TRANSITION SCENARIO IMPACTS AND PRIORITIES

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Navigating through uncertainty – climate scenario analysis in the financial sector

What happens when you have a destination but are not sure how to get there? You probably open an app on your phone and let it work out the fastest route. But then you remember you will need to stop to refuel. And to take a break. And so your route needs to adjust accordingly.

With climate change we have our destination – net-zero greenhouse gas emissions by 2050 and temperatures below 1.5°C - but we do not know the exact route yet. We do though know that whatever route - or transition path - we end up facing, the financial sector will have to deal with the consequences and play its part in smoothing the adjustment for the economy.

To do that, firms need to understand how different climate outcomes and different transition pathways will impact their business. That will enable them to identify both risks and opportunities. Scenario analysis is the key tool for making these assessments, helping navigate through uncertainty by considering a range of possible outcomes.

Climate scenario analysis is a core component of the Prudential Regulation Authority's (PRA) supervisory expectations for how banks and insurers should manage the financial risks from climate change. We expect firms to use scenario analysis to inform both strategic planning and risk management. And recognising this is still a relatively new field where some firms may not know where to begin, the Climate Financial Risk Forum – an industry group co-chaired by the PRA and Financial Conduct Authority – has produced a series of freely available practical guides and tools.[1]

Firms are therefore well supported in undertaking such analyses, increasing with sophistication over time. There is a natural temptation to become bogged down in achieving a spurious level of precision over multi-decade horizons. This can be unhelpful and unnecessary for decision-making. Sound qualitative assessments supported by quantitative analysis and reasonable assumptions where there are data gaps can produce insightful results.

Designing the climate scenarios which plot the transmission of the physical and transition risks that arise from climate change into economic and financial risks is fiendishly complicated. The data and methodologies to translate climate outcomes into macroeconomic and financial risks are incomplete and inadequate. And of course the future path of climate risks themselves is subject to huge uncertainty. Reflecting these challenges, the Macrofinancial workstream of the central banks & supervisors Network for Greening the Financial System (NGFS) has launched a project to co-design climate scenarios with a consortium of world leading climate scientists. The latest iteration of these climate scenarios was published last summer.[2] We have learned some valuable lessons along the way.

First, we have a clear picture of where greenhouse gas emissions come from across the economy - so we know what the building blocks of the transition are.

Second, we have learned that the cost to the economy in aggregate of getting to net zero need not be substantial. Our latest economic modelling suggests that reaching net zero might have a small or negligible effect on economic aggregates such as GDP, unemployment and inflation if the transition is managed well - so while we know we need to be prepared for a range of outcomes, we also know that that early action brings lower risks.

Third, even in an orderly transition, the impacts from physical risks are expected to be significant – so we must focus on the race to climate resilience as well as the race to net zero.

That calls for action. At the Bank of England, we are pursuing our own scenario work based on those of the NGFS. In June 2021, we launched the Climate Biennial Exploratory Scenario exercise to assess the resiliency of major UK banks, insurers, and the wider financial system to different climate scenarios. Participating firms have made their submissions and we are in the process of reviewing the results prior to publication by May 2022.

The Bank of England will continue to support the development of climate scenarios and their use across the financial sector, to improve risk management, resiliency, and help navigate the risks and opportunities along the route to net-zero. And by embracing scenario analysis, the financial sector will be better equipped to take the actions that are needed today to reduce the risks of tomorrow.

1. Climate Financial Risk Forum
2. NGFS Phase II Scenarios

LAURENT MIGNON

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Banks ready to seize the opportunity for environmental transition

All economic actors need to transition their carbon-emitting activities, as only "green" or neutral activities will survive. For the real economy, this requests upfront significant investments, beyond any public possible efforts, and a longer-term strategic approach.

Financial players, as reliable and expert partners of Corporates, retail clients and investors, play a key role to advise them and finance their transition, even more effective as their own transition risk is their clients' transition risks.

Public authorities need to provide with the adequate regulatory framework to speed the transition while ensuring a fair transition. European authorities have issued a series of useful texts: a common definition of what is a sustainable activity (Taxonomy regulation), disclosure frameworks to enhance transparency and prevent green washing (CSRD, SFDR…), ESG financial products frameworks (labels, ESG client preferences…) and more recently measures to change the supply and demand equilibrium in different sectors like car selling restrictions or reforestation. Public acceptance is also a major concern. The Commission's initiative to launch a social fund is much welcome to ensure a fair transition.

This is only the beginning. All companies including banks, understand the transition to be a forward-looking way to manage risks, to reduce future costs, ideally undertaken in advance of regulatory/political constraints. It is much more a business opportunity than an economic burden.

Banks' signature of the Net-Zero Banking Alliance bears witness to this commitment.

French banks already entered transition initiatives. For instance, they took commitments to end coal-related and reduce unconventional fossil fuel financings. BPCE is among the first main green bonds global issuers and has been successfully promoting an attractive financing package to ease the energy renovation of condominiums and of households for senior or low-income population.

We need pragmatic tools to go further. We need available and reliable data. Timing differences, lack of consistency between EU regulations, lack of data for non-EU or small activities… are creating a huge issue for companies to fulfill their obligations. They are forced to use proxies and external providers leading to different results.

We also need an instrument to better recognize the transition efforts, as the heterogeneity of the ESG results and practices is undermining the confidence of all stakeholders. Confidence and transparency go hand in hand in this process.

We very much welcome recent developments to better take into account transition (looking at the evolution of the GAR, transitional and enabling activities, green Capex …) but this remains far too complex to explain and understand for non-specialists. It may create confusion and undermine the retail market's trust in sustainable regulations.

Moreover, it keeps not sufficiently promoting the transition efforts that companies undertake, particularly needed for harmful activities: a company might need to invest in a 20 years-project to replace one harmful activity by another. If its commitment is very strong, it is key that the regulatory framework recognizes the harmful activity as being in transition and not shaming it, which would undermine its ability to enter a fair transition by increasing its cost of financing. The idea is to allow profitable activities to finance upskilling and needed infrastructures, to decrease their emissions on the harmful side during this interim period.

**Transition cannot wait.
Banks are totally involved in this
challenge alongside with their clients.**

To effectively redirect capital flows towards the transition, we need first a common methodology to assess the transition plans and communication of our portfolio alignment. We also need a simple and comparable ratio measuring the company's transition plans. This transition ratio would also be reflected in financial products like the green ratio. French banks are looking at using a common methodology, based on international sectorial trajectories to assess the transition of company's activities. A third party would assess these transition plans and produce this Transition Ratio used in all investments like the green ratio.

Transition cannot wait. Public initiatives will be key to ensure a fair transition. Banks are totally involved in this challenge alongside with their clients to find pragmatic and effective solutions.

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Enabling the transition in an imperfect data environment

When the COP26 conference took place in Glasgow in November 2021, there was a strange feeling of déjà vu. The Paris conference in 2015 had laid the foundation for a global commitment to keep rising temperatures in check but the years since were mostly spent on other priorities. And so, Glasgow was an opportunity to re-affirm commitments, to confirm net zero transition goals (with varying timelines) and spell out the pathways to getting there.

From the perspective of the financial sector, the relevance of sustainability and responsible investments has followed a more stable path. We have seen an increasing investor appetite for green and sustainable investment products. Rather than being driven by altruistic motives, financial performance – and indeed financial outperformance - has been a key reason why investors have become attracted to this space. As an example, BNY Mellon research[1] demonstrates that financial outperformance is 21% more likely in gender-diverse companies, and 33% more likely in ethnically diverse firms.

Since 2019 we have also seen a regulatory focus on risks driven by climate change. And on the legislative side, Europe has led the charge requiring transparency through the implementation of the Sustainable Finance Reporting Directive (SFDR) and the introduction of the EU Green Taxonomy which was rolled out earlier in 2022.

The challenge with these requirements has not been the sectors' willingness to embrace and implement the initiatives but rather an incomplete external data landscape. Reporting on investment products and their sustainability credentials, and crucially their principal adverse impacts on other sustainability indicators, is complex in a world where the underlying securities' detailed corporate information is often lacking. We often hear about the need for consistent and comparable scope 3 emission data – data associated with indirect corporate carbon emissions (e.g., business travel by staff), but recent research has shown that many corporates are even failing at making scope 1 & 2 emission data widely available[2]. In that context, the financial services industry is the tail that tries to wag the dog. Our responsibility to investors and regulators requires more transparency around investments in corporates that are not themselves obliged, or able, to be transparent around their own sustainability indicators. In that context, the decision to set up the International Sustainability Standards Board is very welcome – another reason to cheer the outcome of the Glasgow COP26 summit – but it will take some time yet for consistent standards and sufficiently rich sustainability data to become available.

There is however no excuse for our sector to throw their arms up. As corporations, we should explain our own commitments and indicators and lead by example in creating credible transition pathways and indicators. More importantly, we can support the real economy by accompanying their transition plans through financing and servicing of investments, supporting green debt issuance, but also through providing data and analytics capabilities. The goal for the financial industry, which includes both public and private sector stakeholders, is to lead the transition by supporting our clients and the global scale innovation needed to deliver the new technologies required to meet the Paris Agreement goals in a diminishing timeframe.

The focus needs to be on facilitating and accelerating the 'transitioning' process.

In that process, it is important to avoid simply leaving sector and company assets behind, thus creating stranded assets or moving them into the less or even unregulated sector. The focus needs to be on facilitating and accelerating the 'transitioning' process. And in assessing our own portfolios, in risk managing our own assets, we need to be careful not to allow a simple switching out of "brown" assets to "green" assets. In that context, I welcome the Commission's announcement in July 2021 - as part of their renewed sustainable finance strategy - to work on a 'transition taxonomy' that would recognise interim transition efforts by companies. Such an approach should set the standard for other jurisdictions to follow and could prove another key milestone in our joint path to net zero.

[1] https://futurefirstforum.bnymellon.com/pdf/F3-RecapArticle.PDF
[2] https://www.tcfdhub.org/wp-content/uploads/2021/10/PAT_Measuring_Portfolio_Alignment_Technical_Considerations.pdf

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The responsible road to COP27

The end goal of the transition to a net zero world has been committed to by more than 450 financial institutions during COP26 in Glasgow. The financial world directs USD 130 trillion to net zero by 2050. There is no turning back now. The next significant milestone of progress will be reported by COP27 in November of this year. All financial institutions member of GFANZ, are working to further define their existing ESG ambitions and make them concrete, credible and consistent with industry best practices. The world is watching.

Banks' role facilitating transitional pathways

Banks have and will continue to play a crucial role in financing the economy. They also help providing solutions for social issues and can help build a sustainable society where clients can achieve sustainable growth. For banks operating globally, sustainable strategies will have to reflect the interests of all stakeholders; national policy makers, central banks, the industry, regulators as well as the public. Each economy has their own starting point, their own energy mix and their own unique incentives and ability to transition to a net zero world. Most banks support a wide range of companies and industries, including those in areas which are reliant on oil, gas and even coal for the most basic needs of heat, food and shelter. This will not change overnight. The key for these sectors is to become more energy efficient and banks can encourage these efforts by adjusting their individual ESG policies and procedures. However, they must do so in a responsible manner to ensure the energy transition runs a smooth course without unnecessary disruption to the financial system and the real economy.

Policy and Regulatory framework and the transition

Transition Financing has become the key focus of the private sector, but also policymakers and regulators. The EU taxonomy was an important first attempt to draw a clear line between which economic activity is sustainable and which is not, but it is important that we continue to ensure that the regulatory framework remains open to allowing for transitional activities. Regional sectorial pathways will become a key focus across all jurisdictions and we will have a better picture about how credible these pathways will be due to improved reporting, enhanced risk management and more coherent public policy frameworks. And while climate change is a global phenomenon, the dynamic nature of ESG risk and opportunities - and the dynamic nature of the transition - in local markets will need to be taken into consideration when assessing progress of individual financial institutions.

It cannot be said enough; we need all regions on board and we cannot afford to leave anyone behind. We have seen a strong commitment from the financial services industry to find a global policy and regulatory framework for a global problem and we need to prevent fragmentation along jurisdictional lines. At the same time, this ambition does not mean we cannot provide flexibility for local market dynamics, which will need to take into consideration technical innovation in energy efficiency, energy consumption patterns and market dynamics in new energy sectors.

A set of principles for Transition Financing will be essential to facilitate pathways to net zero.

Working together to support the transition

Achieving net zero targets, even with the resources, talent and technology available today, is going to be a tremendous challenge. We need to recognize that an orderly transition to a net zero society requires a huge sum of money reoriented to "hard to abate" sectors, the expectation is that private banks provide the funds to reduce GHG emissions of these sectors (e.g. oil & gas). Societies at large need to work together to explore opportunities for new energy solutions and the financial sector remains key to provide financing for the transition. In the context of the Net Zero Banking Alliance, our bank is leading the work to put together transition finance principlwit which form the global baseline for steering a responsible road to decarbonized banking, allowing for a credible framework on the road to Sharm El Sheih.