Sustainability Update

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What should banks do with the issuance of IFRS S1 and S2? P1

What should banks do with the issuance of IFRS S1 and S2?

As mentioned in our last thought leadership piece related to ESG reporting, 'Sustainability Counts II,' the International Sustainability Standards Board issued IFRS S1 and S2 in June 2023. These sustainability reporting standards aim to provide a global baseline against which the primary users of financial services information can assess companies' sustainability-related risks and opportunities that could potentially impact business and financial performance.

These standards were developed with clear reference to the TCFD recommendations, which consist of four core pillars: governance, strategy, risk management, and metrics and targets. The focus is on providing investors with sustainability-related information that goes beyond the data typically mentioned in annual financial reports, supporting them in their decision-making processes.

Core content of IFRS S1 and S2

As financial intermediaries, banks should consider risk exposures arising from their client portfolio, not only those that affect the banks' business operations but also potential impacts on clients' financial performance. Clients are under pressure to transform and strategise their businesses for greater resilience and sustainability, aligning with the commitment to limit the increase in global temperature to 1.5°C, as stated in the Paris Agreement. In this context, their financial performance may be affected. Consequently, this indirect impact could adversely affect the banks' risk exposure.

<table>
<tr><th colspan="2">Overview</th><th>What to do</th></tr>
<tr><td>IFRS S1</td><td>Requires companies to disclose all sustainability-related risks and opportunities that are expected to affect their financial and business performance.</td><td rowspan="2">1. Define clear roles and responsibilities within the organisation to manage, assess, monitor and evaluate sustainability-related risks and opportunities.
2. If you have adopted GRI, conduct a materiality assessment which not only considers potential impacts on people and the environment, but also evaluates the financial effects on the bank.
3. Identify and measure sustainability-related risks and opportunities, assessing their impacts on the bank’s strategy, performance, and client portfolio.
4. Perform climate scenario analysis and climate stress testing to assess the possible outcome under specified assumptions and constraints, evaluating the resilience of the bank’s business.
5. Develop a climate-related transition plan.
6. Integrate how sustainability-related risks and opportunities are being managed within a bank’s risk management framework and processes.
7. Calculate GHG scope 1, 2 and 3, including financed emissions.
8. Determine metrics and targets to monitor the implementation of sustainability commitments and initiatives set by the company.</td></tr>
<tr><td>IFRS S2</td><td>Requires companies to disclose climate related risks and opportunities that are expected to affect their financial and business performance, supplementing information disclosed in IFRS S1.</td></tr>
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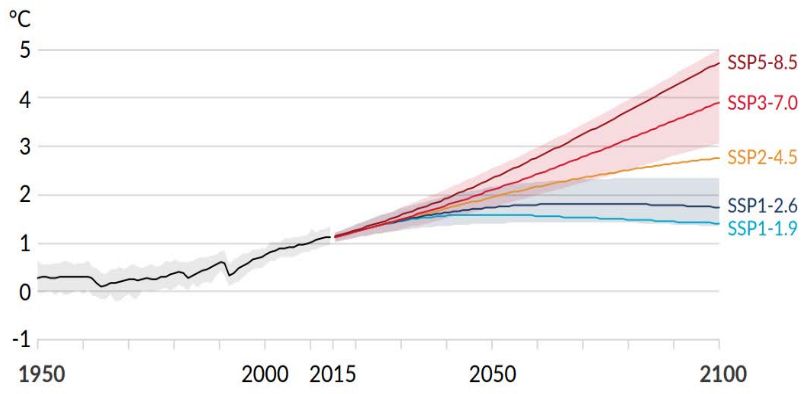
Those seeking more detailed information related to the standard could refer to our previous thought leadership, ‘Sustainability Counts II’, and ‘IFRS Sustainability Disclosure Standards - Guidance, insights and where to begin’

A. Climate-related risks assessment and scenario analysis

Considering that climate-related risks, both physical and transitional, could adversely affect the business performance of a bank's portfolio, they can indirectly drive credit, market, liquidity, operational, and reputational risks for the bank. Therefore, it is important for banks to identify relevant climate-related risks, measure their exposure to them, and adjust the bank’s strategy accordingly.

However, it is challenging to predict how climate-related risks will ultimately manifest themselves. As such, banks need to conduct scenario analyses to assess the possible futures against different future states in order to inform strategic decision-making and assess their business resilience.



Global surface temperature change relative to 1850-1900 under different climate scenarios.
Source: [IPCC AR6 Working Group report 2021]

How to start?

1. Stay updated on changing regulatory requirements and evolving stakeholder expectations.
2. Identify top risks and opportunities, including physical and transitional risks, to your business by conducting a qualitative risk assessment.
3. Perform scoping and define climate scenarios, based on the International Energy Agency (IEA), Intergovernmental Panel on Climate Change (IPCC) or Network for the Greening of Financial System (NGFS), to be considered for the assessment.
4. Build climate-related data inventories or explore available options for data sources and tools to facilitate a quantitative scenario analysis (e.g., geographical location of debtors and their collateral, GHG emissions of the debtors)
5. Develop climate-related risk modelling/an assessment approach
6. Develop a credible strategy and action plan based on the assessment result.

Case example:

To meet the 2060 NDC goals, the government intends to conduct coal phase-out by 2040 at the latest. Therefore, banks should consider their credit risks in the medium and long term, as the financial viability of their coal portfolio might be shorter than expected. Consequently, banks may consider investing more in renewable energy and revisiting their portfolio strategy to ensure the resilience of the banks in the future against this condition.

Climate scenarios are used to illustrate various pathways and potential emission trajectories for the remainder of the century. They depict the potential impact on global temperature increases compared to pre-industrial levels. These trajectories are based on the different rates of decarbonisation of the world economy and will influence the how both physical and transition risks crystallize.

The ability of banks to collect data related to climate-related risks will help them assess a range of possible values within the results of each scenario. For physical risks, the assessment can be performed at the geographical level (country, region, area) and then matched with the company's asset value, including banks' portfolio.

Banks should also consider revamping the client onboarding process by incorporating an environmental questionnaire and integrating this information into the loan underwriting process to minimise the bank's exposure to credit risk arising from climate-related risks.

Regulatory update:

In March 2024, the Indonesia Financial Services Authority (OJK) issued guidelines on conducting climate risk management and scenario analyses (CRMS) for banks to support the achievement of Net Zero Emissions by 2060. These guidelines cover governance, strategy, risk management and disclosure aspects to ensure the resilience of banks' business models and strategies toward climate change. The guidelines consist of six books, which form an integral part of the guidelines, as follows:

1. General guidance of CRMS
2. Technical guidance of CRMS
3. Methodology of GHG Emissions calculation
4. Macroeconomic supporting data
5. Physical risks supporting data
6. Working paper of CRMS

Source: OJK

B. Transition plans

As mentioned in IFRS S2, banks shall disclose transition plans in line with the framework's Strategy pillar. Financial institutions, including banks, will play a vital role in the transition (e.g.,towards net-zero scenario) by leveraging their influence as lenders, advisors, insurers, investors and brokers across the economy.

Referring to NGFS, transition planning refers to the internal process within a firm to develop a transition strategy to: i) achieve climate targets voluntarily adopted by firms or mandated by the relevant authority, and/or ii) devise a long-term response to effectively manage risks associated with transitioning to a low-emission economy. A transition plan should articulate how the bank's business model will remain relevant in a low-carbon future as banks have a key role to play in helping deliver the low-carbon transition through providing capital and financial support to the real economy. Additionally, by transitioning the bank's portfolio, it can ensure its contribution towards the fulfilment of the Paris Agreement.

In developing its transition plan, a bank should have a good understanding of its business and climate-related risk exposure, based on its portfolio. Banks can utilise scenario analysis and stress testing to gain a better overview of the potential impact of climate-related risks and opportunities across various climate scenarios. Moreover, banks need to closely engage with customers to gather more data related to their risk profiles concerning climate-related risks.

Key benefits of successful transition plans for banks

1. Fostering collaboration and facilitating transformative efforts to fulfil both the banks' and clients' climate-related commitments and targets.
2. Facilitating a strategic and coordinated assessment of climate-related risks, identifying opportunities amidst uncertainty and supporting long-term business objectives.
3. Enables clear communication of initiatives to external stakeholders, including regulatory bodies and investors, related to climate strategy actions and progress.
4. Better position of banks' businesses to capitalise on market opportunities as inventors will have better projections of banks' resilience strategies amid the climate crisis.

The following are the five plans of the Net Zero Transition Plan Framework as developed by the Glasgow Financial Alliance for Net Zero.

1. **Foundations**
   Define the banks' goals to achieve net zero emissions by 2050, aligning with 1.5°C pathways. Banks should also establish clear and measurable strategic timelines and identify priority financing strategies for net-zero transition actions.

2. **Governance**
   Define roles for the Board or strategy oversight body for net-zero targets, including design and delivery of the transition plan. Banks should provide training and development along with implementing a change management program to embed the net-zero transition plan.

3. **Engagement strategy**
   Support clients in adopting net-zero-aligned transition strategies and collaborate with industry peers and engage with public sectors to advocate, exchange transition expertise, address common challenges, and represent cohesive financial sector views to external stakeholders.

4. **Metrics and targets**
   Establish metrics and targets to drive execution of the net-zero transition plan and monitor progress. Include metrics and targets focused on aligning financial activity in support of the real-economy net-zero transition;

5. **Implementation strategy**
   Utilise products and services to accelerate the transition to 1.5°C pathways for clients, aligning with the banks' strategy. Integrate net-zero goals into evaluation processes and establish policies for high-priority sector, e.g. high-emitting sectors.

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