Banks play an important role in ESG

Banks play an important role in our economy as they are the gatekeepers for allocating capital and liquidity to the real economy. Through their financing, advisory and investment functions, banks play a key role in financing environmental projects, which in turn helps in achieving the global Sustainable Development Goals.

Climate and environmental issues are emerging risks for the real economy and, hence, affect our banking system directly. Climate events, such as drought, flooding, or changes in environmental policies, can affect the credit quality of the borrowers, and potentially lead to an increase in financial risks for the banking system. Regulators across the globe and international bodies such as Task Force on Climate-related Financial Disclosures (“TCFD”) have been urging banks to integrate climate and environmental risks into their risk management practice.

The European Union has led the way by introducing the EU Action Plan on Finance in 2018, which impacts financial market participants directly. As a result, Banks in the European Union are integrating ESG factors within their business model and are setting examples for banks globally. The United Kingdom and German banking regulators have issued requirements in 2019 asking banks to account for climate-related issues into their Internal Capital Adequacy Assessment Processes, and to perform scenario analysis in assessing their exposure as well as resilience to climate-related issues.

High momentum is noted in the Asia Pacific region as well. Financial regulators in China, Singapore, Australia and Japan have either issued green and sustainable banking requirements and recommendations, or have announced plans to do so in the near future.

Regulatory trends for green and sustainable banking in Hong Kong

The Hong Kong Monetary Authority (“HKMA”) and the Securities and Futures Commission (“SFC”) have issued frameworks and circulars to promote the ESG initiatives in the financial services sector. Both regulators are actively exploring potential policy changes in the area and are expected to issue new guidance in the near future.

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<th>SFC</th>
<th>HKMA</th>
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<td>In September 2018, the SFC first announced its strategic framework for the development of green finance in Hong Kong.</td>
<td>The HKMA announced three-phased measures to promote the development of green and sustainable banking in May 2019.</td>
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<td>In December 2019, the SFC completed and published Results of the &quot;Survey on Integrating ESG factors and Climate Risks in Asset management&quot;.</td>
<td>In December 2019, the HKMA issued a consultation on the “Common Assessment Framework on Green and Sustainable Banking” (also known as “Common Assessment Framework”).</td>
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Our observation of market readiness in green and sustainable banking

Europe-based banks are leading the pack when it comes to green banking, while their counterparts in Hong Kong have only just embarked on the sustainable banking journey with plans to develop green and sustainable banking practices. We noted that Hong Kong banks are at different stages of maturity when it comes to their ESG journey[1]. A few banks in Hong Kong have already developed their green product offerings and others have issued green bonds. A number of banks are thinking about upping their game by integrating ESG holistically into their organization – from governance, strategy, risks, products to explore an end-to-end integration.

How the banking and financial system operates will clearly have an impact on the way in which climate risk is managed or reduced.

Norman Chan, former Chief Executive, The Hong Kong Monetary Authority[2]

Key challenges for the banking industry

Achieving green and sustainable banking will require tremendous effort across all functions of the banks. Challenges include:

- Lack of talent with ESG expertise
- A need to develop a holistic approach from strategy to implementation
- Risk management, such as climate and environmental data needs for quantitative risk management, and expertise to develop scenario analysis and stress testing models

Based on our market observations, most of the banks have not integrated ESG and climate risks into their business and risk management process. The regulator expects that banks should have a plan to close the gaps (if any) in the next 1 – 3 years. They will issue supervisory expectation in the second half of this year asking banks to account for climate-related issues into their Internal Capital Adequacy Assessment Processes, and to perform scenario analysis in assessing their exposure as well as resilience to climate-related issues.

If you have not even started planning for ESG integration, you should start now.

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Environmental, Social and Governance (ESG): An opportunity for Banks

A holistic approach from strategy to implementation will be the key to success

It is paramount that banks determine a bank-wide strategy on how to integrate ESG into their operating model, with appropriate governance in place for oversight and direction. We set out, below, a conceptual framework on how key elements of ESG strategy and implementation should be tied together.

What you need to consider going forward

Board of directors will need to lead the way in setting the ESG vision, while all business functions will need to be involved in building a comprehensive plan for ESG integration. Given the vast scope of work required to integrate ESG and climate risk, banks need to prioritise to meet the expectation of the regulator and other key stakeholders.

How PwC can support your ESG journey

Banks need to address the fundamental areas (see figure below) to integrate ESG and climate risk across their operating model and core processes. We can support banks on different areas of their ESG journey.

Governance: oversight and directive on ESG matters in line with existing regulatory expectations over governance, such as SPM CG-1 and IC-1

Strategic goal setting: set common definitions of ESG issues, identify and prioritise material ESG issues and set the vision and mission around ESG

Strategic planning: integrate the strategy and the risk objectives to cater for sustainable development of the bank

Execution & monitoring: embed the ESG and climate risk into the business processes and perform ongoing monitoring

Disclosures & communications: manage internal and external stakeholders, and obtaining third party independent assurance where considered appropriate

What you need to know more about green and sustainable banking? Contact us and learn more.

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