advisory and financing mechanisms. One participant described how they determine which clients they can work with: *“Those sharing an unwillingness to transition are the ones we exit; the ones sharing ‘transitional journeys,’ whatever that actually means, are the ones we will work with. The relationship and other factors dictate how much latitude we will give for that journey.”*

But even accepting clients with credible transition plans is not without its complications: *“If a new client is quite bad in terms of carbon emissions today, but they have a robust, credible plan for transition, what should we do? We should invest. But we, the bank, will then have worse performance today on scope 3 emissions because we added that client,”* an executive said. One participant predicted that some companies will elect to split into brown business (like a bad bank) to be wound down and green business to grow in order to escape that legacy and access new financing.

Banks can influence clients through multiple mechanisms

“For big corporates, it’s more, How do we see the shift happening? What [mergers and acquisitions] are they doing? Are they divesting from carbon-intensive aspects of the business? Are they fundraising for major investments into sustainable businesses?”

– Executive

How banks engage with clients on their transition is still taking shape, and banks are approaching it from several different perspectives:

- **Advising clients on transition.** Some participants see an obvious role for banks in advising their clients; others see this as primarily a risk assessment. One participant suggested the risk expertise that banks have positions them well to help corporate clients develop transition plans, such that banks should be building out the equivalent of a consulting arm to advise clients on transition.
- **Using financing facilities to influence clients.** Others are focused less on advice to change behaviors and more on using financing facilities with climate-related covenants and metrics as a lever. A participant observed, *“You can do sustainability-linked financing, setting the metrics and [key performance indicators] around financing facilities. We are working on aligning that to hard financial metrics, but it is nascent.”*
- **Focusing on assessing clients’ transition plans.** An executive said, *“Most big companies will understand the pathways for them in their sector better than you do as a bank.”* A director went further, stating, *“The idea that we as a bank would be better positioned to tell your business how to do this transition to clean energy is ridiculous. But what we can do is try to understand and assess what you say you are going to do, and then make our own decision on how viable we think that is.”* As a result, an executive said, *“For big corporates, it’s more, How do we see the shift happening? What [mergers and acquisitions] are they doing? Are they divesting from carbon-intensive aspects of the business? Are they fundraising for major investments into sustainable businesses? There are new ecosystems being created—for example, around electric vehicles building out the charging network; how are they investing in these new ecosystems? Some oil and gas companies are getting involved because they recognize the need to replace traditional sources of revenue.”*

Ultimately, banks’ assessments of clients’ transition plans can and should lead to turning away business or enforcing policies that may put pressure on clients. Banks can also raise standards. A director reported, *“One large European bank went through this. The property sector was one of their biggest, and they said, ‘Unless you align with these climate targets, we will not help you.’ They have not lost a single client. Clients need partnering and support through this.”*

Working with retail customers presents additional challenges

“You’ve got to get a happy marriage somehow between the conduct and consumer protection regimes to protect vulnerable customers and the cost of addressing climate change.”

– Participant

The challenge of achieving net-zero commitments is made more complex by the mix of customers banks serve. One participant said, *“The banks are all focused on what they do with their big corporate customers; the path there is a lot clearer than what to do with the retail markets. We don’t want to totally focus on the corporate side of the balance sheet without looking at the retail/mortgage side, because when you add that up, it’s a big part of most banks’ balance sheets.”* Another participant asked, *“What about retail customers? They are a completely different kettle of fish. Are they prepared to pay extra when their first need is to survive? People are motivated to invest in green, but are we sure we’re not misleading customers that it’s truly a green product? Then we get into the realms of conduct issues generally.”*

Providing green products to retail customers could present real conduct risk, another participant asserted: *“The elephant in the room is that the conduct and compliance issue is a material risk— the amount of first- and second-line people coming to us saying, ‘I have no clue what I am doing here.’ It’s absolutely critical.”* As a result, another participant emphasized the balance that banks and regulators need to strike: *“You’ve got to get a happy marriage somehow between the conduct and consumer protection regimes to protect vulnerable customers and the cost of addressing climate change and environment. That is not a straightforward thing, and we will need some latitude.”*

Others worried that *“you’ll have a new definition of unbankable and unbanked.”* These concerns will require new forms of communication and disclosure between banks and customers about existing products and assets and potential climate risks, about green products, and about potentially *“unbankable assets.”*

Banks need to build new capabilities to assess transition plans

Even if banks conclude that they are in no position to advise clients on how to transition, they will need to be able to effectively assess transition plans. A participant said, *“Your teams’ ability to judge transition plans needs to massively improve, like the ‘60s and ‘70s, when banks got into oil and gas lending and realized they needed the same engineers and geophysicists that oil and gas companies had. That will be beefed up significantly in the coming years. The ability of firms to assess this very accurately, for it to be data driven—that’s a whole new area to explore.”*

“Climate is the most pressing issue facing banks in terms of investor relations.”

– Director

Some of that capacity will come through acquisition, but a director said, *“This comes back to training for all financial institutions. How do we train risk managers? We are all learning about these issues ourselves. They haven’t been trained for that at all. How do you train people to make a judgment on transition?”* Greater climate competency will be necessary across the bank, including for front-line employees managing client relationships, risk managers, traders, and those serving retail customers.

Investors are looking for evidence that banks are acting on commitments

In recent years, institutional investors have made climate risk a leading priority and are pushing the private sector to respond. In his annual letter to CEOs, BlackRock Chief Executive Larry Fink has continued to highlight environmental sustainability as a driving force behind the investment firm’s decision-making. Activists are also stepping up their efforts. Earlier this year, activist hedge fund Engine No. 1, supported by investors and proxy advisory firms, began the largest boardroom showdown yet over climate concerns when it won a proxy fight to get four new candidates for directors, including those with climate experience, onto the Exxon board.¹⁴ According to one participant, *“Exxon was complacent. They simply did not understand the expectations of their investors, in my opinion, and you have to do that. You have to listen and have a clear understanding of expectations.”*

“Sector exposure, scenario planning—those are all important factors here.”

– Investor

A bank board chair declared, *“Climate is the most pressing issue facing banks in terms of investor relations.”* While supportive of public commitments, investors are now looking for evidence that these commitments and the plans to achieve them are influencing decision-making. Participants discussed the following investor expectations and challenges around engagement:

- **Improving climate disclosures.** An investor said, *“The European banks are actually providing pretty good disclosure on climate at this point. Some of the others are still a way behind. We’re essentially asking banks to respond to an enhanced version of TCFD. Target setting, disclosing risk, capturing progress—that’s what we’re focused on. Then you get to scope 3, and scope 3 is the primary thing you’re involved in as a bank. Sector exposure, scenario planning—those are all important factors here.”*

“When you go to your shareholders next year and they ask if you’ve identified the businesses that you are not going to be able to do in 2030, can you and will you answer them?”

– Participant

- **Providing real-world examples.** An investor stated, *“We want you to be helping to invest rather than divest. I’m not a big fan of divesting; you only get a chance to walk away from the table once.”* As a result, however, investors want to see evidence of how banks are working with clients. Another investor reflected, *“When we ask for examples of where banks have worked with a client to reduce emissions, it’s like getting blood from a stone. I think it’s a reasonable argument to say there is no point in dumping those clients, and we agree the answer is to engage; we need them to transition. But if that is the approach, then, at the very least, we need case studies of where and how that is happening.”* A bank executive said, *“We have had conversations with clients that do not have credible plans—either can’t or won’t create one—but we will not discuss those publicly. So we can’t share that evidence, but we’ve got it. Our onus is to come up with the successful ones.”* Still, more broadly, a participant asked, *“When you go to your shareholders next year and they ask if you’ve identified the businesses that you are not going to be able to do in 2030, can you and will you answer them?”*
- **Engaging with investors to build support for transition plans.** A director explained that their bank decided to hold a shareholder advisory vote on their net-zero plan: *“We put that stake down and had to work back from it. It adds a degree of urgency. It’s no longer a ‘nice to have’—we’ve got to have it for shareholders to have an advisory vote on it.”* While some companies are moving to a vote on climate-transition plans, one investor said, *“I don’t like ‘say-on-climate.’ It makes it a binary yes or no rather than an opportunity for engagement.”* The same investor observed, *“It’s very strange to me that ESG is the one thing where we collect data even though we don’t know if it matters or not. Engagement has become about outcomes.”*

“I don’t like ‘say-on-climate.’ It makes it a binary yes or no rather than an opportunity for engagement.”

– Investor

Banks are but one part of a complex financial system

Large banks are a core part of global finance and thus can play a critical role in capital allocation; however, banks are but one part of the complex financial system, limiting their ability to influence capital flows. *“We have created financial markets, shadow banking, and credit that goes way beyond what the banks are lending. It’s so disconnected,”* said one participant. Derivatives markets, public-debt markets, and various sources of private capital are outside the banks’ direct control.

“There will always be buyers in the market, and they may not be public entities.”

– Director

Returns are still there for the taking, and other sources of capital will fill the void as banks move out of “dirty assets.” Several participants noted that if banks quickly exit carbon-intensive sectors, private capital will move in. That could exacerbate the challenge facing global leaders combating climate change as these assets move out of the glare of public markets and public scrutiny. The *Financial Times* noted in October, “Hedge funds have been quietly scooping up the shares of unloved oil and gas companies discarded by environmentally-minded institutional investors and are now reaping big gains as energy prices surge.”¹⁵ The *New York Times* reported, “Many oil companies have begun shedding some of their dirtiest assets, which have often ended up in the hands of private equity-backed firms ... At the same time banks, facing their own pressure to cut back on fossil fuel investments, have started to pull back from financing the industry, elevating the role of private equity.”¹⁶

A director observed, *“Capital is like water: it flows anywhere there is a crack in the mortar. Just because public money starts divesting fossil-fuel interests doesn’t mean they go away. There will always be buyers in the market, and they may not be public entities. Divesting might make yourself and your company feel better, but you’ve made zero contribution to achieving carbon neutrality.”* Some participants called on banks and their investors to commit to some form of stewardship regarding where dirty assets go, but others see this as unrealistic.

“Commitments regarding the future create demand that can mobilize investment.”

– Executive

An executive emphasized the need for large banks to be among the first movers in commitments to net zero and climate transition: *“Commitments regarding the future create demand that can mobilize investment. We cannot wait for consensus; we cannot wait for the last one to agree.”* Even if banks focus on *“value, not values,”* as one investor put it, there are reasons for urgency in starting the transition to net zero: one participant analogized climate transition to the tech boom of prior years, warning, *“You don’t want to find yourself with a lot of Xerox and not much Apple in your portfolio.”*

Charting a path requires bank leaders to tread in uncomfortable territory: managing risk and opportunity over very long time horizons, making decisions based on incomplete and imperfect data, determining whether what is good for business is also good for society, and engaging with policymakers, investors, and even activists in new ways.

Appendix

The following individuals participated in these discussions:

Participants

- Andre Abadie, Managing Director, Centre for Carbon Transition, JPMorgan Chase
- Giles Andrews, Non-Executive Director, Bank of Ireland
- Laura Barlow, Group Head of Sustainability, Barclays
- Win Bischoff, Chair of the Board, JPMorgan Securities
- Bill Connelly, Risk Committee Chair, Société Générale, Chair of the Supervisory Board, Aegon
- Jonathan Davidson, Senior Advisor, Sustainability and Climate Change, FCA
- John Dugan, Chair of the Board, Citigroup
- Mary Francis, Non-Executive Director, Barclays
- Richard Goulding, Risk Committee Chair, Bank of Ireland
- Callum McCarthy, Nomination and Compensation Committee Chair, China Construction Bank
- Richard Meddings, Audit Committee Chair, Credit Suisse
- Scott Moeller, Risk Committee Chair, JPMorgan Securities
- Mary Phibbs, Chair, Virgin Money Trust Managers
- Nathalie Rachou, Non-Executive Director, UBS
- Susan Revell, EMEA Deputy Chair and General Counsel, BNY Mellon
- Phil Rivett, Audit Committee Chair, Standard Chartered and Non-Executive Director, Nationwide Building Society
- Tim Rowe, Manager, Sustainable Finance, Financial Conduct Authority
- Alan Smith, Senior Advisor, ESG and Climate Risk, HSBC
- Gavin Smyth, Chief Risk Officer, Nationwide Building Society
- Katie Taylor, Chair of the Board, RBC
- Tim Tookey, Risk Committee Chair, Nationwide Building Society
- Rhian-Mari Thomas, Chief Executive, Green Finance Institute
- Rob Walker, Managing Director and Global Co-Head of Asset Stewardship, State Street Global Advisors
- Jasmine Whitbread, Culture and Sustainability Chair, Standard Chartered Bank

EY

- Omar Ali, Managing Partner, Client Services, EMEA FSO
- Nigel Moden, EMEA Financial Services Banking and Capital Markets Leader
- Steve Varley, Global Vice Chair, Sustainability
- Mike Zehetmayr, Capital Markets Technology and Sustainable Finance Leader
- Gillian Lofts, Global Financial Services Sustainable Finance Leader, EY UK Wealth & Asset Management Leader

Tapestry Networks

- Dennis Andrade, Partner
- Brennan Kerrigan, Senior Associate
- Tucker Nielsen, Principal

About the Bank Governance Leadership Network (BGLN)

The BGLN addresses key issues facing complex global banks. Its primary focus is the non-executive director, but it also engages members of senior management, regulators, and other key stakeholders committed to outstanding governance and supervision in support of building strong, enduring, and trustworthy banking institutions. The BGLN is organized and led by Tapestry Networks, with the support of EY. *ViewPoints* is produced by Tapestry Networks and aims to capture the essence of the BGLN discussion and associated research. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, senior management, advisers, and stakeholders who become engaged in this leading-edge dialogue, the more value will be created for all.

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Tapestry Networks is a privately held professional services firm. Its mission is to advance society's ability to govern and lead across the borders of sector, geography, and constituency. To do this, Tapestry forms multistakeholder collaborations that embrace the public and private sector, as well as civil society. The participants in these initiatives are leaders drawn from key stakeholder organizations who realize the status quo is neither desirable nor sustainable and are seeking a goal that transcends their own interests and benefits everyone. Tapestry has used this approach to address critical and complex challenges in corporate governance, financial services, and healthcare.

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EY is a global leader in assurance, tax, transaction, and advisory services to the banking industry. The insights and quality services it delivers help build trust and confidence in the capital markets and in economies the world over. EY develops outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, EY plays a critical role in building a better working world for its people, for its clients and for its communities. EY supports the BGLN as part of its continuing commitment to board effectiveness and good governance in the financial services sector.

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