PROSPECTS AND CHALLENGES FACED BY THE GREEN TRANSITION

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The war in Ukraine is forcing Europe to make crucial green transition choices

Despite progress in the development of renewable energies in particular, greenhouse gas (GHG) emissions have barely declined. The latest reports from IPCC Working Groups 2 and 3, published in February and April 2022 respectively, anticipate that, given the policies currently implemented, GHG emissions will continue to increase beyond 2025, leading to an average warming of 3.2°C in 2100. A temperature increase of more than 3°C would have major economic and financial implications. Meeting the objectives of the Paris Agreement therefore requires strong actions now.

The war in Ukraine, the resulting sanctions taken against Russia, and the weaponization of commodity exports by Russia are sources of human suffering, but also risks for financial stability. In particular, energy prices currently observed correspond to an increase similar in magnitude to that simulated by the NGFS at the end of a transition. For instance, oil prices double by 2030 and gas prices triple in most NGFS scenarios. In the case of an orderly transition to Net Zero by 2050, this increase is gradual over the next 10-15 years. In the case of a delayed transition, this increase is concentrated at the end of the period. The current increase in fossil fuel prices is however more brutal, concentrated over 2-3 quarters. Such a development is, in itself, fraught with risks. Beyond the effect of the war on prices, the situation renders obsolete in the very short term (with a destruction of economic value and corresponding financial losses on the balance sheet of their owners) all the infrastructures allowing the import of these fossil fuels from Russia. In a sense we are already paying the price of the transition.

The war in Ukraine forces Europe to make crucial choices in the very short term. Europe can reduce its dependence on Russian oil and gas imports by seeking other sources of supply and by investing massively to adapt the continent's energy infrastructure (liquefied natural gas regasification terminals, adaptation of refineries to the characteristics of these new products) and/or extend the use of coal. Alternatively, Europe can seek to accelerate its transition to carbon neutrality by rapidly making the necessary investments in terms of energy savings, renewable energy production, storage and adaptation of distribution networks, in particular.

The search for new sources of fossil fuel supply would likely delay the transition, thereby contributing to an increase in physical risks in the medium and long term and/or risks of a disorderly and delayed transition in the short or medium term. In addition, new investments whose amortization period is not compatible with the respect of the objectives of the Paris Agreement imply an increase in the volume of assets likely to become stranded assets over time. The NGFS scenarios clearly illustrate the adverse economic and financial consequences of a delayed transition: GDP would be 5% lower by 2050 compared to an orderly transition. The economic and financial losses would be further aggravated in the absence of transition. This response to Ukraine's war-induced energy crisis would therefore contribute to increased financial risks related to climate change.

> The risks of a disorderly climate transition are increasing with the impact of the war in Ukraine.

The circumstances are in place for an acceleration of the transition to carbon neutrality, a preferable choice in terms of short, medium and long-term risks. Given the levels currently reached, the price of fossil fuels should limit the use of those energy sources in a proportion similar to the effect of the introduction of a carbon tax in the NGFS scenarios and encourage the deployment of carbon-free production capacities. As such, it represents an opportunity to accelerate the transition to a carbon-neutral economy. Caution is needed however, as the option of investing massively in the transition to a decarbonized economy is not entirely risk-free either, and could lead to an increase in the prices of energy and of minerals that are needed to develop renewables, which are also subject to geopolitical risks.

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Climate transition: risks and opportunities

Summer 2022 saw record-breaking heatwaves and forest fires across Europe. Climate change makes such extreme weather events more likely and increases the hot and dry conditions that fuel wildfires. These events, just like the floods seen in Europe last year, remind us of the need to take urgent action to transition towards a carbon-neutral economy. The war in Ukraine has also brought into sharp relief the need to accelerate the green transition and make Europe less reliant on Russian gas and oil, as confirmed by the Commission's REPowerEU Plan. [1]

The European Commission estimates that Europe will need around €520 billion in additional private and public investment per year until 2030 for the green transition.[2] Globally, the International Energy Agency estimates that investments in clean energy of around USD4 trillion annually will be required by 2030 to get the world on track to achieve net-zero by 2050, and that around 70% of that investment will need to be carried out by the private sector. Climate change is not just a risk for credit institutions, it is also a financing opportunity.

At the same time, financial markets are faced with pronounced economic and geopolitical uncertainty. Increasing transition investment might well be a challenge for indebted governments and private firms. The most recent euro area bank lending survey by the European Central Bank (ECB) showed a tightening of credit standards, a trend that banks expect to continue through the third quarter.

Fortunately, despite the macroeconomic uncertainty and difficult market environment, the demand for sustainable investments has remained relatively stable. Sustainable investments continue to grow globally, driven by an increased volume of environmental, social and corporate governance (ESG) funds and green bond issuances. While the bond market as a whole has suffered a significant slowdown in recent months, in the first half of 2022 green bond issuances were comparable to those in the first half of 2021, amounting to USD245 billion globally. During the COVID-19 market turmoil, investors in ESG funds were less sensitive to past negative performance. This suggests that ESG investors might constitute a relatively stable source of financing to support the transition. ECB research has indeed shown that investors are willing to pay a premium for green bonds.

The ECB's recent climate stress test showed that almost two-thirds of bank income from non-financial corporate customers stems from greenhouse gas-intensive industries. In many cases, banks' "financed emissions"[3] are coming from a small number of large counterparties, increasing bank exposure to transition risks, pointing out vulnerabilities in portfolios in terms of physical and transition risks (and missed transition opportunities). In view of the far from negligible income generated from financing carbon-intensive industries, banks must step up their long-term strategic planning.

In order to properly understand their exposure to climate risks, banks need to gain insight into their clients' transition plans. To be clear, we are not asking banks to divest from carbon-intensive activities. Rather, we are asking banks to fully grasp and manage transition risks in order to make their portfolios more resilient. This means that banks should evaluate what transition entails for their risk exposures to sectors that will continue to be reliant on carbon-intensive technologies for some time and reflect their evaluation in their overall risk management. Not all sectors will decarbonise overnight.

The stress test results also confirmed that timely action pays off. In an orderly transition scenario, where climate policies are introduced early and gradually become more stringent, banks face considerably lower potential losses compared with scenarios where transition policies are phased in late or not at all. This is also in line the ECB's economy-wide stress test last year, which showed that the advantages of early action outweigh the initial costs over the medium to longer term. Acting now is not only the right thing to do, it also makes economic sense.

Depth and breadth in capital markets are needed to complement bank lending and public investment in order to close the investment gap for the green transition. Research shows that economies with a higher share of equity funding tend to reduce their carbon footprint more rapidly. This is just one of the reasons why the ECB fully supports the European Commission's Capital Markets Union (CMU) Action Plan.[4]

Initiatives that improve the comparability and standardisation of sustainable finance products, or otherwise enhance the quality and availability of sustainability-related information, will be essential to create a genuinely green CMU and to address the risks of greenwashing.

[1] Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions - REPowerEU Plan (COM/2022/230 final).
[2] Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions - The EU economy after COVID-19: implications for economic governance (COM(2021) 662 final).
[3] Financed emissions refers to greenhouse gases emitted by entities that receive financial services, loans or investments from financial institutions
[4] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the regions: A Capital Markets Union for people and businesses – new action plan (COM/2020/590 final).

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Supporting Member States towards green and just transition

To what extent inflation strains the green transition?

Just when the economies started to bounce back after the COVID-19 restrictions were lifted, the Russian invasion in Ukraine created new negative shock for all economies across the globe.

Due to their geographical proximity and high dependency on Russian gas and oil supplies, the European Union (EU) is particularly severely impacted.

The latest statistics confirm the seriousness of the situation. In June 2022 reported inflation rate of the EU reached 9.6%. In 15 Member States, it reached a double-digit, between 10% – 22%. Amongst the most impacted are the Central and Eastern European Member States. Many of them already experienced complete disruptions of the supply of these commodities. It is thus no surprise that the energy component of the inflationary developments is the highest. In March 2022 the recorded rate was as much as 40%.

The deployment of renewable energies needs to be accelerated for the EU to become independent on energy. The tragic invasion of Ukraine by Russia has confirmed that the path towards the green transition embraced by the EU some years ago was, and still is, the right one. The European Commission, through the Technical Support Instrument (TSI), is stepping up efforts to help Member States achieving this objective in such difficult times.

What is the role of REPowerEU and DG REFORM in this context?

The REPowerEU Plan is the most prominent EU policy initiative that addresses the double urgency characterising EU's current energy system: (i) the dependency on Russian fossil fuels and (ii) the climate crisis. The implementation of the REPowerEU Plan requires joint EU and Member States action, including in the implementation of ambitious reforms and investments.

Reforms, in particular, are essential to tackle structural problems and to provide long-lasting solutions to energy production and supply in Member States. To address the urgent needs of Member States, and to complement the REPowerEU initiatives, the European Commission's Directorate General for Structural Reform Support (DG REFORM), is supporting through the TSI 17 Member States in phasing out their dependency on Russian fossil fuels and identifying investments and reforms (Support to REPowerEU) to accelerate the EU's green transition.

In addition, DG REFORM has identified several areas where Member States can ask for technical support for the year 2023 to further accelerate the Green Transition as well as boost Smart, Sustainable and Inclusive Growth:

(i) Support to Climate Adaptation,
(ii) Accelerating permitting for renewable energy (europa.eu),
(iii) Support to industrial ecosystems (europa.eu)
(iv) Integration of environmental dimensions in public finances (europa.eu).

How to describe and address the ESG risks in the EU in current circumstances?

This year's increased surge of wildfires across the EU and globally only re-confirms that the world has an enormous task ahead in containing global warming. Addressing climate change remains a priority for the EU and an important opportunity for the financial sector.

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The growing demand for green investments and financial products give more importance to the proper management of possible effects of the environmental, social and governance (ESG) risks. Moreover, up until very recently, the environmental risks were featuring amongst the most urgent, given the increased occurrence, severity and geographical spread of natural disasters. The Russian invasion of Ukraine brought a new spin within the "S" and "G" dimensions. We witness unprecedented global businesses response through voluntary discontinuation of activities in Russia. Businesses attach clear value to "terms" like freedom, democracy, human rights.

To address the emerging ESG risks in the financial sector, Member States can ask the Commission for technical support via the TSI through the ESG risk management framework for the financial sector (europa.eu). The support will build on a long track record of accompanying Member States through these challenges. Since 2016, DG REFORM supported over 160 projects targeting clean energy, circular economy, just transition, green budgeting and taxation and sustainable finance.

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Sustainability standards should not be a modern day Tower of Babel

7th century BC, somewhere in Mesopotamia. A group of builders who embarked on the uniquely technical and complex task of building the tallest tower ever suddenly find themselves speaking different languages. Although the goal was still the same, the lack of a common language led to the failure of the project.

As policymakers and standard-setters race to roll out sustainability reporting standards, this myth represents an important lesson: that a myriad of different languages can be the difference between success and failure, even if everyone is driving towards the same outcome.

The recent wildfires and record temperatures here in Europe serve as poignant reminder of the impact of climate change and what is at stake if we don't effectively act in a coordinated manner.

Private investors are central to the climate transition and to deliver on the European Green Deal's objectives, but to properly achieve their role, they need reliable and comparable sustainability-related data. Yet, access to basic sustainability data remains challenging and the picture is fragmented across global markets. Data gaps arising from incomplete disclosures mean the indicators used by various stakeholders often rely on diverging methodological choices and assumptions, leading to wildly inaccurate estimated figures. At FTSE Russell, we have found that have found that even in markets with well-developed sustainability reporting, only 73% of companies disclose scope 1 and 2 emissions, which has barely changed since 2018.

Furthermore, the interchangeable use of different terminologies creates a general confusion and lack of measurability of the various contributions to the transition. As such, FTSE Russell's clients, namely large global asset owners, will indistinctly refer to the "race to net zero" or to "the Paris agreement", or to a general "decarbonisation path". Those terms will ultimately reflect a common collective intention, but they will be declined in different objectives that will be difficult to compare.

The greater the difference in approaches and terminology among policy makers, the more challenging the climate transition will be, especially as the world is facing complex geopolitical dynamics and de-globalisation trends.

In that regard, LSEG welcomes the vital political agreement reached on the Corporate Sustainability Reporting Directive (CSRD) as a key building block towards achieving these goals.

As a next step, LSEG is advocating for a common approach to specific metrics or concepts among the European Financial Reporting Advisory Group (EFRAG), the Securities and Exchange Commission (SEC) and the International Sustainability Standards Board (ISSB). As an example, we believe that the opposition of single materiality versus double materiality is artificial. Both concepts should indeed be seen as part of a dynamic continuum – a company's material impacts on external factors (the environment or the society) will ultimately lead to financial impacts, and can therefore constitute a financial risk to be accounted in an actual period of reference. Agreeing on a simple and well-defined set of key metrics to measure climate impacts and transition plans is also needed as a matter of priority.

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Finally, sustainability is not, and should not, only be about climate change. To ensure a balanced transition, it is important that other environmental and social areas be accounted for. In that respect, nuance matters: too narrow a focus on climate change could indeed create new risks and destabilize entire ecosystems. For example, the extraction of rare minerals mining for electric vehicles and hydro-electric dams are two climate positive activities that can significantly degrade surrounding ecosystems and displace local people. This is recognised by asset owners who are increasingly asking for innovative sustainable benchmarks, such as UN Sustainable Development Goal (SDG) aligned benchmarks, with this broader lens.

The task is no small feat. Modern day financial accounting took a hundred years to develop and in comparison, we are making giant steps to measure sustainability impacts. It is however critical that we get the foundations right and achieve a common reference framework. Indeed, to paraphrase the Tower of Babel myth, if one people speaks the same language, then nothing will be impossible to them.

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Developing an internationally consistent approach to climate change transition

We can all agree that carbon neutrality is a universal priority, while pathways towards it differ by countries and regions, neither moving in tandem nor yet speaking the same language. However, the flow of capital moves on a cross border basis. Companies operate globally and must consider the impact of their activities across different jurisdictions, while also accelerating enormous investment to make their business more sustainable.

Both European and Japanese energy companies have been mutually entering into renewable energy markets, but they may face a challenge to fund the transition, due to insufficient liquidity or impairment of traditional cash-cow assets. The pace of transition should be managed to balance the drive towards sustainability with maintaining the resilience of fundamental economic activities.

The energy price surge and the shock from supply chain disruptions have created severe and rapid inflationary pressures and subsequent interest rate rises may negatively impact credit markets. Bond issuance in EMEA decreased by approximately 40% year-on-year in the second quarter of 2022. Even while steering their business through these circumstances, companies must maintain sustainability initiatives. It is essential to monitor whether funds continue to flow into the green transition both globally and locally.

Banks and investors need to properly assess the "transitionability" of companies as greater challenges are coming up in driving sustainability initiatives. Although pathways will differ for each business, a standardised process would increase the transparency of transition plans. A uniform taxonomy would allow them to understand the transition status, but should get better result if it focuses on reflecting their mid-to-long term transition efforts. Thereby companies should be able to implement their respective transition plans in a more consistent way to achieve a just transition.

Policymakers have been discussing regulatory requirements for sustainability disclosure, due diligence and ESG rating standards, however, those discussions are still underway and the lack of a consistent approach risks causing fragmentation across jurisdictions. ESG rating agencies and data providers are striving to develop ESG assessment methodologies and definitions to evaluate a corporation and these are increasingly referred to by banks and investors.

While such analyses are helpful, there is currently no broadly-accepted standard approach and dataset. Some cases appear to only show a snapshot of the status of a corporation, rather than focusing on its path towards sustainability. Therefore, a common language set by any future regulations should create a consistent approach to assessing transitionability from both companies and investors perspectives.

We may come across fragmented trends across countries or regions due to an increased focus on energy security. RePowerEU evidences the EU's flexibility and strong commitment in achieving the EU Green Deal, but countries approaches may differ depending on economic, industry and energy interests. Corporations and investors need a clear and universal regulatory standard to avoid fragmented and unbalanced capital flows for the transition.

Prioritise an internationally agreed standard to ensure global consistency.

One solution would be to prioritise an internationally agreed standard to ensure global consistency and a level playing field. While national discretion may be allowed on top of that where needed, policymakers should focus on setting a global standard as a minimum requirement. We welcome that the BCBS concluded the principles for the effective management and supervision of climate-related financial risks, aiming to create a common baseline across jurisdictions, although this is still at an early stage and various challenges remain. We urge policymakers to collaborate in rulemaking to reduce global fragmentation, especially where rules have an extraterritorial effect, which would facilitate sufficient funding for achieving the targets set and a just transition.