Carbon Accountability Programme

Banking on Carbon Accountability

2: The carbon impact of investment

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Friends of the Earth Scotland

Financial institutions are in a unique position to influence greenhouse gas emissions through investment; however current carbon reporting fails to capture this opportunity.

Banks and other financial institutions occupy a uniquely powerful position among private companies to influence the course of future global climate change. The financial sector in the UK handles trillions of pounds of finance and investment every year and affects the activities of millions of corporate clients. With this influence, the financial sector has the potential to bring about extremely significant greenhouse gas emission reductions in the economy as a whole.

However, this potential influence and impact on emission reductions is not currently captured by banks' environmental management strategies, conventional carbon assessments, or the Government's climate change strategy.

This briefing proposes one tool to measure the climate performance of financial institutions, taking account of both their climate policies and their direct financial investment.

> **We recognise that as a financial institution, the biggest impact we have on society and the environment is through the financing we provide to our clients**
>
> **Standard Chartered Sustainability Review 2007**[1]

Influenced emissions

A financial institution's 'influenced emissions' could be defined as: the greenhouse gass (GHG) emissions of an institution's corporate clients influenced by the provision of finance or financial services.

This wide-ranging definition could include emissions from a new-tech company operating on finance from an investment fund, an office building owned by a pension fund, a new power station project funded by a consortium of banks or any number of other examples.

The financial sector's set of 'influenced emissions' far outweighs the emissions from its offices, travel and procurement. However, clearly financial institutions are not primarily responsible for influenced emissions (and these emissions will appear in national GHG accounts attributed to the industry-sector from which they derive). So why should financial sector organisations, Government or civil society consider these indirect emissions?

1. High-emissions in an investment portfolio are risky

To shareholders, investors and portfolio managers GHG emissions in a financial institution's portfolio represent a potential risk on returns.

Climate change will have significant implications for individual assets and represents a risk to returns on investments; currently coined 'climate risk' or 'carbon risk'.[2,3] This risk partly exists as the shared and public risk of exposure to climatic impacts and severe events. But importantly, it also incurs exposure to new fees and regulations targeted at private institutions to mitigate emissions.

Two 2009 reports outline this carbon risk. *Towards a Royal Bank of Sustainability*[4] argues that best environmental practice in RBS will best protect Government investments and *Carbon Risks in UK Equity Funds*[5] finds that "*fund manager complacency on corporate carbon performance could put pension fund assets at risk as carbon-intensive companies face rising carbon costs and their company valuations fall in the short-term in anticipation of future carbon risk*".

To environmental or sustainability managers in institutions high-emission investment also risks accusations of 'greenwash'.

Environmental or sustainability managers have a mandate to promote a 'green' reputation for their organisation and many have embarked upon ambitious carbon reduction targets for their offices and data centres. However institutions that do not include climate change in their financing policies will increasingly face accusations of 'greenwash' for the financing of, for example, fossil fuel extraction and power generation. Managing this risk will require promoting the building of carbon into decision-making at a board level.

1 Standard Chartered, Sustainability Review 2007, Standard Chartered, 2008, <http://www.standardchartered.com/_documents/2007-sustainability-review/sc_2007_sustainabilityReview.pdf> [accessed 24 July 2009], p. 3.

2 World Bank, Managing Climate Risk: Integrating Adaptation into World Bank Group Operations, Working paper no. 37462 (Washington D.C., World Bank, 2006).

3 World Resource Institute, Subprime carbon: preparing for the dangers of hidden carbon risks, WRI, 2008, <http://www.wri.org/stories/2008/10/subprime-carbon-preparing-dangers-hidden-carbon-risks> [accessed 23 July 2009].

4 Nick Silver, Towards a Royal Bank of Sustainability: protecting taxpayers' interests; cutting carbon risk, People & Planet, World Development Movement, PLATFORM, Friends of the Earth Scotland and BankTrack, 2009 <http://www.platformlondon.org/carbonweb/documents/royalbankofsustainability.pdf > [accessed 3 November 2009]

5 Trucost, Carbon Risks in UK Equity Funds, Trucost, Mercer and WWF, 2009, <http://www.trucost.com/CarbonRisksinUKEquityFunds.pdf> [accessed 3 November 2009]

2. GHG Protocol 3: indirect emissions

Many organisations, financial institutions included, have begun to look to their indirect emissions such as those embedded in their product and service supply chain. Indirect emissions are called Scope 3 emissions under the GHG Protocol[6] and for many organisations, especially those whose core business is not primary material production, they can represent the largest carbon impact and most significant opportunities for carbon saving.

Third-party organisations may hold primary responsibity for supply chain or Scope 3 emissions but it is recogised the purchaser inherits some responsibility on purchase. There is no logical difference with financing. The product in this case is a share, project or other asset and all have GHG emissions related to them.

3. A significant and neglected opportunity for emission reductions

The drastic effects of unmitigated climate change on society are now well documented. However, the potentially key role banks and other financial institutions could play in the solutions to climate change are not widely appreciated.

Investments made today dictate the carbon-intensity of the economy tomorrow; therefore institutions with significant influence on investment can play a central role in reducing emissions and should be accountable for the carbon impacts for their investment decisions. Delivering climate change targets will require action and accountability across all sectors of the economy with *influence* on GHG emissions; not just the significantly polluting sectors.

> **"present investments determine the carbon intensity of the future to come"**
>
> **Banktrack[10]**

Capturing the influence

To harness the influence of the financial sector on carbon reductions it is critical to measure institutions' 'climate performance'.

Financial institutions have two types of influence on carbon reductions that can define its climate performance. One, the activities they choose to finance; and two, the governance and policies they apply to and promote among clients.

The Cooperative Bank excludes from its financing "*any business whose core activity contributes to global climate change, via the extraction or production of fossil fuels*"[7] This is an example of the first type of influence. Cooperative Investments takes a different approach, they engage with business to promote a reduced reliance on fossil fuels following their Ethical Engagement Policy.[8] This is an example of the second type of influence.

In reality the two types of influence described sit at the ends of a spectrum. HSBC's Energy Sector Policy describes situations when HSBC will not provide financial services, for example if the project is sited in a UNESCO World Heritage site. The policy goes on to state that as "*part of its commitment to engage with clients and assist them towards higher standards of sustainable development, [HSBC] will also work with clients who may not currently meet these standards due to legacy assets, but who have a credible, documented and time-bound plan to meet them.*"[9]

> **"[The] finance sector can play a unique 'enabling' role in unlocking a low carbon economy"**
>
> **The Climate Principles[11]**

6 Greenhouse Gas Protocol, Corporate Accounting and Reporting Standards, World Business Council for Sustainable Development and WRI, 2004, < http://www.ghgprotocol.org/files/ghg-protocol-revised.pdf > [accessed 3 November 2009]

7 Co-operative Financial Services, Ethical Policy, CFS, 2009, http://www.goodwithmoney.co.uk/ethical-banking [accessed 30 September 2009].

8 Co-operative Financial Services, Ethical Engagement Policy, CFS, 2005 http://www.goodwithmoney.co.uk/environmental-sustainability [accessed 30 September 2009].

9 HSBC, Energy Sector Policy, HSBC, 2006, www.hsbc.com/1/2/sustainability/our-sustainable-approach-to-banking/sector-guidelines [accessed 30 September 2009].

10 Banktrack, Mind the Gap: Benchmarking Credit Policies of International Banks (Utrecht, Banktrack, 2007), p. 74.

11 The Climate Group, The Climate Principles <http://www.theclimategroup.org/about/corporate_leadership/climate_principles> [accessed 30 September 2009].

> **Delivering climate change targets will require action and accountability across all sectors of the economy with influence on GHG emissions; not just the significantly polluting sectors.**

1. Key Sector Investment Ratio

The simplest way one could measure the climate performance of a financial institution's financing activities is to add up the gross amounts of finance provided to key high-carbon and low-carbon sectors.

The definition of the high-carbon sector and low-carbon sector is obviously critical and discussed below. However if an agreed upon definition were used across a number of institutions the ratio of gross finance between the two sectors would provide a comparison between institutions of varying size:

Key Sector Investment Ratio = [£'s of low-carbon finance] / [£'s of high-carbon finance]

A higher ratio would mean a greater percentage of the institution's financing activity is provided to low-carbon projects and vice-versa.

How would one define high and low carbon financing? This requires a sector segmentation model to define in what camp, high-carbon or low-carbon, each investment sits. Existing segmentation models such as HSBC's Global Climate Change Benchmark Index identify companies that derive more than 50% of reported total revenue from "*climate change related activities*" to define companies included in a 'green fund'.[12]

Clearly there are many activities that will not be clear cut, for example a corporate loan to an engineering firm constructing both private and public vehicles. To tackle this issue the segmentation model could be reduced in complexity to include only key sectors and activities at the extremes. Sectors that drive the transition to a low carbon economy, for example renewable electricity production or energy efficiency measures, and at the other extreme, sectors that would lock the economy into a high carbon future, for example new fossil fuel power stations or road infrastructure.

A Key Sector Investment Ratio analyses what activities an institution has chosen to finance and therefore deals with the first type of influence the financial sector has on carbon emissions.

2. Benchmarking climate governance

Some institutions engage, or have committed to engage, clients on climate change issues as part of their due diligence and governance procedures. For example, banks signatory to the Climate Principles agree to "*develop products and services that enable our customers to manage their climate change related risks and business opportunities*" and "*engage with our customers, suppliers and wider society to seek opportunities for a low carbon economy*".

Two recent studies from Ceres and Sustainable Asset Management have benchmarked banks on climate governance (see annex).[13,14] These studies rate the frameworks, policies, monitoring, staff education and other schemes in operation in banks designed to help manage and reduce their environmental impact. These studies cover internal operational emissions but also how banks engage their clients on climate change issues and risks.

These climate governance benchmarks analyse how institutions apply and promote climate change issues with clients and therefore deals with the second type of influence the financial sector has on GHG emission reductions.

12 HSBC, HSBC Investable Climate Change Index, HSBC, 2008, http://www.hsbcnet.com/treasury/attachments/structured-products/ca/issues/climate2_index_bg.pdf [accessed 30 September 2009].

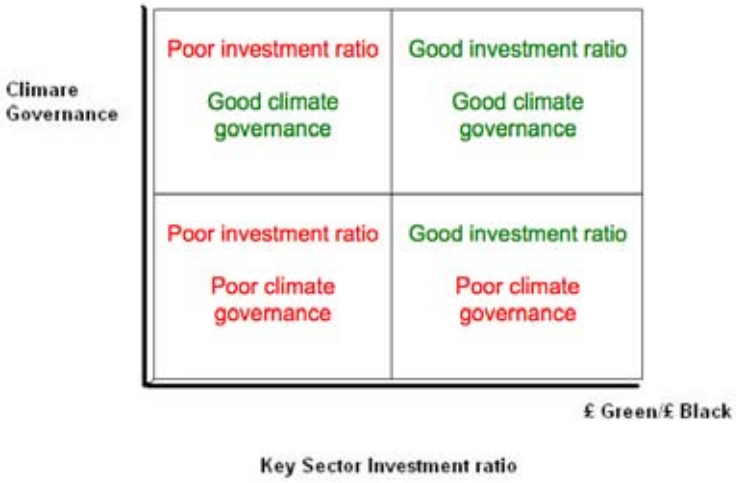
13 Douglas Cogan, Corporate Governance and Climate Change: The Banking Sector, Ceres, 2008, <http://www.ceres.org/NETCOMMUNITY/Document.Doc?id=269> [accessed 16 August 2009].

14 Bettina Furrer, Volker Hoffmann and Marion Swoboda, Banking & Climate Change: Opportunities and Risks. An Analysis of Climate Strategies in more than 100 Banks Worldwide, SAM Group, 2009, <http://www.sam-group.com/downloads/publications/sam_study_banking_e.pdf> [accessed 01 July 2009].

Climate governance versus investment

As detailed above the financial sector can influence GHG emissions and potential emission reductions in two important ways. Through the activities they choose to finance and through the policies and governance they promote among their clients. Measuring the performance of a financial institution on climate change therefore requires a tool that looks at both aspect of their influence.

The figure below outlines a performance matrix that captures both aspects. The 'Climate Governance' y-axis rates how an institution engages with clients. The Key Sector Investment Ratio x-axis rates the ratio of low-carbon to high-carbon activities the institution chooses to finance.



Both axes of the measure are important. The climate-related policies an institution has in place are a central driver in promoting good climate risk governance internally and with clients. The finance actually provided to high-carbon and low-carbon activities is however the outcome, the most direct impact on GHG emissions. An institution may have excellent policies but if it continues to heavily invest in high-carbon activities its environmental impact is high and its climate performance must be rated lower.

Does the data exist?

Existing governance benchmarks such as that developed by Ceres and Sustainable Asset Management provide a method and dataset for the y-axis. However, banks and financial institutions do not currently disclose data on sector-specific gross finance required to calculate the x-axis. This data is available for large banks in market-research databases but to construct an accurate picture including smaller banks and smaller companies will require a willing institution or greater disclosure across the sector.

> **"More banks will need to... [track] the relative flow of capital into carbon vs. non-carbon energy sources"**
>
> **Ceres Corporate Governance and Climate Change**

Accountability imperative

It is essential that a wider responsibility to consider influenced emissions be fostered in the financial sector.

An institution's decision to finance a high-carbon activity will contribute to the impacts of climate change on people and societies around the world. A responsibility must exist for this decision, coupled with the institution's duty to shareholders to consider increasingly significant climate risks to business.

Any measure of climate performance for a financial institution must consider the influence financial institutions hold and the significant opportunities that exist to promote emission reductions in portfolios.

Finance is key to a low-carbon future; clearly the financial sector has a critical role to play.

Existing carbon accountability tools

What accountability already exists for the carbon impacts of a financial organisation's financing decisions? This annex describes existing tools or benchmarks to measure a financial institution's performance on climate change with a particular focus on accountability for the carbon impact of financing decisions.

Companies Act

The Companies Act 2006 (c. 46), the umbrella British corporate law, determines that company directors must '*have regard*' to environmental impacts when making decisions.[15] Large companies must also publish an annual report that includes environmental issues, encompassing their environmental policy and impact (clause 417).[16] Guidance is given, but there are no mandatory requirements defining how companies should report this information.[17]

The Government expects businesses to report on any significant environmental impacts. The guidance applies to a large range of companies and is therefore open to interpretation but broadly follows the GHG protocol by defining direct and indirect emissions.

The principle of accountability for financed or influenced emissions is not necessarily precluded from this guidance but is not specifically considered or mentioned. However, a large financial institution is expected to set its own environmental key performance indicators to capture its significant environmental impacts.

Carbon Disclosure Project

Sending a questionnaire on environmental policy and impacts to companies around the world, the Carbon Disclosure Project's objective is to gather information that will be of use to decision-makers in the private and public sectors.[18]

Questions are grouped into four categories: 1. how the company considers and manages the risks, opportunities and business implications of climate change; 2. company GHG reporting, including any data for scope 1, 2, 3 and other emissions plus boundary and methodology information; 3. detail on any carbon management plans and emission intensity and; 4. governance, including board oversight and lobbying activities.

The CDP has successfully increased the availability of financial institutions' climate change information. Six banks, ten insurance firms and 41 other diversified financials in the UK responded to the questionnaire in 2008.

The CDP does not define guidance on the scope of responses, leaving this up to the individual company, but the principle of more, rather than less, detail and transparency is encouraged.

No questions are explicit in defining accountability for investment strategies or GHG emissions in a company's loan or investment portfolio. Financial institutions do in general refer in their responses to climate change risks faced by their clients.

Global Reporting Initiative

The Global Reporting Initiative (GRI) proposes a social, economic and environmental sustainability reporting framework adapted to different sectors and countries in the Sector Supplements and Country Annexes.[19] The objective of the framework is to provide a standardised assessment of organisations that makes it possible to compare results across the economy and across time.

Financial sector organisations have their own supplement, the Sustainability Reporting Guidelines & Financial Services Sector Supplement.[20] Here the principle of financed or influenced emissions is not included in the indicators but is recognised in the commentary:

'*If the financial [institution] also produces estimates related to the emissions of the financing portfolio, these figures should be disclosed separately from data related to [total direct and indirect GHG emissions]*'.[21]

15 David Chivers QC, The Companies Act 2006: Directors' Duties Guidance, (London, Corporate Responsibility, 2007), p15.

16 Companies Act 2006 (c. 46) London, OPSI.

17 Defra and Trucost, Environmental Key Performance Indicators: Reporting Guidelines for UK Business, Defra, 2006, <http://www.defra.gov.uk/environment/business/repoting/pdf/envkpi-guidelines.pdf> [accessed 23 July 2009].

18 Carbon Disclosure Project, "FAQs" Carbon Disclosure Project, 2009, <http://www.cdproject.net/faqs.asp> [accessed 16 June 2009].

19 Global Reporting Initiative (n.d.) "What we do" Global Reporting Initiative, n.d., <http://www.globalreporting.org/AboutGRI/WhatWeDo/> [accessed 30 June 2009].

20 Global Reporting Initiative and UNEP-FI, Sustainability Reporting Guidelines & Financial Services Sector Supplement. (Amsterdam, GRI, 2008).

21 Ibid, p. 34.

Equator Principles

Private banks developed a set of guidelines, called the Equator Principles, containing ten principles to be applied in project financing linked to the standards of the World Bank and the International Finance Corporation; a multilateral development institution under the World Bank Group.[22] The intention is that the signatories – private institutions that adopt them publicly and voluntarily – use them as the guiding principles for internal policies and control mechanisms for the social and environmental issues in project finance.

The world's largest project financiers have signed the Equator Principles, accepting in principle that – for at least for some kinds of lending – there is a need for banks to assess sustainability implications.

The Equator Principles establish to some degree the need for institutional accountability for financed or influenced GHG emissions. The monitoring requirements are however weak: nowhere do the principles require any related reporting such as number of GHG-intensive projects financed, and there are no official sanctions for non-compliance.

Governance-based benchmarking

A Ceres-sponsored study, Corporate Governance and Climate Change: The Banking Sector, assessed 40 of the world's largest banks against a GRI checklist of climate change governance criteria.[23] This methodology benchmarks a bank's governance, policies and management mechanisms devoted to sustainability matters resulting in an overall score for the company. It does not rank results or efficiency in achieving reductions in the environmental impacts of a financial institution.

Good practice on financed or influenced emissions is rewarded with high scores. The Royal Bank of Canada has performed a carbon risk profile of the firm's lending portfolio and Bank of America is highlighted after it made a '*formal, but modest, commitment to shift the balance of its financing in the power sector in favour of lower-carbon utilities*'.[24]

Banking and Climate Change: Opportunities and Risks is a benchmarking study by Sustainable Asset Management and others, assessing specific and applied items of policy related to bank's operations, business and governance and weighted according to Sustainable Asset Management's findings of contributions to value creation.[25]

Examples of indicators include: the pricing of carbon risk in lending and investment operations; assessment of client companies' emissions; elimination of high-emission industries from the portfolio; requirement of climate change-related risks insurance from clients; and hedging of climate change risks in the portfolio.[26] This study benchmarks the banks' direct emissions, but also includes the principles of carbon risk and influenced emissions.

Footprint-based benchmarking

Calculating a financed emissions footprint has been attempted by a number of organisations. Clearly this style of assessment links accountability for the financing of carbon intensive activities to financial institutions.

French bank Caisse d'Epargne and consultancy Utopies developed a sustainability labelling system for banking products aimed at high-street customers. A savings account is rated for financial security, social responsibility and climate change with diagrams similar to those of energy efficiency on electrical appliances.[27] The climate change label takes into consideration both the bank's operational emissions and a whole-life-cycle assessment of all financed emissions.

External NGOs have also calculated the financed emissions of various banks using publicly available data. A study by Milieudefense (Friends of the Earth Netherlands) and consultancy Profundo focuses on the financing of fossil fuels production and renewable energy by Dutch banks.[28] Rainforest Action Network produced a similar report highlighting the carbon intensity of every dollar saved by high-street customers of Canadian banks.[29]

22 Equator Principles, 2006, <http://www.equator-principles.com/documents/Equator_Principles.pdf> [accesed 3 November 2009]

23 Douglas Cogan, Corporate Governance and Climate Change: The Banking Sector, Ceres, 2008, <http://www.ceres.org/NETCOMMUNITY/Document.Doc?id=269> [accessed 16 August 2009].

24 Douglas Cogan, Corporate Governance and Climate Change: the Banking Sector, (Boston, Ceres, 2008), p. 14.

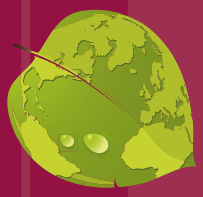
25 Furrer, Hoffmann and Swoboda, Banking & Climate Change.

26 Ibid, pp. 19-21.

27 Groupe Caisse d'Epargne and and Utopies, (2008) Sustainability Development Labelling of Banking Products, Utopies, 2008, <http://www.utopies.com/docs/Methodologie-General-Juin2008-GB.pdf> [accessed 03 July 2009].

28 Milieudefensie, (2007) Investing in Climate Change: Dutch Banks Compared 2007, Milieudefensie, 2007, <http://www.milieudefensie.nl/klimaat/publicaties/rapporten/investinginclimatechange2007.pdf> [accessed 06 July 2009].

29 Sarah Denie and others, Financing of Fossil Fuels and Renewable Energy by Canadian Banks, Rainforest Action Network, 2008, <http://climatefriendlybanking.com/fileadmin/materials/comms/mediacontent/reports/profundo_banks_report.pdf> [accessed 06 July 2009].



Carbon Accountability Programme

We promote accountability in environmental claims to improve business and personal confidence in low-carbon products and markets.

Our work will help businesses to be confident that their green choices are effective and rewarded

Our findings will help consumers have confidence in the actions they take to reduce carbon

Our partnerships with business and NGOs will help to develop carbon accountability solutions with consistency and transparency

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