TRANSITION OF FINANCIAL ACTIVITIES TOWARDS NET ZERO

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Leading a global transition in finance

The case to accelerate a transition to a low-greenhouse gas economy has never been stronger. But climate change is a global issue that requires global solutions. Policies must be developed in a way that works for both the finance sector and the real economy; that works at home and around the world; and that bridges the goals of tomorrow with the realities of today. Within that global, cohesive approach there is opportunity for the UK and European partners to show leadership on sustainable finance.

Transition plans

Central to ensuring the finance sector and economies can move from where we are today, to where we need to be to reach Net Zero by 2050 is planning for that transition. Transition plans are how firms, both in the financial sector and across the whole economy, set out how they will adapt as the world transitions towards a low carbon economy. This includes actionable steps to meet the commitments firms have made.

Transition plans, and their disclosure, are critical in joining up the strong regulatory and international work on sustainability disclosures and the strong private sector leadership on net zero commitments, ensuring these pledges turn into real action. Championed by the UK and established in 2021 at COP 26, the Glasgow Financial Alliance for Net Zero (GFANZ) – a voluntary initiative made up of financial firms with global assets of $130 trillion – has been clear in its 'Call to Action' that policy makers should set a target for implementing mandatory net zero transition plans.

Some building blocks for this call and leadership are already in place. Globally, almost 8500 companies and over 550 financial institutions have committed to the UN's non-state actor initiative. To develop a 'gold standard' in how firms plan for the transition, HM Treasury established the Transition Plan Taskforce (TPT) in April 2022. The TPT's mandate is to bring together industry, academic, and regulatory leaders to develop this gold standard – for both financial firms and the real economy. The TPT will issue its final Disclosure Framework in October this year, setting out this good practice for credible transition plans, to support the global efforts towards the Paris Agreement.

International standards

A key to the framework's design, and achievement of the Net Zero goal, is global interoperability. The TPT's Disclosure Framework builds on the International Sustainability Standards Board's (ISSB) recently published final climate-related disclosure standard (IFRS S2), their definition of a climate-related transition plan, and a wider set of concepts and definitions in the IFRS S1 - their general sustainability requirements standard. The UK Government welcomes the ISSB's inaugural standards, endorsed by IOSCO, as a necessary new voice to the conversation surrounding transition plans and the ISSB as a key actor in progressing interoperable transition plan standards and mandatory disclosure requirements.

Alongside this join-up with the ISSB, the TPT's work further addresses this need for international cohesiveness, drawing on the five transition planning components of foundations, implementation strategy, engagement strategy, metrics and targets, and governance identified by GFANZ to solidify the link of the outputs of these two initiatives. Therefore, whilst the TPT's framework is drawn on in the UK, this link with ISSB and GFANZ will ensure it has global applicability and can be used worldwide for an internationally consistent approach to transition planning.

To create global momentum in transition planning and disclosure, the creation and adoption of international norms needs to be at the core of approach. Without these, comparability and consistency cannot occur and reporting costs for firms will be higher. Positively, there is a growing global momentum around transition plans in the private sector. However, there is still a way to go to ensure private sector targets and pledges on net zero are realised.

Looking ahead

The UK is taking action to contribute to developing this global approach. Beyond our establishment of TPT and support of GFANZ and the ISSB, the Government committed in Mobilising Green Investment - 2023 Green Finance Strategy (March, 2023) to consult later this year on the introduction of requirements for the UK's largest companies to disclose their transition plans if they have them. To support the transition, the Government is also commissioning a Transition Finance Market Review to convene market experts to consider what market tools the private sector could provide to ensure there's a scaling of transition focussed capital raising, building on the TPT's work.

The UK Government welcomes the ISSB's inaugural standards, endorsed by IOSCO, as a necessary new voice to the conversation.

Market discipline is important and powerful, and transition planning and disclosure is central to this. Globally we've seen investors drive real change in how seriously firms take climate change over the last few years and there is recognition that getting to Net Zero and achieving our environment targets is not just essential to tackling climate change and biodiversity loss, it is also a huge growth opportunity.

Together, the UK with European and global partners can show real leadership at a critical time.

TAKANORI SAZAKI

Regional Chief Executive Officer for EMEA - MUFG Bank, Ltd.

We need financing to go where the emissions are

Whether it is the stick in the form of the EU Taxonomy or the carrot in the form of the Inflation Reduction Act in the US, the Net Zero Industry Act in the EU or GX strategy announced in Japan, on the road to net zero we will need both the carrot and the stick to ensure sufficient capital is directed towards what the financial sector refer as 'transition finance'[1].

We welcome the recently announced intention by the European Commission to further define transition finance in the EU framework. Enabling large financial institutions to provide transition finance presents a tremendous business opportunity, resulting from thorough assessments of where climate risk is located in our economies and on our balance sheets. The financial risk resulting from climate change is real, but the success of the financial sectors' mitigation strategy to help reduce this risk will ultimately depend on governments, corporations and financial institutions making adequate and well-informed decisions about how best to deploy capital to transition the entire economy to carbon neutrality. It is possible that deploying transition finance may result in a temporary increase of our 'financed emissions'.

The transition needed to achieve a carbon neutral world is something unprecedented and requires a fundamental transformation of the energy and industrial sectors. It requires a deep understanding of available and credible technologies. It also requires dialogue between policymakers, society and the private sector and for them to come to an agreement about whether current assumptions, methodologies and new technologies available today and in the future will enable us to get to our goal of achieving net zero in a credible, feasible, but also bankable manner.

In Japan, the energy and industrial sectors (glass, cement, steel, paper, chemicals) are responsible for 70% of the emissions. There is often talk about the strong focus of the financial sector on the 'E' in ESG, but if we do not fundamentally reform the global energy system, we will not be able to decarbonize other important sectors that fuel our economies today, resulting in us failing to stay within the 1.5 degree mark. Reducing CO_2 in the energy sector is equally relevant in many other countries across Asia.

Going back to the role of the financial sector, at MUFG, we view providing transition finance as the most sensible approach to mitigate the climate risk on our own balance sheet. We also view it as our responsibility to support the management of the risks associated with the net zero transition as best as we can from today until the point that the world has reached a carbon neutral state. This means engaging with the real-economy and helping our corporate clients to achieve their transition strategies. If we divest, who will help those hard to abate sectors to decarbonize?

Having a transition plan beats no transition plan.

Our efforts and engagement with our clients is essential and we refer to this continuous dialogue as transition planning. Ever since the Glasgow Alliance for Net Zero (GFANZ) published its first Transition Planning Guide in November 2022, many financial institutions have engaged in an intense process of supporting transition planning, with a view to better formulate individual institutions' transition strategy. The considerations, assumptions and strategic decisions resulting from this process will form the institution-specific transition plan. We need to be careful to make a distinction between the process of transition planning and the transition plan itself.

When assessing individual client's plans, the strategic decisions one bank makes about how best to deploy its capital for the purpose of transition finance - and the result the provision of transition finance would have for the reduction of actual emissions in the real economy- should consider financing results as part of the basis of whether a transition plan is credible. In our case, this means a process of respectfully but thoroughly assessing and challenging our clients' transition plans.

Our commitment to supporting the energy sector's decarbonization - especially in Asia - will contribute to our success for supporting real-economy decarbonization. This means the public and private sector will need to focus on financing to transition away from where the emissions are. All of us need to chip in and, to a certain extent, bare the risks of investing in credible new technologies. I believe large banks are committed and feel some responsibility for ensuring their balance sheets move towards carbon neutrality. Before joining GFANZ, most financial institutions did not have a transition plan.

MUFG has worked hard to define our contribution to the world's decarbonization efforts and today we are starting to put our plans into action. The world depends on those with a transition plan and ultimately, having a plan beats no plan at all.

1. *"Financial Institution Net-Zero Transition Plans. Fundamental, recommendations and guidance", Glasgow Financial Alliance for Net Zero, November 2022*

BENOÎT DE LA CHAPELLE BIZOT

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Accelerating the transition to net-zero

Climate change and environmental degradation are an existential threat to the world as remembered by the European Commission when announcing its Green Deal.

The climate challenge requests more than ever a transition and, to be more precise, a fair transition which is much more complicated... This means unprecedented needs, appraised by the European Commission, in her last report 2023 Strategic Foresight Report "the 2023 SFR", up to 1 200€ billion per year of investment to meet the objectives of the *Green Deal* and *RepowerEU*. Considering budgetary constraints of Member states, the largest part of the financing will come from the private sector.

Bankers are key for this transition, as advising their clients and financing the adaptation of their business model. As part of their day-to-day business, they finance assets and technologies contributing to the decarbonation of the economy and instruments accompanying their clients' transition. In addition, they are offering a wide range of ESG financing tools («green loans/bonds", "sustainability-linked bonds" ...) and instruments traded on carbon markets.

However, as a link in the economic chain, banks' transition depends and can only reflect the real level of sustainable economy: banks depend on actors' appetites to enter a transition.

In our view, a successful transition implies realistic planning in consultation with all economic actors both at the EU and national level. Public policies need to clearly define the pace & the scale of the environmental transition and ensure its social and economic viability. Public policies will change consumers' behaviors. Corporates will then be able to design their transition plan accordingly.

In France, the Sustainable Finance Institute (IFD) has started to work on this with all public and private stakeholders. It published a report in May 2023 to provide with a shared diagnostic & pragmatic guidance to support the French transition. It assessed its costs to 30-65 billion a year until 2050, far below current available private savings: money is there but not ESG projects.

IFD pointed out the lack of profitability of ESG projects, especially regarding the energetic renovation of buildings, to attract the private sector. It therefore suggests a series of measure co-supported with public funding to bridge the gap between investors and corporates needs. Obviously, the transition of actors must remain economically viable to happen. For this reason, governments have a key role to play in creating incentives to offset potential short-term loss of profitability at national level.

A successful transition implies realistic planning in consultation with all economic actors.

The same approach should prevail at international level. As stated in the 2023 SFR, the EU represents only 6.9% of greenhouse gas emissions and around 5% of the world population. The importance to ensure that the rest of the work embraces the transition is key but still uncertain. In the interim, EU should ensure fair competitiveness via extended & effective transition adjustments' mechanisms if it wants to avoid a massive industry & linked services' offshoring. Not less important, transition costs will be finally borne by the most fragile population. Regulation will need to ensure inclusion to preserve our democracies.

IFD also stressed the complexity and burdensome character of the current ESG regulatory framework, whether French or European. If Europe wants to reach its sustainable objectives, it needs to move on a more pragmatic and inclusive approach. The ESG framework is yet far too complex and does not consider enough the needs of the concerned stakeholders, i.e., the corporate private sector and particularly SMEs more vulnerable to additional costs. For instance, SFDR and the taxonomy have a different definition for sustainable investment; green activities include transitional, enabling activities, 100% green capex....; priority is given to detailed reporting and not to effective transition itself, not so well recognized yet... A faster transition means a more stable, consistent, readable regulatory framework.

In uncertainty, public authorities need to give stability to actors, meaning:

- Clear, precise, simple, consistent, even imperfect regulations, also suitable for SMEs,
- A measurable and effective transition,
- Public-private economic partnerships and social measures to ensure the transition's acceptability,
- A market tool Framework to ensure data availability, easy transparency, fair competitiveness, and some comparability when calculating transition plan for both corporates and banks. The focus on the ETS system & carbon markets should be expanded,
- Pragmatic and intermediary objectives on prioritized sectors. The fit for 55 package is a good starting point but needs an adjustment with social and economic constraints: the rise in energy price, inflation, worldwide competition, the EU autonomy for critical sectors...

More than ever, the establishment of a clear and common set of regulations involving stakeholders (businesses, the financial sector, consumers, and public authorities) is essential.