September 22, 2023

Treasury Department Releases Principles for Net-Zero Financing and Investment

Principles Focus on “Scope 3” Financed and Facilitated Greenhouse Gas Emissions

SUMMARY

On September 19, 2023, the U.S. Department of the Treasury released nine principles for net-zero financing and investment by financial institutions.[1] The Principles focus on “scope 3” financed and facilitated greenhouse gas emissions (*i.e.*, indirect emissions included in a company’s value chain) and advocate that financial institutions making credible net-zero commitments should develop transition plans with clear practices, targets, and metrics, and should support their clients and portfolio companies adopting their own transition plans. Although the release states that use of the Principles is “wholly voluntary” and that the Principles “do not impose legal requirements on any activities or institutions,”[2] financial institutions that have made net-zero commitments—or are considering making net-zero commitments—should consider reviewing the Principles to better understand how Treasury is approaching issues related to net-zero commitments and climate change more generally.

PRINCIPLES FOR NET-ZERO FINANCING AND INVESTMENT

- ***Principle 1:*** A financial institution’s net-zero commitment is a declaration of intent to work toward the reduction of greenhouse gas emissions. Treasury recommends that commitments be in line with limiting the increase in the global average temperature to 1.5°C. To be credible, this declaration should be accompanied or followed by the development and execution of a net-zero transition plan.
    - The release states that credible commitments “should be consistent with the goal of reaching net zero no later than 2050 and include credible short- and medium-term targets in line with limiting the increase in the global average temperature to 1.5°C.”[3]
    - The release defines a financial institution’s net-zero transition plan as “the set of goals, actions, and accountability mechanisms, including practices, metrics, and targets, designed to meet a

commitment and deliver GHG emissions (emissions) reductions across all emission scopes in line with achieving global net zero,"[4] and provides that a robust transition plan should generally address:

- the firm's overall commitment and priority practices;
- metrics and targets;
- implementation processes and structures (*i.e.*, the ways in which internal business and operating procedures, products, services, and policies reflect the commitment);
- engagement strategy (*i.e.*, the ways in which engagement with external stakeholders is prioritized and made consistent with the commitment); and
- governance.

- Recognizing that approaches to transition planning are "still being developed and refined," the release encourages financial institutions to adopt "flexible approaches that allow for improvements over time and comparability with peers," and states that transition plans "should be updated regularly, particularly as new technologies, methodologies, and emerging best practices enable financial institutions to increase the scope of their net-zero-aligned activities or as changes to climate science and the markets in which the institutions operate necessitate adjustments."[5]

- ***Principle 2*:** Financial institutions should consider transition finance, managed phaseout, and climate solutions practices when deciding how to realize their commitments.
  - The release asserts that the following three practices are particularly important for effective commitments and each "will be necessary to facilitate a smooth transition to net zero."[6]
    - ***Transition finance*:** The release defines this practice as "providing financing, investment, or advisory services to clients and portfolio companies that are implementing measures to significantly reduce the emissions from their goods and services."[7] The release states that transition finance "can support decarbonization in high-emitting sectors for which decarbonization is particularly difficult due to the current limitations in technological viability and/or price-competitiveness of low-emissions alternatives."[8]
    - ***Managed phaseout*:** The release notes that managed phaseout, which involves "financing, investing, or advisory services that support a managed or accelerated transition from high-emitting to zero- or near-zero-emissions assets,"[9] such as early decommissioning of high-emitting assets, can "help avoid the stranding of assets while reducing global emissions."[10] The release warns of the potential for greenwashing in this practice, and emphasizes that phaseout processes "should be transparent and invite accountability."[11]
    - ***Climate solutions*:** The release defines this practice as involving "financing, investment, or advisory services that support innovation and the adoption of zero- or near-zero-emissions technologies, services, or products that will contribute to the elimination, removal, or reduction of real economy[] emissions by replacing, significantly reducing demand for, or repurposing high-emitting alternatives."[12] The release states that the climate solutions practice can promote technological innovation, production innovation, and at-scale adoption.[13]

- ***Principle 3*:** Financial institutions should establish credible metrics and targets and endeavor, over time, for all relevant financing, investment, and advisory services to have associated metrics and targets.
  - The release states that, consistent with fiduciary, regulatory, and legal requirements, financial institutions should (1) set interim targets for 2030 or sooner and at no more than five-year intervals thereafter until the end-state target of 2050 or sooner; (2) endeavor for targets to cover all relevant financing, investment, and advisory services for clients and portfolio companies; (3) appropriately tailor targets to specific sectors/portfolios and asset classes; and (4) rely on resources and

emerging industry practices that utilize the latest science and methodological advances when defining target-relevant terms, data, and calculations.[14]

- The release also suggests that, in tracking any financed emissions targets for a portfolio of assets, financial institutions "should endeavor to calculate and disclose the proportion of emissions reductions due to changes in underlying client and portfolio company emissions," in contrast to changes resulting from shifts in the client base, portfolio holdings, or other characteristics.[15]

- ***Principle 4*****:** Financial institutions should assess client and portfolio company alignment to their (*i.e*., financial institutions') targets and to limiting the increase in the global average temperature to 1.5°C.
    - The release states that robust approaches to assessing client and portfolio company alignment may include the use of (1) classification systems and lifecycle emissions calculation tools; (2) benchmarks like sectoral pathways; and (3) client and portfolio company net-zero transition plans.[16]
- ***Principle 5*****:** Financial institutions should align engagement practices — with clients, portfolio companies, and other stakeholders — to their commitments.
    - The release states that, consistent with fiduciary, regulatory, and legal requirements, a financial institution's net-zero transition plan should "include a strategy for collaborating with and supporting relevant clients and portfolio companies to adopt and implement net-zero transition plans."[17]
- ***Principle 6*****:** Financial institutions should develop and execute an implementation strategy that integrates the goals of their commitments into relevant aspects of their businesses and operating procedures.
    - The release states that, consistent with fiduciary, regulatory, and legal requirements, financial institutions should consider (i) leveraging existing or creating new products and services that support client and portfolio company efforts to transition to net zero; (ii) establishing policies and conditions relating to activities in sectors highly relevant to the net-zero transition; (iii) incorporating net-zero objectives and practices in core evaluation and decision-making processes; and (iv) incorporating net-zero objectives into resource allocation and business planning.[18]
- ***Principle 7*****:** Financial institutions should establish robust governance processes to provide oversight of the implementation of their commitments.
    - The release states that financial institutions should "fully integrate the implementation" of transition plans into governance and enterprise risk management systems and define governance-related policies, procedures, and processes concerning net-zero commitments and transition planning activities.[19]
    - The release states that these policies, procedures, and processes should address board oversight, senior management roles and responsibilities, relevant skills and culture development among staff, incentives and remuneration, and any other relevant accountability mechanisms.[20]
- ***Principle 8*****:** Financial institutions should, in the context of activities associated with their net-zero transition plans, account for environmental justice and environmental impacts, where applicable.
    - The release states that "[p]roactively engaging excluded and marginalized populations can help to address" concerns regarding the impact of transition planning activities on environmental justice and just transition of the workforce.[21]
- ***Principle 9*****:** Financial institutions should be transparent about their commitments and progress towards them.
    - The release states that "appropriate transparency" is "part of a credible commitment" and is "necessary for external accountability," and may, in some cases, involve "voluntary public disclosures exceeding those required by applicable law."[22]

- The release also states that disclosed information should include (1) relevant data and data sources; (2) frameworks and methodologies leveraged; (3) approaches to and progress of client and portfolio company engagement; and (4) other key decisions that a financial institution makes in developing and executing its transition plan.[23]
- The release notes that transparency of quantitative information that reflects progress towards targets is "particularly important to the evaluation of financial institution net-zero activities" and that disclosed information should allow a financial institution's targets and progress to be "reasonably compared" to what is disclosed by other institutions and needed by stakeholders to assess an institution's overall progress.[24]
- With respect to carbon credits, the release notes that financial institutions should "provide sufficient information to give stakeholders a clear understanding of whether and/or the extent to which" the voluntary use of such credits is part of the net-zero commitments.[25]

The release also identifies areas where gaps exist and further clarification on approaches and methodologies would be helpful. For example, with respect to transition finance, the release encourages financial institutions to "work to overcome barriers to integrating sectoral pathways and client and portfolio company scope 3 emissions data into measurement and target-setting efforts."[26] In addition, the release notes that there are "gaps in available and fit-for-purpose methodologies for assessing client and portfolio alignment, and a need for continued improvement of target-setting methodologies."[27] Accordingly, the release urges financial institutions to consider how to work with relevant stakeholders to improve methodologies and approaches.[28]

OBSERVATIONS

Although the Principles do not create any new legal or regulatory obligations, they represent Treasury's view that credible net-zero commitments require thorough transition planning, as well as Treasury's efforts to begin the benchmarking of existing practices against the "emerging best practices" identified by Treasury.

In remarks accompanying the release, Treasury Secretary Janet Yellen stated that if financial institutions do not monitor shifting consumer preferences and new technologies and assess the "significant financial impacts" of climate change, they "risk being left behind with stranded assets, outdated business models, and missed opportunities to invest in the growing clean energy economy." [29] She also stressed that financial institutions' activities in support of their net-zero commitments "need to be rigorously managed," but noted that the Principles were designed to be flexible and that a "one-size-fits-all approach won't work."[30] To this end, she acknowledged that "[h]ow smaller firms apply the Principles may look quite different than how larger ones do"[31] and that "[a]pproaches will vary depending on business model, client base, products and services, and jurisdiction."[32]

In connection with the release, Treasury also highlighted several announcements from civil society organizations. To support the policy objectives underlying the Principles, several philanthropic organizations—including Bezos Earth Fund, Bloomberg Philanthropies, Climate Arc, ClimateWorks

Foundation, Hewlett Foundation, and Sequoia Climate Foundation—committed $340 million for the continued development of research, data availability, and technical resources intended to help financial institutions develop and execute robust, voluntary net-zero commitments.[33] Further, additional organizations announced plans to "generate tools and technical work needed to facilitate the execution of net-zero commitments."[34] For example, the Glasgow Financial Alliance for Net Zero (GFANZ) launched a 45-day consultation on its work to further refine the definitions of its transition finance strategies and support financial institutions in forecasting the impact of these strategies on reducing emissions. GFANZ expects to release a final report at the 2023 United Nations Climate Change Conference (COP28) later this year.[35] As another example, the Partnership for Carbon Accounting Financials (PCAF) announced its plan to publish its standard for facilitated emissions later this year, which will cover capital markets transactions.[36]

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ENDNOTES

1 U.S. Department of the Treasury, *Principles for Net-Zero Financing & Investment* (Sept. 2023), *available at* https://home.treasury.gov/system/files/136/NetZeroPrinciples.pdf.

2 *Id*. at 2.

3 *Id*. at 4.

4 *Id*. The release explains that the term "transition plan" refers to either or both (i) any internal-facing processes, documents, communications, or resources that outline and guide a firm's transition plan goals, actions, and accountability mechanisms, and (ii) any external-facing communications meant to inform stakeholders of this information. *Id*. The release recognizes that, in many cases, such internal-facing processes, documents, communications or resources will be different from what is publicly shared. *Id*.

5 *Id*. at 5.

6 *Id*.

7 *Id*.

8 *Id*.

9 *Id*. at 6.

10 *Id*.

11 *Id*.

12 *Id*.

13 *See id*.

14 *See id*. at 7.

15 *Id*. at 8.

16 *See id*. at 9.

17 *Id*. at 10.

18 *See id*. at 11.

19 *See id*.

20 *See id*.

21 *See id*. at 12.

22 *Id*.

23 *Id*.

24 *Id*.

25 *See id*. at 13. The release warns that voluntary carbon markets "remain relatively small and face challenges related to market transparency and credit integrity," but notes that these markets "represent potentially important channels for unlocking significant capital to climate-impactful investments that can help limit the increase in the global average temperature to 1.5°C." *Id*.

26 *Id*. at 8.

27 *Id*. at 11.

28 *See id*.

ENDNOTES (CONTINUED)

[29] Remarks by Secretary of the Treasury Janet L. Yellen in New York, New York on Treasury's Principles for Net-Zero Financing & Investment (Sept. 19, 2023), *available at* https://home.treasury.gov/news/press-releases/jy1750 ("*Secretary Yellen Remarks*").

[30] *Id*.

[31] Neither Secretary Yellen's remarks nor the release define the terms "larger" or "smaller."

[32] Secretary Yellen Remarks.

[33] Press release, "Treasury Releases Principles for Net-Zero Financing & Investment, Applauds $340 Million Philanthropic Commitment and Other Pledges" (Sept. 19, 2023), *available at* https://home.treasury.gov/news/press-releases/jy1744.

[34] *Id*.

[35] *See id*.

[36] *See id*.

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