CORPORATE & INSTITUTIONAL

Financial Services ESG Insights

Brought to you by Lloyds Bank and Baringa

December 2023

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ESG Insights – December 2023

Our Insights from COP28

The Big Picture

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This year's COP28 comes at a pivotal moment, as there is growing evidence that the world could surpass 1.5°C of warming; to avoid missing this goal **action from governments, corporates and financial institutions is required.**

COP28 Key Takeaways

Moving from ambition to action

For financial institutions, the focus needs to firmly remain on moving from ambition to action. This means 2024 will be about going beyond net zero pledges and sustainable financing targets.

Aligned efforts to direct capital

Central to this is ensuring capital flows to where it is needed most – the highest impact decarbonisation areas, protecting against the worst physical impacts of climate change, and enabling the transition of all societies and individuals in a fair, accessible and affordable manner.

The importance of transition plans

Transparency and disclosure, in the form of transition plans, are integral to this – allowing information to flow from companies to financial institutions. This will help inform decision-making and help to evidence progress to consumers and end-investors including those seeking to contribute to sustainability-aligned outcomes.

Policy intervention is needed

To enable the actions of financial institutions and remove barriers to capital flow, more action is needed from governments, regulators and agencies. These include ensuring a consistent basis for information flows between parties and how this information is used to support decision-making.

Our Insights from COP28

This year's Conference of the Parties (COP28) climate summit comes at a **decisive** moment for international climate **action**. The **UN's Global Stocktake report** shows that much more needs to be done to meet the Paris Agreement to limit global warming to 1.5°C above pre-industrial levels. In order to understand what happens at COP it is important to understand how it works in practice. Each COP brings two key elements – the first is **formal direction through the negotiation of climate actions agreed between governments;** the second is **priority areas for the coming year in announcements and analysis by non-state actors.**

Over the past two weeks we have been closely monitoring the commitments and initiatives emerging from this year's COP discussions. Based on these, we see **four major themes that will shape the financial sector's actions on climate**:

1. The continued growth of green finance
2. The time has come for transition finance to scale
3. Adaptation is inevitable
4. People must be at the heart of the transition

The continued growth of green finance

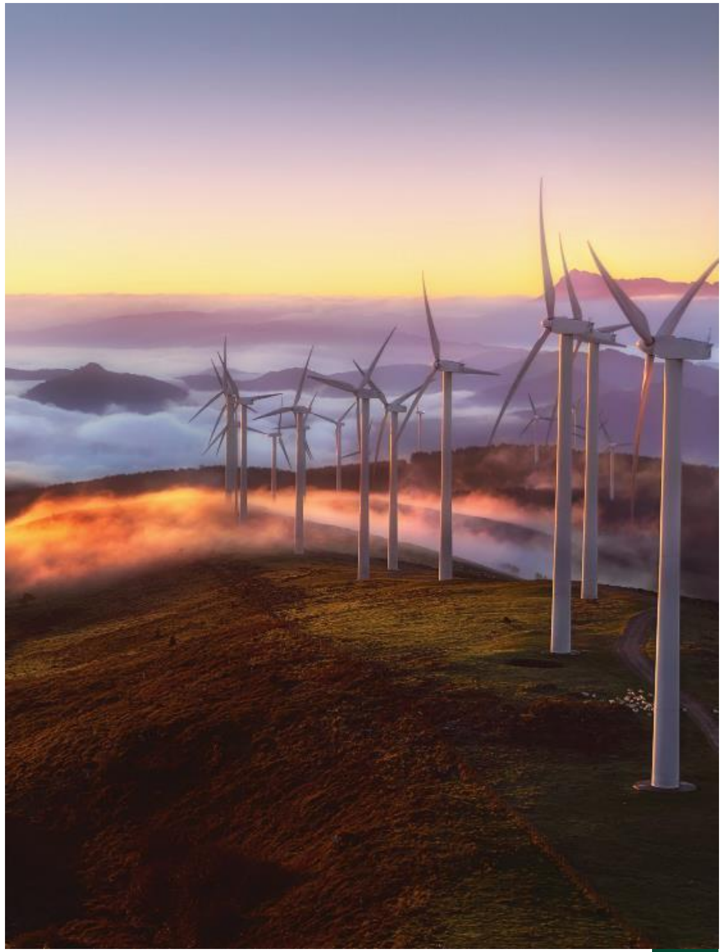
The focus on renewables and energy efficiency

2023 was a record year for renewable energy capacity addition, supported by the US Inflation Reduction Act and similar policy action in the European Union and China. However, to work towards 1.5°C, green technologies need to be scaled further. Alongside the formal negotiations, 118 countries signed the Global Pledge on Renewables and Energy Efficiency, involving a headline goal to triple installed renewable energy to 11TW by 2030, alongside a doubling of energy efficiency improvements to 4% a year in the same timeframe.

Delivering on this transformative pledge will require financing of existing technologies which have achieved bankability such as solar and wind. Just as importantly, energy efficiency improvements are likely to reduce energy demand, meaning that existing renewables energy power generation capacity can meet a greater share of demand and reduce reliance on fossil fuels. In addition to the financing of existing mature green technologies, innovative financing solutions will be needed to address the risks associated with relatively nascent technologies, such as geothermal, biogas and biomass, hydrogen, and carbon capture, utilisation, and storage (CCUS).

Emerging markets need attention

Moreover, COP28 has emphasised the critical importance of renewable energy and efficiency financing reaching emerging markets, preventing carbon lock-in as their economies and populations grow. The Independent High Level Expert Group on Climate Finance found that 90% of the increase in clean technology investment since 2021 has taken place in developed economies and China, meaning a greater proportion of future investment needs to make its way toward emerging markets.



The time has come for transition finance

Financing hard-to-abate sectors

COP28, underscored by being hosted in a petrostate, brought a realism to discussions in financing hard-to-abate sectors. Whether in the form of the Global Flaring and Methane Reduction Partnership pledge made by 49 countries, or progress on the agreement to retire the Indonesian Cirebon-1 coal fired power plant seven years early, climate mitigation finance will be needed from both public and private sources to enable business model transformation by sectors, from cement to coal.

However, significant concerns remain over reputational risks, including greenwashing associated with financing, or financing of sectors which attract NGO and broader civil society attention such as oil and gas. These were highlighted by new guidance from the International Organization of Securities Commissions (IOSCO) and the Sustainability Disclosure Requirements (SDR) issued by the Financial Conduct Authority (FCA), which stated that greenwashing is already punishable under regulatory frameworks. In response, COP28 saw the launch of key components to manage these risks, detailed in the box on the right.

Many of these will also be relevant for financial institutions preparing to disclose against the Transition Plan Taskforce, currently consulting on guidance for seven sectors including asset managers, asset owners and banks.

Addressing greenwashing risk

Several announcements at COP28 were aimed at providing guidance on transition finance.

- UK confirming its intention for a Transition Finance Market Review
- Monetary Authority of Singapore (MAS) launching an official transition finance taxonomy
- A new Taskforce on Net Zero Policy was launched to create an enabling policy environment for such frameworks
- At a platforms level, the Glasgow Financial Alliance for Net Zero (GFANZ) signaled work on avoided emissions metrics to allow financial institutions to measure their contribution to the transition
- The United Nations Environment Partnership – Financial Institutions (UNEP-FI) launched a discussion paper on transition finance metrics for banks.

Adaptation is inevitable

Adaptation measures cannot be avoided

The frequency of climate disasters has increased, and whilst efforts continue to ‘keep 1.5 alive’ current government pledges under the Paris Agreement are aligned to warming between 2.5 and 2.9°C.

In response, action on adaptation by governments, companies and financial institutions was a significant focus at COP28, as the level of adaptation needed, even under 1.5°C of warming, has become apparent.

COP28 brought further progress on the Global Goal on Adaptation originally enshrined in the Paris Agreement including that adaptation financing will need to increase ‘manyfold’ and go beyond the mandated doubling for 2025. These discussions encouraged the idea of reforming the international financial architecture and brought a raft of commitments and early-stage discussion on how financial institutions can mobilise capital toward adaptation.

There have discussions by multilateral and development institutions to increase climate finance and make it easier to blend this into structures alongside private financial institutions. Examples of commitments include USD1bn by the Islamic Development Bank on adaptation with a focus on conflict areas, and the UAE’s flagship USD30bn Alterra Fund announcement including concessional capital and the involvement of large organisations including BlackRock and Brookfield. The EU, among others, also made a significant contribution to operationalising a new fund responding to loss and damage.

People must be at the heart of the transition

The transition needs to be equitable, accessible and affordable for all

As the global economy transitions to net zero, it is becoming increasingly clear people will experience the transition in different ways. This can be as employees (e.g. changing skills requirements), as consumers of transition products (e.g. housing retrofits and electric vehicles), or individuals as part of an interested and affected community. Against a backdrop of higher interest rates, financial institutions are looking at alternative ways to support the transition in an affordable manner.

This was a key facet of discussions at COP28, with UNEP-FI and the International Labor Organisation releasing a new publication on the roadmap for banks and insurers to incorporate the 'just transition'. The discussion called for no-one to be left behind, at both a strategic level, and in the designing of products which specifically enable a just transition. The concept was given further impetus by the first-ever ministerial roundtable on just transition, which heard from financial services experts. Gender inclusion was also part of discussions to drive social equality and improve decision making, focusing on the need for women in senior management positions.

Bringing together many of the themes at COP, the European Investment Bank (EIB) launched a 'just resilience' approach seeking to bring a just element into climate resilience finance, with particular focus on emerging markets. The EIB's move exemplified the wider role that multilaterals and development finance institutions are seeking to play, including through blended finance, in mobilising climate capital.

The Implications

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Corporate-level

Capital Providers

Intermediaries

Enablers

There is an enormous amount of work to do in **decarbonising the global economy** across all sectors and geographies. **Companies of all sizes are at the heart of the economy** and will either need to re-invent their business models or adapt themselves so that they can support the transition. They will require a blend of governmental policy and capital provided by financial institutions.

These companies will need to develop **credible transition plans**; these are tangible documents outlining their climate ambitions, how they will achieve them, and what is required to do so. These plans will provide a structured basis upon which financial institutions can support companies.

Corporate-level

The Implications

The importance of transition plans

With the world falling behind on delivering net zero, there is growing pressure on companies from actors across the financial ecosystem. COP28 saw the introduction of a new taskforce on net zero policy to hold firms accountable in meeting their net zero emissions commitments and aligning with regulatory policy. Improved decision making and supporting action remains a priority, underlying the importance of talent, meaningful data and products that can help companies facilitate their transition.

A credible and transparent transition plan is critical in responding to these pressures and will need to be updated periodically and form the basis of transparent reporting on ambition and progress. The work of the Transition Plan Taskforce during 2023 has been central in creating a shared understanding of what such reporting could look like, consistent with the ambition of being a 'gold standard' and aligned with the work of the International Sustainability Standards Board (ISSB).

Through their transition plan, companies can articulate the shape of their transition, and the capital needed to deliver it. In hard-to-abate sectors, this will need to cover how business models may diversify or change and how the transition may change how revenue is generated or anticipated profitability, over time.

Energy Efficiency

Many larger corporates have acted on energy efficiency as part of their transition plans, given the often-short payback periods. With incremental improvements in technology, this should continue to be revisited. Smaller companies should also follow suit, thinking about how planned investments in new equipment or upgrades can provide an opportunity to assess efficiency, as part of the overall cost.

Unlocking capital through effective transition planning

At their core, transition plans may become the gateway to retaining access to capital and scaling availability of finance.

Given attention from regulators and ratings agencies, pace is important. Transition plans will not only become mandatory in the UK for accounting periods starting January 2025, but are already beginning to feature in rating agencies methodologies and as a standalone ratings product among some ratings providers.

Corporate-level

The Implications

What is a just transition?

The United Nations defines a just transition as:

“ensuring that no one is left behind or pushed behind in the transition to low-carbon and environmentally sustainable economies and societies”.

Including just transition considerations

It is imperative for companies to include just transition considerations that cover their employees, supply chains and consumers, in their transition plans. This will require a broad range of actions, for example:

- Upskilling and reskilling workers
- Employee incentive schemes and support, such as salary sacrifice for electric vehicles
- Green/Sustainable product innovation and development
- Customer education
- Supporting communities
- Supporting their supply chain as they work through measuring and managing their emissions.

Corporate-level

Capital Providers

Intermediaries

Enablers

Capital providers have a key role to play in the **provision of capital across mitigation and adaptation** activities to both individual and corporate borrowers. Such provision of finance will need to be delivered with due consideration of how it is **supporting real economy decarbonisation** and **enabling a socially just transition** for individuals in their dual roles as citizens and employees. Capital providers will need to come up with **innovative financing structures** where necessary and seek out opportunities to **collaborate with policy makers** to ensure the net-zero transition does not increase social inequity. Companies' transition plans should form the basis of engagement and should **drive decision-making** on where and how to allocate capital.

Capital Providers

The Implications

The Challenges

Whilst capital providers continue to deploy capital to green and transition finance, the key concerns about this continued practice are:

1. The ability to generate returns in a changed economic climate, especially for less proven technologies
2. Identification of adaptation activities
3. Susceptibility to accusations of greenwashing when providing financing to hard-to-abate sectors.

Generating returns, incentives are required

On the first point, there were numerous examples given at COP28 of renewable energy projects which are struggling to attract financing as interest rates remain high in most economies. Indeed, some capital providers are not seeing enough product opportunities to satisfy their desire to deploy capital into green and climate solutions in a way that delivers returns to their investors. A recent report from Phoenix Group and Make My Money Matter found that despite the appetite to scale up investment, UK pension schemes will only find opportunities to invest between £200bn and £300bn by 2025, just 15% of what is required to meet net zero.

In response, capital providers in developed markets are increasingly reliant on the design of incentive schemes to support mitigation and adaptation climate finance. For example, in the UK, this has encompassed enhancements to the UK offshore wind regime which both increases headline payments, but also offers incentives for supply chain emissions reductions and community benefits. The picture is very different in emerging markets, where capital providers remain reliant on risk sharing by multilateral financial institutions and guarantors to finance projects.

Capital Providers

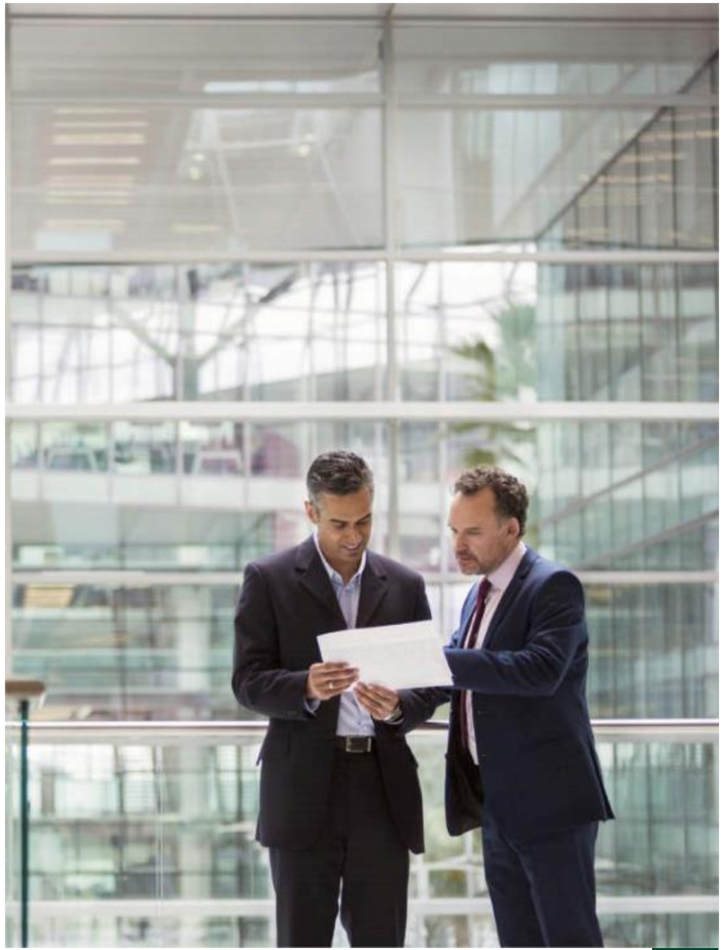
The Implications

Adaptation needs definition

On the topic of adaptation finance, securing financing for implementing adaptive measures requires transparency of needs through a transition plan. It will also require that capital providers are able to independently validate the adequacy of adaptation measures; both from a technology perspective, and through the ability to model potential future physical climate impacts and the effectiveness of the plans in addressing these. COP28 saw progress made to reform the climate finance architecture by making climate adaptation finance more available, accessible, and affordable with blended finance. Whilst the challenge of developing 'public good' adaptation measures such as coastal flood defenses primarily sits with governments and sovereigns, incentive structures will be needed to attract private capital, especially in emerging markets with greater perceived risk.

Increased guidance to address greenwashing risk

On the third challenge, UNEP-FI has released guidance for banks on 'Developing Metrics for Transition Finance' which speaks to greater granularity of reporting against financing of transition activities (use of banks' transition finance taxonomies), measurements of committed decarbonisation and supporting evidence. Reporting of these metrics will provide greater need on capital providers to assess the credibility of companies' transition plans and engage with them. This complements work led by the Glasgow Financial Alliance for Net Zero (GFANZ) on metrics such as avoided emissions, which can be applied by a wider range of capital providers and help demonstrate contribution to the transition. However, both organisations' work will be aided if 2024 brings clearer entity- and activity-level definitions of what is deemed to be transition and therefore eligible for the moniker of 'transition finance'.



Corporate-level

Capital Providers

Intermediaries

Enablers

Financial Intermediaries have a unique role in the financial ecosystem, as they provide **the bridge between retail investors and customers and those allocating their capital**. In this position, their role is multifaceted; they will need to educate investors, determine investment objectives, and ensure alignment with the desired outcomes.

Intermediaries

The Implications

What needs to be done?

The role of financial intermediaries in increasing consumer awareness across the landscape of sustainable finance solutions will continue to be key. Whether from the perspective of customers needing to retrofit their homes or retail investors seeking "sustainable investments", the role of the intermediary will be to **support the upskilling and awareness of customers**, maintaining clarity across the labelling of green/sustainable investment products to **ensure consumer protection**, and **scaling solutions** via technology to make these accessible as demand persists.

Supporting customers

Firstly, banks, asset managers and wealth managers have a duty to support their customers and clients in how best to deploy capital to meet their desired sustainability-aligned outcomes and through a just transition. For example, for homeowners, this could involve supporting the upskilling of the customers on the benefits of retrofitting their homes for greater energy efficiency and supporting those from low- and middle-income households with innovative financing solutions. For retail investors this will involve greater transparency on where their funds are being deployed and support on how to continue to balance the trade-off between the desire to generate social and environmental benefits, whilst maintaining the required financial return versus their risk appetite.

Asset owners' fiduciary duty requires them to consider, evaluate, and make decisions based on what supports the best interests of their stakeholders. This could include a pension provider who believes they should help bring about a world for their members to retire into, that mitigates the worst impacts of climate change. The Transition Plan Taskforce's asset owner guidance suggests institutional investors should disclose whether and how their interpretation of fiduciary duty supports the strategic ambition of their transition plan.

Intermediaries

The Implications

Attention on anti-greenwashing

To further promote enhanced transparency and access to information, anti-greenwashing legislation is gaining greater attention. For example, The Financial Conduct Authority (FCA) in the UK has published its final version of the Sustainability Disclosure Requirements (SDR), which requires all FCA-authorised firms to “reinforce that sustainability-related claims must be fair, clear and not misleading”. The rules detail naming and marketing rules, a transparent labelling regime and enhanced levels of disclosure. This parallels the influence of the EU Sustainable Finance Disclosure Regulation (SFDR) which is seeking to improve fund transparency around environment and social impacts.

Redirecting capital flows to have impact

Increased transparency further underpins growth in impact investing due to it being value accretive. In 2022, the Global Impact Investing Network (GIN) sized the global impact investing market at USD 1.2tn. To further demonstrate this, equity funds falling under SFDR's Articles 8 and 9 have experienced 3.4 times more cumulative inflows than their Article 6 counterparts since 2019. As appetite continues to grow, there will be an increasingly need for ESG-categorised products to be more accessible for a growing pool of retail investors and asset managers, who in turn will need to demonstrate how they have met their sustainable investment objectives.

Labelling under the UK’s Sustainability Disclosure Requirements (SDR)

Similarly, the UK’s SDR, which includes a ‘Sustainability Improvers’ category is likely to result in a shift in fund flows towards sustainability-themed and transition funds thus affecting capital distribution, reflecting a preference for companies aligned with specific themes. The increasing adoption of the transition taxonomies will be a significant catalyst for investing in such companies and sectors. Taxonomies and frameworks will be a driver in directing capital towards enhancing sustainable outcomes whilst mitigating greenwashing risk.

Corporate-level

Capital Providers

Intermediaries

Enablers

Enablers have a broad but key role to ensure effective **functioning of the system**. Sovereign agencies, regulators, insurance, ratings agencies and other market participants, all have a role to play in **enabling capital to flow to support the transition**, through facilitating information flows, mitigating the potential for harm and misaligned outcomes and innovating to overcome barriers to capital flow.

Enablers

The Implications

Climate mitigation finance

Across mitigation, for green and transition finance, insurance will be essential to enable the technology needed to decarbonise hard-to-abate sectors. Beyond conventional coverage for construction and liabilities, new prospects will emerge for insurance to reduce risks in the value chain for these investments. Greater protection against uncertainty or specific outcomes may support an investment case. In addition, insurers will need to support this transition in a just and inclusive manner, as indicated by UNEP-FI's 'Just Transition Finance', including pathways for insurers and banks.

Carbon markets unlocking climate finance

In addition, carbon markets were at the forefront of discussions at COP28, due to their role in unlocking climate finance.

As the United Nations Sustainable Stock Exchanges (UN SSE), International Organization of Securities Commissions (IOSCO) and UNFCCC convened, they put emphasis on the need for regulatory bodies, stock exchanges and standard setters to align their efforts towards sustainable finance. As part of these efforts, the US Commodity Futures Trading Commission (CFTC) issued proposed guidance, 'The Voluntary Carbon Market Proposed Guidance' to "help shape standards in support of integrity, which will lead to transparency, liquidity, and ultimately price discovery". Carbon credit certification bodies followed suit, with the likes of Verra, American Carbon Registry (ACR), Gold Standard and others coming together for the Carbon Markets Pledge, collaborating in order to promote integrity for credit quality, supporting activities as they deliver mitigation and community benefits. As they look to align to The Integrity Council for Voluntary Carbon Markets (ICVCM) Core Carbon Principles, alignment of methodologies among the registries should make improvements to issues around double-counting and additionality.

Enablers

The Implications

The Adaptation Finance Gap

UNEP's 'Adaptation Gap Report 2023', speaks to an adaptation finance gap of

USD194 – 366bn per year

with adaptation finance needs in developing countries likely to be 10–18 times as great as finance flows.

Developed nations supporting developing nations

Whilst developing countries are disproportionately impacted by climate risks, COP28 saw advanced economies channel some of their Special Drawing Rights (SDRs) to developing countries with more pressing needs. For example, Japan announced a commitment to support the innovative facility developed by the AfDB and IDB to leverage SDRs for climate and development. Public funding cannot plug the gap alone; the importance of blended finance mechanisms as an enabler to unlocking private capital will need to be supported by increased innovation from intermediaries and enablers.

Insurers have a key role to play in managing climate-related risks

The insurance industry can be critical in providing risk-engineering services to help clients effectively manage climate-related risks. Insurers can provide services, including rigorous risk assessments and engineering solutions tailored for natural hazards, pre-construction advisory services. Additionally, post-loss incentives could be developed to encourage reconstruction in locations characterised by enhanced resilience or reduced vulnerability. Despite the gradual unfolding of climate change impacts over decades, insurers should look to expand their capabilities now to seize on developing opportunities. This might involve strategic initiatives like the recruitment and comprehensive training of underwriting talent, ensuring the industry's preparedness.

What to look out for in 2024

Market Developments

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COP28 came at a pivotal moment and involved some intense negotiations. The commitments signed and pledges made will inevitably play out over the coming years.

As we look to 2024, alongside a continued focus on climate, the year will bring further evolution for ESG in financial services. Here’s some of the developments to look out for in future editions.

What to look out for in 2024

Market Developments

Regulation and transparency

- With the finalisation of the UK Sustainability Disclosure Requirements (SDR), all FCA-authorised firms will need to ensure that "that sustainability-related claims must be fair, clear and not misleading". The FCA has already conducted a review of fund managers' practice and found inconsistencies in product naming, fund holdings and disclosures.
- Against such concerns, the focus across financial services will also need to move beyond climate, and the tricky issue of how to demonstrate impact. The recently announced Impact Disclosure Taskforce is focused on voluntary guidelines to help financial institutions navigate, with a consultation expected in Q2 2024.
- The UK's HM Treasury is expected to release an ESG Data and Ratings Code of Conduct setting out clear standards for market participants, mirroring steps taken by regulators in countries including the EU, India and Japan. This comes amidst growing pressure for ESG ratings to incorporate both companies' impact on the environment, and how a company is impacted by the environment.
- Debates will continue, on the inclusion of financial services within the EU's Corporate Sustainability Due Diligence Directive (CSDDD), expected to be concluded in the coming year and with meaningful implications for financial institutions if scoped in.

What to look out for in 2024

Market Developments

Nature and biodiversity

- Biodiversity, including risks to financial stability, continue to rise up the agenda. Spurred by the release of a first wave of Taskforce on Nature-related Financial Disclosures (TNFD) signatories in Davos in January 2024 and expectations from the European Central Bank (ECB), efforts to assess and manage nature risks and opportunities in the financial sector will grow. The inclusion of biodiversity on the International Sustainability Standards Boards' (ISSB) 2024 priorities imply quicker progress and international alignment than seen on climate.
- Catalysing government and corporate action on biodiversity, 2024 will see governments bring their National Biodiversity Strategies and Action Plans (NBSAPs) to the biodiversity COP, showing how they will contribute to shared goals including conservation of 30% of land and sea areas, and reform of USD500bn a year of nature-harming incentives. Both bring potentially significant transition risks for corporates and the financial institutions that serve them.

Thank you for reading.

We hope you have enjoyed reading this inaugural edition of our ESG newsletter and we would welcome your feedback.

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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