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Climate change and the banking industry

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A sector note setting out the key considerations arising for the banking industry concerning climate change, as well as a discussion of sustainable finance offerings in the industry. This sector note focuses primarily on UK law and provides a high-level overview of EU law, where it may be of relevance to UK banks.

Scope of this note

This note sets out the key considerations arising for the banking industry in relation to climate change, including:

- The banking industry's direct and indirect impact on climate change.
- Existing and anticipated climate change law and regulation that specifically relates to the banking industry.
- Key risks identified in banks' climate change disclosures.
- Emerging trends and the industry's reaction to climate change.

The note also includes discussion of the growing number of sustainable finance offerings from the industry.

For an overview of:

- The key climate change legislation that can impact businesses more generally, see Practice note, Climate change issues for companies.
- Practical Law's resources on climate change, see Climate change toolkit.
- Practical Law's resources on the climate-related and environmental disclosures required as part of annual corporate reporting, see Climate-related and environmental disclosures toolkit.

The banking industry's direct and indirect impact on climate change

The banking industry is in a unique position to influence the transition to a low-carbon economy. Financing companies gives it a degree of control over the allocation of capital both towards and away from specific industries. Owing to this position, the banking industry has become a focus for those advocating climate change action, who say that the industry should restrict or stop financing for sectors that contribute materially to climate change.

Most banking industry participants measure the direct impact of their own operations on climate change and either consider their operations to be net zero already or have plans in place to become net zero.

The more challenging aspect for banking industry participants is the indirect impact of their operations or the emissions they finance. CDP Worldwide, which is responsible for a global disclosure system to help investors, companies and cities manage their environmental impact, estimated that, based on disclosures in 2020, emissions arising from banks' financing activities were approximately 700 times higher than their direct operational emissions.

Steps are being taken to establish consistent ways of measuring financed emissions. For example, the Partnership for Carbon Accounting Financials (PCAF) has established a global accounting and reporting standard for measuring and disclosing emissions financed via various asset classes including listed equity and corporate bonds, business loans and unlisted equity, project finance, commercial real estate, mortgages and motor vehicle loans. The PCAF approach has wide support across the banking industry, with many of the largest UK-based banks now referring to the PCAF guidance in their disclosures. Some UK-based banks have also developed their own methodologies for measuring the emissions they finance (for example, Barclays has created a system for measuring and tracking financed emissions at a portfolio level against Paris Agreement goals) and have acknowledged the areas of their business that are particularly carbon-intensive in terms of emissions financed. Banks look at new business opportunities with a view to reducing their exposure to carbon-intensive industries by measuring their carbon content, reducing the share of coal in the financed energy mix and by setting reduction objectives. For example, in September 2022, six large lenders to the global steel industry signed the Sustainable STEEL Principles agreement, which establishes a methodology for banks to measure and report the emissions associated with their steel loan portfolios relative to net zero pathways.

Banks are also offering greener investment opportunities such as green loans or green bonds to corporate and retail investors and providing sustainable investment opportunities to the clients of their asset management arms. For more information, see Green loans: checklist and **Increase in sustainable finance products being offered by industry participants**.

While climate change is generally considered to be an important subject in its own right in the banking industry, it is sometimes considered together with other environmental, social and governance (ESG) or sustainable finance considerations (and the terms ESG, sustainable finance and green finance are often used interchangeably). For further information on ESG generally, see Environmental, social and governance (ESG) toolkit: UK.

Existing and anticipated law and regulation relating to climate change

As with many industries, the banking industry is affected by a range of climate-related law and regulatory measures. Key areas of existing and developing regulation in this area include:

- Financial risk requirements from the UK Prudential Regulatory Authority (PRA) (see **Managing financial risks** below).
- Amendments to the Listing Rules to align with the Task Force on Climate-related Financial Disclosures (TCFD) recommendations, as well as other measures requiring disclosures against the TCFD recommendations (see **Amendments to Listing Rules for TCFD disclosure** below).
- The Bank of England (BoE) Climate Biennial Exploratory Scenario (see **The BoE Climate Biennial Exploratory Scenario** below).
- The EU Sustainable Finance Disclosure Regulation ((EU) 2019/2088) (SFDR) and the Taxonomy Regulation ((EU) 2020/852) (see **The EU's Sustainable Finance Disclosure Regulation and Taxonomy Regulation** below).
- The UK Stewardship Code (see **The UK Stewardship Code** below).
- The FCA's sustainability disclosure requirements (SDR) (see **Sustainability Disclosure Requirements** below).
- The FCA's work on driving positive sustainable change in financial services firms, considering culture, governance, remuneration and incentives, and competence (DP23/1) (see **The FCA's work on driving positive sustainable change** below).
- The development of mandatory transition plans (see **Development of mandatory transition plans**).

Managing financial risks

Both UK-based financial regulators, the PRA and the Financial Conduct Authority (FCA), specifically recognise that climate change is a potential material financial risk. In April 2019, the PRA issued a supervisory statement setting out its high-level expectations on climate change for certain firms it regulates, including banks and building societies (see PRA: Supervisory Statement 3/19: Enhancing banks' and insurers' approaches to managing the financial risks from climate change (15 April 2019)). In July 2020, it wrote to those firms clarifying some of the expectations. Firms were expected to have their climate-related financial risk plans fully embedded by the end of 2021 (see PRA: Dear CEO letter: Managing climate-related financial risk – thematic feedback from the PRA's review of firms' SS3/19 plans and clarifications of expectations (1 July 2020)). In brief, the PRA expects firms to:

- Embed consideration of climate change risks in their governance arrangements, including by dedicating adequate resources and expertise to these risks and by allocating responsibility to the relevant senior management function.
- Incorporate climate change risks into existing financial risk management practice, including by updating their existing risk management policies, monitoring and reporting, and by having a credible plan in place for managing exposures.
- Use scenario analysis to inform their strategy and risk assessment (including shorter-term analysis within a firm's business planning horizon and longer-term analysis, in the order of decades, on a range of different climate pathways).
- Develop an approach to disclosure of these risks, which includes engaging with TCFD recommendations. See Practice note, Task Force on Climate-related Financial Disclosures (TCFD): recommendations for disclosing climate-related financial information: overview.

In implementing these expectations, the PRA expects firms to take a proportionate approach that reflects their exposure to climate-related financial risk and the complexity of their operations.

In 2022, the PRA's supervisory approach shifted from assessing implementation to actively supervising against the expectations set out in SS3/19. In October 2022, the PRA published a further *Dear CEO* letter on climate change, setting out the capabilities it expects firms to be able to demonstrate and examples of effective practices, as well as its observations on where firms are (see PRA: Dear CEO letter: Thematic feedback on the PRA's supervision of climate-related financial risk and the Bank of England's Climate Biennial Exploratory Scenario exercise (21 October 2022)). For a checklist to help banks respond to this Dear CEO letter, see Checklist, PRA supervision of climate-related financial risks.

For more information about the PRA's expectations of banks in respect of managing climate-related financial risks and how it supervises firms generally, see Practice notes, Managing climate-related financial risks: PRA requirements and expectations and PRA supervisory model.

Amendments to Listing Rules for TCFD disclosure

The TCFD recommendations aim to provide a standardised approach to climate-related financial reporting, so that risks and opportunities can be categorised consistently, and organisations across different sectors and jurisdictions can be compared. The TCFD recommendations comprise overarching recommendations and specific recommended disclosures in relation to governance, strategy, risk management, and metrics and targets. The TCFD recommendations are intended to improve and increase reporting of climate-related financial information (see Practice note, Task Force on Climate-related Financial Disclosures (TCFD): What are the TCFD recommendations?).

Some banks are either listed companies or within listed groups and, as such, the FCA's Listing Rules apply to them or their group holding companies. The FCA amended its Listing Rules to require companies with a premium listing to make disclosures in line with the TCFD's recommendations or explain why they are not able to do so, which applies for accounting periods beginning on or after January 2021.

The requirement also applies in relation to accounting periods beginning on or after 1 January 2022 in respect of:

- Companies with a standard listing of equity shares.
- Companies with standard listed shares other than equity shares.
- Standard listed issuers of global depositary receipts (GDRs) representing equity shares.

It excludes investment entities and shell companies (such as special purpose acquisition companies (SPACs)).

See, for further information, Practice note, TCFD recommendations: climate-related financial disclosures for premium listed and standard listed companies (LR 9.8.6R(8) and LR 14.3.27R).

Further, since 1 January 2022, rules are in force (subject to phased implementation) for asset managers (as well as life insurers and pension providers) to make TCFD-aligned disclosures at an entity, product and portfolio level. See Practice note, Climate-related disclosures and ESG: FCA requirements and expectations.

A further requirement has been introduced for the inclusion of a non-financial and sustainability information statement in the strategic report of certain UK companies, including banking companies of a certain size, in relation to financial years beginning on or after 6 April 2022. See Practice note, Strategic report: non-financial and sustainability information statement: financial years beginning on or after 6 April 2022: Companies required to include an NFSI statement in their strategic report.

For further information on TCFD disclosures by other entities, see Practice note, TCFD recommendations: climate-related financial disclosures for premium listed and standard listed companies (LR 9.8.6R(8) and LR 14.3.27R): Mandatory TCFD disclosures by other entities.

The BoE Climate Biennial Exploratory Scenario

The BoE also conducted its biennial exploratory scenario (BES) during 2021 with seven large UK banks and building societies (as well as certain insurers). The BES intended to test the resilience of those banks' business models and the financial system to climate-related risks, and the scale of the adjustment that will be needed in future for the sector to remain resilient. The BoE sought to measure the impact of the BES on those banks' end-2020 balance sheets with a focus on the credit risk exposure of the banking book to large corporate counterparties. A second round of the BES was announced in February 2022 to further explore participants' strategic responses to the scenarios published as part of the first round. The results of the exercise were published in May 2022 (see Legal update, BoE announces results of 2021 Climate Biennial Exploratory Scenario). The BoE found that, while UK banks (and insurers) were making good progress in some aspects of managing climate risk, much more work was needed in understanding and managing their exposures. It highlighted, in particular, the lack of available data to understand climate risk.

While the main aim of this exercise is to inform the Financial Policy Committee's (FPC's) approach to system-wide policy issues and the PRA's approach to supervisory policy, the BoE also gave firm-specific feedback to participants and the PRA are using the findings to assess firms' progress against its expectations in this area (as set out in SS3/19). See Practice note, Hot topics: UK regulation of sustainable finance for more information.

Scenario analysis is part of the BoE's wider work on assessing regulatory capital frameworks. Its March 2023 report on climate-related risks and regulatory capital frameworks recognises that assessing whether banks are adequately capitalised for future climate-related losses is challenging, when identifying and measuring climate risks has inherent difficulties, for example due to a lack of granular data, and where methodologies in capital frameworks may not be appropriate for climate risks, for example because they take too short-term an approach. The BoE recognises that further work needs to be done, including in terms of building its understanding of gaps and its own capabilities to assess the resilience of the financial system. No policy changes have been made at this stage, but the BoE intends to conduct further work to determine whether changes to the regulatory capital frameworks are required. See BoE: Report on climate-related risks and the regulatory capital frameworks (13 March 2023).

The EU's Sustainable Finance Disclosure Regulation and Taxonomy Regulation

The EU's SFDR and its Taxonomy Regulation are both part of the European Commission's package of reforms relating to sustainable finance. See Practice note, Hot topics: EU sustainable finance regulation and Practice note, EU sustainability disclosures for financial institutions.

The SFDR has imposed transparency and disclosure requirements relating to sustainability matters and risks, such as climate change, on certain financial market participants including, for example, private banks providing portfolio management and investment advice. The SFDR sets out, among other requirements, the information firms must disclose and maintain on their websites, the information that must be provided to investors and the requirements for periodic reporting to investors. See Practice note, Sustainable finance: SFDR: overview. The SFDR entered into force on 29 December 2019 and most of its provisions have applied since 10 March 2021.

The core provisions of the SFDR did not apply until after the end of the Brexit transition period and it has not been onshored in the UK. The FCA has been working on its own, separate disclosure framework under a SDR regime. See **Sustainability Disclosure Requirements** below and Practice note, Hot topics: UK regulation of sustainable finance: Sustainability disclosure requirements (SDR).

However, the SFDR remains relevant for UK firms. Practically, a UK firm may decide to voluntarily comply with the SFDR because of investor pressure. In addition, UK firms marketing funds into the EU or managing EU funds may also be within scope of the SFDR. For further information, see Practice notes, Sustainable finance: EU SFDR: overview: Application of the SFDR in the UK.

The Taxonomy Regulation establishes criteria for determining whether an economic activity is environmentally sustainable. It applies to financial market participants as defined in the SFDR and certain large public-interest entities. It is intended to provide investors with a common language to identify to what degree economic activities can be considered and labelled environmentally sustainable (or "green"). It also obliges the entities that are in scope to make statements about how their financial products and activities align with the taxonomy it specifies. See Practice note, Sustainable finance: EU Taxonomy Regulation: overview.

As with the SFDR, the Taxonomy Regulation's disclosure provisions entered into effect after the Brexit transition period. While the majority of the Taxonomy Regulation has been onshored in the UK, this is not the case for the delegated acts adopted pursuant to the Regulation. All provisions of the Taxonomy Regulation could still apply to UK firms, for example, where UK firms market funds into the EU.

On 9 June 2021, HM Treasury published a press release announcing the establishment of the Green Technical Advisory Group (GTAG), an expert group whose purpose is to provide independent advice to the government on the development and implementation of a UK green taxonomy, which will build on existing international taxonomies, including the EU taxonomy (see Legal update, HM Treasury establishes Green Technical Advisory Group). The GTAG published its advice on the development of a UK green taxonomy on 7 October 2022 (see Practice note, Hot topics: UK regulation of sustainable finance: GTAG advice to government on UK green taxonomy). While secondary legislation relating to the UK green taxonomy was originally due in 2022, the government has now said that it expects to consult on it in autumn 2023.

For more information, see Practice notes, Sustainable finance: EU Taxonomy Regulation: overview: Application of the Taxonomy Regulation in the UK and Hot topics: UK regulation of sustainable finance: UK green taxonomy.

The UK Stewardship Code

The UK Stewardship Code 2020 sets out responsible business standards for, among others, asset owners and asset managers, as well as the service providers who support them. It applies, therefore, to banks' asset management and private bank divisions. Although adherence to the Code is voluntary, it is widely supported. Principle 7 of the Code requires signatories to systematically integrate stewardship in investment decisions, including material ESG issues and climate change, to fulfil their responsibilities. In practical terms, the Code also provides a basis for asset managers who hold shares in listed banking entities to apply pressure to those entities to have regard to material ESG issues (including climate change). For further information, see Practice note, UK Stewardship Code 2020.

Sustainability disclosure requirements

In light of the increasing importance of providing the market with accurate and high quality information about sustainability-related matters, the FCA has developed its SDR regime. The SDR will bring together existing sustainability-related disclosure requirements under one integrated framework, including the existing TCFD-aligned disclosure requirements (which are to be made fully mandatory across the UK economy by 2025 and which are already expected of PRA-supervised financial services firms), and will include a number of new requirements. This includes a requirement for creators of investment products to report on the products' sustainability impact and relevant financial risks and opportunities. This information will form the basis of a new sustainable investment labelling regime that will make it easier for consumers to navigate the range of investment products available to them. The introduction of such measures was driven by concerns about claims that firms are making about the green credentials of their investment products, and the associated harm to consumers and damage to consumer trust in the market. Through the development of different labels for different products according to their sustainability objectives and features, the FCA hopes to provide greater transparency and consistency for consumers. The consultation period ended on 25 January 2023, and the FCA intends to publish final rules and a policy statement in Q3 2023.

For further information, see Practice note, Hot topics: proposed FCA sustainability disclosure requirements (SDR) and labelling regime.

The FCA is also proposing a general "anti-greenwashing" rule for all regulated firms, forming part of the ESG sourcebook. It will mean that all FCA-regulated firms have to ensure the naming and marketing of financial products is clear, fair and not misleading, and consistent with the sustainability profile of the product or service. For further information, see Practice note, Hot topics: proposed FCA sustainability disclosure requirements (SDR) and labelling regime: New anti-greenwashing rule.

The FCA's work on driving positive sustainable change

The FCA has recognised the evolving nature of work on many different aspects of sustainability and is encouraging dialogue on sustainability-related governance, incentives and competence. In February 2023 the FCA published a discussion paper setting out the various existing initiatives in these areas, and posing questions about firms' current arrangements and views on future regulation. The feedback will help the FCA to decide on its future regulatory approach. The paper recognises that attention is turning to areas of sustainability other than climate, which include human rights, diversity and biodiversity.

For further information, see Practice note, Hot topics: UK regulation of sustainable finance: Discussion paper on finance for positive sustainable change.

Development of mandatory transition plans

There is no mandatory requirement at present for all companies to publish a net zero transition plan (TP). However, while the TCFD disclosures required of premium and standard listed companies (on a comply or explain basis, see **Amendments to Listing Rules for TCFD disclosure**) do not require the publication of a TP, a TP is an expectation of reporting against TCFD recommendations.

HM Treasury launched the Transition Plan Taskforce (TPT) in April 2022, with the aim of developing a "gold standard" for transition plans and the TPT opened its draft recommendations for consultation at COP 27 in November 2022. The FCA has been involved in the work of the TPT and has made clear that they "intend to draw on" the outputs once they have been finalised in relation to strengthening disclosure requirements for listed companies and regulated firms.

For further information on the recommendations for certain UK companies to publish a net zero transition plan, see Practice note, Net zero transition plans for UK companies.

Key risks identified in banks' climate change disclosures

Many banks already produce a non-financial report covering ESG matters, including climate change, and disclose in line with the recommendations of the TCFD (see **Amendments to Listing Rules for TCFD disclosure**).

In line with TCFD guidance, risks are generally categorised as either:

- Transition risks (see **Transition risks** below).
- Physical risks (see **Physical risks** below).
- Connected risks (see **Connected risks** below).

For more information on non-financial reporting and climate risks, see Practice note, Narrative reporting: climate-related and environmental disclosures in annual company reports: overview and Climate change toolkit: Summary of risks.

Transition risks

Transition risks identified in TCFD reports include policy, regulatory and legal changes initiated as a response to climate change, as well as technology shifts and changing market demand. Specific examples include:

- Rapid policy or regulatory changes, for example in relation to carbon taxes, which could lead to the increased credit risk of clients and counterparties.
- Credit risk in sectors particularly vulnerable to climate change (for example, aviation, oil and gas), where clients or counterparties may fail to fully honour their obligations to the bank (see Sector note, Climate change and the oil & gas industry).
- Market risk resulting from changes in market conditions adversely impacting the value of assets or liabilities (including "green swans" or sudden market shifts).
- An increased risk of potential climate-related litigation, including in relation to stranded assets, acute climate events or resulting market price declines. This type of risk (liability risk) is often categorised as a stand-alone category of risk, along with transition, connected and physical risks, see **Climate-related activism and litigation in the banking industry** below.

Physical risks

Physical risks identified in TCFD reports include risks from extreme weather events (classified as acute physical risks) and longer-term shifts in climate patterns, such as sustained higher temperatures or sea-level rise (termed chronic physical risks).

Such events or patterns could affect supply and demand, which could impact on market prices in susceptible sectors or countries, resulting in market risk. In particular, extreme weather events may present operational issues relating to property owned by the bank and ongoing business continuity.

For example, extreme weather events pose a risk to banks' infrastructure and could jeopardise their operational continuity by damaging offices and data centres. Banks may also suffer reputational harm if their clients and customers perceive them to have mismanaged physical risks or if they fail to provide adequate support to communities and customers affected by extreme weather events.

Banks may also be vulnerable to fluctuations in commodity and other asset prices caused by extreme weather events. If customers' income or profitability is reduced, banks will be exposed to a greater risk of credit losses. Further, rising sea levels and increased flood risk or increasing forest fires could increase the risk of customer default. In particular, the cost of damage to residential or commercial property may leave borrowers unable to meet mortgage payments.

Connected risks

Connected risks are second-order risks arising from transition or physical risks. Examples include recessionary pressures and reputational risk if a bank's clients include those that have the potential to cause or contribute to significant adverse impacts on the climate.

In modelling these risks, banks use different quantitative and qualitative methodologies to calculate a counterparty credit risk that incorporates data from physical, transition and connected-risk scorecards. For example, banks assess their counterparty's reliance on non-green energy, or their strategy to protect physical assets from future physical risks, as well as transition initiatives for a more sustainable operating model. The main issue is the lack of reliable and objective data that would enable comparisons between counterparties.

In the PRA's *Dear CEO* letter of October 2022, it noted that, in general, banks did not have a complete picture of counterparties' exposures or transition plans and had faced challenges in procuring this information. It noted that some banks were developing their counterparty engagement processes to collect this data. See PRA: Dear CEO Letter (21 October 2022).

The industry's reaction to climate change and emerging trends

The banking industry's response to climate change and emerging trends in the industry include:

- The climate goals and commitments being made by industry participants (see **Climate goals and commitments** below).
- The increase in sustainability-linked products being offered by industry participants (see **Increase in sustainable finance products being offered by industry participants** below).

- Industry groups and reports (see **Industry groups and reports** below).

Climate goals and commitments

Banks are committing to a growing number and variety of climate-related goals and metrics. These include measures to reduce their environmental impact through net zero carbon commitments, reducing or stopping funding of fossil fuel projects and directing investment to more environmentally friendly products and sectors.

Net zero carbon emissions

In line with the UK's 2050 net zero target, many UK-based banks have made commitments to become net zero (including in relation to their emissions financed or "scope 3 emissions") by 2050 or sooner.

Some UK-based banks are members of the Net Zero Banking Alliance (NZBA), which is a UN-convened but industry-led alliance representing over 40% of global banking assets, which have committed to align their lending and investment portfolios with net zero emissions by 2050.

In April 2021, the Glasgow Financial Alliance for Net Zero (GFANZ) was launched, bringing together existing net zero finance initiatives (including the NZBA, which is the banking element of GFANZ) into one forum and working to accelerate the financial sector's progress towards net zero. Signatory companies are required to show credible plans for reducing investment in high-carbon assets (see Practice note, Climate change and sustainability work by international financial services authorities: tracker: Glasgow Financial Alliance for Net Zero (GFANZ)).

Many banks have also signed the Paris Pledge for Action, which allowed businesses to demonstrate their commitment to the objectives of the 2015 Paris Climate Agreement.

Reduction in fossil fuel investing

Some banks are beginning to take action to reduce, or entirely halt, their investment in carbon-intense or ecologically damaging fossil fuel projects, often as a result of growing public pressure. For example, in December 2022, HSBC announced it would stop funding new oil and gas fields that received final approval after the end of 2021 and would expect more information from energy customers over their plans to cut emissions (see reuters.com: HSBC to stop funding new oil and gas fields as part of policy overhaul (14 December 2022)). In 2023, BNP Paribas also announced it will no longer provide dedicated financing for the development of new oil and gas fields (see reuters.com: BNP Paribas: will no longer finance development of new oil and gas fields (11 May 2023)).

Green investment strategies

In addition to restricting investments in fossil fuel projects, many banks are actively directing their investment strategies to greener products and industries. In particular, investment is being channelled into renewable energy and low-carbon vehicles, as well as to enable clients to make the low-carbon transition. For example, in 2020 HSBC announced that, over the next decade, it aims to provide between $750 billion and $1 trillion of financing and investment to assist in the transition to lower-carbon emissions (see reuters.com: HSBC targets net zero emissions by 2050, earmarks $1 trillion green financing (9 October 2020)).

Increase in sustainable finance products being offered by industry participants

In recent years there has been huge growth in the market for green and sustainable financing products. Market participants have sought to demonstrate their commitment and ambition to a more sustainable future, by utilising an existing financing need to firstly support and complement wider environmental strategies, including climate change mitigation, and secondly to help drive behaviours.

Banks have a key role to play in steering capital towards sustainable economic activity, through lending, structuring, underwriting, intermediating, purchasing and trading sustainable finance products such as:

- Equity in corporates that meet environmental, social or governance sustainability criteria (such as FedEx that has set a goal of operating an all-electric, zero-emission global pickup and delivery fleet by 2040) or are ranked in sustainability indices such as the FTSE4Good.
- Green, social and sustainable bonds (GSS bonds).
- Green and social loans (GS loans).
- Sustainability-linked bonds (SLBs).
- Sustainability-linked loans (SLLs).
- Sustainable commercial paper.
- Green securitisation.
- Green asset-backed financing.
- Green project financing.
- Related ESG-linked derivatives.

Banks are also using a range of green and sustainable finance products to finance their lending portfolios.

Green financial products

GSS bonds and GS loans are the most mature sustainable finance products. They are often referred to as "use of proceeds" financing as they require net proceeds to be used for specific green or sustainability projects (such as projects related to climate change mitigation), with associated ongoing tracking of funds and related reporting. This means that borrowers need to have a sufficient volume of green or sustainability projects to be able to use the net proceeds of the bond or loan.

By way of example, the European Investment Bank (EIB) has issued several climate awareness bonds, with net proceeds earmarked for projects contributing to climate action in the renewable energy sector (such as wind, hydro, solar and geothermal energy production targets) and the energy efficiency sector (such as building insulation and energy loss reduction in transmission and distribution projects), as well as projects related to research, development and deployment of innovative low-carbon technologies. See EIB: Climate awareness bonds.

While the green bond asset class consists largely of senior green bonds, this asset class has expanded with innovations such as green hybrid bonds and green convertible bonds. The market for "use of proceeds" asset-backed or securitised bonds remains small, mainly due to a lack of green underlying assets, but there are a few examples of such bonds where recourse is to a group of climate-related projects such as solar leases or to mortgages that finance energy efficient homes. There are also examples of project bonds where proceeds are ring-fenced for specific green projects, such as wind farms, which can aid climate change mitigation efforts by plugging the investment gap in greener infrastructure.

A number of banks and other market participants helped to formulate the voluntary principles set out in the Green Bond Principles and the Green Loan Principles in connection with GSS bonds and GS loans and are encouraging their use in connection with green bond and loan issuance. While the Green Bond Principles are the main principles guiding the green bond market, there are other industry guidelines that may also be relevant, including the Climate Bonds Initiative's climate bonds standard and certification scheme. See Climate Bonds Initiative: Climate bonds standard and certification scheme.

From a regulatory perspective, in July 2021 the European Commission published a proposal for the creation of an EU Green Bond Standard (EU GBS). The EU GBS is intended to be a new voluntary "gold standard" for green bonds with a common framework of rules, intended to help finance sustainable investment while addressing concerns around greenwashing.

This development may help to further energise climate change mitigation efforts by green bond issuers that have a sufficient volume of climate change mitigation projects to fund, and banks may notice interest in the green bond asset class by issuers that are keen to demonstrate compliance with this new "gold standard". For further information on the development of the EU GBS, see European Commission: EU Green Bond Standard and EU green bond standard (EU GBS): legislation tracker.

See also Practice notes,

- Green, social and sustainability bonds.
- Green loans.
- Social loans.
- Green loans: what an in-house bank lawyer should know.
- Green loans: checklist.

Sustainability-linked finance

Banks have also helped to develop sustainability-linked finance products, which corporate borrowers are increasingly turning towards to finance their sustainability strategy. SLBs and SLLs are highly flexible financing products, as the proceeds may be used for general corporate or other specified purposes. The use of proceeds is not restricted to specific projects (unlike GSS bonds and GS loans) and there is no need for ongoing tracking of proceeds.

SLBs and SLLs are forward-looking performance-based instruments that involve both:

- The selection of key performance indicators (KPIs), which are predefined, quantifiable metrics used to measure the performance of selected indicators.
- The calibration of sustainability performance targets (SPTs), which are ambitious (beyond business-as-usual) and measurable improvements in KPIs that a borrower commits to over a predefined timeline.

The KPIs and SPTs are aligned to a borrower's sustainability goals, which allows them to be individually tailored. While the regulator's approach suggests that banks may need to play an important role in attaching ambitious but appropriate environmental targets to SLBs and SLLs, considerations such as competing offerings on the market and alignment with customers need to be taken into account. Many borrowers have set targets to reduce the GHG or carbon emissions of their own operations. Some borrowers have gone further by committing to decrease such emissions in their supply chains too. KPIs could also cover increased use of renewable energy sources, energy efficiency of buildings, water usage and waste or recycling targets. A structuring mechanism such as a coupon step-up mechanic is built into the terms of the SLB or SLL and this acts as an incentive for an issuer to meet its SPTs or otherwise face the prospect of higher interest payments to investors. In the SLL market, it is fairly typical to see a two-way margin ratchet, with a coupon step-down mechanism that kicks in if a borrower meets its SPTs, as well as a coupon step-up mechanism that applies if a borrower fails to meet its SPTs.

A number of banks helped to formulate the voluntary principles set out in the Sustainability-Linked Bond Principles and the Sustainability-Linked Loan Principles and are encouraging their use by bond and loan market participants.

See also Practice note, Sustainability linked loans.

Transition finance

Some banks have indicated that they intend to help clients in carbon-intensive sectors (such as oil, gas and aviation) to progressively transition towards a low-carbon emission future. The International Capital Market Association's (ICMA's) Climate Transition Finance Handbook provides guidance and establishes common expectations for capital markets participants on the practices, actions and disclosures to be made available when raising funds in bond markets for climate transition-related purposes. See Legal update, Climate Transition Finance Handbook and Q&A. The Loan Market Association is also exploring the concept of transition finance and how existing sustainability frameworks can be amended to financially support a company's transition in the loans market.

Sustainability-linked derivatives

Derivatives markets can also play an essential role in facilitating the transition to a sustainable economy. As well as offering rate and FX hedging solutions for sustainable finance products and offering lenders liquidity and risk solutions for such products, the market has also started to see OTC derivatives contracts for interest rate or FX products with a specific climate action overlay. The terms of these contracts include a specific incentive to hit pre-defined climate action targets (such as increased use of renewable energy sources, reduction in GHG emissions or achieving a target ESG score). As with SLB and SLL financing products, this could involve an adjustment to the cashflows if a particular KPI is met or missed (for example, an adjustment to the spread or the payment of a premium or rebate) or an agreement that the counterparty (such as a bank) will contribute to an environmental project if the obligated party hits or misses that target. The KPIs are highly customisable and can apply to either one or both counterparties. A small but growing number of these transactions have been executed to date, primarily where the climate action element has been embedded in an interest rate swap. Often the associated financing has included a climate action element or has been for a business focused on clean energy. For further details of these transactions and also the wider role of OTC derivatives in sustainable finance, see ISDA: Overview of ESG-related derivatives products and transactions and ISDA: Sustainability-linked derivatives: Where to begin?.

For further information on green finance generally, see Environmental, social and governance (ESG) for finance lawyers toolkit (UK).

Climate-related activism and litigation in the banking industry

Over the past few years there has been an increase in climate activism directed at the banking industry. Shareholders of listed UK-based banks have increasingly proposed climate-related resolutions (see Practice note, Resolutions on climate change at annual general meetings of FTSE 350 companies). Environmental NGOs have run campaigns lobbying for banks to reduce financing of fossil fuel companies and specific projects which contribute to climate change, as well as campaigns criticising the climate commitments and goals that banks have made. There has also been pressure from large institutional investors to focus on climate change risks. In September 2021, ShareAction, a UK charity focused on responsible investment, published analysis of the climate and biodiversity practices of Europe's largest banks, concluding that the industry still has much progress to make to address climate risks and recommending strategies for investors to engage with banks to facilitate progress. Since then, ShareAction has continued its focus on the financial sector. For example, in February 2022, ShareAction published a further report criticising continued bank funding of oil and gas expansion, and, in February 2023, ShareAction reported that it coordinated letters from 30 investors to Europe's top banks urging them to stop the direct financing of new oil and gas fields by the end of 2023.

In April 2021, the NGO ClientEarth issued proceedings in the Belgian courts against the Belgian National Bank (BNB) on the basis that the bank breached environmental and human rights laws when implementing the Corporate Sector Purchase Programme set up by the European Central Bank (ECB) and purchasing assets under it. ClientEarth alleged that the BNB's asset purchases effectively direct capital into sectors which fuel the climate crisis. It asked the Belgian courts to refer the question of whether the ECB's decision to establish the purchase programme in 2016 was valid to the European Court of Justice, and to make orders halting the BNB from making purchases under the programme (see Westlaw Edge UK: ClientEarth launches climate-based legal challenge against Belgian National Bank (14 April 2021)). ClientEarth's claims were rejected at first instance and it appealed the decision. In November 2022, ClientEarth withdrew its case following the ECB's announcement in September 2022 of reforms to decarbonise its bond buying programme. This is a good example of the strategic objectives that claimants in climate litigation are seeking to achieve (see ECB: ECB provides details on how it aims to decarbonise its corporate bond holdings (19 September 2022)).

In February 2023, ClientEarth issued an application for judicial review against the FCA in the UK, arguing that its approval of the prospectus of an energy company was unlawful as the energy company had not made sufficient risk disclosures about climate change to comply with the Listing Rules or to fully inform investors (see Legal update, ClientEarth seeks High Court permission for judicial review of FCA over fossil fuel company's climate risk disclosures in oil and gas company prospectus). In February 2023, NGOs also brought an action against BNP Paribas in France under the French Duty of Vigilance law, focusing on its support of fossil fuel projects and clients.

There have also been complaints brought against ING Bank in the Netherlands under the OECD Guidelines in relation to climate change-related matters, and some cases brought against banks in Australia relating to non-disclosure of climate-related risk, which have all settled before trial.

For more information, see Environmental, social and governance (ESG) litigation risk for lenders.

Industry groups and reports

The most notable national industry group in relation to climate change is the Climate Financial Risk Forum (CFRF), which is jointly convened by the PRA and the FCA in order to advance the banking industry's responses to the financial risks posed by climate change. Since June 2020, the CFRF has published a number of guides to help the financial industry approach and address climate-related financial risks. The guides provide industry views on best practice associated with risk management, scenario analysis, disclosures and innovation (see FCA: Climate Financial Risk Forum (CFRF) and Practice note, Climate-related disclosures and ESG: FCA requirements and expectations: Role of Climate Financial Risk Forum).

Internationally, the BoE is a founding member of the Network of Central Banks and Supervisors for Greening the Financial System (NGFS) established at the Paris "One Planet Summit" in December 2017. There are now over 120 members across the world. The NGFS aims to assist the financial system in providing funding to low-carbon investments in line with a policy of sustainable investment and promotes best practice as well as conducting and commissioning analytical work on green finance.

While not an industry group, it is also worth mentioning that the UN's Expert Group on the Net Zero Emissions Commitments of Non-State Entities has published a report providing guidance to businesses, financial institutions, cities and regions on making net-zero pledges. See Legal update, UN publishes recommendations for net zero commitments by businesses, cities and regions.

Climate change and the operation of the industry

The increasing focus by the industry on climate change is creating (and will continue to create for some time) a number of complex issues for banks to consider, including:

- The types of clients and projects a bank supports.
- Whether a bank's subsidiaries and companies in its supply chain have climate change policies that are comparable to the bank's own policies in relation to climate change. (For information on parent company liability for the environmental impacts of their subsidiaries' operations, see Practice note, Environmental law: overview: Parent company liability for environmental damage.)
- How climate change affects the bank's hedging and investment decisions over time.
- How climate change affects the pricing of the risks of investing in commodities and shares, particularly of companies who are seen to be contributing to climate change.
- The impact of climate risk on banks' own financial positions.