

## Navigating climate risk and implementing transition plans

In March 2023, the UN Intergovernmental Panel on Climate Change (IPCC) issued its latest report, synthesizing findings from its earlier work. It concluded that global warming has already reached 1.1°C, and near-term emissions trajectories “make it likely that warming will exceed 1.5°C during the 21st century and make it harder to limit warming below 2°C.” The IPCC warned that “there is a rapidly closing window of opportunity to secure a liveable and sustainable future for all.”<sup>1</sup>

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*“Politics doesn’t hold a candle to thermodynamics.”*

– Executive

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While combatting climate change remains an urgent global priority, competing pressures and priorities are hindering financial institutions’ efforts to respond. The war in Ukraine entered its second year in February 2023, contributing to rising energy costs and underscoring concerns about energy security, given the continuing dependence on fossil fuels for safe, reliable, and affordable energy. In some places, these competing objectives are also polarizing views regarding the appropriate response: some conservatives in the United States deride attention to climate change and other environmental, social, and governance (ESG) issues as “woke capitalism,” while some on the left condemn business leaders’ pledges to cut carbon emissions as greenwashing. All of this has complicated the ongoing work of integrating climate transition into financial institutions’ strategy, operations, and risk management frameworks. One finance executive observed, “Politics doesn’t hold a candle to thermodynamics,”<sup>2</sup> reminding the group of the ultimate factors at play. Nevertheless, in the short term, leaders of financial institutions must navigate the competing demands of politics, public sentiment, and the realities of a warming climate.

On June 13–14, directors and senior executives from among the largest banks, insurance companies, asset managers, and financial technology companies, along with regulators and subject matter experts, came together for the 2023 Financial Services Leadership Summit. Participants discussed their efforts to address climate risk and implement transition plans. This

*ViewPoints* synthesizes discussions before and during the summit, focusing on the following themes:

- Delivering climate transition plans presents significant challenges
- Assessing climate risk exposure remains an inexact science

## Delivering climate transition plans presents significant challenges

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– Executive

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The UN Climate Change Conference of the Parties (COP26) held in Glasgow in November 2021 generated significant momentum for financial institutions’ efforts to support climate transition, symbolized most clearly in shared pledges to achieve net zero greenhouse gas emissions by 2050. As one participant noted, *“In the run-up to the Glasgow COP, everyone was setting targets. Pretty much everyone set a net zero target in that timeline.”*

Attitudes have shifted over the last two years. One executive said, *“I think the honeymoon of the net zero statements of ambitions is over.”* This executive was suggesting the conversation has matured from making commitments to tackling the realities of achieving net zero. The discussion is increasingly focused on sober assessments of the challenges and tradeoffs financial institutions face in making progress on those goals, on the need to develop more concrete transition plans, and on a reconsideration of the reputational, legal, and political risks of making public pledges. One executive said firms are now asking themselves, *“How on earth are we going to do this?”*

## Aligning strategy and operations with transition plans

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*“It’s all about moving from pledges to detail and implementation at scale.”*

– Participant

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With the focus now on transition plan implementation, financial institutions confront the difficult task of aligning business strategies with those commitments. One participant said, *“It’s all about moving from pledges to detail and implementation at scale.”*

Doing so presents a host of operational issues. Participants identified key areas of focus during the implementation process:

- **Moving from net zero pledges to setting near-term targets.** Although the global goal of net zero carbon emissions by 2050 often dominates climate-related conversations, one participant pointed out, *“It’s not just about 2050; it’s also about near-term targets. We are targeting a 25% improvement in carbon intensity in our investment portfolio by 2025 and a 50% improvement by 2030.”* Another participant emphasized the need to establish the short-term targets that can have the greatest

impact: *“We are very focused on setting near-term targets for the top-10 emitting sectors.”*

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– Participant

- **Engaging with carbon-intensive sectors.** Financial institution leaders consistently emphasized the need to work with high-emitting sectors, rather than simply winding down investments, to ensure an orderly transition. A participant said, *“Oil and gas will play a key part in that transition. We need to continue to heat our homes and power our vehicles. We need to stay invested and engage in a collaborative way and move when the policy framework is in the right place.”* While oil and gas often generate the most attention, other sectors are also critical: *“Everyone talks about oil and gas, but agriculture is also a crucial sector,”* said one participant. Another agreed: *“We bank one in four farms in the UK, so we’re asking questions like, How is the food system going to navigate that transition, and how can we change the economics of that system? How do we integrate nature considerations into that in terms of land use? How do we think about the just transition in the food system?”* While every financial institution’s portfolio is unique, the key is to delve into portfolio details and to take a strategic approach to engagement. One institution, for example, is focusing on relationships that represent just 20% of their investments but account for approximately 80% of the emissions in their portfolio.
- **Scaling green investments.** In addition to setting near-term emissions-reductions targets for high-emitting sectors, financial institutions are expanding investments in sectors and technologies needed to drive the transition to a low-carbon economy. A participant said, *“We are tilting our portfolio toward companies that are going to be winners in creating new climate solutions and broader sustainability solutions.”* Another emphasized wanting to *“use our full resources to help companies in hydrogen, carbon capture, and hard-to-abate sectors like agriculture ... to bring technologies to scale.”*
- **Supporting SMEs in their transition planning.** Helping small and medium-sized businesses (SMEs) chart their paths to net zero presents a real dilemma. SMEs typically lack the capabilities of larger corporates and may look to financial institutions to support them in reducing their emissions and navigating the transition to a low-carbon economy. A bank executive said, *“The SME issue is a huge issue and huge opportunity for large financial institutions.”* One participant described the SME sector as *“the most challenging: they account for 50% of*

*emissions, but they typically say they don't have the financing or competency, don't trust the mechanisms, and don't know what they would do to decarbonize. Across financial services, we have seen a huge uptick in engaging with clients, including retail investors and SMEs, in a dialogue and educating them on what their footprint is and what their options are."*

### Progress depends on external developments

Participants noted that a range of factors outside their control affect their efforts to implement climate transition plans. These obstacles include the lack of coordinated policy and collective action, an increasingly polarized public, and ongoing challenges related to metrics, data, and measurement.

### Coordinated policy approaches are often lacking

Making meaningful progress on climate change requires coordinated action within the financial services sector, across industries, and between the public and private sectors. One participant said, *"Our plan is dependent on the actions of others. When you come to climate solutions, you need a strong policy framework to make it worth our while to invest."* Finding the balance between reducing investments in fossil fuels and meeting the world's ongoing energy needs poses particular challenges. *"If financial institutions are materially changing their investment strategies, they are driving up the cost of capital to fossil fuels, but there's no solution on the other side driving up investments in alternative energy. We really need to do something collective. It's a societal issue. The reality is that the politicians need to take on this challenge and put in place a global structure to address this problem. In the interim, we'll all be tilting at windmills."*

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Past policy efforts have delivered some individual success stories. For example, one participant said, *"Offshore wind policy evolved drastically to make it attractive to invest and derisk the technology, which facilitated large wind farms in the North Sea. That reduced the cost of capital to make it more attractive to invest."* But truly global policy coordination has been rare. The UN-led COP process will have its 28th annual meeting later this year, underscoring for some the slow pace of intergovernmental negotiations and policy development. One participant noted, *"These negotiations are hard, and they often don't reach conclusions. [Noted climate activist] Greta Thunberg said she is not coming anymore because it's just talk."*

Coordinated policy even within individual nations has been difficult to achieve. One participant pointed to residential lending as an example of an area where lack of a national policy has hindered progress. *"We have not set*

*[the level of emissions in our residential lending portfolio] as a target currently because there is a huge dependency on policy support for homeowners to reduce their use of oil and gas and replace boilers with lower-carbon alternatives. We didn't feel it was appropriate to suggest we'd cease providing mortgage services to the market in the absence of policy."*

The slow pace of both intergovernmental negotiations and the creation of public policy solutions means that policymakers *"often look to the private sector to claim wins,"* one participant said. The fanfare accompanying the launch of the Glasgow Financial Alliance for Net Zero (GFANZ) at COP26 was a significant example. But that approach raises questions about whether it is appropriate for the financial sector to be driving what are essentially public policy initiatives. A participant commented, *"GFANZ showed that financial services can move quickly. But it raises the question, How democratic is this? Intergovernmental negotiation is slow [and] the private sector is faster, but is that democratic?"*

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*"Intergovernmental negotiation is slow [and] the private sector is faster, but is that democratic?"*

– Participant

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### Attitudes on climate are increasingly polarized

Financial institutions continue to face pressure from forces representing competing sociopolitical viewpoints as they work to implement their climate transition plans. Critics from the left continue to accuse financial institutions of not moving fast enough in severing their financial ties to the fossil fuel industry and dismiss emissions reduction pledges as greenwashing. Climate activists disrupted the 2023 annual meetings of a number of European banks and insurers, including Barclays, HSBC, Lloyds Bank, ING, and Lloyd's of London. In the United States, protestors defaced Citi and Bank of America offices in New York with graffiti that called the banks "climate criminals."<sup>3</sup>

At the same time, conservatives in a number of US states are threatening to enact—or have already enacted—policies to punish financial institutions for any indication of reductions in fossil fuel financing. Arizona, Arkansas, Florida, Kentucky, Louisiana, Missouri, Oklahoma, South Carolina, Texas, Utah, and West Virginia have all threatened financial institutions, including JPMorgan Chase, Morgan Stanley, Wells Fargo, and BlackRock, with divestment.<sup>4</sup>

GFANZ has faced pressures too: over the course of 2022 and early 2023, a number of large banks criticized GFANZ for overly strict decarbonization requirements. One participant noted, *"The pledge was great; then the UN tried to add in parameters like the race to zero, which added conditions that private finance had not anticipated, like exiting coal by 2030."*

Some financial institutions have moved beyond criticisms to action. In December 2022, Vanguard CEO Tim Buckley pulled the firm from GFANZ,

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– Participant

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claiming that meeting its fiduciary duty to clients would be difficult while also committing to align its assets with the 2050 net zero target.<sup>5</sup> By the middle of 2023, the UN Net Zero Insurance Alliance (NZIA), one of the member bodies of GFANZ, had lost 18 of its 30 members, including AXA, Allianz, Munich Re, Hannover Re, Zurich, Tokio Marine, SCOR, and Lloyd’s of London,<sup>6</sup> who withdrew in the face of criticism from conservative politicians and threats of antitrust action. In the wake of these departures, the NZIA announced that it would eliminate any requirement that member firms establish or publish emissions reductions targets.<sup>7</sup>

Reflecting on the increasing politicization of the climate agenda and the difficulties it presents for large financial institutions, a participant commented, *“Stakeholder management is super complex. You’ve got shareholders, employees, civil societies, and NGOs, and of course it is very localized. Even in the US, it is localized state by state ... It’s ultimately about setting a strategy and defining a narrative around the materiality of what you are doing and responding to a whole host of stakeholders, including some who would like you to be more ambitious than you might want to be.”*

### **There are gaps and inconsistencies in data and measurement methodologies**

Lack of adequate data and robust methodologies hinder financial institutions’ ability to measure carbon emissions, set reductions targets, and assess the impact of climate change on their businesses. One director said, *“Data is so critical. It’s the huge challenge we’re all facing, and it will underpin execution, reporting, capital allocation, and disclosure. This is a huge subject for every board.”*

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*“Plotting a transition route to net zero if you still don’t really understand what the levers are is impossible.”*

– Director

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Businesses across sectors face difficulties in accounting for carbon emissions, but the challenge is particularly acute for financial institutions because the bulk of their carbon footprint comes from financed, or scope 3, emissions. One director said, *“There’s still an awful lot of companies out there who don’t understand their scope 3 emissions, and certainly very few companies have really worked out how to measure them. Plotting a transition route to net zero if you still don’t really understand what the levers are is impossible.”* An executive noted, *“We’d all like to capture actual emissions data, but the reality is that we are going to have to work with proxies for the time being. Ultimately there will be improvement, but we’re not there yet.”*

Industry initiatives are seeking to address this challenge. One participant pointed to the Partnership for Carbon Accounting Financials (PCAF), an industry-led initiative to equip financial institutions with what they need to

measure the emissions associated with their loans and investments through greenhouse gas accounting standards for the financial industry.<sup>8</sup> One participant noted that PCAF *“is not perfect, but it allows you to compare one asset to another, even if there are still some asset classes where there are no methodologies yet.”*

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*“There isn’t a common framework. There isn’t a Basel III equivalent for ESG.”*

– Participant

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Inconsistencies across disclosure frameworks remain a challenge. Despite significant recent activity from the European Union, the US Securities and Exchange Commission, and the International Sustainability Standards Board, a participant noted that *“there isn’t a common framework. There isn’t a Basel III equivalent for ESG.”* While these bodies insist that harmonization and interoperability are key principles, there are important differences in their approaches and timelines to implementation. The result, said one member, is *“emerging reporting and disclosure regimes that aren’t unified globally.”*

In addition to a lack of consistency, existing disclosure frameworks may discourage the kind of engagement with carbon-intensive sectors that many financial institution leaders say is crucial to a just transition to a low-carbon economy. One director said, *“The big challenge is the long-term nature of the investments we make versus the short-term nature of the metrics. I might want to invest in people taking the right steps to decarbonize, but also recognize that it is a long-term journey. But the metrics seem to ask me to invest in people who have already made the investment and are already green.”*

## Assessing climate risk exposure remains an inexact science

Financial institutions also need to assess the physical and transition risks that potential future climate scenarios pose for their businesses, both to inform their own risk management frameworks and to respond to demands from investors and regulators for increased climate risk disclosures. But climate risk measurement remains nascent, and financial institutions are struggling to assess the real impact of climate change on their businesses.

Over the last year, several regulators and central banks have subjected financial institutions to various climate scenarios in an attempt to assess the direct financial impact those scenarios would have and also to assess the financial institutions’ ability to navigate the transition to a low-carbon economy. In general, these analyses found that climate change posed material but modest risks to financial institutions, with little risk to institutions’ solvency or the stability of the financial system.

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*“You can be net zero and have a large climate risk. They are not synonymous.”*

– Participant

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Some attribute the relatively limited financial impact of climate change revealed in these analyses to the fact that financial institutions are not well-equipped to quantify their climate risk exposure. One participant said, *“There are some obvious [climate risks], like if a bank has a huge concentration of residential or multifamily real estate exposure right on the coastline. But extending from there to a more three-dimensional picture is hard, and I think everyone is grappling with it. I don't think anyone has any answers yet.”*

Indeed, central banks cautioned that the results of climate scenario exercises could be the outcome of flawed methodologies or inadequate data and warned that banks could be significantly underestimating potential losses. The Bank of England acknowledged, “Projections of climate losses are uncertain. Scenario analysis in this area is still in its infancy and there are several notable data gaps.”<sup>9</sup> It concluded that “UK banks and insurers have made progress but still need to do much more to understand and manage their exposure to climate risks and develop transition plans.”<sup>10</sup> The European Central Bank warned that only a fifth of the banks it assessed accounted for climate change in credit risk models, only a third have “robust climate risk stress-testing frameworks,” and most “lack relevant data.”<sup>11</sup>

Participants identified several points to keep in mind about efforts to measure and assess climate risk:

- **Achieving net zero and minimizing climate risk are distinct issues.** *“You can be net zero and have a large climate risk. They are not synonymous,”* one participant pointed out. *“By committing to net zero, you may be missing the focus on managing the risks that emerge on the road to net zero. If you look at climate as a risk problem, carbon emissions is [only] a small part of that.”*
- **Climate risk modeling has a “massive data problem.”** Unlike many other risks, climate risk does not have an accumulation of historic data to provide effective guidance for the future. One participant pointed out that climate risk *“is all forward looking. Where do you get data on the future? You don't get it from the past. You get it from the heads of people, from what scientists are saying.”* Effectively utilizing scientific assessments of the probability and impact of future climate scenarios may require the deployment of artificial intelligence and machine-learning technologies.
- **Assessing counterparties' climate risk exposures is tricky.** One bank executive predicted that in the future, *“climate risk will be looked at alongside the credit risk rating. It is a factor. Alongside every credit*

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*“Climate risk will be looked at alongside the credit risk rating. It is a factor.”*

– Executive

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*assessment you will have an environmental assessment and perhaps, in the future, a social assessment which will help to inform decisions.” At present, however, quantifying that risk remains difficult—even in concrete areas such as counterparties’ physical assets. A participant said, “Banks*

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*“If I’m a bank and I have a corporate loan portfolio, how do I actually assess the transition risk of the corporates that I lend to?”*

– Director

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*have typically not needed to know anything about their physical counterparty risk, such as risk to data centers or factories. Banks offer credit to companies with large physical assets. Climate change will attack those physical assets, which is not accounted for in loans and leads to massive mispricing.”*

More broadly, one director asked, *“If I’m a bank and I have a corporate loan portfolio, how do I actually assess the transition risk of the corporates that I lend to?”* Financial institutions are still limited in their ability to make those assessments: *“If I have a loan to Ford and I have a loan to General Motors, how do I distinguish between their transition plans to determine which would be the better credit risk from a climate perspective?”* the same director asked.

## Appendix

The following individuals participated in these discussions:

### Participants

- Andrew Bailey, Governor, Bank of England
- Laura Barlow, Group Head of Sustainability, Barclays
- Colin Bell, Chief Executive Officer, HSBC Bank plc and HSBC Europe
- Zelda Bentham, Group Head of Sustainability, Aviva
- Megan Butler, Audit Committee Chair, Morgan Stanley International
- Matthew Brewis, Director, General Insurance and Conduct Specialists, Financial Conduct Authority
- Jan Carendi, Non-Executive Director, Lombard International Assurance
- Michael Cole-Fontayn, Non-Executive Director, JPMorgan Securities
- Diane Côté, Non-Executive Director, Société Générale
- Martha Cummings, Non-Executive Director, Marqeta
- Ron Dembo, Chief Executive Officer, riskthinking.AI
- Terri Duhon, Risk Committee Chair, Morgan Stanley International
- Tim Flynn, Audit Committee Chair, JPMorgan Chase
- Charlotte Gerken, Executive Director, Insurance Supervision, Prudential Regulation Authority, Bank of England
- Tom Glocer, Lead Director, Morgan Stanley
- Danuta Gray, Chair of the Board, Direct Line
- Tobias Guldemann, Audit and Risk Committee Chair, Edmond de Rothschild
- Mark Hughes, Risk Committee Chair, UBS
- Daniel Hurl, Head of Insurance Market Analysis and Policy, Financial Conduct Authority
- Shonaid Jemmett-Page, Non-Executive Director, Aviva and ClearBank
- Janet Johnstone, Chief Administrative Officer International, BNY Mellon
- Matthew Jones, Chief Strategy Officer, Cowbell
- Alan Keir, Risk Committee Chair, Nationwide Building Society
- Phil Kenworthy, Non-Executive Director, ClearBank
- Jonathan Kewley, Partner, Co-Head, Tech Group, Clifford Chance
- Stuart Lewis, Non-Executive Director, NatWest Group
- Elisabeth Ling, Non-Executive Director, Esure
- John Lister, Risk Committee Chair, Old Mutual, Pacific Life Re, and Phoenix Life
- John Liver, Non-Executive Director, Barclays UK
- Roger Marshall, Senior Independent Director and Audit Committee Chair, Pension Insurance Corporation
- Edward Ocampo, Risk Committee Chair, JPMorgan Securities
- Kevin Parry, Chair of the Board and Nominations Committee Chair, Royal London; Chair of the Board, Nationwide Building Society
- David Roberts, Chair of Court, Bank of England

- Aaron Rosenberg, Partner, Radical Ventures
- Sabahat Salahuddin, Director, Investment Stewardship, BlackRock
- Simon Samuels, Founding Partner, Veritum Partners
- Mohit Sarvaiya, International Chief Information Officer, BNY Mellon
- Nick Silitch, Former Chief Risk Officer, Prudential Financial
- Gregor Stewart, Audit Committee Chair, Direct Line
- Paul Taylor, Non-Executive Director, Morgan Stanley International
- Simon Toms, Partner, Mergers and Acquisitions; Corporate Governance, Skadden
- Tim Tookey, Audit Committee Chair, Royal London
- Nick Turner, Group Chief Executive, NFU Mutual
- Kevin Walsh, Deputy Comptroller for Market Risk, Office of the Comptroller of the Currency
- Lewis Webber, Head of Division for RegTech, Data and Innovation, Prudential Regulation Authority, Bank of England
- Christian Westermann, Head of AI and Data Transformation, Zurich Insurance Group
- James Wilde, Chief Sustainability Officer, Phoenix Group Holdings

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- Jan Bellens, Global Banking and Capital Markets Leader
- Alejandro Latorre, Principal, Financial Services Risk Management Advisory
- Gillian Lofts, Global Sustainable Finance Leader
- Peter Manchester, EMEIA Insurance Leader and Global Insurance Consulting Leader
- Nigel Moden, EMEIA Financial Services Banking and Capital Markets Leader
- Isabelle Santenac, Global Insurance Leader
- Chris Woolard, Partner, EMEIA Financial Services Consulting and Chair, EY Global Regulatory Network

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## About this document

This *ViewPoints* document is the output of Tapestry Networks' convening of financial services board members, executives, and stakeholders, together with other subject matter experts, with the goal of addressing pressing problems and enhancing trust in financial markets. The meeting was organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

*ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, members of management, and advisers who become systematically engaged in this 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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## Endnotes

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- <sup>1</sup> [“AR6 Synthesis Report: Headline Statements,”](#) Intergovernmental Panel on Climate Change, accessed July 24, 2023.
- <sup>2</sup> *ViewPoints* reflects the network’s use of a modified version of the Chatham House Rule whereby comments are not attributed to individuals or corporations. Quotations in italics are drawn from conversations with participants in connection with the meeting.
- <sup>3</sup> Tatiana Bautzer, [“Climate Activists Spray Protests on U.S. Bank Offices on Eve of Annual Meetings,”](#) Reuters, April 24, 2023.
- <sup>4</sup> James McAllister, [“Kentucky Threatens to Divest from 11 Banks over ESG Policies,”](#) *Ballotpedia News*, January 20, 2023; Dan Ennis, [“Kentucky Puts JPMorgan, Citi, BlackRock on Divestment List,”](#) *Banking Dive*, January 4, 2023.
- <sup>5</sup> Terrence Keeley, [“Vanguard CEO Bucks the ESG Orthodoxy,”](#) *Wall Street Journal*, February 26, 2023.
- <sup>6</sup> Chantal Kapani, [“Former NZIA Members Should Not Abandon Climate Pledges – Insure Our Future,”](#) *Insurance Times*, July 3, 2023.
- <sup>7</sup> Tommy Wilkes, [“UN Climate Alliance Scraps Emissions Rules for Insurers after Exodus,”](#) Reuters, July 6, 2023.
- <sup>8</sup> [“About PCAF,”](#) Partnership for Carbon Accounting Financials, accessed July 25, 2023.
- <sup>9</sup> Bank of England, [“Bank of England Publishes Results of the 2021 Biennial Exploratory Scenario: Financial Risks from Climate Change,”](#) news release, May 24, 2022.
- <sup>10</sup> Bank of England, [“Bank of England Publishes Results of the 2021 Biennial Exploratory Scenario: Financial Risks from Climate Change.”](#)
- <sup>11</sup> Martin Arnold, [“Eurozone Banks Are Underestimating the Hit from Climate Change, Warns ECB,”](#) *Financial Times*, July 8, 2022.