Analysis

An analysis of financial institutions' climate action plans

DNB Analysis

DeNederlandscheBank
EUROSYSTEEM

An analysis of financial institutions' climate action plans

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Introduction and observations

Around 50 banks, insurers, pension funds and asset managers signed the Dutch Financial Sector Climate Commitment in 2019. De Nederlandsche Bank (DNB) welcomes this initiative. By signing the Climate Commitment, the financial institutions involved show their commitment to achieving the goals of the Paris Agreement and the Dutch Climate Agreement. As part of this commitment, the institutions published their climate action plans (action plans) by the end of 2022, detailing their contribution. The action plans reflect the long-term thinking that is necessary for the transition to a carbon-neutral economy.

Although DNB is not responsible for supervising progress on the Climate Commitment, the action plans are relevant to DNB as a prudential supervisory authority. First, the implementation of these plans will help financial institutions manage climate-related risks and adapt their strategy, business model and governance where necessary in anticipation of the transition. The insights from the action plans are a supplementary source of information for DNB, in addition to the regular supervisory information submitted by these institutions. Second, the plans allow the institutions to respond to society's increasing focus on the environmental impact they have through their investments and assets. Insufficient progress in achieving the goals of the action plans may therefore actually increase institutions' reputational and legal risks. These potential risks prompted DNB to include the action plans in its supervision and conduct this analysis.

This publication presents the results of an analysis of financial institutions' action plans from DNB's perspective as a prudential supervisor. It should be noted that DNB welcomes the institutions' initiative to draw up and publish action plans. It should also be noted that translating the observations from this analysis to a specific institution requires taking into account, among other things, the type of institution and the relevant choices the institution has made in its plan.

The main observations in this analysis are the following.

While institutions have created an important reference point by setting a long-term climate target, they could explain the dependencies they face and the rationale for excluding specific assets in more detail.

- The long-term climate targets provide a reference point that helps institutions adapt their business models in the transition to a carbon-neutral economy and also potentially helps reduce their exposure to transition risks.
- In view of reputational and legal risks, it is recommended that institutions provide a realistic picture of their dependence on other parties in achieving their climate targets, as well as the risks that emerge if these targets cannot be met.
- Institutions could explain the assets they consider irrelevant in more detail. Based on the action plans, especially for those institutions that consider asset classes to be partially relevant, it is difficult to assess the extent to which transition-sensitive assets have been justifiably excluded, and thus whether the action plans actually contribute to adequate preparation for the transition to a carbon-neutral economy.

Institutions have taken a first step in the right direction by establishing a management and monitoring framework in their action plans.

- They have set up monitoring indicators for the assets that deserve the highest priority, and have defined transition paths in most cases, thus creating an initial framework for management and monitoring.
- Institutions should be aware that part of the change in carbon monitoring indicators may be driven by non-climate-related variables, such as a change in a company's market value. To get a better picture of transition risks, institutions must have an understanding of the various carbon monitoring indicators.
- It is important that institutions continue to critically review their management and monitoring framework. On the one hand, sticking closely to the chosen transition path facilitates the monitoring of progress to targets. At the same time, institutions will need to ensure they take into account changes in government policies that affect the pace of transition in specific sectors.

It is important that institutions continue to elaborate and implement their defined strategies – even when a link to carbon reduction is not immediately obvious.

- Institutions have drawn up strategies to achieve their policy objectives. However, in many of the action plans the strategies are not elaborated in detail or lack a clear link to the objectives. Institutions can be more specific in what actions they are taking and how these are linked to the climate targets.
- Strategies such as engagement or investing in climate solutions are inherently difficult to link to carbon targets. However, these strategies can significantly help institutions adapt their operational management. They also encourage knowledge development within the organisation and may be important to adequately assess future investments. Institutions could therefore be more specific in these strategies about their efforts and about the objectives they aim to achieve.

A greater focus on governance aspects will benefit the successful implementation of action plans.

- Institutions provide little insight into how responsibilities for implementing the action plans are assigned within the organisation. Given that the implementation may involve major changes to business processes and span a period of almost 30 years, it is important that institutions put in place appropriate governance.

Finally, the Climate Commitment would benefit from a uniform disclosure format and a digital environment for storing and monitoring action plans. Our analysis shows that the action plans vary widely in terms of content and design, which complicates their comparability. In addition, the multi-year nature of the plans poses a major challenge for time-consistent implementation of the plans. A uniform reporting format and a digital environment for storing and monitoring Climate Commitment action plans can contribute to the information value for the general public and all relevant stakeholders – including DNB as the supervisory authority.

1. The action plans in perspective

This section outlines the framework in which financial institutions have published action plans (Section 1.1), discusses the role of the financial sector in the transition (Box) and explains why the action plans are relevant to DNB (Section 1.2).

1.1 The action plans reflect the institutions' contributions to the financial sector's Climate Commitment.

By signing the Paris Agreement and translating it into the national Climate Act, the Dutch government has committed itself to climate targets.[1] For example, the Netherlands wants to be climate neutral by 2050 and must emit 55% less greenhouse gases by 2030 compared to 1990. In the Dutch Climate Agreement, a package of measures and agreements was agreed between companies, civil society organisations and governments to ensure that this reduction target is met in the various sectors of the economy.

As part of the Dutch Climate Agreement, a number of financial institutions have signed the Climate Commitment. By doing so, they want to contribute to the goals of the Paris Agreement and the Dutch Climate Agreement. Given its intermediary role (see Box 1), the financial sector aims to make a substantial contribution and to do so on a market-oriented basis. The institutions have agreed to:

1. Monitor the carbon intensity of their relevant funding and investments (from 2019 onwards) and to disclose these figures.
2. Establish carbon reduction targets to be achieved in 2030 (starting from 2022).
3. Publish action plans (by the end of 2022) in which they explain how they intend to contribute to the Paris climate targets.

In the action plans, financial institutions set out how they design their operational management to prepare for the transition to a sustainable economy. They set climate targets and explain the actions they will take to achieve them. The plans aim to integrate climate-related considerations into financial institutions' operational management and decision-making processes.

The institutions entered into the Climate Commitment on a voluntary basis, with progress assessed annually by an independent party. In cooperation with the Ministry of Economic Affairs and Climate Policy and the Ministry of Finance, the industry has prepared a guidance document to facilitate institutions in drafting their action plans and to promote consistent implementation of the Climate Commitment agreements. The Financial Sector Climate Commitment Committee (*Commissie Financiële Sector Klimaatcommitment –CSFK*) was established to assess the progress of the financial sector.[2] The CSFK presents its report on the progress made by the financial sector to the Dutch House of Representatives annually. In addition, the Dutch authority for the Financial Markets (AFM) (under

[1] wetten.nl - Regeling - Klimaatwet - BWBR0042394 (overheid.nl)
[2] KPMG prepared two progress reports on behalf of the CSFK. Other parties have also examined the action plans, such as the fair money guide and the sustainable finance lab.

the Corporate Sustainability Reporting Directive) will supervise the reporting of action plans published by large listed companies after 1 January 2024.

Box 1: The role of the Dutch financial sector in the transition

By raising and investing capital, the financial sector plays an intermediary role in the economy, so its exposures reflect the characteristics of the real economy. This means that the extent to which financial institutions are able to meet their carbon reduction targets in time depends to some extent on the climate policies of the Dutch government and the EU, and on the behaviour of homeowners and businesses. The pace at which the economy is moving towards carbon neutrality is therefore a key dependency for financial institutions to achieve their climate targets.

At the same time, the financial sector's choices also influence future economic activities. To make a solid contribution to the government's climate targets, it is first of all important that financial institutions adequately address climate risks in their models. If pricing and risk models are calibrated on historical data without considering government transition policies, there is a risk that financial institutions' lending or investment policies will not adequately take into account future risks of carbon-intensive business models, or that they will underestimate the profitability of sustainable activities. Action plans help ensure that financial institutions take into account the climate impact of the activities they invest in. This can add value when this impact is not fully taken into account in the institutions' risk assessment – which may be the case, for example, when carbon emissions are insufficiently taxed. Action plans also help institutions operate from a long-term perspective. The transition to a sustainable economy takes place over a longer time span than the maturity of many corporate loans, for example. Setting long-term target helps financial institutions take into account changes in the business activities of their customers and their own organisations.

1.2 The action plans are relevant to DNB as a prudential supervisory authority

Although DNB has no formal role in the Climate Commitment or in the implementation of the action plans, the plans are relevant to its supervisory work. The Climate Commitment is a sector initiative through which financial institutions aim to contribute to the government's climate targets. The question of whether financial institutions contribute sufficiently to the transition to a carbon-neutral economy does not fall under DNB's prudential supervision. However, climate-related risks are part of DNB's prudential supervision of financial institutions (see, for example, the Sustainable Finance Strategy and the Climate and Environmental Risk Management Guide). The action plans are directly related to the climate-related risks faced by financial institutions and are relevant to DNB as a supervisory authority for three reasons.

Firstly, the action plans can help manage climate-related transition risks. In the plans, financial institutions identify which assets play a relevant role in the transition, collect relevant data and draw up strategies to reduce their exposure. Although this does not guarantee that institutions

adequately address transition risks in their risk management, the implementation of the plans does contribute to reducing the exposure to these transition risks and thus the financial risks the institutions face. [3] The plans thus provide DNB with an supplementary source of information on the extent to which institutions aim to limit their exposure to these risks, in addition to regular supervisory data.

Secondly, the action plans illustrate how the relevant financial institutions are adapting their business models and governance to prepare for the Dutch government's long-term climate targets. With the Climate Commitment, the financial institutions involved prepare for the government's long-term climate targets, which can contribute to the future-proofing of their business models. For example, institutions will adapt their lending processes and ensure they have adequate knowledge and skills regarding the transition to a carbon-neutral economy. The institutions also address how they will adapt their governance to prepare for the transition to a carbon-neutral economy, for example by unambiguously assigning responsibility within the organisation for implementing the action plans, but also by possibly adapting the organisational structure to integrate the plans into their operational management. DNB's Climate and Environmental Risk Management Guide underlines how important it is that institutions such as pension funds and insurers embedd climate and environmental risks in their business model, strategy and governance.

Thirdly, the reputational and legal risks to which financial institutions may be exposed are also reason for DNB to include the action plans in its supervision. In their action plans, financial institutions address the impact of their investments on society. This aligns with the increasing focus on the damage that economic activities can have on the environment – and on the associated role of financial institutions. A steady implementation of climate action plans can help reduce reputational and legal risks for financial institutions arising from negative climate impacts. Conversely, financial institutions will also need to be aware that insufficient progress in implementing the plans can actually increase reputational and legal risks. Since reputational and legal risks are part of the operational risks DNB supervises, the action plans are included in its supervision.

[3] Transition risk for financial institutions refers to the risks created by the transition from a fossil-based economy to a climate-neutral economy. This includes increased credit risk and market risk due to unexpected or premature writedowns of loans and investments in carbon-intensive activities.

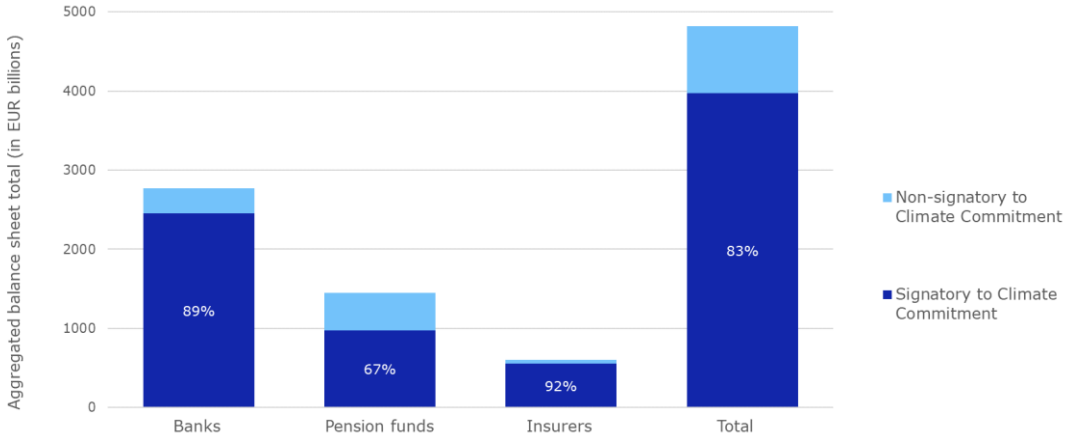
2. The action plans in practice

This section presents the results of the analysis of the financial institutions' action plans published at the end of 2022.[4] We first present some general observations, after which we discuss the following four aspects: targets, monitoring indicators and transition paths, strategy and governance.

2.1 General observations

A large part of the Dutch financial sector has signed the Dutch Climate Commitment. These institutions comprise about 83% of the aggregated balance sheet size of Dutch financial institutions (see Figure 1). A broad-ranging group of institutions, both large and small in size and consisting of banks, pension funds, insurers and asset managers, are participating in the Climate Commitment. In this study we exclude asset managers, as the action plans they have drawn up relate to third-party assets and are not at their own risk.[5]

Figure 1: A large part of the Dutch financial sector has signed the Climate Commitment



This figure shows the amount of assets held by all Dutch financial institutions, distinguishing between assets held by institutions that have signed the Climate Commitment (dark) and those that have not (light).

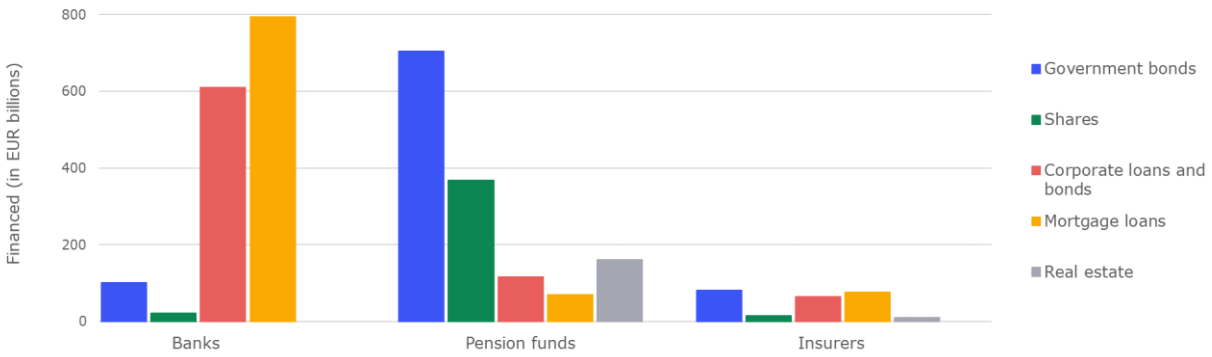
To understand the choices made by financial institutions in their action plans, it is important to consider the different business models of the institutions. Figure 2, for instance, shows that pension funds invest relatively heavily in shares, resulting in a focus on adjusting investment allocations or addressing voting policies at shareholder meetings in their action plans. Banks, on the other hand, relatively often act as lenders. Mortgages and business loans will generally

[4] We analyse these aspects using the action plans published by institutions by the end of 2022. Although not required by the Climate Commitment, some institutions have published an update of their action plan in 2023. For the sake of consistency, these have been excluded from this analysis. It is therefore possible that institutions are actually taking more measures than is evident from the assessment of the action plans from 2022.

[5] In addition, asset management involves tailoring the investment portfolio to customers' specific needs and personal situations.

have a lower tradability, leading banks to focus their action plans on adjusting the lending process. Some institutions have a specific business model and therefore a specific approach, such as development banks with a focus on developing countries' climate policies. These differences in focus have implications for the strategies that institutions adopt to achieve their reduction targets, which makes it difficult to compare institutions.

Figure 2: Asset classes held differ by sector



This figure shows financial institutions' exposure to different asset classes, aggregated by sector. For the banking sector, exposure to (commercial) real estate is included under corporate loans. The figure includes only institutions that have their registered office in the Netherlands.

There are a number of challenges in assessing climate action plans. While the sector has issued a guidance document to facilitate consistent disclosures, institutions are free to use their own disclosure formats. In many cases, the action plans are published as appendices to the annual report and therefore vary widely in design. The degree of depth and concreteness of the plans also varies between institutions. Finally, the content of the plans also varies, since several sustainability indicators are still under development. These elements are partly related to the differences in type and size of institutions, but complicate a consistent assessment.

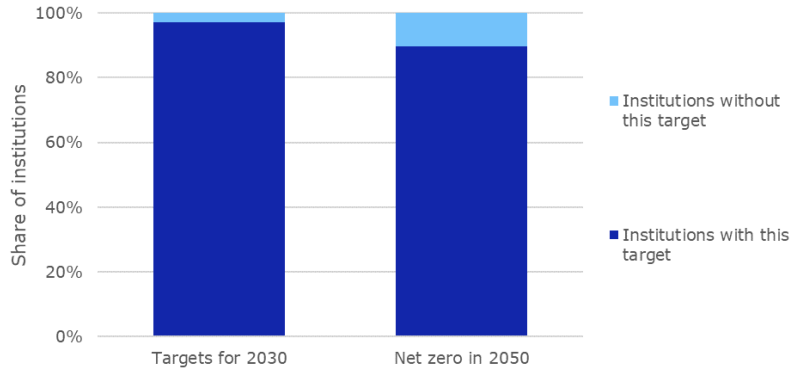
The Climate Commitment would benefit from a standardised disclosure format and a digital environment for storing and monitoring plans. Our analysis shows that the action plans vary widely in terms of content and design, In addition, the multi-year nature of the plans poses a major challenge for time-consistent implementation of the plans. A uniform disclosure format and a digital environment for storing and monitoring Climate Commitment action plans can contribute to the information value for DNB as a prudential supervisory authority and for the general public.

2.2 Climate targets

In their action plans, financial institutions explain their long-term climate targets and how they intend to achieve them. The Climate Commitment requires institutions to contribute to the government's climate targets and to define a carbon reduction target for 2030. However, neither the Climate Commitment nor the Dutch Climate Agreement are specific about what the targets of financial

institutions should look like. It is up to the institutions to specify this in further detail. It is therefore important that they identify which government targets are relevant to them and how they can translate these to institution-specific targets.

Figure 3: Virtually all financial institutions have set targets for 2030 and are aiming to achieve *net zero* by 2050[6]

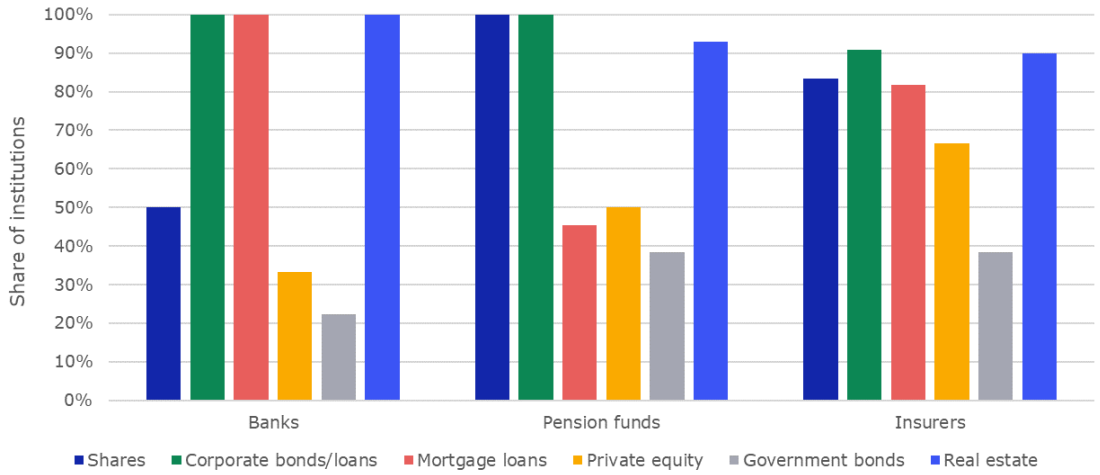


The institutions' targets are very much in line with the Dutch government's carbon targets. The action plans show that the vast majority of Climate Commitment signatories aim to achieve carbon neutrality with respect to their asset investments by 2050 (see Figure 3). This target relates to financed emissions, or the aggregated carbon emissions of the parties financed by the institutions. The 2050 target is in line with the Dutch government's target for achieving the Paris Agreement goals. In addition, 97% of institutions have set carbon reduction targets for 2030 in their action plans, in line with the Climate Commitment agreements. While the government states that emissions should be 55% lower in 2030 compared to 1990, institutions generally do not have a 1990 baseline and therefore use a different baseline year.

The strength of institutions' commitment to these target varies, however. Some institutions have formulated specific targets, while others express aspirations or describe possible actions to pursue a carbon-neutral balance sheet, without designating this as a specific target. Institutions thus seek to contribute to the government's climate targets while taking into account their dependence on the parties they invest in to achieve their targets.

[6]For 2030, the government aims to reduce carbon emissions by 55% compared to 1990. However, many institutions do not have data from 1990 and use a more recent year (e.g. 2020) as a benchmark for their carbon reduction targets.

Figure 4: The proportion of institutions that consider specific asset classes to be relevant varies



This figure shows the proportion of institutions that consider specific asset classes to be relevant. It shows whether an institution owns a specific asset class and whether the institution includes this in its carbon reduction target. This means that if an institution does not own a specific asset class, it is excluded for the relevant category in this figure. For this analysis, we made some choices with regard to interpreting the relevance of asset classes. For example, we consider asset classes that are explicitly mentioned in the context of formulating an overall net-zero target for carbon emissions as relevant. If an institution purchases green government bonds, we consider government bonds to be relevant in this context.

In general, institutions know how to distinguish between asset classes that are relevant to them and those that are not. In the Climate Commitment, institutions have agreed to measure and report the carbon emissions of their relevant investments. While the 2050 targets generally apply at balance sheet level, most institutions start by classifying relevant shorter-term assets to formulate more detailed policy targets.[7] Figure 4 illustrates that institutions set targets and policies for relatively many asset classes. If institutions choose not to consider certain assets as relevant, they substantiate this in many cases. For example, they indicate that the influence they have on reducing emissions within an asset class is limited (government bonds), or that they have only a limited position (e.g. banks' exposure to equities). There may also be more practical reasons for qualifying asset classes as irrelevant, such as a lack of data to measure carbon emissions.

At the same time, there are two caveats:

First, the qualification of relevant asset classes differs between institutions. For example, institutions that provide mortgages (mainly banks) in particular consider this asset class to be relevant. Institutions that invest in mortgages through an intermediary (mainly pension funds and, to a slightly lesser extent, insurers) are less likely to consider this to be a relevant asset class. With regard to private equity we also see differences between institutions, and it is notable that only a few have defined targets or policies with respect to this asset class. While this asset class is known for its

[7] The Climate Commitment's guide provides examples of how institutions can deal with this.

low transparency, it is also a category that is often illiquid and has a relatively high risk profile, which is why it may be particularly important to emphasise climate-related risks here.

Second, institutions could do more to explain why they exclude certain (parts of) asset classes. For example, several banks choose to focus in their action plan only on those funded sectors they deem most relevant, such as commercial real estate or fossil fuel producers, or only on certain equity portfolios. Institutions often indicate why they consider certain assets to be relevant, but less often substantiate why they exclude certain assets.

While institutions have created an important reference point by setting a long-term climate target, they could explain the dependencies they face and the rationale for excluding specific assets in more detail.

- The long-term climate targets provide a reference point that helps institutions adapt their business models in the transition to a carbon-neutral economy and also potentially helps reduce exposure to transition risks.
- In view of reputational and legal risks, it is recommended that institutions provide a realistic picture of their dependence on other parties in achieving their climate targets, as well as the risks that emerge if these targets cannot be met.
- Institutions could explain the assets they consider irrelevant in more detail. Based on the action plans, especially for those institutions that consider asset classes to be partially relevant, it is difficult to assess the extent to which transition-sensitive assets have been justifiably excluded, and thus whether the action plans actually contribute to adequate preparation for the transition to a carbon-neutral economy.

2.3 Monitoring indicators and transition paths

Institutions use different indicators to monitor and manage their portfolio composition. The challenge for institutions is to translate the long-term targets they have set at balance sheet level into short-term actions. Defining monitoring indicators and a transition path (used as a reference for progress) is an important step in this respect. Institutions often choose indicators and transition paths for sub-portfolios, focused on asset classes or economic sectors (such as the portfolio of loans to fossil fuel producers).

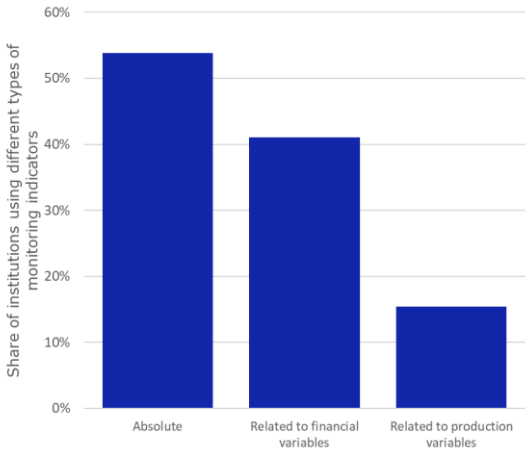
Monitoring indicators

Selecting monitoring indicators is not straightforward. Institutions can select absolute or relative indicators to monitor the carbon intensity of their investments. In the case of absolute indicators, the carbon emissions of the company in which an institution invests are allocated to the investments based on the relative ownership in the company or the funded share in the company. The use of absolute indicators is in line with the United Nations' call. Although these indicators provide insight into the absolute impact of investments, changes in absolute carbon emissions can also be driven by a financial institution's balance sheet adjustments. Institutions can also use relative indicators that are related to financial variables. These indicators are not only influenced by absolute carbon emissions, but also by financial developments of the company concerned, such as a change in

turnover, change in value or exchange rate effects (see DNB, 2023). Finally, it is also possible to relate a company's carbon emissions to its production. These indicators focus on the carbon efficiency of business processes, such as the amount of carbon emissions per tonne of steel produced (for the steel industry). The use of carbon efficiency provides an opportunity to align with specific government policies for the sector and respond to the transition challenges of investee companies. In addition, these indicators are robust to changes in asset allocation and balance sheet size.

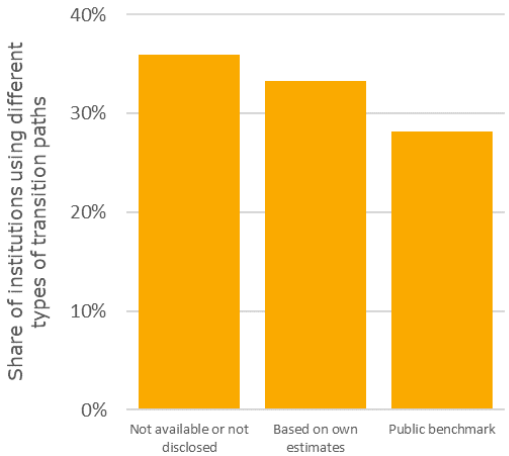
Institutions mostly use a single monitoring indicator for each asset class. Figure 5 provides insight into which types of indicators institutions use to monitor the carbon emissions of their investments. Roughly half of the institutions monitor their portfolios for absolute emissions (see Figure 5). Some 40% of institutions use indicators that relate carbon emissions to company turnover or market value. Only a small number of institutions, most of them banks, also use indicators based on the carbon efficiency of the economic activity. The vast majority of institutions that have real estate in their portfolios – either directly or as collateral – monitor and manage for energy efficiency per m^2.

Figure 5: A limited share of institutions use carbon indicators related to a production variable



The figure concerns the monitoring indicator used for equities and corporate loans and bonds. Absolute indicators include indicators expressed in tonnes of carbon and indicators related to the balance sheet of the financial institution itself (e.g. carbon emissions per euro invested).

Figure 6: Share of institutions that do not use a transition path, define their own path or use a public benchmark path



Institutions may use several types of transition paths. The public benchmark includes transition paths set by public authorities or that are publicly available; only institutions that adopt all requirements of such a benchmark are included. When institutions only adopt partial criteria or make an additional translation of the requirements, this is classified as 'based on own estimation'.

Transition paths

A large number of institutions are defining a transition path to operationalise and monitor progress towards the target. The government has not defined a transition path for financial institutions and leaves the choice of which path to follow to the institutions themselves. The Climate Commitment also lacks a transition path for financial institutions. Roughly a third of institutions do not use a transition path at all (Figure 6), making it unclear how they monitor their progress. The vast majority of institutions that do use a transition path use public sources to define it, or derive it from existing paths.[8] Dutch institutions are also contributing to the development of public scenarios.[9] While defining transition paths generally provides guidance to institutions, these paths must be consistent with the characteristics of the relevant exposures and reflect current relevant transition policies. For example, the net zero scenarios of the International Energy Agency (IEA) provide a basis for fossil fuel reductions, but are set at the global level. Because developed countries are expected to transition at a faster pace than less developed countries, the transition required in the Netherlands may have to be faster than set out in the IEA's global net zero scenarios.

Institutions have taken a first step in the right direction by establishing a management and monitoring framework in their action plans.

- They have set up monitoring indicators for the assets that deserve the highest priority, and have defined transition paths in most cases, thus creating an initial framework for management and monitoring.
- Institutions should be aware that part of the change in carbon monitoring indicators may be driven by non-climate-related variables, such as a change in a company's market value. To get a better picture of transition risks, institutions must have an understanding of the various carbon monitoring indicators.
- It is important that institutions continue to critically review their management and monitoring framework. On the one hand, sticking closely to the chosen transition path facilitates the monitoring of progress to targets. At the same time, institutions will need to ensure they take into account changes in government policies that affect the pace of transition in specific sectors.

2.4 Strategy

Most signatories set out the strategies they are using to achieve their carbon reduction targets in their action plans. Roughly speaking, the main strategies are 1) deleveraging carbon-intensive exposures and investments (through exclusion, divestment and allocation changes), 2) encouraging parties to become more sustainable (engagement) and 3) taking a more active role in financing climate solutions or sustainable activities. Following on from these three strategies, in this subsection we examine three specific cases that feature frequently in institutions' action plans.

[8] It has been scientifically verified for many of these reference transition paths that they actually lead to an economy that is consistent with the Paris Agreement. For example, four institutions aim to follow the EU Paris aligned benchmark, but there are also institutions that only adopt partial criteria from this benchmark. They create their own benchmark based on the same reduction rate (7%), but do not adopt the criterion regarding the start carbon intensity.

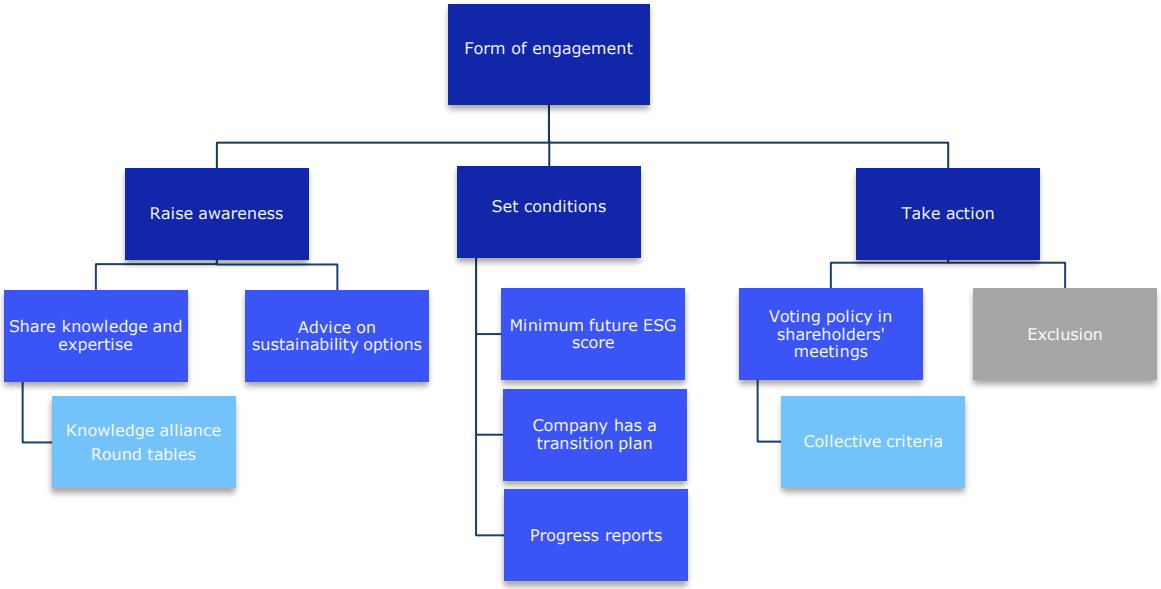
[9] Examples include the Poseidon Principles for the shipping sector and the CCREM scenarios for real estate energy efficiency.

However, institutions in many cases fail to make direct links between the actions listed and the contribution to their targets. In formulating their strategy, institutions take into account the contribution to their climate targets and the impact on their regular operational management. The most appropriate strategy may differ between types of institutions and asset classes – tradability and type of exposure play a major role here. We find that the level of elaboration of strategies differs between institutions, and that institutions often fail to make direct links between their strategies and carbon targets. On the one hand, this can be explained by the fact that institutions are to some extent dependent on the behaviour of the parties they invest in. Moreover, for several strategies it is difficult to determine the contribution to the targets in advance, such as the impact of engagement or investing in climate solutions. On the other hand, this makes it challenging to assess the effective implementation of strategies in some cases.

2.4.1 Engagement: influencing companies

Through engagement, financial institutions aim to help the parties they invest in prepare for the transition to a sustainable economy. Engagement can play an important role in making carbon-intensive sectors more sustainable. Behavioural influencing can be implemented through a variety of means and is characterised by varying degrees of intensity. Figure 7 provides a schematic overview, distinguishing between forms of engagement that are 1) non-committal, where the financial institution merely conveys information to its customer and thus raises awareness of the importance of a timely adjustment, 2) conditional, where the institution sets conditions that a company must meet in order to be eligible for a loan, for example, and 3) action, which could, for example, consist of shareholder voting policies or even the exclusion of a company (see the next subsection).

Figure 7: Through engagement, financial institutions aim to change the behaviour of the parties they invest in in various ways.



This figure provides an illustration of the forms of engagement financial institutions use and what role they attribute to themselves. The actions in the figure are examples of the actions institutions may take and do not constitute an exhaustive list. Institutions may also use multiple approaches (e.g. in an escalation ladder).

Most institutions (85%) mention in their action plans that they use engagement, but many of them fail to elaborate on this. Many banks engage in knowledge sharing based on their expertise in lending. A number of them participate in knowledge alliances to increase the level of knowledge about the transition in a particular sector. Banks also mention that they have an advisory role in their lending operations. Pension funds and insurers more often approach engagement from a shareholder perspective. They impose conditions on the parties they invest in, exercise direct influence by voting at shareholder meetings and, in some cases, proceed to sell investments. It is notable here that in many cases institutions outsource their engagement to specialised parties or vote based on collectively established criteria.

It is difficult to assess the contribution of engagement to the institutions' carbon targets. In general, institutions only explain their engagement policies in broad terms, and many lack specific criteria for successful engagement and associated follow-up steps. This makes it difficult to assess how and to what extent this engagement takes place in practice. In addition, action plans often lack a link between the engagement efforts and the resulting carbon reduction. Some institutions address the dependence they have on the adaptability of the companies they invest in.

2.4.2 Exclusion: fossil fuel producers

Refusing to invest in specific economic activities or companies making insufficient adjustments is the most rigorous way to align investments with climate targets.[10] Financial institutions apply exclusion policies with regard to fossil fuel producers in particular. Almost all Climate Commitment signatories implement exclusionary policies towards the fossil industry. Only about 10% of institutions do not address this in their climate plans.

Financial institutions face the challenge of having to strike a balance between financing the economy's ongoing need for fossil fuels and the need to reduce this consumption in order to achieve a carbon-neutral economy by 2050. The Climate Commitment has no prescriptive policy on investment in fossil fuel producers. The Dutch government banned the use of coal for electricity generation in 2019[11] but also states that natural gas and oil will still be used for a long time. The European Union also classifies the use of natural gas as a renewable energy source in the transition under certain conditions. Several parties are calling on financial institutions to stop investing in new fossil fuel projects. For example, the UN (McKenna High-Level Expert Group) calls on financial institutions to refrain from providing financing for coal-fired power generation and activities that contribute to increasing oil and natural gas supplies or production. The science-based target initiative (SBTi)[12] sees this as a prerequisite for action plans to be compatible with the Paris Agreement.

A closer look at the action plans shows that pension funds and insurers are relatively strict in their exclusion policies. Pension funds and insurers in many cases distinguish between conventional and unconventional fossil fuel extraction, and in most cases unconventional extraction, such as drilling in the Arctic or extraction from tar sands, is excluded altogether. Some 64% of pension funds and 80% of insurers have exclusion policies for conventional extraction, almost all of them basing these policies on the share of fossil fuel extraction to a company's turnover. It is notable that a substantial number of institutions have policies in place that are more stringent than what is required to achieve EU Paris alignment.[13]

All banks have exclusion policies towards fossil fuel producers; however, the degree of concreteness of these policies varies. Three banks completely exclude fossil fuel producers. Three other banks use a definition that focuses on limiting funding for new fossil fuel exploration, in line with the UN call (McKenna). However, it is not easy to assess how this works in practice. For example, the exclusion policy may relate to project financing (e.g. for discovering new sources of fossil fuel) – and not lending at the corporate level. Some banks follow IEA oil and gas demand scenarios to reduce their exposure to fossil fuel producers, in addition to their exclusion policies. This implies that the reduction target for their portfolios for 2030 is around 20% (compared to 2020).

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[10] Financial institutions can also achieve their carbon reduction targets by adjusting their portfolio composition and selling carbon-intensive assets. We do not regard this form of divestment as exclusion.
[11] Fossil fuels in the future | Renewable energy | Rijksoverheid.nl This ban encompasses a numer of phasing-out rules.
[12] SBTi is a collaboration between the CDP (formerly the Carbon Disclosure Project), the United Nations Global Compact, the World Resources Institute (WRI), and the World Wide Fund for Nature (WWF). The organisation developed and introduced the first net-zero standard. This standard provides companies with the framework and tools to set science-based net-zero targets.
[13] The Paris Aligned Benchmarks exclude companies generating significant revenue from fossil fuels, specifically: gas (50% or more), oil (10% or more) and coal (1% or more).

2.4.3 Contributing to climate solutions: mortgage loans

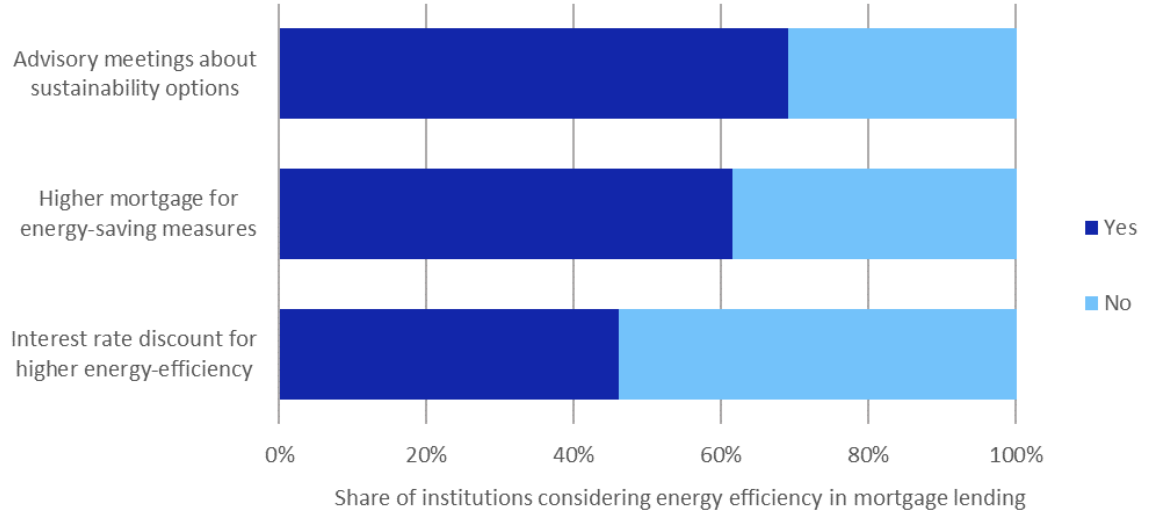
Besides engagement and exclusion, a third strategy consists of financing climate solutions or investing in them. Financing climate solutions is important for the transition to a sustainable economy. In their action plans, institutions mention various contributions to climate solutions, such as building up a portfolio of green bonds or investing in individual sustainable projects. Financing the sustainability of the housing market is a key theme for many institutions and is therefore highlighted in this sub-section.

Through their lending, Dutch financial institutions can play an important role in making the Dutch housing market more sustainable. Making the Dutch housing market more sustainable is likely to result in substantial credit demand (DNB, 2022). How Dutch financial institutions respond to climate-related aspects in their lending can be an important factor in this transition. For instance, Dutch homes are generally financed with a mortgage loan[14], with banks having a market share of roughly 80% (DNB, 2023). Pension funds and insurers have increased their share in the mortgage market in recent years, often acting as investors. The sustainability transition of the Dutch housing market is therefore an important development for financial institutions.

In particular, institutions that provide mortgages have included targets and consider energy efficiency in mortgage lending. Roughly 60% of institutions providing mortgages have included targets for this (see Figure 8). In doing so, they offer their customers the opportunity to take out a higher mortgage if this financing is used for energy-saving measures – thereby reducing potential barriers to sustainability.[15] In addition, institutions also include energy efficiency as a factor in setting the interest rate on mortgages.[16] Of the institutions that have included mortgage targets, half offer customers interest rate discounts. Finally, institutions also offer information services to help customers get better insight and tips on reducing energy consumption. Although financial institutions indicate in their action plans that improving the sustainability of their mortgage portfolios depends heavily on the behaviour of homeowners in conjunction with targeted government policies, the major banks have set substantial targets for improving the energy efficiency of the homes they finance (a 34% to 57% improvement in energy efficiency by 2030 compared to 2021).

[14] Only 20% of homes are fully equity-financed, according to Statistics Netherlands (CBS).
[15] Mortgage lending standards allow for this: Can I get a higher mortgage if I take energy-saving measures? | Rijksoverheid.nl
[16] Banks are also expected to consider residential energy efficiency in their risk management when calculating collateral value. Low energy efficiency can lead to a lower valuation of a home and can affect the risk cost of a mortgage.

Figure 8: How financial institutions include sustainability in their mortgage lending



The figure concerns only institutions that have included targets for their mortgage portfolios. The three actions are the most frequently mentioned.

Further elaboration and implementation of the defined strategies is important – even when a link to carbon reduction is not obvious.

- Institutions have drawn up strategies to achieve their policy objectives. However, in many of the action plans the strategies are not elaborated in detail or lack a clear link to the objectives. Institutions can be more specific in what actions they are taking and how these are linked to the climate targets.
- Strategies such as engagement or investing in climate solutions are inherently difficult to link to carbon targets. However, these strategies can significantly help institutions adapt their operational management. They also encourage knowledge development within the organisation and may be important to adequately assess future investments. Institutions could therefore be more specific in these strategies about their efforts and about the objectives they aim to achieve.

2.5 Governance

In their action plans, financial institutions often address governance aspects to promote the achievement of objectives and the implementation of strategies. Explicit allocation of responsibilities and tasks and a balanced distribution of these across functions can contribute to effective implementation of action plans. It is important that policymakers have sufficient knowledge, experience and skills in the area of climate and environmental risks to be able to assess the institution's exposures to these risks and make balanced decisions about them (see DNB's Guide to managing climate and environmental risks). The recommendations of Taskforce on Climate-related

Financial Disclosures (TCFD), which have also been adopted by the ECB in its supervisory expectations, also require disclosure of board and lower management involvement in implementation.

The action plans vary in terms of openness about governance aspects and their design. Given the importance and impact of the plans, the management board supports and monitors the implementation of the plans at the majority of institutions. At roughly two-thirds of signatories, the board openly supports the plans. The extent varies to which the board is (visibly) involved in defining the strategy and verifying that implementation is in line with the policy frameworks. A limited number of institutions provide insight into how responsibility has been delegated to a lower level in the organisation. When allocating and explicitly assigning tasks, it is notable that only a quarter of the institutions assign responsibility for the relevant sustainability policies to specific functions.

A greater focus on governance aspects will benefit the successful implementation of action plans.

- Institutions provide little insight into how responsibilities for implementing the action plans are assigned within the organisation. Given that the implementation may involve major changes to business processes and span a period of almost 30 years, it is important that institutions put in place appropriate governance.