

Banking: Materials for Class on Tuesday April 2

Because banks are so central to financial activity they are subject to regulation to ensure their safety and soundness, often described as prudential regulation. In addition to requiring that those who manage banks are fit and proper we subject individual banks to capital adequacy regulation, designed to protect the deposit insurance system (to prevent bank runs we insure retail deposits in banks so bank depositors do not have to worry about bank failure). And we worry about the financial system as a whole: systemic risks in the financial system which might cause financial crises.

Banks are exposed to climate related risks in the context of their lending activities. A bank that lends money to many businesses and/or households that are negatively affected by physical or transition risks² may lose money on those loans, and catastrophic weather events have an impact on bank lenders.³ Non-performing loans are a serious problem for banks, reducing their profitability and with implications for the adequacy of their capital.⁴

As with insurers, bank regulators are concerned to identify climate-related risks affecting individual banks, as well as systemic risks, which are risks to financial stability generally. One way of addressing climate related risks to banks is to require banks to make disclosures about the risks they face. The Basel Committee on Banking Supervision published a consultation document on this type of disclosure in November 2023, asking for views on bank-specific disclosure requirements that would complement the disclosure framework being developed by the ISSB for non-financial businesses.⁵ The document notes that it is likely that the development

¹ © Caroline Bradley 2024. All rights reserved.

² Cf. Hyeyoon Jung, João A.C. Santos & Lee Seltzer, *U.S. Banks' Exposures to Climate Transition Risks*, FRBNY Staff Report Number 1058 (April 2023) (finding banks' credit risk exposures to transition risks are modest, and some banks are engaging in transition risk management).

³ Cf. Owen Nie, Martijn Regeling & Dieter Wang, *Banking Sector Risk in the Aftermath of Climate Change and Environmental-Related Natural Disasters*. World Bank Group Policy Research Working Papers 10326 (Feb. 2023) (finding that "severe disaster episodes lead to an increase in the level of systemwide non-performing loans, which is persistent over time.")

⁴ Banks are required to have capital investment by investors in their equity shares and close equivalents to equity to act as a cushion in the event that the bank becomes insolvent.

⁵ Basel Committee on Banking Supervision, *Disclosure of Climate-related Financial Risks*, Consultative Document (Nov. 29, 2023).

of this bank disclosure framework is “likely to be an iterative process.”⁶ The approach to disclosure involves qualitative disclosures relating to “(i) governance; (ii) strategy; (iii) risk management; and (iv) concentration risk management in relation to climate-related financial risks,”⁷ and quantitative disclosures. With respect to quantitative disclosures the Basel Committee is considering whether banks should disclose exposures to standardized sectors of the economy, and to risk by geographical area, as well as disclosures relating to financed emissions.⁸

The European Central Bank and European Systemic Risk Board have proposed three frameworks for addressing financial stability risks from climate change: a surveillance framework, a framework of policy responses from focusing on borrowers, to capital requirements to dealing with greenwashing and insurance protection gaps, and a framework to address nature degradation.⁹ With respect to the surveillance framework the report states:

“banks will be key in managing and reducing climate-related financial stability risks, with lending disproportionately tilted toward firms and households with high climate risk exposures. With the carbon footprints of EU banks having shown little sign of decreasing in recent years, banks remain strongly exposed to carbon emissions in their lending portfolios. The share of high-emitting economic sectors in bank lending is around 75% higher than its equivalent share in economic activity, while more than 60% of banks’ interest income derived from firms operating in the most carbon-intensive sectors. Exposures to the real estate, construction, and wholesale and retail trade sectors stand out most as requiring transition risk management. A tilt in mortgage borrowing towards high-emitting households is noteworthy, as they comprise typically 60-80% of total mortgage lending in euro area countries. Beyond transition risk, the physical risk of lending portfolios is also substantial. More than 50% of total loan exposures towards firms in the mining, water supply and wholesale sectors are affected by extreme flood risk, while more than 10% of exposures towards the mining sector are affected by extreme wildfire risk.

High climate risk exposure is not distributed evenly across banks. For transition risk, exposure concentrations are high in a subset of banks. They would face substantially larger losses than their more diversified peers when confronted with a transition shock. The impact of portfolio concentration could lead to a 60%

⁶ *Id.* at 1. We will think about disclosure requirements generally later. Here the point is to notice that disclosure of risks is seen as relevant to bank supervision, in particular because disclosure allows market participants to assess the risks.

⁷ *Id.* at 3.

⁸ *Id.* at 5.

⁹ *See, e.g.*, European Central Bank & European Systemic Risk Board, *Towards Macroprudential Frameworks for Managing Climate Risk* (Dec. 2023).

increase in expected losses on corporate lending portfolios during a disorderly transition. The lack of information on clients' transition plans prevents a proper aggregate assessment of how these exposures are being managed. Available data indicate that the adjustment of bank portfolios has remained limited, with only slow shifts in portfolios towards activities aligned with EU environmental objectives. Concerning physical risk, potential exposures to climate hazards remain highest for water stress, wildfires and subsidence.

Climate risk exposures may give rise to financial risk through the interplay with financial vulnerabilities. Banks' vulnerability towards combined transition and credit risk via their loan portfolios could triple in the event of a pronounced shock. At the same time, underprovisioned credit risk is highly concentrated among relatively few banks: in a disorderly transition, around a quarter of total loan portfolios might already account for some 50% of total additional losses within just a few years. Concerning physical risk, the construction, manufacturing, transport, and wholesale and retail sectors present the highest physical-to-credit risk intensity for both flood and wildfire risks. The portfolios of smaller firms, in particular, carry a relatively higher risk, given that small and medium-sized enterprises (SMEs) tend to operate more locally and are highly reliant on bank credit.¹⁰

The report also identifies four systemic mechanisms that may amplify losses from climate change:

“Many estimates of losses resulting from first-order impacts of climate change appear manageable at face value, particularly over a long horizon. However, several systemic risk channels could bring forward seemingly distant losses or amplify seemingly concentrated losses. The prospect of these sources of amplification, not reflected in past data, would not be reliably captured by traditional back-testing, no matter how rigorous. A first source of systemic amplification is climate shocks – even seemingly localised hazards related to heat and water stress tend to be self and mutually-reinforcing and could lead to abrupt financial market repricing. A second source of systemic amplification is economic – global supply chains could imply shock propagation across borders. This is particularly relevant for the euro area as a very open economy, in which international exposures could magnify domestic losses due to floods multiple times, depending on the potential for trade reallocation. A third channel of systemic amplification relates to traditional financial externalities in the event of rapid changes in financial sentiment – noting interactions across financial participants could amplify shocks as climate risks become more salient. Traditional counterparty risk might be a particularly strong source of risk propagation through the financial system, through credit, market and liquidity

¹⁰ *Id.* at 4.

linkages across financial firms. A final source of prospective systemic amplification, and a particularly difficult one to assess, is risk transfer – sovereigns might be tempted to step in to cover underinsured climate losses. The insurance protection gap across euro area countries is noteworthy, with only 25% of average climate losses currently insured (and up to 95% of climate losses remaining uninsured in some countries). This significant protection gap is likely to worsen if climate shocks continue to become more potent and leaves both financial institutions and governments heavily exposed to climate risk.”¹¹

Some commentators have suggested that existing central bank tools and mandates are not adequate to deal with issues relating to climate change, and, worse, that relying on what central banks can do forecloses other, more effective action:

“Whilst it is clear that interventions are necessary to mitigate the effects of humanity’s continued burning of hydrocarbons and the resulting social ills which accompany these practices, from a practical perspective, requiring central banks to consider their roles in this endeavour—at least under their current powers—amounts to little more than virtue-signalling... More worryingly, these measures distract from the task of meaningful consideration of the proper role of financial authorities in arresting the further degradation of the climate. Bending regulations in this way allows governments and others to claim that they are doing ‘what they can’ to act on climate change whilst neglecting the opportunity to adopt new paradigms, and new, more powerful tools to address the issues directly.”¹²

As with insurers, banks are also involved in climate change risks as financiers of fossil fuel businesses and other significant ghg emitting businesses. A Guardian investigation in 2022 showed that fossil fuel companies were planning very large numbers of “carbon bomb” projects “that would drive the climate past internationally agreed temperature limits with catastrophic global impacts.”¹³ Banks are financing these projects.¹⁴ One study found that the 60 largest banks had been involved in \$5.5 trillion fossil fuel financing in the seven years since the Paris

¹¹ *Id.* at 5.

¹² Jay Cullen, *Central Banks and Climate Change: Mission Impossible?*, 9 *Journal of Financial Regulation* 174-209, 209 (2023) <https://doi.org/10.1093/jfr/fjad003>.

¹³ Damian Carrington & Matthew Taylor, Revealed: the ‘Carbon Bombs’ Set to Trigger Catastrophic Climate Breakdown, *The Guardian* (May 11, 2022).

¹⁴ Ajit Niranjana, “Carbon Bomb” Financiers Threaten World’s Ability to Curb Warming, *Mother Jones* (Nov. 2, 2023).

Agreement.¹⁵ Royal Bank of Canada and JP Morgan were among the most significant lenders. And this lending has been happening when banks were making public net zero commitments. The report states:

In 2021, France's La Banque Postale committed to end financing for all companies expanding oil and gas, and to exit the sector completely by 2030. Consistent with this robust policy, La Banque Postale shows no financing for 2022 in this report. Until the remaining 59 banks in this report also enact policies to exclude financing for fossil fuel expansion, any commitments to net zero emissions are nothing more than greenwash.

Thirteen banks still have no fossil fuel exclusion policy strong enough to merit any points in our evaluation. This includes eleven out of the thirteen Chinese banks in scope, State Bank of India, and U.S. Bancorp. U.S. Bancorp lags far behind its peers' already inadequate policies.¹⁶

The war in Ukraine changed perspectives on energy, leading to more emphasis on renewable energy sources in the EU, but banks such as JP Morgan continue to have lending relationships with Gazprom, despite sanctions measures against Russia.¹⁷

In addition to facing complaints by activists, banks may also face legal proceedings. Friends of the Earth Netherlands (Milieudefensie) sent a notice to ING Bank in January 2024 stating that it was planning to sue the bank because it had breached legal obligations by contributing to climate change.¹⁸ For example:

“Although on paper ING has numerous green intentions, in practice it is short of the mark. ING's climate policy is miles away from what is necessary to achieve the 1.5°C target. In addition to the substantial emissions of ING, this also becomes painfully clear when we zoom in on ING's fossil fuel portfolio. ING still finances companies that start new oil, gas, and coal projects, while the science clearly states that starting new fossil projects is incompatible with limiting climate change to 1.5°C. There is no doubt that the use of fossil fuels must be phased out as quickly as possible to prevent dangerous climate change. Nevertheless, the bank continues to provide billions in financing to this sector. Even the revised climate policies that ING announced in December 2023, are merely a small step

¹⁵Rainforest Action Network, Banktrack, Indigenous Environmental Network, Oilchange, Reclaim Finance, Sierra Club & Urgewald, *Banking on Climate Chaos: Fossil Fuel Finance Report 2023* (Apr. 12, 2023) at 4.

¹⁶ *Id.* at 8.

¹⁷ See, e.g., Evan Hsiang, *Fossil Fuel Financing and the Russia-Ukraine War*, Harvard International Review (Aug. 28, 2023).

¹⁸ <https://en.milieudefensie.nl/news/this-is-our-official-letter-to-ing>.

and remain insufficient. In 2022 ING had over 15 billion euros in loans to the oil and gas industry outstanding, of which some 5 billion in new loans were issued in that year. In addition, research of Investico and Follow The Money shows that ING has supported the fossil fuel industry since the Paris Agreement through the issue of 83.2 billion euros in bonds.

The dangerous climate change that ING contributes to leads to large-scale human rights violations for current and future generations all over the world, including in the Netherlands. In order to prevent dangerous climate change as much as possible, it is essential that ING takes responsibility and takes serious steps to get its climate policy in line with the 1.5°C target of the Paris Agreement.

ING has been aware of the seriousness of the climate crisis since at least 2007... You previously described the situation exactly as it is: ‘flooding, widespread heatwaves and forest fires across the globe all signalled an existential crisis that cannot be ignored.’ Climate change is ‘threatening both our planet and its people.’ Despite all internal knowledge, ING still continues to finance and support clients and activities that cause this crisis to get worse by the day....

Under Dutch law, companies have a responsibility to respect human rights. They also have the legal obligation to ensure that they do not create any danger that can lead to avoidable damage to property and personal injury (also called ‘endangerment’). This obligation is called the duty of care and arises from the legal general societal standard of care and the related case law. The content of the duty of care is determined on the basis of relevant facts and circumstances. This includes things such as scientific findings, treaty provisions, national and international case law, soft law, legislation and codes of conduct. The influence of these sources on the societal standard of care (i.e. also the duty of care) is generally acknowledged in the case law and literature.”¹⁹

This claim that ING may be liable for its role in creating climate change follows successful litigation against Shell under Dutch law, where the court found that Shell would need to reduce its emissions between 2019 and 2030 by 45%.²⁰

The letter to ING sets out a number of demands:

“1. ING sees to it that its climate policy is in accordance with the 1.5°C target of

19

<https://en.milieudedefensie.nl/news/this-is-our-official-letter-to-ing/@@download/file/Milieudedefensie%20Climate%20case%20ING%20notice%20of%20liability.pdf>.

²⁰ Vereniging Milieudedefensie et al v Royal Dutch Shell plc, District Court of The Hague, ECLI:NL:RBDHA:2021:5337 (25 May 2021), 4.4.53, <https://uitspraken.rechtspraak.nl/#!/details?id=ECLI:NL:RBDHA:2021:5337>. See <https://climatecasechart.com/non-us-case/milieudedefensie-et-al-v-royal-dutch-shell-plc/>. Shell has appealed the decision.

- the Paris Agreement;
2. ING reduces its emissions by at least 48% CO₂ and at least 43% CO₂e in 2030 compared to 2019;
 3. ING, in addition, ensures that it is not linked to adverse climate impacts of large business clients, such as:
 - a. ING demands that all large corporate clients provide a good climate plan;
 - b. ING ceases financing and supporting large corporate clients who do not have a good climate plan within one year;
 - c. ING demands that fossil fuel clients stop fossil fuel expansion and draw up a good phase-out plan;
 - d. ING ceases new financing and support for fossil fuel clients who continue fossil fuel expansion or who do not have a good phase-out plan;
 - e. ING ceases all financing and support for fossil fuel clients who after a year still continue fossil fuel expansion or who do not have a good phase-out plan; and
 4. ING engages in a conversation with Milieudefensie in order to properly give substance to the above-mentioned measures.”

ING has responded that it takes climate change seriously and is putting in place a policy in line with the 1.5°C target of the Paris Agreement, that the 48% emissions reduction target is not appropriate, that ING is working on reducing emissions and in most of the sectors it is financing it is aiming to reduce emissions intensity rather than absolute emissions, and that ING is working on collecting climate data from its clients and reducing financing to fossil fuel companies. However:

The vast majority of companies exploring or producing oil & gas do so from both existing as well as new fields and your demand would lead to full divestment from these oil & gas companies. Unfortunately, 80% of the world’s energy still comes from fossil fuels, used for heating, cooking, transportation and generating electricity. In the Netherlands, the percentage is even higher. These percentages will only gradually come down as new energy sources become available. That’s why the United Nations at the COP28 climate conference agreed to ‘transitioning away from fossil fuels in energy systems, in a just, orderly and equitable manner’ – so not overnight.

We do not believe that divesting from oil & gas overnight is the right thing to do, and it is also not in line with the pathways that scientists set for the transition to Net Zero by 2050, or what the Paris Agreement calls for. Instead, we choose to engage in dialogue with our clients to help them progress in their climate strategies. As you know, based on the latest scientific insights and the outcome of the United Nations climate conference in December 2023, we have decided that we will speed up the reduction of our upstream oil and gas portfolio and fully exit by 2040; well ahead of the goal of the Paris agreement. We also decided that we

will aim to triple our financing of renewable energy by 2025.²¹

²¹ <https://www.ing.com/MediaEditPage/ING-letter-to-Friends-of-the-Earth-English.htm>.