SUSTAINABLE ORGANIZATIONS & FINANCE

Square

GIVING A FUTURE TO TALENT

THE TRANSITION TOWARDS SUSTAINABLE FINANCE: THE CHALLENGES FACING BANKS

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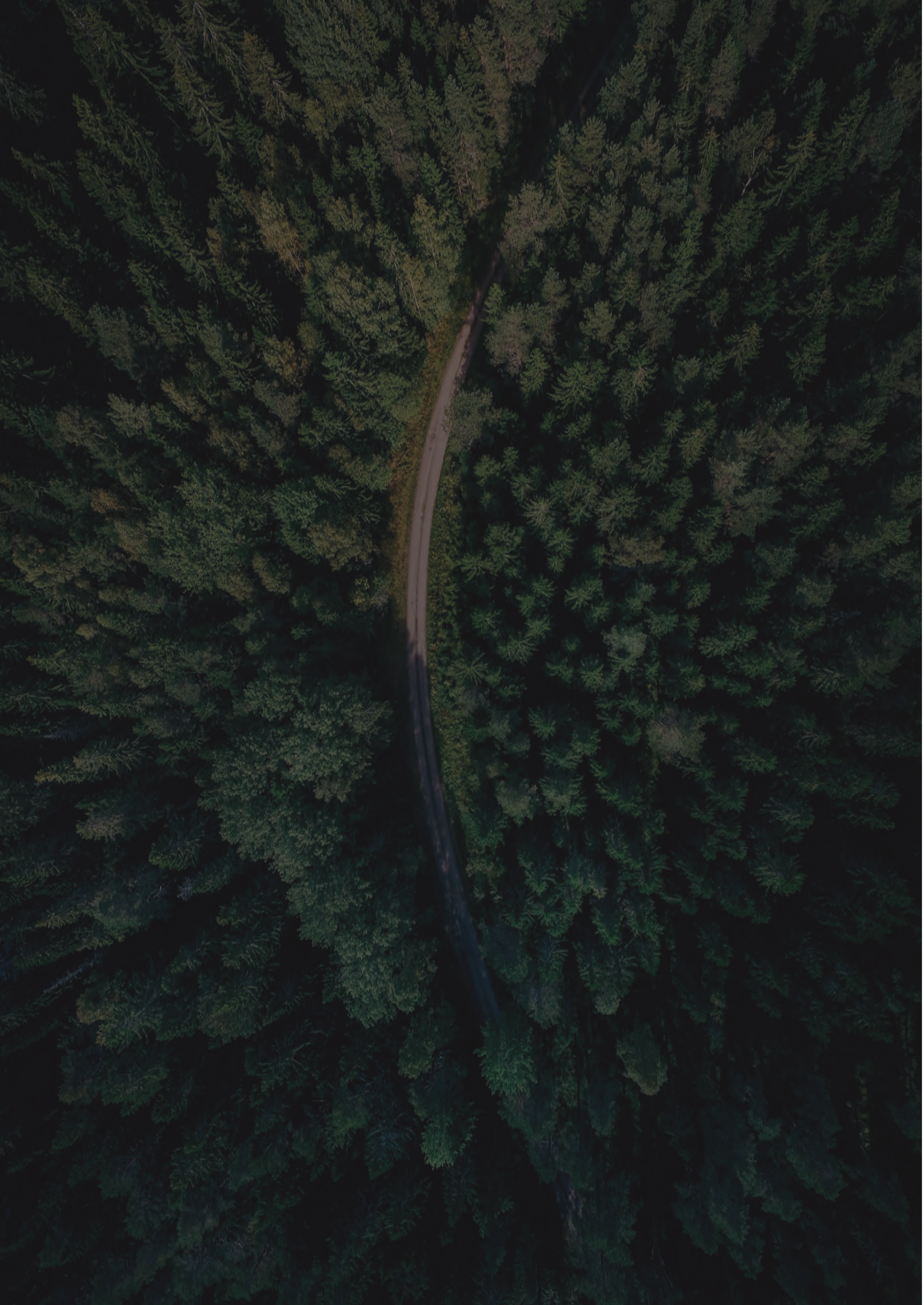

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Authors: Marie Vigué, Marc Campi,
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1.

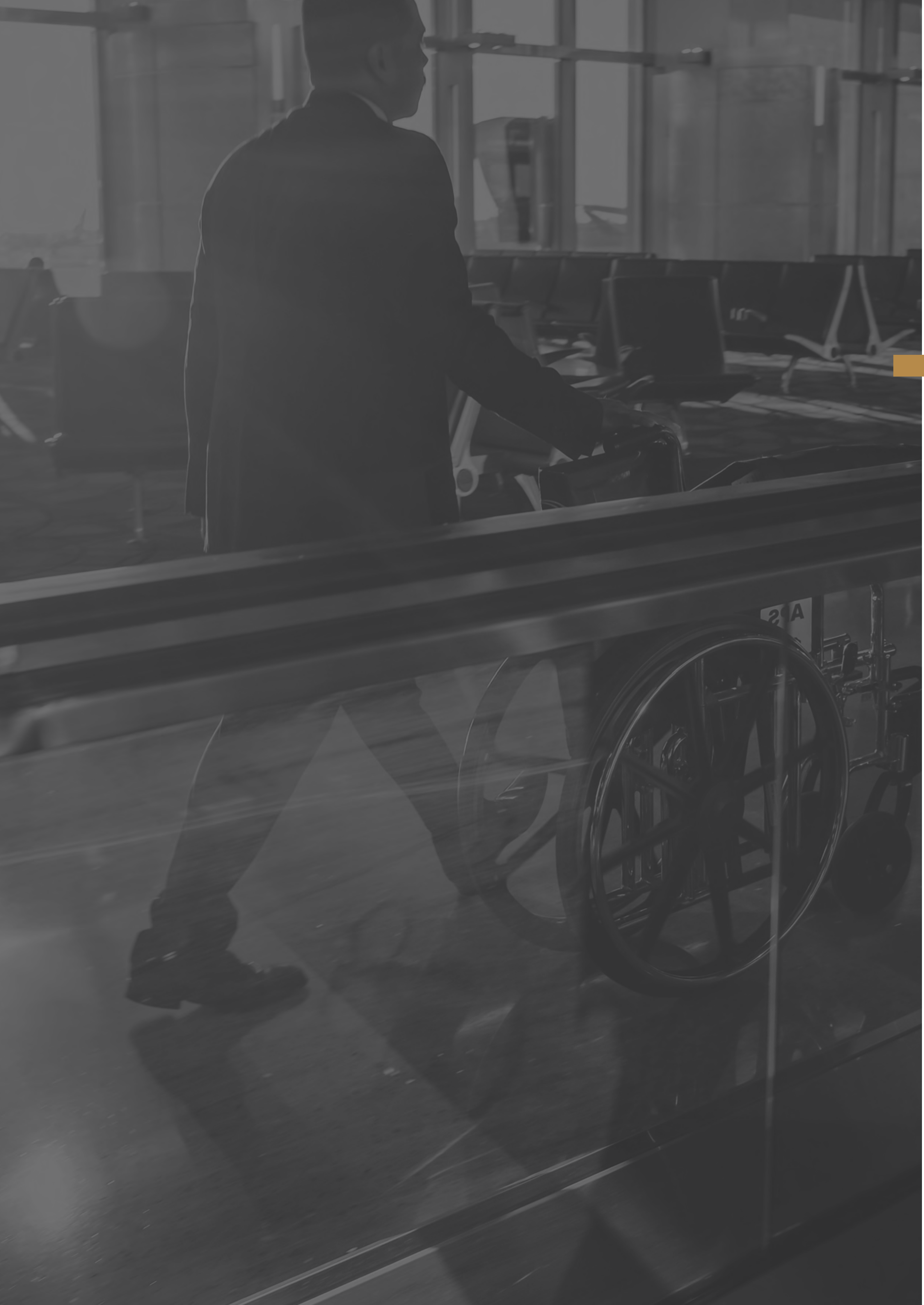
INTRODUCTION

For a long time, banks have not placed Environmental, Social and Governance (ESG) criteria at the heart of their strategy. With regards to environmental criteria, this situation could be explained by the fact that the banking activity was considered to be intrinsically low-polluting: unlike other sectors, banks do not emit toxic fumes, use chemicals, or consume fossil fuels in their direct production process. With regards to social criteria, it was explained by the fact that the primary mission of collective interest assigned to banks was the financing of the economy. Until a few years ago, a bank that participated in efforts to finance the economy was a bank that contributed to its mission of collective interest. With regards to governance criteria, the situation of banks was not specific: corporate governance was the exclusive responsibility of their management and shareholders.

This vision is now outdated and banks must now be able to justify that they are full and complete players of sustainable finance: either to defend themselves from the increasingly strong accusations of certain stakeholders accusing them of inaction or, worse, of concealment ; or to live up to the expectations placed in them so that they become engines of the transition towards a more sustainable development model. To this end, they must be able to meet the ESG requirements that constitute the three pillars of a "Sustainable" financial system, more in line with the aspiration of society:

- A financial system that supports the energy transition towards a less carbon-intensive economy, helps activities with low environmental impact and discourages polluting activities.
- A financial system that is not based solely on financial and short-term criteria, but capable of supporting projects that facilitate the inclusion of more fragile people and/or integrate a medium- and long-term vision.
- A financial system that is "governed" in a more transparent way, more diverse in its thinking patterns and in the members that are making it up.

This focus report will first describe the mechanisms that force banks to become key actors in this transition towards sustainable finance; it then presents how banks can build this strategy and initiate concrete actions that will make them credible actors of sustainable finance.



2.

WHY COMMIT TO SUSTAINABLE FINANCE?

Three reasons force banks to become key actors of sustainable finance:

2.1 A dense regulation and ambitious timeline.

2.2 Stakeholder pressure.

2.3 Banking risk management.

2.1 A dense regulation and ambitious timeline

Until recently, the specific regulations weighing on banks in terms of environmental or social aspects have been rather limited. Since banks have not been identified as players with high environmental stakes, they have not had any significant specific environmental standards imposed on them. With regard to social issues, banks were not identified as requiring specific regulations either. In many countries, the issue has long been analyzed strictly from the point of view of the relationship with employees, and banks generally offer rather advantageous status compared to other activity sectors.

In France, similarly to all large companies, they have "simply" had to disclose a Déclaration de Performances Extra-Financière (DPEF ; Statement of Extra-Financial Performance), in application of a European directive of 2014[1]. This reporting obligation has been reinforced, starting in 2015, in compliance with Article 173 of the Energy Transition Law. This article in fact requires financial institutions to disclose the integration of ESG criteria and the consideration of climate risk in their financing and investment decisions[2]. However, overall, the specific regulatory pressure on banks in terms of environment or social commitments has remained fairly limited.

The situation was very different with respect to governance regulations. Banks were indeed held responsible for the 2008 crisis and a regulatory storm fell upon banks in the years following this crisis. This maelstrom concerned many issues (organization of internal control, anti-money laundering and anti-terrorist financing measures, advice to investors, …) and affected multiple aspects of banks' internal governance.

1. *The Déclaration de Performances Extra-Financière (DPEF) or Statement of Extra-Financial Performance is a requirement resulting from the European directive of 22 October 2014. It requires companies with more than 500 employees and 40 M€ turnover to disclose yearly, in a document included to their annual report, "the way they operate and manage social and environmental challenges". The content of this statement is validated by a certified third-party organism.*
2. *Article 173 of the law of 17 August 2015 relative to energy transition for green growth.*

But it is, above all, the recent initiative of the European Commission, which intends to make Europe a champion in the fight against climate change and which officially aims to achieve carbon neutrality for the entire continent by 2050[3] that will place ESG priorities at the heart of a more global and ambitious approach: the shift towards **"sustainable finance".**

The intellectual journey that leads the European Commission to carry a project of such ambition is as follows: achieving carbon neutrality by 2050 is considered the only way to meet the commitments made in the framework of the COP21 summit held in Paris[4] in 2015. To meet these commitments, considerable financial efforts[5] must be made that public investment alone cannot cover[6]. Only a massive reorientation of private savings flows towards economic projects that enable energy transition is likely to address the planet's climate challenges. This reorientation requires a complete overhaul of "Finance" so that it factors in all three ESG aspects to build a new financial model, i.e. sustainable finance.

This approach was adopted by the European Commission in its "action plan for sustainable finance" presented in March 2018, which we will call "green act" throughout this document. This document, the founding act of the mandate of the new team at the head of the European Commission, presents a very ambitious action plan for transforming the European economy and proposes that the financial sector "be part of the solution" by financing the necessary adaptation of the economy. This approach is summarized in the press release issued for the presentation of this plan: "Each player has a role to play in making growth more sustainable. Reorienting private capital to more sustainable investments requires a comprehensive of how our financial system works. This is a necessary change if the EU is to make economic growth more sustainable, guarantee the stability of the financial system, promote greater transparency and longer-term vision in the economy".

The provisions of this action plan were, after consultations with the States and stakeholders, included in the "European Green Deal" that was presented on 11 December 2019. This action plan places financial actors at the heart of a coherent "ecosystem" of initiatives aimed at transforming the European economy in a more sustainable direction.

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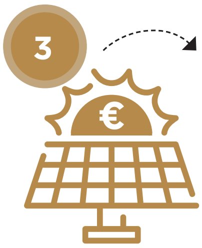
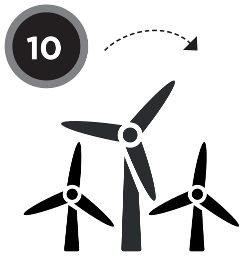
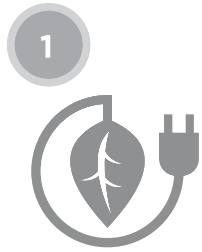
3. *Objective stated during the European Council of 5 March 2020. "Carbon" neutrality is defined as the balance between carbon emissions and absorption of atmospheric carbon by carbon wells. It requires reducing greenhouse gases by 40% compared to 1990.*
4. *"COP": the Conference of Parties is the highest organ in the Climate Agreement signed after the Rio summit of 1992. The first COP summit took place in Berlin in 1995. The Paris summit in December 2015 was the 21st meeting of the States Parties of the Agreement. The next meeting is scheduled for November 2020 in Glasgow. In Paris, 195 countries committed to reduce their greenhouse gas emissions in order to limit the temperature rise to 2°C above pre-industrial levels by 2100.*
5. *The European Court of Auditors, based on the works of the HLEG (High Level European Group), estimated the cost to 11,200 billion € between 2021 and 2030 at the European level, equivalent to €1,120 billion per year. These figures are the subject of intense discussions and the HLEG figure is often viewed as excessive. The European Commission, in its preparative work to the presentation of its action plan for a sustainable finance in March 2018, has evaluated the additional investment needs to €180 billion yearly.*
6. *For example, the "green fund for climate" created at the COP17 in Durban to help developing countries finance their energy transition should have been subsidized with USD 100 billion per year. In fact, the fund has merely obtained less than USD 10 billion in subsidies since it was founded.*

Figure 1. European Commission Action Plan







GOALS

- **Reorient capital flows** towards sustainable investments in order to reach a sustainable and inclusive growth.
- Manage **financial risks** resulting from climate change, scarcity of resources, environmental destruction and social issues.
- Favor **transparency** and **long-term vision** in economic and financial activities.

ACTIONS PROPOSED BY THE COMMISSION

1. Taxonomy.
2. Labels (funds and bonds).
3. Sustainable projects[1].
4. Integrating ESG preferences.
5. « Green » benchmarks.
6. ESG criteria in financial ratings.
7. Transparency of information.
8. Sustainability in prudential requirements.
9. Non-financial reporting.
10. Corporate governance.

ACTION PLAN

The Action Plan aims to bring finance back to the service of a sustainable and inclusive economy, especially by factoring ESG criteria into investment decisions.

The actions are targeting multiple actors of the sustainable finance "ecosystem".

Source: European Commission Action Plan on sustainable finance, March 2018.

1. Promoting investments through the design of sustainable projects, no regulatory impact identified yet.

NON-FINANCIAL AND FINANCIAL FIRMS

1. Classify "green" operations.

9. Improve non-financial reporting to harmonize practices across EU.

10. Integrate sustainability in shareholder's commitments and relationship between firms and investors.

INVESTMENT SERVICES PROVIDERS

2. Use EU labels for better product promotion.

4. Integrate sustainability during customer advice activities.

5. Structure "green" indices to track more effectively the climate objectives of products.

7. Ensure transparency and sustainability of reporting and process for entities and products for market actors and advisors.

BANKS AND INSURANCE[2]

8. Integrate sustainability and climate risks in prudential requirements.

For banks, integration will take place following two phases[3]:
- Integration of sustainability in risk management, supervisions and reporting (8A).
- Classification of assets and prudential processing (8B).

RATING AGENCIES

6. Integrate sustainability in financial rating and harmonize practices of non-financial rating agencies.

2. Together with the requirements cited above in the context of banking or insurance groups.

3. Source: "Milestone for EBA regulatory mandates on sustainable finance", December 2019.

In fact, we note that although actions of the plan target multiple economic actors, integrated banking groups, owing to the diversity of their activities, will be especially impacted:

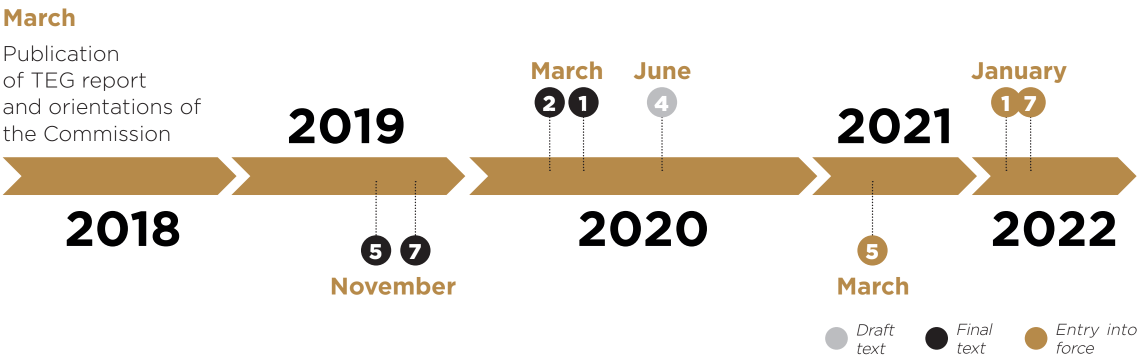
- As investment services providers, they will be able to enhance readability of their investment products through the use of labels provided by the Commission (action 2) ; they will have to integrate the ESG preferences of clients into their advice and sales processes (action 4). Finally, they will have to increase the transparency of their practices by factoring ESG risks into their portfolio management strategy and reporting (action 7).
- As organizations, they will first have to classify their own activities with regards to the taxonomy (action 1), especially for credit-granting. Then, they will need to integrate sustainability and climate risk issues into their prudential requirements (action 8)[7]. Finally, they are also encouraged to review their non-financial reporting (action 9)[8].

The following figures outline the timeline for the various initiatives included in the European

7. *In December 2019, the EBA published a roadmap covering these requirements. In France, banks have carried out their climate stress tests in the Spring of 2020: results will be published in December 2020 by the ACPR.*
8. *Consultations pertaining to the revision of the NFRD directive are ongoing and the Association Française des Entreprises Privées (AFEP) has already issued recommendations.*

Figure 2. Timeline for investment services providers (actions 1, 2, 4, 5, 7)

** Source: Based on the European Commission timeline*



5 **Disclosure:** publication of the regulation "Disclosure 2019/2088" in November 2020. Consultation for the Level 2 text completed in September 2020. **Entry into force in March 2021.**

7 **Benchmark:** publication of the regulation "Disclosure 2019/2089" in November 2020. **Entry into force of the main requirements in January 2022.**

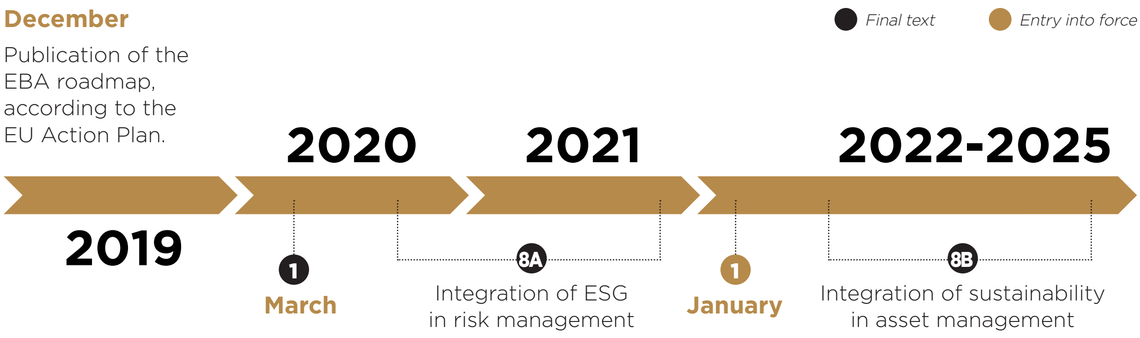
2 **Labels:** Green Bonds report published in March 2020. Draft of the "Ecolabel" report published in December 2019. **Entry into force to be confirmed.**

1 **Taxonomy:** TEG final technical report published in March 2020. Text published in June 2020. **Entry into force in January 2022** (adaptation and mitigation criteria).

4 **Customer advice:** Amendment projects for the MIFID and IDD directives, subjected to consultation in June 2020. **Entry into force to be confirmed.**

Figure 3. Timeline for banks and integration of sustainability in credit activities

Source: "Milestone for EBA regulatory mandates on sustainable finance", December 2019.



1 **Taxonomy:** publication in March 2020, followed by a consultation. **Entry into force in January 2022** (adaptation and mitigation criteria).

8 **Integration of sustainability in prudential requirements for banks:**

- 8A **Integration of sustainability in risk management, supervision and reporting**
  Report draft and EBA consultation expected for the end of year 2020. Final report in 2021.
  Date of entry into force to be confirmed.
- 8B **Classification of assets and prudential processing**
  Report draft and EBA consultation expected for the end of year 2020. Final report in 2021.
  Date of entry into force to be confirmed.

Commission's "Green Plan". For investment services providers, known requirements (mainly actions 1 and 7) are structuring and dense and their implementation schedule is complex. Regarding the measures pertaining to sustainability risk for credit activities and prudential requirements, sustainability is integrated as per the draft texts and consultations that will take place at the end of 2020 and 2022.

2.2 Stakeholder pressure

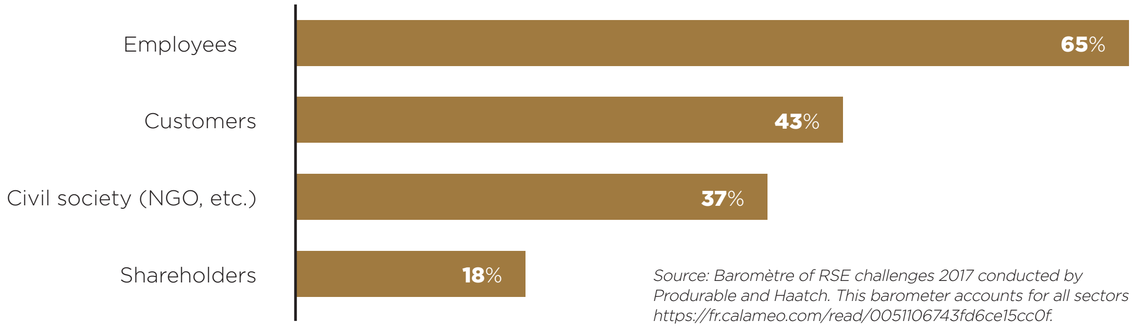
Stakeholders are also exerting increasing pressure. They consider that banks must play a crucial role in transforming the economic development model. Historically exerted by militant actors or activists, this pressure on the sustainable development issue has spread widely and now concerns all bank's stakeholders:

2.2.1. Non-governmental organizations
2.2.2. Shareholders
2.2.3. Employees
2.2.4. Clients

2.2.1 Non-governmental organizations

The banking sector has become, from the years 2000s, one of the favored targets of NGO critics who accuse them of both financing a high-carbon economy and engaging in "greenwashing" through commitments that they consider superficial or mere communication effects.

Figure 4. Involvement of stakeholders in sustainable development actions of companies



Source: Baromètre of RSE challenges 2017 conducted by Produrable and Haatch. This barometer accounts for all sectors https://fr.calameo.com/read/0051106743fd6ce15cc0f.

LEARN MORE

BOTNIA pulp mill: Argentinian demonstrators blocking a bridge linking Uruguay and Argentina

Thousands of Argentinian demonstrators are protesting against the polluting Botnia factory, largely financed by French banks. As a reaction, the latter have announced that they are withdrawing from the financing.

source: https://en.mercopress.com/2007/04/29/new-argentine-protests-against-uruguayan-pulp-plant

Beyond the occasionally excessive fierceness of certain critics, it is interesting to note that NGOs are helping to advance the debate on the role of financial institutions in the transition towards a more sustainable economic model. This contribution is made on two aspects.

It is first of all carried out on time-limited projects that are highly symbolic, in which NGOs strongly mobilize the opinions against investments in high-carbon or polluting projects such as the Botnia pulp mill[10] or the Alpha Coal coal mine[11]. In these projects, both very emblematic of short-term economic cycles, NGOs managed to stop or modify the projects by making their financing impossible or much more difficult, thanks to the pressure put on the large banking institutions that financed them.

It also takes place in a broader way, by "challenging" banks on the methodologies to be adopted to shift their activity in a more sustainable

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10. Construction of a polluting Uruguayan paper pulp mill at the Argentinian border, which transformed into an international geopolitical feud between 2005 and 2008. Strongly opposed to the project, Argentina went as far as referring the matter to the International Court of Justice in The Hague and the escalation weakened the Mercosur agreements. Large demonstrations took place and roads between the two countries were blocked. ING, one of the biggest financers of the project, withdrew. The other financer, Calyon, was forced to generalize the Ecuador principles.

11. Construction of a gigantic coalmine in Australia and of an extension to a harbor located nearby the Great Barrier of Reef, estimated to 1.8 billion tons of C02. Activists protested, which resulted in 2014 in the withdrawal of Société Générale.

direction. This challenge mainly concerns the credibility and relevance of the banks' public commitments to implement sustainable finance[12]. The most credible and constructive NGOs have in fact been very keen to verify that such commitments go beyond the level of mere greenwashing discourse and translate into sincere and relevant actions.

The main criticism addressed to banks deals with the question of their impact on greenhouse gas emissions: voluntary commitments would, according to this criticism, be time-limited, difficult to monitor, and not comparable between banks. NGOs recommend that the banks' voluntary commitments rely on a broader scope of analysis that not only includes direct activities, but also activities in which banks invest or that they finance. The question of the relevance of such a claim and the actions that banks could implement on this subject is detailed in part 2 of this focus report. But it is clear that there is strong pressure from NGOs for banks to reduce the support they provide through their investments or financing to activities that generate greenhouse gases[13,14].

2.2.2. Shareholders

Shareholders are also concerned about the sustainability of the banking business, sometimes for ethical reasons, mainly for financial performance reasons. Indeed, it has now been shown that the value of a share of a financial institution can be negatively impacted by behaviors or strategies that are not compatible with the principles of sustainable finance. This negative impact may result from image risk or losses on investments or financing provided to non-sustainable projects.

As a result, shareholders are beginning to demand that the principles of sustainable finance be implemented by bank executives. The most symbolic demonstration of this pressure was provided at the Barclays bank's general meeting in 2020. At this meeting, two resolutions on climate change were passed: they required Barclays[15] to divest all financing of fossil fuels and of any organization not aligned with the Paris climate targets by 2050. This approach illustrates the shift of a shareholding interested in sustainability criteria and determined to assert its rights.

2.2.3. Employees

The employees and future employees of banks are also a sensitive stakeholder in the banks' commitment to sustainable finance. According to a survey conducted in 2017 across all business sectors, 71% of employees would like their employer to make more CSR commitments[16].

This trend is particularly pronounced among young people: it concerns ecological issues, like the initiative launched by the "Pour un réveil écologique" ("For an ecological awakening") movement in 2019, whose manifesto gathered over 32,000 signatures among students; 400 education institutions mobilized and 67 leaders met with 5 bank executives operating in France. This trend also impacts other social responsi-

12. *Voluntary commitments of financial institutions to adopt environment and social criteria for the projects that they finance. The first initiative was launched in 2003. Until now, 105 international financial institutions, including 6 French ones, have adopted these principles.*
13. *"Climate: how can I choose my bank" by Les Amis de la Terre (Friends of the Earth) in 2015. The report underlines the 218% rise in the "support of banks to major carbon actors" between the entry into force of the Kyoto protocol (2005) and 2013 and points out the weak results in emissions reduction compared to the total emissions in the same period of time.*
14. *Oxfam report: "The colossal carbon footprint of French banks: a state's affair", 2019. The assessment methodology consists in attributing the carbon footprint of a project or activity to the institution that finances it.*
15. *Resolutions voted in 2020 and coordinated by ShareAction. Barclays has set an objective of zero net by 2050 that will mandatorily have to be followed by its administrators.*
16. *Source: barometer of 2017 CSR challenges by Calaméo, conducted by PRODURABLE and HAATCH.*

bility topics such as working conditions, gender equality, inclusion, business ethics[17]...

Thus, in order to attract and retain talents, banks will need to provide concrete evidence of their commitment to move towards a sustainable finance model. This is a necessary condition for their employer brand to be maintained at a level compatible with their recruitment and retention needs for young talents.

2.2.4. Clients

Clients are the last major category of stakeholders lobbying for sustainable finance.

As far as individual customers are concerned, with the exception of a militant and minority group, it is exaggerated to say that a bank's sustainable finance strategy has a strong impact on customer attraction or attrition, for the time being. According to a study conducted by IFOP (French Institute for Public Opinion) in December 2018[18], clients' expectations of their banks focus mainly on the subjects of data security (39%), alert in case of suspicion movements on accounts (37%), reachability (28%) and transparency on fees (27%). Offering responsible savings products or being committed to a CSR policy are expected by only 9% and 7% of respondents respectively.

To date, pressure from individual customers has come mainly from their demand to give meaning to their financial investments; a survey conducted for BNP Paribas Asset Management in 2018 revealed that 15% of individual clients in fact consider social/ethical and ecological criteria to be "the most important when it comes to investing money". This figure is still lower than those observed for the security (32%) and return (29%) criteria, but it is increasing. In the same survey, 57% of French people and 63% of Belgian people said that they were prepared to "invest at least a small part of their portfolio in socially responsible investments".

As far as asset managers are concerned, the pressure is mainly exerted by private bankers in the asset management business. For several years, these businesses have been pursuing ambitious policies aiming to integrate ESG criteria into their policies. BNP Paribas Asset Management states on its website that it has "adopted ESG criteria based on the 10 principles of the United Nation Global Compact for all its investments" and, for the most controversial sectors, "has implemented sector policies defining the minimum ESG requirements that must be met by issuers". In the same vein, Amundi, the asset manager of Crédit Agricole, indicates that by 2021, "all actively managed open funds will be required to outperform their ESG index or benchmark". It also indicates that by 2021, 100% of Amundi's votes at shareholders' meetings will factor in ESG criteria.

2.3 Banking risk management

Banks, owing to their role of financial intermediation, stand exposed to many risks. Risk management constitutes the heart of the business of a financial institution: credit risk[19], market risk[20], operational risk[21], and liquidity

17. *PwC highlighted in the "Workforce of the Future" study that 88% of millennials aspire to work in a company with values in accordance to theirs.*
18. *IFOP survey of December 2018: The French, their banks, their expectations. The study was ordered by Fédération Bancaire française (French Banking Federation).*
19. *Credit risk is the risk of losses that would result from the inability of the bank's clients, or of other players, to meet their financial commitments.*
20. *Market risk is the risk of losses due to evolutions in financial markets (interest rate risk, exchange rate risk).*
21. *Operational risk is the risk of losses due to process failures, human errors, external events; it encompasses the risks related to sanctions imposed upon banks.*

risks[22] are the classes of risk to which banks stand exposed and that they manage in the course of their activities.

Climate change and the ensuing energy transition are shifting the content of the risks that banks face. Mark Carney, Governor of the Bank of England, even mentions in a now famous speech delivered in September 2015[23] the emergence of a new class of banking risks: the climate risk.

This risk, per se, does not constitute a new class of risk that is independent of the classes already known to bankers. Rather, it can be analyzed as a cross-sectoral risk that impacts:

- **Market risk:** for instance, climate risk can generate an exchange rate risk on the currencies of countries that are highly dependent on oil and gas.
- **Operational risk:** for instance, climate risk can increase the physical risk related to natural disasters on banks' properties; it can also prompt legal risks such as class actions by individuals suing banks financing activities that generate risks for the populations (respiratory diseases, deaths, etc.) or clients calling the banks into question on their duty of advice in investments matters.
- **Credit risk:** large organizations in the energy, automotive, chemicals, and air transport sectors now account for a significant proportion of the banks' credit commitments. These firms could see their credit quality deteriorate significantly, should they not succeed in shifting their business models towards a lower-carbon model, thereby exposing banks to a new kind of credit risk. This deterioration of credit quality could result from the deterioration in the conditions under which these companies operate (lower selling price, higher costs due to increased regulatory pressure, …) as well as from the explosion of their legal risks, similar to what happened in the tobacco industry.

Major debates remain on the urgency and acuteness of climate risk for banks and the financial sector in general. This debate can be symbolized in the controversy that opposed the consulting firm IHS[24] to the British NGO Carbon Tracker at the 2017 Davos Forum.

Alongside this forum, IHS Vice-President Daniel Yergin, a historian of international relations and expert in energy issues, published an article stating that "climate is not Lehman Brothers", thus supporting the thesis that climate change should not be considered a systemic risk to markets and banks. He argued that the decline of fossil fuels would take several decades and that the transition was likely to be smooth, adding that financial systems had already integrated the gradual decline of oil into oil prices and the valuation of oil companies.

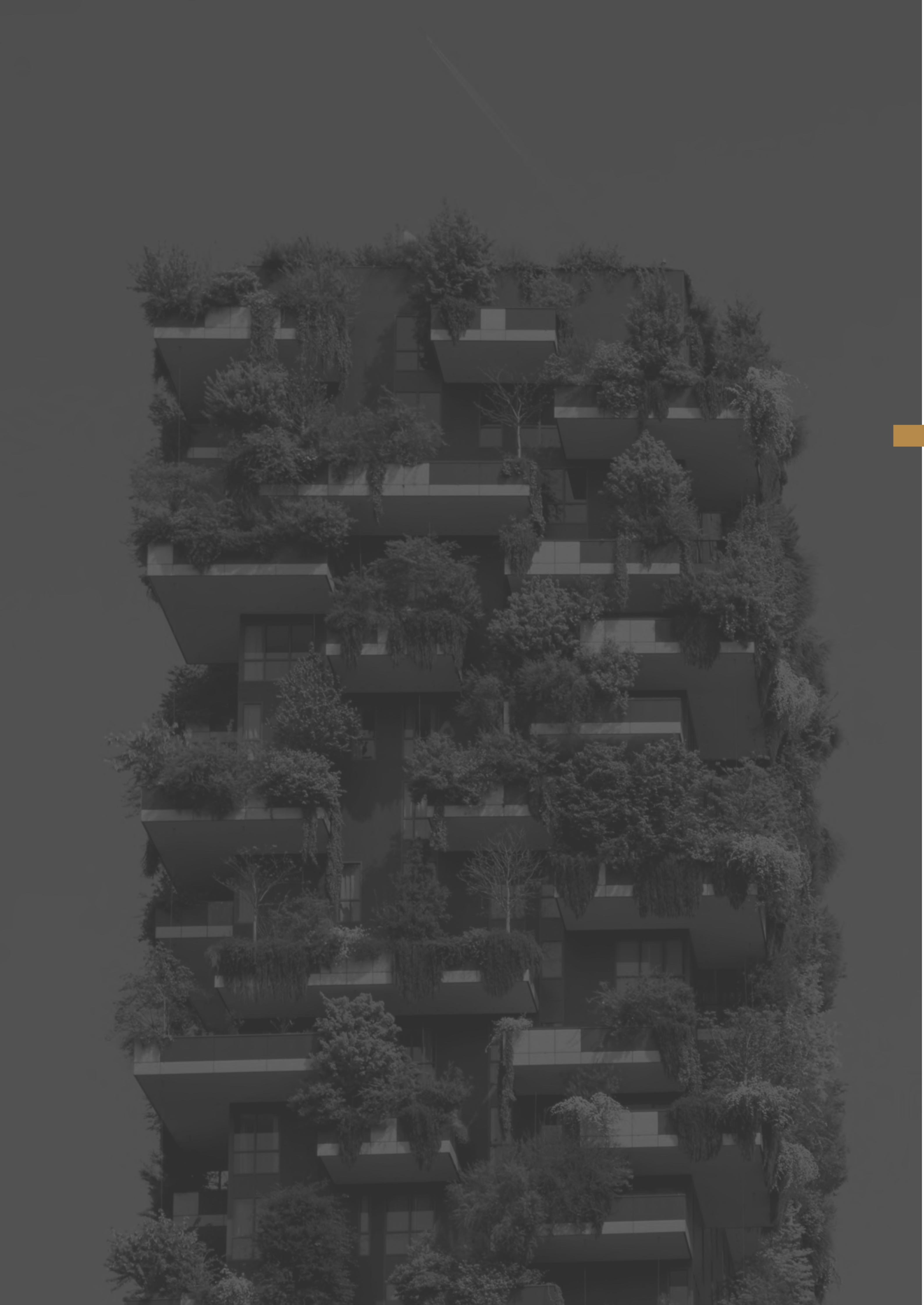
On the contrary, the NGO Carbon Tracker emphasized the urgency of the risk, arguing that the very large fluctuations in oil prices observed between 2014 and 2017 were caused by minute variations in oil supply and demand, which bear no relation to what will happen in the medium term. It also observed that the capital investment costs of the oil industry would soar and greatly exceed the profits generated with the current prices and that it was thus better, in the interest of shareholders, to direct investments towards low-carbon sectors.

22. Liquidity risk represents the risk that the bank does not meet its cash flow maturities.
23. This speech is generally known as the speech on "the Tragedy of the Horizons".
24. IHS is a consulting firm focusing, among others, on energy issues.

Without taking side in this debate, it seems certain that banks are now facing a “climate risk”, due to their intermediation role, which impacts their traditional risk management in a transversal way. They must account for the fact that energy and climate issues can change radically, and with unprecedented speed, the acuteness of certain market, legal or credit risks. They must in fact factor this “new” climate risk in their risk management strategy.

This awareness of climate risk has been officially recognized by the Autorité de contrôle prudentiel des banques françaises (ACPR – Prudential Control Authority for French banks). In its report n°101-2019, the ACPR recommends an approach that distinguishes three classes of climate risks highlighted by Mark Carney, which weigh on financial stability. These are the “physical risk”, the multiplication of extreme climate- and weather-related events, the “transition risk”, representing the cost of low-carbon compliance and “liability risk”, which impacts reputation and criminal liability. The ACPR even provided, in this report, a summary of the assets of French banks subject to transition risk.

I JUST TOOK
A CO_2 TEST
TURNS OUT
I'M 100%. DYING
ONLY 1
FUTURE



3.

WHAT ACTIONS CAN BE TAKEN TO SHIFT TOWARDS A SUSTAINABLE FINANCE MODEL?

Regulations, stakeholders and sound risk management are leading banks to become actors of a "more sustainable finance". This chapter outlines the actions that banks will need to take to achieve this transformation. These actions fall into two main categories: on the one hand, actions to comply with European regulations and on the other hand, actions to better promote their voluntary commitments.

3.1 Transforming regulatory constraints into strategic levers

As outlined in part 1a of this focus report, the "green act" presented by the European Commission represents a true regulatory "ecosystem" of 10 complementary measures designed to make "finance more sustainable"; almost all of these issues have an impact on banks, albeit to varying degrees. Although much of the specific content of these regulations has yet to be written, it seems important today for European financial institutions to anticipate their enforcement. Indeed, these regulations pose cross-cutting challenges that will require coordinated responses between the different business lines and functions concerned.

These challenges are of three kinds:

1. **A "Data" challenge** related to issuer data, in order to create a "green" language common to all economic actors. This challenge mainly affects actions 1 and 9 of the 10 measures of the "green act".
2. **A marketing and offer challenge** for the Investment services providers to target customer needs and improve the transparency of product reporting to direct savings towards sustainable products; this challenge mainly concerns actions 2, 4, 5, and 6 of the "green act".

3. **A strategy and governance challenge** for banks with the ultimate objective of impacting their equity depending on the sustainability risks incurred. This challenge mainly concerns action 8 of the "green act".

3.1.1 The "Data" challenge of the "sustainable finance" regulation

It may seem paradoxical to consider that the first challenge posed to banks by the rules included in the "green act" concerns Data. This results from the fact that European Union regulations intend to enforce a common language between companies, financial actors and public authorities on issues of classification of polluting activities: the European green taxonomy. This classification will harmonize current methods by proposing criteria and indicators common to the entire ecosystem, on environmental aspects. Companies with more than 500 employees will have to classify their activities or turnover based on the following criteria:

- Mitigation of climate change
- Adaptation to climate change
- Protection of water and sea resources
- Transition to a circular economy
- Pollution: mitigation and control
- Protection and restauration of biodiversity and ecosystems.

For each criterion, the regulations suggest metrics and thresholds to be met in order to assess whether or not an activity is "green" and compliant. Non-financial companies will thus highlight the "green" part of their revenues and activities. The compliance approach is as follows:

- Intégration des informations (critères, indicateurs, seuils) dans les outils de pilotage existants (financiers/extra-financiers).
- Integration of information (criteria, indicators, thresholds) in existing management tools (financial/non-financial)
- Data analysis and monitoring.
- Updating of extra-financial reporting, in conjunction with the review of the NFRD Directive (action 9). Developments regarding the Déclaration de Performance Extra Financière in France are therefore expected.

Portfolio managers and investment funds producers will present the "green" part of the portfolios under management and the activities in which they invest. These market players will have to:

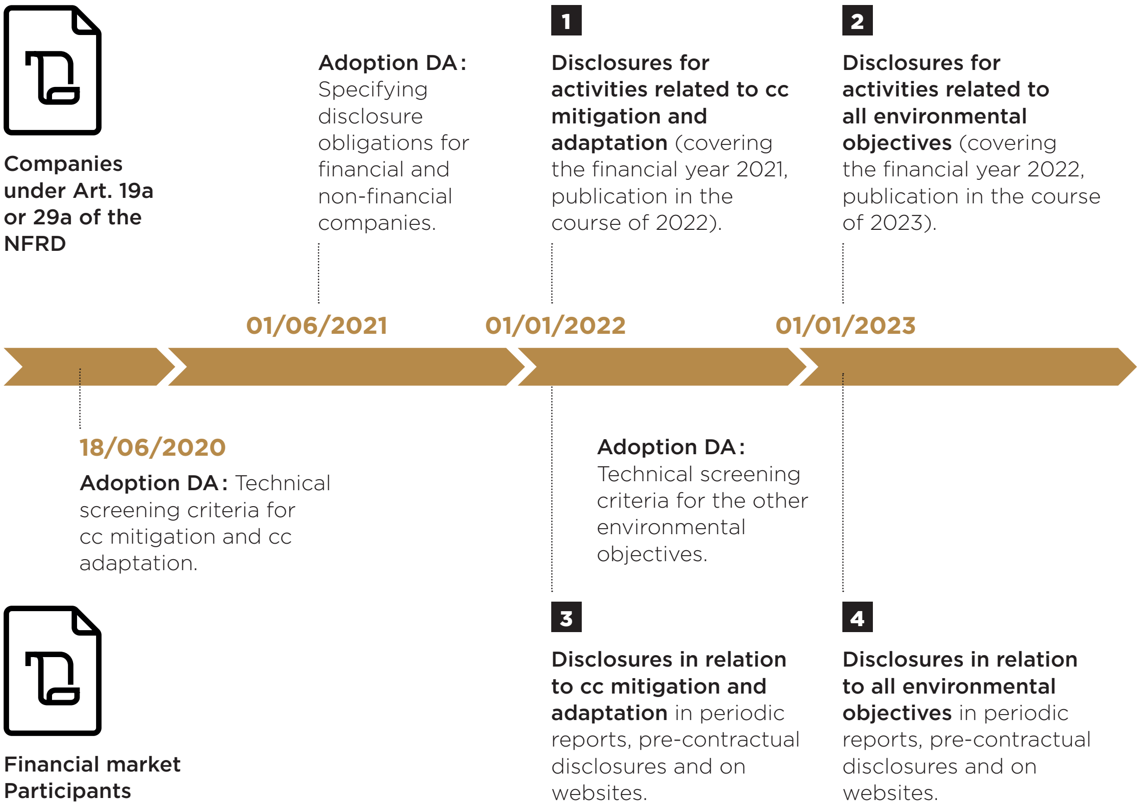
- Obtain information related to taxonomy of companies via external service providers (data providers, financial/non-financial rating agencies).
- Integrate the information into the commercial and legal documentation of their product.

Finally, banks will be able to classify the "green" part associated with project financing and credit-granting policies. These data will thus be used to manage their climate risks. They will be able to obtain the information when they start the relation and feed this information back into their tools.

The deadlines for the application of these rules are relatively short: January 1, 2022 for the classification and reporting of the activities related to the first two criteria (mitigation and adaptation) and January 1, 2023 for the other criteria. Thus, the different actors should implement a data management strategy in coordination with their data providers and other partners (suppliers, need for sharing, supervision, costs…). An early application will allow Investment services providers to question the "green" character of the products they design and distribute, as well as to adapt their range. Banks, for their part, can review the "green" nature of their classification of internal and sectorial policies, identify the sectors with the greatest need for financing in order to accelerate the energy transition, anticipate the operational impact of these regulations or even raise their clients' awareness of these issues.

Figure 5. Taxonomy: detailed timeline for non-financial and financial companies

Source: TEG Report of March 2020 and regulatory updates



The TEG report of March 2020 suggests complementing the taxonomy of "green" activities as follows:

- Integrating the social objectives associated with the taxonomy by setting minimum standards and identifying activities that contribute significantly to social objectives.
- Implementing a "brown taxonomy" that would classify the most polluting activities. To the classification of "green" activities, there would therefore be added that of "brown activities" or "red activities", and thus the creation of a category of "other" activities.

3.1.2 A marketing and offer challenge for ISPs

Reorienting savings towards more sustainable investments is a key objective in the transition towards sustainable finance. The EU regulatory arsenal relies on two levers to achieve this transition: first, promote the **creation of investment products more favorable to sustainable finance** and second, improve **transparency (entities and products) and the advisory approach for more sustainability.** This dual approach will thus require banks to adapt their entire customer journey and eventually create new investment product ranges.

The creation of new, more sustainable investment products is not explicitly an objective of the European Commission. Quite on the contrary, the new regulations, especially those relating to taxonomy and creation of labels, aim to inform investors without discriminating existing products. However, it seems likely that the new regulations will help structure the market for investment products and the need to create new products will emerge. In particular, "producers" will have to develop products with more targeted ESG objectives and greater impact for example by structuring thematic funds that will factor in, from the start, the taxonomy objectives into their management strategies or the use of the UN's 17 Sustainable Development Goals.

The strengthening of transparency is detailed in actions 2 and 6 of the "green act". They mainly concern the "producers" of investment products. They will have to adapt their approach to product structuring by integrating ESG concepts in the identification of their target market and the implementation of an appropriate distribution strategy. In order to deploy a coherent distribution strategy and reach the end customer, producers will initially be able to use the Commission's suggestions of new labels. These labels apply to funds (EU Ecolabel) or bonds (EU Green Bond Standard). They are based on the taxonomy and allow to harmonize the different existing reference systems across Europe.

Furthermore, the Disclosure regulation (action 6 "SFDR" published in November 2019[25]) will require producers and distributors to review their governance and communication by factoring ESG risks and sustainability factors into their processes and reporting of entities and products.

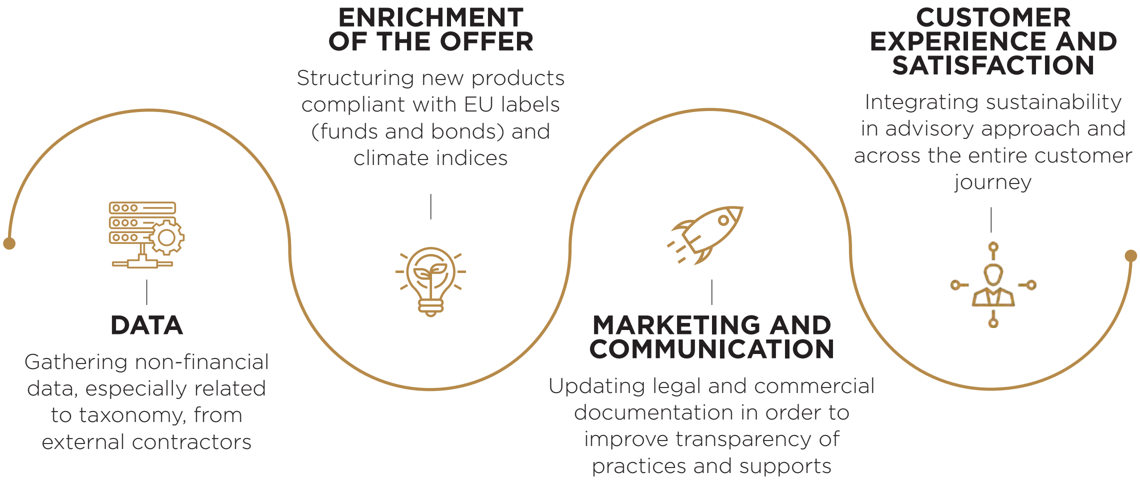
This last regulation will be crucial for customer journey and understanding of the product's sustainability objective. In fact, it allows ESG financial products to be better categorized and offers associated reporting. For instance, it introduces a distinction between products that "pursue ESG objectives among others" (e.g. SRI funds)[26] and "sustainable investments" (e.g. GreenFin-labeled funds tracking stakes related to energy transition). The challenge here is to define "intensities and ambitions" of product sustainability and to propose a coherent framework for the associated legal and commercial documentation. The objective is to bring more visibility and avoid "Greenwashing" for better understanding and tracking.

Finally, the advisory approach is directly targeted by action 4 of the "green act". This point will require banks to review the advisory approaches that had been established in application of the MIFID Directives, by systematically factoring ESG preferences into the advisory approach and product recommendation. For distributors, this will involve structuring a system capable of integrating the non-financial dimension into all customer processes: pre-sales, advice, after-sales, suitability survey and product governance.

25. « Sustainable Finance Disclosure Regulation » , Réglement 2019/2088 du 27 Novembre 2019
26. Categories are being defined

The review of these processes involves significant adjustments. It is a considerable undertaking, especially since it is likely to come at a time when the MIFID and IDD regulations have only just been fully integrated by banks and their sales force.

Figure 6. Challenges of the "green act" for ISP



3.1.3 For the credit activities of banks: a strategy and governance challenge

Finally, action 8 of the "green act" aims to integrate sustainability risks into the strategy and governance of banking organizations. It is one of the most ambitious measures and its implementation will be the subject of numerous consultations and regulatory updates over the 5 coming years.

This action in fact aims to "integrate sustainability in prudential requirements" by factoring these risks into the management policies of banking institutions and calibrating capital requirements. It should be noted that these measures will be implemented together with the objectives and criteria defined by the taxonomy.

In response to this European Commission project, the European Banking Authority (EBA) published its action plan on sustainable finance[27] in December 2019. The following areas of work have been identified:

1. **Risk management and supervision:** Develop a common definition of ESG risk (physical risks and associated transition risks), integrate these risks into management policies and deploy a relevant governance framework.
2. **Metrics and reporting:** improve stakeholders' understanding of the impact of these risks on financial stability and support them in setting up appropriate reporting.
3. **Stress scenarios:** develop common methodologies for conducting climate transition stress scenarios.

25. Per the "EBA Action Plan on Sustainable Finance" published in December 2019 [URL]

4. **Prudential processing and capital calibration:** identify whether environmental and social risks should be subjected to a specific calculation methodology and identify the necessary qualitative and quantitative data.

For each of these areas, the EBA identified the regulations and articles that should be amended:

- For banks: the Capital Requirement Regulation (CRR II) and the Capital Requirement Directive (CRD V) (versions published in June 2019 and applicable in June 2021).
- For investment firms: the Investment Firm Regulation (IFR) and the Investment Firm Directive (IFD) (versions published in December 2019 and applicable in June 2021).

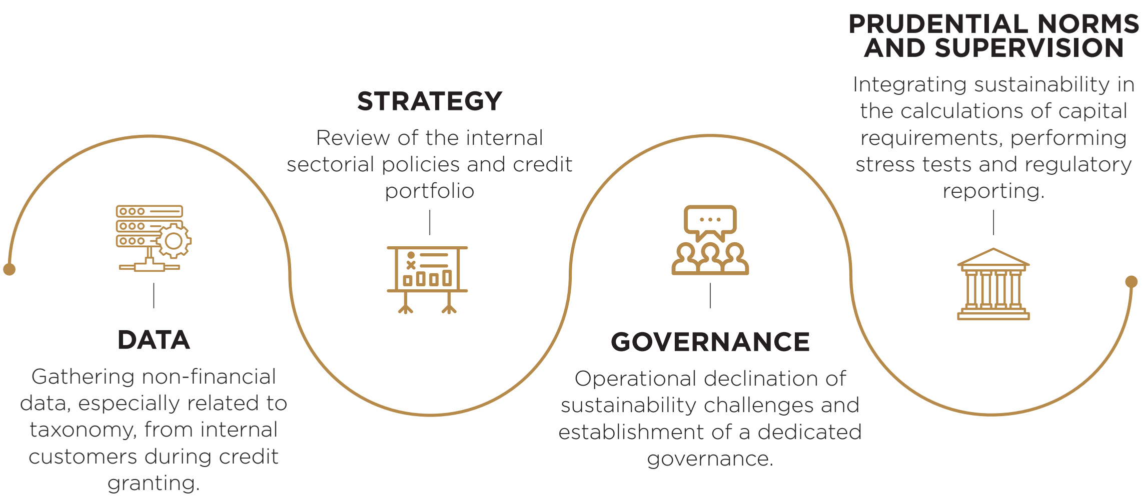
As the objectives are ambitious, the EBA has structured its roadmap in two milestones:

- In the second half of 2020, technical reports and consultation projects should begin with regard to the integration of ESG risks into risk management systems, supervision and reporting (axes 1 and 2). A first draft text is expected for 2021.
- With regards to asset classification and their prudential processing (axes 3 and 4), discussions should be initiated in January 2022 and lead to a draft text by June 2025.

In France, the Banque de France (Bank of France) and the ACPR have already taken up the subject since the stress tests of French banks are being carried out in 2020. France is therefore one of the pioneers, along with the Netherlands, which performed its first stress tests in 2019, and the UK, which plans to perform these in 2021. An initial approach to performing such stress tests has been suggested, based on four types of scenarios[28]:

This works has also enabled progress to be made in the way in which the nature of climate risk is

Figure 7. Challenges of the “green act” for financing activities



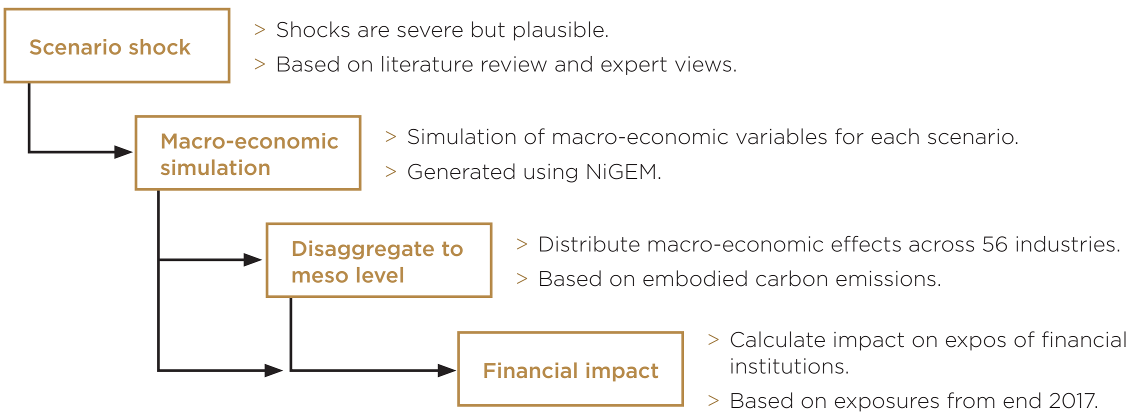
28. https://www.dnb.nl/binaries/OS_Transition%20risk%20stress%20test%20versie_web_tcm46-379397.pdf

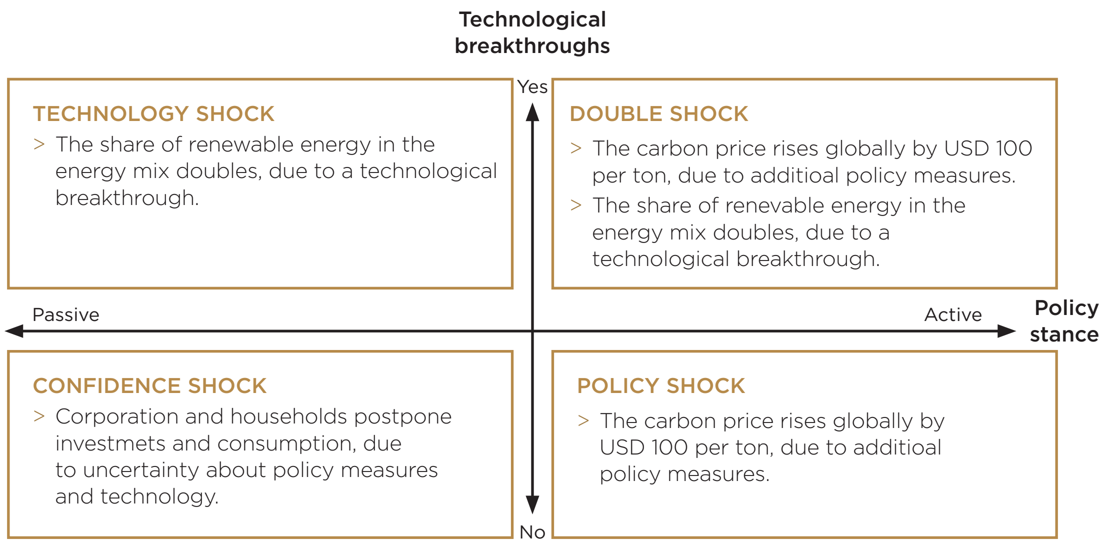
classified. It should be recalled that this would be divided into two classes of risk: a physical risk weighing on the facilities of banking institutions; and a so-called "transition" risk that would be factored in the credit risk.

The message of the EBA in the conclusion of its report is clear: ESG risks and factors will profoundly affect the banking business models. Players are thus encouraged to integrate them as soon as possible in their strategy and governance without waiting for regulatory pressure:

> ***« This requires consideration now (i.e. before the EBA completes its mandates included in this action plan) and action as early as possible notably on (i) strategies and risk management, (ii) disclosure of key metrics and (iii) scenario analysis ».***

Figure 8. Stress Tests - climate risk





The proactivity of banking players on this subject is therefore essential and requires the structuring of teams dedicated to ESG risk management and a global strategic vision. Making and maintaining voluntary commitments therefore makes it possible to anticipate upcoming European regulations.

The costs generated by such regulations will be significant for all financial players and their clients. A coordinated and structured application of these measures could be a source of differentiation for banks and could create value (sustainable and financial) for the end consumer.

3.2 Accelerating and optimizing voluntary commitments

Beyond complying with regulations of the European "green act", banks have also been taking steps for several years to transform their business towards a more sustainable model. These voluntary commitments mark a major departure from the past and target areas that are sometimes highly symbolic. However, they are still considered insufficient or only imperfectly responding to the challenges and should, therefore, in our opinion, be optimized.

3.2.1 Voluntary commitments representing a major shift and targeting highly symbolic areas

Voluntary commitments made by banks in favor of a more sustainable finance are a striking phenomenon in recent years. These commitments are often highly symbolic.

The most spectacular initiative was probably the one taken in September 2019, under the impetus of about 30 global banking groups, including 3 French ones (BNP Paribas, Société Générale and the BPCE/Natixis group), and called "The Principles for Responsible Banking". These principles were developed within the framework of the United Nations Environment Program Finance Initiative (UNEP FI) to provide a framework to support the banking industry towards a more sustainable system and demonstrate its positive contribution to our society. 130 banks holding over 47 trilling dollars in assets signed this document in September 2019. With regards to French banks, Crédit Agricole and La Banque Postale were added to the three banks mentioned above.

These principles concern all ESG issues ; they are structured around 6 major areas that aim to align banking operations with the Paris Agreement and the UN Sustainable Development Goals (SDGs), enhance their positive impacts and minimize their negative ones, have responsible policies towards their clients (individuals, organizations, and institutional investors), consult their stakeholders, make targeted and public commitments and report on their progress. This agreement comes 13 years after the Principles for Responsible Investment (PRI)29 and 6 years after the Principles for Sustainable Insurance (PSI)[30].

French banks have also, within the framework of the Fédération Bancaire Française (FBF – French Banking Federation) and in preparation for the 5th edition of the Climate Finance Day on 29 November 2019, published a "Climate Manifesto"

29. Principles for sustainable investment
30. Principles for responsible insurance
31. Climate manifesto published on 25 November 2019

of French banks[31]. In this Manifesto, the FBF insists on its understanding of the urgency and the inadequacy of the current approach while also recalling that "the commitment of French banks in the financing of the renewable sector alone reached 37 billion euros in 2018, a 41% increase in 2 years".

In addition to subscribing to collective voluntary agreements, made in the frame of international agreements and collective statements, each bank also deploys its own policy of voluntary commitments. On this topic, the European and French banks appear as pioneers, especially with regards to their policies for financing fossil fuels. In fact, according to the Rainforest Association Network[32], of the 10 banks with the highest global scores 8 are European and 2 from the UK. In this top 10, Crédit Agricole reaches the highest spot, followed by BNP Paribas (ranked 4th), Société Générale (ranked 5th) and BPCE/Natixis (ranked 7th). With regards to coal-financing policies specifically, and thanks to their commitment to no longer finance new projects related to this fossil fuel nor to offer financing to companies overly dependent on coal, 5 French banks are present among the top 7 players. French banks also make up the top trio (BNP Paribas, followed by BPCE/Natixis and Crédit Agricole) for their financing policy for oil sand projects and BNP Paris obtains the highest score thanks to its policy of not financing shale gas.

These commitments are important steps towards a more sustainable finance, especially since they are made by institutions that are emblematic by their size and reputation. They however do not escape criticism from NGOs. These criticisms are summarized in a contribution by Lucie Pinson, spokesperson for the Les Amis de la Terre association, in an opinion published by Le Monde in 2018. She criticizes these commitments for being only statements of principles, with no obligation to provide concrete actions on their short-term actions and that cannot be compared between banks[33].

3.2.2 A need for banks to optimize their approach to voluntary commitments

The criticisms voiced by NGOs undoubtedly do not take sufficient account of the innovative and disruptive nature of the steps taken by banks to transform their model towards a more sustainable finance, on the entire set of ESG topics.

With this in mind, it is striking to notice that beyond the sometimes excessive nature of these criticisms, NGOs are clearly pointing out weak points that exist in these voluntary commitments.

The weak points most frequently cited are the difficulty to compare banks with each other and the inability to confirm that commitments made by banks are sufficient to meet the upcoming challenges; the latter especially applies to climate commitments and meeting the global warming limitation objectives. The Reclaim Finance association and Les Amis de la Terre NGO have developed a tool[34] allowing to easily compare the quality of coal policies of French financial players. Its dual objective, according to

32. Banking on climate change 2020, Rainforest Action Network

33. Climate: carbon, alone, killed the Paris agreement, opinion published on 14 March 2018 on the Le Monde website.

34. Coal Policy Tool of the Reclaim France association

35. BNP Paribas is accelerating its timeline for completely divesting from coal, press release published on 12 May 2020. This statement reinforces its withdrawal policy presented in 2019 and "extends to all OECD countries its objective for end 2030 of coal use by its electricity-producing customers", while the measures initially only targeted EU countries in 2030, before an extension to the rest of the world planned for 2040. Furthermore, "starting today, no new customer having a proportion of more than 25% of its turnover related to coal will be accepted by BNP Paribas".

the association, is to "facilitate the comparisons of policies based on identical and public criteria and make it possible for clients, the media, and other stakeholders to evaluate gaps between current actions and the goal of limiting climate warming to 1.5°C". Updated on a frequent basis, this tool sparked multiple reactions as, just after its release was announced and pointing out the limitations of the coal policy of BNP Paribas, the latter released a new strategy[35], which was more ambitious than the one released at the end of November 2019.

It is in the context of this debate on comparability of commitments made on greenhouse gas emissions and their actual reach that the debate on the calculation scopes (also called "Scope") is taking place. In order to evaluate gas emissions and harmonize the fight against climate change, the Green House Gas (GHG)[36] Protocol was established in 2001, jointly by international actors such as governments, NGOs, and organizations. The principles of emission calculations are detailed in the chart below. Three different calculation scopes are distinguished:

- The first exclusively concerns the emissions generated by the direct activities of the company (Scope 1).
- The second one also factors in the emissions generated by the company' upstream activities (Scope 2).
- The third one is much broader; it accounts for the emissions generated directly or indirectly, upstream or downstream of the company's activities. For banks, the principal issue resides in the integration, within Scope 3, of the greenhouse gas emissions of the sectors in which banks invest or that they finance. In a survey conducted in 2013, direct emissions of Crédit Agricole's facilities and of the commuting of its employees only represented a mere 0.4% of the group's total emissions when the operations financed were factored in[37].

To date, it is probably unrealistic to require large financial institutions to calculate their emissions relative to Scope 3 in a reliable way. Methodological difficulties are still too high to perform such calculations in a reliable way. However, the medium-term pressure to carry it out appears very high, as it will be the only way for banks to demonstrate their commitment to change their financing behavior and provide convincing elements to the associations formulating the harshest criticisms. This stance has been echoed by many stakeholders. The ADEME indicates, in fact, that the most relevant center concerns "financed emissions"[38]. Similarly, in a report published in 2016, the Réseau Action Climat association recommended "providing a tool for globally tracking the reduction of financed emissions after actions have been implemented", underlining the fact that "such a monitoring could make the impact of actions much more transparent to external eyes"[39]. In the near term, our conviction is that the pressure will tremendously rise to make the publications of Scope 3 emissions by banks become more relevant and unified.

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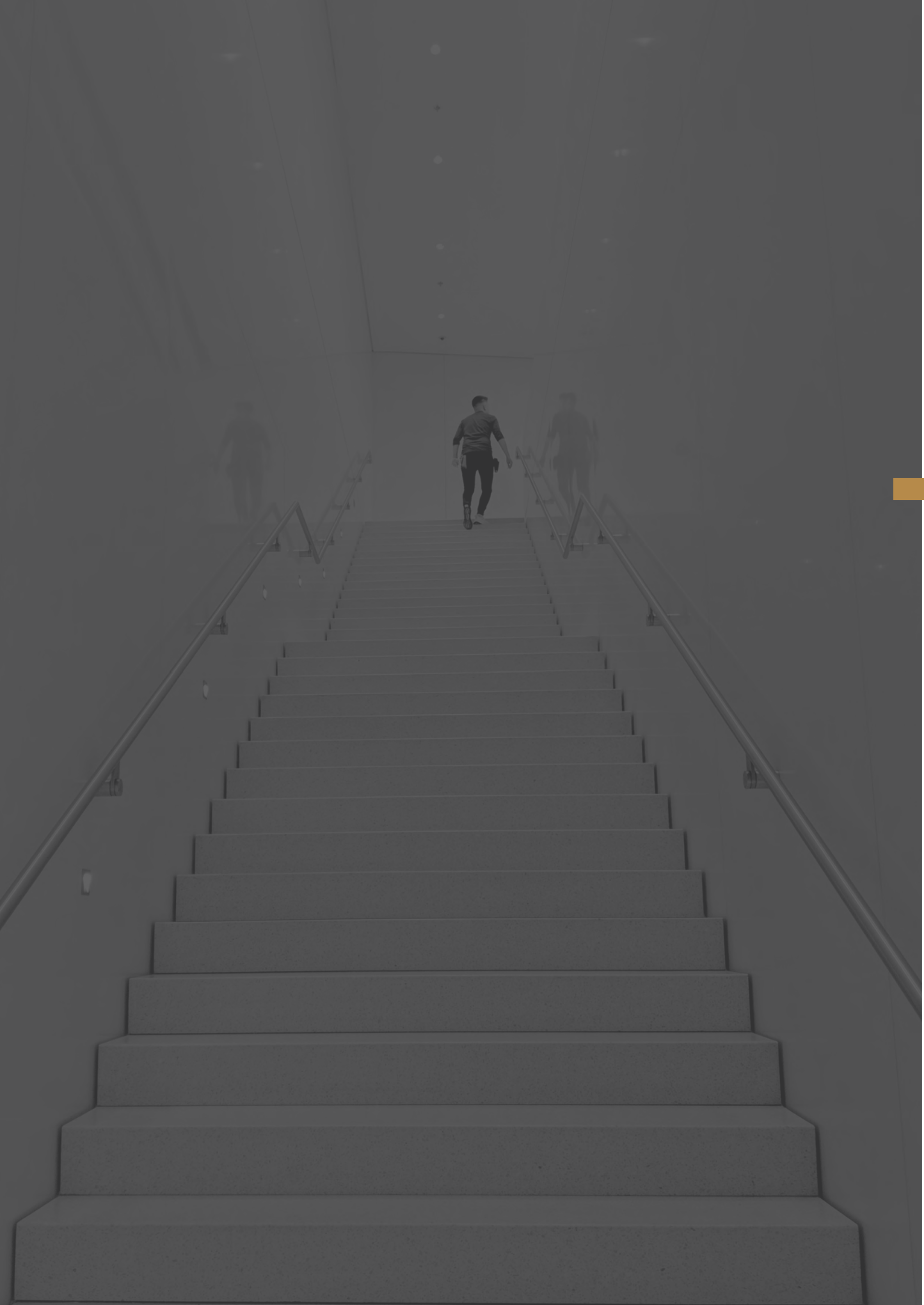
36. https://ghgprotocol.org/calculationg-tools-faq

37. Rose, Cochard, Courcier (2013) "Pour une approche catabolique de l'empreinte carbone induite des établissements financiers » (« For a catabolic approach of the carbon footprint induced by financial institutions »), Jan-March 2013, Analyse Financière n°46.

38. Ademe & you, 2014

39. The climate responsibility of corporations should be extended to indirect emissions! published by Réseau Action Climat France



4.

CONCLUSION

Part of the public opinion (sometimes) like to hate banks and considers that they are the symbol of a predatory and short-sighted capitalistic system. The point of view developed throughout this document shows, quite on the contrary, that banking institutions have started their transition, although considerable changes still need to be achieved to meet the challenges set out by sustainable finance.

The shift of the global financial industry to a more sustainable model has now started. It is supported by three types of trends that are already making banks adapt their business models. On the one hand, regulations, albeit little demanding for a long time, are changing and start imposing more and more ESG constraints on bank, especially in Europe where the European Commission has chosen sustainable finance as one of the main themes of its new mandate. On the other hand, stakeholders (associations, shareholders, clients, employees, or future employees), out of activism or sheer interest, are pressuring banks to make clear and transparent commitments to a more sustainable model. Finally, the banks themselves are now factoring ESG risks and especially climate risk into the management of their investments and financing portfolio so as not to be overexposed to sectors carrying risks.

This shift of banks towards sustainable finance represents a challenge at least as great as the one they had to overcome to adapt to the new world after the financial crisis of 2008.

This challenge assumes that banks will be able to face the regulatory amendments that will come alongside this shift. In Europe, under the impetus of the European Commission, these amendments, which are integrated in the "Green Deal for Europe", will be crucial and impact numerous businesses or functions in banking (asset management, investment support, capital calculations...). To be compliant, banks will need to get organized and conduct complex cross-sectoral projects that must be anticipated and prepared well before the application dates of new regulations. The regulatory "shock" of sustainable finance will at least be as powerful as the regulatory landslide that has hit banks since 2008, and banks have a strong incentive to take an approach based on anticipation and preparation rather than merely standing by.

This challenge also assumes that banks win the battle of reputation and credibility in the eyes of their stakeholders. Considerable progress has been made in the past years by large European banks, especially French ones, in the frame of their voluntary commitment policies. These commitments factor in all ESG elements, while the reputation battle will mostly be played around the commitments in terms of climate. In this area, public debate will undeniably consider that the banks' impact on climate should be evaluated with regards to their own activities as well as with regards to the activities in which they invest or that they finance. This approach brings major methodological and calculation challenges; banks should not hide behind these hardships and adopt a defensive approach in which they would measure their commitment based on their direct emissions only. They should, on the contrary, think of the modalities to evaluate and communicate reliably on their greenhouse gas emissions, including the activities that they support indirectly through their investment or financing. It is in this context only that they will stay true to their commitment to a sustainable finance.

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Founded in 2008, Square is a strategy and business consulting group that bring together 9 medium-sized firms in France, Belgium and Luxembourg. dway, Circle, Flow&Co, Forizons, Initio Belgique, Initio Luxembourg, Tallis, Vertuo, Viatys are consulting firms specialized in trade, activity sector or level of intervention.

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Ce focus « Transition vers la finance durable : quels défis pour les banques ? » a pour ambition de présenter un état des lieux de l'avancée des réflexions sur la finance durable dans le secteur bancaire. La première partie décrit les raisons pour lesquelles nous pensons, chez Square, que les thématiques de finance durable vont devenir, au cours des prochaines années, la priorité absolue des institutions bancaires : pression des parties prenantes, réglementations nouvelles mais également apparition de nouveaux risques vont conduire les banques à modifier de manière profonde leur modèle d'affaires et à davantage prendre en compte les critères ESG dans leur activité. La seconde partie expose plus en détail les chantiers ouverts dans les banques pour être à la hauteur du défi de la finance durable. Ces chantiers sont présentés en deux blocs. Le premier bloc est celui qui va permettre d'être à la hauteur du défi réglementaire de la finance durable. Il comporte des volets data, marketing, finance, risque, considérables et va exiger d'importants efforts. Le second bloc est celui des engagements volontaires des banques. Ces engagements volontaires constituent déjà des avancées spectaculaires dans l'engagement des banques en matière de finance durable, particulièrement pour les banques européennes et françaises, qui font figure de pionniers sur ce domaine. Notre conviction est que ces banques devront progresser encore dans la lisibilité, la comparabilité et le suivi de ces engagements pour asseoir leur crédibilité comme acteurs de la finance durable.

Square est un cabinet de conseil en stratégie et organisation. Très présent dans le secteur banque et assurance, il développe depuis quelques années des expertises pointues dans le domaine de la RSE et propose des accompagnements spécifiques sur les thématiques de la finance durable dans ses aspects réglementaires, data (modélisation des risques climatiques), marketing (offres nouvelles) et organisation.

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