

U.S. DEPARTMENT OF THE TREASURY

# Principles for Net-Zero Financing & Investment



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## About this document

In recent years, financial institutions — including over 100 U.S. firms<sup>1</sup> — have independently made voluntary net-zero commitments. Successful execution of such commitments can help firms mitigate exposure to climate-related risk and unlock economic opportunities as the United States builds the clean energy economy of the future. In recognition of firms' commitments, the United States Department of the Treasury (Treasury) is releasing Principles for Net-Zero Financing & Investment (the Principles) to:

- Underscore the importance and value of financial institutions' net-zero commitments;
- Promote consistency and credibility in financial institutions' approaches to these commitments; and
- Highlight and encourage greater adoption of emerging best practices pertaining to these commitments.

Treasury and the Biden-Harris Administration welcome robust net-zero commitments made by financial institutions. Treasury hopes financial institutions will use the Principles to support the implementation of their commitments.

The Principles focus on financial institutions' scope 3 financed and facilitated greenhouse gas (GHG) emissions, which are typically the largest type of emissions for financial institutions.<sup>2</sup> The Principles are based, in large part, on the existing body of work developed by private sector and non-governmental organizations and initiatives. They reflect an in-depth review of existing literature and research as well as input from over a year of stakeholder engagement.<sup>3</sup> Treasury developed the Principles after consulting with representatives of a number of other U.S. Cabinet agencies and the White House. In the face of the increasingly severe climate crisis, the Principles are being released in the context of extensive actions taken by the Biden-Harris Administration to reduce emissions and enable financial institutions, non-financial companies, communities, and workers to benefit from the new clean energy economy.<sup>4</sup>

Over the past year, Treasury engaged financial market participants, Tribes, research organizations, and civil society organizations to understand how financial institutions are setting and meeting their net-zero commitments. These stakeholders noted the proliferation of research, guidelines, and voluntary standards about net-zero financing, investment, and advisory services. They also expressed the need for further clarity on where emerging consensus exists and where gaps in best practices remain. Treasury intends for the Principles to help address some of that need.

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1 Includes firms from net-zero initiatives for asset managers, asset owners, banks, insurers, and venture capital companies.

2 Scope 1 GHG emissions are directly attributable to an entity's owned or controlled sources, scope 2 GHG emissions are emissions that come from purchased energy, and scope 3 GHG emissions are indirect emissions included in a company's value chain. For more information on emission scopes and their definitions, see resources provided by the GHG Protocol, <https://ghgprotocol.org/>. For a discussion of the relative size of financed and operational emissions, see CDP, *The Time to Green Finance* (2020), 34-36, <https://cdn.cdp.net/cdp-production/cms/reports/documents/000/005/741/original/CDP-Financial-Services-Disclosure-Report-2020.pdf?1619537981>.

3 This includes a review of the G20 Sustainable Finance Working Group's 2022 recommendations on Improving the Credibility of Private Sector Financial Institution Commitments, see G20 SFWG, *2022 G20 Sustainable Finance Report* (2022), 41-53, <https://g20sfwg.org/wp-content/uploads/2022/10/2022-G20-Sustainable-Finance-Report-2.pdf>.

4 See, e.g., White House, "Paris Climate Agreement," January 20, 2021, <https://www.whitehouse.gov/briefing-room/statements-releases/2021/01/20/paris-climate-agreement/>; White House, *A Roadmap to Build a Climate-Resilient Economy* (October 14, 2021), <https://www.whitehouse.gov/wp-content/uploads/2021/10/Climate-Finance-Report.pdf>; White House, "Fact Sheet: One Year In, President Biden's Inflation Reduction Act is Driving Historic Climate Action and Investing in America to Create Good Paying Jobs and Reduce Costs," August 16, 2023, <https://www.whitehouse.gov/briefing-room/statements-releases/2023/08/16/fact-sheet-one-year-in-president-bidens-inflation-reduction-act-is-driving-historic-climate-action-and-investing-in-america-to-create-good-paying-jobs-and-reduce-costs/>; White House, "Fact Sheet: Biden-Harris Administration Releases Updated Fact Sheets Highlighting Bipartisan Infrastructure Law Investments in all 50 States, D.C., and Territories," May 15, 2023, <https://www.whitehouse.gov/briefing-room/statements-releases/2023/05/15/fact-sheet-biden-harris-administration-releases-updated-fact-sheets-highlighting-bipartisan-infrastructure-law-investments-in-all-50-states-d-c-and-territories/>.

Use of the Principles is wholly voluntary. A financial institution's strategy, business model, size, client base, products and services, and fiduciary, regulatory, and legal obligations will affect its approach to the net-zero transition, including whether and to what extent it may choose to apply the Principles. The Principles do not impose legal requirements on any activities or institutions. They are not standards and are not intended to be exhaustive. Significant changes and improvements in climate science and climate-related strategy and risk management are likely to occur over time, which may affect the relevance and efficacy of the resources cited in the Principles; such citations should not be construed as endorsements.

Treasury's mission is to maintain a strong economy and create economic and job opportunities by promoting the conditions that enable economic growth and stability at home and abroad. Climate change is a shared, global, and existential challenge that poses a severe risk to the productive capacity of the economy and requires an economy-wide response to safeguard U.S. economic growth and energy security. Treasury expects to build on its engagement with stakeholders to elevate best practices, address challenges, and support financial institutions in their efforts to execute on their commitments.

The intended audience for this report includes financial institutions and the broad ecosystem of stakeholders that shape how voluntary net-zero commitments by financial institutions are developed, implemented, assessed, and communicated, particularly in the United States. While the Principles are directed at those firms that have already made a net-zero commitment or are considering making one, other financial institutions may find the concepts helpful as they navigate the risks and opportunities of the net-zero transition.

## Summary of the Principles for Net-Zero Financing & Investment

**PRINCIPLE 1:** A financial institution's net-zero commitment (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.

**PRINCIPLE 2:** Financial institutions should consider transition finance, managed phaseout, and climate solutions practices when deciding how to realize their commitments.

**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.

**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.

**PRINCIPLE 5:** Financial institutions should align engagement practices — with clients, portfolio companies, and other stakeholders — to their commitments.

**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.

**PRINCIPLE 7:** Financial institutions should establish robust governance processes to provide oversight of the implementation of their commitments.

**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.

**PRINCIPLE 9:** Financial institutions should be transparent about their commitments and progress towards them.

*References to what financial institutions should do or consider doing refer to only those institutions that have made or are making a commitment.*

## Principles for Net-Zero Financing & Investment<sup>5</sup>

**PRINCIPLE 1:** A financial institution’s net-zero commitment (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.

A financial institution’s commitment for the purposes of the Principles pertains to the financing, investment, and advisory services the institution provides to clients and portfolio companies.<sup>6</sup> An effective commitment is accompanied by the identification of net-zero priority practices (practices) by which a financial institution seeks to fulfill its commitment. To support these practices, financial institutions should develop net-zero targets or goals (targets) that reflect measurable milestones toward achieving their commitments. Net-zero metrics (metrics) are used to measure and track progress toward meeting target(s). A financial institution net-zero transition plan is 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.<sup>7</sup> The Principles focus on financial institution financed emissions, which are typically the largest type of emissions for financial institutions. Financial institution net-zero efforts should aim to enable emissions reductions by their clients and portfolio companies.

Net-zero commitments can be appropriate for a broad range of financial institutions. Financial institutions that have made commitments vary widely in terms of strategy, business model, size, client base, products and services, and fiduciary, regulatory, and legal obligations. These factors may influence how and the pace at which financial institutions make and realize their commitments. However, 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.

Enabling emissions reductions primarily involves engaging with clients and portfolio companies to support them in taking the actions needed to better manage risks and opportunities associated with the net-zero transition, including implementing robust net-zero transition plans. In some cases, financial institutions might choose to reallocate financing, investment, and advisory services away from clients and portfolio companies that over time act in ways inconsistent with a financial institution’s commitment and transition plan. In those cases, such reallocation can reduce a financial institution’s exposure to companies facing high transition risk.

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5 This document focuses on financial institution scope 3 financed and facilitated emissions. For brevity, we refer to “financed and facilitated emissions” as “financed emissions.” Efforts to reduce other forms of financial institution emissions are important but not the subject of the Principles. References in this document to what “financial institutions” (also referred to as “firms” or “institutions”) should do or consider doing refer to only those firms that have made or are making a commitment.

6 In the context of this document, “financing, investment, and advisory services” includes many forms of financing and investment, asset management, debt and equity capital markets facilitation activities, and similar products and services provided by banks and non-banks, including corporate and project financing provided to publicly listed or private companies. As credible methodologies for measuring net-zero alignment develop and mature, the Principles may become relevant to additional types of financial institutions and activities. Further, in the context of this document, “clients and portfolio companies” include companies that are recipients of financing, investment, or advisory services from financial institutions. Where relevant, financial institutions should consider how the Principles apply to consumer financial products such as auto loans and mortgages.

7 The term “transition plan” in this document 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 in the context of the definition above, and (ii) any external-facing communications meant to inform stakeholders (e.g., investors, clients, portfolio companies, civil society, governments, and others) of this information. In many cases, the processes, documents, communications, and resources defining a firm’s transition plan internally will be different (e.g., more detailed, diffuse, and deliberative) from what is publicly shared.

To be credible, a commitment should be accompanied or followed by the development and execution of a net-zero transition plan. A financial institution net-zero transition plan is a tool to help a firm mitigate risk and seize transition-related opportunities. While the specifics will reflect an institution’s individual characteristics, a robust net-zero transition plan should generally address the following: (i) the firm’s overall commitment and priority practices; (ii) metrics and targets; (iii) implementation processes and structures (*i.e.*, the ways in which internal business and operating procedures, products, services, and policies reflect the firm’s commitment); (iv) engagement strategy (*i.e.*, the ways in which engagement with external stakeholders — like clients, portfolio companies, and other stakeholders — is prioritized and made consistent with the financial institution’s commitment); and (v) governance (*i.e.*, the oversight structures and processes put in place to build an environment of trust, transparency, and accountability necessary for successful execution of the financial institution’s net-zero transition plan).<sup>8</sup>

When possible, financial institutions should consult leading transition plan frameworks, and reference any frameworks they use, to promote credibility and comparability of resulting activities. Net-zero 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. Approaches to net-zero transition planning are still being developed and refined. Financial institutions should adopt flexible approaches that allow for improvements over time and comparability with peers.

Principles 2-8 relate to net-zero transition plan development and implementation.

**PRINCIPLE 2:** Financial institutions should consider transition finance, managed phaseout, and climate solutions practices when deciding how to realize their commitments.

Several financial institution practices are particularly important for effective commitments. These practices — “transition finance,” “managed phaseout,” and “climate solutions” — are not mutually exclusive; financial institutions with commitments may pursue one or several simultaneously. Each practice will be necessary to facilitate a smooth transition to net zero.

- **Practice 1 – Transition finance:** This practice involves providing financing, investment, or advisory services to clients and portfolio companies that are implementing measures to significantly reduce the emissions from their goods or services. 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. Decarbonization in these historically “hard-to-abate” sectors may entail capital intensive retooling and high upfront costs for critical production technologies. Transition finance can also apply to sectors other than those considered hard-to-abate.

Clients and portfolio companies may be “aligned” (*i.e.*, their emissions profiles are in line with limiting the increase in the global average temperature to 1.5°C, and the transition finance will enable them to maintain that alignment) or “aligning” (*i.e.*, their emissions profiles demonstrate the need to make changes to their operations or business models to be in line with limiting the increase in the global average temperature to 1.5°C, and transition finance will support them in doing so). To be considered “aligned” or “aligning,” a client

<sup>8</sup> Note that financial institutions may choose to apply these high-level issues differently, reflective of firm characteristics. Existing work on transition plans includes: Transition Plan Taskforce, *The Transition Plan Taskforce Disclosure Framework* (November 2022), <https://transitiontaskforce.net/wp-content/uploads/2022/11/TPT-Disclosure-Framework.pdf>; Glasgow Financial Alliance for Net Zero (GFANZ), *Recommendations and Guidance on Financial Institution Net-zero Transition Plans* (November 2022), <https://assets.bbhub.io/company/sites/63/2022/09/Recommendations-and-Guidance-on-Financial-Institution-Net-zero-Transition-Plans-November-2022.pdf>.

or portfolio company should at a minimum demonstrate historical evidence of progress to decarbonize, have set interim and end-state targets, and demonstrate serious intent to achieve its targets, such as by taking concrete actions related to governance and implementation.

For example, a financial institution could provide capital to a steel company that is acquiring lower-emitting electric arc furnaces. An institution providing transition finance should be able to explain how its financing results in reductions of its client's or portfolio company's emissions. Such activity benefits the net-zero transition when it results in a client or portfolio company aligning with limiting the increase in the global average temperature to 1.5°C.

- **Practice 2 – Managed phaseout:** A subset of transition finance, this practice involves financing, investing, or advisory services that support a managed and accelerated transition from high-emitting to zero- or near-zero-emissions assets. This includes early decommissioning, which may include repurposing strategies. Any early decommissioning effort should show associated emissions reductions and avoid emissions leakage. While a financial institution's financed emissions may increase in the short term as phaseout of the high-emitting asset is financed but emissions reductions are not yet realized, capital allocated to a credible managed phaseout process is consistent with the transition to net zero, if: (i) the phaseout occurs, (ii) the phaseout is significantly accelerated relative to prior plans, (iii) the phaseout happens in line with the country's net-zero plan or equivalent strategy, and (iv) substantial emissions reductions are realized relative to business as usual (e.g., an energy or other demand-side gap created by the phaseout is filled with a zero- or near-zero-emissions activity, although that activity need not be financed by the same firm) and help keep a 1.5°C global warming trajectory within reach. Managed phaseout can help avoid the stranding of assets while reducing global emissions.

Financial institutions' managed phaseout activities should demonstrate adherence to strict activity criteria, verification requirements, and rigorous guardrails — areas in which broader consensus on good practice is needed. Given the potential for greenwashing in this practice, phaseout processes should be transparent and invite accountability.<sup>9</sup>

- **Practice 3 – Climate solutions:** This practice involves financing, investing, 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<sup>10</sup> emissions by replacing, significantly reducing demand for, or repurposing high-emitting alternatives.<sup>11</sup> Examples include scaling up zero- or near-zero-emissions technologies as well as nature-based solutions and carbon removal technologies.<sup>12</sup>

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9 For example, the Energy Transition Accelerator, which is still in development, will provide aggregated best-practice criteria and guardrails for managed phaseout as part of comprehensive energy transition strategies. See: U.S. Department of State, The Rockefeller Foundation, and the Bezos Earth Fund, "U.S. State Department, Bezos Earth Fund, and The Rockefeller Foundation Announce Next Steps on Energy Transition Accelerator," news release, January 15, 2023, <https://www.rockefellerfoundation.org/news/u-s-state-department-bezos-earth-fund-and-rockefeller-foundation-announce-next-steps-on-energy-transition-accelerator/>.

10 "Real economy" refers to economic activity outside of the financial sector.

11 References in this document to zero- or near-zero-emissions technologies, services, or products pertain to the emissions that the use of a given technology, service, or product avoid, reduce, or remove, rather than the emissions that result from the production, transportation, and operation of the technology, service, or product. However, these value chain emissions should be considered in whether a technology, service, or product can truly be considered a "climate solution."

12 Nature-based solutions to climate change are a collection of approaches that offer the potential to both reduce and remove emissions. They do this by enhancing the ability of ecosystems to sequester carbon dioxide or reversing the degradation of an ecosystem so that it stores more carbon than it emits. See: Leo Mercer, "What are Nature-Based Solutions to Climate Change?" *The London School of Economics*, November 15, 2022, <https://www.lse.ac.uk/granthaminstitute/explainers/what-are-nature-based-solutions-to-climate-change/>.

Financing, investing in, and advising on climate solutions can promote technological innovation, production innovation, and at-scale adoption. Technological innovation results in new zero- or near-zero-emitting substitutes that may take the place of today's higher-emitting technologies (e.g., green hydrogen). Production innovation makes costly, but rapidly maturing, zero- or near-zero-emitting substitutes more economically competitive (e.g., lowering the fixed costs of building offshore wind turbines). At-scale adoption is the further proliferation of mature or nearly mature climate solutions.

Some forms of financing may align with several of the above practices. For example, capital directed to a utility company replacing coal power with solar and wind generation may be both transition finance and investment in at-scale adoption of climate solutions. In line with transition finance practices, the utility company's overall emissions footprint is being reduced over time (e.g., in line with limiting the increase in the global average temperature to 1.5°C). Additionally, in line with climate solutions practices, the financial institution's capital helps enable the utility company's deployment of zero- or near-zero-emissions assets (e.g., solar arrays). This example would not be considered managed phaseout unless the coal or other high-emitting asset is retired *before* the end of its scheduled useful life.

**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.

Financial institutions should, in a manner that is consistent with their fiduciary, regulatory, and legal requirements:

- 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.
- Over time, endeavor for targets to cover all relevant financing, investment, and advisory services for clients and portfolio companies.
- Appropriately tailor targets to specific sectors/portfolios and asset classes. For areas of the business or geographies for which this is not immediately feasible due to lack of available or fit-for-purpose methodologies or data, financial institutions should commit to work towards full coverage of relevant business activities, which could include participation in the development of additional methodologies and reporting practices.
- Rely on resources and emerging industry practices that utilize the latest science and methodological advances when defining target-relevant terms, data, and calculations.<sup>13</sup>

Financial institutions should select the credible target-setting approaches that are most appropriate for them while seeking to adhere to industry best practice, where appropriate. Target-setting methodologies, particularly related to the practices outlined below, are still being developed and refined.

<sup>13</sup> Examples include: GHG Protocol for defining client/portfolio company emissions, see GHG Protocol, *A Corporate Accounting and Reporting Standard* (2015), <https://ghgprotocol.org/sites/default/files/standards/ghg-protocol-revised.pdf>; Partnership for Carbon Accounting Financials (PCAF) for calculating financed emissions, see PCAF, "The Global GHG Accounting and Reporting Standard for the Financial Industry," <https://carbonaccountingfinancials.com/en/standard>; Science Based Targets initiative (SBTi) for sector-specific guidance, see SBTi, "Sector Guidance," <https://sciencebasedtargets.org/sectors>; and net zero initiative target-setting protocols for target-setting available through <https://www.gfanzero.com/membership/>.



- Targets associated with **transition finance** should be consistent with credible benchmarks (e.g., 1.5°C science-based sectoral pathways and benchmarks incorporating such pathways<sup>14, 15</sup>); include all GHGs (e.g., methane and nitrous oxide in addition to carbon dioxide) when measurable; cover client and portfolio company scope 1, scope 2, and, when material and quantifiable, scope 3 emissions; and incorporate both intensity metrics, which allow for more effective comparisons among entities within a sector (particularly when based on physical production), and absolute emissions reduction metrics, which are necessary to assess progress towards economy-wide targets. Whether absolute or intensity metrics are more suitable for a target may vary by firm, sector, and applicable benchmark or framework. Sectoral pathways and reliable client and portfolio company scope 3 emissions data are inputs to target setting that will likely become more readily available over time as stakeholders further develop methodologies and improve scope 3 data availability. Financial institutions should work to overcome barriers to integrating sectoral pathways and client and portfolio company scope 3 emissions data into measurement and target-setting efforts.
- Targets associated with **managed phaseout**, in addition to incorporating the guidance for transition finance, should additionally consider emissions reductions from early retirement activities and measures to mitigate negative and unintended consequences, such as moral hazard.<sup>16</sup>
- Targets associated with **climate solutions** should measure the amount of capital deployed toward climate solutions (broken out, if appropriate, by type of solution) and year-over-year changes in capital deployed.

Depending on the nature of its commitment and priority practices, a financial institution should consider setting targets and tracking performance in ways that reflect the coverage and progress of the financial institution’s own net-zero efforts. This could include tracking the ratio of the institution’s overall financing, investment, and advisory services that have an associated net-zero target and metrics that demonstrate progress towards transition plan goals.

Further, 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. This is in contrast to changes resulting from shifts in the client base, portfolio holdings, or other characteristics, which can obscure a financial institution’s actual contribution to emissions reductions.

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14 A science-based sectoral pathway is a scientifically credible, goal-oriented scenario or combination of scenarios answering the question, “What needs to happen?” in the context of a specific objective (e.g., in this case, what are the steps needed to limit global warming to 1.5 °C). A scenario is a projection of what can happen by creating plausible, coherent, and internally consistent descriptions of possible climate change futures. Scenarios are not predictions of the future. Sectoral pathways provide the link between the science of the remaining carbon budget and the detailed steps that a specific sector could take to reduce GHG emissions to a particular level in a specified timeframe. Sectoral pathways do this by providing a benchmark on the pace and timing of GHG emissions reductions needed. See GFANZ, *Guidance on Use of Sectoral Pathways for Financial Institutions* (June 2022), [https://assets.bbhub.io/company/sites/63/2022/06/GFANZ\\_Guidance-on-Use-of-Sectoral-Pathways-for-Financial-Institutions\\_June2022.pdf](https://assets.bbhub.io/company/sites/63/2022/06/GFANZ_Guidance-on-Use-of-Sectoral-Pathways-for-Financial-Institutions_June2022.pdf).

15 A number of organizations have developed science-based sectoral pathways, scenarios, and relevant benchmarks that can be leveraged by financial institutions. Examples include: Sustainable STEEL Principles, *The Sustainable STEEL Principles* (February 2023), [https://steelprinciples.org/wp-content/uploads/2023/05/sustainable\\_steel\\_principles\\_framework.pdf](https://steelprinciples.org/wp-content/uploads/2023/05/sustainable_steel_principles_framework.pdf); SBTi, *Cement Science Based Target Setting Guidance* (September 2022), <https://sciencebasedtargets.org/resources/files/SBTi-Cement-Guidance.pdf>; International Energy Agency, “Net Zero Emissions by 2050 Scenario (NZE),” <https://www.iea.org/reports/global-energy-and-climate-model/net-zero-emissions-by-2050-scenario-nze>.

16 One example includes preliminary guidance on managed phaseout targets developed by the Rocky Mountain Institute (RMI). See RMI, *Managed Coal Phaseout: Metrics and Targets for Financial Institutions* (January 2023), [https://rmi.org/wp-content/uploads/dlm\\_uploads/2023/01/managed\\_coal\\_phaseout\\_metrics\\_and\\_targets\\_financial\\_institutions.pdf](https://rmi.org/wp-content/uploads/dlm_uploads/2023/01/managed_coal_phaseout_metrics_and_targets_financial_institutions.pdf).

**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.

Robust approaches to assessing client and portfolio company alignment may include the use of:

- Classification systems and lifecycle emissions calculation tools to evaluate whether or the extent to which an activity or company can be considered a climate solution.
- Benchmarks like sectoral pathways, which are based on carbon budgets estimated to keep certain global warming temperature increases within reach.
- Client and portfolio company net-zero transition plans.

In the context of transition finance and managed phaseout practices, “alignment” can be considered the degree to which a company’s behavior and emissions trajectory, taking into account its carbon budget, would support an outcome aligned with limiting the increase in the global average temperature to 1.5°C if all economic actors behaved similarly relative to their own carbon budgets. In the context of climate solutions, “alignment” can be considered the extent to which a company provides or enables 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 the demand for, or re-purposing high-emitting alternatives. These approaches are not mutually exclusive and can complement one another. Additionally, there is an ongoing need for additional and improved methodologies and greater availability of the data that underpin these approaches. Financial institutions should develop and disclose their preferred approaches to assessing alignment of clients and portfolio companies. The most appropriate approach for a financial institution to use will depend on the nature of the asset, client, or portfolio to which the approach is applied and the jurisdiction(s) in which the financial institution operates.

- **Classification systems:** In the context of climate solutions, classification systems such as sectoral and economic activity-based categorizations or lifecycle emissions calculation tools can be appropriate ways to assess client and portfolio company alignment. However, to be maximally useful, such classification systems should be consistent or translatable across financial institutions and stakeholders. Such convergence has not yet been achieved.
- **Benchmarks:** In the context of transition finance and managed phaseout, sectoral pathways — when they are available and scientifically sound — can be effective benchmarks for assessing the net-zero alignment of clients and portfolio companies. Depending on their design, credible sectoral pathways assess data such as absolute emissions metrics, emissions intensity metrics, technology characteristics, or projections of future emissions reductions — alongside historical emissions reductions — to help judge the degree to which a client or portfolio company is aligned or aligning to limiting the increase in the global average temperature to 1.5°C. Other benchmarks and forward-looking alignment metrics based on sectoral pathway benchmarking (e.g., implied temperature rise metrics) may also be applicable. Financial institutions that are active outside of the United States may choose to reference jurisdictionally appropriate benchmarks, subject to those benchmarks having sufficient scientific integrity.
- **Client and portfolio company net-zero transition plans:** Client and portfolio company net-zero transition plans are useful for assessing alignment in the context of transition finance and managed phaseout. Client and portfolio company net-zero transition plans, similar to financial institution net-zero transition plans, should include the following: (i) overall commitment and strategy; (ii) metrics and targets covering scope 1, scope 2, and, when material and quantifiable, scope 3 emissions; (iii) implementation processes and structures (iv) engagement strategy (especially with value chain participants); and (v) governance. The contents of each component in a client or portfolio company transition plan will depend on the characteristics of that company. Reliable client and portfolio company scope 3 emissions data will become more readily available over time as stakeholders, including financial institutions, further develop methodologies and improve scope 3 data availability.

Many of the aspects of a financial institution's net-zero transition planning process are also relevant to the net-zero transition planning within the real economy (e.g., consulting, as appropriate, leading frameworks to maximize credibility and comparability of plans). Client and portfolio company transition plans should provide sufficient clarity to financial institutions about whether a given client or portfolio company is aligned or aligning to limiting the increase in the global average temperature to 1.5°C. Financial institutions should have processes in place to assess the strength of client and portfolio company net-zero transition plans and outcomes. Such assessments should consider:

- Forward-looking metrics or information regarding the company's business plan, including any interim and end-state targets it has set — and whether those have been verified by a third-party.
- How transparent the company is regarding the data, methodologies, and targets that underpin its net-zero transition plan, including its emissions footprint, which should include scope 1, scope 2, and, when material and quantifiable, scope 3 emissions.
- Evidence — if available — of a track record of progress, including changes in historical emission levels, past changes in business operations to be more net-zero-aligned, or similar indicators.
- Governance and accountability mechanisms set up by the client or portfolio company, including whether leadership is held accountable for the implementation of the net-zero transition plan.
- The degree to which the information provided enables a comparison with like companies.

Financial institutions may experience the temporary misalignment of a client, portfolio company, or portfolio if it has significant operations in or exposure to emerging markets and developing economies where the net-zero transition is in earlier stages. This may occur, for example, when the best available benchmarks and classification systems do not factor in emerging markets and developing economy contexts. Relatedly, it may be appropriate to adjust targets by geography. In all cases, temporary misalignment due to financing or investments in high-emitting emerging market and developing economies assets would not justify a financial institution's prolonged misalignment with its commitment.

**PRINCIPLE 5:** Financial institutions should align engagement practices — with clients, portfolio companies, and other stakeholders — to their commitments.

One of the most effective ways for clients and portfolio companies to improve their emissions profiles and align with limiting the increase in the global average temperature to 1.5°C is to develop and execute their own net-zero transition plans. Given that a financial institution's financed emissions reflect the emissions of its clients and portfolio companies, a financial institution's net-zero transition plan should — to the extent consistent with fiduciary, regulatory, and legal obligations — include a strategy for collaborating with and supporting relevant clients and portfolio companies to adopt and implement net-zero transition plans. These transition plans will facilitate clients' and portfolio companies' ability to better manage climate-related risk and take advantage of significant financial opportunities related to the transition. These plans may also generate financing, investment, and advisory opportunities for net-zero-committed financial institutions.

Engagement should be consistent with a financial institution's degree of ownership of and influence over the client or portfolio company as well as the institution's investment and financing strategy. Financial institutions should justify and be transparent about their approaches to phasing in this type of engagement with relevant clients and portfolio companies. In some cases, a financial institution's net-zero-related engagement with clients and portfolio companies may not sufficiently leverage the financial institution's expertise, influence, and resources in the context of its commitment and transition plan. To avoid potential "paper engagement," financial institutions should establish transparent processes for meaningful engagement and track the efficacy of such processes. Financial institutions should further decide the terms or timeframe under which they would consider changes in their engagement approach. These changes could include deepening or lessening engagement based on client or portfolio company

activity or disengaging from a given client or portfolio company that does not sufficiently manage the risks and opportunities associated with the transition.

There are gaps in available and fit-for-purpose methodologies for assessing client and portfolio company alignment, and a need for continued improvement of target-setting methodologies. Financial institutions should consider how to work with relevant stakeholders to improve methodologies and approaches.

**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.

Financial institution net-zero transition plans should, in a manner consistent with their fiduciary, regulatory, and legal requirements, consider:

- Leveraging existing or creating new products (e.g., green financial instruments and tools) and services that support client and portfolio company efforts to transition to net zero.
- Establishing policies and conditions — or a timeline for establishing them — related to activities in sectors highly relevant to the net-zero transition (e.g., thresholds or boundaries for financing, investment, and advisory services for select activities that will face greater challenges as the transition continues).
- Incorporating net-zero objectives and practices in core evaluation and decision-making processes (e.g., by incorporating relevant considerations into portfolio management, transaction approval, due diligence, marketing, and sales processes).
- Incorporating net-zero objectives into resource allocation and business planning.

The nature and extent to which the above are implemented by a financial institution will vary according to the financial institution’s characteristics.

**PRINCIPLE 7:** Financial institutions should establish robust governance processes to provide oversight of the implementation of their commitments.<sup>17</sup>

A financial institution should fully integrate the implementation of its transition plan into its governance and enterprise risk management systems and define governance-related policies, procedures, and processes concerning the financial institution’s commitment and transition planning activities. Such 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. A financial institution’s governance structure should allow for regular review of the net-zero transition plan by the board and senior management to incorporate material developments, address implementation challenges, and identify and mitigate risks to the transition plan.

<sup>17</sup> Note that this document refers to “governance” as pertaining to board oversight, roles and responsibilities, corporate culture, incentives and remuneration, and skills, competencies, and training; and refers to “business and operating procedures” (Principle 6) as pertaining to business and financial planning practices, business-strategy-related policies and conditions, and product and service offerings.

**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.

A financial institution should demonstrate an understanding of how transition planning activities may impact issues including but not limited to employment, quality of life, affordability, rights, and access to resources, particularly for Tribes, indigenous peoples, and disadvantaged communities in the places where the financial institution operates. If overlooked, environmental justice and just transition of the workforce considerations can also have financial implications for financial institutions. Proactively engaging excluded and marginalized populations can help to address these concerns and improve financing and investment sustainability.

Further, financial institutions should demonstrate an understanding of how transition planning activities may impact the environment, including nature and biodiversity. Financial institutions should put safeguards in place to account for unintended consequences and consider emerging frameworks and resources that seek to protect nature and biodiversity.

In many cases, the public sector should and does play a leading role in reducing or addressing negative impacts from climate change mitigation activities like those referenced above.

Significant changes and improvements in net-zero-related activities are likely to occur over time, including how such activities intersect with and incorporate actions related to climate resilience and adaptation, biodiversity, nature, environmental justice, and addressing the just transition of the workforce.

**PRINCIPLE 9:** Financial institutions should be transparent about their commitments and progress towards them.

Appropriate transparency is part of a credible commitment and is necessary for external accountability. Transparency enables stakeholders to develop a reasonable understanding of how a commitment impacts a financial institution's lending, investing, advisory, and operational decisions. In some cases, this may involve voluntary public disclosures exceeding those required by applicable law.<sup>18</sup> Disclosed information should include relevant data and data sources, frameworks and methodologies leveraged (e.g., related to transition planning), approaches to and progress of client and portfolio company engagement, and other key decisions that a financial institution makes in developing and executing its transition plan. When an institution cannot conform to emerging best practice as it relates to commitments, it should explain the reasons.

Transparency of quantitative information that reflects progress towards targets (e.g., the measurement of financed emissions) is particularly important to the evaluation of financial institution net-zero activities. Sufficient information should be disclosed such that targets and progress towards them can be reasonably compared to what is disclosed by other firms and needed by stakeholders to assess a financial institution's overall progress towards its commitment. There remain challenges related to data quality and availability, particularly regarding client and portfolio company scope 3 emissions. While such challenges should not preclude measurement efforts, they can impact the ability of financial institutions, clients, and portfolio companies to precisely measure and communicate progress towards their targets. Data quality and availability challenges represent a priority for market participants, civil society, and governments to resolve.

<sup>18</sup> See, e.g., voluntary disclosures made under the Task Force on Climate-Related Financial Disclosures (TCFD). TCFD, *Implementing the Recommendations of the Task Force on Climate-Related Financial Disclosures* (October 2021), [https://assets.bbhub.io/company/sites/60/2021/07/2021-TCFD-Implementing\\_Guidance.pdf](https://assets.bbhub.io/company/sites/60/2021/07/2021-TCFD-Implementing_Guidance.pdf).

Some financial institutions may supplement direct value chain emissions reduction measures with the voluntary purchase of carbon credits. A financial institution should provide sufficient information to give stakeholders a clear understanding of whether and/or the extent to which the voluntary use of carbon credits is part of its commitment. Any voluntary use of carbon credits should be accompanied by sufficient detail on the nature and integrity of those credits (*e.g.*, linkages to a credible certification standard and demonstration of sufficient monitoring, reporting, and verification). Voluntary carbon markets (VCMs) remain relatively small and face challenges related to market transparency and credit integrity.<sup>19</sup> However, high-integrity VCMs 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. Treasury and other federal agencies are actively engaging with relevant stakeholders, including international partners, on ways to assess and improve the quality of VCMs and carbon credits so that this potential may be realized.<sup>20</sup>

Finally, financial institutions should determine in what format to publish information about their commitments in light of evolving practices. Regardless of format, such information should be made easily accessible to stakeholders, such as in a regular publication or periodic filings. In addition, to improve accountability, enable system-wide assessment, and improve comparison with peers, financial institutions should consider reporting relevant information to resources that aggregate and disseminate this information.

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19 According to Bloomberg New Energy Finance (BNEF), the market size in 2022 was likely around \$2 billion.

20 For example, market confidence could be enhanced through significant improvements related to setting conservative baselines; addressing emissions displacement; ensuring robust monitoring, reporting, and verification; promoting market health (*e.g.*, sufficient liquidity and transparency); providing assurance that communities situated in or by project development areas are not adversely impacted; and addressing other relevant issues.

