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Research

# ESG for European Banking: Financing the Future

## #PositiveImpact

Robert Noble
Banks Research Analyst

Atul Hanamante
Banks Research Analyst

Debbie Jones
Global Head of ESG, Company Research


Sustainability regulation, climate change, investor expectations, and consumer preferences have enhanced ESG related risks and opportunities. As a result, European Banks are putting significant resources towards environmental, social and governance objectives. This includes (but is not limited to):

- Sustainable finance strategy
- Internal controls & supervision
- Portfolio decarbonisation / net zero targets
- Sustainable product development & labelling
- ESG/performance linked compensation
- Climate stress testing
- Diversity & inclusion
- Financial inclusion
- Cybersecurity & data privacy
- Reputational risk
- ESG assessment of clients & vendors

Climate risks & opportunities have increased coming out of the Paris Agreement (COP 21) in 2015. Ultimately, banks will need to help finance the estimated USD 4-6trillion/year (per the UN) in necessary investments to support the green transition. European governments and regulators in particular are more advanced than other regions in their efforts to support a global transformation to a low-emissions economy. This includes the development of the EU Taxonomy, a green classification system that helps to establish sustainable activities and turnover and direct investment towards these projects.

Earlier this year the ECB published results of its inaugural climate stress test. The ECB highlighted the additional potential incremental losses for banks from a disorderly transition to net zero or, in a worst case, no new policies. The results were interesting and signalled an effort to incorporate climate risk into the ECB's analysis, but had limited practical impact.

The more recent thematic review of climate and environment related risks from the ECB in November stepped regulation up a gear. The review was critical of European Banks' approach to climate risk so far. The ECB has set out a firm timeline for banks to comply with expectations for climate and environmental risks including identification; business strategy; measurement of risk; and compliance to all regulatory requirements by end 2023. Non-compliance with the timetable outlined now comes with financial penalties  and be taken into account in banks' capital frameworks- a financial stick which we expect will accelerate banks' decarbonisation.

Portfolio emissions are by far the majority of climate exposure for banks. Disclosure and measurement of portfolio emissions is a growing field and at this point in time an exact comparison of banks emission intensity and progress in reducing emissions is very difficult. In a recently published report we estimate the corporate portfolio emissions intensity and how it is progressing using the newest disclosures. On average, there has been some progress but there is a wide variation between the banks.

A more concerted effort is required globally from banks to reduce emissions. For example, current sustainable finance targets of the European banks total c.$4trn over 5 to 10 years- which compares to UN estimates of $4-6trn annually required to fund the green transition. There are other large banks and capital providers to assist the transition, but we would expect regulatory and shareholder pressure in Europe to accelerate banks efforts in reducing emissions.

To be sure, the banking industry has mobilized to address decarbonisation and sustainability risks and objectives through initiatives such as the UN Net-Zero Banking Alliance (NZBA, 39% of global banking assets) and large adoption of the Equator Principles, an environmental and social risk framework for financing projects. That said, there is increasing scepticism that banks (and other industries) will be able to deliver on their sustainability pledges. Moreover, some banks in the US expressed concern regarding the potential legal liability from these commitments.

In our view, investors increasingly believe that companies prioritising their ESG strategies will create more sustainable organizations and be relatively more attractive vs. peers.

Deutsche Bank Research clients can access the full report here.

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