Transition planning challenges in the finance sector

As the global financial sector accelerates its commitment to sustainable practices, transition planning has emerged as a cornerstone of the industry's response to climate change. However, the path to aligning financial operations with sustainability goals is fraught with challenges and there is much work to be done before robust transition planning is in place.

Through our work with our banking and insurance clients ron their transition plans, we identified a number of challenges which needed to be addressed before a credible transition plan could be put in place, which have parallels across a number of other clients as well as sectors:

1. Strategy: mismatch between group-level and regional-level strategies considering client and industry mix

In the finance sector, effective transition planning requires strategies that are not only aligned at the group level but also customized to meet the diverse needs of regional markets. A common challenge is the mismatch between overarching, global strategies and local strategies that account for the unique client and industry mix in different regions. Group-level strategies may prioritize broad carbon reduction targets, but these strategies often fail to consider the varying economic and industrial contexts of different regions. In practice, some regions might still heavily rely on carbon-intensive industries for economic stability, making a one-size-fits-all approach ineffective. Thus, banks must create region-specific strategies that align global goals with the local realities, ensuring a smoother transition to sustainable finance without jeopardizing regional economic growth or client relationships.

2. Data: low quality data with significant implications for risk management and strategy setting

A significant challenge in the finance sector's transition planning is the lack of high-quality, accurate carbon emissions data for counterparties of the banks, such as other financial institutions, corporate entities, public entities, etc. Without reliable emissions data, financial institutions face substantial risks in their ability to measure and manage the environmental impact of their investments. This lack of data undermines efforts to set realistic climate targets and effectively integrate sustainability into risk management frameworks. The absence of robust emissions reporting increases the potential for financial miscalculations and misalignments in transition strategies, as banks may unknowingly fund high-emission projects that fail to meet long-term sustainability objectives. Addressing this challenge requires not only better data collection processes but also enhanced transparency in emissions reporting from companies within investment portfolios. A pragmatic solution is to set up a process to refresh both datasets and strategy at predefined intervals to help with early course corrections as deemed necessary.

3. Methodology: Lack of Methodologies to Properly Capture Emissions from All Assets

One of the most persistent challenges in transition planning is the lack of standardized methodologies for accurately capturing emissions across different asset classes. For instance, there is currently no universally accepted approach to assessing emissions from held-for-trading assets, such as stocks or bonds. As a result, financial institutions may struggle to determine which entity holds responsibility for emissions generated by these assets—whether it is the bank that owns them at the end of the reporting period or the company that issued them. This uncertainty complicates emissions reporting and makes it difficult to compare the environmental impact of different banks' portfolios. Until reliable methodologies are developed, institutions may face difficulties in making fair and meaningful comparisons, ultimately hindering efforts to assess and improve the sustainability of their portfolio of investments.

Regardless, it may be beneficial for such financial institutions to clearly ringfence their GHG reporting to existing asset classes, focusing on clarifying existing emission sources and figures, as well as developing data infrastructures to better enable future reporting when made possible.

4. Need for a Just transition: carbon-intensive industries still require financing and support key infrastructures in developing countries

A key dilemma for financial institutions is the continued need to finance carbon-intensive industries, particularly in developing countries. These industries often provide critical infrastructure, such as energy, transportation, and manufacturing, that supports the economic development of emerging markets. While transitioning to sustainable finance is a priority, banks face the challenge of balancing the need for financing carbon-intensive sectors with the growing demand for low-carbon alternatives. In some cases, a rapid divestment from high-emission industries could disrupt essential services, leading to negative socio-economic consequences. Therefore, banks must develop strategies that promote a gradual and responsible transition, allowing for continued support to these industries while fostering the growth of sustainable alternatives in parallel.

5. Net impact: Banks with aggressive growth targets might capture the carbon-intensive financing clients, leading to a net-loss for banks with more sustainable agendas

The competitive nature of the financial sector raises concerns about the real-world impact of transition planning, especially when banks with aggressive growth targets may prioritize short-term financial returns over long-term sustainability. Banks that focus on capturing carbon-intensive financing clients might gain a competitive edge in the short term, capturing profitable opportunities in sectors like oil, gas, and heavy industry. However, this strategy could ultimately undermine the efforts of banks pursuing more sustainable agendas, potentially leading to a net loss for broader climate goal achievement as their clients shift toward carbon-intensive alternatives that promise higher immediate returns. The challenge, therefore, lies in aligning growth targets with climate-conscious finance, ensuring that sustainability-minded banks remain competitive without compromising on their long-term transition goals. A way to tackle this is for banks to be more engaged with such clients to aid them in their plans to decarbonise, creating a win-win value proposition for both parties.

In conclusion, transition planning in the finance sector involves navigating a complex landscape of strategic, data-driven, actionable, governance, financing, impact, and methodological challenges. Addressing these challenges requires a concerted effort from financial institutions to innovate, collaborate, and commit to sustainable practices, ensuring a transition that supports economic growth, social justice and environmental preservation. Despite the significance of these challenges, it is heartening to observe that numerous institutions have already begun this journey. By embracing learning, adaptation, and progress, these organizations are making crucial strides toward overcoming obstacles and paving the way for a more sustainable future.

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