

WHITE PAPER

Five hypotheses what the EU election means for banks' ESG efforts

June 2024

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Introduction & Context EU election

From June 6th to 9th 2024, approximately 400 million eligible voters across 27 EU member states had the opportunity to elect the new members of the European Parliament. Although the party of the current EU president Ursula von der Leyen has retained the most seats in the parliament, she will likely need to seek support beyond her existing coalition to secure her second presidency. This uncertainty about the coalition composition for the next legislative period is fuelling ambiguity regarding political priorities, including the future direction of the European Green Deal.

However, despite potential shifts in political focus, the persistence of climate change as a critical issue remains unchallenged. Current projections indicate that with existing climate policies, the world is on track for a global temperature increase of 2.7°C, overshooting the 1.5°C target set by the Paris Agreement[1]. In Germany alone, the investment required for climate action from 2021 to 2030 is estimated at €860 billion[2]. Inaction on climate change is projected to incur substantial global social and economic costs, potentially reaching US$1,266 trillion in cumulative costs by 2100 under a business-as-usual scenario[3].

Given the current political landscape, potentially creating a high level of uncertainty concerning climate regulations and policies, banks may wonder about the implications on their ESG initiatives. To help them navigate this uncertainty, we have developed five hypotheses on the potential implications and recommended 'no-regret moves' for banks' ESG efforts moving forward.

Key Hypotheses for banks

I. Prepare for regulatory requirements: *Bank-specific Regulators (ECB, EBA) are likely to increase pressure on banks to develop and enhance measures to mitigate ESG risks.*

Regulators like the European Central Bank (ECB) and the European Banking Authority (EBA) are expected to maintain or even intensify pressure on banks to enhance ESG risk measures. Though indirectly influenced by political ambitions, regulators are likely to maintain their stance on climate-related and environmental risks. For example, the oversight of adherence to the ECB guidelines on climate-related and environmental risks indicates that the ECB's approach remains steadfast, independent of political dynamics, and is unlikely to reverse. In fact, the ECB has been intensifying its ESG-related monitoring, including potential fines and sanctions for non-compliance.

1. See The Guardian, *World's top climate scientists expect global heating to blast past 1.5C target*, 2024.
2. See BCG, *Klimapfade 2.0 – Ein Wirtschaftsprogramm für Klima und Zukunft*, 2021.
3. See Climate Policy Initiative, *The Cost of Inaction*, 2024.

Furthermore, ESG-related requirements for banks are expected to expand, with a particular focus on nature following the primary emphasis on climate. A recent ECB study highlighted the reliance of Europe's economy on nature, noting that approximately 75% of all bank loans are issued to companies are highly dependent on ecosystem services[4].

Hence, banks should continue their efforts to meet regulatory requirements set by their regulators to avoid fines and sanctions.

II. Manage ESG risk: Banks are financially motivated to manage their portfolios exposure to transition and physical risks, applying a data-driven and scenario-based approach

Beyond regulatory requirements, banks are fundamentally incentivised to adequately manage transition and physical risks. This includes risk identification, quantification, and mitigation to avoid potential damage to their profit and loss statements.

Transition Risk

A fundamental part of transition risks is driven by the shift from legacy technologies to sustainable alternatives like renewable energy and electric vehicles. While short-term regulatory changes can influence these transitions, they are unlikely to reverse the fundamental trends towards established sustainable technologies. Moreover, it is likely that future developments in climate technologies will increasingly be driven by market dynamics, i.e., investors will decide based on financial business cases where to invest. This might lead to a new level of openness towards various technologies which has not been observed before.

Thus, a differentiated and scenario-based approach by sector and technology is more essential than ever to understand and adequately manage transition risks. This holds true for both mature technologies (e.g., electric vehicles) and emerging technologies such as Carbon Capture, Utilization, and Storage (CCUS) as well as sustainable fuels. A scenario-based differentiation for each sector and technology is critical for understanding and managing the associated risk exposures of each technology.

Physical Risk

Mitigating physical risks to reduce losses from extreme weather events is crucial. The decade leading up to 2019 saw damages from natural disasters exceed US$1.5 trillion, with a further increasing trend in both frequency and severity of extreme weather events[5]. The recent floods across Central Europe proved the vulnerability of businesses and their supply chains to extreme climatic events, underscoring the need for effective physical risk management. Adopting data-driven risk management practices similar to the insurance industry can lead to a more comprehensive and effective management of physical risks.

Developing a comprehensive climate risk management system to evaluate and mitigate both physical and transition risks is key to fostering resilience. This proactive approach ensures that banks can better navigate uncertainties and continue to safeguard their financial interests amidst the growing environmental challenges.

4. See ECB, *The economy and banks need nature to survive*, 2023.
5. See World Meteorological Organization, *The Soaring Cost Of Climate Change*, 2023.

III. Pursue green growth: *Leveraging ESG opportunities – using a rigorous business case approach – enables value for banks independent of political ambition levels.*

Leveraging ESG opportunities allows financial institutions to create value regardless of political ambition levels. Banks can capitalize on continuous ESG growth opportunities for potential top-line growth, as many technological transitions (i.e. renewable energy), now have established business cases independent of public funding.

However, a differentiated business case approach by sector and technology is necessary to identify opportunities that might translate into a positive P&L impact. Our BCG three-step approach to identifying ESG business cases includes:

1 Consolidating ESG business case ideas into a comprehensive long list (BCG long list with more than 50 business cases available)

2 Evaluating long-listed ideas using specific, predefined criteria to identify the most promising opportunities

3 Conducting in-depth analysis of prioritized ESG business cases (including quantification of financial effects and enabling factors)

In addition, existing regulations, such as the Corporate Sustainability Reporting Directive (CSRD), will provide banks with valuable ESG data from clients. This data enables proactive identification and addressing of clients' ESG gaps and opportunities using analytics and automation solutions.

IV. Seize efficiency gains: *Leveraging automation potential of GenAI to build capable systems for efficient and scalable business-as-usual processes*

Maintaining momentum in ESG efforts is essential to preserve progress and prevent high recurring costs due to largely manual and inefficient processes. The urgency of topics such as CSRD and EU taxonomy has led many banks to implement interim solutions. While necessary in the short term, these interim measures often lack the efficiency and scalability needed for long-term business-as-usual operations. This presents an opportunity for banks to enhance and automate these processes with GenAI, ensuring they are not only well-integrated into operations but also cost-effective and resilient.

As more companies become subject to CSRD reporting in the coming years, the ESG data gap will continue to narrow. In fact, the growing availability of data will facilitate the integration of ESG into a bank's business operations and decision-making processes in a more automated and thus more efficient way.

Banks currently lagging behind in their data and technology infrastructure can seize this opportunity to catch up by upgrading their processes and systems, especially while some competitors may be holding back and waiting for the current uncertainty to resolve.

V. Build ESG Talent: *Building a workforce that is knowledgeable and passionate about ESG will drive innovation and ensure long-term success.*

Banks might be hesitant to prioritize investments in developing their internal ESG talent and skills due to concerns about future regulatory developments. However, this period of ambiguity presents a unique window of opportunity for proactive banks to enhance their ESG capabilities and gain a competitive edge.

As technology and sustainability requirements continue to evolve, the demand for sector- and technology-specific expertise is increasing. Integrating ESG profiles into recruitment and talent development programs fosters a corporate culture that embeds ESG as a core component of the bank's target operating model, equipping it to navigate and shape the evolving ESG landscape.

Conclusion

Despite the current political context, ESG should remain a top priority for banks. Many ESG challenges for banks remain unresolved, with further developments anticipated. While some sectors and technologies may face increased risks due to short-term political changes, the green transition – and so Europe's determination to tackle it – is here to stay.

Making "no-regret moves" and decoupling ESG initiatives from short-term political developments, allows banks to ensure resilience and long-term success. However, continuous monitoring of market trends and regulatory change, including upcoming landmark elections, is crucial for adapting strategies effectively.

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Acknowledgments

The authors would like to thank Kristopher Weber and Simon Weber for their contribution to this white paper.

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