Industry overview — as it relates to executive compensation

Financial services

The impact of climate change on the financial sector is stark, as is the sector's ability to steward the transition to a net zero and climate-resilient future. Consider the following data points:

- $6.9 trillion a year is required up to 2030 to meet climate and development objectives (Organisation for Economic Co-operation and Development (OECD) climate financing futures). In 2019, the World Bank estimated that capital required would be $90 trillion over 15 years.
- There is approximately $300 billion of estimated maximum credit losses on outstanding debt resulting from a carbon tax.
- Along with the more than 230% increase in the number of catastrophes caused by natural hazards from 1980 to 2019, economic losses (adjusted for inflation) increased by approximately 150%, from $60 billion in 1980 to $150 billion in 2019, with a peak of $350 billion in 2018 with major implications for reinsurance.
- As interest and uptake of climate-conscious investing has soared in recent years, investment banks and asset managers are increasingly making sustainable and ethical investment the new standard. There were $760 billion in assets under management in ESG mutual funds and ETFs in 2018, up 68% from $453 billion in 2013

While there is a clear threat of climate change for the industry, there are opportunities too. For example, the World Bank says that transitioning to a green economy can provide opportunities to recoup the vast investment required, estimating that a $1 investment could yield $4 in benefits. Further, according to a report from CDP, the financial sector could see potential revenue of $1.2 trillion (more than any other industry) from:

- The introduction of new sustainable products, services and related jobs
- Shifting consumer preference
- Increased capital availability as financial institutions increasingly favor low-emissions producers

Regulatory, governance and investor drivers

Regulation and governance is the strongest driver of action against climate change for the industry. New regulations across the globe will require greater climate risk disclosure and management, stress-testing, scenario analysis and stewardship; standards are evolving and should serve to both make compliance more stringent and reduce the amount of “greenwashing”.

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Focus by region

- The U.K. and New Zealand lead the way in terms of mandatory climate reporting and regulation, although other countries are following suit (particularly across Europe), with the G7 calling for mandatory climate risk disclosures. Further, financial supervisors have set expectations for regulated firms to integrate climate-related metrics into executive compensation frameworks (for example, the Prudential Regulation Authority's "Dear CEO" letter).
- Association of Southeast Asian Nation (ASEAN) countries are beginning to regulate on climate, with 70% of ASEAN countries having issued or revised sustainable banking regulations.
- While climate-related activity (regulation, governance, measurement and disclosure) in North America has been more limited to date, under the Biden administration, there are significant moves underway to integrate climate risk into the financial architecture of the United States. This is on the back of years of pressure from investors and corporate stakeholders pressing the U.S. Securities and Exchange Commission (SEC) to mandate greater climate disclosure.

The industry response

In response, the financial sector commitments to net zero now stand at over $70 trillion and are increasing in the lead up to CoP26 in Glasgow (coordinated by the Glasgow Finance Alliance for Net Zero (GFANZ). With the acceleration toward a net zero economy, there is already increasing focus on how financial services organizations are also aligning portfolios and making commitments in the short term. This is undergoing a similar pattern observed in the corporate world, where there has been initial activist pressure to exclude certain companies, rather than trying to steward companies through the transition required (i.e., by choosing to continue to underwrite or invest but under conditions that those companies will agree to decarbonize or transition in line with the science). Stewardship is particularly important in aiding high polluters to make the transition.

Some financial institutions want to be neutral on climate and be steered by policy and markets, while others are seeing it as their fiduciary duty. We expect boards to see more liability cases on this topic in the next few years.

What are companies measuring and reporting?

Financial institutions are using a number of reporting frameworks related to climate and sustainability. Further to an announcement by G7 finance ministers in early 2021 regarding mandatory climate disclosure, many financial institutions are reporting in line with the Task Force on Climate-Related Financial Disclosures (TCFD) framework of governance, strategy, risk management and targets and metrics.

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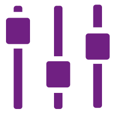
Since 2019, much activity has focused on:

- Scenario analysis to inform risks and opportunities driven in part by U.K. Finance and the Prudential Regulatory Authority's 2021 Biennial Exploratory Scenario
- Establishing financial risk metrics related to climate change
- Initiatives around net zero and Paris alignment (1.5o)

In addition, many banks are increasingly committing to net zero targets and portfolio carbon accounting frameworks.

Climate-related data and metrics are still evolving. With increasing focus on net zero, financial institutions are typically using or considering using carbon-related metrics, including financed as well as operational emissions. Nonetheless, we expect other approaches to emerge as a side conversation on strategy and the best metrics for financial institutions to develop, such as measures relating to value at risk or portfolio alignment.



Aligning climate goals and targets with executive compensation

Globally, the prevalence of 'E' metrics in incentive plans across the industry (when reviewing main indices across U.S., Continental Europe and the U.K.) is 11% but this masks the regional differences. Only 2% of U.S. companies have incorporated environmental metrics within their incentive plans, while 20% have across Europe and the U.K. have done so, which reflects the varying degree of investor and regulatory pressure in those markets.

Metrics seems to focus on progress against green and sustainability funding and financing commitments of the company as well as carbon emissions and footprint-reduction targets, with metrics in both annual bonuses and LTIs.

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Challenges aligning climate goals and executive compensation

Metrics and target selection is a challenge, given that use of climate-related metrics at the company level are still nascent among financial institutions. While carbon metrics are commonly being used, there is increasing recognition they do not necessarily capture a firm's financial risks, or necessarily the effectiveness of its actions in driving outcomes in the real economy. An area of debate is whether

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the transition to net zero will require a shift to only financial metrics or whether carbon metrics will still have a role. Intensities are often used in this area as implied temperature ratings (ITRs) as recommended by the TCFD in its recent portfolio alignment guidance.

The methodologies for these are also nascent and yield different results based on their coverage and approach, but we expect to see this applied to asset levels and portfolios as part of the mix.

Another challenge related to target setting and the ability to track progress is the availability of reliable, complete data sets and transparent analytics or models to interpret them.

Additionally, companies must take care to ensure incentive design is aligned with removing perverse incentives from the point of view of climate resilience; for example, still encouraging and profiting from the financing of new fossil fuel exploration and infrastructure verses attaining climate targets, risk reduction or stewardship.

Leading company example — Standard Chartered

- **Metric name and description:** “Purpose and people” – a strategic metric within the bonus scorecard. One of the three targets is: “Exceeded our 2020 target in financing services for renewable energy projects and on track to the sustainability aspiration target of $35 billion; all other sustainability measures also at or above target.
  - **Weight in vehicle:** one of three targets within this metric weighted at 10% in annual bonus plan
- **Metric name and description:** “Sustainable finance” (1. Develop and implement a framework to align our financial services with net zero emissions by 2050, and deliver 2023 targets consistent with that plan; 2. Provide $35 billion (cumulative) worth of project financing services, M&A advisory, debt structuring, transaction banking and lending services for renewable energy that align to our verified green and sustainable product framework; 3. Only provide financial services to clients that are less than 80% dependent on earnings from thermal coal (based on % EBITDA at group level)).
- **Metric name and description:** “Responsible company” (1. Reduction in property emissions of 10% annually, 2. Reduction of flight emissions of 25%, 3. Offset 95% of all residual emissions from our operations).
  - **Weight in vehicle:** the two metrics above constitute 15% of the long-term incentive plant

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