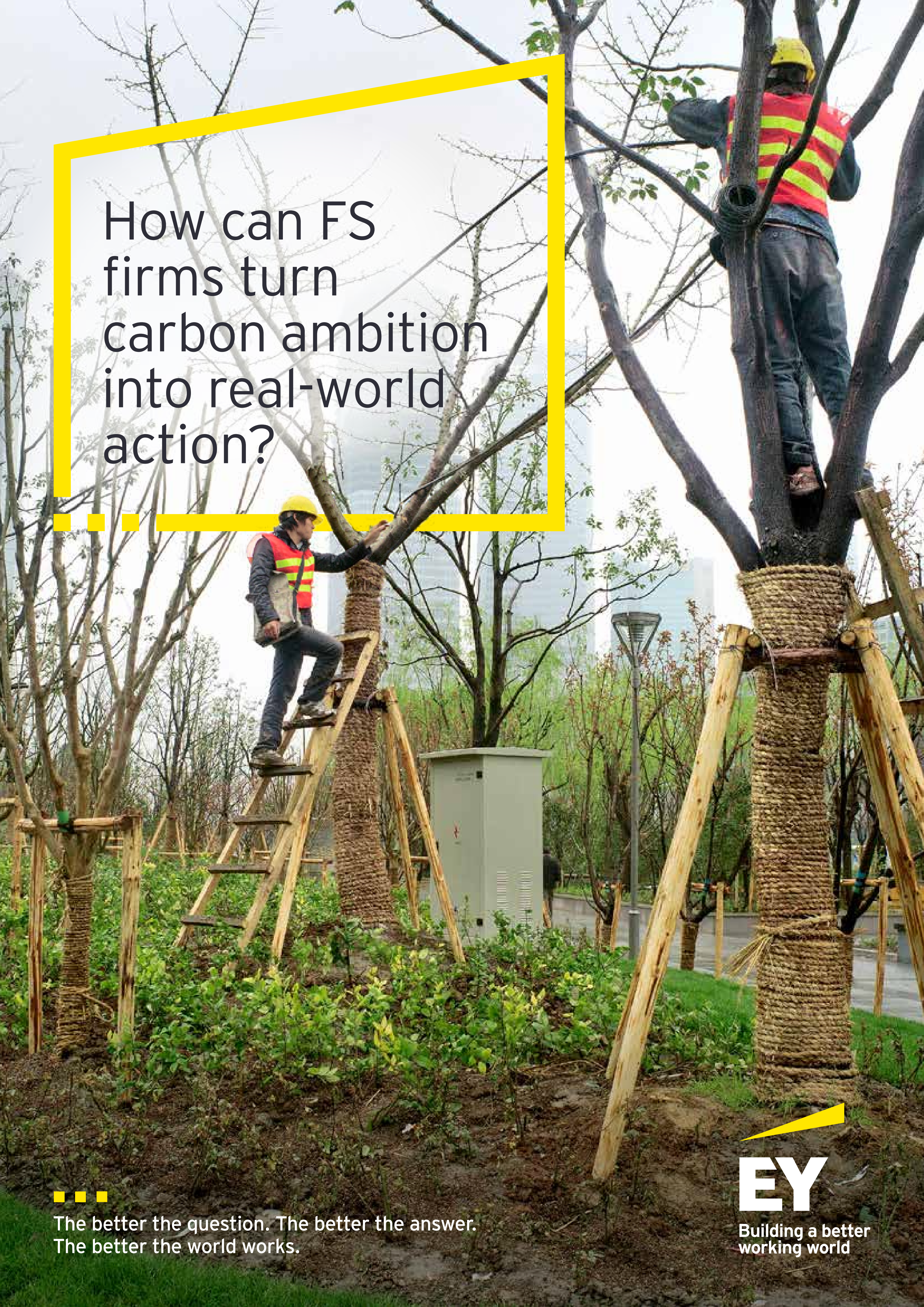
How can FS firms turn carbon ambition into real-world action?



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Building a better working world

The 2021 United Nations Climate Change Conference of the Parties (COP26) in Glasgow, Scotland, represents a watershed moment in the world's response to the climate crisis. Coming in the wake of stark warnings from the Intergovernmental Panel on Climate Change, the sheer scale of the required transformation and the necessity of rapid action is only too clear.

Financial service organizations (FSOs) have a key role to play in the global response to the climate crisis. Many are keen to demonstrate leadership and are not only committing to eliminate the scope 1 and 2 greenhouse gas emissions associated with their own energy use, but also to reduce their scope 3 emissions — including the "financed emissions" associated with client activities they fund, invest in, insure or facilitate.

It is important to acknowledge that the financial industry cannot act independently of the wider economy in which it operates. Every FSO needs to determine its own decarbonization strategy, and each must engage with a range of stakeholders including investors, customers, regulators and governments.

Whichever approach FSOs choose, the ability to set out credible decarbonization plans will be critical to reducing financed emissions and building a shared sense of purpose with stakeholders. Making this possible depends on three high-level imperatives:

1. Setting science-based targets to reduce emissions associated with financing activities
2. Setting targets to increase finance flows for climate solutions
3. Building trust in those targets through credible planning, disclosure and reporting

This paper explores how FSOs seeking to decarbonize their entire emissions footprint can respond to these imperatives. It sets out the current uncertainties facing firms, and the biggest challenges confronting the industry right now. It then describes a practical four-stage approach that FSOs can use to build market-leading decarbonization plans that will help achieve stated targets and, more importantly, deliver the real economy changes that are ultimately required to limit anthropogenic climate change to 1.5 degrees Celsius over preindustrial levels.

Introduction

Firms face a huge task to deliver on their own ambitious targets

Companies, financial institutions, cities and **more than 130 countries** have either committed or are planning to target the reduction of greenhouse gas (GHG) emissions to net zero by the middle of the century. Net zero is the crucial longer-term goal, but steep emissions cuts during the 2020s – especially by the largest GHG emitters – are also critical to limiting global warming and safeguarding a livable climate.

Facing pressure from investors and customers and, for some, the prospect of mandatory regulation, many FSOs are now making ambitious commitments to reduce their scope 3 financed emissions. To date, around 50% of major FSOs have set net zero targets for 2050.

This wave of ambition is welcome, but FSOs now face a huge task to make this real and play their role in reshaping the financial system. Mobilizing capital for decarbonization at a greater scale and developing new techniques to finance the transition are essential. But for individual FSOs, the most fundamental requirement is for credible decarbonization plans. The efforts of the Race to Zero campaign and its respective financial alliances and initiatives have moved this forward considerably, but FSOs still face several key implementation questions:

- **Where are we now?** Firms need a clear baseline of their scope 1, 2 and 3 emissions against which they can track progress. For FSOs, scope 3 emissions, including financed emissions, are critical. Calculating these is complex since the relevant requirements, data and methodologies are still evolving.
- **Where are we going?** Financial institutions need to set targets based on what the latest science shows is required to achieve Paris Agreement goals. Ambitious FSOs want to facilitate the transition of carbon-heavy industries at the same time as supporting climate solutions. This requires assessing counterparties' own transition plans for adequacy and credibility.
- **How do we get there?** Developing clear decarbonization strategies that incorporate interim and long-term goals is not easy and requires strong governance and controls. Senior management also need to understand and agree on the levers available to reduce emissions, while adhering to important principles, such as supporting a just and equitable transition.
- **Who do we need to tell?** FSOs will require transparent and controlled communication strategies to disclose their plans to customers, investors, regulators and staff if they are to build trust, confidence and momentum in their targets.

The next 5 to 10 years are critical in terms of commitments and actions. GHG emissions need to be halved by 2030 if net zero is to be achieved by 2050. Time is short for the industry to help transform every sector of the economy even though some of the low hanging fruit has already been harvested.

Lastly, firms must be alert to the potential opportunities created by the rapid scaling of low-carbon solutions. Traditionally, climate action has been viewed as a requirement to shoulder the burden of decarbonization. There is now growing recognition of a different perspective: that the global transition gives FSOs the chance to participate in an innovation and technology revolution with unprecedented potential for value creation.

Challenge

Building emission baselines is complex and judgmental

Establishing boundaries for emissions ownership is a particular challenge in assessing the current state of a firm's emissions footprint. FSOs can struggle to understand where the boundaries for emissions that they "own" are drawn, what should be accounted for within different scopes and which quantification methodologies to use or that may be required.

Unfortunately, companies' current climate data is often inconsistent and, in most cases, incomplete. Where actual GHG data cannot be collected directly from counterparties, it needs to be estimated based on proxies such as activity data or industry averages.

FSOs also need to review clients' financed emissions profiles associated with client activities they fund, invest in, insure or facilitate and keep a robust record of the basis of the calculations used. However, calculation methodologies are still relatively nascent. Responding to industry demand for a globally accepted standard for accounting for GHG accounting, the Partnership for Carbon Accounting Financials (PCAF) has recently developed a standard for calculating financed emissions covering six asset classes. In addition, the collective effort of FSOs through respective UN-convened net zero financial services alliances have helped to create joint momentum on framing new methodologies. However, gaps still remain and will need to be addressed in the future.

Credible decarbonization pathways must be anchored in climate science

A range of climate reference scenarios and transition pathways are available to FSOs. However, their forward-looking nature means that each is based on a set of assumptions about how underlying economic, social and environmental dynamics will play out in coming years. FSOs need to choose between a range of industry and internally driven approaches. Each has its benefits and limitations, and it can be hard to know which methodology has the greatest relevance to each portfolio or loan book, and which will provide the greatest possible comparability between counterparties.

To show leadership, FSOs should consider aligning their targets with the goals of the Paris Agreement, using the latest climate science to ensure sufficient ambition. Best practice is to use methodologies such as the Science Based Targets initiative (SBTi) where possible and to support the decarbonization of emissions-intensive industries, as well as the expansion of climate solutions. However, most methodologies are still evolving and are typically applicable to a limited range of financial institutions, depending on their activities and asset classes. SBTi, for example, is being refined and expanded with a version 2.0 expected to be released later this year.

Strategy is vital, but represents a difficult balancing act

Selecting decarbonization levers — specific changes to the ways in which FSOs choose the companies, activities and assets they wish to finance, invest in or insure — is the crux of an effective net zero strategy. However, identifying enough of those levers, and implementing them in a sufficiently coordinated way, is highly challenging, even for the most ambitious firms, and involves difficult decisions. There is no shortcut to achieving net zero emissions.

There are several reasons why selecting the right levers is challenging. One is the vital importance of making substantial, tangible reductions in emissions within the current decade. Another is the need to go beyond simple divestment; FSOs will only enable decarbonization in the real economy if they engage with counterparties to support their transition to lower emissions. A third challenge comes from the need to rapidly scale up the flow of capital to clients and activities that provide climate solutions. Finally, FSOs need to balance net zero goals with other sustainable development goals and an appreciation of wider social, economic and political factors. If decarbonization efforts hurt society or prosperity, they will not command public or political support.

The need for support and engagement means that communication is also a crucial element of successful strategies. If FSOs are to build trust and buy-in among stakeholders, they need to find a clear way to communicate decarbonization strategies — and the thinking behind them — to their own investors, clients and key partners.

Disclosure is evolving fast, but convergence is proving much slower

Public and regulatory bodies around the world are working to develop robust nonfinancial reporting frameworks. That includes a set of emerging requirements around transition plans, which have become a core component of guidance from the Task Force on Climate-related Financial Disclosures (TCFD). Regulators, such as the UK's Financial Conduct Authority, are now signaling their intention to refer to that guidance when assessing whether firms' climate-related financial disclosures are consistent with the TCFD's recommendations. Meanwhile the European Union, seeking to build its green finance credentials, is planning to require transition plans from all large companies, including short-term targets and reports on progress.

Transparency is vital to achieving net zero outcomes, so every initiative is welcome. But while alignment is improving, true harmonization is only beginning. Standards are still multiplying; frameworks are still in development, interpretations vary and inconsistencies are widespread. In some countries, market forces rather than regulation that are driving change. Many emerging frameworks are also unsuited to less mature markets. These limitations pose huge challenges for FSOs, which prize credible data as the basis for decision-making.

Furthermore, the importance of clear disclosure cuts both ways. FSOs themselves need to be able to communicate their decarbonization progress to investors and other stakeholders as transparently as possible. For now, however, we remain a long way from climate-related reporting being anywhere near as reliable or usable as the information in core financial statements.

Practical steps

FSOs can use four key actions to plan their journey to net zero

For FSOs, the need to transform their own activities while guiding the entire economy onto a new footing feels daunting. Especially since the work must start immediately. CEOs need to "build the car while driving it."

Despite the challenges they face, there are four very practical steps firms can use to construct credible decarbonization plans. The overall goal is to build a framework that allows FSOs to measure, monitor and reduce their emissions, and to communicate progress to stakeholders. To succeed, these four stages must also be underpinned by a set of pragmatic design principles.

At the global EY organization we call this a decarbonization framework: **an approach that aligns practical steps with climate science, allowing FSOs to assemble the building blocks of credible transition planning.** Credible decarbonization plans allow firms to build confidence in their net zero targets, and to provide stakeholders with a clear rationale for how they will achieve them. They can also help governments, shareholders and customers to understand current and potential gaps in financing, and to formulate appropriate responses.

Stage 1
Understand your current emissions

FSOs have a deep understanding of their balance sheets and profit and loss accounts. As they become more familiar with their other scope 1, 2 and 3 emissions, firms need to apply their financial knowledge to mapping their current scope 3 financed emissions — the first step toward delivering on their net zero commitments.

FSO's structures and balance sheets are complex, so it's important to define exactly how the boundaries of emissions ownership are drawn among different activities and sectors. Engaging business units in this process is critical to achieving stakeholder engagement and buy-in. Once boundaries are identified, it's vital to understand the applicability of actual, estimated and proxy methodologies and their associated data requirements. Establishing the principles of carbon accounting upfront will help to determine which data can be collected from counterparties, which must be estimated and – if proxies are needed — which methodology to use. These can be leveraged from PCAF standards and the ongoing work programs of the financial services net zero alliances affiliated with Race to Zero.

Documentation and governance are key too and will be subject to future scrutiny, especially where decisions lead to an absolute change in emissions. FSOs must take stock of each client's financed emissions profile and keep a full record of the calculation methodologies used.

Data inputs and availability continue to be the subject of heated debate. EY has assessed over 150 environmental, social and governance (ESG) data providers in relation to existing reporting requirements. Even in the baselining area of carbon accounting, FSOs have a choice of multiple providers. Firms need to establish clear guard rails for assessing data providers, demonstrating that those selected are suited to the nature of the business and have been thoroughly evaluated.

Stage 2
Develop your decarbonization ambition and targets

The ability to directly tie net zero targets to board-level ambitions and firms' wider ESG commitments is central to credible transition planning. Net zero targets also need to flow through the organization and be represented in all strategic priorities from a functional (e.g., risk and finance) and business perspective. Key stakeholders must be clear on the risks being managed, but also on the opportunities associated with credible transition planning, focused on:

- New products and services that incentivize green behavior
- Differentiated offerings across offerings and customer segments
- Driving investor engagement by demonstrating real economy impacts
- Increased value creation for all stakeholders

For all this to be possible, governance structures from the CEO down need to be clear and transparent. To achieve real change in the organization, those in authority must institute measures and KPIs that drive delivery. At leading FSOs, these metrics will be tied to remuneration structures.

At the same time, FSOs need to accept that they are setting targets that are not fully within their control. They can decide where and how to provide finance, but they can't directly influence the actions of governments and consumers or the pace of innovation. FSOs should be clear on their assumptions about future developments in policy, technology and public behavior — while remaining focused on their own role as facilitators of clients' transitions.

These considerations make it essential for decarbonization pathways to be directly linked with climate science. To show leadership, FSOs should consider signing up to the SBTi. This will allow firms to focus on setting mid-term (2025 and 2030) and long-term (2050) financed emissions reduction targets aligned with the chosen transition pathway, including:

- Top-down targets (i.e., at portfolio or loan book level)
- Sector and subsector targets
- Asset class or activity level targets
- Green financing or investment targets

Stage 3

Design and implement your decarbonization strategy

Setting an effective decarbonization strategy needs to start with FSOs assessing the suitability of potential decarbonization approaches for all the activities in their portfolio. Firms should compile a longlist of potential levers to pull across different business units, sectors or asset classes, grouped into three categories:

1. **Where can the institution engage?** Via advice, advocacy and investment stewardship, or by favoring low-emissions uses of capital or insurance over high-emitting activities
2. **Where can the institution make exclusion choices?** Through divestment, or the withdrawal of financing, advice or insurance
3. **Where can the institution scale-up climate solutions?** For example, by increasing the provision of green financing, green investments or green insurance

The potential actions identified should then be prioritized according to their impact on emissions, risk, costs and customer relationships. That will allow FSOs to generate a workable shortlist of feasible levers.

Next, the impact of those levers needs to be calculated and assessed against the short-term and medium-term targets set out in the decarbonization plan. Implementing the levers, tracking their effects and subsequent re-iteration needs to be managed within the governance and frameworks set up by the FSO. This will ultimately lead to the publication of a decarbonization policy that includes each firm's stance on choices about engagement and participation, and which discloses explicit criteria for "green" financing, investments or insurance.

Stage 4

Communicate your performance

Effective communication and reporting are critical for FSOs to convince stakeholders of the credibility of their decarbonization strategies. The Transition Pathways Initiative (TPI) considers two factors when assessing a company's emissions management and reporting:

- **Management quality (processes):** This refers to the governance of GHG emissions and their related risks and opportunities, as well as the quality of a firm's targets.
- **Emissions performance (outcomes):** This describes an FSO's exposure to assets aligned with national and international targets, including the Paris Agreement, relative to individual sector pathways.

Management quality and emissions performance are considered separately because research shows that the relationship between the two is not necessarily linear. This is particularly true in financial services, given the limited availability of reliable data for financed emissions. We expect to see management quality improve quickly for FSOs, with the resulting improvements in emissions performance building more slowly.

In contrast, the quality and transparency of FSOs' decarbonization reporting typically increases in line with improvements in management quality. Sector benchmarking plays a critical role in assessing emissions performance, and often relies exclusively on disclosed information. In 2020 EY helped Climate Action 100+ to develop an initial framework for capturing and structuring the data needed to gauge companies' performance on climate transition. The framework identifies key indicators of company reporting, aligned with the TPI methodology for assessing public disclosures.

More broadly, FSOs can build confidence around their ability to deliver emissions reductions by framing their performance reporting within a wider stakeholder communication effort setting out their decarbonization strategy, its underlying rationale and its resulting real-world impact.

Conclusion

Despite the accelerating pace of decarbonization, current rates of change won't be sufficient for many FSOs to achieve their net zero targets, let alone to keep climate change within acceptable limits. Credible science-based pathways give firms a mechanism for achieving the decarbonization goals they choose to set, and for generating buy-in for this approach from stakeholders. FSOs can reduce their emissions through the four iterative stages described above:

- Understand current financed emissions
- Develop decarbonization ambition and targets
- Design and implement a decarbonization strategy or strategies
- Communicate decarbonization performance and strategy

For this approach to work, FSOs need to back up their efforts with the right culture and mindset. A strong sense of shared purpose is key to building and sustaining momentum, as is the willingness to press ahead with decarbonization efforts despite the many challenges this poses. The building blocks of credible transition planning therefore need to be underpinned by some pragmatic design principles:

- **Act fast:** don't wait for perfect information or make 30-year plans. Set near-term targets and review plans continually as data and standards evolve.
- **Aim for real gains:** target a real-world reduction in emissions, not just a balance sheet improvement.
- **Follow the mitigation hierarchy:** avoid using emissions offsets to achieve reductions in emissions targets.
- **Demonstrate responsibility:** set targets that achieve a fair share of emissions reductions, given each FSO's size and history.
- **Ensure justice:** achieve net zero in a fair, inclusive way that leaves no one behind.
- **Be transparent:** communicate honestly and clearly about the need for a "best efforts" approach to a fast-evolving picture.
- **Create comparability and auditability:** build a robust data and technology framework that enables organizations to capture high-quality data over time.

Net zero is not the ultimate destination in the fight against climate change. Even so, it represents a major target on the long journey to keeping our planet livable — and a target to which many FSOs are now committed. Credible decarbonization plans provide a map that will guide FSOs toward that goal. But a map alone does not make the journey. FSOs also need to identify the obstacles they will face, the resources they will need along the way — and new, innovative ways to build the roads that will allow the journey to be completed.

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EYG no. 009323-21Gbl

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GA 142825401

ED None

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