

Transition planning in the financial sector

1. Transition plans: one of the hot topics of the climate and finance agenda with ongoing developments

The Chair noted that transition plans have been one of the hot topics of the climate and finance agenda since Glasgow in 2021. In the past two years, there has been progress on the consideration and delivery of transition plans. This includes the foundational Network for Greening the Financial System (NGFS) report in spring last year, and the work at the Financial Stability Board, the Basel Committee and the International Organization of Securities Commissions (IOSCO). Transition plans already feature in the legislation of some countries. Some private sector institutions have prepared transition plans.

2. First observations from recently issued transition plans

2.1 Main aims, features, reactions and benefits

An industry speaker highlighted their bank's recently published transition plan. So far, the plan has been well received. The aim of the plan is to provide a rationale and to explain how the set goals will be achieved. Previously, it was difficult to understand how all the pieces fit together, but this is a robust plan to help achieve the net zero commitments. All staff should understand what the organisation is doing and how to play their part. The plan is a powerful way of galvanising the organisation.

The document is structured in three parts. The first part looks at the vision; the second part is about the sectors' transition; the third part is about implementation. The vision is an opportunity to articulate the strengths of the organisation. Articulating those strengths and how to use them is a useful place to start. As a bank well embedded in the world economy, the first job is to work out how to reduce emissions. There is a focus on catalysing the new economy and helping newer technology to scale. The report is structured around the decarbonisation of trade and supply chains. It also tries to quantify the opportunity, clarifying that there is potential financing to be done and money to be made.

2.2 Banks must be able to adapt since they are dependent on economic sectors' transition path and public sector continued support

An industry speaker stated that banks are dependent upon the real economy moving, clients' willingness to decarbonise and there being the right incentives in the economy for them to do so. Banks can support this through finance, while clients must provide the ambition.

The middle chapter of their bank's report, which focuses on sectors' transition, is interesting and unique. It has been critical to articulate where emissions come from. A transition plan must first describe what and where the problem is. The chapter starts with a technical description of emissions sector by sector, looking at the timelines for technological change. Some sectors will move faster than others. Policymakers face the challenge of trying to enable banks to stay at 1.5-degree pace. To achieve a low-carbon future, scenario curves must be followed. Critically, those scenarios are dynamic. It is necessary to be flexible, pivoting as the world progresses so that banks remain relevant and able to support clients.

An industry speaker highlighted their bank's first transition plan, published at the end of January. This is the first version and needs further development. It has been important to integrate transition planning work into the bank's business strategy. The bank has four home markets, with a focus on the retail segment. About 80% of the bank's lending portfolio is related to real estate. In its four home markets, it is estimated that there is an opportunity to release up to 90 terawatt-hours by making buildings more energy efficient. The focus is on enabling clients to seize opportunities by offering lending to invest in solar panels, heat pumps and insulation improvements. The Energy Performance of Buildings Directive is directly linked to this, so it is also up to governments to play their part.

2.3 Rather than withdrawing, banks closely engage with each client after strictly cross-referencing their sector's level of sustainability risk with the client's own transition plan and the government technology roadmap

An industry speaker explained that their bank disclosed its transitional plan concept two years ago, together with its exposure to high sustainability risk sectors. The system seeks to identify and monitor high-risk areas by evaluating risk along two axes: clients' sectors and the status of clients' responses to transition risks. On the vertical side, the significant high-risk sectors were listed. The bank has also introduced horizontal approaches, plotting risks depending on customers' transition plans. If companies have a 2050 carbon-neutral business plan that is appropriate and practical, they can be regarded as low-risk companies even in a high-risk sector. If a company has no transition plan and no intention to make one, it will be regarded as high-risk.

The transition plan will be achieved not by divesting, but by engagement in investment. The agreement made with management is that the bank will achieve carbon neutrality by 2050 with its clients. The emphasis is on how to evaluate appropriate transition plans for each client in each sector. About two years ago, the Japanese government came up with a technology roadmap for certain sectors. The bank did a similar exercise internally. Conceptually, an assumption was made

about the 2050 ideal in each sector in terms of achieving carbon neutrality and sustainable economic growth. The assumptions compared what the industry looks like today with what would need to be done to reach the ideal situation by 2035. The gaps that emerge through this analysis are the challenges that must be tackled. Using its experience and knowledge of the industry, the bank speaks with clients and agrees on what to achieve by 2050, then calculates how to fill the gaps.

An industry speaker commented that it is important to differentiate between the transition plans of banks and clients. As a bank, it is necessary to manage the portfolio and the way that a client is supported. Their bank's transition plan starts from science, which clearly shows the sectors that need to move to low-carbon energy. The plan is also based on the importance of incentivising an increase in society's sobriety level. There are three pillars. First, the bank invests massively in renewable energy and energy efficiency. Secondly, it supports clients in the social and economic transition. Thirdly, it organises a phase-out from fossil fuel energy. Supporting change in society is the most complex point. Net transition is the way to quantify the transition and the support of the bank. Last year, the bank (published its climate guide, covering five sectors. A further five sectors were published last December. Net zero is useful in setting the direction of change.

A regulator observed that transitional plans are about firms, banks and financial companies working out how to implement transitions, policy sets and objectives. Some policy objectives have been clearly set in many countries. Objectives do not need to be immediately transmitted to all agents in society; agents must adjust to the policy objectives. All financial institutions should have a good idea about where they are now, where they want to be within the policy objective, and where they think they will be in 50 years. Institutions began putting together statements about where they want to be. Given the many interlinkages, these statements are always dependent on other actors in society.

2.4 Internal buy-in of transition plans and their operationalisation are essential

An industry speaker highlighted that the last part of their bank's report is about implementation. It describes the rewiring of the bank through tools and processes such as transition plan assessments. Transparency matters when describing how business is being adjusted, where there are emissions, and how the bank is addressing them. Transition is not achieved in a vacuum; it requires many other actors to move. The biggest challenge in designing the transition plan was that hundreds of people were working on it. Although there were no new commitments, it took a long time for the organisation to be comfortable with the pieces being put together in one place. However, it was time well spent. From the board down, there is a commitment. Colleagues are understanding how everything fits together.

An industry speaker explained that their bank has used a bottom-up approach, starting from the field entities. This takes time, but it has changed people's mindsets. Milestones, an action plan and emission reductions have been defined. Three key lessons have been learned.

Firstly, although the approach is sectorial, the management of the transition is local, taking into account the strengths and weaknesses of local territories. Secondly, the net zero approach is workable if the local ecosystem is considered. Lastly, the transition has huge commercial potential for the bank. This way of thinking based on local strengths has encouraged people to see the transition not only in terms of regulations, but also in terms of creating new, green business.

3. In the EU, transition plans are expected to explain how banks manage the many risk factors and clarify whether the overall financial system is resilient and capable of supporting the transition policies with a timeframe of 2030

A regulator stated that transition plans need to properly reflect on operationalisation in order to measure and manage the risks involved. Institutions need to manage physical and transitional risks and the risk of clients not complying with the transition plans.

In 2022, the Single Supervisory Mechanism (SSM) concluded that the status of transition planning among European institutions was weak. It is good that institutions are working on transition planning. At the micro level, prudential supervisors will continue to assess risks. The EBA has guidelines and a consultation on how to assess environmental, sustainability and governance (ESG) risks under the Pillar II framework.

The EBA is also concerned about the resilience and capability of the overall financial system. The EBA is currently doing a stress test with other European supervisory authorities to determine the robustness of the financial system in terms of achieving the Fit for 55 strategy. The assessment is not about the micro level and the preparedness of every financial institution; rather, transition planning is about the potential risks to the system.

4. Financial market supervisors pay particular attention to transition plans in order to avoid the risks of greenwashing

A regulator stated that market regulators ensure transparency for investors by laying foundations in terms of regulation and supervision. The International Sustainability Standards Board (ISSB) disclosure standards are being promoted. As several jurisdictions are already implementing those standards, the regulator is assisting them with capacity-building. In Europe, there is a binding regime that serves as a forerunner. It is important that this framework is in place as a first step. The second pillar of regulation is

about audit. Trusted information is needed in the disclosures. Audit standards are being prepared and will be ready internationally by the end of 2024.

The second foundation is supervision, where it is necessary to focus on greenwashing risks across the ecosystem and value chain. Forward-looking information and transition plans are riskier, as projections are more difficult. Regulators are paying attention to this and will provide guidance. In the last four weeks, there have been publications by the French Autorité des marchés financiers (AMF) and the Dutch Autoriteit Financiële Markten (DAFM). The UK has already provided guidance. As this is a gradual process, greenwashing is sometimes involuntary. Preparers need to gain experience and recruit staff. It is not only about monitoring and supervising, but also giving guidance to help preparers.

5. Necessary public sector contributions to transition planning

5.1 Financial sectors' agility and their maximised contribution requires public decision-makers clarifying the transition

An official highlighted the importance of remaining agile in the process of producing transition plans. Public authorities try to help the private sector by providing macro milestones. European legislators have consistently chosen not to constrain private players too much in terms of methodology, as institutions must adapt to different local realities. The French Treasury created the Secrétariat général à la Planification écologique, which is working directly with the prime minister and oversees the national decarbonisation strategy. The French Treasury is also producing sectoral strategies, with the aim of providing milestones for private players when they are designing their own transition plans.

An industry speaker observed that tackling transition activity in Asia is a challenge. 70% of coal-fired power plants are in Asia. The industry is still developing, so energy demand is growing. Within Asia, each country has different pathways, so it is difficult to design an appropriate transition plan for every region. Industrial policies drive transition pathways. To understand the industry dynamic, it is important to focus on communication with policymakers. Those eliminating CO₂ should be economically rewarded. Carbon credit is one of the frameworks that must be established so that the cost of decarbonisation is shared on an equal basis globally.

The Chair noted that transition plans should improve as updated versions are produced. However, they will only improve with clear ideas about where to focus attention. NGFS is concerned that multinational firms tend to initially consider the transition from the perspective of the places where they are headquartered. It is important to consider the diversity of the global economy.

An industry speaker stated that it is important to ensure that policies or regulations give the private finance sector the flexibility to back transition. There is a

concern that regulations in one part of the world could create barriers in another. It makes sense to manage financed emissions globally. This battle will be won or lost in emerging Asia and the Middle East petrostates. It is necessary to consider how to engineer a transition that makes sense for the parts of the world that matter. Anything that prevents international banks playing a role in those parts of the world will be damaging.

There is no one-size-fits-all pathway. It is challenging to create consistency of expectation. Companies and banks should consider the right set of measures without being prescriptive about how to solve the problem, as approaches will look different in various parts of the world.

5.2 By promoting the availability of transition plans in the economy, the public sector increases the ability of financial players to define their transition path

An official commented that the transition of the real economy is important. Even after the full implementation of the Corporate Sustainability Reporting Directive (CSRD), not all European firms will have sophisticated transition plans. The role of public authorities is to incentivise transition planning.

The French Treasury has changed its ESG label to environmental, social and responsibility (ESR). One condition will be for fund managers to make sure that transition planning tools are available for firms. 15% of firms in the portfolio of labelled funds for high-impact sectors will need to be aligned with the Paris Agreement target as of 2026. This threshold will be increased. Banque de France is developing a sustainability indicator to cover firms without their own ESG ratings. Firms without the means to conduct full transition planning exercises should not be pushed out of the market.

5.3 Sector transition plans should be reflected in the taxonomy in order to capture the transition dynamics involved

An industry speaker stated that the challenge is to change the economy and achieve progress in a short period of time. Transition and the cost of energy is a real concern. Regulation and supervision are important, but the cornerstone of regulation is the taxonomy. The transition timeframe has not been clearly defined and should be a political project. There is a lack of confidence between regulatory bodies, banks and the financial sector. They all know that they must change the way they do business. Taxonomy is a cornerstone of regulation, but transition should be the second cornerstone. The transition needs to be defined in a sectorial way.

It is important to acknowledge what is being done for the green economy. The green asset ratio does not reflect the efforts that have been made. The reduction of financed emissions should be acknowledged by the indicator; otherwise, finance will not flow to the green economy.

5.4 Transition plans' iterative improvements, supervisors' engagement, and the implementation of existing EU sustainability legislation are the key priorities

A regulator emphasised that the process of producing transition plans is complex and multidimensional. The

current transition plans are initial versions that will be improved. The problem with the development of regulation is that it tends to have a certain sense of direction and stability in the framework that is put forward. Supervision is the right tool to push forward dynamic solutions. Regulators cannot write regulations and then wait to see whether they have written them correctly; instead, the expectation needs to be that regulations will be systematically revised and improved. There should be more reliance on supervision rather than regulation as the initial approach.

An official observed that much has been achieved under this Commission. There has been a great deal of activity on the sustainable finance agenda. It is now about ensuring that this regulatory architecture enters the everyday life of firms. For financial players, CSRD will be in full implementation by 2028, providing the raw data to work with clients. For transition planning itself, there is a big question mark as to whether the Corporate Sustainability Due Diligence Directive (CS3D) will enter into force. That might change the scope of the transition planning requirements. Finally, the European Financial Reporting Advisory Group (EFRAG) is doing an important job with the sectoral European sustainability reporting standards (ESRSs).

An industry speaker stated that transition planning is not a one-off. There will be challenging years ahead, as regulation is not yet in place. The CSDR will enable more data analysis to be conducted. Banks and regulators need to be able to compare data and share the same definitions. The transition plans of banks, clients and nations need to be aligned, so cooperation is important.

5.5 Mitigating the credibility risk of transition plans is an essential challenge

A regulator stated that transition plans have been voluntary so far. With the future CSDDD-directive, transition plans will become mandatory. For banks, there is another framework. It is important to note that

transition plans might lead to credibility risks. Plans might not be backed by sufficient resources, there may be premature commitments, or the use of carbon credits may not be sufficiently explained. There are also problems with corporates, which have a cascade effect on non-financial firms that rely on them.

Secondly, gathering appropriate data for Scope 3 is a challenge. Regulators will try to help with guidance. Another dimension is international coordination. At COP28, IOSCO committed to monitoring the landscape within its remit of investor protection. Others are doing the same in their remits. Further guidance might help to bring more convergence to the system.

An industry speaker stated that client transition plans are being assessed to determine whether clients are investing real capital in meeting these challenges.

5.6 The success of carbon transition policies requires the simultaneous deployment of broader economic and social policies on a global scale

An industry speaker stated that the amount of climate transition pressure that can be applied in other parts of the world is limited. 75% of emissions derive from energy. The priorities of many countries are broader than just climate, so they will not stop producing a certain type of energy if asked to do so. Pressure from rich countries will not automatically translate into climate-aligned activities in poorer parts of the world. If the private sector is afforded the flexibility to find solutions, it will be able to play an important role.

The Chair concluded that the focus should be on the end goal of limiting climate change well below 2 degrees. Secondly, global and local perspectives should be managed simultaneously. Thirdly, everything is conditioned upon climate policies. Finally, it is important to continue being ambitious and pragmatic, relying on supervisors to challenge institutions.