



cutting through complexity

READY OR NOT?

An assessment of sustainability
integration in the European
banking sector

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Foreword from KPMG

The financial services industry and banks in particular have always created value for society. They provide the credit and capital that fuels business, enabling the creation of jobs and wealth and the development of goods and services that benefit society. Through their own operations, they contribute taxes to the economy and create employment.

Yet this positive contribution to society comes at a price. In the course of doing business, banks have both directly and indirectly financed activities that draw on the natural resources of the planet and can have negative effects on people and communities. And more recently we have seen, that some financial institutions have put the financial system at risk and destroyed financial capital resulting in sometimes disastrous impacts for society at large.

Against this background, we believe banks are facing a fundamental question, which is how to remain relevant in the evermore transparent and interconnected world of today and tomorrow;

relevant to customers, employees and business partners and in a broader sense to wider society. This question comes into sharper focus as environmental and social megatrends kick in, including our growing global population, the increasing scarcity of water and other resources, and changing weather patterns.

Banks are increasingly confronted with these megatrends and their impact on the financial performance of their customers, and risk profiles of their loan and investment portfolios. We believe that the banking sector needs to better understand, quantify, monetize and manage these environmental and social risks and opportunities, because business value is at stake. Furthermore banks need to consider reallocating capital from unsustainable to more sustainable sectors and business practices within the real economy, in the interest of their clients and wider societal goals.

The degree to which European banks have accepted this notion varies from country to country and from institution to institution.

This study provides an overview of the current state of environmental and social risk integration in the European banking sector and identifies examples of good practice. However, “good” practice is not necessarily “best” practice. This report acknowledges that we need nothing less than a radically different approach for directing capital toward environmentally and socially sustainable economic activities.

Clearly this report cannot provide all the answers to these challenges, and it does not set out to do so. We do hope it will provide a useful springboard for new thinking, new management practices, and, above all, for the action that will create the ‘next generation’ bank. A bank that will build corporate and societal value while addressing pressing environmental and social challenges.

Barend van Bergen
Partner and Global Head of Sustainability Advisory
KPMG Advisory N.V.

Foreword from WWF

This report contains an overview of the current approaches and practices of 12 major European banks regarding the integration of environmental and social factors in commercial and investment banking activities. It also includes an overview of how these banks integrate specific conservation concerns related to climate change, freshwater and those soft commodities that pose great threat to critical ecosystems and the Earth's natural resource base.

The survey shows that while the identification and control of environmental and social issues in the core banking practices is becoming more common, the integration of sustainability criteria in lending and investment banking activities still requires significant improvement if banks aim to protect the value of their assets in the short and longer term.

“Financial products are ultimately derivatives of the natural economy. The owners and managers of global financial assets are those most exposed to the systemic risks resulting from degradation of our planet's natural resource base. They also hold influence over the actions of firms and markets”¹.

The WWF 2014 Living Planet Report indicates that we are currently consuming natural resources at a rate faster than Earth is replenishing them or the

equivalent of 1.5 planets. At the current pace of growth, we would need three planets in the coming decades to meet humanity's needs.²

The trends outlined in the Living Planet Report will lead to increased uncertainty and may cause acute resource scarcity. This could have an impact on business value and might increase risks in banks' loan and investment portfolios. However, there is also opportunity for banks to create value – for their customers specifically, for society at large and for the planet. There are new financing opportunities that are to be created as we move to a renewable, fair and equitable energy base and invest in infrastructure consistent with a sustainable economy and the banking sector can play a critical role in financing the transition to a low carbon economy.

Banks can facilitate change by eliminating or reducing financing of certain sectors such as coal fired power generation, invest and lend in green technology, create value for clients by actively informing and advising on more sustainable choices and also by taking a role in promoting stronger environmental and social regulations.

Water is a new risk area where the banking sector should take a more engaged approach. WWF believes that the banking sector should

treat water as a critical ecosystem service and integrate water into risk analysis and portfolio composition while supporting active stakeholder engagement on regulation and governance matters for water-risk locations.

This study shows that the banks surveyed report a number of good practices in responding to reputational risks, and we hope this study will help to inform others along the journey of environmental and social risk integration. However it also shows that the banking sector at large does not yet have an adequate strategic response to manage all financial and business risks caused by environmental and social issues, and in doing so, to move from a reactive stance to a leadership role in enabling the transition towards a sustainable future.

Maria Boulos
Director, Corporate Engagement
WWF-International

¹ WWF (2012) The 2050 Criteria: guide to responsible investment in agricultural, forest and seafood commodities (http://wwf.panda.org/what_we_do/how_we_work/businesses/transforming_markets/solutions/commodity_financing/2050_criteria)

² WWF (2014) Living Planet Report (http://wwf.panda.org/about_our_earth/all_publications/living_planet_report/)

About this Survey

Scope

Participating banks

12 major European banks were selected for this research; see map in figure 1.

The selection was based on the size of the banks (in terms of balance sheet size), their relevance to the European banking sector in general, and their exposure to key environmental issues such as climate change, water and agri-commodities.

Focus on integration in commercial and investment banking

This report focuses on two core banking activities, Commercial and Investment Banking (CIB) activities, to allow for more detail and deeper understanding of integration of environmental and social (E&S) risks beyond policies. These activities represent a major share of banking activities and have a large impact on E&S issues.

The report discusses the integration of E&S considerations in core processes of the bank with particular attention to translating policy into practice ('beyond policy'). Incorporating E&S factors in core banking processes is a challenging task for banks. It is difficult to quantify E&S risks,

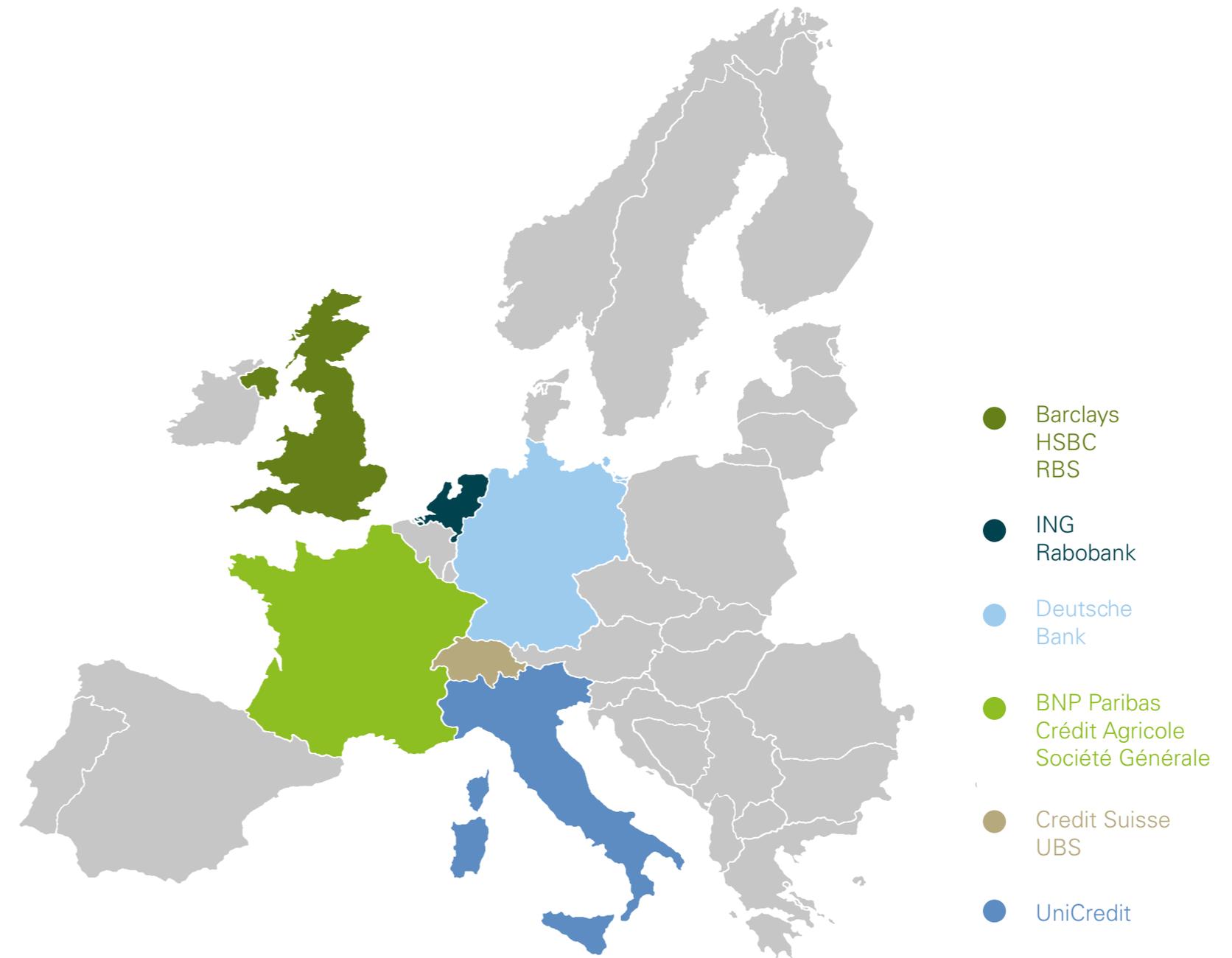


Fig. 1
Overview of participating banks

and most impacts are expected to materialize in the medium or long term. Most studies therefore focus on the integration of E&S factors in risk policies and guidelines. The ambition of this report is to provide good practices and insights for banks on how to address the practical challenge of implementation.

This survey focuses on integration into risk management at all levels (from client and transaction to portfolio risk management) and also addresses the incorporation of E&S factors in developing and pursuing business opportunities such as new product development and service offerings.

Information gathering

The report is based on desk research of (mainly) public information of the participating banks, plus additional insights from interviews with all the participating banks, conducted by KPMG professionals.

Desk research

The desk research phase took place from November 2013 through January 2014. The purpose of this phase in the information gathering process was to draft an initial profile and a customized questionnaire for each bank. All banks were invited to share relevant additional (non-public) information before the interview.

Interviews

The interviews with all the participating banks took place from January 2014 through March 2014. The purpose of the interviews was to complete the required information for this survey based on the customized questionnaire, and to engage with banks on their ideas on development and challenges of incorporating E&S factors in their core banking processes. Most interviews were conducted with a combination of global heads of sustainability and sustainability experts and senior E&S risk experts.

As indicated above, the information was collected from November 2013 through March 2014.

The sustainability or E&S risk strategies, policies, and activities of the participating banks may have changed since the completion of the research at the end of March 2014. These changes are not reflected in the findings presented in Part 1 of this report.

Methodology³

The following key areas were examined to assess the current approaches and practices of the banks related to the incorporation of E&S factors into their commercial and investment banking activities and decision making processes:

1. Strategic framework

This section assesses the extent to which the sustainability strategy is integrated in the corporate strategy, and in capital allocation and budgeting processes. This includes an assessment of the approaches/strategies the banks apply to manage the positive and negative impacts of core banking processes on E&S issues. For example, to what extent do banks consider E&S issues only as (reputational) risks or as potential business opportunities as well. Also, the type of sustainability targets banks have in place and responsibility for achieving them is assessed.

Definitions

Commercial banking

Business activities focused on large corporations (e.g. general lending, commercial finance, payments, and cash management), including project finance

Investment banking

Corporate advisory-related services and debt and equity capital transactions (e.g. trading, initial public offerings (IPOs), bond underwriting)

³ Methodology based on framework used in previous study by WWF and KPMG on sustainability performance of banks: see WWF Schweiz & KPMG (2012) Environmental performance of Swiss banks: shifting gears toward next generation banking

2. Integration in commercial and investment banking processes

Integration of E&S factors in these processes is assessed by the extent to which E&S factors are integrated in different risk management processes such as risk identification and assessment, risk appetite, risk controls, and client and transaction approval procedures. It is also assessed to what extent banks treat E&S factors as predominantly reputational risks or as issues that could cause counterparty default risks, actual business risks, as well.

3. Operating model

This section assesses the overall management framework to manage E&S risks and opportunities throughout the organization. It identifies where and how the critical work in relation to E&S risk and opportunity management gets done across the organization. The operating model is a vital link between a bank's sustainability strategy and the more detailed organizational design that it puts in place to deliver on the sustainability strategy. It includes an assessment of elements such as governance structure, operational infrastructure and organizational controls in relation to E&S risk and opportunity management.

4. Reporting and disclosure

External and internal reporting on E&S issues provides an idea of the extent to which these issues are integrated in mainstream banking activities. The disclosure of policies, portfolio, risk management framework, and voluntary frameworks is assessed, together with internal reporting on E&S risks and opportunities.

Each area consists of a number of underlying criteria for measuring the performance of the participating banks. The observed performance of the participating banks is assessed against scoring tables for each sub-element detailing four model observations ranging from minimal to assumed industry good practice⁴.

In addition to the four building blocks, the participating banks were assessed on their performance on the basis of three critical issues within the broad 'E&S issues' scope. These environmental issues constitute the areas of expertise and key agenda items of WWF:

- a. Climate change
- b. Water
- c. Agri-commodities

Good practices of banks

The report also showcases existing good practices of the banks to illustrate research findings and recommendations. The good practices were identified and selected by KPMG when evaluating the research outcomes. The actual descriptions of the good practices were formulated in cooperation with the relevant banks and do not necessarily represent the views of KPMG or WWF.

⁴ Assumed good practices was determined by assessing and comparing existing E&S practices and activities of the participating banks and should not be considered as an absolute statement of the ultimate objective for the sector. The good practices mentioned in this report are used as practical examples to illustrate our key findings and recommendations and should not be considered as an exhaustive enumeration of all good practices currently available in the European banking sector.

Relevance of including E&S factors in valuing and rewarding economic activity by banks

The world around us continues to change. Over the next 20 years, economies and businesses will be increasingly exposed to E&S megatrends that could bring both risks and opportunities in the search for sustainable growth. The IPCC, for example, warns in its Fifth Annual Assessment Report that if left unchecked, climate change will increase the likelihood of severe, pervasive, and irreversible impacts for people and ecosystems⁵. Furthermore, as a consequence of material resource scarcity individual companies are likely

to face increasingly tight trade restrictions and intense global competition for a wide range of material resources that become less easily available⁶. Those megatrends could also create opportunities. For example, the infrastructure requirements for a low-carbon economy, across transport, energy, water systems, and cities, are estimated at around USD 90 trillion, or an average of USD 6 trillion per year over the next 15 years⁷.

One of the flaws of the current economic model is that it is failing to include such E&S considerations in valuing and rewarding economic activity: in other words, to price externalities caused by these E&S megatrends. To create sustainable growth, not only now but also for generations to come, it is key to shift toward a different economic model, which takes into account the planetary boundaries through appropriate pricing.

Banks have the opportunity to be an agent of change, given their pivotal role in the allocation of capital and redistribution of risk. They have the ability to price material E&S externalities, and by doing so help catalyze the transition toward a more sustainable global economy. It is also in their own interest to do so. E&S issues

like climate change, water scarcity and ecosystem decline are already impacting the risk profiles and current and future cash flows of sectors and companies they finance and invest in. Not taking into consideration these E&S issues in valuing and rewarding economic activity would be unwise and reduce the bank's resilience. It is not a matter of 'if' E&S externalities will be internalized by regulations, market dynamics, and stakeholder actions, but 'when' and 'to which extent' this will happen.

Furthermore, consumers and society also expect from banks that they take such sustainability issues into consideration in their financing and investment activities and to have a positive impact on societies in which they operate⁸.



⁵ Intergovernmental Panel on Climate Change (IPCC) 2014, Fifth Assessment Report

⁶ KPMG International 2011, Expect the Unexpected – Business value in a changing world

⁷ The Global Commission on the Economy and Climate 2014, Better growth & better climate – the new climate economy report

⁸ See for example, WWF Schweiz & KPMG 2012, Environmental Performance of Swiss Banks – shifting gears toward the next generation bank

To assess the extent to which banks already include E&S considerations in valuing and rewarding economic activity, this report aims to gain a better understanding of how banks are currently integrating such considerations in their commercial and investment banking activities and decision making processes. In their journey toward full integration of E&S factors in these core banking activities, banks are confronted with major challenges. The second ambition of this report is to provide banks with good practices, insights, and practical recommendations to support banks on this journey.

The results of the survey are presented in two parts:

Part One



Environmental & social risk and opportunity management: current approaches and practices

This section looks at the current status of the integration of E&S factors into the commercial and investment banking activities of the 12 major European banks that participated in the survey.

Part Two



Recommendations for bringing environmental & social risk and opportunity management to the next level

This section provides banks with practical recommendations and insights on how to further integrate E&S factors in their commercial and investment banking (CIB) activities.

Part One:

Environmental & Social risk and opportunity management: current approaches and practices



Sustainability strategies of banks aim to both protect and create value

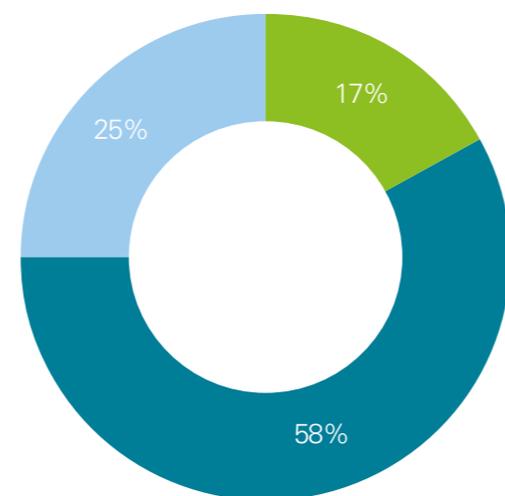
Sustainability strategies of banks are changing

To manage the E&S issues within their commercial and investment banking (CIB) activities, most banks in the survey have developed sustainability strategies aimed to both protect and enhance the long-term business value created by these core banking activities. The research shows that the banks are starting to move their sustainability strategies toward the 'next level', beyond a single focus on enhanced (reputational) risk management (see figure 2). Only 17% of the banks have a sustainability strategy in place that is only focused on managing the reputational and/or other downside risks of E&S issues within their CIB business. These strategies aim to avoid harm and minimize the negative impacts of their CIB activities by avoiding business engagements with companies that are involved in, for example, environmental pollution or abuses of human rights. These banks aim to protect their short and longer-term business value with such (reputational) risk-driven strategies.

83% of the banks go one step further. They are moving toward the opportunity side of sustainability as well, with the ambition to not

only manage the negative impacts of their CIB activities, but also to create value for the bank and society. Such strategies aim to provide, for example, financing structures and knowledge to solve certain environmental and social challenges, such as the transition to a low-carbon economy or more sustainable commodities supply chains.

Fig. 2
Type of sustainability strategy



- Strategy mainly (reputational) risk driven
- Strategy both (reputational) risk and opportunity driven; opportunity side lacks systematic approach and is limited in scope
- Strategy both (reputational) risk and opportunity driven; opportunity side has systematic approach and is limited in scope



Sustainability activities focused on creating value still immature

Figure 2 also shows that the sustainability-related activities and programs within the CIB divisions, aimed at creating a positive impact on both bank and society, are currently immature at most banks. Only 25% of the banks execute opportunity-driven sustainability activities in a systematic and strategic way throughout the whole bank. At 58% of the banks, such activities are mainly driven by a single pocket of expertise within the commercial or investment banking division, for example, energy sector team or sustainable lending/advisory team within the commercial banking division. Furthermore, these activities have limited scale compared to their mainstream activities and are also restricted to the more obvious opportunities in the field of renewable energy and clean

technologies such as financing renewable energy solutions and providing energy-efficiency loans at a corporate level, project finance, and structured finance relating to clean or renewable energy production and the trading of CO₂ certificates. Value-creating activities of a reasonable size in the field of water scarcity, resource scarcity, circular economy, sustainable agriculture, etc. are less common.

Although 25% of the banks apply a more systematic and strategic approach on managing business opportunities caused by E&S issues (see good practices below), none of these banks have integrated E&S factors in their annual capital allocation and budgeting process yet.

Good practices

Sustainability strategies

HSBC

Climate Business

HSBC's Climate Business includes banking activities that focus on seeking long-term commercial business opportunities arising from the transition to a low-carbon economy. Climate Business is formally embedded in the organisation and managed both top-down to ensure a consistent approach and bottom-up i.e. client-driven. HSBC's Climate Business Council, established in 2010, is the central body representing all commercial business divisions which aims to ensure the significant opportunities arising from this sector are realised.

Société Générale

Positive Impact Finance

The "Positive Impact Finance" project seeks to promote the financing of investments or programs that have a demonstrated positive impact on one of the sustainable development pillars provided (e.g. the environmental or needs of the population) and have appropriate corrective measures in place for potential negative impacts. Société Générale has developed "Positive Impact Finance" as a strategy to bring additional finance to bridge the existing gap between investors' appetite and the huge investment needs to address the basic needs of the population, and the development of the poorest countries, while taking into account planet boundaries. In 2014, Société Générale booked for more than EUR 950 million (total investment in the projects reaching more than EUR 9 billion), which represents an increase of 53% versus the EUR 619 million reported in 2013.

Sustainability strategies to some extent aligned with business strategies

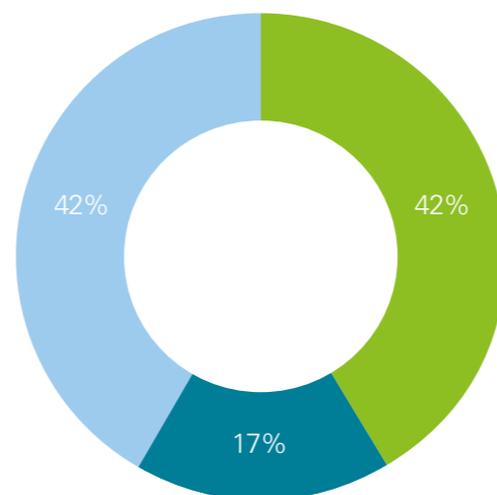
Some banks consider sustainability to be a strategic priority

To bring their sustainability strategies to the 'next level', more than 50% of the participating banks have somewhat aligned the sustainability strategy with their business strategy (see figure 3). Approximately 40% of these banks have strongly aligned their sustainability strategy with the business strategy by making sustainability explicitly part of their business strategy. These banks consider sustainability to be one of the strategic priorities of their business strategy. 17% of the banks consider sustainability to be a way of contributing to the execution of the business strategy.

Close to 40% of the banks only implicitly mention sustainability in their corporate strategies. These banks mention sustainability in their business strategies, but it is not operationalized or exactly clear how sustainability contributes to the execution of the strategy.

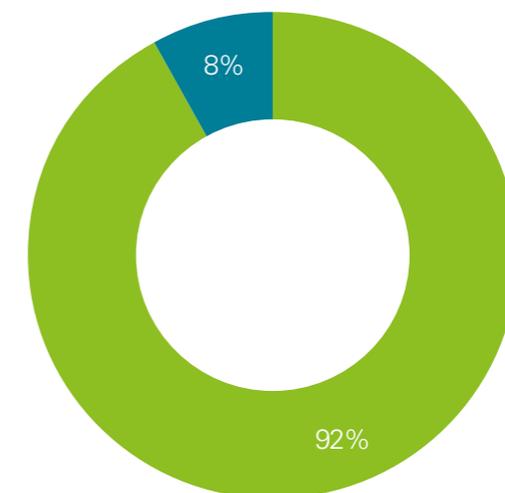


Fig. 3
Level of alignment sustainability strategy with business strategy



- Weakly aligned with business strategy
- Aligned with business strategy
- Strongly aligned with business strategy

Fig. 4
Type of sustainability targets



- Qualitative Sustainability targets
- Both qualitative and quantitative Sustainability targets



Quantitative sustainability targets are currently lacking

The outcome that more than half of the banks have somewhat aligned the sustainability strategy with their business strategy could imply that the relevance of sustainability for the long-term value-creating potential of banks and the call for a more societal role of banks⁹ has been picked up by the leaders and senior managers of the banks. However, the alignment of the sustainability strategy with business strategies also creates new responsibilities for banks. Firstly, sustainability strategies should be executed and result in better business performance. In practice, this means that sustainability strategies should be translated into specific and clear targets and KPIs for individual business divisions, such as commercial and investment banking. Secondly, banks should be able to explain to investors and other stakeholders how their sustainability decisions and actions are linked to the long-

term business performance. In other words, banks should be able to help investors to connect sustainability performance with its implications for the current, mid/long-term business performance. If banks are not able to follow up on these two tasks, they run the risk of the alignment of the sustainability strategy with the business strategy being regarded as a marketing or reputation enhancement action, or even green washing, by external stakeholders.

Despite the fact that the banks surveyed have somewhat aligned their sustainability strategy with the business strategies, most banks have formulated only qualitative sustainability targets for managing the sustainability activities and programs within their CIB divisions (see figure 4).

⁹ See, for example, Respublica (2014), Virtuous banking: placing ethos and purpose at the heart of finance

Good practices

Aligning sustainability strategies with business strategies

Barclays

Integration of sustainability in goal, purpose, and Transform program

Barclay's 2015 Citizenship Plan is integrated in its corporate goal (becoming the 'Go-To' bank for all stakeholders), purpose (helping people achieve their ambitions, in the right way), and the RISES values (Respect, Integrity, Service, Excellent, Stewardship). Furthermore, the 2015 Citizenship Plan is embedded in Barclay's Transform program, the strategy that will help Barclays to become the 'Go-To' bank. In this program, sustainability contributes to achieving the overarching goals 'Turnaround' and 'Sustain FORward Momentum' by providing additional guidance for cultural change and on how Barclays wants to do business now and in the future. Finally, an externally reported Balanced Scorecard has been introduced by Barclays to define what it needs to achieve to become the 'Go-To' bank and demonstrates what success looks like across "5 C's": Customer & Client, Colleague, Citizenship, Conduct, and Company.

Rabobank

Quantitative sustainability target in place for commercial banking division

Rabobank has formulated a quantitative sustainability target for its commercial banking division. The bank has a sustainability target on the percentage of wholesale clients that needs to be screened on an annual basis through GAIA, its proprietary E&S customer assessment system. This target is also included in the performance scorecard of the management team of the commercial banking division.

Accountability for sustainability performance not yet fully embedded

Supervision of sustainability targets is not always cascaded into CIB divisions

Accountability for sustainability performance is not yet fully embedded in most banks. Although sustainability strategies are becoming more advanced and aligned with business strategies (see, for example, figure 3), ownership and accountability of sustainability performance and implementation is still only assigned to sustainability departments and Board member(s)/committees in 50% of the banks. In these banks, senior and middle management in the CIB divisions does not have a formal supervisory role regarding the sustainability performance of their divisions (see figure 5). In only 17% of the banks, the supervision of sustainability targets is assigned to not only the sustainability department and senior management, but also to the department/team managers of the CIB divisions.

Sustainability-related KPIs in performance dashboards managers of CIB divisions not common practice

Furthermore, despite the fact that sustainability strategies of the banks are to some extent aligned with their business strategies, in only 50% of the

banks, senior and/or middle management within the CIB divisions has sustainability-related KPIs in their performance dashboards (see figure 6). In all other banks, responsibility and accountability for implementing sustainability strategies and programs is assigned only to the sustainability department, with support from the Board/Board member, although one bank has no KPIs in place.

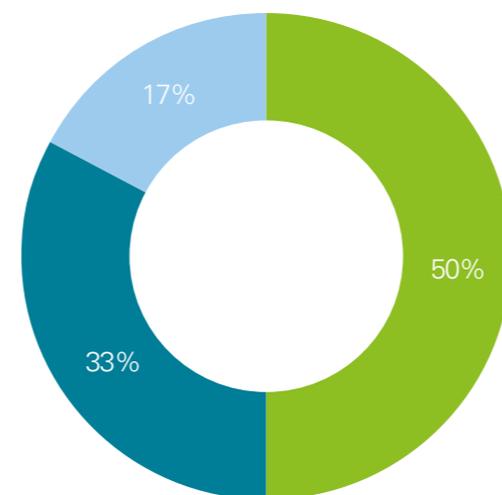


In their journey toward full integration of E&S factors in everything they do, the role and commitment of senior and middle management in implementing sustainability strategies and programs is not yet fully utilized by the banks. There seems to be a misalignment between the sustainability ambitions and strategies and the governance structures needed to drive these ambitions and strategies.

This potential mismatch could further prevent the integration of E&S factors in the business processes and activities of the CIB divisions. Accountability and ownership, including integration of E&S factors in incentive schemes, are important elements for creating a strong E&S risk culture within the division to stimulate the desired conduct of employees. It creates understanding and clarity on what is expected from the different departments and divisions in terms of sustainability.

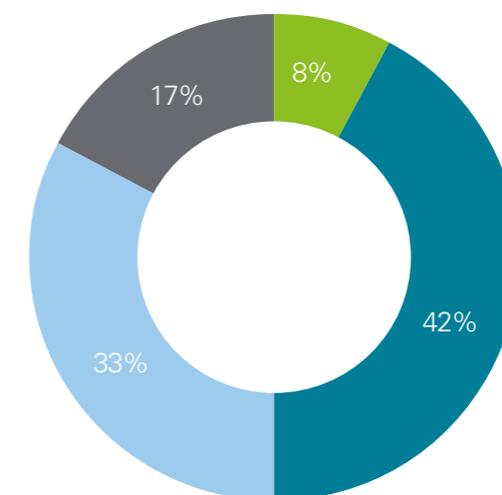
It also prioritizes E&S risks in the decision-making frameworks of the divisions. Without a strong E&S risk culture and desired conduct of employees within the CIB divisions, it will be difficult for banks to promote a more sustainable economy and to fully integrate E&S factors in the organization.

Fig. 5
Supervision of sustainability targets



- Sustainability department and/or at Board-level
- Sustainability department, at Board-level and senior management at Business division-level
- Sustainability department, at Board-level and senior middle management at Business division-level

Fig. 6
Integration of sustainability-related KPIs



- No KPIs formulated
- KPIs at Sustainability department-level and/or Board-level
- KPIs at Sustainability department-level, Board-level and senior management Business division-level
- KPIs at Sustainability department-level, Board-level and senior and middle management Business division-level

Good practices

Accountability for sustainability performance

ING

Commercial lending teams held accountable for sustainable financing

All global commercial teams of ING's commercial banking are developing growth strategies and action plans through dedicated resources towards sustainable lending. A KPI-dashboard for example, with the percentage of sustainable lending was launched in 2013 and is accessible via the intranet. Senior managers responsible for commercial lending have compensation-related targets set for identifying clients and transactions which support the transition towards a sustainable economy.

Crédit Agricole

Oversight sustainability targets at group and divisional level

Crédit Agricole's sustainability approach 'FReD' cascades responsibility into the organization. The Group's sustainability team sets a framework for different actions on CSR, but divisions choose most of their 15 annual actions themselves within this framework. The group sustainability team also determines annual group priorities, which are compulsory for all divisions to include in their sustainability action plans. To further embed the accountability for sustainability performance in the organization, Crédit Agricole has included financial incentives for CSR

performance in the variable compensation of the Group Executive management. One third of their deferred variable compensation is indexed to CSR performance through the FReD progress index. The Long Term Incentive (deferred payment with 2-4 year horizon) for the Group's executive managers is composed of one third market performance, one third results of the company and one third CSR performance of the group, as measured by the FReD index. The FReD Index is audited every year by one of the Group's statutory auditors

E&S risk management frameworks at transactional level in place

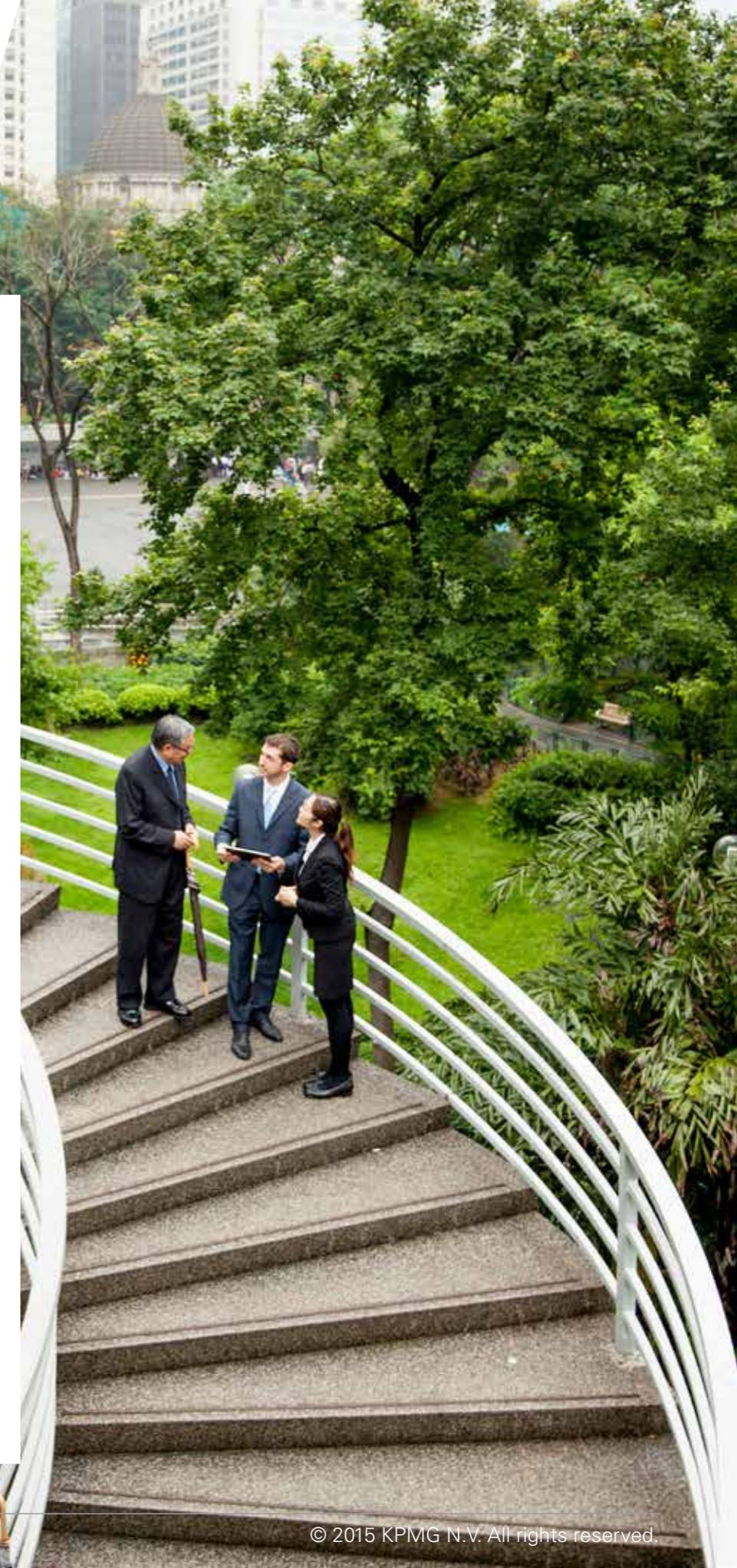
E&S risk management framework applied to all CIB activities

All the banks that participated in the survey have an E&S risk management framework in place to identify, assess, classify, and manage potential E&S risks or issues associated with a transaction, client, or project in their CIB activities.

An E&S risk management framework consists of E&S risk policies, procedures, governance, capabilities, and guidance that a bank follows to review and manage the E&S risks or issues. The E&S risk management frameworks of the banks apply to all CIB activities, products and services. Only the practical application of the framework may vary within and between these core banking activities. Factors which might influence the approach to E&S risk screening and management are, for example, the type of financial service offered (e.g. generic corporate loan vs. project finance transaction), the role of the bank in the financial transaction (single financier vs. part of a broader consortium), and the industry sector (low vs. high E&S risk sector) that the client is operating in.

Strong E&S screening and due diligence processes in place at most banks

All the banks apply a transaction and client E&S risks managed E&S screening and due diligence across the lines of business. When entering into a business engagement, 58% of the banks assess and classify potential E&S risks or issues at both client and transactional level. Banks classify a client's or transaction's E&S risk as, for example, high, medium/high, medium or low-risk. 42% of the banks only assign an E&S classification to either clients or transactions (see figure 7). At all banks, the E&S screening and due diligence at client level is undertaken as part of the overall client on-boarding process (e.g. as part of know your client (KYC) check). The E&S screening or due diligence at transactional level is applied when the bank engages in a transaction with a client operating in a sensitive or high-risk sector from an E&S perspective. In general, the banks first undertake an E&S screening at client level to check whether the client activity is in line with the bank's E&S risk policies and principles, irrespective of the transaction. Once the bank is comfortable with the client, it applies an E&S screening at transactional or project level.





E&S risk policies mainly sector-based and primary responsibility for implementation assigned to front office

To support the E&S screenings across the lines of business, all banks have a clear E&S risk policy framework in place, consisting of mainly sector policies, guidance, and escalation criteria for assessing and managing transactions and client relationships in sensitive or high E&S risk sectors (see also next section) such as sector policies for the chemical sector, metals and mining, oil and gas, and utilities sector.

To identify, assess, classify, and manage the potential E&S risks and issues associated with a transaction, client, or project in CIB activities, all the banks involve both front office employees

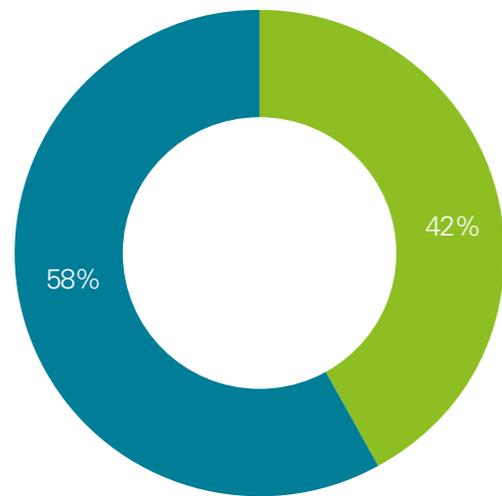
(i.e. employees who have direct client contact and originate transactions) and risk management departments. Front office employees execute a first assessment and classification of the potential E&S risks and issues, with escalation options and triggers to the E&S risk experts within the risk departments at group or decentralized level (see figure 8). Almost all banks (92%) have a formal and mandatory escalation process on E&S risks and E&S risk experts in place for at least transactions, project, or clients in sensitive or high E&S risk sectors.

At some banks, the compliance department also plays a role with regard to E&S screening at client level. To embed E&S risk management more deeply in their core banking activities, the banks aim to further increase the involvement of front office employees by, for example, improving their E&S understanding, knowledge, and capabilities.

To further support and enable implementation of the E&S risk management frameworks by front office employees and E&S risk experts, all banks have E&S screening tools and infrastructure in place. In most cases, banks have developed

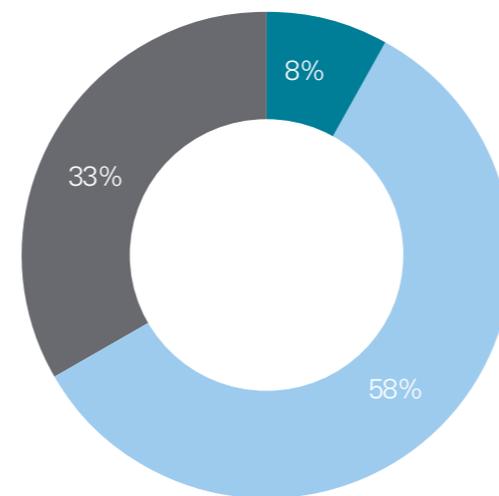
sector and/or issue-specific checklists to support the E&S screening and due diligence process (see figure 9). Three banks developed more advanced proprietary tools such as media search tools, reputational risk tools, etc.

Fig. 7
E&S classification assigned to clients and/or transactions



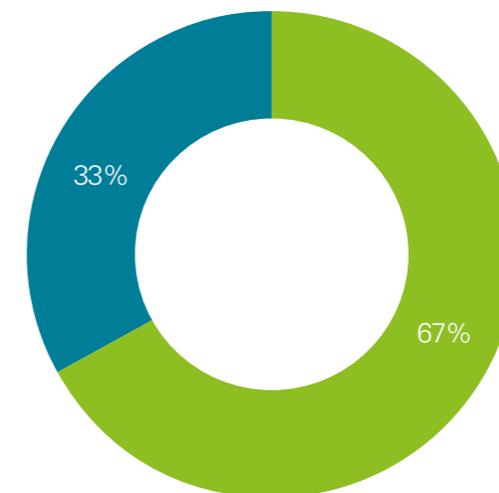
- Internal E&S rating/classification for transactions or clients
- Internal E&S rating/classification for both transactions and clients

Fig. 8
Type of E&S risk escalation processes



- No triggers applied
- Voluntary escalation to an E&S risk expert
- Mandatory escalation to an E&S risk expert for high risk transactions in sensitive sectors/areas only
- Mandatory escalation to an E&S expert for all transactions in sensitive sectors/areas

Fig. 9
Type of tooling for E&S risk assessment in client/transactions approval



- Sector/Issue-specific checklists to support E&S due diligence
- Sector/Issue-specific checklists to support E&S due diligence in combination with advanced tooling (e.g. information database/search engines)

Good practices: E&S risk management frameworks

UBS

Integrated screening approach to identifying potential risk

At UBS the screening of corporate clients for E&S risks is integrated into, rather than an add-on, to the bank's due diligence processes. UBS implements a strong global E&S risk management system to manage the sustainability risks of its lending and financing transactions. The environmental risk management system is part of the ISO 14001 certification of UBS and is verified annually by an independent third party and is part of an annual sustainability disclosure assurance audit.

Before onboarding a new corporate client or proceeding with a transaction, the compliance

officer or relationship manager runs the client's name against a global database as part of the standard Know Your Customer processes. This database includes advanced data analytics on companies associated with E&S risks. If this check uncovers potential E&S risks at client level, the client is then referred to the E&S risk team for further assessment. The systematic nature of this tool significantly enhances UBS's ability to identify potential risk. In 2014, over 1,800 referrals were assessed by the E&S risk unit, of which more than 50 were rejected or not pursued, and more than 180 were approved with qualifications.

Credit Suisse

Decentralized E&S governance model

Credit Suisse applies a regional governance structure for supporting the integration of sustainability in the core banking processes. Credit Suisse has a global Sustainability Affairs team with approximately ten professionals with operative responsibility for a range of sustainability activities, which includes regional sustainability contacts across the different regions the bank is operating in (Switzerland, EMEA, Asia Pacific, and Americas).

This gives Credit Suisse the advantage of being very close to the business, enabling it to build up strong relationships with front office employees, and having a better understanding of what is going on in the individual business units of the bank.

Good practices: E&S risk management systems

BNP Paribas

Outcomes application E&S risk identification and assessment process:

BNP Paribas reviews a large number of transactions on E&S risks, and a relative high percentage of these reviewed transactions results in a 'not fully compliant' with conditions for finance. This happens throughout the entire loan portfolio; in 2014, 56 of 481 transactions reviewed at the CSR Group level were rejected.

Rabobank

Proprietary GAIA system

Rabobank has a proprietary customer assessment system in place, called GAIA, for all its corporate clients. It is an IT system that supports client relationship managers in its individual business units to annually assess and review/update the E&S risk and opportunity profiles of new and existing clients as part of the transaction approval processes.

GAIA consists of several tools:

- **country scan:** shows the client relationship manager all relevant E&S issues per country in which a client is active;
- **sector scan:** provides an overview of all Rabobank Group's sector policies that are applicable to the client;
- **web-based search engine:** this proprietary search engine enables the client relationship manager to search for relevant public information about the E&S performance and approach of clients; if the client is involved in any E&S-related lawsuits, for example.

- **Sustainalytics client profiles;**
- **SIGWatch and RepRisk company information** to provide relationship managers with more qualitative data.

GAIA enables Rabobank Group to gather a broad range of discussion points on E&S issues in its role as an engagement partner for clients and to respond to risks in accordance with internal policies. For business clients that have more than one million euros in financing a client photo should be made, that includes a sustainability rating and corresponding argumentation. For this purpose, the supporting IT-systems for Wholesale, Rural and Dutch business clients are complemented with sustainability trends, best practices and sample questions per sector.



E&S risks managed from a sector perspective

Mainly sector specific E&S risk policies in place

As part of their overall E&S risk management framework, the banks have a clear E&S risk policy framework in place to support the E&S screening and due diligence process at a transactional level, as shown in previous section. However, the E&S risk policies, guidelines, and escalation criteria the banks have developed are mainly sector-based. Only 25% of the banks have also developed E&S issue-specific policies and guidelines to identify, assess, classify, and manage potential E&S risks in transactions and client relationships (see figure 10 and 11). Besides E&S risk sector policies, these banks have developed policies on material E&S issues such as biodiversity and agri-commodities supply chains and have integrated these policies into E&S screening and risk management processes.

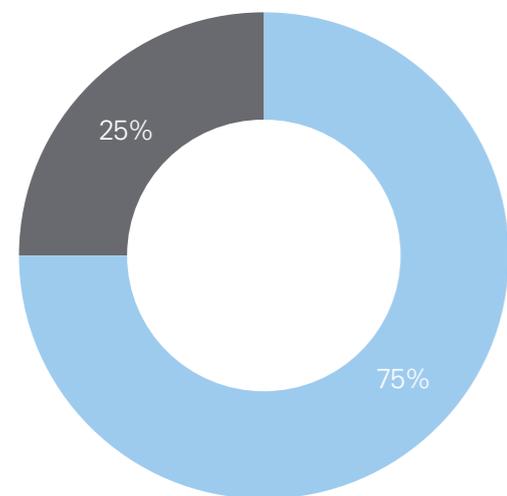
Several other banks have developed E&S issue-specific position statement or ambitions (e.g. mainly in human rights and climate change), but have not translated these high-level policies into concrete guidelines and screening and decision making criteria for E&S risk management purposes yet.

By managing E&S risks mainly from a sector perspective, banks run the risk of not taking into consideration cross-sectoral E&S risks. E&S issues such as climate change, water scarcity, and resource scarcity could impact the risk profile and cash flows of companies of several sectors. From a risk management perspective, it is important for banks to understand, assess, and manage such risk exposures to certain E&S issues. Otherwise, this could potentially lead to concentrations of risk exposures to certain E&S risks.

Not including issue-specific policies and guidelines in the E&S risk management framework could impact the quality and depth of the E&S screening and due diligence in the transaction and client approval processes of the banks. Not all E&S issues are financially material in a business engagement. It is key that front office employees and E&S risk experts pay particular attention to the

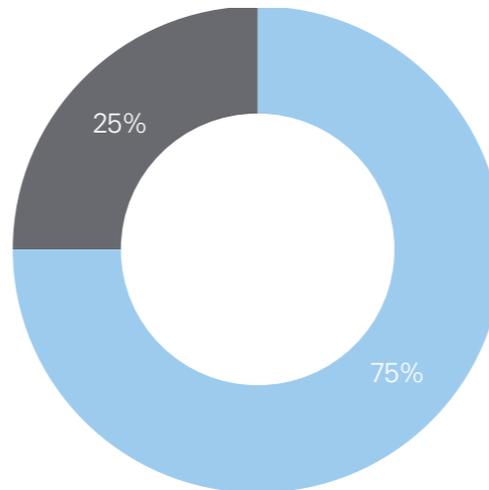
financially material E&S issues and understand and assess how clients are managing these issues. E&S issue-specific policies and guidelines could provide front office and E&S risk experts with a better understanding and knowledge of a particular E&S issues and the specific knowledge and clarity for appropriately assessing the client's performance regarding these issues.

Fig. 10
Type of E&S risk policy framework

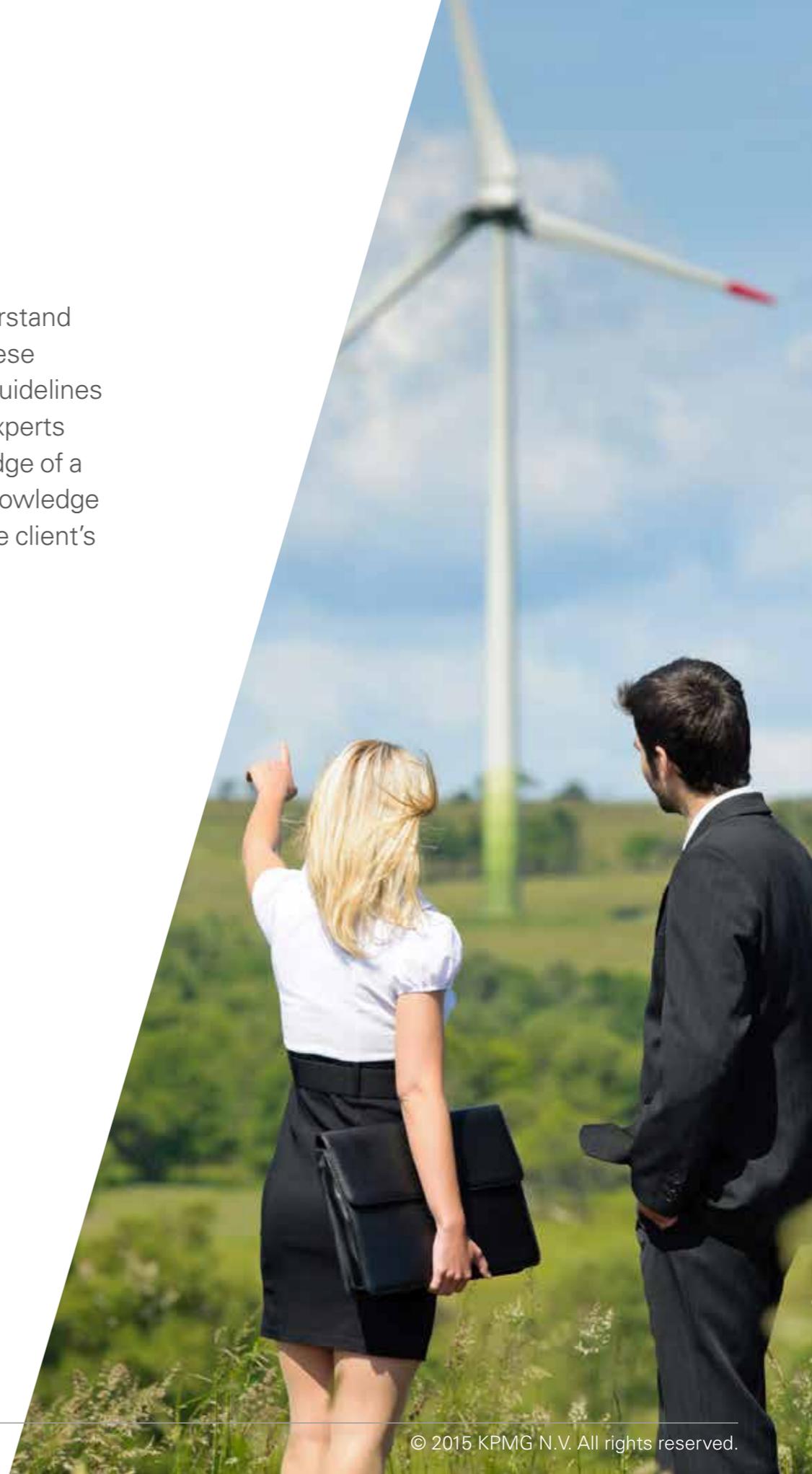


- No
- Single sustainability policy
- Sector specific policies
- Sector specific and issue policies

Fig. 11
Nature of E&S checklists



- None
- General
- General and Sector specific
- General, Sector and issue specific



Good practices:

Issue specific E&S risk policy

Société Générale

Cross-sectoral issue policy on biodiversity

Société Générale has eleven sensitive sector policies in place. In addition to this general framework of sectoral policies, Société Générale has developed a cross-sectoral policy on the specific E&S issue of biodiversity. The cross-sectoral policy includes material aspects related to biodiversity, which are considered in client- and transaction reviews, such as habitat loss or degradation, over-exploitation, and dependence on ecosystem services. At a minimum, Société Générale requests compliance with E&S laws and regulations on biodiversity in each relevant

country. Société Générale has defined biodiversity criteria that are integrated in its decision-making process when considering the provision of banking and financial services. For new dedicated transactions with a potential material impact on national and international legally protected areas or other key biodiversity areas, for instance, a third party assessment has demonstrated that the client has an active biodiversity approach and adequately consults with the local population and other relevant stakeholders.

Limited E&S risk management at portfolio level

E&S risks mainly assessed and measured at transaction level

To assess, classify, and manage E&S risks and related reputational risks, the banks are strongly focused on managing these risks at the level of individual transactions, clients, and projects. Most banks in the survey do not systematically assess and measure E&S risks at portfolio level. Only 17% of the banks assess and measure E&S risks at portfolio level based on E&S classifications (e.g. percentage of high-risk transactions at portfolio level/in some sectors) or risk exposures to certain E&S issues like climate change or biodiversity (see figure 12). All other banks manage E&S risks and related reputational risks only in the client and/or transaction approval processes and its corresponding periodic review process. These transaction-specific risks could be narrowly defined and might not reflect the broader portfolio-wide E&S risks for the bank, for example, cross-sectoral risks and concentrations of risks exposures to certain E&S risks.

Limited focus on actively managing E&S risk exposures of existing portfolios

Besides limited E&S assessment and measurement at portfolio level, banks also do not yet systematically implement E&S measures to mitigate the E&S risk exposures of their current CIB portfolios and reduce the E&S impacts of their CIB activities. 83% of the banks take E&S measures incidentally or on a case-by-case basis to reduce the E&S risk exposures of their client

and loan portfolios (see figure 13) and improve the sustainability performance of their clients. To manage and monitor the E&S impacts of their CIB activities, most banks generally regard their client and transaction approval process, and corresponding periodic review process, as the key point of leverage to influence the E&S performance of (new) clients. Potential E&S measures are defined and implemented, on a case-by-case basis, to enable clients to comply with the bank-specific E&S risk policies and standards. Banks are less focused on active

Fig. 12
Assessing and measuring E&S risks at portfolio level

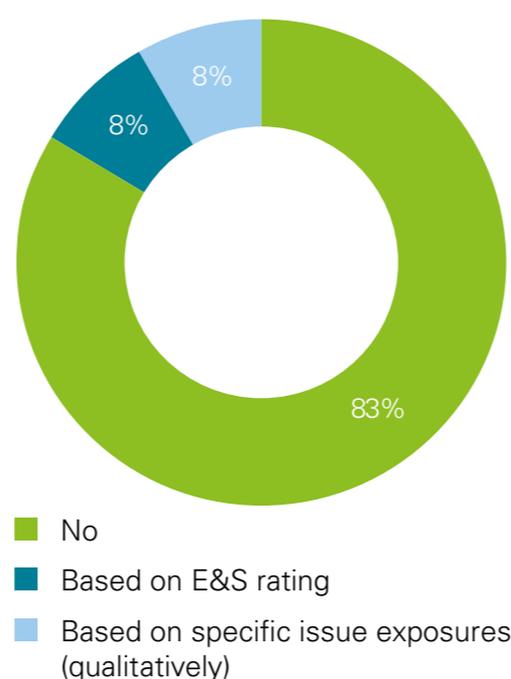
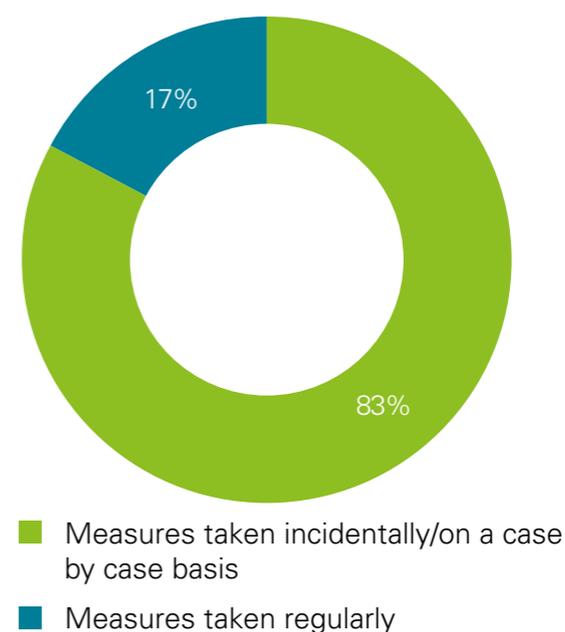


Fig. 13
Measures taken to improve E&S performance of existing clients



Good practices: E&S risk management at portfolio level

management of E&S risk exposure of their client and loan portfolio by further improving the E&S performance of existing clients who already comply with internal E&S risk policy criteria. Currently, only 17% of the banks had moved from selection at the gate to active management and monitoring of E&S risks at portfolio level. In other words, banks typically engage with their clients on E&S issues rather than guide them outside the transaction flow.

UBS

Investment banking portfolio monitoring

UBS moved toward a more integrated and broader approach in addressing E&S business opportunities within its investment banking division. UBS mapped its total client base in the area of capital raising and strategic advisory services to identify and select companies that

offer products that make a positive contribution to climate change mitigation and adaptation. In 2014, Investment Bank supported 175 such clients, either in equity or debt capital market transactions (total deal value CHF 17 billion) or as financial advisor (total deal value CHF 14 billion).

Room for further integrating E&S factors in the bank-wide risk management framework

E&S risks not yet integrated in bank-wide annual risk identification and assessment process

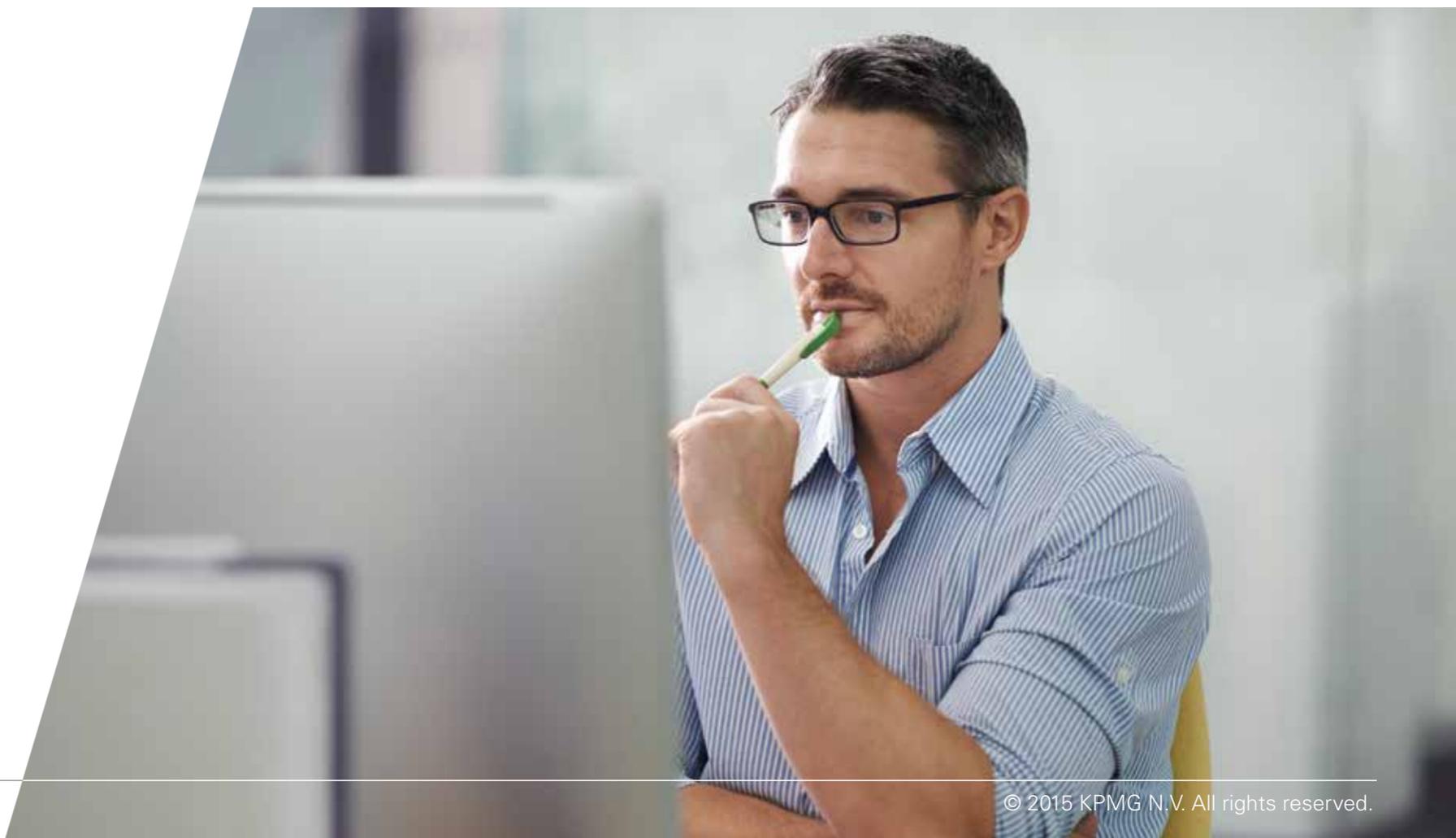
Although the banks have an E&S risk management framework in place at transactional level, most of them have not fully integrated E&S factors in their bank-wide risk management frameworks yet to, among other things, encourage more consistent E&S risk management across the bank. The bank-wide risk management framework is the framework through which the Board and management:

- establish the bank's strategy,
- articulate and monitor adherence to risk appetite and limits, and
- identify, measure, and manage material risks.

In their bank-wide risk management frameworks, most banks regard E&S risks not as a separate principal risk category of their risk profiles, but mainly as part of the reputational risk category, despite the fact that more than 40% of the banks in the survey made sustainability an explicit element of their business strategy.

Accordingly, the annual E&S risk identification and assessment process is the task of the bank's sustainability department and has not yet been systematically integrated in the bank-wide annual risk identification and assessment process of principal risk categories like market, credit, and liquidity risks (see figure 14). For example, E&S issues are not yet part of most banks' scenario analyses or stress tests. In addition, at almost all banks, the periodic E&S risk identification and

assessment process is qualitative and not yet quantitative in nature as part of, for example, the internal capital adequacy and assessment process (ICAAP) of the bank. In general, the surveyed banks have difficulties with quantifying the E&S impacts on their business. This limited ability to adequately quantify E&S impacts could restrict further integration of E&S factors in credit risk management.



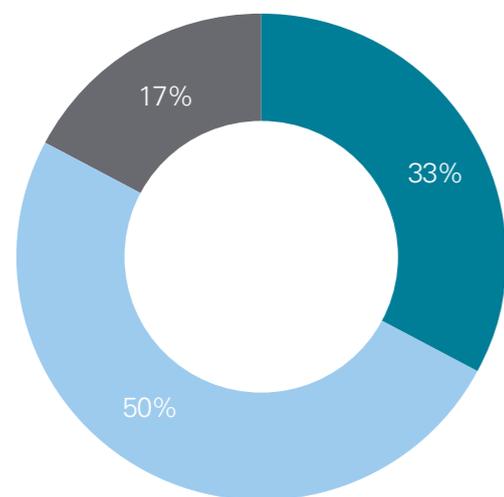
E&S risks not yet included in risk appetite statements and risk limits frameworks

Furthermore, at most banks, E&S risks are not yet included in the banks' risk appetite statement (RAS) or risk limits framework (see figures 15 and 16). Only one bank in the research integrated E&S factors in the risk

appetite statement or risk limits framework to some extent.

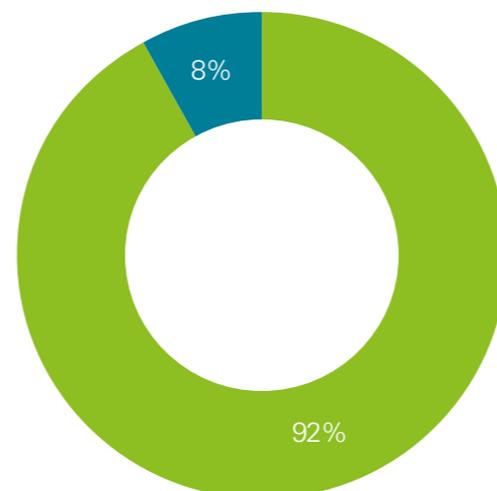
E&S factors are also not yet integrated in the risk models of the banks as leading indicators in determining the risk level of assets and calculation of capital requirements. More than half of the banks do not yet include E&S factors in the determination of the internal credit ratings of clients. Only one third of the banks use them on a case-by-case basis.

Fig. 14
E&S integration in bank-wide risk identification and assessment process



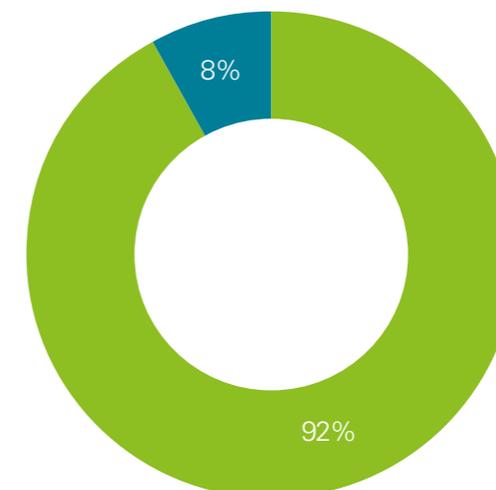
- No
- Incidentally
- Regularly
- Structurally

Fig. 15
Integration of E&S factors in risk appetite statement



- No
- Yes, both Social and Environmental risks

Fig. 16
Risk limits framework that addresses E&S risks



- No
- Limits based on E&S rating

Good practices: Integration of E&S factors in bank-wide risk management framework

HSBC

Identification and assessment of bank-wide risk management framework

Sustainability risk is considered to be one of the material risk categories (separate from reputation risk) of the risk profile of HSBC. Sustainability risk identification and monitoring is

part of HSBC's monthly risk mapping process, the bank's mainstream process for identifying, assessing, managing and monitoring the bank's risks.

E&S risk reporting and disclosure in its infancy

Market participants, like analysts and investors, should be enabled to assess relevant information about a bank's risk exposures, measures, and management to assess the bank's long-term soundness and profitability. For example, it is key for investors to understand the mid- to longer-term business vulnerabilities of a bank and how they are managed. Since E&S factors can have a material effect on a company's risk profile, reputation, and hence could have a financial impact on the firm's performance¹⁰, it is key that banks report and disclose relevant information about their risk exposures to E&S risks and how these E&S risks are measured and managed.

Limited reporting and disclosure on E&S risk exposure and management

The survey outcomes show that E&S risk reporting and disclosure by major European banks is still fairly limited. Looking at the level of transparency regarding how E&S risks are being managed, only 25% of the banks provide investors and other stakeholders with a complete overview of their E&S risk policies and the way these policies are being applied (see figure 17). 50% of

the banks only publicly disclose a summary of their E&S policies and way of application.

In addition, reporting and disclosure on risk exposures of banks related to E&S factors is not yet common practice at these banks. Most banks do not provide detailed information about the E&S risk profile of their loan portfolio to investors and other stakeholders (see figure 18). 75% of the banks only disclose a breakdown (e.g. by sector or region) of their project finance portfolio, mainly driven by the reporting requirements of the Equator Principles¹¹.

Only 25% of the banks go beyond project finance and provide a sector breakdown of their entire loan portfolio. In addition to such a sector breakdown, 17% of the banks also provide a detailed breakdown of their energy sector portfolio (e.g. % of loans in the energy sector allocated to renewable energy, gas-power generation, etc.)

Furthermore, in this research, no bank has been identified that discloses information on how current and emerging E&S trends link to such loan portfolio mappings and which implications this might have for the current and medium- to long-term business performance.

Integration of E&S factors in Pillar 3 reporting is lacking

Pillar 3 reporting is a sector standard about the way banks should disclose information about risks, as well as their risk measurement and management, to assist market participants in better understanding the overall risk profile of an institution. Pillar 3 reporting is part of the Basel III framework.

Pillar 3 reports are currently not used by the banks to disclose their E&S risk profile and management practices to investors and other stakeholders (see figure 19). 83% of the banks do not disclose E&S factors in their Pillar 3 reports, either as separate risk category or as part of credit risk. Only 17% of the banks in this survey disclose information on the E&S risk management activities of the bank in their Pillar 3 report as part of the credit risk paragraph.

10 Oxford University & Arabesque Partners (September 2014): From the stockholder to the stakeholder

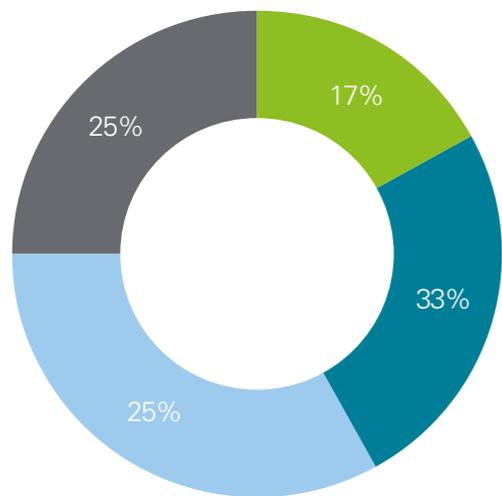
11 For reporting requirements pursuant to the Equator Principles, please see: <http://www.equator-principles.com/index.php/members-reporting/reporting-requirements>

At present, Basel III does not explicitly require or encourage banks to disclose information about (systemic) E&S risks or risk practices in Pillar 3 reports. However, Pillar 3 does require extensive disclosure on credit risks of banks. Because E&S risks could be considered as potential credit risks, one could argue that banks

are implicitly required to disclose E&S risk information in their Pillar 3 reports. In addition, more than 40% of the banks integrated sustainability in their business strategies. This indicates that a significant amount of banks consider E&S risks as material to their current and future business performance.

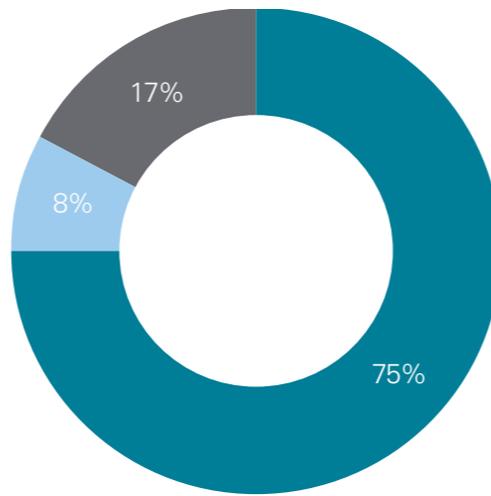
Consequently, one would expect that banks should integrate E&S factors in their Pillar 3 reports in order to allow market participants to assess all relevant information about the banks risks profile and management practices.

Fig. 17
Disclosure of E&S risk policies



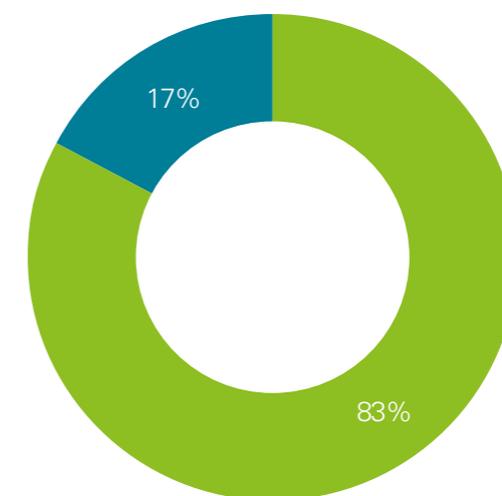
- No disclosure
- Summary policies only
- Complete E&S risk policies
- Complete E&S risk policies and detailed information on application policies

Fig. 18
Disclosure of breakdown loan portfolio



- No disclosure
- Disclosure breakdown project finance portfolio only
- Disclosure breakdown whole loan portfolio
- Disclosure breakdown whole loan portfolio, incl. disclosure exposures bank to one or more sensitive sectors

Fig. 19
Disclosure E&S risk profile and management in Pillar 3 report



- No disclosure in Pillar 3 report
- Disclosure on E&S risk profile/management as part of credit risk

Good practices: E&S risk reporting and disclosure

RBS

Transparency regarding E&S risk exposures

Compared to other banks, RBS is very transparent about the composition of its loan portfolio from a sustainability point of view. RBS publishes a detailed annual report (16 pages) called 'Our financing of the energy sector' (http://www.rbs.com/content/dam/rbs/Documents/Sustainability/Energy_Financing_Report_2013.pdf). The aim of this annual report is to provide enhanced disclosure on its lending to the energy sector in the context of sustainable development. The annual report provides information on lending to the energy sector and the split of the total loan portfolio of RBS. It also includes trend analyses using data from previous reports as well as new metrics on the carbon, water, and waste intensity of clients.

ING

Transparency regarding E&S risk policies and its application

For the purpose of informing stakeholders and to give details of the bank's commitment and performance in the area of sustainability, ING has publicly disclosed a document (38 pages) on its Environmental and Social Risk (ESR) framework. The document describes in detail the structure of the ESR framework (e.g. scope of application), the ESR policies (sector policy, exclusion policy, human rights and environmental policy, defense policy), ESR due diligence process, ESR governance structure, and ESR waiver requests.

Part two:

**Recommendations for
bringing environmental
& social risk and
opportunity
management to the
next level**



Introduction

Part one of this report shows that the banks have become increasingly aware of the reputational risks caused by E&S megatrends and have started managing these risks accordingly. They have developed, for example, E&S sector policies with minimum standards for sensitive sectors such as palm oil and the oil and gas sector, established specialized E&S teams within their risk management departments to support the implementation of these policies and integrated E&S factors in the client and transaction onboarding processes.

The outcomes of the survey also indicate that this approach has not led to the full integration of E&S factors in the core business processes of the CIB divisions. At this moment, the E&S management framework and practices are siloed to a certain extent. There is still room for further integration of E&S factors in strategic planning, capital allocation, bank-wide risk management framework and daily decision making and performance management in the CIB divisions.

To sum up, the research indicates that the current E&S management approaches and practices at the group of major European banks are well suited to manage the reputational risks caused by E&S megatrends. Most approaches and practices are less suited to capture also the broader business risks and opportunities of E&S issues like, for example, the financial impact of E&S issues on the loan portfolio (in certain sectors) of the bank and on the future cash flows of individual clients.

To further integrate E&S factors in their core banking activities, banks need to break new ground and consider E&S factors as actual business risks and opportunities and adjust their E&S approaches and practices accordingly. Banks can do so by applying existing risk management frameworks and pursuing opportunities within existing operating models, but taking a broader concept of risk and return into account which includes E&S factors. Viewing the role of banks and their function in the economy through an E&S lens does change the perspective, How transparent should a bank be on its E&S risk exposures in the formal risk reports does change the perspective, but not the nature of their business.

In Part 2 of this report, some practical recommendations, good practices and insights are presented on how banks could further integrate E&S factors in their CIB activities.

The recommendations are grouped into four categories:

-
- ➔ Further integrating E&S factors in the bank-wide risk management framework

 - ➔ Starting to quantify and monetize E&S risks and opportunities

 - ➔ Optimizing opportunity-driven sustainability strategies

 - ➔ Improving the E&S risk culture

Further integrating E&S factors in the bank-wide risk management framework

Recommendation 1:

Integrating E&S risks in the risk appetite statement (RAS)

Integration of E&S factors in core banking processes is obviously not a goal in itself. The integration of E&S factors is relevant as it allows banks to capture – and to a certain extent contribute to – the shift toward a more sustainable economic model. It is in the interest of banks to assess and monitor the impact of the transformation on their risk positions and determine their risk appetite accordingly. In the RAS the bank can articulate the types and levels of E&S risk that it is willing to accept, or to avoid, in order to implement the business strategies and achieve its business objectives. An actionable and measurable RAS will improve the effectiveness of the bank's supervision of E&S risks and helps encourage decision making that is in the long-term interest of the bank, its shareholders and stakeholders. It would also create a stronger alignment and integration of the business and sustainability strategy of the bank.

Action points:

- Including qualitative and, where possible, quantitative statements on acceptable E&S risks in the RAS. This would create a stronger alignment of managing risk for the purpose of pursuing business targets and managing E&S risks.
- Developing tools and methods for translating qualitative statements into quantitative risk management controls. For example, a more quantified approach to E&S risk at portfolio level (e.g. financed emissions) could lead to a more quantitative RAS.



Recommendation 2:

Integrating E&S factors in capital models

Although banks have made significant steps toward integrating E&S factors in risk management and business development processes, many institutions still manage E&S factors to avoid financing activities that would potentially lead to negative responses from society. Only few banks have adopted E&S risks as actual business risks and have attempted to integrate E&S factors as leading indicators in risk models.

Good Practice

BNP Paribas

Integration in internal credit ratings

Group risk management has started to include ESG issues in credit policies (general and specific) and rating policies for some specific sectors. This is in the process of being implemented in all sectors as ESG considerations are included each time a policy is reviewed. The ESG information and analysis can influence the overall credit analysis. This can be positive or negative, but currently it is mainly used for some ESG risk outliers with a negative implication on credit risk.

Action points:

- Developing research on integrating E&S factors as leading indicators in determining risk level of assets and calculation of capital requirements. Inclusion of E&S factors in capital models could enhance the resilience of banks in the transition to a more sustainable economic model and would provide a direct incentive to treat E&S risks as equal to financial risk across the institution.
- Engaging with regulators to promote the inclusion of E&S factors in capital models and to collaboratively find ways of dealing with typical model validation requirements such as back-testing (testing the validity of indicators by applying it to historic data on portfolio and credit rating migrations of clients and transactions). The European Banking Authority (EBA) and the Bank for International Settlements (BIS) could be relevant regulatory stakeholders.



Starting to quantify and monetize E&S risks and opportunities

Recommendation 3:

Further integrating E&S factors in bank models for credit risk analysis

The results in Part 1 of this report show that current E&S risk identification and assessment practices in credit risk analysis processes are qualitative in nature at most banks. In addition, these practices are mainly transaction focused and the E&S risks are assessed independently from the financial due diligence of a facility. Consequently, not the full impacts of E&S risks are identified and assessed in this way. Bank models for the analysis of E&S risks in credit risk analysis should include elements that capture

quantitative impacts of E&S risks, enable forward looking assessments and include practices that interlink E&S and financial performance of a client or a transaction. Such models are based on the concept of 'true value', in which financial analysis is complemented with a quantitative analysis of E&S externalities and a risk assessment with regard to the extent such externalities can or will be priced in. The sum of the financial value and expected E&S driven value is called 'true value'.

Methodology to calculate the 'true value' of transactions

E&S megatrends such as climate change, water scarcity, ecosystem decline, etc. are increasingly impacting the risk profiles and financial performance of individual companies and sectors, driven by changes in e.g. regulation, consumer preferences, and costs of more sustainable technologies. Not taking into consideration such material externalities in credit risk analysis seems unwise. KPMG has developed the KPMG True Value methodology in order to support financial institutions in quantifying and monetizing the impact of E&S externalities on the business performance or risk profile of clients, projects, and other assets. The methodology can be applied both at individual transaction level and portfolio level (e.g. for calculating the impact of potential climate regulation on the future earnings of clients in the energy sector).

Good Practice
UniCredit

Reducing indirect environmental impacts: measuring negative external factors linked to financing

To better manage its indirect impacts, UniCredit assesses the impact of its commercial activities. The bank launched a pilot project to quantify, in monetary terms, the impacts of the pollutants generated by the construction and operation of all of the coal-fired power plants financed by UniCredit.

After identifying all the coal-fired power plants and power generation companies that received project financing or other loans, UniCredit

created an emission inventory and estimated financed emissions. These calculations followed the GHG Protocol, developed by the World Resources Institute and the World Business Council for Sustainable Development. Each pollutant was then assessed for impact on human health, ecosystems, climate change and reserves of natural resources. Finally, a monetary value was assigned to each impact indicator, using a peer reviewed budget constrained valuation model.

Action points:

- Developing assessment frameworks for client and transaction due diligence that capture externalities and assess the likelihood and materiality of these externalities being priced during the life of a proposed facility.
- Capturing the difference in economic and true value and reporting it as E&S or societal risk value. The E&S risk value could be a strong portfolio indicator for the E&S sensitivity of the portfolio and could be included as a more quantitative E&S risk control.

Recommendation 4:

Integrating E&S factors in portfolio monitoring and management



At a portfolio level, banks should increase their attention to risk reporting on drivers of transformation toward a more sustainable economic model. Which exposures are sensitive toward increased regulation of changing consumer preferences? What is the total exposure of extreme weather events, drought, water shortages, and food security? Which exposures would be vulnerable to increased regulation of emissions? How is the bank assessing these risks and what mitigants are in place? Are these mitigants effective or is residual exposure not in line with the (credit) risk appetite of the bank? To the extent that these considerations have been included in transaction due diligence and mitigating

action has been agreed with clients, such actions could be captured in the bank-wide risk management system for tracking and follow-up. One step further would be to develop an environmental and social action plan (ESAP, mandatory in project finance) at client level and to include the actions defined as a covenant in loan documentation, breaches of which would be considered an event of default and would bring the bank back to the table with the client to negotiate next steps or even new terms and conditions. Finally, banks could consider disclosing their ESR management and the resulting risk profile in more detail in their annual disclosure statements (e.g. 'Pillar 3 report').



Good Practice

ING

Monitoring and managing E&S risks and opportunities at portfolio level

ING has embedded environmental and social risk assessments in core Know-Your-Client processes, and a transaction ESR assessment in its credit approval process. These assessments focus on a clients' capacity and track record on E&S risks, as well as transparency, policies and standards, and stakeholder management; including the E&S impacts of the use of funds. The bank has augmented these assessments to identify transactions and clients which are best in class in each sector, and which satisfy certain sustainable criteria.

In terms of monitoring, the Sustainable Lending Team (SLT) of ING has developed an internal dashboard to show its current involvement in sustainable business as well as various tools to help deal teams recognize E&S friendly transactions and customers. E&S impacts meanwhile are monitored through annual transaction reviews, periodic client reviews, and proactive contact with the bank's clients. Reporting on both the SLT internal dashboard and E&S reviews is made to senior management.

Action points:

- Developing E&S metrics that can be aggregated to portfolio level for the purpose of monitoring specific E&S risks. In due time, when experience has been gained from monitoring such metrics, these metrics could feed into risk appetite statements or lead to more quantitative E&S risk management controls
- Recording agreed actions with clients in the bank-wide risk management system for monitoring and follow-up. Including the tracking and follow-up of client actions on E&S as a performance driver for front office employees
- Where relevant, making clients commit to an ESAP and including adherence to the ESAP as a covenant in transaction documentation
- If considered material for the execution of the strategy and achievement of the bank's objectives, considering to disclose the E&S risk profile and management practices in more detail in the Pillar 3 report and risk disclosure statements in the annual report (see also page 43, Improving E&S risk reporting and disclosure).

Optimizing opportunity-driven sustainability strategies

Recommendation 5:

Applying more top-down approach on managing opportunity-driven activities and strategies

Banks are already involved in mainstream business opportunities relating to sustainability in the form of financing renewable energy solutions and providing energy-efficiency loans at a corporate and retail level, project finance and structured finance relating to clean or renewable energy production, and the trading of for example CO₂ certificates. In most banks, these activities are initiated bottom-up or on an ad-hoc basis by business line managers who see an opportunity or senior managers who commit to a particular initiative.

Advanced banks have started to collect their loans and investments related to climate change adaptation and mitigation and to formulate a climate change strategy to leverage on these activities going forward. A centralized, top-down coordination is effective in both cost efficiency-enhancing activities that create a positive impact and in dealing with the growing expectation that banks should contribute to long-term value creation. The next step would be to commit to targets for financing the transition to a low carbon economy in the annual capital allocation and budgeting process.



Good Practice

ING

Establishment of the Sustainable Lending Team accelerates the transition towards a sustainable economy

ING aims to move its portfolio toward clients that are more progressive on sustainability by working with clients to improve their Environmental & Social performance, working with clients on sector specific (financing) challenges, and by seeking new clients with a progressive sustainability approach and/or in a sustainable sector such as renewable energy, waste management, or new sustainable business models.

ING's Sustainable Lending Team (SLT) aims to improve the quality of ING's lending portfolio by driving business opportunities with forward-thinking companies who are considered the clients of tomorrow. ING's dedicated Sustainable Lending Team was established in 2012. The SLT has been set up as a response to an extensive

Sustainable business opportunity analysis within Commercial Banking (two front office teams 100 days business opportunity analysis), driven by the Head of Lending Services. The SLT consists of four Full Time Equivalents (FTEs) and 25 ambassadors with part-time sustainability functions within the Commercial Banking division and has a global mandate to promote sustainable business opportunities within Commercial Banking. Together with all global Commercial Banking teams, it works on pursuing sustainable business. Experts have been brought together from various areas of lending to explore opportunities in sustainable sectors such as renewable energy, water and waste management, but also developments like circular economy and smart grids.

Action points:

- Mapping all activities that create a positive impact
- Identifying opportunities for leveraging these activities in a cost-effective manner (e.g. information sharing on product development, applying strategies across sectors)
- Developing a top-down strategy for financing activities that create impact and/or contribute to the transition to a more sustainable economic model
- Setting targets and KPI for lines of business in the annual capital allocation and budgeting process

Recommendation 6:

Advance structuring and arranging capability to facilitate sustainable investment



Banks have the opportunity to arrange transactions and develop innovative financing structures by working with lenders and investors with different risk-return appetites. Where such transactions cannot be structured in a financial return only environment, banks can seek to develop structures that capture non-financial returns and find ways to monetize those.

The concept of Social Impact Bonds offers an interesting viewpoint on arbitraging non-financial return: the government commits to repay such bonds if the social return meets a certain mark that warrants a cut in government spending. In other words, positive externalities are rewarded financially by the party or collective arrangement (i.e. the public in case of Social Impact Bonds).

On the environmental side, structures have emerged to support REDD projects by monetizing the carbon credits for financing the preservation of forests. Banks should be encouraged to further develop similar structures, where positive externalities or reduced negative externalities are monetized and contribute to the repayment of investments made.

Good Practice

Deutsche Bank

BEI Soft Commodities Compact

BEI (Banking Environment Initiative) is a group of international banks – including Deutsche Bank - with the objective to identify ways to collectively direct capital towards environmentally and socially sustainable economic development. Central to the BEI's overall strategy is forging collaborations with groups of major corporate clients that have ambitions to create sustainable economic systems and could be assisted in this pursuit by the banking industry.

The BEI Soft Commodities Compact was developed by BEI as a result of extensive collaboration with CGF (Consumer Goods Forum; global industry network of 400 retailers, manufacturers, and service providers) and with advice from WWF. The 'Soft Commodities' Compact, which Deutsche Bank, among other banks, has adopted, is an initiative that aims to mobilize the banking industry as a whole

to contribute to transforming soft commodity supply chains (scope: palm oil, timber products, soy, beef) and therefore help clients achieve zero net deforestation by 2020.

A lack of access to appropriate forms of finance is cited by many producers as one of the barriers they face if they are to transition their means of production to more sustainable methods. The provision of finance to producers may not be straightforward and may require the creation of new financing solutions, including the involvement of buyers or off-takers to reduce the risks involved, to be commercially viable. By working with CGF supply chains to find supply chain finance solutions in this way, Compact banks hope to accelerate this transition. Without this active collaboration, proactive efforts for financing the transition will not meet the scale of demand.

Action points:

- Identifying lenders and investors with different risk-return appetites for structuring and arranging transactions where a level of impact or social capital is necessary to leverage bank lending for promoting investment in activities supporting economic transition
- Developing new financing structures that capture and monetize non-financial value for unlocking a new area of loans and investments

Improving the E&S risk culture

Recommendation 7:

Involving middle management in managing E&S risks and opportunities

While client-facing employees are trained and senior management is aware of the necessity to structurally address E&S considerations, it is typically middle management that needs to manage both financial and E&S-related objectives. The (perceived) short term need to deliver commercial results is often highest at this level within the organization. Particularly when financial objectives are conflicting in nature, they usually outweigh E&S-related objectives due to more advanced performance measurement techniques on financial objectives, both on business targets and risk controls.

Action point:

- Including E&S targets and KPI in the performance dashboards of departments and business managers

Good Practice

BNP Paribas

Financial incentive for top 5,000 managers for CSR performance

BNP Paribas applies specific financial incentives to further integrate E&S factors in core banking processes. BNP Paribas's top 5,000 senior managers have CSR criteria integrated in their annual variable compensation. CSR criteria incorporated in remuneration schemes include rate of socially responsible assets under management, percentage of women among senior management, number of people served by financial education programs created and/or facilitated by BNP Paribas, greenhouse gas emission, and percentage of employees having a positive opinion about how the group practices its CSR. Depending on the number of targets met at group level, the top 5,000 will receive additional or less variable compensation.



Recommendation 8:

Integrating E&S factors in performance management

Coming from a history of focusing on financial risk only and facing increasing regulation on the management of financial risk, the culture of banks and the incentives of bankers cannot be changed by training and discussion only. The best way of emphasizing the need for change is to include E&S factors in performance management systems for bankers.

Action point:

- Integrating E&S factors in performance appraisal and, potentially, remuneration schemes of senior management and other relevant employees

Good Practice **Rabobank**

Ethics Committee

To help front office employees deal with E&S challenges they encounter in the course of their jobs, Rabobank Group has introduced an Ethics office. The Ethics office gives advice based on previous cases and can provide support to interpret Rabobank's policies. The ethics committee discusses new cases and advises the entire Rabobank Group on E&S challenges, including E&S-related issues such as controversial weapons, land grabbing, food speculation, shale gas, and sustainability in livestock farming.

If client relationship managers or E&S risk experts within the bank struggles with an E&S-related challenge, they can take this issue to the Ethics office for advice. Any conclusions or advice given by the committee is communicated to the relevant persons throughout the organization who may face similar types of

issues. Rabobank tries to align the behavior of its employees on E&S-related issues using this model.

The Ethics committee meets four to six times a year. In addition to the CEO acting as committee chair, all relevant departments are represented, including risk management, sustainability, corporate communications, and legal.

Besides managing the organization of the ethics committee, another task of the ethics office is to provide training and awareness sessions on ethics management at all levels of the bank. For example, the office regularly organizes workshops on ethics management for local supervisory boards and makes videos for increasing awareness of E&S questions and challenges.

Recommendation 9:

Stimulating dialogue on E&S risk and opportunity management within the organization

Some banks included in the survey have set up committees or platforms to discuss E&S issues and risks with the purpose of advancing understanding and developing an organizational view and risk appetite for E&S risks in relation to business objectives. These committees typically do not have a mandate for structuring the E&S risk management framework or deciding (rather than advising) on individual transactions and are therefore free to explore issues in greater detail. Supporting dialogue on E&S risk and opportunity management integration within the organization could improve the consistency of awareness and development of knowledge, experience, and confidence among front office employees so as to implement the E&S risk policies effectively.

Good Practice

Barclays

Lens

In 2013, Barclays developed and piloted 'The Barclays Lens'. This is a values-based decision-making tool, which is being applied alongside other tools to help decision-makers move beyond legal, regulatory, and compliance requirements for considering broader societal impacts and opportunities in business decisions. The Barclays Lens is designed to serve as a guide in the first stage of the decision-making process to help facilitate a discussion about its impact as well as the potential to create sustainable value for wider society – in the short and long term. Questions include 'How are we making a profit (directly or indirectly)?', 'How are we creating shared value?', and 'Is this the right thing to do?'

Action points:

- Creating formal platforms or bodies in which challenges or specific cases regarding E&S risk management can be discussed for further developing an implicit risk appetite of the organization
- Communicating the results of the discussions within the organization for promoting awareness regarding E&S considerations and informing employees on the choices the organization is making in this regard

Recommendation 10:

Improving E&S risk reporting

The Basel guidelines for banks have included reporting as the third pillar for strengthening the risk management frameworks of banks. Banks have generally adopted this principal with regard to E&S strategies and policies, but far less so with regard to the effectiveness of E&S risk management and the actual E&S risks in portfolio. Banks could more actively discuss in their annual reports the E&S megatrends that impact the way clients do business and the risk profiles of engaging with these clients. Consequently, banks could report on the changing requirements for more integrated risk management and the way banks answer to these developments. Only informed stakeholders will be able to make decisions with regard to the adequacy of the E&S risk management of banks in the context of a changing environment.

Good Practice

HSBC

E&S integration in Pillar 3 report

HSBC is one of the very few banks that currently report on sustainability or E&S risks in their Pillar 3 reports. In HSBC's Pillar 3 report, sustainability risks are mentioned as one of the principal risk categories of HSBC's risk profile. Sustainability risk is defined as the 'risk that arises from the provision of financial services to companies or projects which run counter to the needs of sustainable development; in effect, this risk arises when the environmental and social effects outweigh economic benefits'.

Action points:

- Enhancing Pillar 3 disclosures of the bank by providing disclosures to the capital markets about the bank's exposures to systemic E&S risks and the effectiveness of its risk management framework to manage these risks. This would provide investors and analysts with additional information on more broader and longer term vulnerabilities and value creating potential of the bank.
- Providing context on trends influencing the risk profile of portfolios in the annual report
- Communicating the sustainability strategy and the way the strategy is implemented with regard to the pursuit of business opportunities and mitigation of business risks. This enables the bank to connect its E&S activities and programs with the implications for the medium and longer-term business performance of the bank.

Closing Remarks

Our survey on the current state of E&S risk and opportunity management in the European banking sector shows that the sector stands at a crossroads. On the one hand, the banks have E&S risk management frameworks in place. On the other hand, the outcomes of the survey also indicate that this approach has not led to the full integration of E&S factors in the core business processes of the CIB divisions of the banks. There is still room for further integration of E&S factors in, for example, strategic planning and bank-wide risk management framework and implementation of E&S risk policies by front office employees remains one of the biggest challenges for the banks.

To further integrate E&S factors in their core banking activities, banks need to break new ground and start to treat E&S risks as actual business risks rather than predominantly reputational risk. Besides discussions on the acceptance of certain clients and transactions and minimum standards applied in high E&S impact sectors, banks should consider E&S impacts of clients and sectors which they finance as normal business issues that could influence the future financial performance of individual companies and industries and offer new business

opportunity accordingly. If management and front office employees start to understand the potential financial impacts of E&S risks and opportunities on companies and sectors and see how E&S factors could add value to their client relationships, E&S integration will not be the exclusive ground of sustainability and E&S risk departments anymore.

The research indicates that banks are slowly moving in this direction. It has shown that, for example, some banks are already experimenting with quantifying and monetizing E&S impacts on some sectors and individual clients and that most banks have already developed sustainability strategies that are aimed at protecting and enhancing the long-term business value of the bank. Also at a sector level, a discussion started for integrating E&S factors in the Basel III framework¹². However, besides some good practices, there is currently no bank within the European banking sector that is leading the pack on this. The recommendations presented in Part 2 of this report aim to provide banks with practical insights into what it means to consider E&S factors as actual business risks and which potential adjustments are needed in their operations.

Considering E&S factors as actual business risks and also implementing them within the core banking processes as such lead to new challenges for banks. For example, how to quantify and monetize the impacts of climate change and deforestation on certain companies and sectors, how to integrate E&S factors in bank-wide risk instruments and policies such as stress tests, scenario analysis, and risk appetite frameworks, how transparent should a bank be on its E&S risk exposures in the formal risk reports and disclosure statements?

Clearly this report cannot provide all the answers to these challenges, and it does not set out to do so. We do hope it will support the banking sector with determining the next steps on E&S integration in their core banking activities, and, above all, with taking actions that will create the “next generation” bank. A bank that takes E&S factors into consideration in valuing and rewarding economic activity.

¹² University of Cambridge Institute for Sustainability Leadership & UNEP FI (2014), *Stability and Sustainability in Banking reform: are environmental risks missing in Basel III*

APPENDIX

Appendix A: Assessment framework

Dimensions	Criteria
1. Strategic framework	
Level of integration sustainability strategy	Type of sustainability strategy Level of alignment sustainability strategy with business strategy Level of integration sustainability-related KPIs into performance dashboards management Level of integration sustainability factors into capital allocation and budgeting processes
Target setting	Type of sustainability targets Type of sustainability-related KPIs Supervision of sustainability targets
2. Integration into commercial and investment banking processes	
Risk identification & assessment	Level of integration E&S factors in bank-wide (annual) risk identification and assessment process: frequency Level of integration E&S factors in bank-wide (annual) risk identification and assessment process: type of assessments
Risk appetite	Level of integration E&S factors in Risk Appetite Statement Type of E&S risk policy framework
Risk controls	Level of integration E&S factors in limits framework Assignment of E&S classification to clients/transactions Level of integration E&S factors in determining internal credit ratings of clients/transactions Scope of application risk controls (in terms of bank activities covered)

Client & transaction approval procedures

Scope of E&S integration in client/transaction approval process

Type of tooling for E&S risk assessment in client/transaction approval process

Type of E&S risk escalation processes

Frequency of “non-compliance” (with conditions) cases as a result of E&S assessments in clients/transaction approval process

3. Operating model

Identification

Type of governance structure E&S risk identification process

Nature of E&S checklists applied

Assessment

Type of governance structure E&S risk assessment process

Level of diversification in treatment of E&S risks based on outcomes E&S risk assessment

Approval

Type of governance structure approval process clients/transactions based on outcomes E&S risk assessment

Type of treatment advice on E&S risks (profile) clients/transactions in approval process

Monitoring

Monitoring E&S risks at portfolio level

Level of monitoring compliance with E&S policies, covenants and clauses of existing clients/transactions

Measures taken to improve the E&S performance of existing clients in portfolio

Supervision

Responsibility for oversight E&S risk management

Level of integration E&S factors into internal/external audit plans and activities

Application incentives for addressing E&S risks

Soft controls

“Tone at the top” in relation to E&S risk & opportunity management

Level of E&S capacity and knowledge among front office employees

4. Reporting and disclosure

E&S risk policies	Level of disclosure E&S risk policies
Loan portfolio	Level of disclosure breakdown loan portfolio
E&S risk management framework (Pillar 3-reporting)	Level of disclosure E&S risk profile and management in Pillar 3 report
Internal reporting	Level of internal reporting on E&S risk profile, management and measures
Voluntary frameworks	Level of reporting to voluntary E&S frameworks (e.g. Equator Principles, CDP)

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