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Climate change to bear upon banks' financial performance

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For investors evaluating financial institutions, the climate crisis will soon become a key consideration. Our research shows there is already a wide dispersion between the sector leaders and laggards.

In his historic 2015 speech, Mark Carney, then Governor of the Bank of England, invoked the spectre of a "Minsky moment", a climate-driven collapse in asset prices. Back then his words seemed dystopian, a distant prospect. Today, however, they look more prescient.

A broad spectrum of central banks fear climate change could spark the next financial crisis. For this reason, regulators in Europe and the UK are already beginning to scrutinise banks' resilience to climate change – looking into both the likely stresses from the shift to a zero-carbon economy over the coming decades, and the impact of extreme weather.

For now, though, central bankers' anxiety is not reflected in fixed income or equity markets, which seem relatively unaffected by climate risk. Yet over the next few years climate change could become a key driver of financial performance and an important factor for investors evaluating banks. Even in the short term there are risks to earnings, while in the medium term it is likely that banks judged to have higher climate-related exposures will face higher capital requirements, not to speak of reputational risks.

But this is not just a question of risk. Looking ahead a few years, there may also be opportunities for the banks that lead the financing of the transition to a zero-carbon economy. Indeed, it is estimated that green investing and financing could harvest as much as $50 billion of revenue over the next five to 10 years.[1]

Drivers of change

As climate change becomes a defining topic, we believe it will soon no longer be enough for banks to make high-level climate pledges. Under mounting scrutiny they will have to improve climate risk disclosure, show that climate considerations feed through into underwriting standards and reduce their carbon footprints.

Although the extent of banks' lending exposure to fossil fuels is relatively modest – carbon-intensive sectors to-date represent less than 10% of European banks' lending exposure – a climate crisis could increase banking system losses by up to 60%, according to European Central Bank (ECB) calculations , and impact earnings as fossil fuels account for 10%-15% of global wholesale banking revenues.[3]

Already reputational risk is rising. Take the criticism of JP Morgan Chase in 2020 for its energy lending.[4] It was revealed as the biggest financier of fossil fuels globally in a report compiled by a collaboration of non-governmental organisations (NGOs)[5] including Rainforest Action Network and BankTrack. With public feeling about climate change mounting, the possible damage to reputations should not be ignored.

Bank regulators are beginning to enforce change, especially in the EU and the UK. The French and Dutch central banks ran climate stress tests in 2020; the Bank of England did so in 2021; and the ECB plans to in 2022. Looking forward to 2025, the European Banking Authority intends to introduce its ESG capital review, which will differentiate the capital treatment of assets according to environmental and social factors. In the UK, banks will have to abide by the standards of the Task-Force for Climate-Related Financial Disclosures by 2025, providing standardised information on their climate risks.

In the US, too, tougher regulation is clearly coming. In November 2020 the US Federal Reserve identified climate change as a risk to financial stability for the first time. What's more, President Biden has stated that he views climate change as a priority and plans to require public companies to disclose climate-related financial risks.

Leaders and laggards

So far, though, there is little evidence that banks are cutting back their fossil fuel lending, with the important exception of coal. But investors may soon start differentiating between the leaders and laggards as better regulatory disclosure allows them to do so. Additionally, shareholder engagement and NGO activism could soon impact bank stocks' valuations.

We conducted an engagement exercise with more than 50 banks globally. We asked questions around climate strategy and climate risk management and followed up with a series of meetings. We found clear patterns emerging. At a high level, some of the UK, Dutch and Swiss banks are performing well. The Nordic, French, Spanish and Japanese banks are a little further behind and the Irish, German, Italian and Chinese banks are lagging.

We have started to factor banks' exposure to climate change risks into our research. While climate change is not yet impacting banks' earnings or capital requirements, it could do so as soon as two to five years from now. As we look forward two years when evaluating companies, we are now incorporating this into our fixed income research and assigning relative ratings to banks. These ratings are beginning to affect portfolio construction.

In our view, it will not be long before investors generally start to differentiate between the leaders and laggards. That will create an opportunity for active investors, while rewarding the banks that have acted early to address climate change with a competitive cost of capital.

Source:

1 Morgan Stanley, 2021.
2 European Central Bank, 2021.
3 https://www.banktrack.org/article/banking_on_climate_change_fossil_fuel_finance_report_card_2020
4 FT.com, JPMorgan Chase promises to shift portfolio away from fossil fuel, 7 October 2020.
5 Banking on Climate Change, https://www.ran.org/wp-content/uploads/2020/03/Banking_on_Climate_Change__2020_vF.pdf, March 2020.

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