

ESG considerations in FS Treasury

FHNW ALM Talk Series

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Fachhochschule
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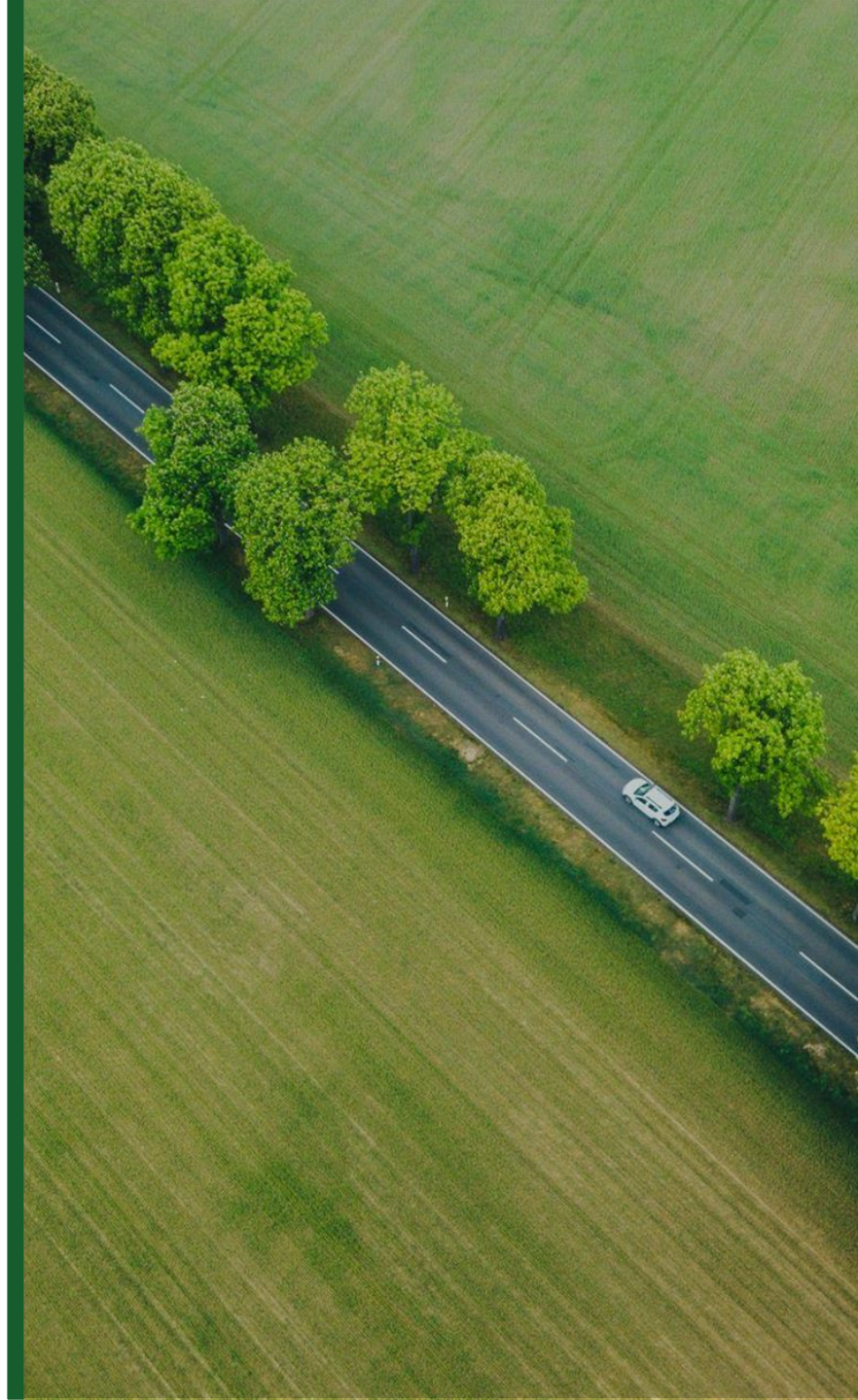
Topics for today

1 Treasury as a business enabler in the new ESG reality

2 Steering a B/S under ESG considerations

2.2 *Focus: HQLA Portfolio*

3 ESG implications for liquidity management?



An aerial photograph of a large, dense tree with yellowish-green foliage, standing in a vast, flat, green agricultural field. The tree is the central focus, casting a shadow to its right. The field is divided into horizontal rows, suggesting a crop field. The overall scene is bright and clear.

01

Treasury as a business enabler
in the new ESG reality

Banks play a paramount role in the European Green Deal

This is because their balance sheets act as a significant transmission channel that puts Treasury more in the focus for ESG than in the past

2030

55%

reduction in greenhouse gas emissions (vs 1990)



32%

share of renewable energy



32,5%

improving energy efficiency



2050

"Zero"

Climate-neutral Europe by 2050 to limit global warming



Green order

The European Union's Action Plan on Sustainable Growth Strategy



Climate law

Climate neutrality as a legal obligation in the EU



The European Union action plan on sustainable funding:
Redirecting funding streams towards sustainable investments.

Pillars of sustainability and non-financial reporting:

- EU Taxonomy for the classification of sustainable activities
- Investing in sustainable investment in the financial services sector (SFDR)
- Standardised corporate reporting requirements with new ESG reporting standards (CSRD)



Banks' balance sheets act as a significant transmission channel into the real economy

The on-B/S of all banks provide a huge lever for policy makers to steer the transmission process from sustainability into the real economy

Climate-related transition and physical risks impact a **banks financial risk** through **economic transmission channels** on a **micro level** (affecting individual businesses and households), as well as an **macro level** (aggregate impacts on the broader macroeconomy).

Environment- and climate-related risks

- Transition risks**
- Policy and regulation
 - Technology development
 - Consumer preferences

- Physical risks**
- Chronic (e. g. temperature, precipitation, agricultural productivity, sea levels)
 - Acute (e. g. heatwaves, floods, cyclones, etc.)

Economic transmission channels

Micro level

Affecting businesses and households

Corporates

- Damage and disruption
- Stranded assets and new renewable CAPEX
- Revenue changes
- **Carbon costs**

Households

- Loss of income
- Damage or restrictions increase costs/affect valuations

Macro level

- Aggregate impacts on the macroeconomy
- Capital depreciation and increased investment
 - Shifts in prices (e. g. supply shocks)
 - Productivity changes (from severe heat, diversion of investment, higher risk aversion)
 - Labor market frictions
 - Socioeconomic changes (changing consumption patterns, migration, conflict)
 - Other impacts on fiscal space, etc.

Financial risks

Credit risk

- Defaults
- Collateral depreciation

Market risk

- Repricing of equities, fixed income, etc.

Underwriting risk

- Increased insured losses
- Increased insurance gap

Operational risk

- Supply chain disruption
- Forced facility closure

Liquidity risk

- Increased demand for liquidity
- Refinancing risk

According to the NGFS transmission channels, all types of risks can be subject to climate risk and thus may be included in ECB climate stress test.

Up until now, financial risks were in the regulator's focus (e. g. ECB guide on climate related and environmental risks EBA ESG report), and we focus on:

Credit Risk:

Is already considered within European regulation (e. g. EBA LOM Guidelines)

Market Risk:

Markets may anticipate future policy changes leading to increased volatility and changes in asset and equity values

Operational Risk:

Is one of the most obviously impacted risk types. Especially reputational risk is likely to increase through growing disclosure requirements (inside-out perspective, greenwashing)

Financial system contagion

Environment & climate and economy feedback effects

Economy and financial system feedback effects

Same transmission channels as chance to steer process through banks' B/S (ca. EUR 35tr in the Eurozone alone)

Sustainable finance requirements call for various CFO capabilities – Treasury is not an exception

The CFO function is key in ESG journeys because of their Reporting and Controlling; Treasury will gain more importance through steering



CFO Capabilities



Cost Controlling

Measuring and managing costs using financial KPIs to maximize efficiency across all lines of business



Financial KPI Measurement

Measuring financial performance using financial KPIs to maximize value across all lines of business



Accounting, Controlling & Regulatory Reporting

Filing data and reports that comply with local and global regulatory reporting standards



Treasury

Sourcing, managing, controlling and optimizing financial resources



Product control

Delivering accessible, timely, accurate and complete accounting results



IR and Tax

Explanations and guidance in areas such as investor relations, corporate development, tax and accounting policy



Exemplary ESG considerations



Develop **ESG KPIs to optimize costs** of sustainable versus non-sustainable investments



Increase oversight of financial and non-financial risks around ESG issues, and **detect opportunities for value creation** that come with recognizing and managing ESG risks successfully



Produce ESG related **disclosures** as per ESG guidelines across all jurisdictions



Treasury role is expanded to delivering responsible finance and investments, enabling ecosystem sustenance with risk management and regulatory compliance consideration

Reviewing capital as a mitigating measure, in particular by incorporating climate risk into the supervisory review and evaluation process (Pillar 2); also changes to Pillar I requirements remain under assessment



Tax transparency is forced by regulators / international organizations (OECD / UN); it helps explaining how ESG criteria are incorporated into the investment policies according to a tax governance strategy

Accounting standards require a company to consider “changes in its business and operating environment when those changes have a material direct or indirect effect on the financial statements”

Example: On-B/S links to the Swiss Retail Banking Sustainability Report (1/2)

Treasury does not create financial products to support sustainability – But it can help steer the bank to promoting them

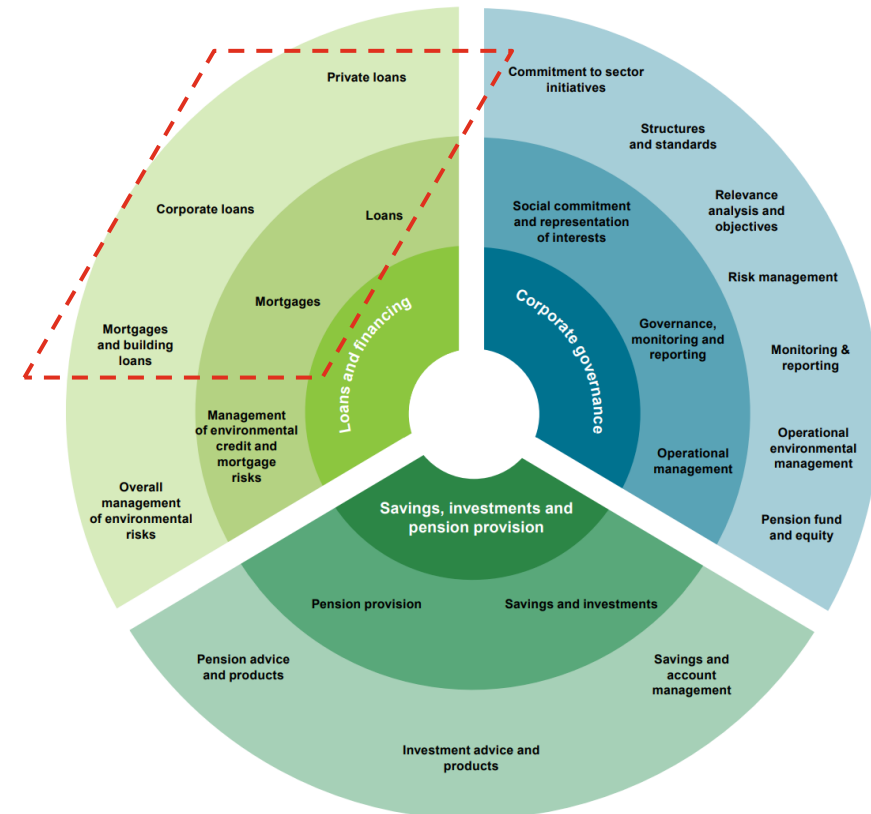


The rating dimensions

- **Corporate governance**
 - Initiatives addressing climate, environmental and social issues
 - Sustainability-related considerations embedded in overall corporate governance
 - Concrete ambitions to align the environmental impacts of core business with the Paris climate targets using science-based methods
- **Savings, investments and pension provision**
 - Offer of sustainable products and transparency around how savings are used
 - Product transparency with regard to environmental impacts or sustainability aspects of investment
 - Potential for innovative, digital solutions to promote sustainable investment behavior
- **Loans and financing**
 - Eco mortgages with preferential conditions for environmentally sound construction
 - Credit solutions that would specifically incentivize sustainable projects and encourage their financing
 - Cross-portfolio risk management to identify and mitigate systemic sustainability-related risks



The concrete rating categories



Example: On-B/S links to the Swiss Retail Banking Sustainability Report (2/2)

Poor ratings in categories that are directly linked to the retail banks' on-B/S will require a larger focus in the future – Treasury can help steering

| | | | | | | | | | Overall result |
|---|---|---|---|---|---|---|---|-----------|----------------|
| Corporate governance | | | | | | | | | |
| Social commitment and representation of interests | ■ | ▼ | ▼ | ▼ | ▼ | ■ | ■ | ■ | ▼ |
| Governance, Monitoring and Reporting | ■ | ▲ | ■ | ■ | ■ | ■ | ■ | ■ | ■ |
| Operational management | ■ | ■ | ▲ | ▲ | ▲ | ▲ | ■ | ▲ | ▲ |
| Savings, investments and pension provision | | | | | | | | | |
| Savings and Investments | ▲ | ▲ | ■ | ■ | ■ | ■ | ■ | ▲ | ▲ |
| Pension provision | ■ | ■ | ▼ | ■ | ▲ | ▼ | ▼ | ■ | ■ |
| Loans and Financing | | | | | | | | | |
| Loans | ■ | ▲ | ■ | ■ | ▲ | ■ | ▼ | ▲ | ▲ |
| Mortgages | ■ | ■ | ▼ | ■ | ■ | ▲ | ▼ | ■ | ▼ |
| Management of environmental credit and mortgage risks | ■ | ■ | ■ | ■ | ■ | ■ | ■ | not rated | ▲ |
| Cantonal Bank of Aargau | ■ | ▼ | ▼ | ▼ | ▼ | ■ | ■ | ■ | ▼ |
| Banque Cantonale Vaudoise | ■ | ▲ | ■ | ■ | ■ | ■ | ■ | ■ | ■ |
| Cantonal Bank of Basel | ■ | ■ | ▲ | ▲ | ▲ | ▲ | ■ | ▲ | ▲ |
| Basellandschaftliche Kantonalbank | ▲ | ▲ | ■ | ■ | ■ | ■ | ■ | ▲ | ▲ |
| Berner Kantonalbank AG | ■ | ■ | ▼ | ■ | ▲ | ▼ | ▼ | ■ | ■ |
| Credit Suisse** | ■ | ▲ | ■ | ■ | ▲ | ■ | ▼ | ▲ | ▲ |
| Graubündner Kantonalbank | ○ | ○ | ○ | ○ | ○ | ○ | ○ | ○ | ○ |
| Luzerner Kantonalbank AG | ■ | ■ | ▼ | ■ | ■ | ▲ | ▼ | ■ | ▼ |
| Migros Bank AG | ■ | ■ | ▼ | ■ | ▼ | ▼ | ■ | ■ | ■ |
| PostFinance Ltd | ▲ | ▲ | ■ | ▲ | ■ | ■ | ■ | not rated | ▲ |
| Raiffeisen Group* | ■ | ▲ | ▲ | ▼ | ▼ | ▲ | ▲ | ▲ | ■ |
| Cantonal Bank of Saint Gall Ltd | ▲ | ■ | ■ | ▲ | ▲ | ■ | ▼ | ■ | ■ |
| UBS Switzerland AG** | ■ | ▲ | ■ | ▲ | ▲ | ■ | ▲ | ▲ | ▲ |
| Valiant Bank AG | ▲ | ■ | ■ | ▲ | ▲ | ▲ | ■ | ▲ | ▲ |
| Cantonal Bank of Zurich | ■ | ▼ | ▼ | ■ | ■ | ■ | ■ | ▲ | ■ |

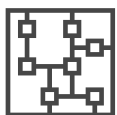
An aerial photograph of a single white wind turbine standing in a vast, green agricultural field. The field is divided into rectangular plots by dark lines, likely furrows or irrigation channels. A dirt road or path runs diagonally across the upper portion of the image. The wind turbine is positioned on a small, cleared patch of ground. The overall scene is bright and clear, suggesting a sunny day.

02

Steering the B/S under ESG considerations

The storyline: Banks will steer the ESG transmission process directly through their B/S

Alignment on how to measure sustainability of positions, however, is still a long way down the road for the industry

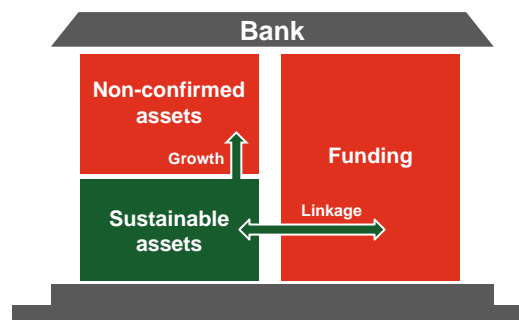


(1) Banks play an eminent role to promote a sustainable economy

- **Investment solutions** in AWM and corporate banking are more and more evaluated towards ESG criteria
- As **financial intermediaries**, banks play an **eminent role** in pushing the economy towards a sustainable balance
- A bank can become greener and promote **greener investments** by:
 - Direct intervention at **balance sheet** level
 - Adjusting the role that **tradable instruments** play in **secondary markets** (outright, SFTs, etc.)

(2) Green asset ratio measures the extent to which exposure is green

- Targets on banks' **green asset ratio** help regulators **steer towards green economy**
- Still **significant uncertainty** if everything planned to will eventually be in scope and if countries like Switzerland will adopt such **KPIs** linked to the green asset ratio
- Should be seen as a **chance** by management to define, measure and promote how green the bank is



(3) Taxonomy is key for that to work

- **Clear taxonomy** is already a **challenge** today; primary markets in the focus
- **Even more a challenge** for **determining a green asset ratio** with lots of secondary market instruments on the B/S

Some simplifying assumptions for this discussion

- We assume fully comprehensive green taxonomy exists; call an item "green" if it meets ESG criteria
- We recognize greenwashing as risk but don't focus on it here
- We ignore uncertainty reg. green asset ratio; assume it's the green share of all the B/S

Background: The EU Taxonomy for sustainable investments

A meaningful taxonomy is absolute key to transmit sustainable finance through the intermediation business of banks – but vastly complex...

The taxonomy

- The EU Taxonomy is a system **classifying environmentally sustainable economic activities**
- It encompasses activities contributing **significantly to climate change mitigation and adaptation**, sustainable use of water and marine resources, and transitioning to a circular economy
- Additionally, it covers activities focused on pollution prevention, control, and protection and restoration of biodiversity and ecosystems

From a bank's perspective

- Banks need to align their operations with the EU Taxonomy to **ensure compliance** with EU regulations on sustainable finance, thereby avoiding penalties or sanctions
- Can help banks **identify environmental risks** within their loan portfolios and adjust lending policies accordingly, promoting better risk management and long-term financial stability
- Adhering can enhance a **bank's reputation** among stakeholders, including customers and investors, who increasingly value commitment to sustainability
- Can guide banks in **identifying and funding sustainable** businesses and projects, thereby tapping into the market for green and sustainable investments

Requirements



Significant contribution to at least one of the environmental objectives



No significant harm to other environmental objectives



Compliance with minimum levels of protection of human rights of workers and the environment

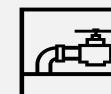
6 environmental objectives:



Mitigation climate change



Adaptation to climate change



Sustainable use and protection of water and marine resources



The transition to a circular economy circular closed economy



Pollution prevention and control and their control



Protection and restoration of biodiversity and ecosystems

Background: The GAR illustrates well how ESG transmission through banks' B/S can be codified

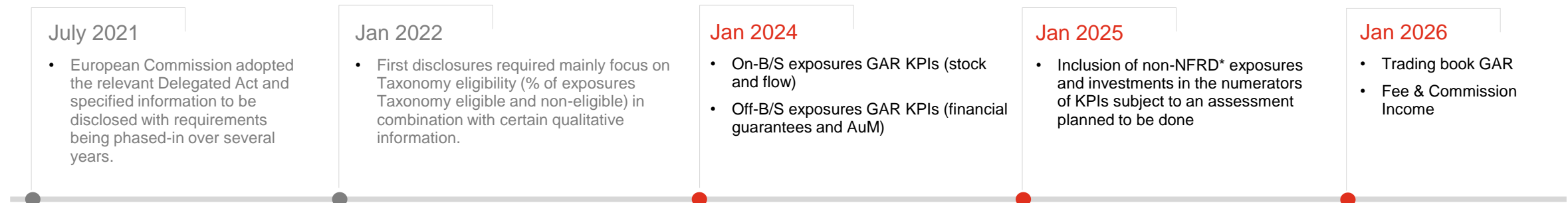
In theory, policymakers can use the GAR later – once fully implemented in the EU – to steer the transmission process via banks' B/S's

Green Asset Ratio

- Measure of the **amount of a bank's financing & investment activities** that are environmentally sustainable, in line with the EU's taxonomy regulation
- Designed to **support the European Green Deal** by helping banks transition towards more sustainable business models and practices
- Calculated as **bank's 'green' exposures** (i.e., those classified as environmentally sustainable under the **EU taxonomy**) divided by **total of all covered exposures** on the bank's balance sheet
- Banks in the EU are required to **disclose their GAR**, with the aim of increasing transparency and accountability around their environmental impacts.
- GAR can **influence a bank's strategic decisions**, as higher GAR could potentially attract more investors / customers who prioritize sustainability
- **Challenge** of accurately classifying and measuring 'green' activities (comes all down to the taxonomy); also GAR does not capture social and governance factors

$$\text{GAR} = \frac{\text{Total taxonomy-compliant assets}}{\text{Total eligible assets}}$$

High-level timeline



Sustainability considerations started rather from the off-B/S but become more relevant on-B/S

Secondary markets will be taken more into account when determining how green the full scope of assets of a bank is



Examples across on-B/S products

Sustainable repos

- Framework to define “green repos” proposed¹
- Definition based on **(1) Green collateral**; **(2) green counterparties**; and **(3) green cash proceeds** (that flow to a green purpose)

Sustainable trading assets

- Trading assets **amongst the easiest** assets to **steer towards a green asset ratio**
- **Banks are expanding their share** of green instruments in their trading portfolios²; green government bonds to play big role³

Sustainable loans

- **Largest factor** to drive a bank’s green asset ratio; **key element linking to green funding** items today⁴

Green derivatives

- One of **more challenging** items to link to green asset ratio because of nature of derivatives and their representation on the B/S
- **Difference** between **vanilla derivatives** with green underlying / green counterparties and **“direct” green derivatives** linked to ESG criteria⁵



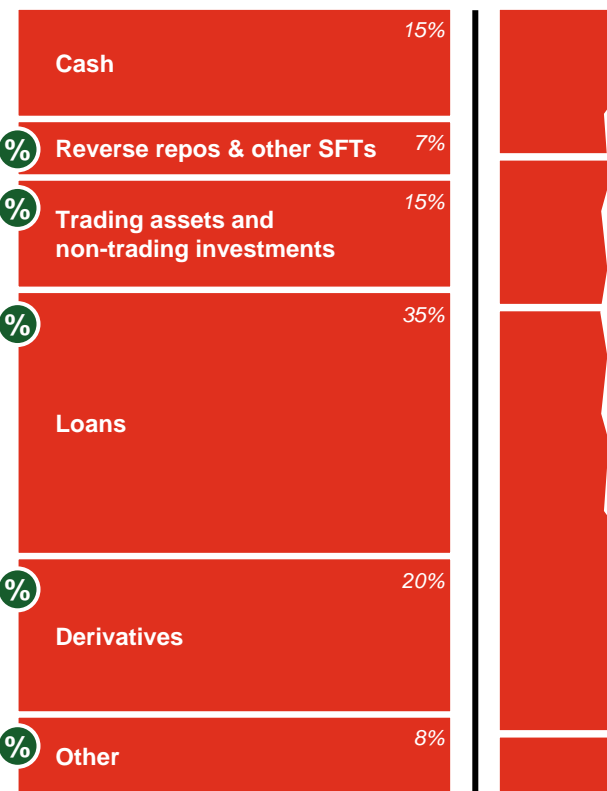
Data channels

Rather “instrument / security”-based

Rather “certified asset”-based



Avg. on-B/S of a G-SIB



1) ICMA, 2021, Green and sustainable finance: The role of the repo market

2) ECB, 2020, Performance and resilience of green finance instruments: ESG funds and green bonds

3) Example: HM Treasury, 2021, Green gilt framework

4) Example: Aareal Bank, “Aareal Bank grants green loan to Cerberus”; BREEAM

5) ISDA, 2021, Overview of ESG-related derivative products and transactions

Little opportunity yet to contribute with the HQLA portfolio to a higher Green Asset Ratio

Banks depend on the availability of large-volume issuances of (sovereign) sustainable debt instruments if ESG shall be reflected in HQLA

ESG in the HQLA portfolio?

- Today, there is only **little opportunity** for Treasury's liquidity managers to contribute with their non-cash HQLA portfolio to the B/S's overall portion of sustainable assets
- Further, it is a **higher priority** that non-cash HQLA meets specific criteria with sufficient market depth to support monetization feasibilities
- The existence of a **greemium** can further counteract yield enhancement successes of liquidity managers in receiving an HQLA uptick; costs would need to be weighted against the reputational benefits as well as clearly identifiable contribution to a bank's net zero strategy, if applicable

Industry developments

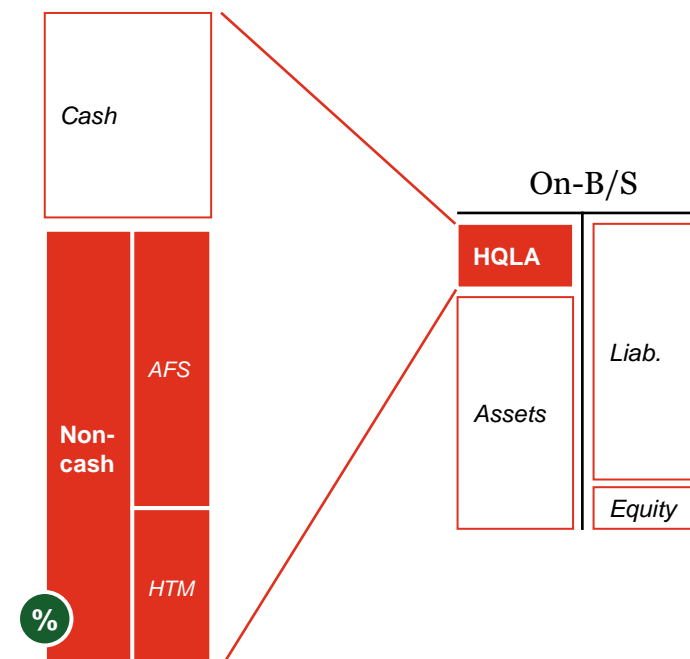
- Some banks approach this topic slowly by **carving out** specific sub-portfolios in which they hold HQLA in form of sustainable debt instrument
- **Governments** have understood that **they need to do their parts**, too, if they require banks to use their B/S for the transmission – increased efforts to define sovereign sustainable debt instruments are interesting for liquidity managers to observe

To keep in mind

- Many **prior learnings** from flagging or earmarking specific features in the past (such as HQLA eligibility) are very much transferable to flagging HQLA as sustainable
- For **"Four-eye"** principle for using data providers to avoid greenwashing risk



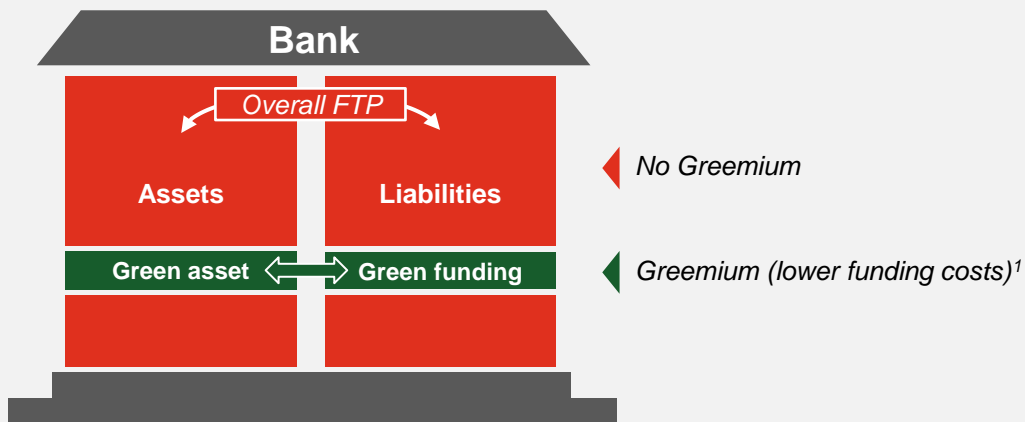
ESG considerations of the HQLA portfolio



Bringing in the liability side

Green funding links to dedicated green purpose and exposure – A simple case in ALM today but in the future it needs to become more holistic

- **Holistic management of green A&L far from becoming applicable** - in its 2021 assessment, ECB found that the pro forma green asset ratio of European banks is ca. at **8%**
- Dedicated, green exposure on banks' on-B/S is targeted and – if applicable – **directly linked** to green funding, e.g. green bonds



- **Funds transfer pricing (FTP)** does not yet play a big role for ESG; **greemium** will simply be accounted for in the overall cost of funding
- Industry expects that a **growing green asset ratio** will call for larger role of FTP, not least for incentivization and steering

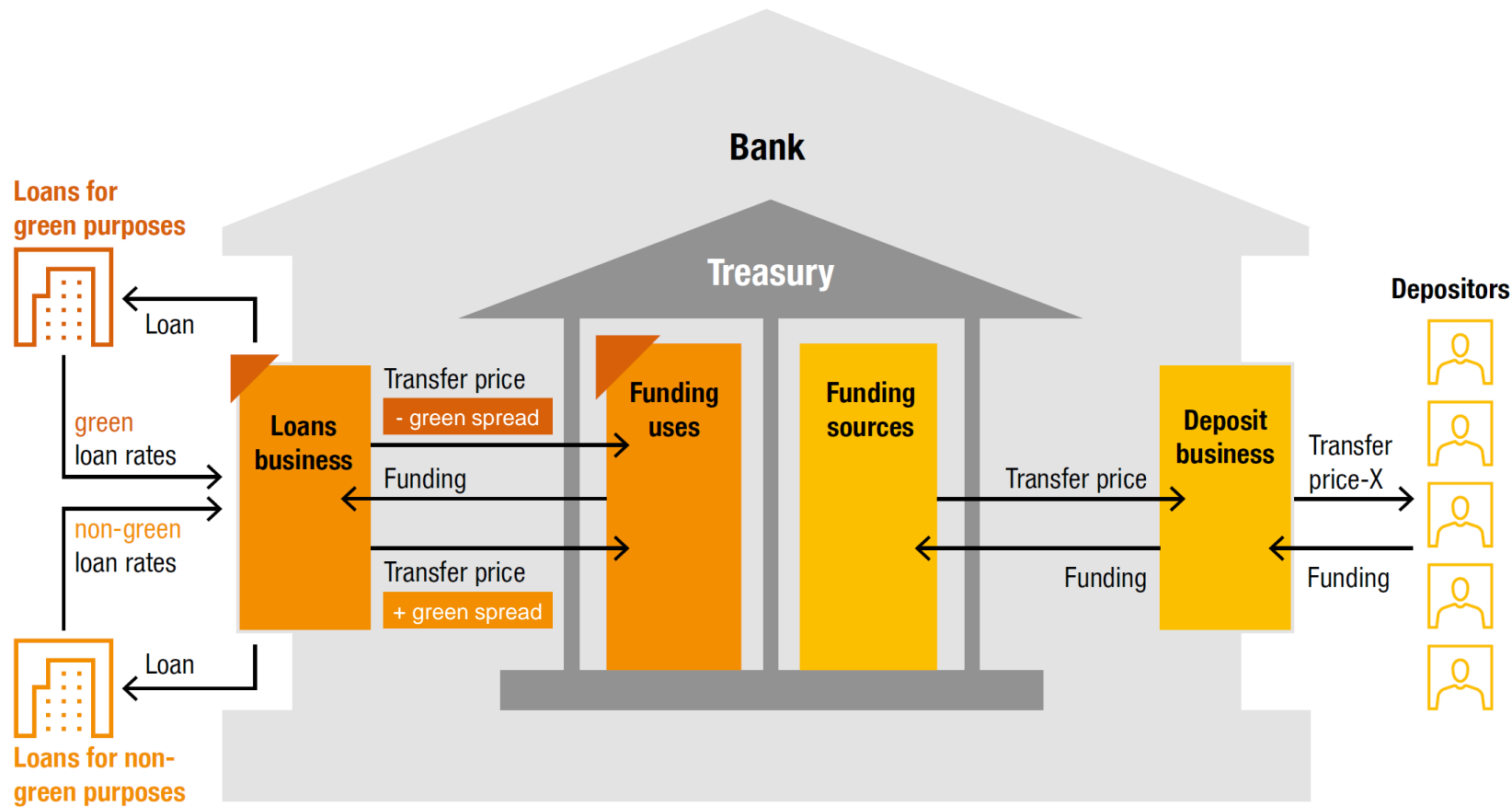
¹) A green premium – or «greemium» called in the market – is a premium on green debt (i.e. lower funding costs, respectively). We expect that a greemium will materialize over time through the usability of green instruments in secondary markets; current research is indecisive on the current existence and size of greemiums



As ESG exposure grows, FTP becomes more relevant

Treasury is the “bank within the bank” –the function’s existing tools can be used to incentivize ESG commitments and targets

- Transfer price to the loans business may be differentiated by type of counterparty or counterparty’s use of loans; loans business would pay lower transfer price for loans given that are determine to be green and a higher transfer price for non-green loans
- This incentivize the loans business to give out higher proportion of green loans by increasing the business unit’s:
 - Profits on green loans.
 - Competitive edge in the green loan market as it could offer lower loan rates to green customers.



Splitting out FTP curves can be a way of steering green assets

By employing existing tools within FTP, banks are able to create a cross-subsidization between green and non-green assets for steering

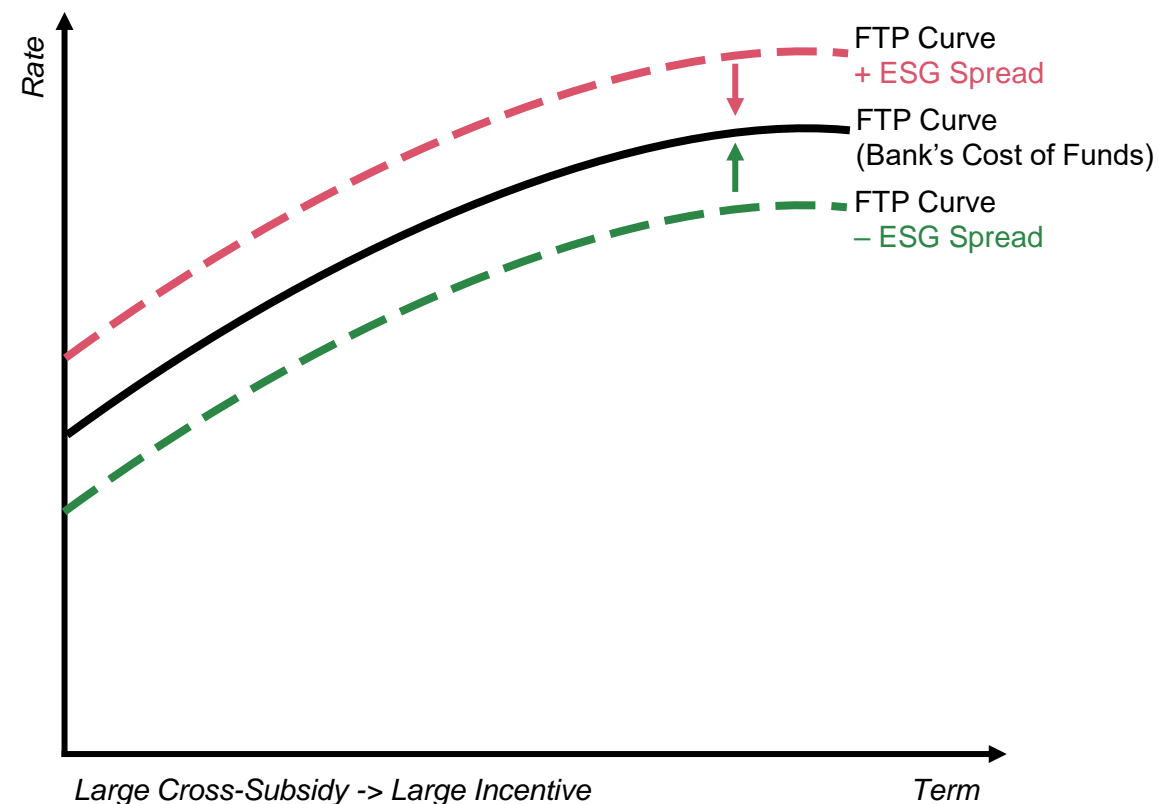


FTP rationale

- In order to achieve this differential transfer price, Treasury may use a **split FTP curve methodology**
- **Green assets would pay lower transfer price** (standard FTP curve less the ESG spread); non-green assets would pay higher transfer price
- This methodology would be **“self-funding”** as increased transfer price to non-green assets would subsidize reduced transfer price to green assets
- The level of incentivization could be **adjusted** by altering the level of the ESG spread and can be later linked to “greemium” on funding side
- Hence, banks can make use of their existing FTP framework to either reflect the reality of different spreads for sustainable funding instruments or directly steer towards KPI’s defined by the management (or regulatory limits in the future)



Simplified illustration





03

ESG implications for
liquidity management?

The ECB has set clear expectations in relation to C&E

Central banks have increasingly recognized the need to account for climate-related and environmental risks in its supervisory activities



Regulatory framework - ECB

The ECB published its final and amended **guide on climate-related and environmental risks (C&E)**:

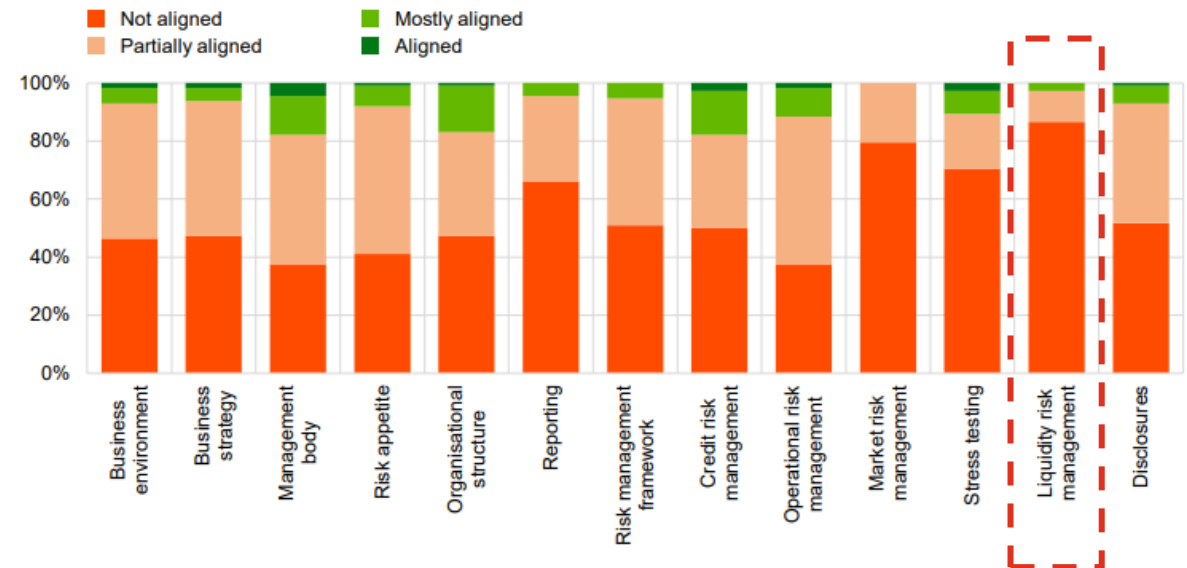
- It outlined the ECB’s understanding of the safe and prudent management of climate-related and environmental risks under the current prudential framework
- Among others, it included the supervisory expectations on market and liquidity risk management (13 total expectations)

In November 2021, the ECB published a report on **“The state of climate and environmental risk management in the banking sector”**:

- Banks showed **the least progress** in the areas of market and **liquidity risk management**, as well as stress testing
- Less than one third of institutions were at least partially aligned with the 13 ECB expectations. Most institutions had not started adapting their practices at all, at the time
- Part of the explanation may be that institutions deem market and liquidity risk to be relatively less materially impacted by C&E risks



Banks’ alignment with the 13 supervisory expectations



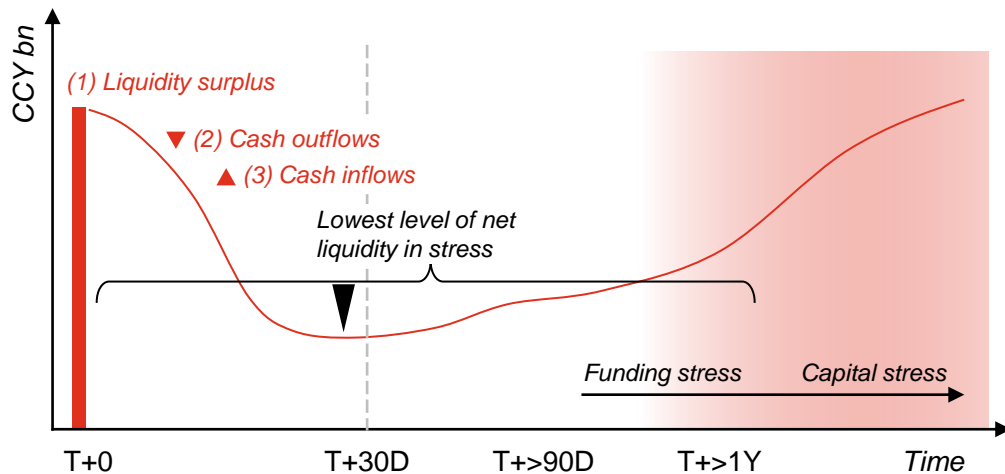
Source: ECB supervisory assessment

It remains to be seen if ESG in fact has to be – and should be – regarded in liquidity risk

Linking ESG risks to managing short-term liquidity risk over period of one to several months may be questionable from a rationale perspective



Liquidity risk illustration



ESG considerations

- Liquidity stress testing essentially works by taking the existing liquidity level and applying a **scenario narrative** of outflows (and inflows) upon it where assumptions are translated into cash outflows over time
- A key question is whether C&E risks as shown in the transmission process to banks' B/S translate into either (1) **reduced monetization** of current liquidity levels (2) **higher outflows** or (3) **lower inflows** in the time frame of interest
- By nature, C&E risks would rather translate into an erosion of economic resources **over long term** and rather on the **inflow side**
- Danger that application of ESG risks into liquidity risk management becomes an “alibi exercise”
- First entry point to continue such thoughts is likely the scenario narrative of the liquidity risk model

Industry publications referenced earlier in this talk

When it comes to determining what of a B/S can be considered as sustainable, reference is made to various industry association publications

UK Government Green Financing Framework



- Example for development of sovereign sustainable debt instruments (Green GILTs)
- [Link](#)

Green Finance – Role of Repo Markets



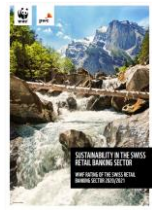
- Considerations for how to classify (reverse) repos as sustainable
- [Link](#)

ESG-related Derivatives



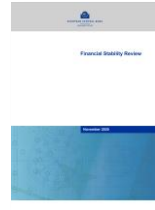
- Publication by ISDA on how derivatives could be regarded from a sustainability perspective
- [Link](#)

Sustainability in Swiss Retail Banking



- How Swiss Retail banks promote sustainability by different criteria
- [Link](#)

Performance and resilience of green finance instruments



- Part of the ECB Financial Stability Review with in-depth analytics around the usage of green bonds at banks
- [Link](#)

Thank you



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