CADWALADER

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In this edition we discuss several updates aimed at the financial sector, including transition planning reports published by the Network for Greening the Financial System, prudential guidance from the Bank of England on how scenario analysis can be used to better quantify climate risk, and improved data relevant to how financial institutions may be affected by climate change published by the European Central Bank. We also discuss the Net Zero Asset Owners Alliance's updated target setting protocol which includes a mandate for its members to reduce their greenhouse emissions by 40-60% by 2030.

Network for Greening the Financial System Publishes Transition Planning Reports

On April 17, 2024, the Network for Greening the Financial System (NGFS) **published three reports** analyzing the role of transition plans in enabling the financial system to manage climate-related financial risks, mobilize capital, and the relevance of transition plans to micro-prudential supervision. The NGFS identified three key actions that can support the global adoption of transition plans:

- Integrated international guidance: Developing international guidance for transition planning, and corresponding frameworks that interact with one another for the disclosure of transition plans.
- Holistic transition plans and processes: Holistic plans should integrate transition and physical aspects of climate change as well as considering nature and biodiversity loss. Transition planning exercises should also be informed by risk management.
- Enabling conditions for adopting transition plans: Clarity about policy directions e.g., national climate frameworks, and economy-wide incentives for developing and disclosing transition plans to broaden adoption and close information gaps.

The three reports, Tailoring Transition Plans: Considerations for EMDEs; Connecting Transition Plans: Financial and non-financial firms; and Credible Transition Plans: The micro-prudential perspective, are a second phase of the network's objective to analyze the role of transition plans which it commenced in 2022.

In phase 1, NGFS **conducted a stocktake** of current transition plan frameworks and practices. The six key findings of that stocktake included that there are multiple definitions of transition plans, reflecting their use for different purposes, and that transition plans could be a useful source of information for micro-prudential authorities to develop a forward-looking view of the whether the risks resulting from an institution's transition strategy are commensurate with its risk management framework.

Bank of England Publishes Article on Using Scenario Analysis to Quantify Climate Risk

On April 17, 2024, the Bank of England (BOE) published an article exploring how the risks posed by climate change to central banks and financial institutions can be quantified using scenario analysis. BOE applies its analysis across three asset classes in particular: sovereign bonds, corporate bonds and residential mortgages. Based on climate scenarios developed by the NGFS, **which we discussed previously**, BOE notes that banks must adjust prescribed scenarios due to the limitations of existing models. Such limitations include that scenarios do not capture the full suite of potential climate risks, calibration of estimated chronic damages from temperature rises remains an area of ongoing research, and that scenarios do not account for the effects of "tipping points" which can significantly increase the effects of climate change. To overcome these limitations, BOE suggests estimating impacts to a higher level of granularity, projecting related variables and addressing temporal misalignments or intra-sector variabilities. Ultimately, such extensions to prescribed models will not be immune from the aforementioned limitations because scenario analysis is a non-exhaustive method of ascertaining risk.

The BOE's call to enhance the way climate scenarios are used to make them more meaningful is not the first. In August 2023, the UK pensions regulator's climate and sustainability lead, Mark Hill, authored an article setting out how trustees can improve the climate-scenario analyses used by their schemes, **in order to make them more "decision-useful."** Climate scenario analysis has come under scrutiny by for example the Institute and Faculty of Actuaries who, in a report entitled **"The Emperor's New Climate Scenarios,"** highlighted the drawbacks of current models and scenario analysis, and cast doubt on the validity of some published outcomes. The general consensus appears to be that tailoring climate scenarios is the most sensible way to bridge the gap.

European Central Bank Provides Improved Data on Climate Change Impacts on Banks

On April 18, 2024, the European Central Bank (ECB) **improved the data it publishes** on how banks are impacted by climate change. The data provides systemic insights into how financial markets are approaching the climate transition, and how financial institutions may be affected by climate change. As a result of the improvement the ECB derived new insights. Although the ECB notes that there is room for improvement it found that progress is being made on:

- sustainable bonds, where around 85% of euro area sustainable debt issuances have received second part opinions, giving investors more information and reassurance that the bonds are what they are claimed to be;
- financing carbon emissions via banks loans, data shows that direct emissions financed via euro area bank loans decreased between 2018 and 2020 but experienced an uptick in 2021 (the latest year the data is available for). The report notes that this data is only part of the answer as to whether banks are greening their loan portfolios effectively. This is because reductions in financed emissions can come from two sources – the emissions of the loan portfolio, or from the general decrease in the bank's investment share – and as such, the ECB's new data allows analysis of this aspect showing that the general decrease in euro area financed emissions is largely due to a reduction in carbon emitted by companies in their processes or banks investing instead in companies with lower emissions; and
- protection measures against financial losses derived from climate change impacts such as floods, in respect of which, the ECB's improved data is enabled by way of an indicator that aims to quantify potential losses in financial terms.

The ECB also **published a dedicated statistical paper** providing more information on the data, methodology and remaining limitations.

Net Zero Asset Owners Alliance Updates Target Setting Protocol

On April 18, 2024, the Net Zero Asset Owners Alliance (NZAOA) **published an update to its target-setting protocol**, requiring its members to set a 40-60% reduction in greenhouse gas (GHG) emissions by 2030, compared to 2019 levels. The NZAOA, whose 89 members together manage $9.5 trillion in assets, released its most comprehensive target-setting protocol and as well as mandating the 40-60% GHG emissions reduction target. The target was also extended to include private assets and sovereign debt for the first time. The extension to include private assets is significant due to the increasingly common practice of selling high-emitting assets to the private sector, which is generally subject to less scrutiny. In October 2023, NZAOA published its annual progress report and announced that the absolute financed emissions of its members had fallen by 7.7 million tons of CO2 equivalent in 2022, despite an increase in membership numbers and assets.

The NZAOA's latest update is notable. Recently, there have been high profile exits from other climate-focused investor alliances, such as Climate Action 100_ (CA100+). **As discussed in our March 18 edition**, JP Morgan Asset Management (JPMAM), State Street, and Invesco left CA100+ as BlackRock scaled back its participation in CA100+. JPMAM stated that it had developed its own stewardship capabilities sufficiently, while SSGA and BlackRock raised concerns about CA100+'s Phase 2 commitment, which involve **a change to the group's aim** from pressuring companies to actively encouraging them to reduce their GHG emissions. The NZAOA emphasized the fact that all 89 of its members voted for the recent updates and reiterated their commitment to the alliance and its objectives. **As we have frequently discussed**, asset owners globally are under considerable pressure to ensure that adequate consideration is given to climate risks in line with their fiduciary duties. The continued focus on climate alliances such as NZAOA indicate that such pressure is unlikely to ease any time soon.