Transition pathways: definition and adoption challenges

1. For the financial sector the priority now is to focus on translating long-term commitments into near-term strategy by defining transition plans

A Central Bank representative stated that the panel will focus on how to decarbonise given the situation has been left very late and since the start of the war has only been worsening. The financial industry has a role to play and all parties need to be committed.

1.1 Turning individual targets into actions, reducing transition and reputation risk, and providing system-wide transition perspectives are among the many objectives of transition planning

A Central Bank representative asked the panel to comment on how the Network for Greening the Financial System (NGFS) sees the transition question. A Central Bank official explained that the NGFS is an opportunity for supervisors and central banks to join forces across the globe to answer the big questions that pose reputational risks to institutions. The stress testing indicated that banks and insurance companies require a better understanding of how to translate long-term commitments into near-term strategy and develop a system-wide perspective by combining transition plans. The NGFS would focus on how supervisors should approach this question.

A regulator highlighted the need to focus on what the finance community will do next with the commitments made at COP26 as well as how to prepare transition plans and turn those into actions. An industry representative highlighted that asset owners are more interested in whether funds are aligned with the 1.5° transition target. Investors' engagement with companies is focused on how businesses will transform to achieve targets and how portfolio risk can materialise into financial risk. Better disclosure is required to assess exposure to climate risk within institutions, sectors and countries.

1.2 Transition planning enables financial institutions to combine supporting existing customers and developing green financings with reduced reputation risk

An industry representative highlighted that reputational risks from climate change are multifaceted and trust could be eroded if shareholders do not feel that adequate action is being taken quickly enough by organisations. Banks are taking a two-pronged approach to the transition strategy by growing the customer base for the future and working to support existing clients to transition. It is important to have a clear transition plan because any reputational risk could harm the organisation's reputation as an employer. An industry representative highlighted that the risk is currently existential, but it is important to fix interim targets so it is clear there is a pathway to the 2050 net zero target.

2. Transition planning success factors

2.1 Useful transition plans require a general effort based on improved data and credible and comparable disclosures

A Central Bank representative queried whether there is a demand for action from both shareholders and staff. An industry representative emphasised the need for more data and improved disclosure alongside a mandated transition pathway. Only a small proportion of companies are reporting on Scope 3 and the data is needed to determine how quickly the 1.5° can be achieved.

An industry representative agreed that data remains a big challenge. Their organisation had already disclosed four net zero pathways, but due to the lack of an underlying framework this was based on many assumptions. The market will respect organisations putting forward best effort basis work to keep driving the transitions forward. A regulator agreed that industry will require 'safe harbour' and to understand that companies will have to provide a best effort of Scope 3, outlining their plan to obtain more accurate data. The industry would need to provide help to businesses to achieve this, in particular looking at the entire investment chain to ensure that the standards are real and green products can be trusted. While the pension funds want to achieve net zero they do not have the data and so do not know how to achieve this.

An industry representative highlighted that sustainability disclosures are at a different level to financial disclosures in that they are negatively assured whereas financial disclosures are positively assured. This meant that their organisation was spending a lot of time on integrating the reporting, and this would also require a framework so the auditor could assure and produce audit opinions. This would be solved by organisations providing further disclosure on how these things were calculated. A Central Bank representative agreed that the word 'humility' was important because everyone wanted to produce models that were as perfect as possible, but in this case industry could not afford to wait.

2.2 The transition plans of financial institutions must be consistent with those of their customers

An industry representative explained that UBS's pathway is about Scope 3 and that the financed emissions side will require UBS to work with its customers, introducing a critical need for stewardship. This would introduce a time-lag on disclosure as UBS would be waiting for clients to disclose their numbers. It will be important to pay attention to the granularity of disclosures to ensure that the underlying multinational could not be identified and to ensure that clients were comfortable with the disclosures made. Hopefully regulators will provide the industry with some 'wiggle room'.

2.3 The definition of consistent sectoral base lines is also essential

An industry representative highlighted fundamental issues relating to the ability to base line the pathway. The volatility meant that a pathway would look different if it was baselined from 2019 or 2021. There are other disclosures besides gross carbon being released into the atmosphere and these needed to be aligned across sectors. The pathway is demonstrated by a shrinking return meaning that the market is struggling to tease out the positive side of the equation and more is needed on the opportunity side.

An industry representative noted that the sector perspective is important to look at the materiality of pathways and indicators to find common ground, allowing for sector specifics when it comes to pathways. An industry representative stated that different sectors would decarbonise at different rates, and this should be considered when conducting transition planning. Regulation is needed to standardise ESG ratings from an understanding perspective but cannot be used as a way of making investment decisions.

2.4 Carbon pricing is a necessary tool to create appropriate incentives

A Central Bank representative asked whether the adoption of carbon pricing could be recommended and would allow a comparison with other countries. A regulator stated that the best solution would be to have a global price on carbon to ensure a wide reach, given that carbon pricing is important for creating incentives.

3. Regulators at the global level are expected to play an important role in improving information regarding transition plans

3.1 It is advisable to combine micro and macro approaches

A regulator highlighted the urgent need for a holistic approach and standardisation to be applied to transition planning, which will include both micro and macro aspects. The regulators should ensure that initiatives are consistent and comparable with common approaches to transition planning. GFANZ was an excellent example to build on from a policy perspective. The industry was confirming the need for standardisation. The Corporate Sustainability Reporting Directive (CSRD) does not set out the metrics and targets required in a transition plan, and this piece of work would need to be complemented on the opportunities side. The transition plans are incentivising the dialogue with the corporates. An industry representative stated that there is a need to understand what metrics could be developed to ensure that investors can compare the transition plans.

3.2 The definition of a disclosure framework should follow the definition of a transition planning framework

A Central Bank official highlighted the need to distinguish between a transition plan and its disclosure. It is difficult to disclose a forward-looking plan without the right metrics. It is tricky to determine the right metrics to illustrate what is intended and it is important to clarify that we want to see plans, not perfect metrics. A more harmonised way of communicating the plans would be developed, but discussing disclosure before agreeing what should be in the plans will mean a missed opportunity to move businesses forward.

3.3 The standardisation should be driven at the global level

An industry representative agreed with the need to achieve global consistency and standardisation. Interoperability across the globe and disclosure can help through the transition period, as a pathway to defend against greenwashing. Their organisation's sustainability report is already 174 pages with 185 different metrics, and this could get out of control if we do not focus on the common denominator. A Central Bank representative that there is a need for standardisation to ensure progress on ESG efforts is achieved and to counter those who deny climate change. A regulator agreed that an authority could struggle with this backlash. Creating different standards in different jurisdictions would hinder the comparability and create hurdles, so there is a strong incentive to strive for interoperability by building on the global baseline provided by the International Sustainability Standards Board (ISSB) . A Central Bank representative expressed a wish to achieve global standard while recognising the values behind those standards.

3.4 Better is the enemy of good

A regulator representative agreed that the ISSB would assist with the task of gaining more data, but it was important not to wait for perfect data and use that as an excuse not to make progress on transition planning. The UK is preparing a template that could be used internationally and would focus on real actions. The industry would be invited to provide feedback on what they did and did not like. An industry speaker agreed there could be a backlash in certain markets and that is where stewardship and clear objectives around engagement would play a key role. It is necessary to engage with companies that are not already transitioning, bringing in financial materiality to demonstrate that it does not make business sense not to take climate risk into account and then building on that.

An industry representative counselled against letting perfection be the enemy of the good. It is important to achieve in areas where there is already agreement and hope the other parts will come together over time. A Central Bank representative stated that it was important to not give up on global standardisation but to understand that there would be difficulties.

3.5 Cooperation, consensus making and adaptability are key success factors to achieve transition planning standards at the global level

A Central Bank official expressed that global efforts can work if everyone is building the same understanding of what needs to be done and was less worried about the divergence of standards. The NGFS was gathering all supervisors to hold a collective discussion about what parts of transition plans should be standardised and this process should build a collective mindset and reduce the risk of fragmentation.

An industry representative noted that their organisation could struggle with balancing the regulator and stakeholder expectations in the different markets. It is important to achieve the best out of the different initiatives, such as the double materiality view in the EU and Partnership for Carbon Accounting Financials (PCAF), and not let the perfect be the enemy of the good. It is important to have realistic expectations when everyone is starting the journey from different points and not expect a client in Sub-Saharan Africa to be in the same position as a client in France.

A regulator reflected that although there are global solutions it is not one-size-fits-all. The good cooperation globally between regulatory organisations is supporting the work.

An industry representative highlighted that industry collaborations are important because credibility can be established through consistency and gaps in the market can be spotted. An industry representative stated that it is important to communicate to SME companies why sufficient disclosure is required, so there is more sensitivity and improved disclosure going forward.

A Central Bank representative noted that one strategy employed by the European Parliament was to give SMEs more time to adapt as well as requirements proportionate to their size. However, many companies felt forced to produce sophisticated Scope 3 data as this is required by their larger clients. An industry representative agreed that SMEs require more time and have fewer resources to dedicate. A Central Bank representative noted that there is no more time to be given even to SMEs.

4. Expanding the data available and improving its quality requires a pragmatic and persistent process

An industry representative explained that the market has created the ESG data provider space and companies are often giving estimated or model data from these providers. The estimated data is also being used as a tool for engagement, encouraging organisations to figure out the correct number. An industry representative noted the importance that conversations would lead to a process of companies understanding why the data is needed. An industry participant suggested that one way to move forward is to introduce the PCAF methodology which includes the concept of a quality score that was based on an industry group and could be obtained direct from the company. It was agreed by another industry representative that the quality of disclosure is important, but this should relate to the real-world impact which is harder to solve if it is not clear whether you are decarbonising from 10,000 tonnes or 100,000 tonnes.

A regulator noted that the providers in this area will likely expand to offer Scope 3 data positions. It is important to help big industries that require carbon offsetting as well as engaging with companies that have no carbon emissions but a large influence and the ability to do something positive. It is important that some kind of standardisation is achieved this year and not hampered by fragmentation.

5. Competition is a key driver for developing efficient transition pathways

A Central Bank representative asked the panel whether competition can be used to push companies to improve without obliging them to disclose vital information that could break competition rules. A regulator stated that regulators will need help to devise a code of standards, but that conflicts of interest and transparency requirements are part of the chain. An industry participant noted that competition is a key driver of pathways to protect against greenwashing and that innovation and entrepreneurial spirit were required for the banking industry to succeed on this journey.

A regulator stated that the regulator will not expect everyone to have the same rating on the company but that there should be transparency about where corporates might fund rating agencies. An industry participant agreed that transparency is vital. Another industry representative highlighted that ratings were powerful and would drive disclosure and behaviour. Everyone would want to be at the top of the league table and this would be achieved via methodologies, so changes in methodologies could have a big impact. The industry representative suggested there will be a move away from ratings to the use of raw data by investment managers rather than relying on methodologies.

5.1 The provision of other ESG dimensions should improve the holistic understanding of corporates' performance

An industry participant highlighted the need to consider other standards, such as methane emissions or water waste. Some will be reliant on harmful sectors and there needs to be a just transition for all.

5.2 What is needed to go beyond a mere ESG rating and look at whether specific decarbonisation pathways are fitted to the various business models

A Central Bank official noted that measurement should not become the achievement because it is about decarbonisation pathways and plans rather than ESG ratings. A pathway should not over-favour certain technologies and prevent innovation. Non-financial corporates are not facing the same problems and they need to understand what their business model looks like in a net zero world. Financial corporates are focusing on how to transition their clients to their end points. A Central Bank representative noted that the panel discussion has confirmed that there is not so much difference between the views of public authorities and those committed to the business. In creating a community that is working together there is a reason to remain optimistic.