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Climate Change Issues Become Increasingly Important For Financial Institutions

Climate change issues are very much in the news lately, from Al Gore's documentary ***An Inconvenient Truth*** winning an Academy Award to the possible listing of the polar bear as a threatened species. A "green wave" is beginning to sweep across corporate and civic America. Corporations, governments, public interest groups and academics are taking steps to conduct their businesses in a more environmentally conscious way, including voluntary compliance with emissions targets, promoting "clean technology" and adopting "sustainable business practices", both as solutions to global warming and as new business opportunities.

Recently, attention regarding climate change has been to shift from focusing on major greenhouse gas (GHG) emitters, such as power plants, to include other sectors of the economy, including financial institutions and mutual funds. A group of institutional investors representing about $3.7 trillion under management known as the Investors Network on Climate Risk ("INCR", which was launched by CERES -- a coalition of investors, environmental groups, companies and public interest groups focused on sustainable business practices and climate change, and author of the CERES Principles -- a code of corporate environmental conduct) has demanded greater attention to and disclosure of climate-related risks by publicly held companies across various industrial sectors, including financial services institutions. CERES/INCR reports on disclosure of climate risk and emissions management by U.S. companies based upon information requested by investors through the Carbon Disclosure Project ("CDP", an international institutional investor collaboration on the business implications of climate change representing about $41 trillion under management). Environmental groups, such as the Rainforest Action Network, have also been pressuring major banks to stop investing in climate-damaging projects and to incorporate climate considerations into their lending practices.

In addition, shareholder proposals on climate change have been filed at financial institutions. In past years, such proposals generally have not appeared in the proxy statements of large financial institutions. This was in part because proposals were rarely made on this topic at financial institutions. Moreover, in some cases, institutions received no-action relief from the SEC authorizing the institutions to omit such proposals from their respective proxy statements and, in other cases, the proposal was withdrawn after the institution agreed to take the action requested by the proponent. However, Wells Fargo, in its 2007 proxy statement, included a shareholder proposal requesting that the company develop emissions reductions goals of its activities and those of its clients. Shareholder proposals on climate change issues have also been submitted to mutual fund families. Thus, it is clear the climate change issues are beginning to impact all facets of the financial services industry.

Furthermore, investment banks including Goldman Sachs, JP Morgan, UBS and Citigroup, have issued major reports on financial risks and opportunities associated with climate change; and insurance carriers including Swiss Re and Allianz have issued reports focusing on the risks and potential losses facing the insurance industry as a result of global warming and resulting extreme weather. In early March, Bank of America announced a $20 billion initiative to support environmentally sustainable businesses in its efforts to address global climate change. In addition, many financial institutions have signed on to the Equator Principles, which set environmental and social impact standards for financing projects, such as dams and pipelines, in primarily developing nations.

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And it is no wonder that financial institutions are becoming involved in these issues. First, banks are implicated because they finance the growth and development of our communities and industries and are therefore uniquely positioned to address climate change issues. As such, they are subject to pressure from stakeholders, including shareholders and activist groups, to make commitments and investments to mitigate climate change -- by adopting the CERES Principles and committing to reduce their emissions to funding "green projects." Second, banks are impacted because they operate in a regulatory environment that requires them to conduct their business in a safe and sound manner and to manage risk as part of their business. Due to these factors, banks both face business risks and enjoy opportunities related to climate change. Indeed, while this article focuses most directly on banks, we have found many of these principles to be equally applicable to financial service institutions generally.

Although banks are generally not significant GHG emitters, they can be significant players in the climate change arena in that they provide financing for industrial facilities and projects that directly or indirectly emit GHGs, ranging from power plants to office parks and housing developments. As such, climate change is an increasingly relevant issue for banks in their capacities as lenders and investors, as well as from their traditional corporate responsibility perspective. Ultimately banks may need to consider climate change and related environmental factors in determining whether they are operating in a "safe and sound" manner, as required by banking regulations. While regulatory guidance on environmental risk for banks has historically been focused primarily on contaminated property and hazardous substances, bank regulators now expect financial institutions to manage environmental risks of all types that could potentially have a significant affect upon the institution. As a result, at some point in the future, when the impact of climate change is felt more acutely, a bank's lending decisions may attract regulatory scrutiny based on excessive climate change environmental risk. In addition, with the advent of Basel II and its focus on the risk based regulation of capital, banks may increasingly need to factor climate change environmental risk into their risk modeling and management systems.

Currently, the principal climate change-related risks to banks are reputational and competitive. There is increasing pressure from institutional investors, non-profit groups and a growing cadre of "green" consumers for institutions of all kinds, including financial institutions to be "carbon responsible" and reduce their "carbon footprint." This might include reducing the bank's own direct and indirect GHG emissions (*e.g*., through energy conservation and "green" building methods, avoiding investments in or loans to major GHG emitting projects, and promoting GHG emission reductions by their customers).

There are potential reputational and competitive opportunities to banks that proactively address climate change and position themselves as being part of the solution. Banks that are perceived as leaders in addressing this problem are likely to gain favorable publicity, goodwill and enhanced reputations. In addition, there may be lending and investing opportunities for banks in the growing "clean technology" sector. With rising demand for renewable energy, efficiency and GHG reduction technologies, lending to and investing in promising companies in these sectors may represent a good business opportunity, although careful due diligence is clearly warranted here as elsewhere. Also, as emission credit trading expands through regional, national and international programs, there may be opportunities in carbon offset trading. There is also a market for developing environmentally conscious consumer products, such as "green" credit cards and eco-friendly loans. It is perhaps too early to say whether the "green" programs and climate change policies implemented by banks to date will provide them with a competitive advantage, but they have, at a minimum, insulated themselves to a certain extent against criticism for failing to act on climate change and garnered favorable publicity.

So, what is a bank to do in this rapidly evolving and uncertain climate? Based on our work in this area, we suggest that banks wishing to be at the forefront of this issue do the following: First, address climate change-related risks and opportunities as part of their overall business strategy and second, adopt an internal climate change policy and program tailored to their business and operations, including an emissions inventory, energy efficiency improvements and a GHG emissions reduction goal. If such a program is developed and committed to, it should be diligently implemented and publicized. Beyond such internal actions, banks could consider incorporating GHG emissions and climate-related risks in their lending policies, credit underwriting criteria and transactional due diligence. A bank might work

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with its clients to address and mitigate the GHG emissions from their projects and operations, and offer preferential terms on loans for energy conservation projects, green buildings or hybrid cars. It may also partner with a reputable non-profit organization in developing a climate strategy or broader "sustainability" initiative. Further, lending and investment opportunities with green businesses could be evaluated. Finally, either individually or collectively, banks should consider participating in state, regional and national policy development regarding GHG controls and assess how such programs may affect their businesses.

As in other areas of financial services, banks can adapt to a changing climate, and those that adapt most quickly and forcefully are likely to thrive in this new business, political and social environment. As climate change becomes a larger and more urgent issue, stakeholders including regulators, customers, shareholders and public interest groups are likely to reward those banks that act to mitigate climate risks and take advantage of climate-related opportunities.

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