Transition scenarios: expectations and related policy priorities

1. In search of the perfect transition – the goal is clear; the path to get there is under construction

The Chair noted that the transition to net zero requires the financial sector to have scenarios, data and information so that it can plan. It is a complex transition because it requires shifting production processes, moving brown capital towards green capital and to cleaner processes for consumption and production. It requires financing, scenarios to guide agents, goals, targets, data, and a taxonomy.

A Central Bank official noted that the destination is known. However, the detail of the path to get there is not. The good news is that the destination is clear and there is increasing clarity on the pathway. However, this is a whole economy change which will take time, and more detail is necessary.

An official suggested that the transition process has three steps. First is to define science-based targets and interim targets. Second is to define and publish transition plans and achieve them. Third is to annually publish all of the elements to monitor progress.

While it may not be a large, homogenised plan at this stage, it is a step-by-step process. There are plans at the European and national levels. There will be plans from financial institutions and companies. As all of the plans are interconnected, some of the inputs for one plan are the outputs of other plans. In the first iteration there will be gaps between the inputs and outputs, which is normal.

A Central Bank official noted that there should be real, intermediate targets published annually and work from those who are behind to catch up.

2. The financial sector faces growing climate urgency

A Central Bank official highlighted how essential it is, for delivering a smooth transition, that emissions in the real economy reduce. That is not about divesting the dirty and investing in the currently green. Capital has to be directed to those who need to develop and who are developing credible plans to reduce their emissions. Transition financing and not paper decarbonisation that will reduce the risk. That is not straightforward to identify in a world of great uncertainty. Transition plans are inevitably national. There needs to be innovation in investment strategies and financing techniques.

An industry representative stated that banks can help and speed up the transition. They can make it happen in a smoother way and they can move capital faster to the companies that have true transition plans. However, transition is urgently needed from industry. What is needed globally is a framework.

2.1 The taxonomy: a solution to face the emergency?

An industry representative insisted on the importance of the taxonomy. It represents the target for where economic activity should be to respect the goals of the Paris Agreement. The taxonomy is not a transition tool; it is a target tool. It is very difficult to use the taxonomy to follow the right transition of a company. While it is a useful tool, it is not enough. It should be complemented by a transition taxonomy.

A Central Bank official explained that this is about stewarding the economy on a pathway to net zero, and there is a need to be able to distinguish between those that have a plan and those that do not, which is why the transition plans are so important.

3. The need for a clear and precise framework to define adequate transition strategies, prioritise policies and reach a carbon-neutral economy

An official emphasised the importance of predictability and coordination between transition plans to reduce transition risk and cost. ADEME has a tool called the Assessing the low-Carbon Transition (ACT) initiative, supported by the United Nations Framework Convention on Climate Change (UNFCCC). This tool specifies how to set targets and define action plans for the 14 most emissive sectors. It is vital to now publish plans and to rely on them to set net-zero targets. All actors, public and private, should publish their plans, all of the assumptions behind those plans and all of the elements that are needed to achieve those plans.

A Central Bank official stressed the need for banks to put in place transition plans which are compatible with EU policies implementing the Paris Agreement. They should be plans with concrete intermediate milestones to enhance banks' long-term strategies and decision-making. A Central Bank official added that it is important to not despair and do nothing while awaiting clarity on the path to net zero. There is a huge amount to do and everyone needs to increase their understanding of what transition means for customers in the real economy. That means engagement, data and understanding their plans.

An industry representative remarked that, as the end goal is very far away, clear intermediate goals are needed. An industry representative added that climate change is a real democratic challenge, and it has to be framed by public authorities. By establishing a transition framework to transform the economy, the transition risk will be reduced. An industry representative noted that frameworks are needed, and this effectively means cooperation between the public sector and public authorities. A route has to be provided as otherwise, whilst it may happen, it may not. That may imply industries indicating what is and is not possible to achieve.

4. An efficient transition will result from tripartite coordination between the real economy, the financial industry and the public sector

A Central Bank official stated that citizens, firms, banks, and prudential supervisors alike are working towards the climate goals agreed in 2015. The EU and national governments are rolling out policies implementing the Paris Agreement.

A Central Bank official agreed that everybody has a role to play. Decarbonising the entire economy requires transition and structural change on an enormous scale. There is a huge amount of uncertainty about that, because there is a need to look decades ahead.

An official added that financial institutions cannot make this transition by themselves. They are closely linked to the economy. Thinking that financiers can change everything or that they can change nothing are errors.

An industry representative stated that there is a need to cooperate. A work plan is needed to support the transformation of the economy as a whole, and that is the role of the public authorities.

An industry representative highlighted that there is no transition and no decarbonisation of the economy by banks or finance alone. A three-party discussion is needed between the public sector, industry and the financing sector to allow this. Cooperation between the three parties is necessary.

An industry representative added that it is key for financial services to establish an understanding of what is within the remit of the transition pathway. There are questions of scope and what risks may arise from transition and the climate risk itself, but also of what might expose firms to reputational risk.

5. The first actions are already in place

An industry representative noted that organisations with a core custody function cannot control what clients deposit every day. However, they can control their own emissions, both in terms of portfolios and their own activities. Clients can be offered tools to allow them to monitor and work on their transition pathways. An industry representative's firm has developed an ESG analytics app, which allows for transparency and alignment among market participants.

An industry representative noted that banks are now making progress in understanding the physical and transition risks. An industry representative's organisation is trying to provide some guidance for transition financing up to COP27. Discussions to that end could help the financial services sector to think more about what innovations there could be going forward.

An industry representative noted that departments of experts in transition are being created, and experts are being brought in to aid with how to get into new technologies that can help with decarbonising the economy. An official remarked that to achieve the 55% reduction of gas emissions by 2030, viable and existing technology has to be relied on for most of the sector.

A Central Bank official noted that the public sector and the financial regulators are doing their part by providing scenarios to work with. They are not perfect, but they are constantly improving. It is better to be roughly right now than precisely right when it is too late.

A Central Bank official agreed that a framework is required. However, though it is not perfect, there is a framework. It starts with the Paris Agreement. There is a translation of the Paris Agreement into European law. There is also the taxonomy. There are proposals to have obligatory transition plans in the new capital requirements directive. There are corporate reporting obligations. All of that together does indeed create a framework.

6. There remain challenges to face up to at several levels

An industry representative noted that transition is a holistic challenge. Moving to a low-carbon economy is a whole sector issue, from scope 1 to scope 3. It is not an issue just for corporates or for a single company. Companies have to be seen in the context of the whole sector.

6.1 Banks and firms exposed to new risks

A Central Bank official stated that for the European Central Bank's banking supervision, the main concern to address with the transition plans is the level of banks' risk exposures and the effectiveness of their controls. It can be asked whether the exposures have been sufficiently mitigated and whether they are prudent. As climate-related and environmental risks become increasingly widespread and more material, banks will inevitably be exposed to them through both physical and transition risks. Banks therefore need adequate risk mitigation measures in place.

6.2 Transparency: the need for data and information to prevent risks and speed up the transition process

A Central Bank official added that for banks to be able to manage their transition risks adequately, they need to have information on how their customers are performing relative to a Paris aligned transition pack. This is where the European Commission's proposal for a Corporate Sustainability Reporting Directive (CSRD) comes in.

The proposed CSRD is a necessary step to address the gaps that currently hinder the development of appropriate sustainability policy, risk management and risk monitoring frameworks for the financial sector. It will not only explicitly ask large banks to disclose their transition plans; it will ask banks' corporate clients to do the same. This last point is crucial, as it will enable banks to assess their climate-related and environmental risks in their asset portfolios.

A Central Bank official noted there is more data available than may be expected. Proxies can be used, and experiences can be shared. In the UK, through the Climate Financial Risk Forum, there are public/private partnerships to try to share the available data, and this will improve over time. This is about making progress now and not waiting for perfection later.

An industry representative remarked that to support the transition and inter-dependence the quality of data becomes critical. There is some data but clearly there is not enough and much more work is needed. A key area is transparency and showing the results of the investments. Much can come together with regards to new technologies like digital and AI. This has been seen with biotech and how much has been possible to achieve in a crisis.

Data is paramount, and it is one of the main issues seen with clients. An industry representative's firm's clients on the crowdsourcing side of the platform mentioned previously are able to send data back to providers. The amount of data considered incorrect is high. The data lacks transparency, which has created climate anxiety and is making it difficult for people to act in the timeline available, which is short. With some of the crowdsourcing the data is at least there, and it is possible to monitor and understand whether it is good or bad. However, quality becomes a critical factor for accelerating the transition and being able to operate in a way that is more transparent without this risk of perceived greenwashing and that the industry is not doing enough or is not there.

6.3 One global pathway or interdependent pathways?

An industry representative noted that financial institutions are not all the same. Transition pathways are necessarily going to be diverse and depend on the business model of each institution. An industry representative added that the political agenda is defined by the region and countries. The pathway and the scenario will be influenced by factors like political agendas.

An industry representative highlighted that the transition will not be easy for small and medium-sized enterprises (SME). They do not always have a very clear view of what they can do or the reality of their carbon emissions. Experts are needed to make sure these businesses can be aided.

An official noted that the transition plans of financial institutions will rely on the transition plans of their counterparties. The transition plans of the companies will require an appropriate public policy for infrastructure, subsidies, regulation, fiscals, taxation, and such. Public policy also needs a degree of maturity and to support both the public and private sectors with their plans.

A Central Bank official suggested that scenario analysis is key. There is a huge amount of uncertainty looking to the decades ahead, and scenario analysis is a fabulous toolkit for helping to think about what might happen in the future. The locations of the opportunities and where change needs to happen can be revealed through scenario analysis. This allows for an evaluation of the uncertainty. Financial institutions live with uncertainty all of the time but that does not mean they do nothing about it. They explore what might happen in different states of the world, they engage to understand the issues and they get the data and capability to understand that data, which will hopefully help to size the uncertainty and determine the right way forward.

A Central Bank official emphasised the degree of urgency, and recommended as a result everyone should work together to achieve the interdependency and the interrelated transition plans needed to reach the destination.

6.4 The social aspect should not be forgotten

An industry representative noted that transition is necessarily multi-dimensional and based on growth. The social aspect of environmental, social and governance (ESG) is almost as important as and is intertwined with the environmental. That is sometimes forgotten, meaning they are kept completely separate.

An industry representative remarked that there is a trade-off between the environmental and social considerations. That is now impacting clients. There is innovative thinking about the potential impacts, and consideration should be given to what can be done upfront.

A Central Bank official noted that everyone recognises that governments and business will drive the transition. There are tough choices with social and economic consequences.

7. The transition is also an open door for new opportunities

An industry representative stated that the transition should be seen not only at a risk level but also at an opportunities level. The Chair noted that François Villeroy de Galhau mentioned in his opening remarks the need for financing new projects and venture capital to finance new technologies. It is not only about investing in existing green projects, with all the problems of greenwashing; it is also about financing new endeavours.

An industry representative stated that the matter concerns plans and also concrete projects that need to be financed. An industry representative agreed that the transition should be looked at not only as being about risk, though there is a need to prepare for the risk and have a framework for that, but as also being about opportunities. It is about being on the side of people who are working on new technologies and trying to make sure that can be invested in. There has to be creativity in the way that is done. It is an exciting period because it is a real revolution, and this revolution means many new things will be invented; new technologies and new ways of doing things will emerge. There is a need to be very active with that, not only in managing risk but also in creating some opportunities.

An industry representative added that climate change is a great opportunity to deploy new capital, to be on the side of new clients and to make sure that they can be helped to find great ideas. The right way to finance must be found.