Financial Services ESG Insights

Mobilising Capital Allocation through Harnessing Transition Plans

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ESG Insights – April 2024

Implementing transition plans

In our last edition covering COP28, a key theme emerging from the newsletter was the importance of companies issuing transition plans to ensure there is an information flow surrounding decarbonisation goals, from companies to financial institutions and wider stakeholders. A 'credible' plan should encompass a company's climate ambition and how they will decarbonise their business, how they intend to navigate the risks and opportunities associated with economy-wide decarbonisation, key assumptions and dependencies, and how they will deliver on their strategy.

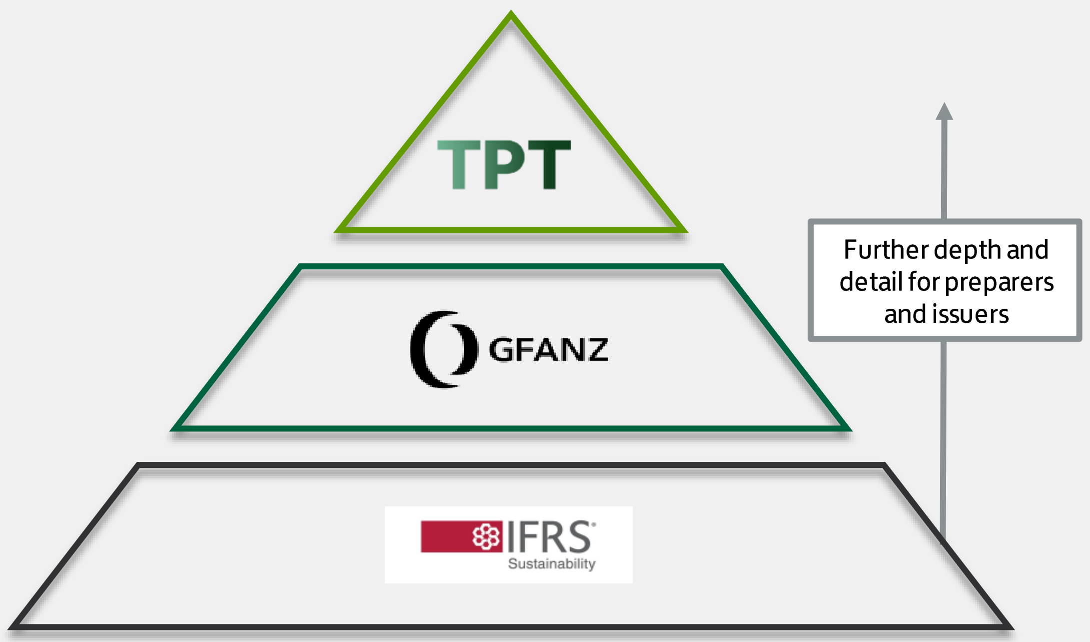
This edition focusses on how financial institutions might begin to prepare internally, and use the transition plans that are emerging from the companies they support, as a mechanism to deliver on their own net zero commitments and reallocate capital towards the transition.

Transition plan disclosures landscape

To use and understand transition plans more holistically within financial services, it is firstly important to take a moment to understand some of the key organisations and initiatives* that have helped to shape the transition plan disclosures landscape, the interoperability between standards and initiatives, and what companies are being asked to report today.

There are currently three main organisations and standards that form the foundation of credible transition plans[1], as below:

The Transition Plan Disclosure Landscape



We recognise there are many more organisations that have helped to shape the transition plan disclosure landscape directly and indirectly, many of which are referred to in the TPT's Sector guidance. Our aim is not to list every initiative exhaustively in this publication but instead focus on the general direction of travel.

Source: 1) TPT Disclosure Framework

IFRS Sustainability Disclosure Standards (IFRS)[2]

In June 2023, the International Sustainability Standards Board (ISSB) launched the IFRS S1 standard, which provides general sustainability reporting requirements, and IFRS S2 standard, which covers specific topics such as climate change. These standards have been specifically developed to meet a need for universal sustainability disclosure standards in order to empower capital market participants with decision-useful and comparable information about an entity. In particular, IFRS S2 incorporates the Task Force on Climate-related Financial Disclosures (TCFD) recommendations, as well as disclosure requirements derived from the Sustainability Accounting Standards Board (SASB). Although IFRS S2 does not explicitly require a transition plan to be put in place, it does require an entity to disclose any plans it has to address climate change.

The Glasgow Financial Alliance for Net Zero (GFANZ) framework[3]

GFANZ was created for financial institutions in April 2021 to offer practical tools and methodologies to help turn a financial institutions' net zero commitments into action. GFANZ aims to coordinate efforts across all sectors of the financial system to accelerate the transition to a net zero global economy. Used for transition planning, GFANZ's guidance acknowledges that net zero transition plans will vary by financial institution and jurisdiction and depend on the individual characteristics of the financial institution, including size, business model, sector coverage, fiduciary duty toward their clients, and other factors. The guidance presents a pan-sector approach to transition planning and aims to act as a reference for regulators and policymakers.

The Transition Pathway Taskforce (TPT)[4]

Announced at COP26 and launched by HM Treasury in March 2022, with a mandate to bring together industry, academia and regulators to develop the "gold standard" for transition plan disclosures for finance and the real economy. Keeping in mind consistency, the TPT framework was designed to build on the GFANZ framework and support companies as they prepare to meet the IFRS S2 requirements, using the same core components and structure but expanding beyond a net zero aligned ambition. Since its launch, TPT has issued a sector neutral Disclosure Framework. Recognising the role the financial services sector plays in mobilising capital, TPT has also published sector-specific transition plan guidance for Asset Owners, Asset Managers and Banks, as well as sector summary guidance, which includes Insurance.

Sources: 2) IFRS; 3) GFANZ; 4) TPT

Utilising transition plans effectively within a financial institution

To help financial institutions get started, we have identified four areas which we believe institutions should consider as they begin to integrate transition plans into their decision-making processes.

These elements draw on implementing a selection of the recommendations from IFRS, GFANZ and the TPT.

We believe having these capabilities in place will ultimately allow focus on the most critical element of your own transition plans, engagement with value chain, through assessment of and action on corporate transition plans.

1. Capacity building

Building capability and specialist knowledge

2. Implementation

Creating fit-for-purpose processes and policies

3. Unlocking Finance

Encouraging innovative products and solutions

4. Engagement

Forming relevant and meaningful partnerships

How our four areas map to the TPT Framework

1. Capacity Building
2. Implementation
3. Unlocking Finance
4. Engagement

To help our clients begin their journey towards meeting the TPT sector guidance, we have identified how these four areas relate to the framework:[5]

Ambition	Action		Accountability	
1. Foundations	2. Implementation Strategy	3. Engagement Strategy	4. Metrics and Targets	5. Governance
1.1 Strategic Ambition	2.1 Business operations	3.1 Engagement with value chain	4.1 Governance, engagement, business and operational metrics and targets	5.1 Board oversight and reporting
1.2 Business model and value chain	2.2 Products and services	3.2 Engagement with industry	4.2 Financial metrics and targets	5.2 Management roles, responsibility and accountability
1.3 Key assumptions and external factors	2.3 Policies and conditions	3.3 Engagement with government, public sector, communities and civil society	4.3 GHG metrics and targets	5.3 Culture
	2.4 Financial Planning		4.4 Carbon credits	5.4 Incentives and remuneration
				5.5 Skills, competencies and training

Our indicative mapping is based on what we have covered in each of our four focus areas, noting these are tangible actions financial institutions can consider as they get started on their transition planning.

Source: 5) [TPT Disclosure Framework]

Supporting the transition to net zero, through the provision of sustainable finance requires organisations to clearly articulate their sustainability strategy, including climate. Setting up governance is an important first step for organisations. Clearly defined roles and responsibilities within the organisation is key for successful implementation of a transition plan. This should start at the executive and board level, who would normally be responsible for the ownership and oversight of net zero targets and their delivery. The assignment of appropriate teams and individuals to all aspects of both the design and delivery of the transition plan is the next step, up to and including decision-making fora.

To support the provision of finance to the products and services required to deliver the net zero transition, one approach we have recently seen being adopted, includes upskilling existing teams in transition technologies to enable them to engage critically with plans and ensure transition knowledge is integrated. Another approach encompasses setting up specialist teams including hiring from within transition sectors to pursue thematic strategies.

Both approaches tend to create deep technical expertise internally, often sitting within a specialist sustainability function. Training wider teams is equally necessary to unlock the benefits of assessing transition plans across an organisation and support scalability. The transition to net zero is complex and has many angles that need to be considered. For example, these include the pace of transition in developed versus developing markets, local socio-economic and political realities, nature and Just Transition considerations, as well as sectoral decarbonisation pathways.

Understanding a client's context and how this connects to transition pathways is key to understanding their transition plan. To do this, risk and front-line teams will need to be confident to engage with clients effectively, identify the potential financing opportunities and advisory support needed, and steer their portfolios towards achieving internal targets and external commitments.

Climate-related risks and opportunities

To assess risks, credit and enterprise risk teams will need to be trained to know what to look out for when reviewing transition plans. For example, when considering longer term investments in the infrastructure space, use of scenario analysis will provide a look through to the assets that underpin the business model and will identify potential stranded assets as a result of transition and/or physical risks. Financial institutions will need to develop the capability to use this information to measure and manage their exposure, using this to feed into their decision-making process by understanding climate-related risks, which can support transition planning efforts and help drive changes in the behaviour towards capital allocation or risk pricing.

While the training curriculum may need to be tailored to participants' roles, it is important that it is science-driven and spans investment and financing teams, risk, and key functional stakeholders as the objective is to ensure a shared set of capabilities to enable organisations to capture the opportunity presented by the transition.

Programmes are frequently tailored based on maturity of the organisations' journey and are often sector and geography specific, to capture the differences in policy environments and technological advancements. This can also inform the selection of delivery partners, ranging from academic to sector professionals, based on the intended learning outcomes.

The Taskforce for Climate-related Financial Disclosures (TCFD)[6]

TCFD reports are used by financial institutions to understand **climate-related risks and opportunities** related to their investments. TCFD reports are produced annually and form part of an organisation's annual reporting process. **Climate transition plans build upon TCFD to address how companies will operationalise their sustainability strategies with concrete actions.**

Source: 6) TCFD

To assist financial institutions with analysing transition plans and effectively engaging with them, they need enabling infrastructure, tools, policies, and processes. The first consideration is processes; there should be clear roles and responsibilities in the collection of climate data and assessment of corporate transition plans, ensuring consistent outcomes when assessing companies within a sector or comparing companies across different sectors.

An initial step involves understanding the maturity of a financial institution's client's journey – for example, the GFANZ framework for transition finance, is actively under review and engaged by financial institutions in its original format or through adaptations, and is used to align clients to one of four strategies.

GFANZ's Transition Finance Strategies[7]

GFANZ has identified four strategies to finance a whole economy transition to net zero, these are defined as financing or enabling:

Climate Solutions *The development and scaling of climate solutions*	**Aligned** *Assets or companies already aligned to a 1.5 degrees Celsius pathway*
Aligning *Assets or companies committed to transitioning in line with 1.5 degrees Celsius-aligned pathways*	**Managed Phaseout** *The accelerated managed phaseout of high-emitting physical assets*

Source: 7) GFANZ Report on Scaling Transition Finance and Real-economy Decarbonization

Leading financial institutions have enhanced their use of climate-risk scorecards in their risk function, using these to examine features such as management strategy, financial flexibility, and reliance on transition technologies, to assess the overall credibility of a transition plan. We see increased analysis of public disclosures and transition plans as an input into these assessments, supporting consistent analysis against a backdrop of increasing quantities of information spanning multiple disclosures.

Scorecards introduce a level of subjectivity to the assessment but intend to make the outputs of a transition plan assessment comparable and decision-useful, with additional weighting placed on 'key' factors that feed into scoring methodology. They can also be designed to incorporate third-party transition data or analysis such as a client's positioning on the Transition Pathway Initiative (TPI)[8] scale, or transition ratings from commercial providers.

Like ESG ratings, having a robust and credible transition plan and thus a higher score in such assessments can make a company more attractive to financial institutions including lenders, investors and insurers. Forward-thinking financial institutions will therefore engage their clients not just on their current transition plans and capital needs, but also to help share best practice and encourage underlying activities or enhanced disclosures which improve a corporates' transition plan.

Embedding climate analysis into credit ratings

In February 2024, Moody's Investors Service (MIS)[9] launched their net zero assessment - an independent and comparable view on the strength of an entity's carbon emissions reduction plans compared to a global net zero pathway. They incorporate an entity's ambition, the implementation of its plan and its governance of greenhouse gas emissions reductions. This further demonstrates how ESG and climate considerations are integrated into its credit ratings by embedding ESG Issuer Profile Scores (including carbon transition scores) and Credit Impact Scores into credit ratings. We have also seen other examples of products in the market such as detailed Carbon Transition Assessments for rated companies in sectors that are most exposed to these risks.

Transition Tooling

Legal and General Investment Management (LGIM) has released a tool available for public use, the **Climate Impact Pledge Score**[10], which illustrates how at its most sophisticated, transition plans, data sourcing, and climate modeling are coming together to assess the credibility of published transition plans.

Sources: 8) TPI ; 9) Moody's (MIS); 10) LGIM Climate Impact Pledge score

Engagement of all forms needs to be underpinned by policies which reflect the role that different financial institutions play, and their individual views on the transition. Lenders, for example, may choose to have exclusionary policies or reduce credit risk appetite for counterparties they deem to have an immature approach to transition planning, either on reputational risk grounds or because of potentially heightened climate risks. The signals this sends may incentivise laggards to improve their actions. However, TPT also calls for a strategic, rounded approach – in preventing 'paper decarbonisation' and seeking to support a real economy transition.[11]

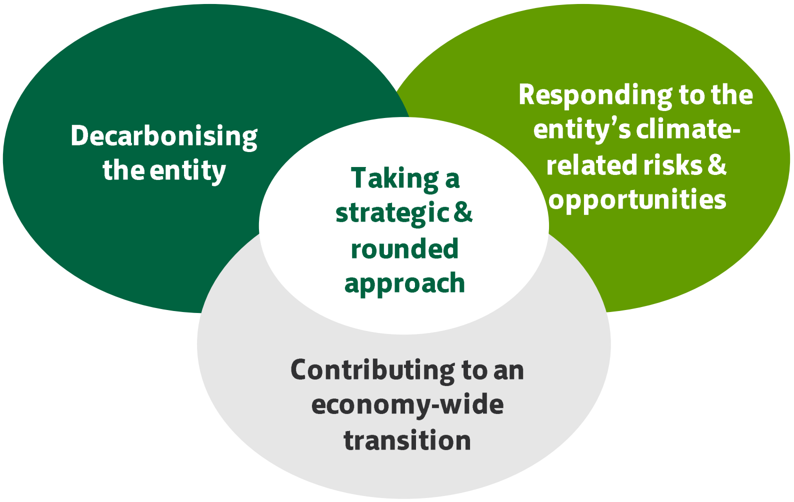
In parallel, active investors (e.g. Sponsors), may see opportunities at sector or technology level to increase capital allocation to companies in this position because of the potential for value upside. This can bring capital into hard-to-abate sectors. In the case of Banks, this could be offered through targeted products and services with preferential pricing or, in the case of Sponsors, with additional Board expertise and detailed decarbonisation plans.

members and detailed decarbonisation plans; this must be done in a way that is consistent with a financial institution's decarbonisation targets.

To facilitate financing of more nascent transition technologies, financial institutions need to define a 'house-view' on these technologies including the drivers which support their uptake and maturity, which is underpinned by an in-depth analysis of likely policy and economic developments across sectors and regions. This should inform financial planning and feed into risk appetite.

Policies therefore play a critical role in internal decision-making, and often in helping external stakeholders understand a financial institution's ambition and intentions. These should be constructed to be a public commitment, such as net zero pledges or sustainable finance targets. You may also consider defining business boundaries in line with the organisation's net zero objectives and priorities, and develop policies for priority sectors and activities, such as thermal coal, oil and gas, and deforestation.

The TPT's three inter-related channels for a strategic and rounded approach



Source: 11) TPT

When thinking about pricing mechanisms, organisations need to price appropriately for risk – a conversation spanning green premiums or higher pricing for 'brown' assets. From a product perspective, Sustainability Linked Loans (SLLs), Bonds and other labelled products have been at the forefront of this agenda. As transition considerations become more common, activity-level eligibility frameworks and specific instruments such as Transition Bonds are emerging in the market.

In developing a view on technology maturity and pricing, financial institutions will come across sectors, companies and assets that are outside their risk tolerance. It is important to assess where this presents an opportunity for product innovation and risk sharing, potentially bringing in multiple partners to share risks. This could range from blended finance solutions, with banks blending their lending with first-loss involvement or guarantees from multilaterals or development banks, to parametric insurance or reinsurance arrangements for both insurers and investors.

Japan's Climate Transition Bond[12]

Japan has released the first tranche of the ¥1.6tn (USD$11bn) inaugural sovereign transition-labelled bond, certified under the Climate Bonds Standard.

The bond's Use of Proceeds (UoPs) will fund the country's Green Transformation programme. Specifically, the UoPs cover a broad range of activities, including:

55% Earmarked to R&D, including 18% for the utilisation of hydrogen in the steel making process and the decarbonisation of the thermal process

45% To support decarbonisation objectives, including subsidies for low-carbon transport and batteries, subsidies to improve the insulation performance of houses, and subsidies to promote the introduction of clean energy vehicles

Source: 12) Climate Bonds Initiative - Japan's Climate Transition Bond

Product innovation can also be anchored around existing risk appetite but seeking to remove the barriers to uptake of transition technologies. For example, financial institutions creating 'one stop shop' solutions or bringing value chain participants together, whether from a supply chain financing standpoint or financial sponsors backing emergent transition technology scale-ups in sectors such as aviation or biofuels, engaging in blended financing opportunities.

As per the GFANZ framework for transition finance, or similar, once a client has been categorised accordingly based on their strategy, this should inform your engagement strategy. Where there is evidence that clients are progressed on their transition journey, the transition plan should form the starting point of an engagement on appetite for and ability to, enter such product innovation.

Whether supporting 'Climate Solutions' specifically through renewables capacity build, less proven transition technologies or M&A activity, the financial institutions' role is to offer suitable technical advisory or financing solutions that support the clients' transition strategy. Where clients are 'Aligned' or 'Aligning', engaging in discussion on energy efficiency measures, or decarbonisation technologies can provide initial support. Where clients' transition plans are in their infancy, taking more of an advisor role and supporting their design of a transition plan can enable subsequent capital mobilisation. The ability to digest their transition plan and understand the clients' needs explored in the prior two areas, anchors a financial institution as a partner in a client's decarbonisation strategy.

In addition, with many financial institutions making transition and green finance commitments and the growing attention on greenwashing risk, transition plans can be used as an audit trail for financing the transition, demonstrating alignment to taxonomies, or connecting to the growing use of financial institution's own transition plans as a supervisory tool.

Financial institutions can support the transition to net zero by proactively engaging with a wide range of stakeholders to help implement net zero ambitions, strategies, and targets. There has been a significant effect from collaborative initiatives, with 144 banks signed up to the GFANZ Net Zero Banking Alliance (NZBA)[13] and 315+ signatories for the Net Zero Asset Managers (NZAM) initiative[14], as well as uptake of voluntary standards such as the Science Based Targets Initiative (SBTi) and Partnership for Carbon Accounting Financials (PCAF). These have helped set common practice, and provide a means for financial institutions to collaborate or achieve a greater voice in acknowledging policy barriers.

Continuing the net zero journey requires a second level of partnership focussed on more active strategies, forming targeted allyships with relevant organisations that can help accelerate the transition of portfolios and economies. These advocacy efforts are clearly articulated by GFANZ and the TPT as a key component of the 'engagement strategy' elements of their frameworks.

At its most straightforward, this can be partnerships with service providers who can provide complementary support to clients on their transition journey including data and analysis. This may include parties who can advise on or develop transition plans, climate scenario analysis to underpin these, or sector-specific technology advice.

More advanced partnerships seek to unlock systemic issues in the transition or overcome policy barriers. These may involve financial institutions joining forces with industry organisations, civil society organisations or think tanks to conduct shared research, advocacy, and lobby governments. At their most sophisticated, partnerships can unlock entirely new businesses.

Sources: 13) NZBA figures as of 3 April 2024; 14) NZAM figures as of 3 April 2024

Partnerships

We are seeing an increasing number of examples of partnerships and initiatives built around deep technical expertise and collaboration.

The Grantham Research Institute on Climate Change and the Environment and the LSE have established a **Just Transition Finance Lab** to be a world-leading centre for experimentation and excellence in the financial solutions needed for a Just Transition to a net zero and nature positive economy. Founding Funders of the initiative include Antin Infrastructure Partners, Barclays, HSBC and Laudes Foundation.[16]

The Just Energy Transition Partnership (JETP) in markets such as Senegal and Indonesia, brings together capital providers, governments and companies to explore shared solutions and support coal-dependent emerging economies make a just energy transition. Contributors include multilateral development banks, national development banks and development finance agencies.[17]

HSBC has partnered with Pollination, a specialist climate change advisory and investment firm, to form **Climate Asset Management**, a dedicated natural capital investment manager whose mission is to develop and deliver investment solutions that accelerate the transition to a net zero, nature and climate resilient future.[18]

Sources: 16) Grantham Research Institute; 17) International Institute for Sustainable Development - Just Energy Transition Partnerships; 18) HSBC and Pollination - Climate Asset Management

TPT sector guidance publication[19]

The TPT published guidance for Asset Managers, Asset Owners and Banks in April 2024, alongside:

- Sector summary guidance, with high level guidance for 30 sectors of the global economy, including Insurance
- Sector-specific transition plan guidance for Electric Utilities & Power Generators, Food & Beverage, Metals & Mining and Oil & Gas
- Independent advisory pieces on Adaptation, Nature, Just Transition and SMEs from the TPT's Working Groups expected to be integrated into the wider sector neutral framework over time

This is following a period of revisions and changes to reflect the feedback received during the consultation period. Financial institutions will need to read the updated guidance and, in the first instance, do a gap analysis between what has already been published as part of existing sustainability reports or TCFD disclosures. Depending on the requirements, firms may need to mobilise a change programme to develop business transition strategy.

UK Transition Finance Market Review[20]

Announced in December 2023 and running until the summer of 2024, this independent review commissioned by the government aims to assess how the UK can become a global hub for transition finance services including capital raising. There is a live call for evidence with responses due by 25th April 2024.

UK nature-related risk analysis release

Ahead of COP16 in Colombia, April will see the launch of innovative analysis by organisations including the Bank of England sizing nature-related risks to the UK economy.

Developing 'house-view' scenarios for strategic planning

Financial institutions are using a base case climate scenario - essentially a central, most likely scenario - to enable them to forecast their financed emissions, assuming that they do not take management action to decarbonise their portfolios. This enables them to size the management actions required to meet their net zero targets. A base case climate scenario also informs transition finance strategies by sizing the markets over the coming years for different technologies, across countries and sectors.

Building decarbonisation strategies

Financial sponsors are focussing on how to support their portfolio companies with decarbonisation strategies, to support their resilience and realise additional value. This involves reviewing decarbonisation commitments, assessing decarbonisation opportunities and accompanying cost-benefit analysis of potential solutions. Increasingly, transition plans are becoming a pre-requisite for exit readiness, to prove out the longevity of strategy and avoid value erosion.

Sources: 19) TPT; 20) Transition Finance Market Review

Call to action

To harness the power of clients' transition plans, financial institutions need to focus on these four areas highlighted to deliver on their own net zero commitments and reallocate capital towards the transition.

These elements draw on implementing a selection of the recommendations from IFRS, GFANZ and the TPT.

By training teams, implementing enabling infrastructure, and engaging with clients effectively, institutions can help drive sustainable decision-making. Embracing the transition journey and collaborating with like-minded organisations can also help to accelerate progress towards delivering a low-carbon future.

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Further newsletters will follow as we keep you informed on the latest ESG and sustainability-related developments that impact the sustainable finance agenda.

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