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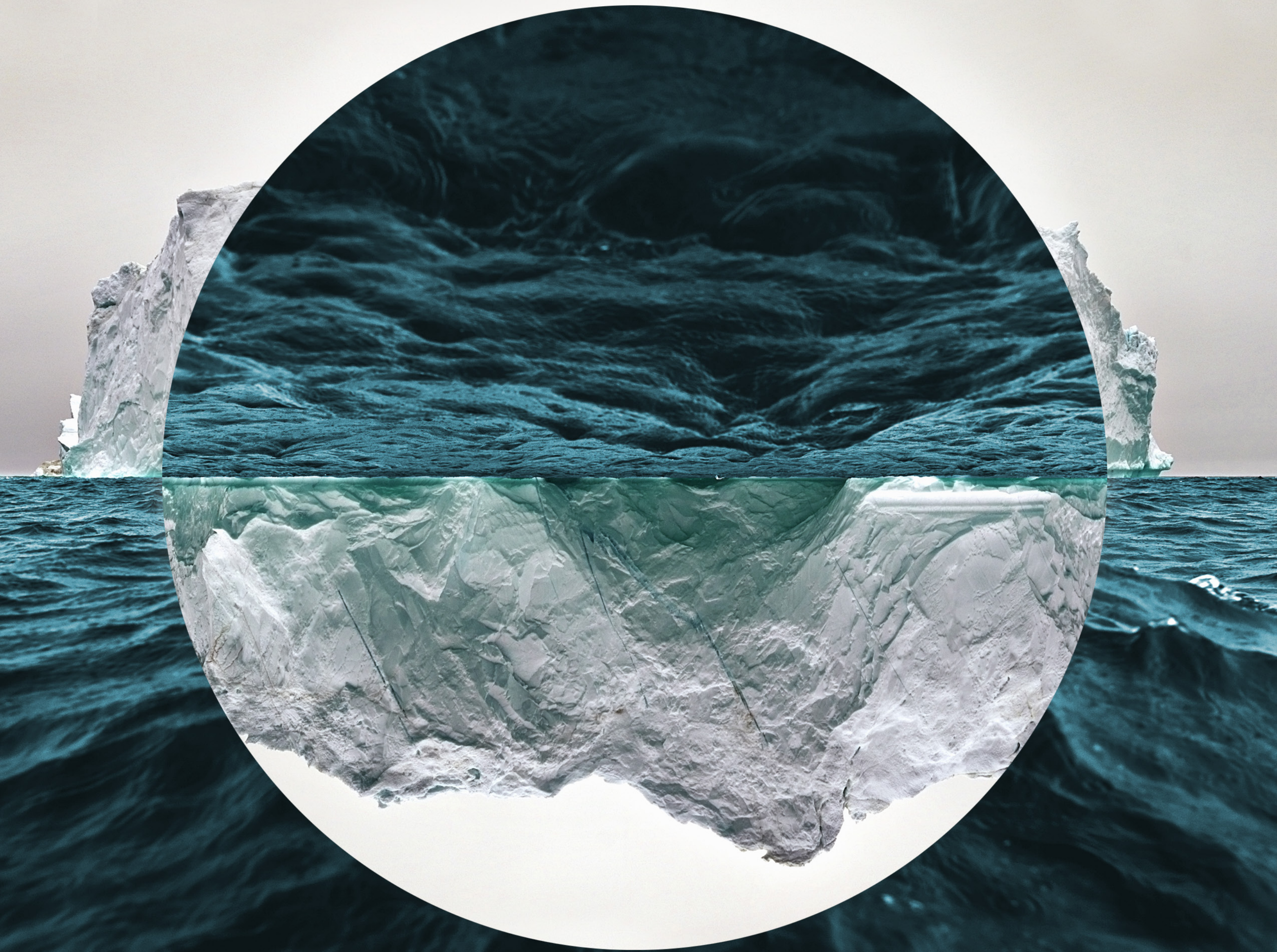

Financial services:
Navigating the transition to a net-zero emissions future

Climate change is affecting all sectors in the financial services industry (FSI) and all aspects of an organization's functions, from its day-to-day operations to its financing activities. FSI executives pondering the multidimensional implications of climate change on their loan books, investments, risk profiles, and business models must understand that it's ineffective to set long-range, net-zero targets without identifying interim steps for attaining them. An effective course of action must align strategic vision with tactical execution based on reliable data. This paper offers some practical suggestions for getting started.

Unlike agriculture and the energy, resources, and industrials sector (ER&I), the FSI industry contributes very little to global greenhouse gas (GHG) emissions in terms of its physical operations. Many banks, pension funds, private equity investors, and insurers have already become carbon-neutral in their day-to-day operations by improving the energy efficiency of their buildings and data centres, directly investing in renewable energy assets, and procuring renewable energy credits and carbon offsets.

However, decarbonizing the sector's financing activities is a different story. The FSI sector plays a far-reaching role in funding the global energy transition away from fossil fuels, supplying capital and generating returns for traditional and low-carbon asset classes while meeting the broader needs of all stakeholders, not only investors. This poses both unique challenges and opportunities in the journey to net-zero.

The implications of climate change

The ramifications for the financial services industry are complex and somewhat ambiguous since climate change affects stakeholders in many different ways. Regardless, FSI organizations generally share some fundamental concerns.

Common challenges

On a practical level, FSI organizations are concerned about the escalating risk of defaults in their loan books or poor performance within their investment portfolios. The prospect of stranded assets looms large in investment sectors such as ER&I, where companies could be caught off guard by the velocity of the transition to a low-carbon economy.

Many FSI organizations are also struggling with how to quantify and incorporate climate-specific risk into their investment underwriting, including how to balance this risk with meeting thresholds for internal rates of return and fulfilling their fiduciary duties.

To date, there has been little guidance from the governing bodies to help them incorporate climate risk into their investment models and fair valuations. The lack of standardized climate data in certain sectors exacerbates the challenge of pricing climate risk into FSI products and services.

These challenges are compounded by uncertainty about what it takes to decarbonize, including questions about the cost and feasibility of existing technologies such as wind, solar, and battery storage, as well as the potential value of emerging solutions such as hydrogen and carbon capture and sequestration (CCS).

While there are generally more questions than answers, the impetus to transform is being widely felt. Some FSI companies based in Canada have responded by setting net-zero emissions targets for 2050 or sooner. For instance, TD Bank intends to achieve net-zero GHG emissions for its operations and financing activities by 2050, aligned with the principles of the Paris Agreement.[1] The net-zero target is part of a global climate action plan, which also includes establishing dedicated teams to advise and support clients as they work to capture the opportunities of the low-carbon economy.[2]

Royal Bank of Canada (RBC) has similar ambitions, aiming to achieve net-zero carbon emissions in its lending by 2050.[3] RBC's plans include adding $500 billion to its sustainable financing funds, measuring and reporting emissions for the major sectors it finances, setting interim targets to reduce these financed emissions, and conducting climate-related stress testing.[4]

Beyond stand-alone initiatives, some institutions, such as RBC Asset Management, British Columbia Investment Management Corporation, Caisse de dépôt et placement du Québec, Canada Post Pension Plan, and Manulife Asset Management, are responding to the climate crisis by joining global industry efforts such as Climate Action 100+.[5] With 545 investors, which are responsible for over US$52 trillion in assets under management in

Big banks back sustainable-finance hub

Canada's Big 5 banks (TD Bank Group, Scotiabank, CIBC, BMO, and RBC) have committed $5 million to the Institute of Sustainable Finance (ISF).[29] The funding will support the institute's efforts in education, professional training, research, and collaboration, as well as outreach to advance Canada's leadership in sustainable finance. Based at the Smith School of Business at Queen's University, ISF's mission is to align mainstream financial markets with the country's transition to a lower-carbon economy.[30] Recognized as a groundbreaking collaborative hub, ISF brings together academia, the private sector, and government with the singular focus of increasing Canada's sustainable finance capacity.[31] The organization recently released the Capital Mobilization Plan for a Canadian Low Carbon Economy, which outlines the investment requirements and opportunities to achieve Canada's 2030 climate targets.[32]

33 markets, Climate Action 100+ is the world's largest investor-led initiative on climate change.[6] Recognizing that the decarbonization of the global economy is complex and will require unique strategies and approaches, investors in Climate Action 100+ seek to provide a common means of engaging on climate change across different businesses, regions, and sectors.[7] This consists of seeking commitments from boards and senior management to:

- Implement a strong governance framework that clearly articulates the board's accountability and oversight of climate change risk.
- Take action to reduce GHG emissions across the value chain that are consistent with the Paris Agreement's goal of limiting the global average temperature increase to well below 2°C above pre-industrial levels and pursuing efforts to limit warming to 1.5°C.
- Provide enhanced corporate disclosure in line with the final recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) and sector-specific Investor Expectations on Climate Change guidelines from the Global Investor Coalition on Climate Change (GIC).[8]

FSI groups including CERES (in North America) and the Institutional Investors Group on Climate Change (in Europe) are pursuing their own regional initiatives in addition to supporting Climate Action 100+.[9]

Meanwhile, citizen-led advocacy groups, such as FossilFree Canada and 350.org, are putting pressure on FSI institutions to divest their investments in fossil-fuel production and infrastructure, especially their interests in coal. While this movement is gaining traction in some regions, investments in traditional oil and gas and mining and metals operations will be a necessary part of the transition to a low-carbon economy.

Transformational opportunities

With pressure mounting, the climate change agenda may be viewed as an impediment instead of a way to drive value. Yet, the transition opportunity may be larger than any experienced since the Industrial Revolution.

Despite the economic impacts of COVID-19, global investment in the low-carbon energy transition totalled US$500 billion in 2020, up from US$460 billion in 2019.[10] Notably, this is more than double the US$235 billion investment made in 2010.[11] The 2020 total, as calculated by Bloomberg NEF, includes investment in large-scale commercial and industrial projects, such as renewable power, energy storage, electric-vehicle charging infrastructure, hydrogen production, and CCS projects.[12] It also includes end-user purchases of low-carbon energy devices, such as small-scale solar systems, heat pumps, and zero-emission vehicles.[13]

To meet the growing demands of decarbonization, Wood Mackenzie estimates that more than US$1 trillion of global investment will be needed in key energy-transition metals by 2035.[14] (These metals—aluminum, cobalt, copper, nickel, and lithium—are essential for generating, transmitting, or storing low- or no-carbon energy.[15]) Such investment may just be the tip of the iceberg: Brookfield Asset Management estimates that shifting to a global net-zero economy will require US$3.5 trillion in investment annually through 2050.[16]

Many organizations see opportunities in fulfilling the enormous appetite for capital to transition our sources of power. To this end, CSA Group is leading the development of a transition-finance taxonomy for a National Standard of Canada for Transition Finance.[17] It will help various stakeholder groups to understand what qualifies as transition-related financial products and services. This will assist Canadian financial institutions providing credit solutions, advisory services, or access to capital markets to enable the transition to a low-carbon economy while also helping clients manage transition risk.[18]

Brookfield Asset Management offers an example of an institutional investor seeking to create value through transition finance. The organization recently announced its intentions to raise at least US$7.5 billion for a new climate-focused fund,[19] the Brookfield Global Transition Fund, which will focus on renewable power and other investments that support net-zero emissions targets.[20]

These opportunities are not limited to institutional investors. Retail banks are finding ways to meet the needs of consumers who wish to reduce their carbon footprints. For instance, TD Bank, which was the first North American bank to attain a carbon-neutral operational status, offers a portfolio of green banking products that includes renewable energy financing for residential solar panels, and loans and discounts for purchasing and insuring electric and hybrid vehicles.[21]

Finance targeting

Export Development Canada (EDC) has made a commitment to ensure its operations protect the environment and people. As part of this effort, EDC has set a finance target (cutting 15% of its emissions by 2023) as a first step. Its leaders are currently working with Deloitte to further define a broader climate strategy, which will assess its climate-related risks and opportunities as well as extend emissions-reduction goals across its entire financing portfolio. Deloitte had worked with EDC on an earlier project to embed ESG principles in its 10-year-strategic plan.

How to get started

FSI industry leaders have largely decarbonized their own operations and have set long-range goals for the activities they finance to also achieve net-zero emissions. Those further along the maturity curve are developing sustainability-linked products, investing in transitional as well as low-carbon assets, engaging with customers around environmental, social, and governance (ESG) goals, and supporting industry efforts to develop a sustainable finance taxonomy.

Yet, many companies are still defining their responses to climate risks and opportunities or attempting to gain traction with basic carbon-reduction programs. Here are few suggestions for jumpstarting those efforts:

Decide how fast and how far, and prioritize initiatives to create value

A decision needs to be made from the very top about how fast an organization will move on climate change and what initiatives it will undertake to create value. To inform this decision, FSI leaders may wish to consider:

- What kind of questions are our board members asking about climate-related risk and opportunity?
- Are our competitors capitalizing on revenue opportunities associated with the energy transition?
- What risks can we quantify in our portfolio due to physical or transition climate risks
- Are we backing companies that are actively making the transition, and are we allocating suitable capital for growth?
- Which sectors pose the biggest risks in our portfolio, and how well-equipped are they to make the transition?
- What levers are available to help us move toward a low-carbon portfolio?
- Are we or are we likely to be a target of activist shareholder campaigns?

Get a handle on the organization's baseline emissions data and climate exposure

This means assessing all GHG emissions from all financing activities across asset classes, industries, and sectors. The Partnership for Carbon Accounting Financials (PCAF) is a global association of financial institutions that are working together to develop an open-source global GHG accounting standard.[24] This harmonized accounting approach provides financial institutions with a mechanism for assessing and disclosing the GHG emissions associated with their loans and investments, and it provides a starting point for setting science-based targets and aligning their portfolios with the Paris Agreement.[25] Supported by the United Nations, the Principles for Responsible Investing (PRI) coalition offers guidance as well.[26] The initiative provides a blueprint for responsible investing, along with a set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice.[27]

Set strategic direction by assessing climate risk and opportunity scenarios

This is important for gaining clarity on the direction in which a company may have to pivot, including how fast and how heavily. But, how does an FSI institution with investments across industries and around the world assess what the future might look like 10, 15, or even 30 years from now? How do financial leaders help their clients and business partners to understand the opportunities and challenges associated with climate risk? Many public and private organizations have already done the heavy lifting by developing research-based scenarios that take both physical and transition risk into account. For instance, the Bank of Canada and the Office of the Superintendent of Financial Institutions (OSFI) are conducting a pilot project that uses climate-change scenarios to better understand the risks to the financial system related to a transition to a low-carbon economy.[22] Among other goals, the project aims to build the climate-scenario analysis capability of authorities and financial institutions, and support the Canadian financial sector in enhancing the disclosure of climate-related risks.[23]

Establish a model and govern well

Establish a governance model right at the start. Assemble an appropriate mix of board and management competencies for scrutinizing new data sources and risk-management methods related to reducing GHG emissions in operations and financing activities. Include climate risk as a category in the current risk-review process. This helps to promote awareness and adoption by enabling everyone to speak the same language.

Grasp the urgency and start now

Setting a 2050 net-zero target is helpful but understanding the time-bound nature of the journey is critical. Climate risk is an immediate concern, not a far-off challenge. Action must be taken now and in short-term increments in order to meet the Paris Agreement's goal of limiting the global average temperature increase to well below 2°C above pre-industrial levels.

Prioritize projects and take action in one- or two-year increments, rather than holding off until frameworks are finalized and a long-range plan is in place. Parts of the portfolio that are noticeably affected by climate risk, such as the infrastructure asset class or the ER&I sector, can be a good place to start. Avoid obligating to greening the entire portfolio upfront, even if the organization has set a net-zero target.

Collaborate with industry peers to help with baselining and target-setting. Remember that the FSI industry as a whole is still struggling with how to quantify the impact of climate change and to incorporate the risks and opportunities into investment models and fair valuations. A number of industry associations and governments are tackling the challenge, but a clear framework that can be tailored to an organization's specific needs has yet to emerge. However, waiting for clarity could be costly. Catching up with the leaders could become exponentially more difficult as climate action and ESG criteria become synonymous with business strategy.

Climate risk is an immediate concern, not a far-off challenge. Action must be taken now and in short-term increments

Stakeholders are the new shareholders

The World Economic Forum recently published *Measuring stakeholder capitalism: Toward common metrics and consistent reporting of sustainable value creation.*[28] The report lends credence to the idea that the traditional metric of 'return to shareholder capital' is being replaced by a more expansive measure of 'creation of stakeholder value,' where shareholders are one of many stakeholders. Accordingly, many FSI organizations are being compelled to act on ESG in general, with an increasingly urgent focus on climate change. As some work to get a handle on their climate risks, they are also discovering the magnitude of the opportunities. Taking advantage of these requires leadership from the top to link climate and ESG goals with the organization's purpose for existing. As that purpose shifts to generating stakeholder value, which involves producing profit in a way that benefits the environment and society, managing climate risk and opportunity may become the business strategy, rather than just being a part of it.

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