Banks and sustainability

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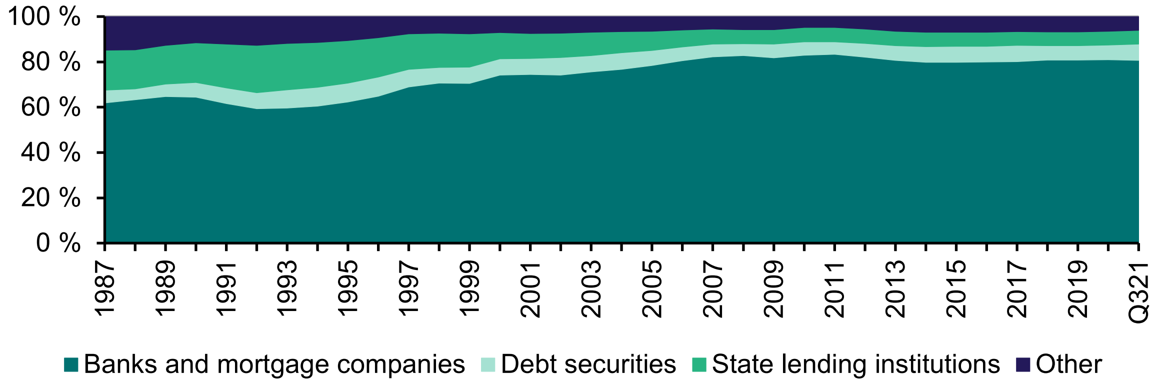
EU to incentivize sustainability through the financial sector

Background

- To deliver on ambitious sustainability targets – including the Paris Agreement and UN's SDGs – EU needs capital flow to sustainable economic activities
- With the financial sector being the enabling framework to steer and stimulate public and private investments needed for transition, EU has since 2018 presented Sustainable Finance policies on financial market participants
- Traditionally, the euro area is more bank-oriented compared to e.g. the US, increasing the banks' potential impact on sustainable capital flows

Lending split, Norway (Q321)

Development lending split, Norway (1987-Q321)



Norway

- Banks and mortgage companies provided 81% of total lending and 75% of lending to NFCs at end-Q3
- The banks' share of total lending has been fairly stable since the 2008-2009 financial crisis.

Source. The European Commission, Statistics Norway

EU’s regulations for sustainable finance

EU taxonomy

A common classification of economic activities substantially contributing to environmental objectives, using science-based criteria

- Taxonomy Regulation

Disclosures

Comprehensive reporting regime to provide investors with the information necessary to make sustainable investment choices

- Sustainable Finance Disclosure Regulation (SFDR)
- Corporate Sustainability Reporting directive (CSRD)

Other tools

Broad toolbox for companies, market participants and financial intermediaries to develop sustainable investment solutions, while preventing greenwashing

- Assessing potential changes in capital requirements for banks and insurance companies
- Standard for European green bonds (in process)
- Etc.

Source. The European Commission

Disclosures – transparency to enhance sustainable investments

EU Taxonomy

Disclosures

Other tools

Companies' reporting of taxonomy-aligned activities will facilitate financial institutions' own Green Asset Ratio (GAR)

Environmental objectives

1. Climate change mitigation
2. Climate change adaption
3. Sustainable use and protection of water and marine resources
4. Transition to a circular economy
5. Pollution prevention and control
6. Protection and restoration of biodiversity and ecosystems

Requirements for sustainable economic activities

Substantially contribute to at least one of EU's six environmental objectives + Do no significant harm to any of the other five environmental objectives + Comply with minimum safeguards

Non-financial companies will be required to report to what extent their revenue, capex and opex derive from aligned activities…

…while financial institutions report their **Green Asset Ratio (GAR)**, i.e. proportion of exposures to Taxonomy-aligned activities compared to their total assets

Scope

- Directly required to report certain ESG KPIs under Article 8 of the Taxonomy Regulation:
  - Large non-financial corporations*
  - Banks and insurance companies
  - Asset managers
- SMEs with bank loans will be indirectly required to disclose relevant information, as banks must report on the taxonomy alignment of their lending portfolios
- Scope expected to expand

Source: The European Commission

*Assets > EUR20m, revenue > EUR40m

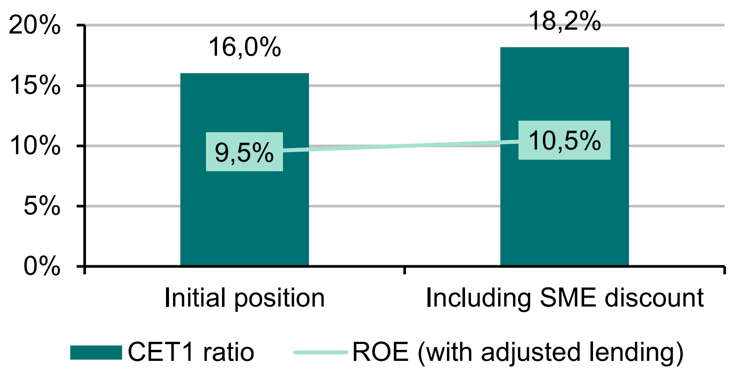
Other tools – impact on banks' capital requirements

EBA to assess integration of ESG-risks into capital requirements by 2023

Potential changes to risk weights

- The European Banking Authority (EBA) is assessing potential changes related to the treatment of exposures associated with ESG-objectives, such as 'Green supporting factor' and 'Brown penalty factor'
- EU has previously demonstrated willingness to adjust capital requirements, e.g. with the SME discount

Equivalent example with SME discount and 25% SME lending



Simplified example – 'green' versus 'brown' bank

Assumptions (NOKbn)	
Total lending	100
Equity	9
CET1 capital	8
Average risk weight	50%
Green supporting factor	**10%**
Brown penalty factor	**10%**
Lending margin	1.75%
Funding margin	0.4%
3m NIBOR	1.5%
Liquidity buffer	15%
Non-interest income (% of NII)	20%
Cost/income ratio	35%
Loan loss ratio	0.25%
Tax rate	25%

Calculated balance sheet figures (NOKbn)	
Risk weighted assets (NOKbn)	50
CET1 ratio	16%
Liquidity portfolio	15
Funding incl. liquidity buffer	106

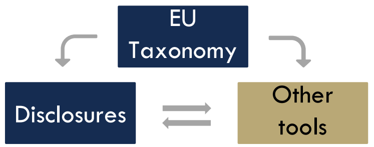
Calculated P&L (NOKm)	
NII	1461
Non-interest income	292
Costs	-614
Profit before loan losses	1140
Loan losses	-0.3
Pre tax profit	1139
Net profit	854
ROE	**9.5%**

	'Green' bank	'Brown' bank
Fraction green lending	25%	0%
Fraction brown lending	0%	25%
Green lending (NOKbn)	25	0
Brown lending (NOKbn)	0	25
Unaffected lending (NOKbn)	75	75
Adjusted CET1 ratio		
Risk weighted assets (NOKbn)	47.5	52.5
CET1 ratio	16.8%	15.2%
Δ CET1 ratio	**80bp**	**-80bp**
Potential dividend distribution (NOKbn)*	0.4	
Potential payout ratio of unadjusted net profit	**47%**	
Adjusted balance sheet figures (NOKbn)		
Potential lending*	105	95
Liquidity portfolio	16	14
Funding incl. liquidity buffer	112	100
Adjusted P&L (NOKm)		
NII	1526	1397
Non-interest income	305	279
Costs	-641	-587
Profit before loan losses	1190	1089
Loan losses	-0.3	-0.2
Pre tax profit	1190	1089
Net profit	**892**	**817**
ROE	**9.9%**	**9.1%**
Δ ROE	**0.4%**	**-0.4%**

Source: The European Commission, DNB Markets

*additional lending/dividend distribution to maintain a 16% CET1 ratio all else equal

Other tools – impact on banks' capital requirements



Integration of ESG-risks into capital requirements – example

Assumptions

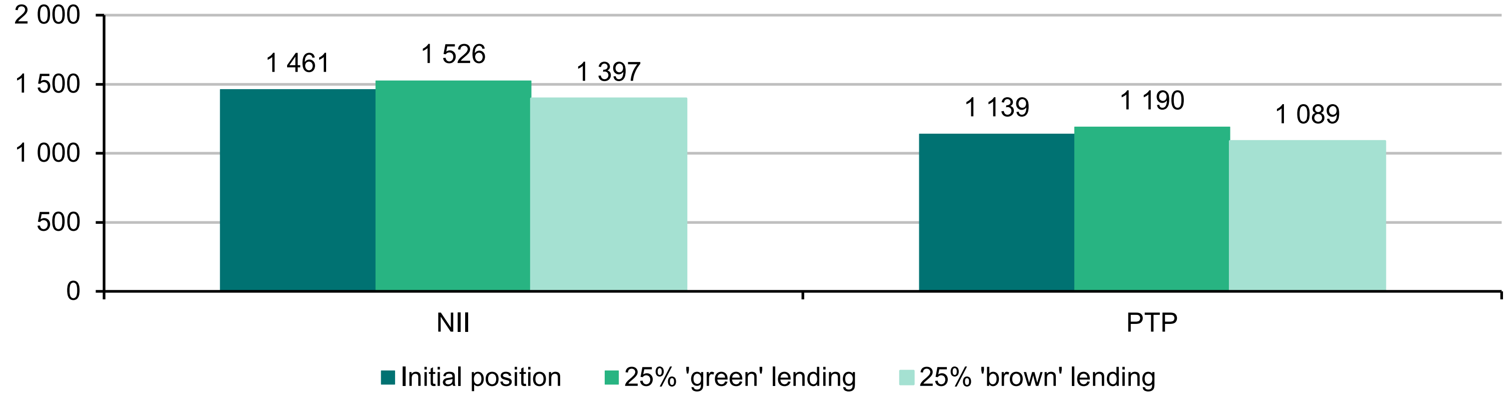
Initial position:

- Bank 1: 25% 'green' lending, Bank 2: 25% 'brown' lending
- 50% average risk weight
- NOK8bn of CET1 capital and NOK100bn of total lending

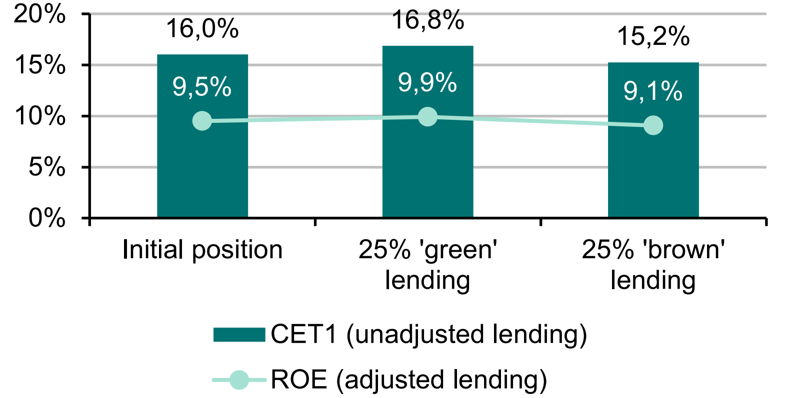
Adjustments:

- 10% green supporting factor
- 10% brown penalty factor
- Increase/decrease lending to maintain initial CET1 ratio

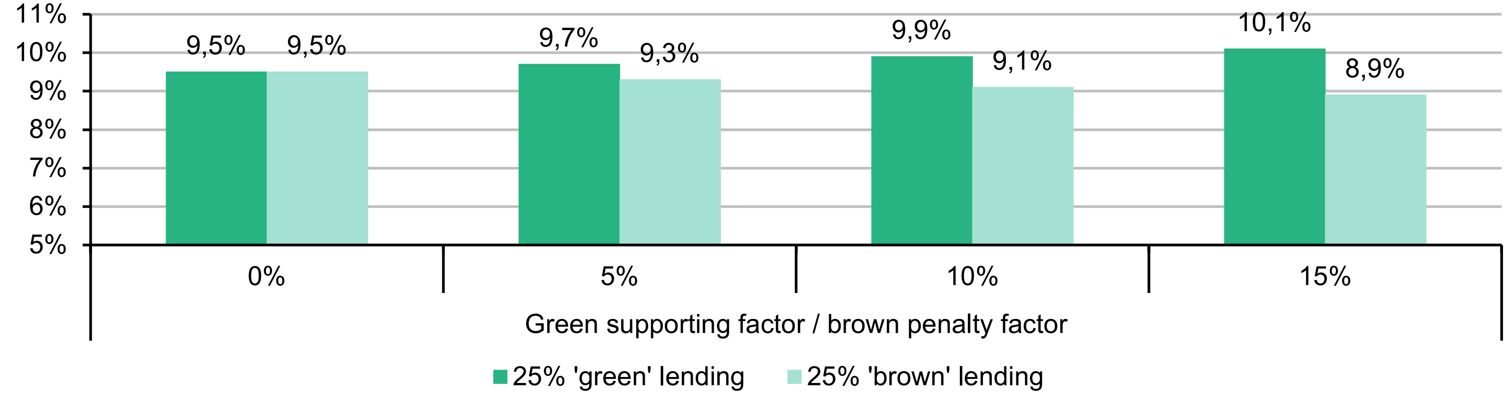
NII and PTP w/ adjusted lending (NOKm)



CET1 and ROE



ROE sensitivity of variations in green supporting factors / brown penalty factors



Source: DNB Markets

Potential impacts of green supporting factor and brown penalty factor

'Green' lending → Lower capital requirements → Higher profitability → The banks allocate more capital (lending) to these sectors/companies → Higher competition and lower interest rates

'Brown' lending → Higher capital requirements → Lower profitability → The banks allocate less capital (lending) to these sectors/companies → Lower competition and higher interest rates

Source: DNB Markets

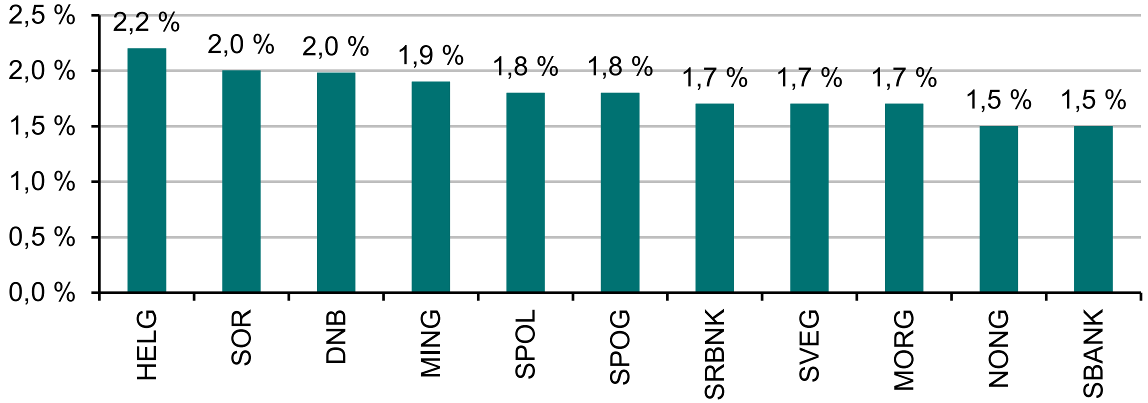
Other tools – impact on banks' capital requirements

EBA to assess integration of ESG-risks into capital requirements by 2023

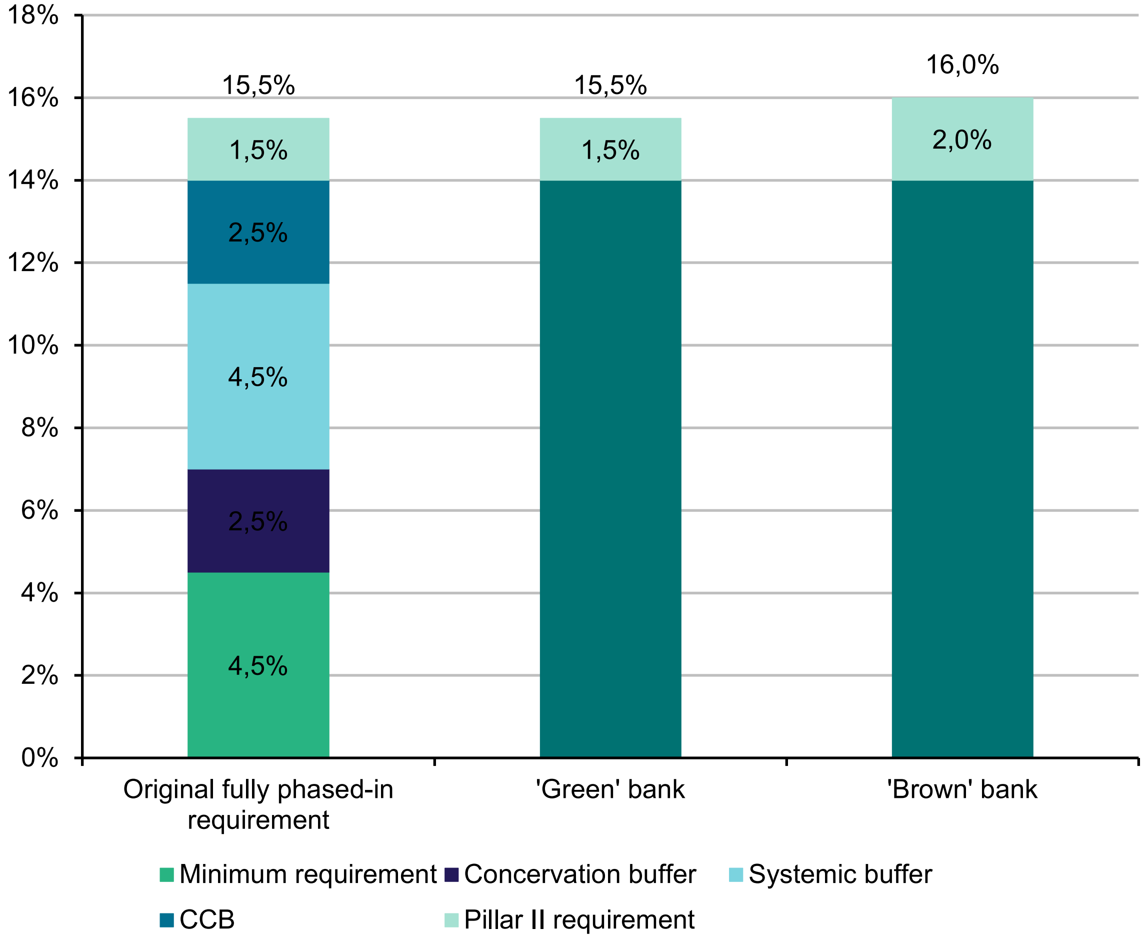
Potential changes to Pillar II – inclusion of ESG-risks in stress-tests

- Pillar II captures the company-specific risk not accounted for in the Pillar I requirement
- Authorities generally use stress-tests to determine the banks' Pillar II requirements
- EBA is now assessing whether to include ESG related risk – such as transition or physical risk – in the stress-tests, potentially increasing Pillar II requirements for banks with high 'brown' exposure

Pillar II requirements (end-Q3)



Simplified example with 0.5%-point ESG-risk penalty

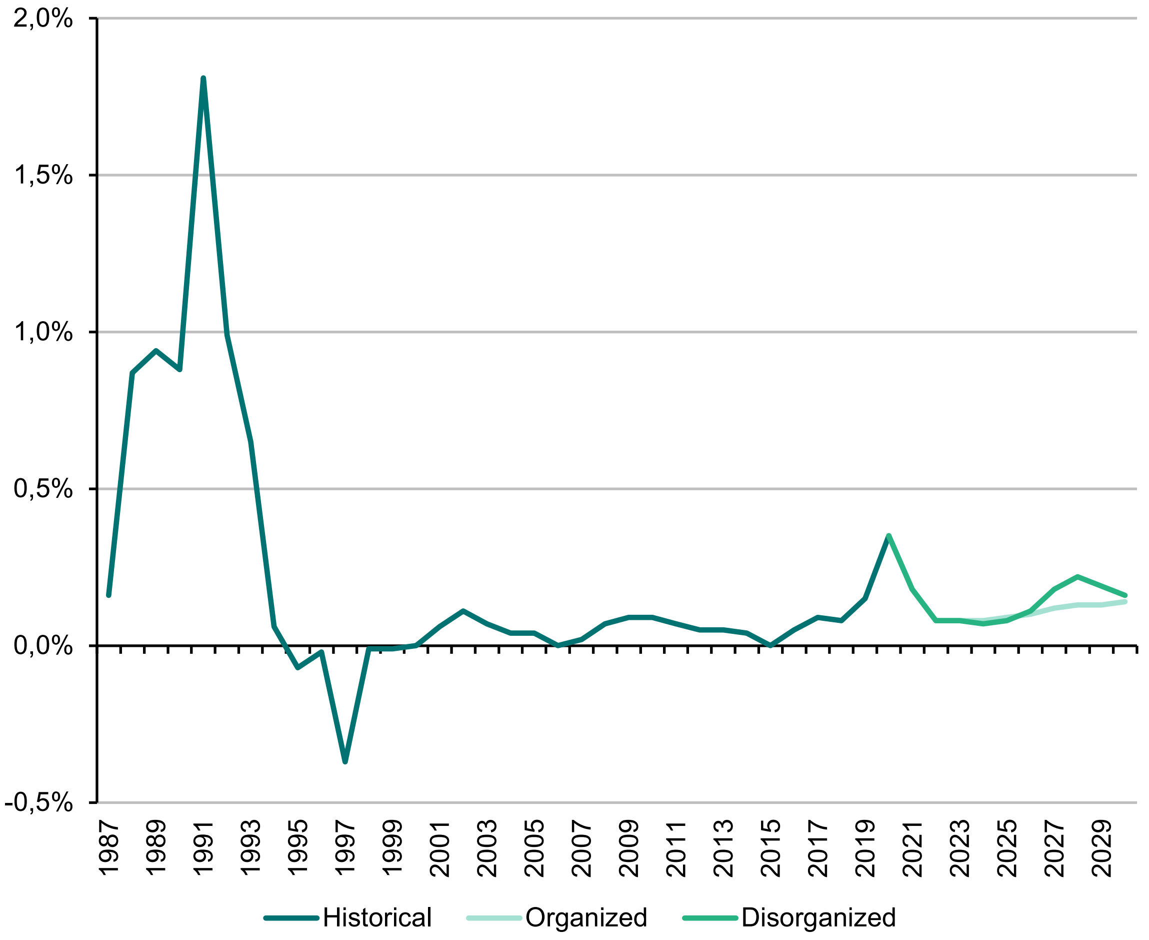


Source: The Norwegian FSA, the European Commission, DNB Markets

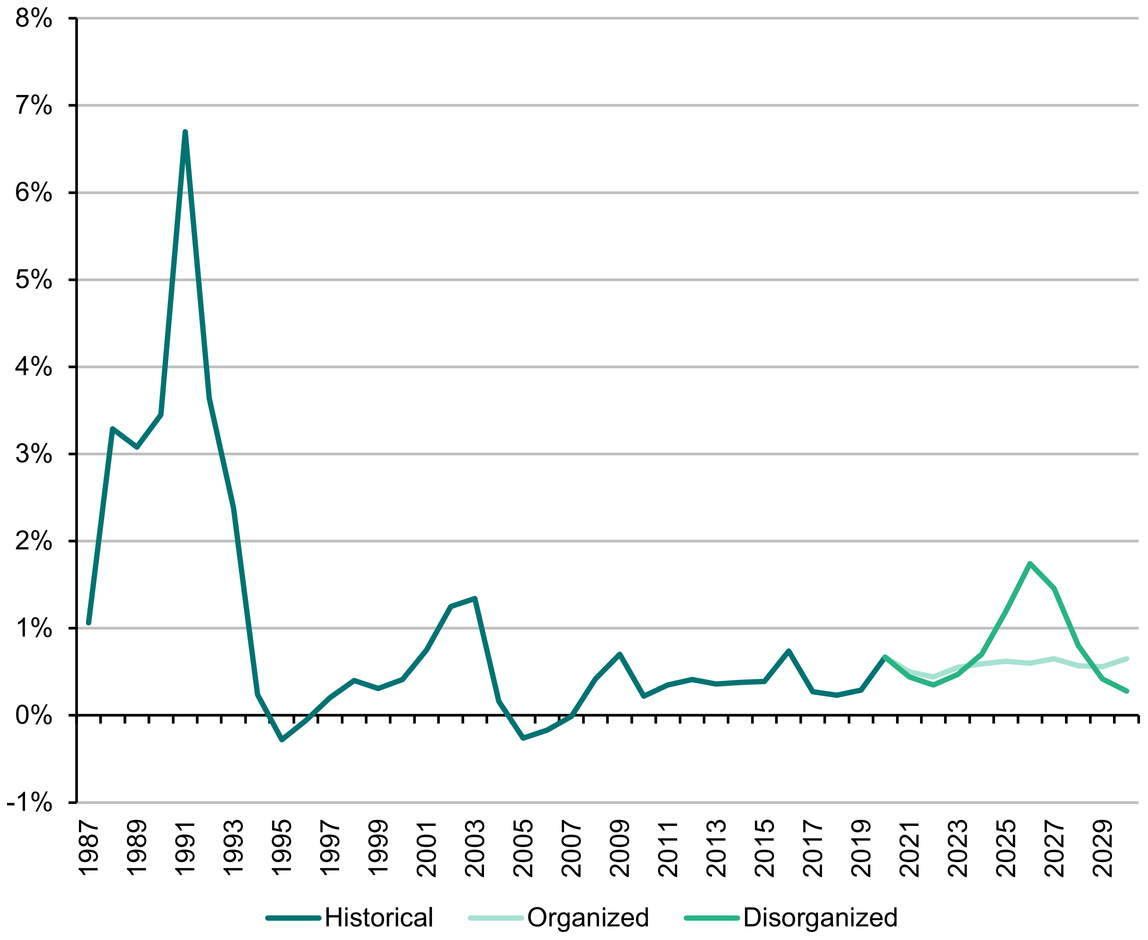
The FSA's climate risk analysis indicate robust Norwegian banks

Potential losses in a disorganized scenario considered manageable

Loan loss ratio – retail lending, scenarios



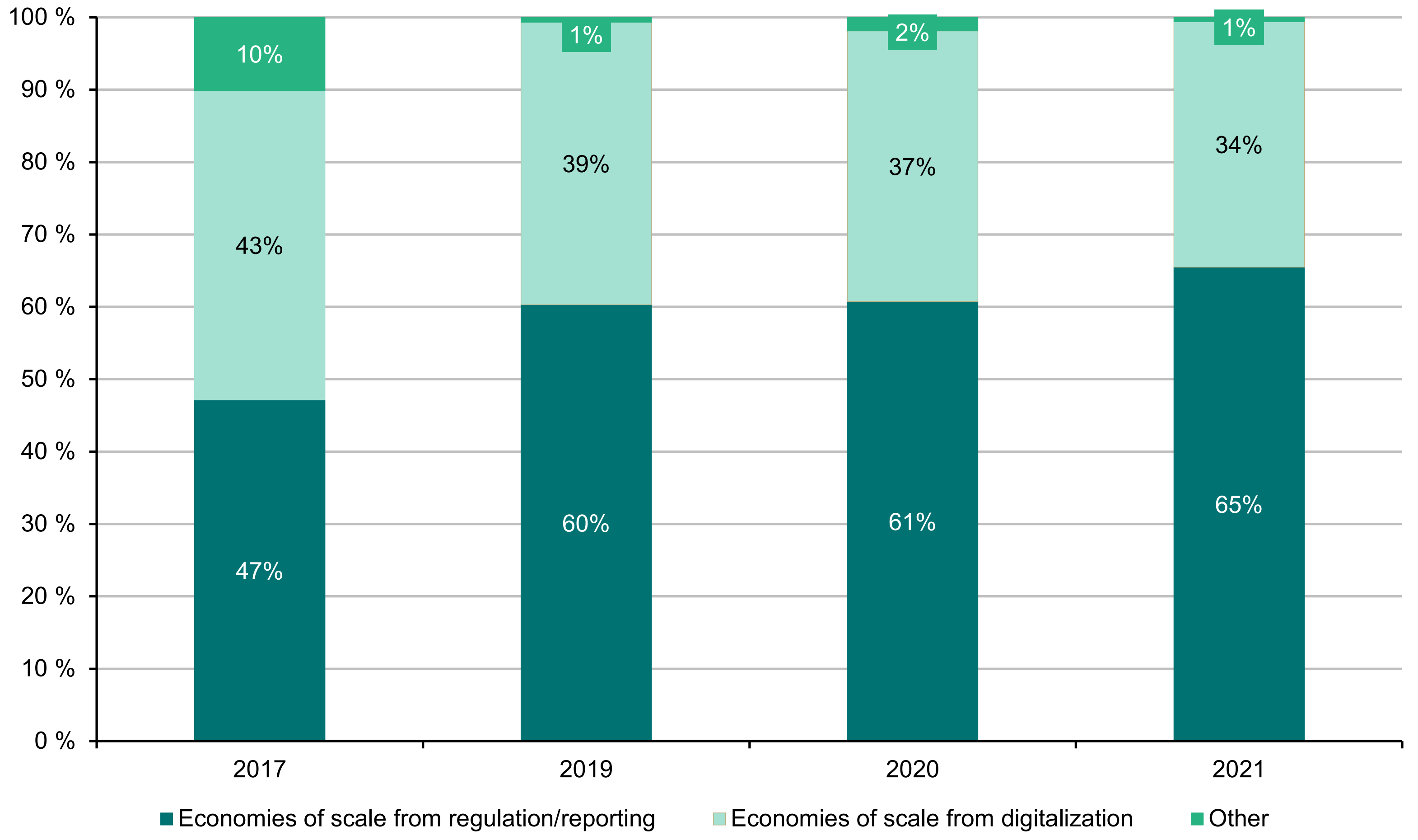
Loan loss ratio – corporate lending, scenarios



Source: the FSA

Regulation to further drive consolidation

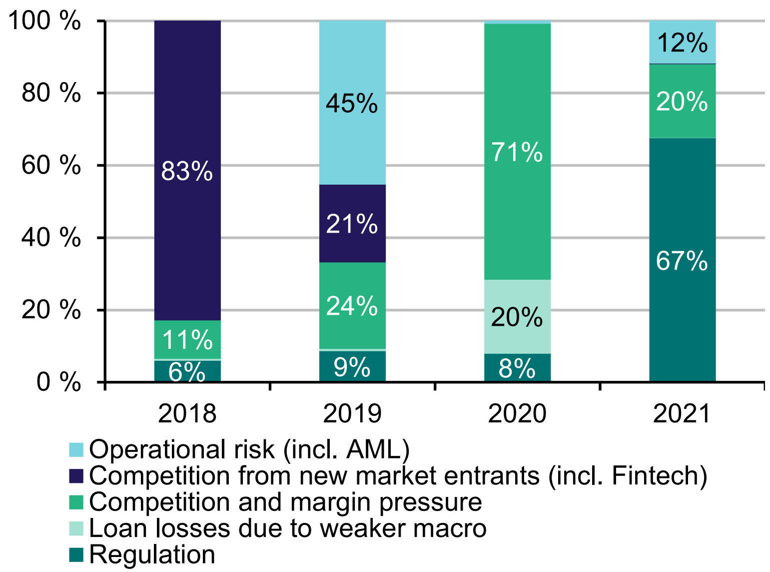
Expected main drivers of consolidation next 10 years



Potential driver of consolidation

- With increased ESG-related requirements, the regulatory complexity is set to increase further for the banks
- In 2021, 65% of surveyed banks highlighted regulation as main driver of consolidation and 67% listed regulations as the top management concern

Managements' top concern the next three years



Source: Companies (survey results)

Tightening requirements encourage different sustainability approaches – DNB and Handelsbanken

DNB – influence transition

- "DNB will be a driving force for sustainable transition, and we will use our position and expertise to actively help our customers to move in a more sustainable direction"
- May exclude certain companies or industries, but state it will primarily use "positive influence" in its sustainability strategy

SHB – «inclusion, exclusion and engagement»

- While also aiming for inclusion of green investments and active engagement, Handelsbanken have a stricter exclusion policy to support its 2040 net-zero emissions target

Relevant targets

	DNB	SHB
Net-zero emissions	Net-zero emissions across financing and investment activities and own operation by 2050	Net-zero emissions for the whole business by 2040
Responsible financing	▪ Finance and facilitate NOK1,500bn for sustainable activities by 2030 ▪ Reduce the emission intensity of the portfolio by 2030; oil & gas by 25%, shipping by 1/3, commercial property by 25-35%	20% of lending defined as green or contribute to a sustainable transition by 2025
Responsible investment	Increase AuM in sustainability themed funds to NOK100bn by 2025 and reduce the emission intensity of DNB Liv's portfolio by 55% by 2030	Investment portfolios aligned with the Paris Agreement, and maximising investors' contributions to the SDGs

Source: Companies

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