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Foundations for Science-Based Net-Zero Target Setting in the Financial Sector:

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Foundations for Science-Based Net-Zero Target Setting in the Financial Sector

Financial institutions have started to focus on net-zero as the guiding principle for their climate mitigation ambition. However, the lack of consistent principles, definitions, metrics, and evidence of effective strategies to meet net-zero targets limits the ability of financial institutions to support the reduction of emissions in the real economy that is needed to stabilize temperatures at 1.5°C above pre-industrial levels. In this foundations paper, the Science Based Targets initiative (SBTi) provides principles, definitions, metrics, and target formulation considerations for financial institutions to set quantitative net-zero targets linked with emissions reductions in the real economy.

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Context

The Intergovernmental Panel on Climate Change (IPCC) Special Report on 1.5°C provided a widely accepted warning that to limit global warming to 1.5°C, the world needs to halve carbon dioxide (CO_2) emissions by around 2030 and reach net-zero CO_2 emissions by mid-century, accompanied by deep cuts to non-CO_2 greenhouse gas (GHG) emissions. The report defined the net-zero state as the point when "anthropogenic emissions of greenhouse gases (GHGs) to the atmosphere are balanced by anthropogenic removals over a specified period."

To decarbonize the global economy in alignment with the goals established by the Paris Agreement, all economic actors in the real economy need to reduce their GHG emissions at a rate sufficient to remain aligned with the mitigation pathways established by climate science. The central enabling role of the finance sector is recognized in the Paris Agreement's Article 2.1(c) on "making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development." Financial institutions (FIs) have a unique influence over other actors in that they provide capital and services to companies with responsibility for reducing their GHG emissions, rather than exercise direct control over any major sources of GHG emissions reductions. It is thus critical for FIs to help drive Paris-aligned systemic decarbonization by leveraging their shared influence and responsibility for aligning incentives and eliminating barriers to emission reductions.

Recent research has found that 77 percent of global emissions and 80 percent of global GDP are covered by net-zero commitments (Hale, et al. 2021). The Glasgow Financial Alliance for Net-Zero (GFANZ) has brought together several net-zero alliances to help drive high-level net-zero commitments. As of September 2021, these net-zero alliances have helped shape many of the initial commitments of financial institutions (FIs), bringing together over 160 firms (together responsible for assets in excess of US$70 trillion).

Our review of the financial net-zero landscape to date finds that approaches differ across dimensions such as the range of financial services that are covered and how FIs are planning to achieve their target. FIs are using a combination of different strategies to decarbonize their portfolios and invest in new climate solutions such as renewable energy and carbon dioxide removal technologies. However, without a common understanding, today's varied net-zero target setting landscape makes it difficult for stakeholders to compare goals and to evaluate whether the actions being taken by FIs are sufficient to achieve a global net-zero economy by 2050 in line with limiting global warming to 1.5ºC.

About This Paper

In 2020, the SBTi published criteria and guidance for FIs to set near-term science-based targets (SBTs) that cover their investment and lending portfolios. FIs are now using the guidance and criteria to validate their SBTs with the SBTi. In October 2021, the SBTi published the SBTi Corporate Net-Zero Standard which provides guidance, criteria, and recommendations for corporates to set net-zero targets through the SBTi. This foundations paper builds on the SBTi Finance Guidance and Criteria as well as the Corporate Net-Zero Standard, advancing progress towards developing a Net-Zero Standard for Financial Institutions.

Acknowledging the critical role of finance in achieving a net-zero economy, this paper provides a conceptual foundation for setting and assessing financial net-zero targets anchored in climate science. This paper presents key concepts, including a working definition of what it means to reach net-zero for a financial institution, what transition metrics are most suitable to track progress towards these goals, and outlines how issues such as the financing of fossil fuels and the use of carbon credits should feature in credible science-based net-zero targets.

This paper aims to create alignment across the financial community on a common language for terms and concepts for net-zero target-setting. The goal is to build a growing group of financial institutions that transparently, quantitatively, and robustly support the emissions reductions in the real economy needed for climate stabilization. The paper does not represent a definitive set of criteria or guidance but, rather, a first step in the process of developing a Net-Zero Standard for FIs.

Key Questions

<u>What does it mean to reach net-zero for an FI?</u>

The SBTi is exploring three broad approaches for how FIs can reach a state of net-zero emissions, consistent with achieving the 1.5°C goal of the Paris Agreement and contributing to the Sustainable Development Goals (SDGs). The three approaches are summarised below:

1. Financed emissions: net-zero claims are based on reducing financed emissions to zero or to a residual level that is consistent with reaching net-zero emissions at the global or sector level in eligible 1.5°C-aligned pathways. Any remaining residual emissions are neutralized by permanently removing and storing an equivalent amount of atmospheric carbon dioxide.
2. Portfolio alignment: net-zero claims are based on financial institutions aligning all relevant financing activities such that each individual asset achieves a state of net-zero consistent with the SBTi Corporate Net-Zero Standard.
3. Contribution to the net-zero economy: Net-zero claims are based on FIs financing both decarbonization activities and explicitly reallocating financing activities to climate solutions at a rate that is consistent with global climate goals.

These approaches are not mutually exclusive, and in future work the SBTi aims to define requirements for how one or more of these approaches can be used to set FI net-zero targets.

<u>How should FIs address their financed emissions?</u>

Companies setting science-based net-zero targets are expected to reduce value-chain emissions to a level consistent with the depth of abatement achieved at the point of reaching global or sector-level net-zero in scenarios that limit warming to 1.5°C with no or limited overshoot. For most companies this means emissions are reduced by at least 90% before reaching net-zero. FIs' financed activity emissions are expected to align with the same 1.5°C-aligned abatement levels when reaching net-zero.

Reducing financed emissions should not occur at the expense of financing the transition in wider economy. Rather than simply reducing portfolio exposure to GHG emissions by aligning with these pathways, net-zero targets for FIs should incentivize engagement with portfolio companies to reduce their own emissions consistently with relevant 1.5°C pathways by setting science-based net-zero targets. This engagement is intended to support financing of GHG reductions in the real economy.

A forward-looking approach can help ensure the necessary transition finance to all companies that have signaled their intention to decarbonize, regardless of their sector or current GHG emission footprint. For companies that are unable or unwilling to transition, however, financial institutions can discontinue the relationship by divesting.

What role do carbon credits play?

Companies are not able to purchase carbon credits as a replacement for reducing value chain emissions in line with their science-based targets - this is often referred to as “offsetting”. However, under the SBTi Corporate Net-Zero Standard framework, investment in mitigation outside the corporate value chain (“beyond value chain mitigation”) is strongly recommended to support societal net-zero goals, and high-quality carbon credits may contribute towards this. In addition, any residual emissions that remain when reaching corporate long-term science-based targets must be neutralized with permanent removals to reach net-zero; these removals may be sourced from carbon credits.

As a general rule, FIs are not expected to purchase carbon credits on behalf of companies to balance unabated emissions on the path to net-zero or neutralize residual emissions from companies in their portfolios at the state of net-zero. The net-zero “burden” is then placed on the companies themselves, rather than the FI. This incentivizes the companies to reduce their own value chain emissions, rather than relying on the FI.

FIs should prioritize the opportunities within their core business to accelerate the transition beyond their SBTs and contribute to wider societal net-zero goal. There may be a limited role for FIs to contribute to reaching societal net-zero goals through the purchase of carbon credits, however the greater opportunity lies within the FIs ability to influence mitigation through direct financing.

How should climate solutions be addressed in net-zero targets?

FIs have an important role to play in scaling up investments in new climate solutions such as renewable energy, sustainable mobility and infrastructure. Recognizing the importance of finance in the coming decade in addressing climate change, options for directing finance towards nature-based climate solutions that secure and enhance carbon sinks to avoid the emissions that arise from their degradation will be explored as part of the standard development process. There is also a critical need for FIs to invest in nascent GHG removal technologies, for example direct air capture (DAC) and geological storage, so that the technology is available to neutralize residual emissions to reach net-zero.

The definition, quantification, and ambition associated with financing of climate solutions remain to be developed. Ambition is usually defined in terms of the rate of change of emissions reductions, and not the rate of change of deployment of financing for new solutions. Questions around whether and how climate-solution financing can be included with net-zero targets will continue to be examined as part of the upcoming development process.

How should SBTs complement NZ targets?

Science-based emissions reduction targets ensure that FIs address relevant sources of financed emissions through sector-based physical intensity or engagement-oriented methods in the near-term. Science-based net-zero targets are expected to go beyond FIs' near-term SBTs to define the state of net-zero and clarify how FIs can do their part to achieve a net-zero economy. This may include engagement of portfolio companies, investments in climate solutions, and wider support of policy to ensure a just transition.

Process to develop the SBTi Finance Net-Zero Standard

This paper represents the first step in developing a science-based, net-zero standard for FIs. The SBTi plans to build on this paper with a transparent and inclusive multi-stakeholder process for developing target validation criteria, detailed guidance, and technical resources to support financial institutions with the development and implementation of science-based net-zero targets.

While the financial sector plays a different role than the corporate sector in achieving net-zero emissions, the forthcoming standard will be informed by, and aligned with, the SBTi Corporate Net-Zero Standard. As part of the standard development process, further research and consultation is planned to address the following key technical questions:

- How net-zero definitions can apply to different types of FIs, given their different abilities to influence and drive reductions in the real economy.
- Clarifying the role of climate solutions in net-zero targets, specifically relating to metrics and whether and how the rate of climate-solution financing should be tied to science-based scenarios.
- Determining the role of emissions removals within asset classes to effectively counterbalance remaining residual emissions and stipulating the conditions for FIs to claim net-zero emissions across their operations and financing activities.
- Integrating the FI net-zero framework with the corporate target-setting pathways used by real economy companies.

Note: The full draft will be released Nov 10, 2021.