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The net-zero nudge

Financial institutions' pivotal role in climate transition planning

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Introduction

How do you meet your greenhouse gas (GHG) emissions reduction targets when less than 1% of the emissions are under your direct control? That's the massive challenge facing financial institutions in the march to net-zero.

In 2015, nearly 200 countries adopted the historic Paris Agreement to reduce global warming and build resilience to climate change, committing to work together to keep temperatures from rising by no more than 1.5 degrees Celsius. That pact set the stage for a 2019 report by the Intergovernmental Panel on Climate Change (IPCC), which concluded that global emissions must peak by 2030 and then fall to net-zero by around 2050 if that goal was to be attained.

Since then, nearly 1,000 companies have issued net-zero pledges, many financial institutions among them.[1] But unlike raw-material manufacturers that generate significant emissions from sources that companies own or control directly (Scope 1 emissions), or other companies that emit considerable emissions indirectly through the energy they purchase (Scope 2), financial institutions' emissions footprint is composed of almost entirely those created by companies they do business with (Scope 3). Those emissions, which represent more than 99% of the industry's GHG emissions,[2] are among the hardest to rein in because they involve emissions that financial institutions finance through loans and investments (i.e., financed emissions) and emissions from activities such as underwriting, securitization, and advisory services (i.e., facilitated emissions).

Financial institutions do, however, have a significant lever to pull in this regard: the power of the purse. As providers of capital, banks, insurers, investment advisers, and private equity and pensions funds can heavily influence others' business decisions and behavior by placing restrictions or embedding incentives into the financial support they provide. They can link access to capital not just to environment and sustainability goals, but to socioeconomic progress as well.

With the credibility of the industry's net-zero pledges at stake, financial institutions need to advance their own progress by qualitatively and quantitatively assessing their corporate partners' transition plans and engaging with them to support and promote their participation in a more sustainable future. This paper lays out Deloitte's recommendations in this regard, with concrete steps financial institutions can consider taking to help build credible transition plans alongside their clients' and portfolio companies' plans, inclusive of tangible interim targets, implementation strategies, active performance measurement, guidelines for engagement, and impacts beyond climate.

The ceiling is mutual

Because financial institutions' progress on sustainability is so intimately connected to their customers' own transition plans, it is imperative that they work together to better understand the composition and reduction potential of emissions-producing activities. The credibility of their net-zero pledges and other such commitments is at stake, with real reputational harm possible if they fall short.

The business case for climate transition creditability goes far beyond this aspect, though, as financial institutions that effectively align their business decisions with their clients' and portfolio companies' transition will more likely avoid entering financing commitments that carry unforeseen costs down the road, avoid mistakes that could jeopardize their credit outlook, generate losses, and take resources away from more sustainable and more profitable choices. Such alignment can also position them to cultivate new financing opportunities, develop and offer new lending and investment products, gain access to growing markets, build awareness of new technologies, and strengthen client and investee relationships by working closer together.

Financial institutions have an increasing array of tools available to help quantify the exposure to emissions and climate risks of their corporate clients and portfolio companies. The Paris Agreement Capital Transition Assessment (PACTA), for example, has been used by more than 3,000 institutions worldwide to analyze what adjustments should happen in climate-relevant sectors to minimize global temperature rise with their own exposure to companies in these sectors.[3] The Science Based Targets initiative (SBTi) has introduced a set of methods for companies in GHG-intensive sectors, such as cement producers, to understand their decarbonization potential and how to align the GHG intensities of their operations to meet the 1.5°C goal of the Paris Agreement.[4]

Yet, climate transition assessments remain largely qualitative in nature owing to a lack of standards and incomplete data. Climate-related disclosures at the center of recent policy proposals around the world are aimed at making comparisons between companies and sectors more uniform (see "Climate disclosures in the crosshairs"). But, at least for now, disclosure rules remain diverse, resulting in net-zero disclosures that vary widely across companies and geographies. This fact, combined with a lack of granular sector-specific pathways and underdeveloped information on specific decarbonizing technologies, makes it difficult for financial institutions to gather relevant climate data and quantify the GHG-reduction potential for their whole portfolios.

Climate disclosures in the crosshairs
Regulators around the globe are focused on standardizing climate-related disclosures for investors and other stakeholders. Here's a quick snapshot of what may be coming soon:

SEC rules: In March 2022, the US Securities and Exchange Commission (SEC) proposed rule changes that would require registrants to include certain climate-related disclosures in their registration statements and periodic reports, including information about climate-related risks that are "reasonably likely" to have a material impact on their business.[5]

California Senate Bills SB-253 and SB-261: Both these bills, which would impact US-based public and private companies doing business in the state, passed the California State Assembly and the California Senate in September 2023 and are awaiting approval or veto by the governor. *SB-253, the Climate Corporate Data Accountability Act*, would require the disclosure and assurance of Scope 1 and 2 GHG emissions starting in 2026, with a phase-in for Scope 3 GHG emissions disclosure by 2027. *SB-261, Greenhouse gases: Climate-related financial risk*, would require "reporting entities" to publicly disclose climate-related financial risks along with the measures they have adopted to reduce and adapt to those risks.[6]

US Department of the Treasury's *Principles for net-zero financing & investment*: The US Treasury Department published nine voluntary principles financial institutions should follow to promote consistency and credibility of their net-zero pledges. It further discusses the different concepts financial institutions can take to engage with and support their clients.[7]

ISSB Sustainability Disclosure Standard: In June 2023, the International Sustainability Standards Board (ISSB) released its "Inaugural Standards" that require entities to provide information about their exposure to climate-related risks and opportunities, based on the climate-related disclosure prototype developed by the International Financial Reporting Standards (IFRS) Foundation.[8]

Europe's Corporate Sustainability Reporting Directive (CSRD): The first delegated act on the European Sustainability Reporting Standards (ESRS) specifying the reporting requirements under the CSRD was published in the *European Journal* in July 2023.[9] The next step is the national adoption of the standards. The ESRS requires companies with transition plans to disclose them, including implementing actions and related financial and investment plans; those with no such plans are required to report what they are doing to develop one and indicate when it will be available.

UK Disclosure Requirements on TCFD: Between 2020 and 2021, the United Kingdom's Financial Conduct Authority published two policy statements that require companies to disclose information in line with the Task Force on Climate-related Financial Disclosures (TCFD) guidelines on a "comply or explain basis."[10]

This climate disclosure callout box presents relevant publications until September 2023, for additional information and the latest developments, please refer to our *Creating a climate of change digest*.

Emerging practices for assessing corporate climate transition plans by financial institutions

Even as the industry awaits new guidance from regulators and other standard-setting organizations, financial institutions have it in their power to develop climate transition plans that match the ambition of their net-zero targets and other climate commitments.

Deloitte has studied and compared transition assessment approaches—including recommendations made by academic and professional institutions and methods already being utilized by our industry clients—and we have identified eight leading emerging practices that financial institutions should consider adopting in the near term to assess their corporates' transition plans.[11]

1. **Set temperature goals and interim targets**
   While many corporates have aligned themselves with the Paris Agreement's goal of 1.5ºC, interim targets on the path to net-zero—illustrating how they plan to make progress toward that goal—are far less common. For analyzing the credibility of corporates' targets, financial institutions need to define a method to not only evaluate the long-term targets but also assess their interim targets. This is a big step in building credibility and avoiding claims of greenwashing, as it shows a commitment to taking specific action in the immediate term. Interim targets should have a maximum time span of five years but also include steps the company plans to take within the next 18 months.

   As part of this process, the financial institution will likely need to conduct an overview of available transition pathways by country and sector to understand the feasibility of each corporate's climate transition plan and decarbonization and different disclosure granularities and define the basis of comparison between companies in the same industry and across industries (see examples below). This step should also involve the identification of new opportunities and technology investments related to these commitments and highlight any known constraints to the transition plan.

2. **Measure performance and progress**
   By now, many businesses are already disclosing their Scope 1 and Scope 2 emissions on an aggregated basis and by business unit, with comparisons to prior years, and some have taken a step further to calculate their Scope 3 emissions as well. Financial institutions may be able to glean this information from corporates' annual reports and sustainability reports, but they will either need to do it manually (due to lack of comparability) or source it from commercial vendor databases.

3. **Define the implementation strategy**
   Financial institutions will rely on corporates' disclosures about how they expect to deliver on their climate commitments through policies, processes, products, services, and relationships. They will then need to define methods for assessing the credibility of these plans considering sector-specific criteria, especially those that are considered high impact (see "Sector pathways in the spotlight").

4. **Strengthen organizational alignment**
   Transition plans can veer off track when they aren't integrated into the company's governance or aligned with its financial planning processes. Financial institutions need to review how corporates take a whole-company approach by incorporating the transition plan into risk management frameworks and the overall business strategy, including budgeting and investment plans. As part of this process, they should try to identify the percentage of each company's spending on decarbonization efforts relative to its operating expenses and capital investments. In addition, they should analyze corporates' executive compensation and performance management, as this can be a revealing source of the corporates' genuine sustainability intentions.

5. **Consider impacts beyond climate**
   It's important to keep in mind that moves companies make to rein in their emissions footprints will have implications beyond the environment—some negative and some positive. Financial institutions need to work to understand the likely impact of net-zero commitments and related investments on workers, suppliers, local communities, and consumers. They can then use this information to establish context-specific sustainability targets and attempt to support a "just transition," with little to no negative externalities to the environment or specific communities.

6. **Update over time**
   Financial institutions need to define a process for regularly reviewing and revising the transition plans, including the methods they intend to use, as well as producing periodic updates on the progress made toward stated targets. Keep in mind that climate science is constantly evolving, and metrics to track climate progress are evolving. As they do, climate transition plans need to incorporate new information. Along those same lines, corporates need to show flexibility and responsiveness in their own plans, for easy adaptation to changing regulations and newly available solutions.

7. Review procedures for disclosures

ESRS, TCFD, and ISSB include requirements for transition plan disclosures. As part of their assessments of corporate transition plans, financial institutions need to confirm that there is a process in place at each company for meeting such requirements, such as through an auditor's review.

8. Analyze policy advocacy

Financial institutions should review each corporate client's or portfolio company's policy positions to assess if they support their stated climate objectives and ambitions and that they don't advocate against climate policy. They should also confirm that those entities are advocating for policies that support their net-zero targets.

Sector pathways in the spotlight

As noted earlier, financial institutions have been constrained in their own climate transition plans in part because of a lack of granular information detailing what each economic sector needs to do to reduce the carbon intensity of their principal operations over time—often referred to as "sectoral pathways."

Looking to help solve this challenge, a handful of organizations have developed guidance to support corporates' and financial institutions' use of sectoral pathways for the creation of their net-zero plans. These include:

- **Glasgow Financial Alliance for Net Zero**: GFANZ, a global coalition of financial institutions working to accelerate the decarbonization of the economy, provides useful information on how to select an appropriate benchmark for a sector as a means for measuring performance and includes examples of financial institutions' efforts in certain sectors such as energy, power, and steel manufacturing.
- **Science Based Targets initiative**: As mentioned above, Science Based Targets—a partnership between CDP, the United Nations Global Compact, World Resources Institute, and the World Wide Fund for Nature—introduced the SBTi to encourage companies to set GHG emissions reductions targets aligned with climate science.[12] To help enable these targets, the SBTi has developed target-setting methods and requirements for various GHG-intensive sectors as well as cross-sector approaches. To date, more than a dozen sector-specific guides have been finalized, are in development, or are in the scoping phase.
- **Transition Pathway Initiative (TPI)**: Using sector-specific methodology, TPI has developed a set of online tools to help investors perform climate assessments of banks, corporate and sovereign bond issuers, and publicly held companies.[13]
- **International Energy Agency (IEA)**: IEA released a study in 2021 that seeks to provide the global energy sector with a road map for transitioning to a net-zero energy system by 2050, including more than 400 milestones.[14]

The tools of engagement

With this information in hand, financial institutions have a basis for increased engagement with corporates and portfolio companies, positioning themselves as valuable, long-term partners.

To date, these interactions have been limited in scope. Climate-related assessments and discussions between financial institutions and their corporate clients are typically performed only as part of the credit underwriting or insurance underwriting process. Value-based banks and insurers have tended to focus their business on sustainable projects, while applying broad criteria for exclusion.

Such limits are shrinking opportunities for financial institutions to leverage their relationships for positive societal change—and may even be exposing them to new risks. Discontinuing relationships with polluting companies and excluding certain industries removes providers of capital and risk transfer from the solution set. Exclusion and divestment may also have unintended consequences. For instance, the Office of the Comptroller of the Currency (OCC) has warned US banks to consider how climate-related financial risks may trigger fair lending concerns if their risk mitigation measures disproportionately affect communities or households on a prohibited basis such as race.[15]

What form should climate transition engagement take? While climate organizations, specialists, and academics have introduced guidelines to help financial institutions collaborate with their clients in this respect (see "The ingredients of collaboration"), examples from the industry are creating valuable precedents for others to emulate.

Some banks, for instance, have established country climate risk ratings to support assessments of physical and transition risks faced by their borrowers, which they combine with their analysis of insurance and management plans. Others have developed "transition scores" for corporates to assess their capability of achieving energy transition and combating climate change; these scores are combined with each corporate's financing score and used in client conversations for evaluating their net-zero business case.

In addition, insurers regularly include the assessment of transition plans as part of their investment and underwriting processes. Some have established an ESG scoring approach based on third-party ratings, which includes an assessment of transition plans in direct client discussions if significant ESG issues are detected in the automated scoring approach. In another example, other insurers and reinsurers have developed proprietary climate risk ratings to help clients better understand their exposure, and they also provide sustainability training to their customers.

Both banks and insurers are using the types of information gleaned from such comparative analysis to offer specific incentives—for example, lower interest rates for loans or risk premiums—for those corporate clients that rate more highly in terms of sustainability.

Finally, as financial institutions seek to more actively engage with their clients and portfolio companies, they may also need to adjust their efforts to sway public policy. A 2023 report by Ceres, a nonprofit organization working with capital markets leaders on sustainability initiatives, found that banks' lobbying practices largely did not align with their stated support of Paris Agreement-related policies and regulations, with 92% advocating against or pushing back on such policies over the past three years.[16] This pattern not only threatens the credibility of financial institutions' climate transition plans, but also undercuts the chances of policies that could support their clients' and portfolio companies' net-zero ambitions.

The ingredients of collaboration

The Climate Policy Initiative[17] and the University of Cambridge[18] have both proposed approaches for how banks and other financial institutions can engage with their clients to more proactively support their transition to net-zero. Here are some of the elements they share:

Baselines and benchmarks: Conduct a quantitative and qualitative assessment of the client's starting position regarding its decarbonization strategy, to begin scoping areas for enhanced collaboration, financing, and underwriting opportunities. Offer technical assistance to develop benchmarks through data sharing. Where possible, utilize tech-enabled tools to perform better comparisons and peer analysis through live simulations of different net-zero pathways.

Plan design: Support the client in designing a clear transition plan, focusing on approaches and technical implementations that are commercially feasible for the client, with associated financial requirements prioritized over the short, medium, and long term.

Product innovation: Structure financial solutions that meet the client's financing, liquidity, or risk transfer needs in line with their climate objectives. For example, these might be specific products that support the financing of climate tech innovations or structuring insurance coverage/premium to benefit the client for steps taken to reduce climate risk. Investigate tax breaks or other specific government incentives that may aid in this effort.

Measurement: Track progress by using tools to measure impact and assess if the adopted methodologies and financing solutions remain relevant to the client's needs and objectives; consolidate insights and learnings to feed into the bank's, investment company's, or insurer's strategy; and strengthen other business relationships.

Third-party support: Engage with third-party providers, such as rating agencies, to help develop transparent and pragmatic methodologies for transition plan evaluation. Other outside help may be needed to analyze government incentives that would better support corporates' climate investments.

Conclusion

Much of the work prescribed previously may well exceed the internal capabilities and knowledge of financial institutions and their corporate clients alike. Significant resources may be required to conduct credibility assessments for every client or portfolio company and support implementation and monitoring of transition plans. Increased engagement with academics and industry specialists, such as by participating in climate-focused forums, can boost their knowledge of sector-specific technologies.

However, financial institutions will also likely need to invest in people and technology, and training their existing staff accordingly, to better assess climate transition plans. The good news is that, with so much attention on the credibility of net-zero plans, the requisite talent and technology is starting to proliferate along with supporting regulations and guidance. Deloitte, for example, has developed GreenLight, a set of technology-enabled accelerators that can help clients establish an emissions baseline for individual companies, set net-zero goals, evaluate tax incentives and other forms of government support, develop a prioritized road map with budget constraints in mind, and deliver streamlined, auditable reporting for internal stakeholders.

As the market continues to evolve, and scrutiny of climate transition plans intensifies further, the market is likely to yield more helpful solutions in the years ahead. But there's little argument for waiting it out—the march to net-zero is afoot. Steps financial institutions take now will likely cement their place and reputations as sustainable problem-solvers. It's time for all companies to step up and outline how they plan to fulfill their climate pledges—and the financial services industry is in a prime position to provide the nudge.

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