EXPLAINER

Four Ways Korean Banks Can Support Carbon Neutrality

The Korean government aims to reduce greenhouse gas emissions by over 40% between 2018 and 2030. Photo credit: KIF. Establish an internal risk management system, implement concrete strategies, enhance governance structure, and strengthen information disclosure.

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Introduction

The Republic of Korea plans to reduce greenhouse gas emissions by over 40% from 2018 to 2030 and become carbon neutral by 2050 in accordance with the 2015 Paris Agreement. To achieve these goals, the government needs to reorganize its climate response system through legislation, establishing and implementing national plans to achieve them, monitoring implementation status, and preparing a system and foundation to promote the transition to a carbon-neutral society and green growth.

To accelerate its efforts to achieve “net zero,” the government enacted the Carbon Neutrality Act to strengthen policy measures to reduce greenhouse gases and adapt to climate change. As required by the law, domestic banks must align their targets and strategies to contribute to this effort.
What is the Carbon Neutrality Act?

In September 2021, the Republic of Korea approved the Framework Act on Carbon Neutrality and Green Growth for Coping with Climate Crisis or the Carbon Neutrality Act. The law aims to prevent serious climate crisis impacts; resolve economic, environmental, and social disparity that may arise during the transition to a carbon neutral society; and foster, promote, and revitalize green technology and green industry for a harmonious development of the economy and environment, thereby improving the quality of life of present and future generations, protecting the ecosystem and climate system, and contributing to the sustainable development of the international community.

How can domestic banks support this Act?

The Carbon Neutrality Act has a provision that urges financial support for climate action. Article 58 of the Act states that the government needs to formulate and implement financial policy measures, including schemes to create financial resources, provide support funds, develop financial instruments, revitalize private investment, strengthen the publication system of information, and reinvigorate trade in the carbon market, for the purpose of coping with climate change, such as the transition to a carbon-neutral society and promotion of green growth. It also mandates the establishment of statutes to promote climate financing.

Establish an internal risk management system

The internal risk management system is needed to measure and control climate change-related transition risks. These might stem from climate mitigation policies, such as carbon neutrality and reduction; technological development; and changes in investors and consumers’ preference and expectations.

A transition toward a low-carbon economy affects the value of loan assets in high-emission areas. As it is, the domestic banks’ corporate lending portfolio is heavily biased toward the high-emission manufacturing sector. In case of a swift transition toward a low-carbon economy, the banks’ lending assets might quickly deteriorate in value. As of end-2019, manufacturers represented roughly 35% of corporate lending, and the 10 largest borrowers mostly overlapped with the 10 largest carbon emitters. Banks must conduct a scenario analysis periodically, include a stress test as part of risk management, and establish a risk governance structure to ensure effective management of transition risks.

Set more concrete net-zero goals and implementation strategy

Financial institutions must measure direct and indirect carbon emissions, including Scope 3, Category 15 emissions, and provide clear reduction targets and implementation plans. According to the GHG Protocol, Scope 3 emission refers to indirect greenhouse gas emitted across the corporate value chain, and Category 15 is specifically for indirect emission caused by financial institutions’ investment activities.
Furthermore, specific goals and plans are needed to provide financial instruments and services for green activities and expand businesses in green finance.

**Strengthen governance structure**

Climate change risk management should be part of banks’ risk governance structure. Currently, major banks are seeking to reshuffle their organizations—for example, by installing a unit dedicated to handling tasks related to climate change and green finance, or organizing an environmental, social, and governance (ESG) committee within the management board. A lack of incentives on the part of the management due to the long-term nature of the goals may require more changes in the governance structure to fully consider the breadth of asset management. To address this, continued monitoring by long-term investors and other stakeholders would be critical.

**Enhance information disclosure**

Banks must get better at disclosing their goals on managing climate risks, carbon neutrality, green finance, and related progress, in response to a growing demand for transparency as they move toward a net-zero business and to curb reputational risks. As it is, the amount and level of disclosed information on these issues vary widely across banks.

Recently, at the COP26 climate talks, the International Financial Reporting Standards announced a plan to establish the International Sustainability Standards Board to align global standards on sustainability disclosure and put together standards according to the Task Force on Climate Related Financial Disclosure—a committee established in 2015 by the Financial Stability Board. It issued a recommendation on disclosing financial information related to climate change, and 2,600 institutions around the world endorsed the recommendation, including approximately 50 public and private institutions in the Republic of Korea. Sustainability disclosure requirements are likely to be strengthened soon.

**Resources**

- Korea Institute of Finance website
- Korea Law Translation Center. **Framework Act on Low Carbon, Green Growth**.
- United Nations Climate Change. **The Paris Agreement**.

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Si-Yeon Lee has been a Research Fellow in the Financial Industry & Institutions Division since 2008. She received her PhD in Economics from the University of California, Berkeley. Her thesis is a study on the value of the premium for corporate control and its dependence on firm-level corporate governance practices. Her research focus is on corporate
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Korea Institute of Finance (KIF)

The Korea Institute of Finance provides expert analysis for the development of the Republic of Korea's financial sector and financial policy.