TRANSITION PATHWAYS: DEFINITION AND ADOPTION CHALLENGES

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Transition is urgent

This chart from the World Energy Outlook 2021 (WEO 2021) of the International Energy Agency (IEA) shows that transition must take place rapidly.
And should be financed. The sooner, the better.

If we continue to procrastinate, it will be more costly.

CO2 EMISSIONS IN THE WEO-2021 SCENARIOS, 2000-2050
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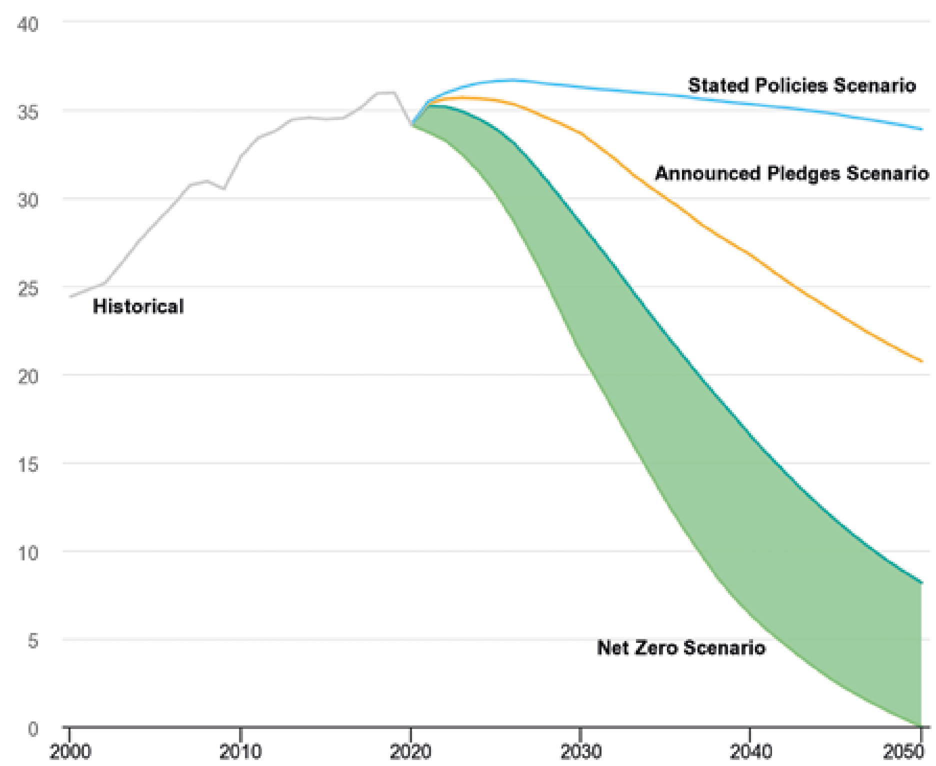

Source : Scenario trajectories and temperature outcomes – World Energy Outlook 2021 – Analysis - IEA

SACHA SADAN

Director of ESG - Financial Conduct Authority (FCA)

From long-term targets to decarbonising the economy

The FCA is committed to supporting the financial sector to enable an economy-wide transition to net zero. Achieving an orderly transition depends on the combined efforts of government, industry, regulators, and individuals. The first stage of any organisation's transition journey is defining ambition and long-term targets. Last year, COP26 catalysed unprecedented long-term net zero commitments from the private sector, including over 5,000 businesses and 450 financial firms.

Commitments are nice but immediate actions are needed. The Network for Greening the Financial System (NGFS) work to build analytically robust transition scenarios has been vital here, as has that of Glasgow Financial Alliance for Net Zero (GFANZ), Transition Pathway Initiative (TPI) and others on sectoral transition pathways. However, building a robust transition strategy is still far from straightforward. A complex web of assumptions, relating to future developments in policy, technology, and science, need to inform any transition strategy. Firms are also having to respond to a seemingly constant flow of global socio-economic shocks: nobody foresaw the global pandemic, war in Europe and a cost-of-living crisis. This underlines the importance of focusing on short-term actions, targets, and milestones, for which existing management will ultimately oversee and be accountable.

But we must take care when shifting from setting long-term targets to developing strategies. Firms' transition strategies should include – but stretch beyond – plans to meet their net zero target. There are three key reasons for this.

First, a focus on decarbonisation of assets and portfolios risks unintended consequences. Firms could divest carbon-intensive investments, selling them to private, unaccountable owners with little incentive to transition investment towards net zero. We must not mistake the greening of portfolios for the greening of the economy. Transition strategies need to focus on active stewardship towards decarbonisation, including through financing responsible phase-out of emissions-intensive assets.

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Second, the emissions profile of a company is not always a robust proxy for financial risk. Let me illustrate with two examples. On the one hand, a software provider might have a low emissions profile, but rely on offering a product that supports oil exploration. On the other, a mining company might have a high emissions profile, but focus on mining lithium to create batteries that power electric vehicles. In both cases a focus on entity-level carbon emissions misses the bigger picture.

Third, the climate transition is a unique, long-term systemic risk. Firms can act today to use their sphere of influence to shape the actions of their workers, policymakers, customers, and communities to accelerate an orderly transition, build strategic resilience and ultimately strengthen long-term corporate value. It is here that low-emitting sectors like the services sector, which makes up approximately 80% of UK GDP, can most effectively contribute to the transition.

So where does the FCA fit in? Last year, we released our ESG Strategy, including new work to support a market-led transition to net zero. Our primary focus is on promoting transparency so investors, clients and consumers can assess transition plans and make effective decisions in response. Last December we set out initial expectations on disclosure of transition plans by listed companies, asset managers and regulated asset owners in accordance with TCFD guidance. But this is not about tick-box compliance. Disclosure should also drive behaviour change in how preparers develop their transition strategies.

The UK Government has now convened a Transition Plan Taskforce (TPT) to develop a gold standard framework for transition plans. My team and I are active participants and will draw on the outputs to develop our regulatory expectations and align internationally. We will also road-test the TPT's outputs with industry, to identify challenges for preparers and assess whether outputs support investor decision-making and stewardship. Another focus is on promoting complementarity between the Taskforce's work and related international initiatives. This includes guidance developed by GFANZ and the ISSB's climate-related disclosure standard. On ISSB, our domestic work on transition plans could demonstrate how the ISSB's vision for a building blocks approach to sustainability reporting can work in practice. We remain a strong supporter of the ISSB's work to create a global baseline of sustainability disclosures, as expressed in our recent response to their exposure drafts.

Last year saw the financial sector step up by setting net zero targets. Our focus – as policymakers, standard-setters, and industry – is now on building a suite of tools that enable firms to develop and disclose robust transition plans, actions, and strategies. These tools need an unwavering focus on driving decarbonisation of the economy. That is the North Star we must all follow.

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Financial institutions' climate transition plans: transparency is vital

Climate transition plans of financial institutions (FI) reflect the highly complex nature and the broad and multi-faceted exposure of FIs to a wide range of economic activities. Consequently, communications on transition strategy cannot be made simplistically in a few bullet points and performance goals. Moreover, such communication from FIs is often dispersed over many different documents, made public at different points in time and for a range of purposes.

Financial institutions could further improve their climate transition communications by being more comprehensive on all relevant parameters for each specific target: scope, time frame, accountability metric and starting level. Currently, such parameters are not provided in a systematic way with key information often left out. All information about the company-wide climate transition plan should be available in one place, easily accessible and up to date on all active key climate action metrics. Improvements are also needed in terms of clarity and visibility: understanding a FI's transition plan can be like putting together the pieces of a jigsaw. A clear mapping of current and scheduled climate actions – according to a clear roadmap – against whole company activities would be most helpful.

Without transparency and universally available data, certain issues would risk remaining unaddressed and unmanaged. Well-coordinated rules across the entire data value chain are needed to ultimately attain these goals because FIs need to rely on the climate data of their customers, investees, lenders, creditors etc. for incorporating into their own disclosures. To date, the biggest obstacles to FIs' action on climate change are limited availability and access to such data, followed by data quality, reliability, and comparability. Regulation should also address the format in which data are made available: more standardized digital formats should facilitate the collection and comparability of data on a much larger scale than is presently feasible.

No regulatory requirements have been imposed to date apart from disclosure, but the power of transparency is not to be underestimated. Well-designed reporting rules implicitly carry multiple related requirements: data systems must be in place, and data collection must be embedded in the various business processes.
Reporting may also be a catalyst for positive (side)effects: awareness about climate-impact and related risks will be raised across many functions and levels within the organisation as well as outside (including customers). This will contribute to shifting business models and corporate culture towards sustainability, enabling the right priorities of actions to be set and identifying challenges in execution.

Transparency also allows engagement with other stakeholders. Constructive dialogue is crucial to push an organisation to the next level.

It is not always possible to compare FIs' transition pathways to the national pathways of the different countries in which they operate. Countries' climate transition plans must reflect local fiscal, regulatory and political positioning on climate. Local FIs' activities are linked to the national pathways, however for international FI's there is no direct link to a single country.

Net zero-aligned firms are committed to transitioning investment and business portfolios to net zero (NZ). As such, NZ initiatives have a complementary role to regulatory rules, closing gaps to achieve a common approach and defining self-imposed requirements. NZ initiative signatories emulate good practices while regulators can observe in an applied setting what is possible, what works, and which challenges exist, ahead of introducing industry-wide regulation.

To make overall transition plans mandatory for FIs may be counterproductive. This is because such plans are generally very broad, staggered, and long-term, which means a mandatory approach to implementation could well cause delays until a full plan is ready and in place. However, mandatory steps on relevant specific aspects, with the potential to trigger other elements (such as mandatory reporting), could be necessary to drive the transition.

For example, the focus on climate-related risks could justify mandatory stress testing. Stress tests carried out by the ECB show that banks should sharpen their focus on climate risk. Regulators could also focus on other areas for mandatory requirements, such as the share of investments in climate solutions or the exposure to activities classified as significantly harmful, as suggested in the draft proposal for the taxonomy extension by the Platform on Sustainable Finance.

MELISSA OCAMPO

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Supporting a just and urgent transition through regulatory collaboration

Considering the recent extreme weather events on multiple continents and the threat to economic and political security posed by soaring energy costs and supply challenges, the case for an urgent and just low-carbon transition has never been clearer. Fortunately, there is broad alignment between banks and regulators; both have a strong incentive to reduce the multiple risks posed by a disorderly transition and to create an environment conducive to directing capital toward activities with the greatest likelihood of helping our society to undergo this fundamental transformation. To benefit from these aligned incentives, we must collaborate closely to find mutually effective solutions.

SMBC Group has set an ambition to be a leader in the low carbon transition. Building on our strong roots as a leading project financier, we are aiming to grow our already market-leading stake in renewable energy projects. SMBC is also building our credentials in new energies, supporting innovative EU projects such as the world's largest green hydrogen power plant, part of a unique baseload solar project in French Guiana called CEOG Hydrogen. SMBC believes green hydrogen will play an important role in energy storage and in unlocking heavy industry decarbonisation.

Through actions such as SMBC Group's recently announced strategic alliance with Marathon Capital, a leader in ESG advisory, and hiring our own in-house decarbonisation advisors, we will support our clients in the EU with their transition through both cutting edge expertise and financing. SMBC is already working with EU clients in diverse industries to understand their transition plans as we work toward achieving Net Zero financed emissions by 2050.

In client conversations, SMBC observe a range of practices, from very advanced firms that have clear, science-based targets, robust governance, and detailed plans to those organisations that are earlier on their transition journeys, due to several factors, such as a lack of availability of technical options or the need to support local economic development in non-OECD countries. SMBC recognises the need to be able to flexibly support a variety of client needs. From a regulatory perspective, we believe that this uneven transition maturity across regions and sectors should be a key consideration when considering the scope of disclosure requirements.

Common principles will be key to ensuring comparability and more time spent on decarbonization.

Recent detailed guidance and focus from regulators is a welcome development, to ensure consistency and comparability across sectors. Along with our industry peers, SMBC is reviewing the European Financial Reporting Advisory Group's recent draft EU Sustainability Reporting Standards (ESRS) to understand expectations and impacts to our business and our clients, alongside the Corporate Sustainability Reporting Directive (CSRD). We welcome the leading role that the EU is taking to develop sustainability reporting standards, and considering the need for more sustainability data across the board from both financial institutions and corporates, it is right that policymakers show urgency in developing these frameworks

Of course, given SMBC's global footprint, ESRS and CSRD are among several recent proposals related to Sustainability disclosure that we are reviewing, which includes the International Sustainability Standards Board's reporting standards. Considering the priority regulators are giving this important topic, harmonisation of standards to drive consistent and compatible frameworks internationally will be welcome.

We are supportive of efforts by the ISSB to develop a global baseline for sustainability reporting standards, and would encourage others in the industry and regulators to engage in this process to foster closer alignment on these standards both within the EU and globally. Especially for banks in the EU with a parent in Asia, having standards that begin to coalesce around a common set of principles and reporting approaches will be key to ensuring comparability as well as more time spent on client decarbonisation and less on interpreting competing standards.

SMBC believes that comparability of performance is important in building trust, so that investors have confidence in the green credentials of the banking industry in the context of both the urgent climate emergency and energy crisis that we face. SMBC has an ambition to be a leading green financing provider in the EU, so we are conscious of supporting transactions that are consistent with that vision and build the trust of our clients.

There is much work to be done, and SMBC EU is keen to actively support this work. As new technology and data becomes available, transition pathways will have to adapt. SMBC also welcomes the availability of more green projects in the near future, given that there is presently more green capital than demand, and we look forward to participating in nimble cooperation with regulators & peer lenders to manage the risks and opportunities presented by the low-carbon transition.

SINTHUJA YOGARAJAH
ESG Integration, Responsibility Platform - Federated Hermes Limited

Transition pathways: the critical role of stewardship in the journey to Net Zero

Although climate change action needs to be significantly increased on a global basis to achieve the goals of the Paris Agreement, the years since its entry into force have already sparked action with more and more countries, regions, cities and companies are establishing net zero targets.

At Federated Hermes Limited, we believe that the investment management industry – working with asset owner clients– could and should be a potent force alongside governments in making a climate-resilient world a reality. The financial industry sits in a unique position, where its actions could continue to compound the climate issues we collectively face, and in doing so undermine its fiduciary obligations to clients, or it could instead use intelligent and considered stewardship of capital to effect genuine and positive change in fulfilment of these obligations.

We have a responsibility as an industry, and indeed as a business, to make the right choices and play our part in delivering the goal of the Paris Agreement: an outcome that is fundamentally in the long-term financial interests of our clients.

Unchecked, we believe that climate change represents a systemic risk to financial markets, the global economy and our ability to create sustainable wealth for our clients and their investors. Of particular concern to us is the possibility that even if transition risk is managed within our portfolios of investments, unmanaged physical risk could still destroy value through business operations or supply chain interruption caused by factors outside the control of our investee companies. This also presents an unprecedented growth opportunity with low carbon sectors expected to grow by several multiples leading to value pools of $9-12 trillion of yearly revenues by 2030 (McKinsey, 2022).

We believe that financial markets are only as sustainable and 'Paris-aligned' as the real economy they serve, and that recently strengthened government pledges on climate action must be complemented with sufficiently strengthened real world policy measures and corporate action, alongside the actions of individuals, communities, philanthropic and civil society organisations to accelerate change. Based on current government policies, overshooting 1.5C is "almost inevitable," and we could still see a temperature rise of 2.7° to 3° C according to the latest IPCC Report. As a result, we believe governments should mandate transition plans to support stewardship and engagement efforts of investors and improve the quality and comparability of what is currently reported on a voluntary basis. New measurement approaches to assess real economy impact will also be required.

Financial markets are only as 'Paris-aligned' as the real economy they serve.

We recognise that companies, regardless of sector, industry and the location they are in, need to understand and plan to manage the potential physical risks to their operations and supply chains that arise from a changing climate. Companies also need to undertake climate transition risk assessments. These are needed to understand what operational and business risks – and also opportunities – may arise from a progressively tightening climate policy environment capable of shifting global markets onto a sustainable footing that is aligned with what scientific experts in the IPCC say is needed to stay within the 1.5°C temperature limit. It is also critical that social considerations are factored into their climate change mitigation plans (including impacts on workers, communities, supply chains and consumers) to ensure a just transition. For example, social and economic considerations present tensions, trade-offs, or constraints that must be considered and addressed in a holistic response that works for both planet and people?

The pathways ahead for investee companies are varied and uncertain, especially in the multiple jurisdictions where climate policies are absent or in early stages of development and where technology just doesn't exist to allow certain industries to move away from their current practices. Investment in the shift to a low-carbon world is about six times lower than it needs to be. Hence, it is key that we continue to invest in the transition and as a global economy help fund the development of new clean technology.

We know that success in the endeavour to achieve a net zero carbon global economy by 2050 will require a far-reaching transformation where coordinated efforts between investors, corporates and governments will be integral.

ANGUS GRAHAM

Sustainability Chief Financial Officer - UBS

The financial sector needs to partner with its clients to deliver net zero

Momentum behind net zero is rapidly reaching critical mass. The financial sector has a powerful influence on the global economy. This is why partnering with clients, providing them with the choice they need to meet their sustainability objectives to help them mobilise their capital toward a more sustainable world and thereby facilitate an orderly transition towards net zero is so vital.

UBS fully recognises the crucial role finance must play. We are organising ourselves to finance the transition, scaling up private capital flows towards a 'net-zero', low carbon economy. Addressing climate change also presents an important opportunity for the financial sector to play a key part in building modern infrastructure for the post-industrial age.

Sustainability means thinking and acting with the long term in mind. We have an obligation to our clients, shareholders, and employees to apply a long-term lens, and we also have a responsibility to those communities in which we operate across the world.

This is why we have put sustainability at the heart of our own business too, with a climate roadmap that takes us from commitment to action, setting out key milestones to deliver on our net zero commitments by 2050, including reducing absolute financed emissions associated with UBS loans to fossil fuel companies by 71% by 2030 and engaging with our main vendors about moving toward net zero emissions by 2035.

The credibility of net zero transition plans - turning commitments into action - can only be assured if we have harmonised science-based metrics and targets which measure where we are, where we need to be, across supply chains, and ensure consistent and collective efforts to prevent global heating from exceeding more than 1.5 degrees above pre-industrial levels.

A global and standardised approach towards measuring and reporting financed emissions will also provide financial sector firms with insights into their portfolios' carbon footprints and the extent to which they are aligned with global net zero climate goals.

It's essential to provide clients with the choice they need to meet their sustainability objectives.

Active ownership by investors can also contribute to the long-term sustainability and success of companies and the markets in which they operate. Effective stewardship, informed at least in part by portfolio alignment assessments, can foster healthy dialogue and enhance performance on a variety of environmental, social and governance issues by monitoring and, where necessary, influencing corporate conduct on matters that affect the long-term value of investee companies. We believe that by working directly with companies on realising sustainability improvements through stewardship and driving positive corporate changes it will lead to better informed investment decisions that help to deliver transition, while positively impacting the company's business performance and generating benefits for the environment and society as a whole.

The alternative - divestment - is not a panacea, at least in the short term. Doing so risks pushing carbon-intensive industries towards alternative sources of capital that may be outside the regulatory purview.

If the world today is sustainable and carbon intensive or green and brown, then we need to turn the brown part green by engaging with it not divesting it. Divesting from entire sectors or simply passing carbon-intensive assets from public markets to private markets will not make the world greener.

It is important to recognise that transition requires time. Changing from one state or condition to another needs to be appropriately sequenced, however this not indefinite. With a clear timeline and end point divestment may be considered a last resort if companies fail to improve.

The cost-of-living crisis in Europe, and its global reverberations, further highlights the importance of a 'just transition' towards a climate-neutral economy, leaving no one behind. In particular, the energy crisis, driven by the war in Ukraine, has underlined the need, now more than ever, to accelerate plans to transition towards renewable energy while at the same time delivering energy security.

All of this needs public support and so, in addition to the pivotal role of finance, the real economy is also central to our collective efforts to reduce the impact of climate change. Governments individually and collectively, also have a significant role to play in designing economy-wide policy frameworks that incentivise companies to re-engineer their production processes while providing the certainty which finance needs to make the necessary investments.