INTUITION

Learning Insights

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Banks Slow to Act on Climate-Related and Environmental Disclosures

As momentum builds internationally for meaningful climate-related and environmental disclosures, an ECB report finds that European banks have made slow progress. Additionally, where disclosure is made, there is a marked lack of substantiation behind the figures.

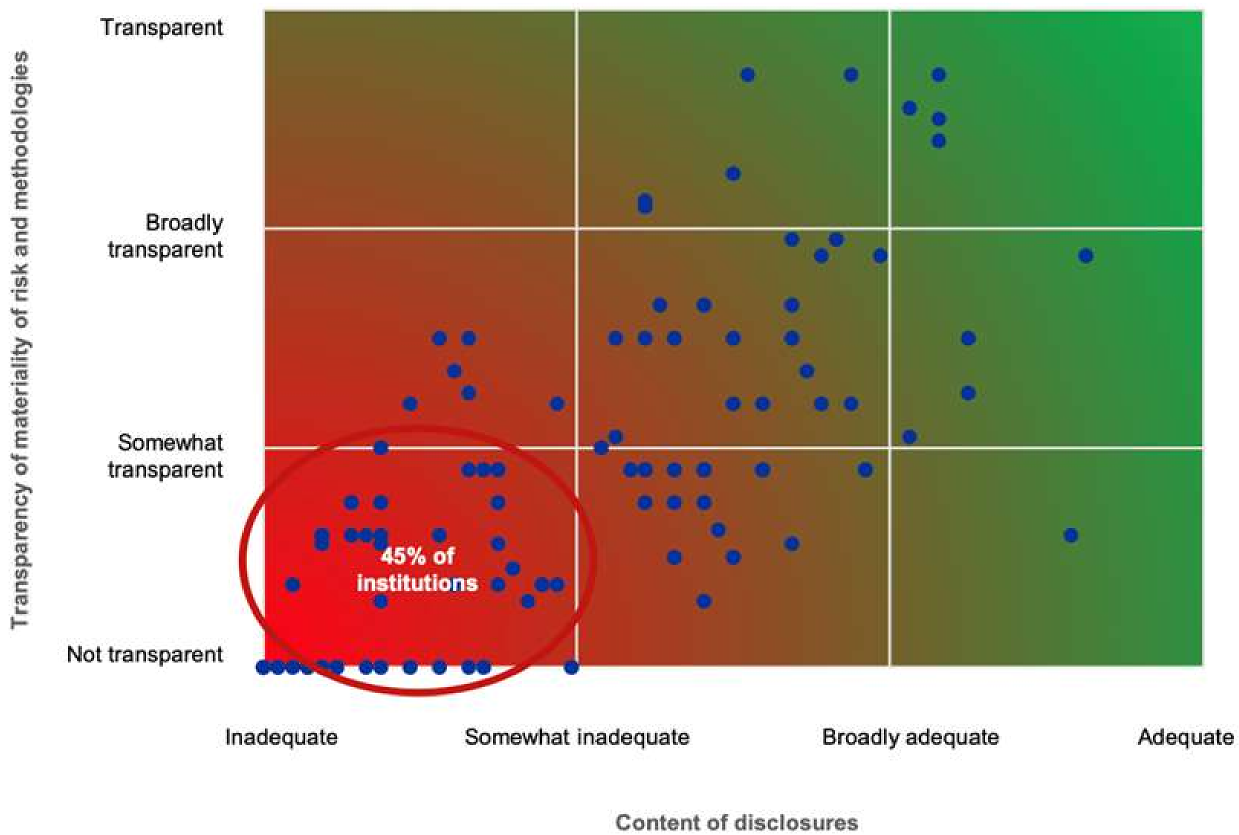
Europe's banks have made little progress on climate-related and environmental (C&E) disclosures since the European Central Bank (ECB) published its first stocktake of banks' C&E disclosures back in November 2020. That is the message from the publication in March of the Bank's latest report on the progress – or lack of it – made by the 112 European banks under the ECB's direct supervision with €24 trillion in combined assets.

The first stocktake coincided with the publication of the ECB Guide on climate-related and environmental risks, a milestone document that set out supervisory expectations relating to C&E risk management and disclosures. At that point, the ECB notes, virtually none of the banks under its supervision met expectations: they were invited to assess themselves against Guide expectations and to submit action plans detailing how they would bring their practices into line.

The findings for 2021 show that improvement in the quality of banks' disclosures has been slight. Seven in ten banks disclosed information about C&E risk management and governance (compared to five in ten in 2020). Only four in ten shared relevant information about the incorporation of C&E risks into their strategic considerations (up from three in ten in 2020). None of the banks fully met the ECB's supervisory expectations for disclosures.

The state of climate-related and environmental risk disclosures in the banking sector in terms of content and transparency

(y-axis: the level of alignment of 109 institutions' disclosures with the supervisory expectations set out in the ECB Guide on transparency and substantiation; x-axis: the level of adequacy of 109 institutions' disclosures as regards the expectation set out in the ECB Guide on the content of disclosures)



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Momentum builds for C&E disclosures

Banks are not alone in being exposed to increasing regulatory pressure to disclose C&E risks. Worldwide, there is a broad push from regulators towards such disclosures for banks, corporate companies, and even for financial products.

The EU's scrutiny of European banks' efforts to meet their C&E requirements takes place against a background of multiple initiatives relating to C&E disclosures.

As far back as 2017, the Financial Stability Board (FSB) published the Final Report of the Task Force on Climate-related Financial Disclosures (TCFD). This Report issued recommendations for helping businesses disclose climate-related financial information that apply across all sectors. The guidance has become something of a benchmark for financially material climate-related information and a number of financial institutions already publish specific "TCFD reports". The TCFD regularly publishes status updates and focus reports, for instance on metrics and targets.

One final noteworthy development was the adoption in April 2021 by the European Commission for a proposal for a Corporate Sustainability Reporting Directive (CSRD), designed to ensure that companies report the relevant, comparable and reliable sustainability information needed by investors and other stakeholders. The CSRD is expected to come into effect for reporting periods starting on or after January 1, 2023.

In November 2021, the International Financial Reporting Standards (IFRS) Foundation Trustees announced the creation of a new standard-setting board – the International Sustainability Standards Board (ISSB). The ISSB is to deliver a global baseline of sustainability-related disclosure standards that provide investors and other capital market participants with information on companies' sustainability-related risks and opportunities.

In Singapore, one of the main financial centres of the world, both the Singapore Exchange and the financial regulator MAS in the last two years announced mandatory C&E disclosures for corporates and financial institutions. From 2023, climate reporting will be made mandatory for businesses listed in Singapore that are active in the financial, energy, agriculture, food and forest products sectors. Reporting will be made mandatory for businesses in the materials and buildings and transportation sectors from 2024.

Just last month, the Taskforce on Nature-Related Financial Disclosures (TNFD) released its beta framework for organizations to report and act on evolving nature-related risks, incorporating nature-related risk and opportunity analysis into the heart of corporate and financial decision making.

In the latest initiative, also last month on the 21st of March, the US Securities and Exchange Commission (SEC) is proposing that public companies be required to disclose in their annual reports their direct greenhouse gas emissions and these disclosures would need to be verified by a third party. SEC-registered firms would also need to disclose plans to reduce emissions.

Delivering on regulatory expectations?

The key Expectation 13 in the ECB Guide states that institutions are expected to disclose “meaningful information and key metrics on climate-related and environmental risks that they deem to be material.” While there is no common threshold for materiality, the ECB prescribes that institutions conduct an assessment tailored to their business model and risk profile over short and longer time horizons. Conclusions on the materiality of information should be “based on concrete quantitative and qualitative thresholds.”

Overview of the institutions that disclose basic climate-related and environmental risk information that would align with ECB expectation 13 and related sub-expectations

Topic	Expectation	Disclosure practices	Percentage
Transparency of disclosures	13	Does the institution disclose that its exposure to climate-related and environmental risks is material?	36%
	13.3	Does the institution disclose methodologies, definitions and criteria associated with any figure, metric or target reported?	21%
Content of disclosures	13.4	Does the institution describe the potential strategic impact of transition risks in the short or long term?	41%
		Does the institution describe the board’s oversight of climate-related and environmental risks?	71%
		Does the institution describe the organisation’s processes for identifying, assessing and managing climate-related and environmental risks?	71%
		Percentage of institutions that disclose all of the information set out in Expectation 13.4	39%
	13.5	Does the institution disclose its Scope 3 financed emissions?	15%
	13.6	Does the institution disclose its key performance indicators or key risk indicators associated with its strategy-setting?	49%
	Percentage of institutions that disclose all of the information set out in Expectations 13.4-13.6		6%
Other environmental risk disclosures	13.7	Does the institution disclose key information on environmental risks other than climate-related risks?	25%

Source: Supervisory assessment based on 109 institutions’ disclosures with a reference date of end-2020 or later when available.

The 2021 stocktake found that roughly three-quarters of the institutions do not disclose whether climate-related and environmental risks have a material impact on their risk profile. This, according to the ECB, indicates a lack of awareness of the potential impact of the risks on their balance sheets or, as is the case with half of these institutions, they are aware of the impact but choose not to transparently disclose it.

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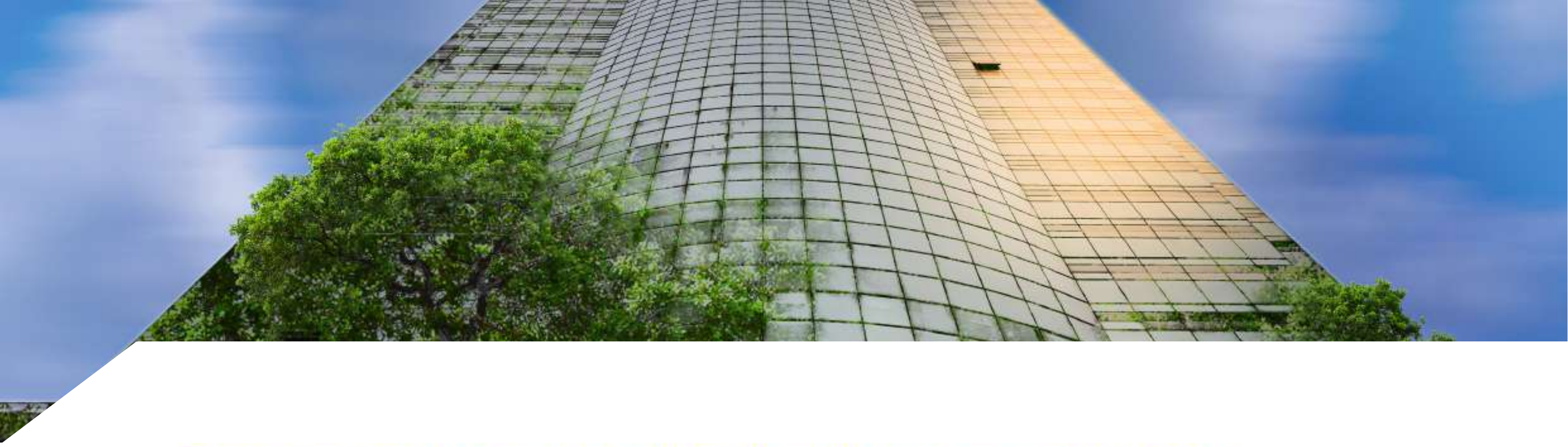
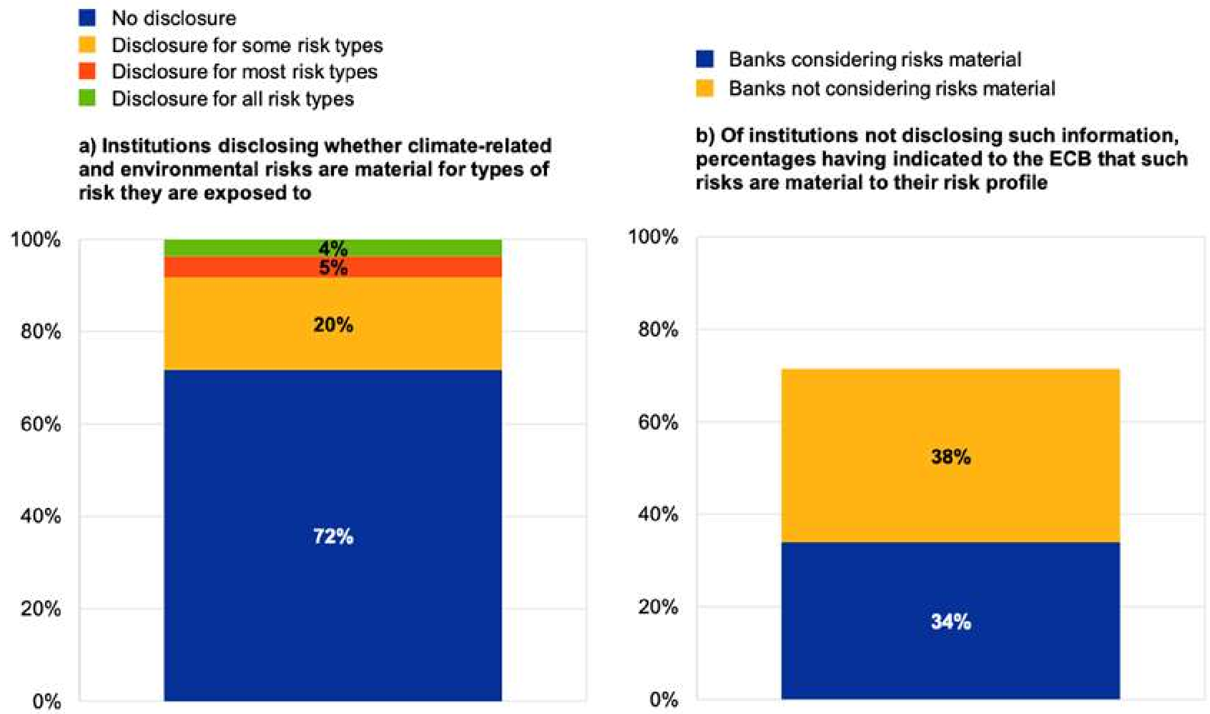


Transparency on the materiality of climate-related and environmental risks



Source: ECB.
Note: Panel b) is based on institutions' views on materiality expressed in the context of the 2021 ECB supervisory assessment.

Lack of validation

Critically, there was low levels of substantiation of such disclosures as were made and considered material. Expectation 13.3 states that when institutions disclose figures, metrics, and targets as material, they are expected to disclose or reference the methodologies, definitions, and criteria associated with them.

The report noted that substantiation is particularly relevant when institutions commit to contributing to climate-related and environmental goals, for example by committing to align with the objectives of the Paris Agreement. Users of institutions' disclosures not only will focus on various metrics and targets but "will increasingly seek information on the methodologies, definitions, and criteria relating to these commitments."

Following the report publication, a keynote speech by Frank Elderson, Member of the Executive Board of the ECB and Vice-Chair of the Supervisory Board of the ECB, asserted that there was “very little justification” for this lack of substantial progress, especially given “the vast amount and quality of climate-related data, tools and information shared by different international and European organizations and institutions in recent years.”

“The sheer speed at which regulation and metrics are developing in this field should leave no room for any doubt: addressing climate-related and environmental risks, and publishing good-quality disclosures, is not optional. Banks can and must do much better to improve the quality of their disclosures, and they need to do it quickly.”

~ Frank Elderson, Member of the Executive Board of the ECB and Vice-Chair of the Supervisory Board of the ECB

There is a “considerable disconnect” between banks’ perception of the importance of C&E risks, as communicated to the supervisor, and what banks choose to publicly disclose.

“Banks are trying to compensate for the poor quality of their disclosures by issuing a great volume of information around green topics,” said Elderson. “We end up with a lot of white noise and no real substance on what both markets and supervisors really want to know: how exposed is a bank to C&E risks and what is it doing to manage that exposure?”

In the light of these findings, and the need for institutions “to make significant efforts to transparently disclose their exposures to climate-related and environmental risks and further improve their disclosure practices,” the ECB has sent individual feedback letters to the banks under its supervision setting out key gaps in their disclosures. It expects them “to take decisive action to ensure they convey their risk profile comprehensively” so as to “accelerate institutions’ preparedness for meeting impending technical requirements.”

Intuition Know-How has a number of tutorials relevant to the content of this article:

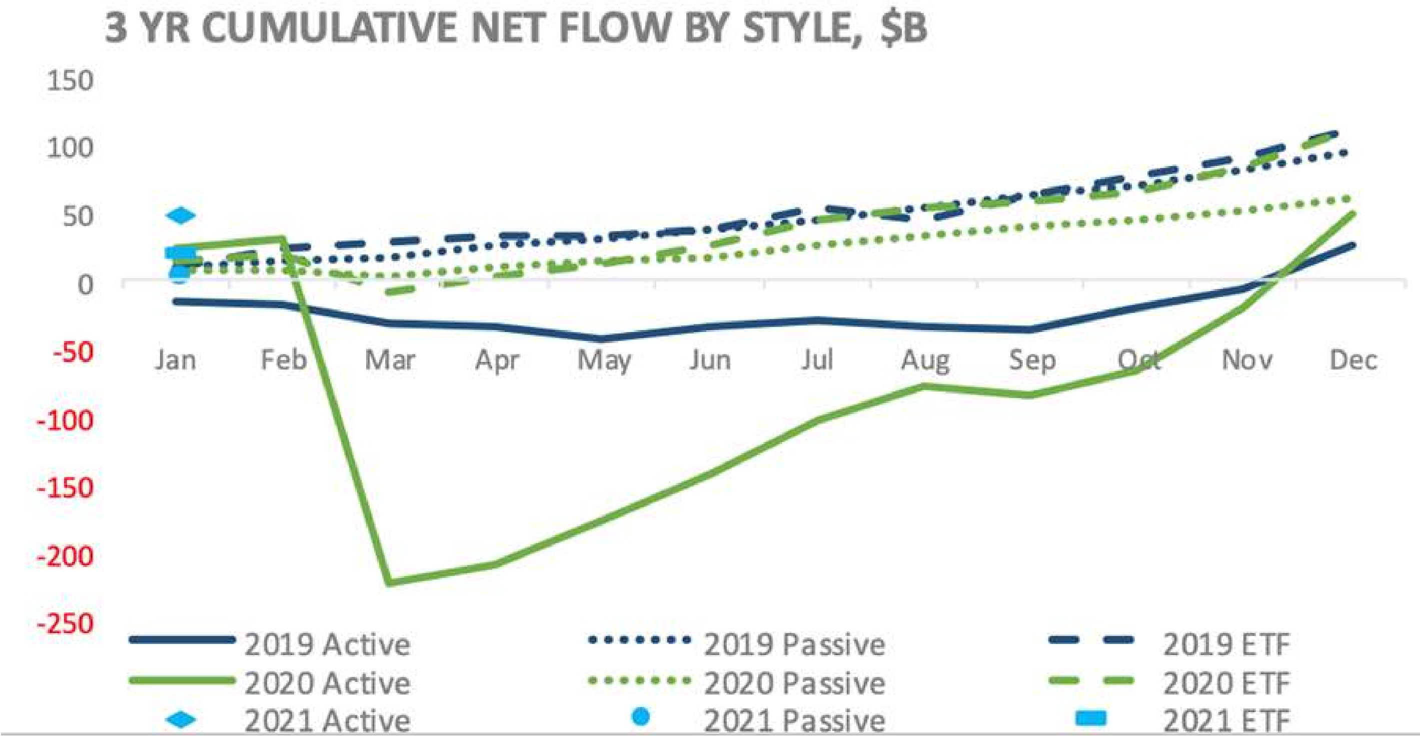
- ESG – Primer
- ESG – An Introduction
- ESG Factors
- ESG Reporting
- Climate Risk – An Introduction
- Climate Risk Measurement – An Introduction
- Climate Risk Measurement – Approaches
- Climate Risk – Banking & Decarbonization

Active Investing Remains the Foundation of Fund Management

Rock-bottom fees have propelled the popularity of passive funds over recent years but there are many reasons why active management will always have primacy in the business of fund management.

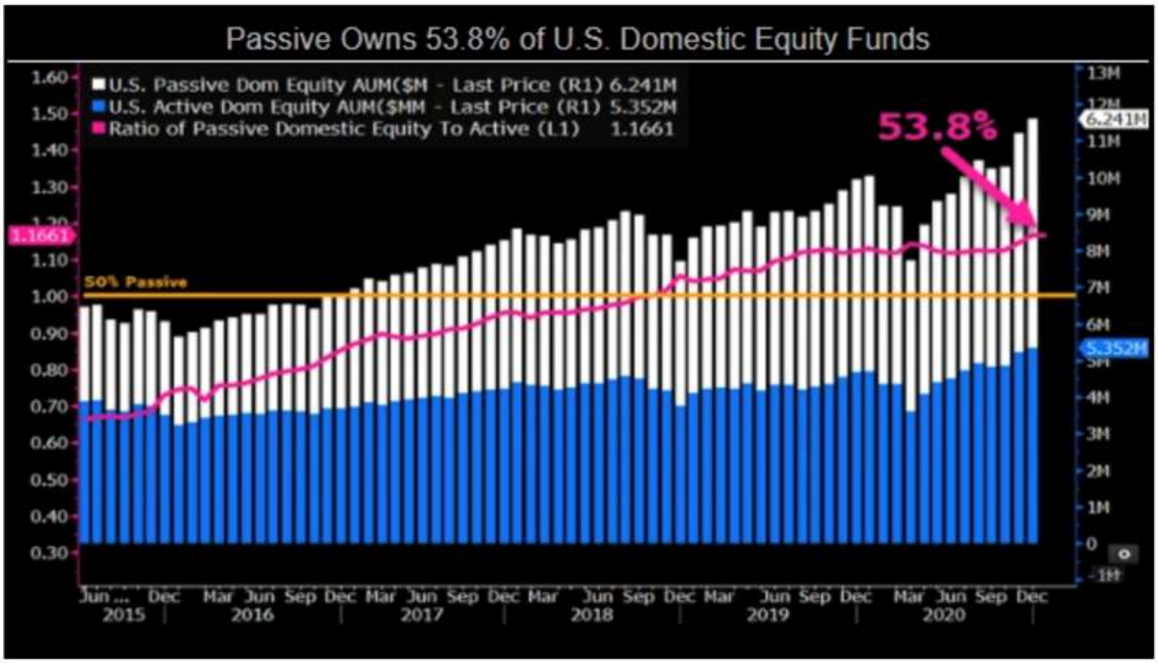
Active fund management rallied in Europe in January, with mutual fund inflows of some USD 50 billion. This compared with an USD 18 billion net inflow for passively managed funds, according to data from Broadridge.

This seems worthy of comment as one of few instances where active funds have been preferred to passive over the past decade. According to Broadridge data, 3-year cumulative net flows for actively managed funds in Europe only entered into positive territory toward the end of last year, lagging well behind passive funds and exchange-traded funds (ETFs) which are overwhelmingly passively managed.



Source: Broadridge

The rise of passive investing at the expense of active has been a major theme in fund management for years. According to Bloomberg, passive investing in the US is set to overtake active within five years due to a widening gap in equities (passive overtook active in 2018) and a growing advantage in fixed income.



Source: Bloomberg Intelligence

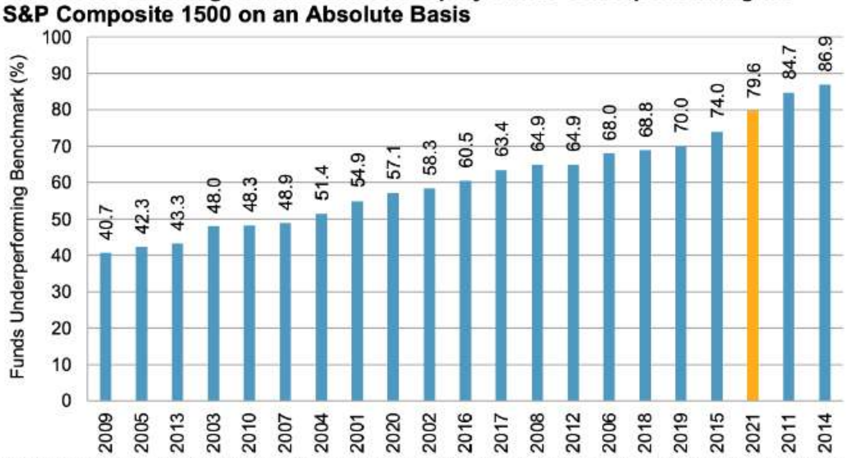
Passive investing is a strategy that tracks a market-weighted index or portfolio. This is normally achieved by buying an index fund that seeks to replicate the performance of a specific index.

The rise of passive is predicated on the acceptance of a core belief: that it is impossible for investors to outperform the market consistently on a risk-adjusted basis. Ironically, it is impossible for passive asset managers even to match their benchmark because of the drag of fees, but investors increasingly choose passive over active because fee levels are considerably lower.

Active performance lags

This choice seems to be justified, according to performance data. S&P found that 79.6% of all (active) domestic equity funds underperformed the S&P Composite 1500 on an absolute basis.

Exhibit 1: Percentage of All Domestic Equity Funds Underperforming the S&P Composite 1500 on an Absolute Basis



Source: S&P Dow Jones Indices LLC. Data as of Dec. 31, 2021. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

On the face of things it would appear that, from an investor viewpoint, pursuit of an active investment strategy is ultimately a futile strategy – but in fact there are a number of major defenses of an active management approach.

Flawed assumptions of passive

First, the rationale for passive investing is based on a fundamental untruth: the assumption that markets are 100% efficient and that participants act rationally and have access to all relevant information all of the time. This cannot possibly be true, and so there is always ample room for stock-pickers to identify mispriced securities that are the result of emotional biases and bad or incorrectly interpreted information.

Passive investing based on index funds also needs a minimum level of volume, liquidity, and low trading costs to function effectively: this rules out their participation in the niche and less efficient markets where information is harder to find and where research and active investing skills can profit.

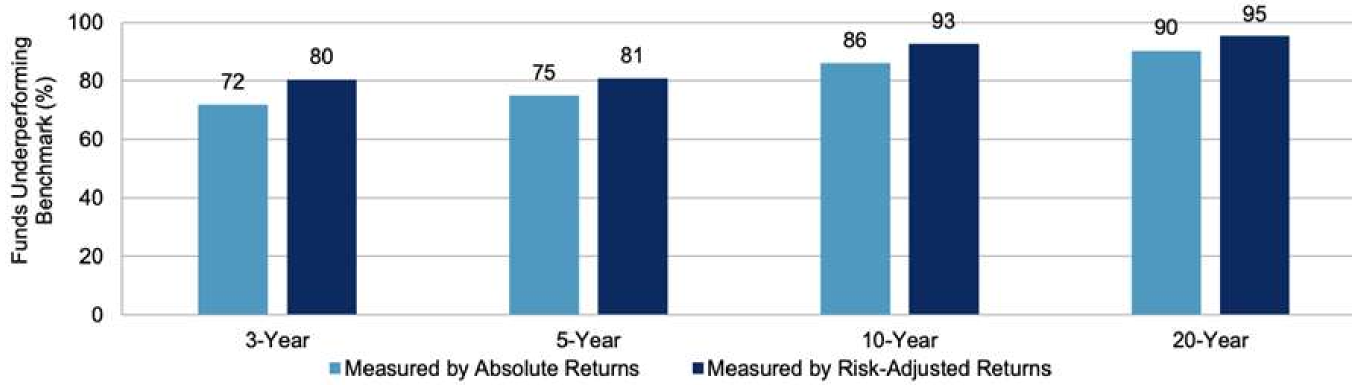
Above all of these investor considerations is the fact that the inexorable rise of passive investing is ultimately unsustainable. Passive investing distorts markets through inefficient resource allocation – directing capital toward the largest companies rather than those capable of generating the highest returns. Similarly, because stocks whose share prices have risen are given greater representation in a capital-weighted benchmark, the approach is based on past successes rather than future prospects.

Conflict with ESG

This often conflicts with ESG principles, particularly in emerging markets where the largest businesses may be environmentally suspect. Likewise, there is the issue of effective stewardship: passive investors are less likely than active to engage with company management in areas such as strategy, management, and ESG.

The inevitable flow of passive funds to large companies also has implications for risk. This is because it can lead to overvaluation of large companies and undervaluation of small, thereby creating the conditions for valuation bubbles. Actively managed funds have far more flexibility and agility in these situations. Active managers are also able to incorporate high conviction and a long-term perspective into their strategy, freed as they are from the constraints of having to replicate a benchmark.

Exhibit 2: Percentage of All Domestic Equity Funds Underperforming the S&P Composite 1500 on an Absolute and Risk-Adjusted Basis



Source: S&P Dow Jones Indices LLC. Data as of Dec. 31, 2021. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

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Passive investment will always underperform the index because, once fees are taken into account it is designed to do just that. While active investing inevitably underperforms net of fees on a global basis, it leaves open the possibility of individual outperformance.

And while the further advance of passive at the expense of active seems likely, it is worth remembering that as more and more assets flow into passive vehicles, so the active opportunity increases.

So, ultimately, active investing remains the foundation of asset management: without active management, passive investing strategies cannot exist.

Intuition Know-How has a number of tutorials relevant to the content of this article:

- Equity Markets – An Introduction
- Equity Trading – An Introduction
- Equity Indices
- Equity Trading Strategies
- Investment – An Introduction
- Efficient Markets
- Portfolio Management – Passive vs. Active Approaches
- Portfolio Performance – Measures