T. Rowe Price

Increased climate oversight in Europe: A competitive challenge for banks

From the Field
November 2024

Key Insights

- Events throughout 2024 show a widening division between how European regulators and other regulators, particularly the U.S. Federal Reserve (Fed), are managing climate risks within the banking sector.
- While the European Central Bank is stepping up its supervisory expectations for banks, the Fed continues to take a more measured approach.
- Continued divergence between U.S. and European regulations could raise climate-related capital requirements for European banks.

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Over the past five years, banks have shifted their focus from reducing operational emissions to decarbonizing their balance sheets. Most banks across developed markets and leading emerging markets have formalized (or are in the process of formalizing) a climate strategy to decarbonize their loan books. At the same time, the world's banking regulators have been taking steps to set expectations on climate change risk mitigation—but at very different paces. The widening division between the stances taken by U.S. and European regulators, coupled with the possibility of climate-related capital requirements in Europe, could act as an additional capital headwind for European banks—with the potential to reduce their competitiveness with U.S. banks.

There has been a long-standing bifurcation between the European regulator and other regulators (particularly the Fed) when overseeing how banks are managing climate risk. The European Central Bank (ECB) has appeared to be the most vocal and prescriptive in nature. The regulator was the first to require meaningful action, warning banks that fail to comply with regulatory requests

Financed emissions eclipse banks' operational emissions

Financed emissions are attributed to banks' financing activities such as lending and investments and are classed as Scope 3[1] emissions.

Financed emissions dwarf the banking sector's direct operational emissions, with research showing that total financed emissions were 700 times greater than that of the sector's direct Scope 1 and 2 emissions in 2020.[2]

[1] Scope 1 (direct emissions from owned or controlled sources), Scope 2 (indirect emissions from the generation of purchased electricity, steam, or cooling), Scope 3 (all other indirect emissions).
[2] CDP Financial Services Disclosure Report 2020, The Time to Green Finance.

that they could face tougher enforcement action. The Fed, on the other hand, has taken an arguably more measured approach, steering clear of driving a specific agenda—with implications to U.S. banks playing out so far at the state level. Several developments in 2024 have widened the chasm, meaning that European banks may need to contend with increased supervisory expectations.

Fed stops short of supervisory implications for U.S. banks

A key development was the Fed's inaugural climate stress test in May 2024. The Fed tested the business models of six U.S. global systemically important banks on their resilience to climate-related financial risks. The results—measuring the impact of physical and transition risks on the probability of default and loss given default (LGD)[1] for aspects of their loan books—showed that climate risks are not of sufficient magnitude to threaten the capital adequacy of banks or the stability of the financial system. Importantly, the Fed made it very clear that the exercise was explorative in nature and did not have any supervisory implications or impact on capital requirements.

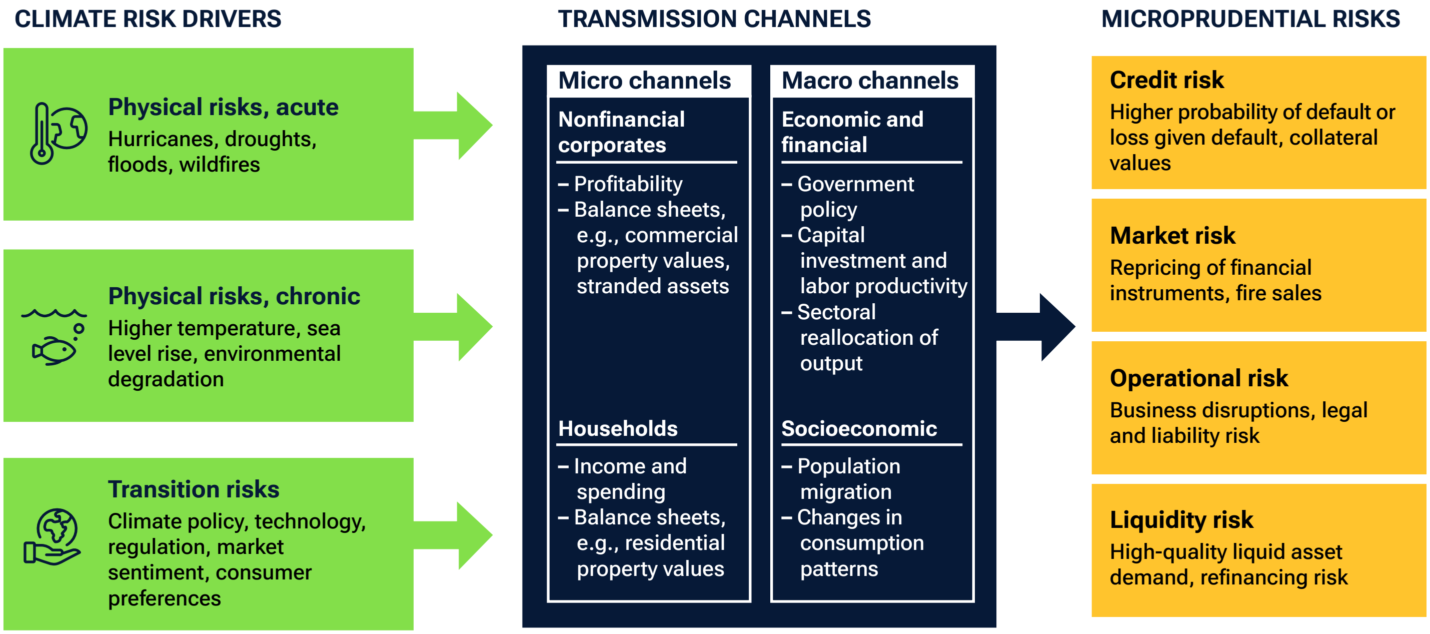
Second, the U.S. Supreme Court decision in June 2024 to overrule the "Chevron deference,"[2] which allowed courts to defer to federal agencies on ambiguous laws, would suggest that less, rather than more, intervention can be expected by the Fed in the future. The broader implications of this overruling will likely play out over several years, but the decision could be interpreted as reducing the Fed's capacity to promulgate new rules unless they have clear statutory authority—which will affect the role the Fed can play in managing climate risks across the banking sector. The deregulatory stance expected in Republican Donald Trump's second term as U.S. president may further reduce the Fed's capacity to enact change.

> "...European banks may need to contend with increased supervisory expectations.

[1] LGD represents the estimated potential losses when a borrower defaults on a loan.
[2] The "Chevron deference" stems from a Supreme Court decision in 1984 related to an oil company of the same name. The legal doctrine allowed courts to defer to experts at specialist federal agencies to interpret ambiguous laws written by Congress. Under the doctrine, agencies have been able to set standards in many different areas, including environmental protection.

How climate risk drivers can manifest as prudential risks

(Fig. 1) The transmission channels through which climate-related risk drivers could impact large banking organizations



Note: Examples are indicative and not exhaustive.
Source: Board of Governors of The Federal Reserve System, Pilot Climate Scenario Analysis Exercise Summary of Participants' Risk-Management Practices and Estimates, May 2024.

"Pecuniary penalties" for climate laggards in Europe

Third, there were news reports in June 2024 that the ECB was set to impose fines on several unnamed banks for deficiencies in their climate strategies.[3] In the same month, Kerstin af Jochnick, a member of the ECB's Supervisory Board, was quoted as saying that the ECB had "notified a few banks that, based on our current assessment, they haven't met the interim milestones, which means they face the prospect of having to a pay a so-called pecuniary penalty."[4] In October 2024, the ECB highlighted that there could be more fines on the way for banks missing "foundational elements for the adequate management of climate and nature-related risks."[5] The imposition of fines is the latest piece of evidence to suggest that the ECB is moving up the escalation ladder.

The ECB published a report in January 2024 assessing the alignment of the European banking sector to the European Union (EU) climate objectives. It found that among the 95 European banks analyzed, 90% are misaligned. In addition to penalty payments for banks not meeting supervisory expectations around management of climate and environmental risks, the ECB has also not ruled out setting legally binding Pillar 2[6] capital requirements as part of its annual Supervisory Review and Evaluation Process. This supports the view that lagging banks may need to contend with climate-related capital requirements. It also helps investors contextualize what the ECB is considering as the next part of the escalation ladder as it considers additional enforcement. While there is currently no evidence to suggest that the growing divergence between the U.S. and European regulators on climate topics is slowing down, there is an argument to be made that this increasing bifurcation may be unsustainable. Whether this prompts the ECB to pause, or at least slow down, its pace remains to be seen.

A multifaceted approach to evaluating banks' climate strategies

We believe one of the core tenets of a bank's climate strategy should be the disclosure and management of financed emissions. The majority of banks across developed markets, and some emerging markets, have signed up to the Net Zero Banking Alliance (NZBA), an industry-led initiative convened by the United Nations. The NZBA commits banks to align their lending and investment portfolios to net zero by 2050, setting interim financed emission reduction targets for high-emitting sectors. The 41 founding signatories were required to have set an interim financed emission reduction target of 2030 for the nine[7] highest-emitting sectors on the balance sheet by April 2024. This involves banks having measured and set targets to reduce around 99% of the financed emissions on their balance sheets, which gives investors a near-complete evaluation of the carbon intensity of each bank's loan balance sheet. However, while annual reporting of interim financed emissions targets on high-emitting sectors can help investors track the progress banks are making in decarbonizing their loan books, a lack of consistent methodologies and definitions across banks means that investors should adopt a cautious approach to drawing conclusions from the underlying data.

Avoidance vs. mitigation

There are two key approaches that banks can take to decarbonize their balance sheets. The first is risk avoidance, which involves divesting from clients and placing exclusions on specific sectors. The second is risk mitigation, which means working or engaging with existing customers and providing the capital required to help that customer transition their business model.

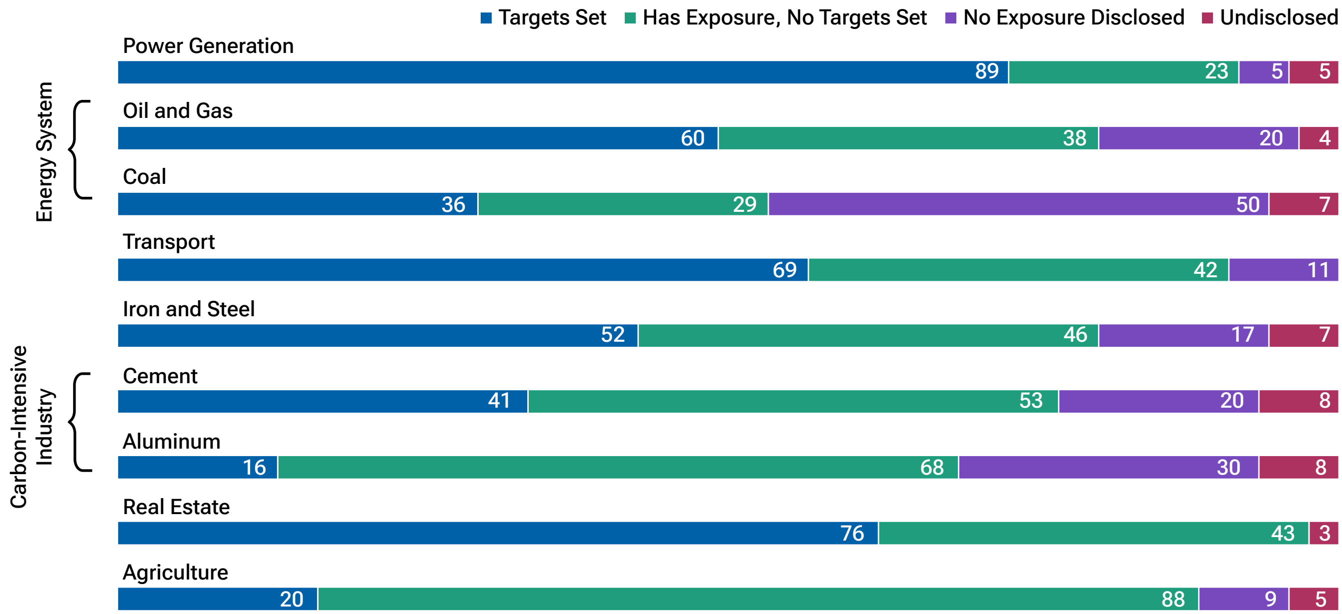
Rather than adopting broad-brush sector exclusions, we believe that a risk mitigation approach is more appropriate—allowing a bank to balance the decarbonization of their loan books with financing an orderly, just, and affordable transition.

Across the NZBA signatories, we continue to see a wide dispersion between the banks and the number of sectors for which they have measured and set financed emission reduction targets. While it is too early to draw firm conclusions in the context of 2030 timelines and significant year-on-year volatility, we have found that banks generally have made at least satisfactory and, in some cases, good progress in reducing their financed emissions. That said, the activities the banks include in their measurements vary widely as does the scope of customers. In certain cases, banks use unusual units of measurement, alongside different activities within scope of their metrics, which can make it difficult for investors to compare versus peers. For example, some banks include Scope 1 emissions from their customers, while others use Scope 1 and 2.

[3] Bloomberg UK, "Banks Told to Brace for ECB Fines After Mismanaging Climate Risk," June 5, 2024. bloomberg.com/news/articles/2024-06-05/banks-told-to-brace-for-ecb-fines-after-mismanaging-climate-risk
[4] ECB, Banking Supervision, Interview with Cinco Días and Kerstin af Jochnick, member of the Supervisory Board of the ECB, June 5, 2024.
[5] Source: ECB, Keynote speech by Frank Elderson, member of the Executive Board of the ECB and vice-chair of the Supervisory Board of the ECB, at the Sustainable Finance Lab Symposium on Finance in Transition, October 4, 2024. In his speech, Elderson said: "In a small group of outliers, foundational elements for the adequate management of climate and nature-related risks are still missing. These banks are now receiving binding supervisory decisions outlining the potential of periodic penalty payments if they fail to timely deliver on the requirements."
[6] The Pillar 2 requirement is a legally binding, bank-specific capital requirement that supplements the minimum capital requirement (known as the Pillar 1 requirement) in cases where the latter underestimates or does not cover certain risks. If banks fail to comply, they could be subject to supervisory measures, including sanctions.
[7] According to the NZBA Commitment Statement and the Guidelines for Climate Target Setting for Banks, the 9 carbon-intensive sectors identified in the guidelines are: agriculture, aluminum, cement, coal, commercial and residential real estate, iron and steel, oil and gas, power generation, and transport.

Banks are prioritizing target setting in sectors with the highest absolute emissions

(Fig. 2) Number of banks that had set targets for the nine carbon-intensive sectors identified by the NZBA



As of May 31, 2024.

Note: This graphic shows results for the NZBA 122 survey respondents (113 of the 122 NZBA member banks that were due to have set some targets by May 31, 2024, plus 9 that had not reached their first 18-month target-setting milestone). Not every respondent would be expected to have set targets for every sector. Many had not reached their 36-month milestone, and not all banks are exposed to every sector.

Source: NZBA 2024 Progress Report, October 2024.

We believe the second core component of a bank's climate strategy should be sustainable finance. The annual incremental financing needed to meet the goals set out in the Paris Agreement is estimated to range between USD 3 trillion and USD 5 trillion per annum.[8] Banks could play a key role in helping close this financing gap, which could pose as an exciting long-term revenue growth opportunity for those at the leading edge of climate finance. Most global banks have set out ambitious sustainable financing targets, and based on our analysis of company reporting, we estimate banks are currently meeting about 60% of the financing gap to meet the Paris Agreement. However, while the green financing opportunity remains a nice long-term story for global banks, questions remain over how investment professionals can consider this in their valuations without improved climate-related disclosure and standardization across the banking sector. For example, we have only seen one large global bank report a revenue figure from its sustainable financing activities.

In addition to sustainable finance and the disclosure of finance emissions, investment professionals can also evaluate how banks are focusing on facilitated emissions. Most banks exclude the facilitated emissions derived from their capital market activities, and, for some banks with large capital market desks, this could mean they are not measuring or reporting on a large portion of their emissions. Banks had typically neglected to measure these emissions due to a lack of industry guidance. The Partnership for Carbon Accounting Financials published this guidance in December 2023, and banks are now in the process of measuring these emissions in line with the recommended methodologies. We are beginning to see some leading banks publish their facilitated emissions, but it is still too early to make like-for-like comparisons across peer groups.

When we evaluate a bank's climate strategy, we believe the focus should be on how the bank is working with customers rather than evaluating the strength of its exclusionary policies. There is a lot of disparity between banks and the language they use to outline what activities are excluded in these policies. To that end, the way banks are evaluating client

[8] Estimates range depending on the source. For example, in 2020, the Global Financial Markets Association and Boston Consulting Group estimated that an annual investment of between USD 3 trillion and USD 5 trillion is required to achieve the ambitions set out in the Paris Agreement (source: sifma.org/wp content/uploads/2020/12/Climate Finance Markets and the Real Economy.pdf). In 2022, McKinsey & Company estimated that capital spending on physical assets for energy and land-use systems in the net zero transition between 2021 and 2050 would amount to about USD 275 trillion, or USD 9.2 trillion per year on average, an annual increase of as much as USD 3.5 trillion (source: "The net-zero transition What it would cost, what it could bring," McKinsey & Company, January 2022).

transition plans is as important and will help regulators differentiate banks. Earlier adopters have disclosed their frameworks to assess the credibility of clients' transition plans and how the customers' scores have changed over time. Therefore, investment professionals can begin to identify the banks that stand out. While this largely involves comparing banks based on their disclosure rather than the quality of these frameworks, we expect this will change over the next couple of years.

Other areas for investment professionals to monitor include how banks are approaching biodiversity- and nature-related risks. We are beginning to see some strong willingness among some banks to play their part in delivering on the ambitions set out in the 2022 COP15 Biodiversity Summit, but it is too early to tell what best practice looks like. Another consideration is the European Banking Authority's requirement for banks to measure the percentage of assets that align with the EU taxonomy, with 2024 as the first reporting year. This is known as the green asset ratio (GAR), with the average GAR being just 2.3% in 2023.[9]

However, caution should be taken when relying on this metric. For example, the GAR may be skewed lower as it ignores non-EU loans, small and medium enterprise loans, transition assets, or assets deemed socially advantageous (e.g., affordable housing loans). Moreover, banks may not be able to comply with ancillary checks (e.g., if the bank provides a loan to a solar panel manufacturer, it must provide evidence that the manufacturer meets minimum social safeguards before it is eligible to be included in the ratio).

The impact of higher capital requirements on European lenders

From an asset manager perspective, there is no doubt that evaluating the climate strategies of the world's financial institutions continues to come with the added complexity of regularly shifting goalposts on market standards. Meanwhile, the regulatory gap between Europe and the U.S. shows no sign of closing. In the short term, climate laggards in the European banking sector may face additional fines or penalties for failing to deliver on mounting supervisory expectations, though these are unlikely to impair balance sheets and could be more symbolic in nature. Importantly, the integration of climate risks into capital requirements could make it more difficult for European lenders to compete with their U.S. rivals. The Supreme Court's decision to overturn the Chevron deference has further exemplified this bifurcation, given that it potentially reduces the Fed's willingness and ability to take a tougher stance. Ultimately, this could result in greater headwinds for equity investors relative to fixed income investors in the longer term given the potential for higher capital requirements in Europe.

[9] Source: *Responsible Investor,* "Controversial methodology pushes EU banks' green asset ratios below EBA estimate," August 6, 2024. responsible-investor.com/controversial-methodology-pushes-eu-banks-green-asset-ratios-below-eba-estimate

Key factors for assessing a bank's climate strategy

(Fig. 3) An overview of some of the key factors to consider when evaluating how banks are managing climate-related risks

Financed emissions disclosure and measurement	$ Sustainable finance
Evaluation of client climate transition plans	X Exclusion policies
Biodiversity-related risks	% Percentage of assets aligned with the EU taxonomy (green asset ratio)

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