vigeo rating The way to responsible investment

Banking the Bubble

Context

2015 is marked in red on the Climate Agenda. After several disappointing attempts, the international community has set its hopes on the United Nations Climate Change Conference, COP21, to be held at the end of 2015 in Paris. Will governments be able to set adequate targets to keep global warming in the 2°C threshold?

This would determine a limited volume of emissions that could be pumped into the atmosphere whilst avoiding the rise of temperature above the target threshold. In practice, this means the existence of a **'budget' for emissions of GHG including CO_2, which entails that only a certain amount of fossil fuels can be burned**. This will have implications throughout the economic system reaching every single corner of it, including the financial sector.

Financial markets have until now shown little interest to recognize and quantify the possibility that political leaders and governments will finally take serious action. However, if they do, clear risks[1] will impact the banking sector, which holds equity and debt of these companies and provide them with capital to finance the development of reserves that are likely to become unburnable.

The banking industry needs to address these risks and develop a framework to integrate climate change issues in general, and stranded assets in particular, into mainstream finance.

Vigeo Findings

As highlighted in **Vigeo European Diversified Banks** sector (published in December 2014), **the sense of urgency of climate protection is still not reflected in the sector performance**: the average score obtained by the sector on this challenge is 39.3/100[2], which is the lowest out of the other environmental issues faced by this industry. This score increased slightly compared to Vigeo's previous review.

Commitments reported by companies remain overall limited (50.8/100):

- The number of banks that have elaborated lending policies for climate sensitive sectors has increased by 12% compared to 2013 review. No bank however appears to have set quantitative targets to reduce its indirect CO_2 emissions related to financing activities.
- Just over half of the banks report to have installed a dedicated structure responsible for the management of climate risks. A good practice is offered by **UniCredit**: here the overall responsibility for climate change is managed by the Environmental Sustainability Steering

[1] Reduction of equity valuations in a low emissions scenario, ratings downgrades of bonds of fossil fuel companies resulting in higher rates to borrow capital and impact on their capacity to face their obligations and to refinance their debt.
[2] Vigeo's scoring scale ranges from 0 to 100, 100 reflecting the highest performance

Committee which comprises the Chief Executive Office, the Head of Group Identity and Communication and the environmental organisation World Wildlife Fund.

In terms of measures implemented by the sector to tackle climate change through their lending practices, almost all banks refer to the implementation of sector policies and describe the methodology to include climate risks in their lending activities. Out of them only 56% provided credit analysts with a dedicated training. **BNP Paribas**, for example, has developed financing and investment policies for particularly sensitive sectors. They set detailed requirements and evaluation criteria. The implementation relies on both the Risk and Compliance functions. Since December 2012, more than 10,000 employees have enrolled in online training courses on sector policies.

In terms of KPIs reported, **data on CO2 emissions related to financing activities are still hardly disclosed.** Only few banks report very partial figures on the CO2 emissions caused by their loan portfolio, such as **Crédit Agricole CIB**, which produced a methodology and a tool to break down the emissions officially reported by countries under the United Nations Framework Convention on Climate Change by industrial macro-sector, allocating the emissions of each country-sector pair to financial operators in accordance with their share of financing and investment.

Finally, **banks are still major financers of coal mining and coal fired power plants**, that have significant impact on the environment and the climate. Indeed, 21 banks are criticised by NGOs such as BankTrack for their financing of coal mining.

However, even though at a low pace, the relevance of this challenge is getting more acknowledged. For example, in its 2014 Sustainability Report, **Royal Bank of Scotland** (RBS) reports that its overall lending to the energy sector has decreased by 36% since 2010, accounting for around 2.9% of the Bank's total lending. In a recent press release,[3] the NGO BankTrack, which targets the operations of banks and their effect on people and the planet, reports that following similar moves from other European companies such as **Barclays, BNP Paribas, RBS and Société Générale, ING** announced at its 2015 AGM it is to end financing for coal mining companies that produce more than one million tons of coal extracted using the highly controversial practice of mountaintop removal (MTR).

Forward

Stakeholders' and governments' pressure on banks' role to fight climate change is increasing . As major economic agents that can rely on huge amounts of financial resources, banks can play a key role in financing the low carbon transition. To have an 80 percent chance of maintaining this 2°C limit, the International Energy Agency estimates an additional USD 36 trillion in clean energy investment is needed through 2050—or an average of USD trillion more per year compared to a "business as usual" scenario over the next 36 years[4]. In their capacity as advisors, lenders and investors, banks are in a position to play a stewardship role by assisting the individuals, companies and projects they help finance to understand and manage the risks, opportunities and adaptation needs relating to climate change.

[3] "ING announces end to financing of major mountaintop removal coal miners" – BankTrack – 11/05/2015
[4] "Energy Technology Perspectives 2012 Pathways to a Clean Energy System" – IEA - 2012

This stewardship role requires banks to develop the expertise, products and services necessary to equip clients and partners to address these challenges. Their role is to create the incentives that shift the way investment decisions are made and capital is allocated away from conventional high carbon technologies, processes and products to leaner, cleaner low carbon alternatives.

COMING SOON: Stranded assets in the Oil and Gas Sector

Vigeo Rating will follow up this research with a study on the operational consequences of stranded assets in the oil and gas sector. The sector has been historically under extreme pressure from shareholders to continuously increase the amount of oil reserves, resulting in companies spending an ever increasing amount of capital on oil exploration and entering extremely risky environments. However, under the theory of "unburnable carbon", these high-risk investments will have no return, pushing some shareholders to backtrack on their previous demands. The study will look into the proportion of oil reserves of major companies that may become stranded under different carbon scenarios, and identify how major industry players are responding to this threat.

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