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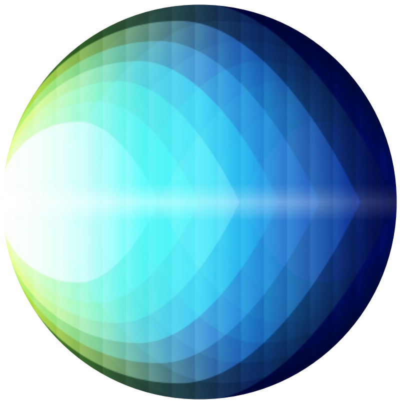
IN SUMMARY: 1 minute read

Financing the transition and managing the risks to reach net zero



In collaboration with Chapter Zero

Chapter Zero
The Directors' Climate Forum

As the world attempts to reduce its emissions, significant investment is needed globally to finance a transition to net zero. This poses material growth opportunities for the banking and capital markets sector, as well as risks that should be carefully understood and managed.

There are several factors that are making transition financing challenging for banks. Firstly, there is a barrier in understanding sector pathways. Banks really need an economy view of how the industry is transitioning.

Secondly, the risk return profiles required by banks and those that are offered by projects do not always align. This is particularly true where the transition relies on emerging technologies, or where there is insufficient clarity on the pathways.

Thirdly, where high-emitting sectors need transition finance, assessing the credibility of their transition plans can be challenging. For example, do they have the attributes of a transition plan? Are they science aligned? Do they include actions that are credible and achievable?

Finally, there is limited provision for transition within existing regulatory sustainable finance regimes, which have traditionally focused much more on green finance.

What is already in place?

Last month, the Transition Finance Market Review – an expert group that brings together private finance and government – put forward a series of recommendations to address the barriers. These explored unlocking the transition finance market by creating the right policies, pathways and signals for finance.

Following the release of the Transition Plan Taskforce disclosure framework last year, we now have a framework for producing and structuring transition plans. This is supplemented by sector-specific guidance documents. We have also seen the rapid adoption and incorporation of transition plans within the regulatory and reporting regimes demanding disclosure.

Both the International Sustainability Standards Board and the European Corporate Sustainability Reporting Directive require the disclosure of transition plans where companies have one.

In November, the UK government announced its plans to consult early next year on taking forward its manifesto commitment to make the disclosure of transition plans mandatory for UK-regulated financial services and FTSE 100 companies. This makes it clear that transition planning is becoming an increasingly core part of corporate strategy and companies, as well as banks, will need to produce and implement these plans.

If we accept that firms need to provide finance to those that need to transition, then firms are going to be taking more transition risk as they are exposed to regulatory risks that make those crystallise. There is a really important role for Risk functions to play in aligning risk appetite with the transition strategy of banks and delivering the necessary toolkits to support this in practice. Read more about how the banking sector is assessing risk.

£50-60bn a year required to meet UK net zero objectives.
Finance is an **enabler** of the transition, not a driver.
Transition plans underpin the **credibility** of the transition finance market.

Find out more about the challenges and opportunities faced by firms in our panel debate.

Based on a webinar discussion on 18 October 2024

Host: **Zahir Bokhari**, Vice-Chair and Senior London Partner, Deloitte UK

Speaker: **Doug Baird**, Head of Climate Risk Analytics, NatWest Group

Speaker: **James Close**, Head of Climate Change, NatWest Group

Speaker: **Alexandra Innes**, Chapter Zero Fellow, NED and Board Advisor

Speaker: **Tasha Clarbour**, Strategy, Risk and Transactions Advisory, Deloitte UK

Speaker: **Jean-Marie Delport**, Strategy, Risk and Transactions Advisory, Deloitte UK

"It is clear that companies and governments will require credible transition finance to deliver on their commitments and meet their goals, and this presents both risks and opportunities for private finance."
Tasha Clarbour

Chapter Zero's knowledge hub

The perspectives of risk

How is the banking sector assessing risk? We examine the progress made to date, look ahead at what needs to be done and explore the challenges that firms may face.

1. Progress to date:
- Climate stress testing
- Regulatory requirements
- Risk measurement and management
- Transition plans

2. Looking ahead
- Improving sophistication of models
- Customising and improving scenarios
- Developing appropriate risk identification tools and capabilities

3. Challenges
- Clarity from regulators
- Quality of data
- Buy-in from stakeholders (Resourcing, Financed emissions likely to increase in short term

Companies have made good progress in measuring and managing climate-related risks. This process started a couple of years ago with the Bank of England's climate stress test, which requires banks and insurers to model and forecast the impact of climate change on their assets. There have also been regulatory requirements like the Supervisory Statement SS3/19, which asks firms to ensure their climate risks are appropriately governed, managed, measured and disclosed.

Outside of the regulatory landscape, initiatives like the Task Force on Climate-Related Financial Disclosures have created opportunities for firms to develop their capabilities. Organisations have evolved their ability to perform analysis on different climate scenarios and integrate current climate and ESG-related risks as part of the risk identification and underwriting process.

When it comes to transition plans, a number of firms are now considering their counterparties' plans as part of the risk identification and underwriting process, and they have also developed the ability to assess the credibility of these plans.

In addition, some larger firms have built the ability to measure and forecast their own emission profile and track progress against their transition plans. This enables them to see whether they are on track to meet their net zero targets and understand what levers they can use to help.

Looking ahead

There is still room for improvement, for example, by increasing the sophistication and accuracy of models. Also, as the transition will rely on emerging technologies, which will typically have a different risk-return profile to incumbent technologies, more sophisticated models will provide more certainty around the forward-looking risks associated with a finance deal, and so will allow for better decision-making.

Many firms have started using scenarios like those from the Network for Greening the Financial System (NGFS), the International Energy Agency (IEA) or the Intergovernmental Panel on Climate Change (IPCC). However, these have limitations so it is important that firms customise these scenarios to accurately reflect their view of the future.

Companies also need to make sure that risk identification metrics and tools are appropriate for use in the context of transition finance. Several banks have developed scorecards to help them identify ESG-related risks, or support disclosures on ESG metrics. While these capture a wide range of risks, they might not be appropriate in a transition finance context. Therefore firms will have to think about customising these tools and making or developing new capabilities that can better support decision-making.

Challenges firms face

More guidance from the regulator on its expectations is usually one of the key things that clients talk to Deloitte about. What are those expectations? What does 'good' look like?

The Prudential Regulation Authority (PRA) provides guardrails for firms in terms of its expectations, but it is up to firms to decide how they implement that guidance.

The industry expects an update to the PRA's Supervisory Statement SS3/19 in the first quarter of 2025 and this will definitely be welcomed by the industry. Data is another challenge. We often find there is a vast range of sources of climate-related data, often with very large differences between them, making it difficult for firms to close their data gaps and improve their data quality with more certainty.

The intention to make transition plans mandatory will support an improvement in data quality, as it will allow for easier integration within risk processes as transition plans will be more standardised.

"When supporting the transition to net zero, a firm's financed emissions is likely to initially increase as they help customers to decarbonise. It is important stakeholders understand and support this way of thinking when setting targets and strategy." **Jean-Marie Delport**

Another obstacle to overcome for many firms is limited resources. A number of risk teams in organisations have very good intentions to further develop their capabilities. However, they are constrained by a lack of resources, in terms of both people and budget. Getting buy-in from stakeholders to release or provide more resources will be helpful.

In conversation with the Deloitte Academy panel

Our speakers discuss the challenges and opportunities facing firms in the context of transition planning and risk management, and share some of the lessons they have learned.

What are the key climate change challenges and what role does private finance play in the transition?

James: A lot of numbers are banded around when it comes to the amount of capital required for the transition, from $3 trillion to $12 trillion a year. This may be overstated but it is going to be a huge amount of money. It is also going to generate a different future economy in terms of the physical nature of it – we will be shifting away from burning fossil fuels to investing capital in renewables – and what this means for customers.

Many banks have made huge commitments around how they are going to mobilise finance but it is very difficult to see what these mean. It is challenging for investors to know what banks are committing to and for their customers to understand the access to capital they are likely to have, and how they are going to source it. There is work to be done to get to a position of greater harmonisation, and ultimately standardisation, around the concept of transition finance.

The Transition Finance Market Review was a useful stocktake in terms of how transition finance is thought of today. But I do not think we are going to create a common taxonomy that everybody will immediately buy into and shift towards. I am very much of the view that a principles-based approach is probably going to be most helpful, which is what the review underpinned.

Having already published NatWest Group's first transition plans, what opportunities are you seeing?

James: We will be publishing our third transition plan in February and the process has forced us to look at our book in a different way. We have moved from thinking about sectors that are somewhat static to systems that are far more dynamic in terms of the way risk can be considered. Batteries is an interesting example. We do not have a battery storage sector, but when you think about the transition, we are going to need enormous amounts of battery storage in lots of different places, from grid-scale storage through to home energy storage and the batteries required for electric vehicles. So, when you start to think about that energy storage in the context of systems, it enables you to think about the sort of activities that are likely to be bankable and how we can allocate our capital to enable that to happen.

And, of course, when we are trying to manage portfolio risk, once we have done one of these projects, we actually like to do quite a few of them so we can manage that portfolio risk. We also like to syndicate them with other banks and, ultimately, into the capital markets. So, I think that is also a very interesting consideration.

What have you done to integrate climate risk at NatWest?

Doug: At NatWest we try to incorporate it across everything we do, recognising that climate change impacts all aspects of society, and therefore all of our customers. Climate is a new risk and an increasingly important driver of the existing risks that we face as a bank, such as credit, market and reputational risk. Therefore, our main aim has been to incorporate climate risk into our overall enterprise-wide risk management framework.

> **"Until banks can price transition risk into their core financial metrics, such as the probability of default, then the risk return benefits expected from investing to support a customer transition will likely not be fully captured."** Doug Baird

We have established a dedicated climate risk team to serve as a centre of excellence in supporting the business-wide integration. But the necessity for that team will diminish as the broader bank integrates and builds the expertise to manage climate risk alongside other drivers.

We are aiming to ensure our transition plan is fully integrated into our wider business and strategic planning processes. The transition plan introduces a number of new characteristics that have to be taken into account alongside financial metrics. This introduces challenges, for example: how do you get stakeholders comfortable with the data? And how do we position this new sort of transition planning metric relative to the others being optimised for?

A key challenge for the industry is that until climate risks are fully embedded within the risk return characteristics of the balance sheet, it will be very difficult for the transition plan to get a fair comparison against competing strategies because the risk-return benefits achieved by the transition plan will not be captured. Unfortunately, this could result in transition actions being deprioritised in favour of alternative strategies that show apparently better short-term financial performance.

What opportunities do you see to extract business value from transition planning?

Alexandra: I think there are lots of opportunities. Done well, transition plans should not only deliver business resilience and growth, they should enhance a

"Non-executive directors are very good at thinking forwards strategically. They are probably less good at wanting to commit to deliverables 5, 10, 20 years in advance." Alexandra Innes

company's brand value, increase investor confidence, attract and retain top talent, and open up a new customer base. However, it is important to engage stakeholders in the development of a transition plan to deliver these positive outcomes. In addition, a mindset shift is often needed at the board level.
As there is now so much disclosure, regulation and compliance, particularly for financial services companies, sustainability and transition plans can often fall into a compliance bucket. As non-execs, we need to move it towards being considered a business growth driver and adding value. It is also a great opportunity for the board to take a strategic, forward-looking view.

Having taken NatWest Group's transition plan through a board approval process, what lessons can you share with others who are embarking on that journey?

James: The board gave us a mandate not just to produce a transition plan, but to start thinking about how it integrates into the business plan. They were very explicit about the need for the two to be interconnected and I would say our second attempt was better than our first. I think our third will be better still.
The production of the transition plan is led by the group finance team, because they are the ones that actually know what good disclosure looks like, and how to integrate it into the business planning process.
For board directors who only come at this once or twice a year, it can be quite difficult to relate to the fact that we are making disclosures around things that are not elegantly defined in terms of inputs and outputs, or double entry book keeping where things balance. So, it is really important to emphasise the journey we are all on and the work the Greenhouse Gas Protocol is doing to get more simplification around Scope 3 and the importance of starting to disclose some of these things. So, even though they are imperfect and complex, they set a baseline from which we can act.

How can board-level discussions on transition finance and planning be elevated?

Alexandra: The first thing is training. For board and ExCo engagement and buy-in, everybody needs sufficient knowledge of the subject matter. I have found that combining board training with a strategy session works well and can deliver a better outcome.
Second is the importance of having external perspective. Use external speakers and advisors as they can really help to inspire, and to bring credibility and a rounded approach.
Thirdly, quantify material opportunities and risks to the extent you can so this data can be used for decision-making.
Lastly, use the stakeholder-first mindset as boards care about investors, customers and the workforce. Look at your biggest investors to see what is important to them. What are their targets? What does a customer of the future want and need? Look at workforce opinion and industry metrics for benchmarking to bring the competitive spirit to the fore!
James: I completely agree but some of this is really challenging. If you are looking at decarbonising assets under management for a portfolio by 2038, it is going to be hard to be investing in banks, for example. It is highly likely that banks will still have a 2050 net zero commitment and it will be challenging to reconcile all of that. But we have to enter into this with the spirit of ambition.

Do you see tension between risk and transition strategies for banks?

Doug: The main one is between short-term and long-term views. Currently, the core financial performance metrics of most institutions are anchored around a short-term time horizon. We need to provide the right analysis to support decision makers in sacrificing apparent short-term performance in order to achieve the longer-term aim of transitioning the balance sheet
James: We have not really talked about tipping points. For those of us who spend time in the climate science world, there are some fairly alarming scientific pieces of research that show we could see significant change in the next 30 years, particularly if the Atlantic Meridional Overturning Circulation starts to weaken. This will involve significant temperature changes in the UK, which would be quite difficult to manage and cope with.

What does the industry need most from its boards?

Alexandra: Support is as important as challenge on this topic.
Doug: Clear support for the transition strategy, and clear communication and demonstration from the leadership that this is a vital part for the overall bank strategy.
James: Key in corporate governance is to ask the right questions. And I think the right questions are around what kind of business do we want in 2030 and what will the balance sheets and P&L look like? How is the transition plan an enabler of that? It should be thought of as both a verb and a noun. Planning is an activity as well as a deliverable and it is sometimes easy to lose sight of the fact that and assume that by producing a climate transition plan, you have actually delivered the transition. But in truth, the plan is the enabler of the action that is going to deliver the plan. Asking good questions supports this.

What is the most crucial takeaway for boards?

Alexandra: Consider all your stakeholders in the process.
James: A 360-degree view of the problem is really important from a board member's perspective. They have to engage with the topic, understand it and provide challenge and direction where appropriate.
Doug: If all the boards around the country had a deep understanding of the tipping point risk that James alluded to, that would go a long way.

"The status quo is not good enough. We must recognise that we have to get the money to where it needs to go to facilitate the transition. Without doing that, we really are going to be in great distress." James Close