The road to net zero

With financial institutions in the UK set to publish their transition plans for achieving net zero, Anthea Bowater and Vanessa Jakovich explore the key challenges and risks involved.
Financial institutions have for some time now been setting climate-related goals and making public disclosures in line with the recommendations from the Taskforce on Climate-related Financial Disclosures (TCFD). These disclosures are intended to explain an institution’s overall approach to climate-related risks and opportunities.

While the TCFD recommends that financial institutions disclose any high-level transition plan they may adopt, a substantive requirement to develop a detailed transition plan represents a significant further step.

The UK government first announced its intention to require financial institutions and listed companies to publish formal transition plans in 2021. HM Treasury set up the Transition Plan Taskforce (TPT) in 2022, with the aim of developing a “gold standard”, informed by and building on international disclosure standards. Its draft guidance was published in late 2022 and is due to be finalised in October 2023.

The Financial Conduct Authority (FCA) has set out its initial expectations for certain asset managers, FCA-regulated asset owners and listed companies to pay heed to the TCFD’s guidance on transition plans.

There are no formal requirements currently in place for other financial institutions to do so, or for any institution to adopt the TPT’s recommendations. But the FCA, itself a member of the TPT and contributing to its output, clearly wishes to build momentum in advance of the TPT’s guidance being finalised and of plans becoming mandatory. Indeed, it indicated earlier in the year that financial institutions should use the current guidance published by the TPT to produce transition plans, and that the FCA will set out its expectations on compliance once the finalised guidance has been published.

One of the most challenging aspects of developing a transition plan for financial institutions is making accurate calculations about their Scope 3 emissions.

What transition plans should cover
The TPT’s draft recommendations are that companies produce a standalone transition plan which sits alongside their annual report, and that a good transition plan covers:

- the way that the institution aims to mitigate, manage and respond to the changing climate, and to leverage opportunities of the transition (including any emission reduction targets or net-zero commitment)
- short-, medium- and long-term actions the institution plans to take to achieve its strategic goals
- governance and accountability mechanisms that support delivery of the plan and robust periodic reporting, and
- measures to address material risks to, and leverage opportunities for, the natural environment and stakeholders such as the workforce, supply chains, communities or customers which arise as part of these actions.¹

The TPT’s draft recommendations are built on the guidance that the TCFD and the International Sustainability Standards Board (ISSB) already contain in relation to transition plans. In practice, this means that in some areas the TPT’s recommendations add a layer of detail to current disclosures. In other areas, the TPT’s recommendations require new and additional disclosures.

There are, for instance, additional requirements to prepare GHG emissions reduction targets across Scopes 1, 2 and 3 and also to set interim targets, to disclose the various metrics used to assess progress towards a specific target, and to disclose current and planned engagement with industry peers, governments, regulators and other entities.

There is a further final requirement to disclose the role and responsibility of the board and its sub-committees in respect of the transition plan.

Scope 3 emissions
One of the most challenging aspects of developing a transition plan for financial institutions is making accurate calculations about their Scope 3 emissions – in other words, their financed emissions. These are the emissions that relate to the companies they finance directly or support indirectly (for example, by acting as a sponsor or underwriter for companies in a capital markets context).² In practice, the vast majority of a financial institution’s emissions will fall into this category, and therefore understanding Scope 3 emissions and formulating a strategy for reducing them is an important aspect of transition planning.

However, making an accurate assessment of emissions related to specific portfolios requires information from the institution’s clients about their own climate-related risks and plans, and those of their client’s counterparties, which may not necessarily be available. Many financial institutions have developed client and counterparty engagement strategies to formally liaise with their clients to better understand their current position and to participate in the way that they are planning for the future (which in some cases, may involve guidance towards a particular transition strategy).

The TPT’s draft implementation guidance recognises that some companies may face challenges in collating and disclosing their Scope 3 emissions, and recommends that in those circumstances they disclose the categories of Scope 3 emissions that are relevant, the steps they need to take to overcome the challenges in setting targets and reporting in this area, and then to include these steps in their strategic roadmap.³

The challenge of financial planning
A second and equally difficult area is financial planning. The TPT’s current draft guidance recommends that companies disclose how their climate-related plans will be resourced (and importantly, how they are reflected in the company’s current financial plans), as well as the projected impact of these plans on the company’s financial position, performance and cash flows, where possible (including any current and committed investment plans and any impact they may have).

In the status update published by the TPT on 27 July 2023, which detailed feedback from companies and financial institutions on the draft guidance, financial planning was...
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highlighted as the single most difficult area. At the same time, companies and financial institutions expected that disclosures in this area would be very useful.

Quantifying the impact that a financial institution’s transition plans will have on its finances, and therefore on its value as a whole, is in many ways the million-pound question, and any disclosed financial impacts could of course have far-reaching consequences.

As well as considering what can accurately be disclosed at the time their transition plans are published – and making any assumptions used in any calculations or projections clear – financial institutions will also need to consider how any financial disclosures will sit alongside their general financial reporting. The TPT’s current draft guidance notes that where companies are unable to provide quantitative information, they should provide qualitative information instead.

Financial institutions will need to take a thoughtful and measured approach to developing their transition plans, as although many of them will want to have plans that are ambitious, they will also need to be mindful of the potential reputational and litigation risks of any plan that is inaccurate or misleading.

Navigating transition plan risks
In practice, financial institutions will need to take a thoughtful and measured approach to developing their transition plans, as although many of them will want to have plans that are ambitious, they will also need to be mindful of the potential reputational and litigation risks of any plan that is inaccurate or misleading.

In particular, financial institutions will want to:
• review the terms on which new and existing clients and other counterparties are engaged, to ensure they include any necessary scope to facilitate the capture of emissions data and implementation of future transition-related policies
• caveat plans appropriately (for example, where data may be unreliable or estimates have been made, including in relation the Scope 3 emissions connected to any particular portfolio) and make any assumptions (such as those sitting behind financial projections) clear
• keep a record of the more detailed plans, evidence and calculations which sit behind the transition plan itself in case there are questions raised about the basis for the plan at a later date
• consider the governance and risk management procedures in place to ensure that each part of the institution is aware of its transition goals and strategy, and works towards them in line with the plan
• monitor progress so that they are aware of any significant risks to the achievement of the transition plans, and
• consider whether it is appropriate to update the plan when there are significant changes (and in any event, the TPT’s recommendation is to update the plan every three years at the latest).

On any approach, the development of a transition plan will be iterative, and there will be an element of trial and error for the whole industry - within reasonable bounds.

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2. The GHG Protocol draws a distinction between “financed” and “facilitated” emissions in the investment context, excluding the latter from scope 3, on the basis that financial institutions which temporarily advise on an investment have less influence over its emissions than investments in which they hold an ongoing interest. However, the recently published ISSB standards propose to expand Scope 3 to include both, in most cases.
3. See Implementation Guidance, page 11
4. See Status Update, page 22
5. See Status Update, page 20
6. See Implementation Guidance, page 22