ACCELERATE ®
CLIMATE
TRANSITION

ROADTEST
LAYMAN REPORT

ASSESSING LOW CARBON TRANSITION

ACT Finance | Banking

Layman report

April 2024

1. CONTEXT OF THE ROAD TEST

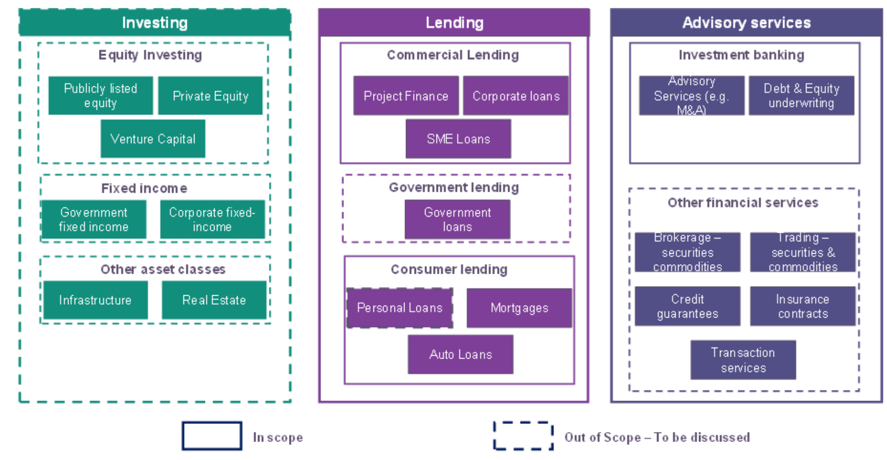
ACT FINANCE - BANKS

While the emissions of a bank's business operations and value chain have some impact in terms of emissions, the most material impact of a financial institution comes from their financed and facilitated emissions. Thus, banks have a key role to play in the transition regarding the support of companies which are transitioning and the shift of their financings towards climate solutions. Over the last decade, methodologies and initiatives have evolved to reflect market understanding of financed and facilitated emissions and support the development of calculation and attribution approaches and relevant metrics. The main challenge of the finance sector is defining and assessing what is within the scope of the financial institution's control and what is "fair" to assess.

ACT FINANCE – BANKING METHODOLOGY

For the past eight years, ADEME, CDP and WBA have been working together on developing the 'Assessing low Carbon Transition' (ACT) initiative, a methodology to assess companies that have set climate commitments and want to take climate action in line with the Paris Agreement. The ACT methodology uses a holistic approach to assess a company's climate strategy and determine its readiness to transition to a low-carbon economy.

The ACT Finance methodology aims at assessing financial institution climate strategy on an international level. The methodology cannot cover all activities performed by financial institution. Thus, the methodology has been split into two sub-methodologies: banking and investing. Some other activities (trading, brokerage, insurance coverage) have been disregarded due to complexity, lack of expertise, data, or methodology at the time (see Figure 1)



Source: GHG Protocol, Guidance for the financial sector: Scope 3 accounting and reporting of greenhouse gas emissions - 2013

FIGURE 1: ACTIVITIES THAT CAN BE ASSESSED BY THE ACT FINANCE BANKING METHODOLOGY

GOALS OF THE ROAD TEST

The project's objectives were:

- to road test the ACT Banking draft methodology and accompanying tools.
- to provide recommendations to refine the methodology
- to ensure that ACT Banking is relevant and robust for the sector
- to engage banks and other stakeholders in the low carbon transition

The aim of the road-test **is not** to make individual or collective judgement on the maturity of the sector.

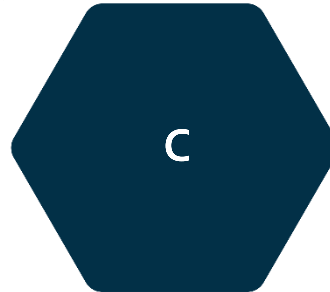
The road test for the ACT Finance Banking Methodology has been carried out, on behalf of ACT, by Deloitte, I Care and Technopolis.

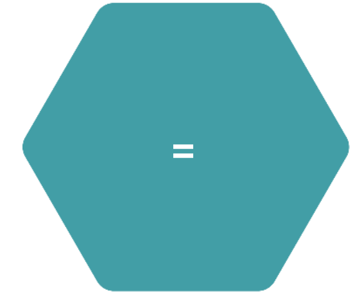
ASSESSED BANKS

+
4 companies assessed using publicly available data

2. RESULTS OF THE COMPANY ASSESSMENTS

OVERALL RESULTS





The average performance score was 5.6/20 where 9.4 was the highest and 2.9 the lowest score. The best scores can be explained by the development of consistent and ambitious transition plans and the implementation of new business models with a reorientation of financing. The lowest scores can be due to insufficient information, an incomplete climate-related strategy, and a low portfolio climate performance. Regarding the latter, there was a global lack of maturity regarding the complex yet core question of defining what is a transitioning / sustainable asset or company. In addition, data gathering was deemed challenging for most of financial institutions.

Top scorers were different among indicators. By combining the best marks obtained on each indicator, the theoretical maximum for this road-test performance score is **12.6/20, showing that financial institutions can learn from each other practices**.

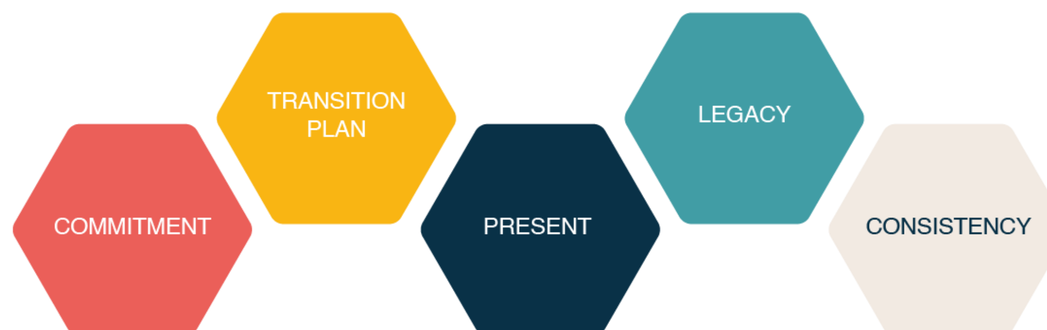
Tool and methodology will need an update in order to ease the usability as well as best rewarding the learning curve for financial institutions.

The average narrative score was C on a scale ranging from A to E**,** indicating an overall medium alignment with a low-carbon scenario. This medium-alignment is overall homogeneous among the five sub-modules, with a high dispersion within each one. Indeed, there are large variations between financial institutions with two participants out of nine scoring A or B and five banks scoring D. Reputations is the module with the lowest score as banks with low narrative score face reputational concerns. Data quality module is improving thanks to disclosure regulations and data providers, nevertheless the score depends on whether the assessment was based on public data or not.

The average trend score was rated equal (=) for the banking sector. This score assesses whether companies are likely to receive a better (+), similar (=) or lowest (-) score if they take the assessment in a few years. The trend score considers as a baseline a sub-set of indicator from the performance score. A complemented layer of expert judgement is then applied in order to take into account holistic information / perspectives. Given the high correlations with the performance score, the analysts extensively relied on the expert judgement layer. 1 company out of 9 obtained a "-" score and 2 a "+" score. Overall, the "=" average represents a slight anticipated improvement in banks' balance sheets, thanks notably to the target-settings implemented. Some banks introduced tools and methods for integrating climate criteria into their lending and service processes, but it is still at preliminary stage and tangible improvement in balance sheets are not expected for the next few years. Eventually the tool might be refined in order to gather more adding value and frame better the expert judgement.

OVERALL PROFILE OF THE 5 ACT DIMENSIONS

While each ACT methodology is sector-specific, they are all based on the ACT Framework methodology and as such there are fundamental commonalities among all of them. The assessment's main goal is to evaluate past, present and (anticipated) future company performance to determine the company's maturity level with respect to its transition to a low-carbon economy. The ACT initiative focuses on five guiding principles to determine company performance:



1

Most of the companies assessed have set sector-specific emissions reduction targets, and in some cases overall reduction and/or exposition targets. The sectors covered by these targets depend on the level of maturity of the various institutions, but broadly cover electricity and oil & gas at this stage. In the case of these two sectors, sectoral targets include both a carbon intensity reduction objective and divestment of the most polluting assets, such as coal-fired power plants. The main differences observed now lie in oil and gas phase-out strategies, with wide variations between financial institutions.

2

Overall, banks assessed take into account the challenge of climate change, as shown by their scores on the modules relating to management and commitment policies. Most of them have undertaken climate stress-testing in line with the recommendations of their respective regulators and are addressing the challenges of transition at the highest level of the hierarchy. They now need to act, by developing more tools for redirecting capital flows to projects and companies in favour of transition, while at the same time equipping themselves with tools for measuring the climate maturity of the objects financed.

3

Companies are starting to report their exposure to the most carbon-intensive assets and are gradually creating tools to redirect their capital flows towards more green assets. This work is still in its early stages, and the need for the most granular data possible will be key to achieving this reorientation, which is currently still a limiting point in the classification of the climate quality level of financed objects.

4

Target setting and climate reporting with quantified indicators are recent developments. Track record is therefore still in its infancy and will need to be closely monitored over the coming months. Nonetheless, most of the players we evaluated have been taking part in several market initiatives for a low-carbon transition for several years now.

5

Initiatives are multiplying but may still lack overall coherence. It is difficult to understand how players intend to act beyond penalizing the brownest assets (exit strategies, reducing carbon impact) and the greenest (financing the transition). Most of their financing remains in assets and companies situated between these two extremes, where it is still necessary to apply a plan to monitor and improve climate performance. This makes it difficult to have an overall vision of the company's transition plan, and its applicability to all group subsidiaries.

3. CONCLUSION AND OUTLOOK

SUCCESS OF THE ROAD TEST

- Nine assessments were completed, leading to **valuable feedback** and **engagement** from banks.
- With some improvements, the Banking methodology will provide a **fair reflection of a bank's readiness** to transition to a low-carbon economy.
- The current assessment methodology **illustrates clearly to financial institutions where are the main gaps / areas for improvement.**
- The methodology encourages much greater **transparency on climate performance, strategies and transition plans** and will help to raise the global scoring for the sector.

LIMITS OF THE ROAD TEST

- Many **difficulties** related to the data collection, in particular for quantitative Modules. Challenges arose from **lacking maturity and/or data** to assess some modules. Around 10 days of working are necessary both for the bank and the analyst to complete the assessment.
- **Lack of guidance** and a more **detailed explanation** could be expected for banks and for the evaluation to ensure harmonized assessments, especially on qualitative modules (6 & 7).
- **Data confidentiality** was a major stake for banks, with some reluctancy to share sensitive information. Despite NDA, some banks could initially be hesitant to share information.

MAIN CHANGES & RECOMMENDATIONS

All inconsistencies or issues experienced by the analysts and companies during the road test have been gathered in a logbook and integrated at the end of the road test after discussion with the Steering Committee and the Technical Working Group. The following points summarise the key recommendations that have been addressed or will be addressed:

- **Lighten the information required to complete module 4**: The Steering Committee remains convinced of the importance for financial institutions to be able to identify low carbon/transitioning companies and assets and base the assessment on the portfolio shifting toward these assets. However, difficulties were identified with the current design (i) challenges that face financial institutions in order to define such a framework and (ii) the burden of the granularity and historicity of the data requirement. It is therefore advisable to (i) reward better the framework itself and (ii) allow working more by proxy at a more aggregated level, so that the assessment can be carried out with the data available and in part with regulatory obligations in the coming years (with the taxonomy regulation or the pillar III requirements of the EBA for banks belonging to the European Union in particular).

- **Enhance the coordination with other industry initiatives** to consider the methodological guidelines of other standards, such as SBTi or the NZBA, especially for sectoral targets (metrics accepted in the methodology) or global reduction ones. This improvement will mainly concern module 1 "Targets", and possibly module 4 “Portfolio climate performance”.

- **Ease the impact** of the level of data quality on the scoring of module 1 and provide more guidance on the coverage of sectoral target emissions according to the parts of the value chain of the different sectors covered.

- **Provide better suggestions and consider new areas of evaluation for module 9: Business models**, hence assessing this essential module in the light of existing tools and innovations, or those currently under investigation, and thus embed the effects of climate change on business operations and balance sheet management.

- Other technical points should be addressed:
  - There is a need to consider how to assess ratio of climate R&D expenditure to total R&D expenditure, given the data gathering burden vs. weighting and definition of meaningful reachable levels).
  - Financial incentives for banks specialising in themes with high ESG value, whereas the latter have no such mechanisms, even though variable remuneration based on performance (financial or extra-financial) does not always exist.
  - The weighting of governance and climate expertise currently assessed based on a single person only in the assessment.
  - Consideration of a better distinction between small and large companies, which are not subject to the same reporting and transition plan submission obligations.
  - Wording to be reviewed on certain sub-modules to be more in line with that of the banking sector.
  - Review of the trend rating (+, -, =), which is too correlated at this stage with performance indicators.

METHODOLOGY RESHAPE AND REASSESSMENT

The lessons learnt from the road-test have been gathered with complementary elements and processed in order to improve both methodology and tool, notably:

- Weighting change of module 8 from 5% to 10% and of module 9 from 10% to 5%;
- Enrichment of some parts (transition plan coverage maturity matrix within 1.4, 4.2 portfolio management…).

These modifications have been tested on the performance score through a quick reprocessing of assessments. Results are the following, **with a global 6.3 (vs. 5.6 previously)**.