

Mid-tiers' slow and steady ESG strategy: Where it's paid off and where banks need to speed up





Mid-tier banks have fallen behind their larger counterparts in supporting the move to a greener economy. Now is their moment to catch up.

As climate change rises higher on the global agenda, financial services firms face growing pressure from all sides to reduce their greenhouse gas (GHG) emissions and support the transition to a net-zero economy. The rhetoric has intensified, and regulatory muscle is quickly catching up to it. So far, much of the supervisory scrutiny in the US has fallen on large banks – but smaller financial institutions could find themselves under the spotlight sooner than expected.

Over the past year, the Office of the Comptroller of Currency (OCC), the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve Board (FRB) released coordinated climate-related guidance and regulation for the financial services industry. Meanwhile, the US Securities and Exchange Commission (SEC) has indicated that it plans to finalize its proposed rules on climate-related disclosures by the end of spring 2023. The SEC's proposed regulations will require all publicly traded companies to disclose their GHG emissions and climate-related financial risks. Meanwhile, the OCC, FDIC and FRB will require similar disclosures from financial institutions supervised by these agencies with >\$100m in assets under management. On top of this, investors are increasingly demanding that banks take action to reduce climate risk.

So, it's clear that change is coming. Financial institutions need to get ahead of it by stepping up climate-related disclosures, risk analysis and strategic planning. But how prepared are mid-tier banks to meet this fast-evolving supervisory landscape?

Our benchmarking study

To better understand how mid-tier banks¹ are progressing on their sustainability agendas, Baringa carried out a benchmarking study on 18 mid-tier banks across the US. Using data from publicly available environmental, social and governance (ESG) reports, we evaluated banks based on their performance in each ESG area.

Our study shows that a small group of mid-tier banks are pulling ahead of their peers. These leaders are setting firm net-zero targets and showing measurable progress toward reducing emissions. They've issued their first reports in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) and they're running initial stress tests on their lending portfolios. Unfortunately, they seem to be the exception, not the rule. The overwhelming majority of banks included in our study are much further behind on ESG issues, especially when it comes to setting net-zero targets and taking tangible steps to address climate-related risks.

The window of opportunity is closing fast. Every day of delay puts banks at real risk of being unable to meet regulatory commitments, protect long-term business value and – most importantly – make a successful transition to net zero.

In this report, we take a closer look at the areas where mid-tier banks are leading and lagging on sustainability-related issues. We'll focus on the climate-related aspects of ESG performance since this is where mid-tier banks urgently need to improve. We've broken these down into three sections:

- Setting emissions targets and driving reductions
- Embedding climate risk in business-as-usual operations
- Providing sustainable finance.

On top of that, we'll suggest different steps that mid-tier banks can take to better prepare for upcoming climate legislation and seize the commercial opportunities presented by the energy transition. Our recommendations are based on our in-depth expertise in this space, acquired over years of helping leading financial institutions to benchmark, improve and report on ESG performance.



¹ For this study, we considered mid-tier banks as institutions with a balance sheet size between \$50bn and \$225bn. The average of banks we assessed was \$160bn in assets.

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Setting emissions targets and driving reductions

Setting emissions targets and driving reductions

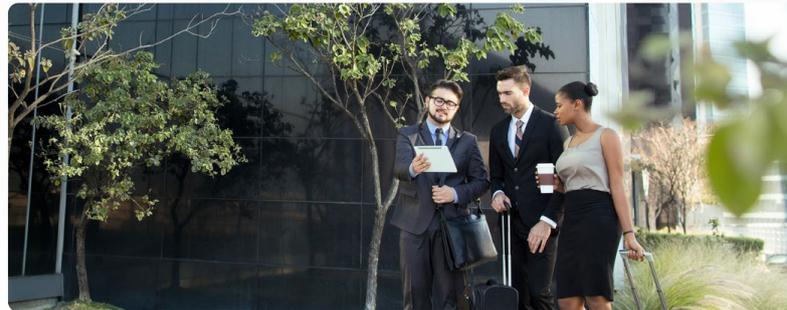
Mid-tier banks are making progress on their climate commitments – but few are going fast or far enough, especially when it comes to setting emissions reduction targets and reporting on financed emissions.

Promising commitments, but poor progress toward net zero

Soaring GHG emissions are an undeniable threat to our planet. They contribute to rising global temperatures and sea levels, disrupting the balance of nature and sparking severe weather events. Urgent action is needed to reverse the trend. The financial services sector has a pivotal part to play in funding the green transition and steering economies to a more sustainable future.

This is a reality that hasn't gone unnoticed by mid-tier banks. Of the 18 organizations we analyzed, half have set emissions reduction goals. This is an encouraging trend in the right direction. But when it comes to setting concrete targets, mid-tier banks fall far behind major financial institutions. Just 18% of the banks in our study have explicit net-zero targets. That's in stark contrast to their larger counterparts. Eight of the top 10 largest banks in the US have pledged to reach net-zero emissions by 2050².

Of course, it's not unusual that large financial institutions should be leading the charge in the industry's transition to net zero. After all, they're at the vanguard of supervisory scrutiny, which has driven them to take action sooner. Many large US banks have a head-start because they've already



had to comply with climate legislation in other jurisdictions, such as Europe, where the regulatory agenda has moved faster than at home.

It also seems that taking a more tentative approach to setting net-zero targets has played in mid-tier banks' favor. In its proposals on climate-related disclosures, the SEC has indicated that organizations could be held accountable to any publicly announced targets and will have to start showing tangible progress toward these goals.

Mid-tiers shouldn't take this as a signal to slow down on emissions reduction objectives. Even if they don't set firm net-zero targets, mid-tier banks should continue to focus on ambitious yet achievable reduction goals. In this way, they can signal their commitment to climate action and gain greater flexibility with regulators at the same time.

However, there's a big opportunity here for bolder banks to enhance their credibility and brand perception. Organizations that are prepared to lead the way in making clear net-zero pledges will set themselves apart from peers with hazier targets. In addition to building stronger momentum around emissions reduction efforts, these net-zero leaders could gain a valuable edge in appealing to green-minded customers and investors.

Just 18% of the mid-tier banks in our study have explicit net-zero targets



² When referencing "large US banks" in this paper, we are referring to institutions included on the following list published by the US Federal Reserve: <https://www.federalreserve.gov/releases/lbr/current/>

Financed emissions: A sizeable opportunity that hasn't been seized

Mid-tier banks are making progress on establishing emissions baselines, with 67% of the institutions we analyzed reporting on scope 1 and 2 emissions. But they have yet to get to grips with perhaps the biggest piece of the emissions disclosure puzzle – financed emissions (scope 3, category 15). This is concerning, given that financed emissions are by far the greatest contributor to banks' environmental footprints.

As scope 3 emissions are large and indirect, it's difficult to estimate, track and report on them. But they are the part of the emissions disclosure challenge that requires the biggest acceleration by mid-tier banks. Unless banks quickly get to grips with their financed emissions, they won't be able to understand the biggest climate risks threatening their businesses. They could easily end up with stranded assets on their balance sheets and find themselves exposed to substantial risks across their wider value chain.

There's also the compliance angle to consider. While measuring and reporting on scope 3 emissions is currently voluntary, regulators are showing increasing interest in scope 3 and how it factors into broader net-zero targets that organizations set. It would be best for mid-tier banks to develop the capabilities and expertise they need to report on and reduce financed emissions sooner rather than later.

While **67%** of mid-tier banks are reporting on **scope 1 and scope 2 emissions**, none are reporting on **financed emissions**



BARINGA RECOMMENDATION

Steps to get to grips with emissions reporting

- 1. Follow existing recommendations.** You can use guidance issued by the FRB and the TCFD framework as a way to set priorities and plan a path to emissions reduction.
- 2. Follow an established framework.** If you haven't looked into it already, the Partnership for Carbon Accounting Financials (PCAF) has established a comprehensive industry-standard methodology to help financial institutions calculate and disclose their financed emissions.
- 3. Tackle low-hanging fruit first.** Certain elements of scope 3 emissions are easier to track than others. Start by looking at emissions associated with working from home and employee commutes, for example, before moving on to emissions from your vendors and suppliers, then emissions from your investments.
- 4. Split it up.** Many of the larger banks we work with are making good progress on reporting scope 3 emissions, by starting with one or two polluting sectors – like transportation and agriculture – then gradually expanding across their portfolios.
- 5. Start engaging with your clients.** Getting data on scope 3 emissions is tricky, so encourage your clients to begin measuring their own emissions now. You can incentivize faster action by assuming clients have high emissions unless they can provide data to the contrary.



Embedding climate risk in business-as-usual operations

Embedding climate risk in business-as-usual operations

While most mid-tier banks agree on the importance of understanding the climate-related risks facing their business, assets and investments, few are actually taking steps to measure and report on those risks.

Catching up on climate risk integration

Risk assessments, scenario analysis, stress testing and other qualitative and quantitative metrics are important to effectively identify climate-related risks. These risks can be broadly divided into two categories:

- **Physical risks** result from extreme weather events like hurricanes, floods and wildfires, as well as more gradual changes in climate patterns that contribute to rising sea levels, drought and higher temperatures. Physical risks have consequences for operating costs, revenues and asset values.
- **Transition risks** involve changes in policy, technology, pricing and consumer behavior that come with the move to a net-zero economy. They can include higher demand for energy-efficient, lower-carbon products and services, increased costs for high-carbon activities and changing values of assets and investments.

All financial institutions need to understand the risks and opportunities that stem from climate change and the transition to a net-zero economy. More mid-tier banks seem to be waking up to this reality, with 67% of the banks in our study stating their intent to assess or analyze climate risks.

Yet far fewer organizations are taking steps to quantify those risks. Just 39% of the mid-tier banks we analyzed appear to be using any climate risk management tools, such as stress testing or scenario analysis. This puts them far behind major banks in the US, where nine out of the top 10 banks are already using some form of scenario analysis.

Mid-tier banks are particularly behind when it comes to developing and applying climate risk scenario analysis. This is a missed opportunity since scenario analysis is an extremely valuable tool for helping financial institutions understand and quantify how physical and transition risk will impact their bottom line.

67% of mid-tier banks have stated an intent to assess or analyze climate risks



Only 17% of mid-tier banks have reported results from a pilot scenario analysis



Scenario analysis is complex, but it's essential for providing the wider context that banks need to better balance risk and return parameters for future decisions and investments. Bringing on an experienced partner can be a huge help in focusing and accelerating your efforts here. They can work with you to shape a solid plan for integrating climate-related risks into your wider risk management framework and help you choose the right scenario analysis model to fit your business needs. They can also help you use sophisticated tools to quantify the financial impact of climate-related risks on your bottom line.

“Climate risk can't operate in a silo – it has impacts across an entire business, which is why it's important for banks to embed climate risk identification, assessment and management activities into their wider risk management framework. That starts with making sure your risk organization understands climate risk and is taking steps to embed that risk into their overarching operating structure.”

Melissa Klimek

Expert in Climate & Sustainability Strategy, Baringa



BARINGA RECOMMENDATION

Steps to prioritize climate risk integration

- 1. Focus on the full picture.** Climate risk management isn't something that can be tackled effectively by a single team. Your entire risk organization and business need to understand how climate risk affects your operations as a whole, so you can address it holistically.
- 2. Don't delay.** It takes time to build up the capabilities and know-how required to integrate climate risk management into your organization. Mandatory scenario analysis exercises might still be a way off for mid-tier banks, but you need to start organizing now to be able to properly respond to these demands when they do come into force.
- 3. Begin training key teams within your organization.** If you haven't already done so, you should train your executive board so that they understand how climate risk affects the bottom line. Then they can drive action throughout the organization. It's also crucial to start training front-line staff and risk management teams, as they'll play a vital role in protecting your business and driving emissions reductions.
- 4. Start small.** When it comes to scenario analysis and stress testing, consider running pilots on a subset of your holdings, such as a sector that you know to be high-risk or a location where you have significant holdings, to get an initial understanding of your exposure and develop your data sourcing strategy.
- 5. Don't let the perfect be the enemy of the good.** The data necessary for identifying, measuring and assessing climate-related risks is currently incomplete and not always reliable. However, this shouldn't prevent progress. Climate change poses a huge, urgent threat to the planet and the global population, and it demands immediate action. So don't be afraid to start by producing qualitative reports, then move toward quantitative reports.

Providing sustainable finance

Providing sustainable finance

Mid-tier banks are leaders in social finance, but they're falling behind on green finance.

Ready to bank on sustainable lending

Mid-tier institutions fill an important niche in the banking system. Closer to Main Street than Wall Street, they tend to have a stronger presence in local communities and more diverse business models that enable them to serve the needs of a wide range of customers. That includes supporting segments of the market that can often go overlooked by larger banks, such as small and mid-sized enterprises (SMEs) and other less-mainstream borrowers.

It comes as no surprise, then, that the mid-tier banks in our study have firm social finance foundations. In fact, 100% of the banks in our study offer social finance and another 72% have started green finance. But we believe that mid-tier banks could do even more to develop their sustainable finance portfolios, and play to their strengths in forging close connections with customers and championing causes they care about.

As a share of total loans, banks' average percentage of sustainable finance stands at just over 6%. Digging a little deeper, we see that the lion's share of that amount is allocated to social finance projects, with most banks doing three times more social finance (4.40%) than green finance (1.66%).

Mid-tier banks have a unique opportunity to use their expertise and learnings from social finance to extend into more green finance initiatives. As social and environmental causes often tend to intersect, advances made in either area stand to have a multiplier effect, helping banks magnify their impact

and returns. This means mid-tier banks can play a truly meaningful role in the transition to a low-carbon economy while seizing commercial opportunities from the energy transition. There are massive potential gains to be made – particularly since the passing of the Inflation Reduction Act.

BARINGA RECOMMENDATION

Steps to steer toward sustainable finance

- 1. Look for new opportunities.** Start by mapping out your existing portfolio and think through how the business you're doing today has the opportunity to support green and social impact initiatives tomorrow.
- 2. Develop your data.** Most existing data platforms and credit risk models aren't designed to take ESG factors into account. You'll need to start sourcing new ESG information, define new data policies and create new scoring models to link ESG considerations to origination policies and products.
- 3. Guard against greenwashing.** If you offer or promote sustainability-related products, you must have a transparent, consistent way of defining and disclosing on them. You should build up a consistent taxonomy and clear labels for sustainable finance offerings, and provide clear explanations as to how sustainability-related considerations are factored into your investment strategies.

“As we're seeking to make the world more sustainable and more equal, there's absolutely a need to integrate environmental, social and governance (ESG) criteria in lending and investment decisions. It's about finding the right balance between mitigating the climate risk, but still pushing the ESG agenda and supporting communities in need. The institutions who succeed in bringing those two strategies together will be the winners within financial services.”

Hortense Viard-Guerin

Expert in Climate & Sustainability Strategy, Baringa

Conclusion

Accelerate your actions

Banks can no longer afford to go slow on sustainability. Stakeholders are calling for clarity and change on ESG issues, policy momentum is gaining pace and the effects of climate change are taking a devastating toll on our planet.

While a wait-and-see approach may have worked well for mid-tier banks to date, a shift is underway. More is being asked of financial institutions of all sizes. That includes more transparent, standards-aligned disclosure, assessment of climate-related risks and target-setting.

If your organization hasn't yet kicked your climate reporting and risk management efforts into high gear, now is the time to do it. The gap between sustainability leaders and laggards is only getting larger – and banks that don't take action to catch up risk being left behind as the world transitions to a net-zero future.

The challenge ahead is considerable, and it will not be a quick win. Banks need time to build up the data, processes and capabilities required to fulfill rising expectations for clear, consistent, high-quality climate disclosures. Organizations in the US can learn from those in other regions, where earlier legislation has driven faster climate action. Along with supporting some of the largest US banks on climate change and sustainability goals, Baringa has also helped dozens of financial institutions across Europe and the UK meet climate-related disclosure and risk management requirements and prepare for supervisory stress tests. US banks can get a leg up by studying the same frameworks, methodologies and initiatives others have used to define their net zero operating model, set emissions reductions targets and report on progress toward these goals.

But mid-tier banks also have a unique opportunity to consider. As major US regulations are arriving in quick succession, institutions here can take a holistic approach and start viewing their whole business through the lens of climate. This is very different from other countries such as the UK, where regulations have come in different areas at different times, so climate activities often end up in siloes.

Banks that rise to the occasion are poised to capture a huge advantage – not only staying ahead of regulatory expectations, but pulling ahead of peers, guarding the business against climate risks, and improving your bottom line while protecting the planet.

To learn more about how Baringa can help you elevate your ESG reporting and accelerate progress on your climate commitments, please get in touch with one of our climate and sustainability experts listed below. If you'd like to find out if your bank was included in the benchmarking study and where it ranked, please reach out to us – we'd be delighted to set up a one-on-one meeting to discuss the results in more detail.

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