TREASURY DEPARTMENT CALLS ON US FINANCIAL INSTITUTIONS TO ALIGN WITH NET-ZERO GOALS

Last month as part of NY Climate Week, the Treasury Department announced the publication of a set of voluntary Principles for Net-Zero Financing & Investment. The Principles underscore the importance the Biden Administration attaches to driving private sector funding to support the transition to net-zero.[1] Key to this effort are encouraging financial institutions to set net-zero commitments ("commitments"), achieving consistency and credibility in approaches to these commitments, and promoting greater adoption of emerging best principles in respect of these commitments.

The Principles address emerging best practices for private sector financial institutions, based on the consensus that these institutions can play a key role in allocating capital and expertise to enterprises and people seeking to meet sharply rising demand for technologies, products and services that can reduce GHG emissions, can support a clean energy economy and can help adapt to changing climate conditions across all sectors.[2] Treasury Secretary Janet Yellen, in her remarks in support of the Principles, cited third-party estimates of over $3.0 trillion in global investment opportunities associated with the transition to net-zero each year between now and 2050. This translates, in the United States into hundreds of billions in "investment opportunities to enhance power generation and the electrical grid, retrofit buildings, and make advancements in agriculture, manufacturing and transportation."

Secretary Yellen cited the more than 650 institutions representing approximately 40% of global financial assets that have made commitments (as part of the Glasgow Financial Alliance for Net Zero (GFANZ) or otherwise) to support reaching net-zero by 2050 at the latest, and noted that while there is no requirement that US financial institutions make such commitments, more than 100 have done so voluntarily.

The Principles

The Principles focus principally on Scope 3 financed and facilitated GHG emissions,[3] which typically are the largest type of emissions for financial institutions, and characterize financial institution commitments as a declaration of intent to work toward the reduction of GHG emissions (Principle 1). Treasury recommends that commitments be in line with limiting the increase in the global average temperature to 1.5°C, per the Paris Agreement. To be credible,

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[1] The announcement of the Principles forms part of a broader whole-of-government focus on climate change. See my previous briefing note on the Financial Stability Oversight Council's Report on Climate-Related Financial Risk, available here.

[2] The key Administration initiatives accelerating the transition to net zero are the Bipartisan Infrastructure Law (*see* my prior briefing note, available here) and the Inflation Reduction Act (*see* my prior briefing note, available here).

[3] Facilitated emissions (emissions from securities and securitizations underwritten in the capital markets) generally are not captured on financial institution balance sheets, in contrast to financed emissions (typically loans and investments), which are on-balance sheet. Capital markets intermediation leads to a temporary association with transactions, and are classified as flow activity, in contrast to loans that are held for potentially years and exposes the lender to credit risk. *See* discussion below of the methodologies being developed by the Partnership for Carbon Accounting Financials for facilitated emissions.

commitments should be accompanied or followed by the development and execution of a net-zero transition plan.

The balance of the nine Principles call (on a voluntary basis) for financial institutions to:

- Consider, when deciding how to realize commitments:
  - ***transition finance*** - providing financing, investment or advisory services to clients and portfolio companies that are implementing measures to significantly reduce the emissions from their goods or services. Transition finance can support decarbonization in high-emitting sectors for which decarbonization is particularly difficult due to the current limitations in technological viability and/or price competitiveness of low-emissions alternatives;
  - ***managed phaseout*** - a subset of transition finance involving financing, investing or advisory services that support a managed and accelerated transition from high-emitting to zero- or near-zero emissions assets, including early decommissioning, which may include repurposing strategies; and
  - ***climate solutions practices*** - financing, investing or advisory services that support innovation and the adoption of zero- or near-zero-emissions technologies, services or products that will contribute to the elimination, removal, or reduction of "real economy" (*i.e.,* economic activity outside the financial sector) emissions by replacing, significantly reducing demand for, or repurposing high-emitting alternatives.
- ***Establish credible metrics and targets*** and endeavor, over time, for all relevant financing, investment and advisory services (broken down by transition finance, managed phaseout and climate solutions) to have associated metrics and targets, including setting interim targets for 2030 or sooner and at no more than five-year intervals thereafter until the end-state target of 2050 or sooner; over time, endeavouring for targets to cover all relevant financing, investment and advisory services for clients and portfolio companies; and tailoring targets to specific sectors/portfolios and asset classes.
- ***Assess client and portfolio company alignment*** to their (*i.e.,* financial institutions') targets and to limiting the increase in the global average temperature to 1.5°C, using, for example, classification systems and lifestyle emissions calculation tools to determine whether an activity/company can be deemed a climate solution; benchmarks such as sectoral pathways based on carbon budgets; and or client/portfolio company net zero transition plans.
  - For transition finance and managed phaseout practices, "alignment" can be considered the degree to which a company's behavior/emissions trajectory, taking into account its carbon budget, would support an outcome aligned with limiting the increase in the global average temperature to 1.5°C if all economic actors behaved similarly relative to their own carbon budgets.
  - For climate solutions, "alignment" can be considered the extent to which a company provides or enables zero- or near-zero-emissions technologies, services

or products that will contribute to the elimination, removal or reduction of real economy emissions by replacing, significantly reducing the demand for, or re-purposing high-emitting alternatives.

Client and portfolio company net-zero transition plans should include the following:

- overall commitment and strategy;
- metrics and targets covering Scope 1, Scope 2 and, when material and quantifiable, Scope 3 emissions;
- implementation processes and structures;
- engagement strategy (especially with value chain participants); and
- governance.

Reliable client and portfolio company Scope 3 emissions data will become more readily available over time as stakeholders, including financial institutions, further develop methodologies and improve Scope 3 data availability.

- ***Align their engagement practices***, with clients, portfolio companies and other stakeholders, to their own commitments. A financial institution's net-zero transition plan should, to the extent consistent with fiduciary, regulatory and legal obligations, include a strategy for collaborating with and supporting relevant clients and portfolio companies to adopt and implement net-zero transition plans. Engagement should be consistent with a financial institution's degree of ownership of, and influence over, the client or portfolio company as well as the institution's investment and financing strategy.

- ***Develop and execute an implementation strategy*** that integrates the goals of their commitments into relevant aspects of their businesses and operating procedures. This could include:

  - leveraging existing or creating new products (*e.g.,* green financial instruments and tools) and services that support client and portfolio company efforts to transition to net zero;
  - establishing policies and conditions, or a timeline for establishing them, related to activities in sectors highly relevant to the net-zero transition (*e.g.,* thresholds or boundaries for financing, investment and advisory services for select activities that will face greater challenges as the transition continues);
  - incorporating relevant considerations into portfolio management, transaction approval, due diligence, marketing and sales processes; and
  - incorporating net-zero objectives into resource allocation and business planning.

- ***Establish robust governance processes*** to provide oversight of the implementation of their commitments, addressing, for example, board oversight, senior management roles and responsibilities, relevant skills and culture development among staff, incentives and remuneration, and any other relevant accountability mechanisms.

- In the context of activities associated with their net-zero transition plans, ***account for environmental justice and environmental impacts***, where applicable. In particular, a financial institution should demonstrate an understanding of how transition planning

activities may impact, for example, employment, quality of life, affordability, rights, and access to resources, particularly for Tribes, indigenous peoples and disadvantaged communities in the places where the financial institution operates. Moreover, financial institutions should demonstrate an understanding of how transition planning activities may impact the environment, including nature and biodiversity. Financial institutions should put safeguards in place to account for unintended consequences and consider emerging frameworks and resources that seek to protect nature and biodiversity.

- ***Be transparent*** about their commitments and progress towards them. In some cases, this may involve voluntary public disclosures exceeding those required by applicable law. Disclosed information should include relevant data and data sources, frameworks and methodologies leveraged (*e.g.,* related to transition planning), approaches to and progress of client and portfolio company engagement, and other key decisions that a financial institution makes in developing and executing its transition plan. When an institution cannot conform to emerging best practice as it relates to commitments, it should explain the reasons.

  The Principles note that data quality and availability challenges represent a priority for market participants, civil society and governments to resolve. Some financial institutions may supplement direct value chain emissions reduction measures with the voluntary purchase of carbon credits. A financial institution should provide sufficient information to give stakeholders a clear understanding of whether and/or the extent to which the voluntary use of carbon credits is part of its commitments. Any voluntary use of carbon credits should be accompanied by sufficient detail on the nature and integrity of those credits (*e.g.,* linkages to a credible certification standard and demonstration of sufficient monitoring, reporting, and verification).

  Voluntary carbon markets (VCMs) remain relatively small and face challenges related to market transparency and credit integrity. Treasury and other federal agencies are actively engaging with relevant stakeholders, including international partners, on ways to assess and improve the quality of VCMs and carbon credits so that this potential may be realized.

Parallel Actions

It is noteworthy that accompanying the release of the Principles were announcements from a range of civil society and philanthropic organizations to support research, data availability and technical resources to help financial institutions develop and implement voluntary net-zero commitments. Bezos Earth Fund, Bloomberg Philanthropies, Climate Arc, ClimateWorks Foundation, Hewlett Foundation and Sequoia Climate Foundation announced a $340 million commitment over the next three years.

GFANZ announced, according to Treasury, that more than 50 U.S. financial institutions, and more globally, will independently publish net-zero transition plans over the next year using the voluntary common frameworks developed by GFANZ and financial sector alliances.[4] In

[4] In 2022, GFANZ identified four strategies necessary for financing a whole economy transition to net zero, which collectively comprise "transition finance." These are defined as financing or enabling: the development and scaling of climate solutions; assets or companies already aligned

addition, the GFANZ Secretariat has launched a 45-day consultation on its work to further refine the definitions of its transition finance strategies and support financial institutions in forecasting the impact of these strategies on reducing GHG emissions, with a final report to be released at COP28.

The Partnership for Carbon Accounting Financials (PCAF) will train and support up to 2,500 financial industry professionals on GHG accounting methodologies and reporting through its new PCAF Academy. PCAF also plans, as part of its mission to enable financial institutions to assess and disclose GHG emissions associated with their financing activities, to publish the first-ever standard for capital markets facilitated emissions later this year.

Concluding Thoughts

Note unlike the efforts in the European Union aimed at engaging the financial sector in funding the transition to net-zero, ultimately the Principles recognize the critical role played by the private sector and are intended to promote transition finance for enterprises and individuals that are developing clean energy technologies, products and services. As Mark Carney, the UN Special Envoy for Climate Action noted when endorsing the Principles (as reported by Reuters), the initiatives encouraging financial institutions to take account of climate solutions to decarbonize existing operations "will help investment flow where it needs to get the entire economy to net zero, … and will strengthen growth, create jobs, and reduce energy prices – all while lowering emissions.

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to a 1.5°C pathway; assets or companies committed to transitioning in line with 1.5°C-aligned pathways; and the accelerated managed phaseout of high-emitting physical assets.