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Include mandatory banking transition plans within Pillar 2

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The Institute for Climate Economics (**I4CE**) is a Paris-based think tank with expertise in economics and finance with the mission to support action against climate change. Through its applied research, the Institute contributes to the debate on climate-related policies. It also publishes research to support financial institutions, businesses and territories in the fight against climate change and that assists with the incorporation of climate issues into their activities and operations. I4CE is a registered non-profit organisation, founded by the French National Promotional Bank Caisse des Dépôts and the French Development Agency.

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EXECUTIVE SUMMARY

Since 2021, the political momentum around the obligation of transition plans for banks has been growing. These plans aim to establish a progressive decarbonisation strategy by 2050, in line with the European Union's objectives. The European Central Bank, through Frank Elderson, as well as several NGOs are calling for transition plans to be made mandatory for banks and to be integrated into prudential regulations.

This report firstly looks at why such a requirement could help to promote an orderly transition, then goes into more detail on what the content of these plans should be and what authority supervisors should have to act. Finally, it details the legislative changes needed to strengthen and clarify the current texts, as well as additional operational changes for supervisors.

Why should a transition plan requirement for banks be included in the prudential ?

Faced with the challenge of climate change and the low-carbon transition, changes in the banking sector and supervisory authorities are expected as they deal with the associated risks. While public policies are gradually being deployed to finance the transition, the banking sector must accompany this transformation of the real economy in line with European objectives.

In recent years, the efforts of the banking sector have focused mainly on integrating climate issues into traditional risk management. However, this approach has not yet led to the necessary transformations in bank practices and the real economy.

Nevertheless, several recent studies illustrate the risks that banking players are exposed to if the transition is disorderly or delayed. Therefore, the idea that supervisors should immediately promote a smooth transition to limit climate risks is gaining traction.

Supervisors have many tools at their disposal to do this. Various studies have shown the value of strengthening the capital requirements (Pillar 1) for fossil fuel projects to address transition risks. However, this approach, only affects a limited part of the activities and risks involved in the transition. Existing supervisory initiatives have so far focused on transparency (Pillar 3) and climate stress testing. These are important steps forward in terms of team awareness and data collection. However, to date, they have not been able to drive real change in banking practices to align them with orderly transition paths.

It is for these reasons that it is now important to move towards an approach that integrates all activities and issues involved in the transition and enables banks to assist their clients toward carbon neutrality.

The EU regulation on transparency has made the disclosure of a transition plan mandatory; however, it needs to go further by integrating it into Pillar 2 of the prudential regulation, to implement this transition support approach. This can be done within Pillar 2 and the Supervisory Review and Evaluation Process (SREP), which will allow supervisors to use stronger policy levers that are more tailored to transition risks.

What should be the content of banking transition plans?

The details of the banking transition plan are yet to be defined. According to I4CE, three dimensions are essential and must be defined in the regulation:

- the content of transition plans,
- the scope of application,
- internal implementation procedures.

The transition plan should set out the bank's overall decarbonisation strategy, broken down into sectoral trajectories, with intermediate emission reduction targets. These trajectories should be developed in connection with National and European transition plans. Finally, the use of carbon offsetting should be reduced to a minimum for banks and their counterparties.

This plan should concern all sectors covered by the bank, starting with the most emitting sectors. It should also cover all of the bank's customers: large companies, SMEs, households and local authorities. For large companies, the existence of a robust company-wide transition plan should be a condition for granting credit. Finally, the banking transition plan should cover all the bank's business lines to ensure overall consistency. This integration of the different business lines can be done gradually depending on the bank's business model.

Furthermore, as governance issues are powerful levers for change, it seems important that the governance structures within the institutions are adapted to the objectives of the transition plan. In order for these commitments to be effectively implemented, it seems essential that each time a decision is taken, whether it is a question of investment, financing or any other decision, the objectives of the transition plan are respected, through indicators that have been put in place. In order for these systems to work, the internal organisation and remuneration levels of the teams (executives, top-level managers, and business managers), as well as the decision-making and risk management tools should be adjusted accordingly.

The review of these transition plans, both in terms of their content and the processes for their implementation, should be carried out on a regular basis by supervisors. Pillar 2, and in particular the SREP, could be an instrument favoured by supervisors for the review of these plans, since it specifically covers the review of the banks' decision-making and risk management processes and tools.

What levers of action will supervisors have following this transition plan obligation?

At present, there are a number of measures within the supervisory process that already allow supervisors to integrate climate change issues into the SREP. However, making banking transition plans mandatory would set out supervisors' expectations and empower them to act. Within the SREP, supervisors aim to verify the sustainability of the institutions' business model and the robustness of their governance and risk management processes. Currently, without the publication of transition plans, it is difficult for the supervisor to analyse the relevance of the institution's strategic plan and the robustness of its governance in the context of the transition to a low-carbon economy. Introducing an obligation to publish a transition plan would provide them with a more comprehensive framework than they currently have.

In the event of non-compliance with bank transition plans, supervisors have a wide range of actions that they could use gradually: requests for training, changes in governance, changes in risk management, concentration limits in certain sectors, changes in remuneration practices, etc. If these supervisory actions prove to be insufficient, supervisors may also be able to impose additional capital requirements on the institutions concerned.

How can transition plans be made mandatory in the legislation?

Existing texts already allow for the integration of ESG issues into the governance of banks, and to a greater extent than the actions proposed so far. The amendments to the CRD and CRR proposed in the banking package go a step further by paving the way for the establishment of mandatory bank transition plans. The content of the plans should then be determined by guidelines coordinated by the EBA. However, for this action to be as effective as possible, these formulations need to be further clarified within the CRD itself. They should also be completed by a reference framework in Level 2 texts such as regulatory technical standards (RTS) specifying the content and scope of transition plans.

How can this recommendation be operationalised beyond regulation?

In order to operationalise the requirement for a bank transition plan and its integration into the SREP, three key issues should also be addressed: the mandate of supervisors, the certification of banking transition plans, and the human resources issues for supervisors.

Although it is not a prerequisite for action, clarifying the mandate of supervisors in the legislative text would facilitate the review of transition plans. This would reduce the risk of divergent interpretations by different National and European supervisory authorities on the subject. England has made this choice, by integrating into the mandate of its Central Bank an objective to promote the establishment of a financial system that supports and enables the transition to a net-zero economy.

Additionally, there is the question of who will certify the quality and robustness of banks' transition plans. While leaving the control of the implementation of the plans, the associated governance structure and the decision-making processes in the hands of the supervisors, it could be possible to delegate the certification of their content to external entities. This certification could be given to different stakeholders, the supervisors themselves or by external entities such as national or European environmental agencies, EFRAG or audit firms.

Finally, in order to face these new challenges, supervisors will have to reinforce both their training and their staff. Priority can be given to the Joint Supervisory Teams, which are the first operators of the SREP. On the other hand, the Supervisory Colleges, which organise the supervision of banks outside the euro area, should also be targeted. Several European banks have subsidiaries in Central and Eastern European countries, where they have more exposure to the fossil fuel sectors.

In conclusion, to ensure the implementation of an orderly transition, the integration of transition plans into Pillar 2 of prudential regulation appears to be an appropriate tool. To ensure the full implementation of these plans, significant changes in practice are expected from banks and supervisors alike. To accompany these changes, the current regulations must be strengthened and clarified. The European political deadlines surrounding the banking package should provide an opportunity to amend the legislative texts to provide supervisors with a common reference framework.

EXISTING AND PENDING **LEGISLATIVE CHANGES** TO STRENGTHEN THE CONSIDERATION OF CLIMATE ISSUES

EXISTING TEXTS ALLOWING THE INTEGRATION OF CLIMATE ISSUES IN THE SUPERVISOR'S ACTIONS

Texts	Summary of the text	Understanding of the text in relation to environmental issues
CRD, Article 74.1 and EBA Guidelines on SREP, section 5	The supervisor should ensure that institutions have a **robust governance and risk management system in place.**	The supervisor can ensure that institutions **have adapted their internal governance** and **risk management processes to the climate issues.**
EBA Guidelines on SREP, section 4.4	The supervisor should assess the **current operating conditions** of the institutions.	**Macroeconomic and sectoral** dynamics **related to the transition can** be integrated into the analysis.

TEXTS IN THE PROCESS OF BEING ADOPTED PAVING THE WAY FOR THE INTRODUCTION OF MANDATORY BANK TRANSITION PLANS, BUT NEEDING TO BE CLARIFIED

Amendments	Summary of the amendment	Elements to be specified
CRD, Articles 76 and 87a	The institutions need to put plans in **place to reduce the risks of not aligning their strategies with EU objectives.**	The content of these plans, their scope of application and the governance processes, should be specified in a **Level 2 text, for example within the RTS (Regulatory Technical Standards),** to make the review more operational.
CRD, Article 98.9	Supervisors should analyse the adequacy of institutions' **ESG governance and risk management processes** with their exposures through their business model.	It should be clarified at which level of governance and risk management this analysis should be carried out.
CRD, Article 104.1	Institutions need to reduce their risks arising from their **non-alignment with EU objectives and transition dynamics,** by **adapting their business models**, strategies and risk management tools.	It should be clarified how this could be achieved operationally in a **Level 2 text.**
CSRD, Articles 19a and 29a	Companies must publish **plans** to ensure that their business model **is compatible** with the **transition to a sustainable economy.**	The **content of the plans** referred to in these articles **needs to be clarified** so that they meet specific criteria.
Sustainability Due Diligence Directive, Article 15	Large companies need to adopt a plan that ensures **their business model is aligned with a sustainable economy.**	

1. WHY SHOULD A TRANSITION PLAN REQUIREMENT FOR BANKS BE INCLUDED IN THE PRUDENTIAL REGULATION?

KEY MESSAGES

- In order to reduce climate risks, an orderly transition of the banking sector must be supported, starting now.
- Increased transparency has not yet brought about the necessary transformations in bank practices and in the real economy.
- To foster the transition, Pillar 2 could play a key role: the Supervisory Review and Evaluation Process (SREP) would allow climate change issues to be integrated into banks' decisions in a more comprehensive and dynamic way than it would be possible with changes in Pillar 1 capital requirements.

Faced with the challenge of climate change and the low-carbon transition, and in order to deal with the resulting risks, the banking sector is making a commitment and seeking to change its activities. This movement was accentuated in 2021 with the creation of the *Net Zero Banking Alliance*[1], in which 34 European banks pledged to becoming carbon neutral by 2050. At the same time, to support this dynamic, regulators and supervisors are transforming their practices to gradually integrate climate risks.

However, this movement remains too slow, given the urgency of acting now to allow an orderly transition. While the climate risk approach has made progress among European regulators and supervisors, it must be reinforced by a transition support approach. This is essential to limit the risks that could arise from a disorderly or delayed transition[2].

To date, the climate risk mainstreaming approach has mainly led to divestment practices or the halting of financing of certain highly exposed sectors (such as coal)[3]. Although these practices seem positive, they raise questions as the end or transition of these activities are not financed and the solid effects on the real economy and on the reduction of emissions remain limited[4]. In view of this, it is necessary to complement the existing approach focusing on financial risks in order to promote the implementation of an orderly transition.

DISCLAIMER: INTEGRATION OF TRANSITION AND CLIMATE CHANGE ADAPTATION ISSUES

Only the aspects of transition financing and transition risks have been considered in this report. The issues associated with adaptation to climate change and physical risks have not been included for the time being, as there is not enough research in the literature at this stage to present sufficiently detailed work on this subject matter.

They can be addressed at a later stage when the level of research on these aspects has advanced.

1 The Alliance was launched by 43 founding members on 21 April 2021 and has since grown to represent over 40% of global banking assets.
2 Banque de France, de Gaye, and Lisack, '"Too Little, Too Late"'.
3 ACPR and AMF. 'Sectoral policies and fossil fuel exposure of French financial market participants'.
4 Fletcher and Brower, 'Hedge Funds Cash in as Green Investors Dump Energy Stocks'.

1.1. To limit climate risks, a gradual and orderly transition of financial actors and the real economy must be promoted

Whilst it initially appeared that managing financial transition risks would be sufficient to protect banks from climate risk and to promote transition, several elements contradict this assumption.

This is firstly because the methodologies for measuring climate risk[5] remain too imperfect for banks to use them as steering tools for the transformation of their activities. This problem is regularly raised by banks that depend on external service providers for these metrics, without transparency or comparability of their methodologies. Faced with this situation, several of them have developed proprietary tools[6], which - with the exception of one bank - remain informative tools. In their current state, they are not used to manage the climate risks to which banks are exposed, nor to guide the transformation of banking activities.

In addition, voluntary initiatives put in place by banks to reduce their exposure to the riskiest sectors are struggling to bear fruit. Several recent controversies[7 8] as well as the latest French banking and market supervisors report[9] have illustrated this difficulty for banks to apply their own sectoral policies. These practices, beyond the controversies surrounding banks' greenwashing, are holding back the expected transformation of the real economy and the transition of banking portfolios.

Finally, several recent studies[10 11] highlight the financial risks of a disorderly or delayed transition, and point to highly heterogeneous impacts depending on the sector.

In view of this threefold observation, it seems essential to complement the climate risk approach with an approach focused on the impact on the real economy, in order to promote an orderly transition and reduce climate risks. Favouring an approach to transforming the real economy now could present transition risks of limited magnitude and duration compared to a delayed and/or disorderly transition. With regard to physical risks, the earlier the transition is initiated, the more they are reduced[12].

It is therefore essential that regulators and supervisors support banks to increase their contribution to transition financing and reduce their negative impact on climate change.

1.2. Pillar 2 could play a key role in integrating climate issues into banks' decisions beyond stress tests

Regulators and supervisors have many tools at their disposal to do this.

Several studies of researchers[13] and NGOs[14] have been done on Pillar 1 instruments, calling for higher capital requirements for climate-damaging projects. These instruments may be interesting, but they have many limitations, starting with the need for international consensus at the Basel Committee level to ensure that banks are treated equally at the global level. Alternatively, this type of instrument can penalise certain activities with a high-risk profile (such as coal, unconventional fossil fuels, exploration activities, etc.), but it does not address the rest of the issues involved in financing the transition of high-carbon economies to a low-carbon and resilient world.

Without waiting for the Basel changes to capital requirements, European regulators and supervisors have developed transparency requirements (Pillar 3)[15] and have undertaken the first voluntary stress testing exercises (Pillar 2)[16 17 18]. These existing approaches are useful, but they are not sufficient on their own to initiate bank transformation. With regards to climate disclosure, the movement has existed for several years, both in France[19] and in Europe[20]. Although this is an essential first step, little change is being driven by

5 Hilke *and al.*, 'Taking Climate-Related Disclosure to the next Level: Minimum Requirements for Financial Institutions'.
6 See in particular the *Green Weighting* Factor developed by Natixis, the *Impact Weighting Factor* of Banque Postale or the Transition Note of Crédit Agricole.
7 Reclaim Finance, 'Crédit Agricole: dodgy coal deals reveal policy breach'.
8 Urgewald, 'Who Is Still Financing the Global Coal Industry?'
9 ACPR and AMF. 'Sectoral policies and fossil fuel exposure of French financial market participants'.
10 Banque de France, de Gaye, and Lisack, '"Too Little, Too Late"'.
11 UN PRI, Battiston, and Monasterolo, 'Why Climate Mitigation Scenarios Should Factor in Transition Risk'.
12 ACPR, 'Scenarios and Main Assumptions of the ACPR Pilot Climate Exercise'.
13 I4CE, Chamberlin, and Evain, 'Indexing Capital Requirements on Climate'.
14 Finance Watch, Simon, and Philipponat, 'A Silver Bullet against Green Swans'.
15 EBA, 'EBA Draft ITS on Pillar 3 Disclosures on ESG Risks'.
16 EBA, '2021 EU-Wide Stress Test Results'.
17 ECB, 'ECB Economy-Wide Climate Stress Test'.
18 ACPR, 'A First Assessment of Financial Risks Stemming from Climate Change: The Main Results of the 2020 Climate Pilot Exercise'.
19 Since 2016 with the entry into force of Article 173-VI, since transformed into Article 29 of the Energy and Climate Law.
20 With the Non-Financial Reporting Directive (NFRD), which became the Corporate Sustainability Reporting Directive in 2021.

disclosure alone[21][22] and the lack of constraints makes its application fragmentary. Furthermore, these requirements are not accompanied by real sanctions in the event of non-compliance, which limits the binding nature of the system. The action of supervisors is currently limited to taking stock of the number of players who do not comply with these requirements[23][24].

Another important advance for supervisors is the arrival of climate stress tests, which have taken different forms depending on the exercises carried out by central banks[25]. These initial exercises still present numerous data and methodological difficulties before arriving at a correct assessment of the risk. The current stress tests are helping to raise the awareness of banking teams and to increase their skills, but the impact of these exercises seems to remain limited in terms of changes in their financing strategy.

These existing approaches must therefore be supplemented by a route that is not yet widely explored, namely Pillar 2 instruments such as the Supervisory Review and Evaluation Process (SREP). The development of Pillar 3 and stress tests could, however, provide an initial information base for integrating climate aspects into the exercise of Pillar 2 by supervisors. In this respect, the publication in January 2022 of new technical standards by the European Banking Agency (EBA)[26] should lead banks to provide information on their exposures to high-emission sectors. These completed tables, as well as the ECB's future climate stress-testing exercise[27] could be integrated into the SREP. This report proposes to elaborate on the different elements of the SREP and to explain why and how banking transition plans should be integrated into it.

21 French Ministry of Environment, 'Application de l'article 173 de La Loi Sur La Transition Energétique'.
22 I4CE *and al.*, 'Article 173: Overview of Climate-Related Financial Dislosure after Two Years of Implementation'.
23 ACPR and AMF. 'Sectoral policies and fossil fuel exposure of French financial market participants'.
24 French Ministry of Environment *and al.*, « Bilan de l'application des dispositions du décret n°2015-1850 du 29 décembre relatives au reporting extra-financier des investisseurs ».
25 NGFS, 'Scenarios in Action, A Progress Report on Global Supervisory and Central Bank Climate Scenario Exercises'.
26 EBA, « EBA draft ITS on Pillar 3 disclosures on ESG risks ».
27 European Central Bank, 'Information on Participation in the 2022 ECB Climate Risk Stress Test'.

2. WHAT SHOULD BE THE CONTENT OF BANKING TRANSITION PLANS?

KEY MESSAGES

- The banking transition plan should be made mandatory and precisely defined in the Pillar 2 prudential regulation.
- The banking transition plan should set out the bank's overall decarbonisation strategy, with a sectoral vision and intermediate targets.
- This plan should cover all sectors of the bank, its customers and its business lines to ensure overall consistency.
- The governance structure, team organisation, remuneration levels, and decision-making and risk management processes of banks should be adapted so that the objectives of the transition plan can be met at all decision-making levels.

To implement this transition contribution approach, the instrument of transition plans for companies[28] and banks[29] has recently emerged in the public debate. Proposed by researchers and supported by regulators[30 31], the transition plan would constitute a trajectory with intermediate steps to reach the objective of carbon neutrality in 2050. Introducing this transition plan requirement would therefore help to promote an orderly transition for banks and the underlying economy.

As this proposal is relatively new, the details of transition plans for both companies and banks have yet to be stabilised, but further work by EFRAG[32], the University of Oxford[33] and the *Prudential Regulation Authority* (PRA)[34] should contribute to this movement.

2.1. Banks should have transition plans that operationally implement carbon neutrality commitments

1. The key elements of a banking transition plan

- A long-term goal of carbon neutrality by 2050.
- The determination of a global decarbonisation strategy for the bank, broken down into sectoral decarbonisation trajectories.
- 5-year interim targets that set a course for sectoral GHG emission reductions and do not defer emission reduction efforts to the end of the period.
- Sectoral trajectories which should be based on plans determining transition trajectories, such as the sectoral transition plans (ADEME)[35] and in connection with national and European transition plans.
- Minimal use of carbon offsetting[36].

28 University of Oxford and Caldecott, 'Net-Zero Transition Planning Should Be Mandatory across the Economy'.
29 I4CE, Evain, and Cardona, « Can Financial Regulation Accelerate the Low-Carbon Transition? ».
30 Elderson, 'Overcoming the Tragedy of the Horizon'.
31 Elderson, 'Prudential pathways to Paris'.
32 Novethic and Redon, 'CSRD : les normes provisoires de l'EFRAG précisent le niveau d'exigence sur le climat'.
33 The UK government launched a Taskforce on Transition Plans in early 2022 and appointed Ben Caldecott as its co-leader.
34 HM treasury, Bank of England, and PRA, 'Regulatory Initiatives Grid'.
35 ADEME, 'Sectoral Transition Plans for Industry'.
36 The Climate and Sustainable Finance Commission of AMF, 'Companies and Carbon Neutrality: Initial Conclusions and Issues Identified'.

2. The banking transition plan should apply to all sectors (with priority given to the high-emitting sectors)

The transition plans must concern all sectors, as too many banking players are still only looking at the energy aspect of the transition. However, it is in fact all economic activities that are affected by both the transition and climate change issues. Having made this initial observation, it is nevertheless necessary to prioritise the projects for the banks and to start with sectoral analyses and plans for the sectors that emit the most. In this respect, the European Banking Agency's proposal[37] to include transparency obligations on these sectors in Pillar 3 is a step in the right direction. The realities may vary from one bank to another, but the energy, transport, industry, construction and agriculture sectors seem to be priorities for European banks.

To build this sectoral vision of the emissions it finances, the bank must rely on reference scenarios, such as the IPCC's P1 and P2 scenarios, the latest IEA Net-Zero scenario[38] or those of the WRI[39]. Sectoral trajectories, such as those proposed by the sectoral transition plans[40] of the Finance ClimAct project, can also serve as a reference point.

The bank should then set carbon neutrality targets for 2050 and intermediate reduction targets for its major emitting sectors. Within these sectoral trajectories, the bank must have a static and dynamic view of how the companies and projects it finances are positioned[41].

These objectives must be implemented operationally within its business lines, which must be restructured if necessary, so that the business managers[42] can achieve the emission reduction targets set.

In the case of new financing or revenues that contravene sectoral targets, the bank must have the ability to wave financing. Several recent controversies[43][44] have highlighted the difficulty for banks to enforce their own sectoral policies and climate commitments when it comes to foregoing profits. There are a number of possible explanations for these cases, but there are three which are most probable. Firstly, there is the shareholder return obligation to which banks are subject to by the financial markets. Secondly, the climate commitments remain focused at the level of the banks' strategy and are not sufficiently operational for the business managers to take them into account. Finally, the teams are not sufficiently trained, or do not have a knowledgeable resource person to turn to when dealing with cases that can be complex. This is particularly important as energy players restructure[45] as banks' sectoral policies evolve to maintain access to finance.

3. The banking transition plan should cover all types of bank customers

In order to be relevant and to provide a comprehensive view, a bank's transition plan should not be limited to covering only large corporate customers, but should cover all of the bank's customers. However, the level of information should be appropriate and proportionate, especially for data on consumer loans and SMEs.

Following the European regulation on climate disclosure[46], banks are increasingly covering the emissions of their corporate clients. However, for most of them, this analysis remains limited to the current GHG emissions of large companies. This view needs to be complemented by a more dynamic view of the transition trajectories of the companies, with intermediate targets of emissions reduction. The arrival of the taxonomy of sustainable activities should make it easier for banks to monitor green financing. However, for high-emitting sectors, banks should not wait for the arrival of a taxonomy of climate-harmful activities. They should rely on the transition plans provided by their counterparties (see below) and compare them with sectoral scenarios. The establishment of the *European Single Access Point* should facilitate this data collection work.

Large companies: determine where the company is in its sectoral decarbonisation trajectory and make credit conditional on the existence of a transition plan

In order to build its transition plan, the bank must base itself on the transition trajectories of the clients and projects it finances. However, given the wide variety of clients, in the short term only large companies appear to be able to provide their own transition plan. The developments in the CSRD[47] should make it mandatory to publish transition plans for these companies. This information should allow the bank to analyse how the company fits into the bank's sectoral decarbonisation strategy and whether the financing it requests is consistent with it.

In the interests of good climate risk management and corporate transition, it would seem appropriate for banks to make the granting of credit to large companies conditional to the existence of a robust transition plan, starting with those in the most fuel-intensive sectors. Some banks have already announced that they have put in place such initiatives.[48][49]

Such a provision, made mandatory at European level and coordinated with corporate transparency requirements,

37 EBA, 'EBA Draft ITS on Pillar 3 Disclosures on ESG Risks'.
38 International Energy Agency, 'Net Zero by 2050 - A Roadmap for the Global Energy Sector'.
39 Waslander, Bos, and Wu, « Banking Beyond Climate Commitments ».
40 https://finance-climact.eu/news/sectoral-transition-plans/
41 Climate Safe Lending Network and James Vaccaro, « The Good Transition Plan - Climate Action Strategy Development Guidance for Banks & Lending Institutions: COP26-version (2021) ».
42 Some banks have restructured their «oil and gas» lines into «energy» lines by also including renewable energy transactions. This is part of the increased skills of the account managers and the general transition of the bank.
43 Reclaim Finance, 'Crédit Agricole: dodgy coal deals reveal policy breach'.
44 Jolly, 'Europe's Biggest Banks Provide £24bn to Oil and Gas Firms despite Net Zero Pledges'.
45 Timperley, 'E.ON Completes Split of Fossil Fuel and Renewable Operations'.
46 Directive 2014/95/EU on Corporate sustainability reporting (CSRD).
47 Directive 2014/95/EU on Corporate sustainability reporting (CSRD).
48 UNEP FI, 'Net-Zero Banking Alliance Reaches Milestone with over 90 Banks Committed'.
49 Hodgson, 'NatWest Cuts Exposure to Most Polluting Clients'.

would ensure a similar minimum level of requirements across European banks.

However, the question for banks is how to evaluate and monitor the implementation of these commitments, as well as the possible consequences if the company does not implement its transition plan. The hypothesis of commitment by the bank to its client appears to have a limited impact, and that of a complete breakdown of the relationship is at this stage envisaged by the banks only as a last resort, especially as its effect on the real economy is likely to be limited.

Nevertheless, two avenues are more promising. The first being to contractually stipulate that the company must meet its reduction targets and to specify penalties in the event of failure to do so. This type of mechanism already exists in the *Sustainability-linked Bonds*[50] *and Sustainability-Linked Loans, which are* bonds and loans whose financial characteristics vary depending on whether the issuer achieves environmental, social or governance objectives.

A second option would be to change the interest rate if companies fail to meet their emission reduction targets. In the current context of inflation and rising interest rates, such a measure could provide a strong incentive for companies.

The important work of standardisation at European level as well as external standards could help to ensure the transparency and comparability of companies' transition plans. A greater role is also expected from the financial market supervisor in this area, to avoid misinformation and greenwashing. In France, the recent publication of the AMF's Climate and Sustainable Finance Commission[51] on its recommendations on carbon neutrality is an interesting example.

Small and medium-sized enterprises: enriching central bank ratings with climate information

Of all the types of bank customers, SME activities seem to be the most difficult to trace. Even so, it seems essential for banks to target SMEs in the most emitting sectors and to tailor their sectoral policies to these types of customers. To facilitate banks' access to information on SMEs, the ratings proposed by central banks could be enriched with climate information[52][53].

Households: using the Energy Performance Certificate as a proxy for energy renovation offers

With regards to households, and considering that housing loans represent a significant part of the banks' balance sheet, it is necessary for them to have an exhaustive vision of the energy quality of the housing they finance as well as the possibilities of house refurbishing. In France, the Energy performance certificate is a good proxy for obtaining this information and work carried out in conjunction with ADEME enables banks to recover the missing data on credit stocks. This is essential for the banking sector, in view of the tightening of regulations on the energy efficiency of housing and the significant risk of loss of value of poorly insulated housing. However, information about the energy performance of housing should not lead banks to refuse credit, but rather to suggest that households carry out energy efficiency work and to direct them towards the subsidy systems that can support the work. There is a strong link between poor energy performance of housing and low-income levels, so care must be taken not to deprive some of the most disadvantaged social groups of access to credit. These regulatory measures should be conditional on the existence of strong public support for energy renovation.

Local authorities: a specific case where immediate action seems premature

The financing of local and regional authorities varies significantly across the European Union. At this stage, it seems premature to require banks to have a vision of the implications of the low-carbon transition on their financing to local authorities. It will first be necessary to go through a stage where each State precisely defines the role of local and regional authorities in the transition, and the type of financing that will follow.

4. The transition plan should cover all the bank's business lines

In order to provide a comprehensive view of the bank's activities, the transition plan must cover all business lines: the traditional lending activities (*banking book*) and investment activities (*trading book*), including both active and passive management. Off-balance sheet activities related to investment banking but generating income for the bank, such as derivatives, should also be included[54]. The rest of the off-balance sheet activities, such as the structuring of bonds, guarantees, advisory activities for IPO, mergers and acquisitions, etc must be included as well. Banks should seek overall consistency across all their businesses[55].

The supervisor may apply a proportionality approach in the early years of implementation of transition plans. Whilst overall consistency should be sought; it should reflect the main sources of income for banks and be in line with their business profile.

50 ICMA, 'The GBP Guidance Handbook'.
51 The Climate and Sustainable Finance Commission of AMF, 'Companies and Carbon Neutrality: Initial Conclusions and Issues Identified'.
52 I4CE, Evain, and Cardona, 'Can Financial Regulation Accelerate the Low-Carbon Transition?'
53 Abdelli and Batsaikhan, 'Driving Sustainability from within: The Role of Central Banks' Credit Rating in Mitigating Climate and Environmental Risks'.
54 'Derivatives Market in Clean Energy Evolves along Adoption Curve'.
55 The insurance activities of banking groups should also be analysed, but as they are not subject to the European banking regulation currently under discussion, they are deliberately not addressed here.

2.2. The implementation of these transition plans should come with a strong and adequate governance structure

1. The decision to put transition plans in place should come from the highest level of governance

First of all, it seems important that the consideration of climate issues within the bank is done at the highest level of its governance. Climate decisions and commitments must be made by the management committee and must be highly strategic decisions. It is essential that these issues are taken into account, first and foremost, by the management to ensure that the operational teams agree with these commitments. It is also important that responsibilities for reaching the targets of this plan have been assigned and that the relevant teams have received the necessary training.

However, as highlighted by a certain number of NGOs[56 57], and also during interviews with banking institutions, announcements of the institutions' commitments made by the highest level of governance do not necessarily lead to solid implementation within the operational teams, which may partly explain the failure to respect these commitments. In order to address this inconsistency, it seems important that climate issues and the objectives of the transition plan are taken into account at all levels of decision-making.

2. The objectives set by the transition plan should be taken into account at all levels of decision-making and risk management processes

The objectives set by the transition plan should be reflected at all levels of decision-making, as well as in the risk management processes. It seems important that all risk management tools and processes are based on the transition plan. Thus, every time a decision is taken to invest in or finance a new project, or a renewal of a project, or counterparty, the committee responsible for taking the decision should incorporate compliance with the transition plan into its decision via relevant indicators that have been put in place. This is what has been done by the bank Natixis with the Green Weighting Factor®[58]. It seems important that the banks put in place indicators from the transition plan that enable them to act on their decision-making criteria. The effective integration of these indicators in the decision-making process could be monitored over time. These indicators and decision criteria from the transition plans should be used in the same way as traditional risk-return criteria[59].

Consequently, all risk management teams, as well as the business managers for each business line, must be fully aware of the issues and commitments made by management on this subject. Interviews with banking institutions revealed that the teams dedicated to the subject - often limited to a few employees - were not large enough to deal with the challenges generated by the transition. The supervisor could also ensure that a sufficient number of staff is allocated to dealing with climate issues within the institution.

In order to enable the teams to correctly understand the challenges and risks linked to the climate in their operational decisions, it would be necessary to put in place a certain amount of training and to ensure that a minimum level of knowledge is acquired at all team levels and for each of the bank's business lines.

56 Reclaim Finance "Coal: Crédit Agricole breaks its own policy".
57 Share Action, "Oil & gas expansion, A lose-lose bet for banks and their investors".
58 https://natixis.groupebpce.com/natixis/en/green-weighting-factor-and-climate-trajectory-rqaz5_111931.html
59 Perrier, and al, 'Rapport Perrier, Faire de la place financière de Paris une référence pour la transition climatique'.

PILLAR 2: HOW STRESS-TESTING EXERCISES CAN FEED INTO THE TRANSITION PLAN

Within the SREP, supervisors should ensure that risk assessment processes and tools, as well as stress-testing programmes, take account of all the institution's risks sufficiently. The inclusion of climate risks in risk management tools and stress-testing programmes is part of the CRD[60] and the CRR[61] amendments and should be strengthened.

The first climate stress-testing exercises carried out at European level[62 63 64] have mainly led to raise awareness and to train the banks' modelling and risk teams in climate risks.

In the future, these exercises could ultimately complement the implementation of banks' transition plans. These exercises allow institutions to model a certain number of climate trajectories[65] and to assess all the risk drivers that may be present in the various transition scenarios towards a low-carbon economy, particularly when the analysis is carried out in a detailed manner at a sectoral level[66].

3. The internal organisation of the teams should be consistent with the objectives set by the transition plan

In order to meet the objectives set by the transition plans, it seems essential that the structure of the teams is consistent with these objectives. For example, it would not necessarily be relevant to keep an "*oil and gas*" team with portfolio emission reduction objectives but rather to create a new "energy" team integrating renewable energies financing objectives. This would allow sectoral teams to continue to have development and growth objectives, and facilitate the transfer of skills from teams specialising in *decarbonised* sectors to teams specialising in more *carbon-intensive* sectors.

Coherent governance organisation could also be put in place so that internal teams can, for example, report effectively all information and problems encountered to the top management. To this end, intersectional committees can be set up to provide a link between all the business lines and management. These committees can also ensure that climate issues are regularly discussed by the management committee.

4. Remuneration drivers should be adapted to the objectives set by the transition plan

Finally, it might be appropriate for remuneration policies, both for top managers and business managers, to be consistent with these objectives, as it is already the case today with the risk management policy of each institution. Remuneration policies should already be consistent with the risk appetite, values and long-term interests of the institution[67].

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60 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC Text with EEA relevance.

61 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Text with EEA relevance.

62 ECB, 'ECB Economy-Wide Climate Stress Test'.

63 EBA, '2021 EU-Wide Stress Test Results'.

64 ACPR, 'A First Assessment of Financial Risks Stemming from Climate Change: The Main Results of the 2020 Climate Pilot Exercise'.

65 NGFS, 'NGFS Climate Scenarios for Central Banks and Supervisors'.

66 I4CE *et al.*, 'Climate Stress Tests: The Integration of Transition Risk Drivers at a Sectoral Level'.

67 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 relating to the taking up and pursuit of the business of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC

3. WHAT LEVERS OF ACTION WILL THE SUPERVISORS HAVE FOLLOWING THIS TRANSITION PLAN OBLIGATION?

KEY MESSAGES

- While a number of measures already allow supervisors to integrate climate issues into the supervisory process (SREP), making banking transition plans mandatory would make the review more operational.
- Supervisors should use a pre-established framework to conduct their review. The review should include an assessment of the sustainability of the business model, as well as the integration of climate issues into governance and internal models.
- In case of non-compliance, supervisors have a wide range of actions that they could use gradually: training requirements, changes in governance, changes in risk management, concentration limits in certain sectors, etc., up to additional capital requirements.

To increase the integration of climate change issues, two main challenges need to be addressed by banks and supervisors that oversee them: accelerating the transformation of their business to be compatible with a low carbon economy and ensuring that these strategic objectives are fully implemented internally.

A certain number of regulatory levers could be at supervisors' disposal to (a) control the proper consideration of climate issues within the decision-making and risk management processes of banks, in particular through the implementation of banking transition plans and (b) initiate actions to make banks change if they fail to take these issues into account.

3.1. A monitoring of climate issues and the review of banking transition plans could be carried out under the SREP by supervisors

1. Strengthen the SREP evaluation framework by integrating climate issues and the evaluation of transition plans

As mentioned in **Part 1**, supervisors and regulators could better support banks in contributing to the financing of an orderly transition of the economy by further integration of climate change issues into their review process.

For the time being, a number of measures within the supervisory process already allow supervisors to integrate climate change issues into the Supervisory Review and Evaluation Process (SREP), whether in the analysis of banking institutions' exposures or in the consideration of climate change issues in governance, decision-making and risk management processes (see **section 4.2.**).

The amendments to the provisions of the banking package[68] on the integration of climate change issues into the supervisory process go some way towards this, but still lack detail on how this review can be transformed to make it more operational. Integrating the review of banking transition plans into the SREP would provide supervisors with a more comprehensive framework for their review than they currently have. This reference framework, a first draft of which appears in **Part 2**, could be used by supervisors to review the processes for setting up these plans and their relevance.

The review of these transition plans may take place within the framework of the Prudential Supervision and Review Process (SREP)[69], in particular through the review of the institutions' *business model* (BMA - Business Model Analysis) and through the review of their internal governance and risk management system.

68 Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2013/36/EU as regards supervisory powers, sanctions, third-country branches, and environmental, social and governance risks, and amending Directive 2014/59/EU.
69 EBA, 'Guidelines on Common Procedures and Methodologies for the Supervisory Review and Evaluation Process (SREP) and Supervisory Stress Testing'.

2. Assessing the sustainability of the banks' business model through transition plans

In their annual assessment within the SREP, supervisors aim to check the sustainability of the business model and profitability of banking institutions[70]. To do so, they have to analyse the strategic and financial plan of the institutions. For the time being however, without the publication of transition plans by banks, it is difficult for the supervisor to analyse the relevance of the institution's strategic plan in the context of the transition to a low-carbon economy and climate change.

Making it mandatory for financial institutions to publish a transition plan would allow supervisors to integrate climate issues into the SREP, resulting in a more comprehensive and forward-looking analysis of the sustainability of the institution's business model in the face of climate issues.

On the basis of a reference framework setting out the main principles of banking transition plans (see **section 2.1.**), the supervisor could assess, or have assessed, the bank's climate strategy and check if that it effectively supports the transition of the activities financed.

Without waiting for a requirement to publish a transition plan, the supervisor can nevertheless start to analyse the business environment of the banking institution, taking into account the current business conditions of the bank based on the technological, regulatory and macroeconomic outlook of its geographical and sectoral exposures. This could be a first basis for the supervisor to assess in which portfolio, and in which sectoral or geographical area, the banking institution is at risk of concentration on assets or sectors which are vulnerable to the risks of the transition to a low-carbon economy.

3. Assessing the governance and internal practices of banks

As noted during interviews with banking institutions, the way in which the governance takes account of climate issues varies greatly from one bank to another and there are currently no precise rules detailing at what level of governance it is important for these issues to be integrated.

The internal decision-making and governance processes of banking institutions are powerful levers for changing behaviour. Within the SREP, supervisors have an obligation to verify that the overall governance of the company is sufficiently robust to deal with its risks.

If the publication of transition plans were to become mandatory for banking institutions, the supervisor would have to ensure that the general governance framework and the structure of the internal teams for each of the bank's business lines were adapted to the internal transformations needed to comply with the institution's transition plan. They would have to ensure that responsibilities had been properly assigned and that the decision-making and risk management systems had been adjusted. This review could include a reference framework that has been established in advance and that the supervisor could use as a basis for its review (see **section 2.2.**). In particular, the supervisor will be able to review the effective inclusion of transition plan indicators in the decision-making processes and their impact on the achievement of the transition plan objectives. This would enable supervisors to closely track the evolution of the processes put in place and their effectiveness.

It should be noted that, the regulation standards already allow the supervisor to ensure that ESG issues have been sufficiently taken into account by the institutions' governance system, Prior to waiting for a transition plan obligation to be put in place. By considering ESG risks as traditional risks, supervisors can already ensure that institutions have adapted their internal governance to climate issues and risks, through an appropriate organisational structure and decision-making and risk management tools and processes that take climate risks into account. Also, that they have set up remuneration levels in line with the consideration of these risks.

3.2. In case of non-compliance, supervisors could take a range of actions

The development of sustainable finance regulations has not yet been accompanied by real binding measures in the event of non-compliance, as most texts only provide for `*comply or explain*' measures. However, within the framework provided by Pillar 2, other instruments would be available to supervisors if the transition plans presented by the banks were not very robust or if they were not followed by operational implementation.

1. Different supervision actions are possible

The first type of instruments are supervisory actions. Within the framework of the SREP, each bank receives an annual letter from the supervisors with different actions to be implemented. These requests from the supervisor are likely to transform the structure of the bank and its processes, and can thus encourage the most reluctant banks to integrate climate issues.

70 EBA "Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing".

Within this framework, many actions[71] related to climate risks and transition could be integrated, including:

- general training for executives, board members, risk committee members and managers;
- the evolution of governance so that climate issues are systematically included, and at the relevant level (management committee, risk committee and supervisory committee in particular);
- assessing the suitability of members of the various committees and key positions on climate issues, and requesting changes in appointments where appropriate;
- strengthening risk management on climate issues and integrating climate criteria into financing decisions;
- strengthening the ambition and robustness of the transition plan and revising the implementation timelines within the bank;
- reviewing the strategy and policies implemented to limit activities in certain highly exposed sectors;
- the revision of the variable remuneration policy to integrate the objectives of the transition plan.

Among these actions, a graduated scale can be implemented depending on how late the bank implements its transition plan.

In a second phase, supervisors will have to ensure that these actions have been implemented and that they lead to changes in banking structures and activities. Particular attention will also have to be paid to ensuring that these changes are properly integrated into the subsidiaries so that they are fully operational.

2. Sanctions through additional capital requirements would also be possible, as a last resort

Beyond supervisory actions, supervisors also have the ability to impose additional capital requirements following a bank's SREP analysis. Frank Elderson recently indicated that the way banks manage climate risks will ultimately impact on their Pillar 2 capital requirements.[72]

These additional requirements are temporary, and should only last for a few months while the bank complies with the supervisor's requests. They can be an interesting lever to initiate a rapid transformation of banks, in the event that the requested supervisory actions are only partially implemented.

However, these additional requirements must be rigorously justified, and supervisors must demonstrate that they are based on a risk that has not been sufficiently covered by the bank. In the case of climate risks, it will not necessarily be easy for supervisors to commit to this approach today. The methodologies for analysing climate risks still have many limitations[73] and supervisors run the risk of seeing their decisions challenged legally for lack of foundation. Clear legal texts should therefore be put in place, allowing supervisors to use this instrument if necessary. Rather than seeking to demonstrate the existence of a specific risk in one type of sector, it would be easier for supervisors to base their arguments on a more general lack of integration of climate risk.

3. *`Name and shame'*, an instrument not currently used but that could be considered by supervisors

The last option envisaged by some observers is for supervisors to make public the list of banks that do not comply with the regulations. In France, the ACPR already carries out this exercise[74], but at an aggregated level and does not publish the names of the institutions using bad practices. The scope of this new route is difficult to predict, given that NGOs already perform this role by highlighting and publicising bank failings. The role of the supervisor would then be to corroborate or qualify by its analysis the elements brought by the NGOs, with the aim of inciting the banks to transform themselves.

71 The possibilities for supervisory action are set out in Article 104 of the CRD.
72 Elderson, 'Full Disclosure: Coming to Grips with an Inconvenient Truth'.
73 Hilke *and al.*, 'Taking Climate-Related Disclosure to the next Level: Minimum Requirements for Financial Institutions'.
74 ACPR and AMF, 'Sectoral policies and fossil fuel exposure of French financial market participants'.

4. HOW CAN TRANSITION PLANS BE MADE MANDATORY IN THE LEGISLATION?

KEY MESSAGES

- Recent statements by Frank Elderson indicate that the ECB is in favour of implementing mandatory transition plans within Pillar 2.
- Existing texts already allow for the integration of ESG issues into the governance of banks, and to a greater extent than the actions proposed so far. The amendments to the CRD and CRR proposed in the banking package provide for the establishment of mandatory bank transition plans.
- Several provisions, as well as a reference framework, need to be specified in legislative texts to enable supervisors to implement this review in an operational manner.

4.1. The ECB has strong political ambitions for the introduction of transition plans in European regulation

Frank Elderson's speech in Vienna, on 20 October 2021[75], emphasised the tragedy on the horizon for financial institutions and the need for them to translate their global targets for 2050 into intermediate short-term and medium-term milestones. The member of the ECB's Executive Board therefore insisted on the structural changes that these institutions would have to undergo in the short term to meet their climate targets. This led him to introduce the idea of mandatory transition plans, compatible with the Paris Agreement and explicitly defined in European law, and to call on legislators to definitively write this project in law.

This commitment was further confirmed in speeches on 18[76] and 23[77] February 2022, where Frank Elderson reaffirmed his belief in the need for transition plans to be considered by supervisors within Pillar 2. He also said that he welcomed the proposals made in the 2021 banking package[78], and recalled the importance not only of the transition plans of banking institutions, but also of the plans of their counterparties. Finally, his speech of 14 March 2022[79] led him to describe as good practice, the choice of a bank to publish its climate strategy to reach the net zero target in 2050 for its loan portfolio. In his view, climate risks are gradually being incorporated into the SREP methodology, and in the longer term, the management of these risks by banking institutions will have an impact on capital requirements under Pillar 2.

75 Elderson, 'Overcoming the Tragedy of the Horizon'.
76 Elderson, 'Towards an Immersive Supervisory Approach to the Management of Climate-Related and Environmental Risks in the Banking Sector'.
77 Elderson, 'Prudential pathways to Paris'.
78 Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2013/36/EU as regards supervisory powers, sanctions, third-country branches, and environmental, social and governance risks, and amending Directive 2014/59/EU.
79 Elderson, 'Full Disclosure: Coming to Grips with an Inconvenient Truth'.

4.2. Supervisors can already rely on some articles of the banking package to integrate the review of climate issues into the supervisory process and to enforce the implementation of transition plans

The current state of prudential regulation, notably through the directive and regulation on capital requirements (CRD[80] and CRR[81]), as well as their amendments proposed in the 2021 banking package[82], already allows supervisors to integrate climate change issues into their review, and pave the way for the implementation of mandatory transition plans for banks.

Article 74-1 of the CRD makes the implementation of strong corporate governance arrangements and effective risk management processes compulsory. If environmental, social and governance (ESG) risks are considered as traditional risks, supervisors can already ensure that governance and risk management processes take into account climate change issues. The revision of Article 104-1 of the CRD in the banking package clarifies this by setting out explicit rules on the management and monitoring of ESG risks and gives supervisors the power to assess these risks.

The concept of transition plans is directly addressed in the amendment to Article 76[83] and referred to again in Article 87a[84]. According to the wording of the banking package, the objective of these plans would be to reduce the short, medium, and long-term risks associated with the failure to align institutions' business models and strategies with the EU's objectives i.e., to achieve carbon neutrality by 2050[85]. Point 5 of Article 87a specifies that the content of these plans will be further defined by guidelines to be provided by the European Banking Authority.

These various amendments to the 2021 banking package introduce the notion of transition plans into the CRD and give EBA the responsibility of defining their content. These tools pave the way for a mandatory publication of bank transition plans. However, for this action to be as effective as possible, these formulations need to be further clarified within the CRD itself, and extended to Level 2 texts such as regulatory technical standards (RTS).

4.3. These general formulations and political ambitions need to be clarified to define the conditions of implementation and the contents of the transition plans

To effectively support the transition of banking institutions, the reference to transition plans in the CRD is not enough. Supervisors need more clarity at the legislative and regulatory levels, which will give them the visibility to act without overstepping their mandate. To accelerate the ongoing movement, it will be necessary to integrate more defined transition plans. This could be relevant within a level 2 text such as in the RTS which specify the CRD, in which could be clarified the content and scope of transition plans.

80 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC Text with EEA relevance.

81 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Text with EEA relevance.

82 Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2013/36/EU as regards supervisory powers, sanctions, third-country branches, and environmental, social and governance risks, and amending Directive 2014/59/EU.

83 "Article 76 is amended as follows: [...] Member States shall ensure that the management body develops specific plans and quantifiable targets to monitor and address the risks arising in the short, medium, and long-term from the misalignment of the business model and strategy of the institutions, with the relevant Union policy objectives or broader transition trends towards a sustainable economy in relation to environmental, social and governance factors.

84 "A new article 87a is inserted as follows: [...] Competent authorities shall assess and monitor developments of institutions' practices concerning their environmental, social and governance strategy and risk management, including the plans to be prepared in accordance with Article 76."

85 "Institutions should assess the alignment of their portfolios with the ambition of the Union to become climate-neutral by 2050."

5. HOW CAN THIS RECOMMENDATION BE OPERATIONALISED BEYOND REGULATION?

KEY MESSAGES

- Clarifying the mandate of supervisors in legislation would facilitate the review of banks' transition plans and reduce the risk of divergent interpretations by different national and European supervisory authorities on the subject.
- The certification of the content of transition plans could be entrusted to different actors. While the content of the plans could be validated by the supervisors themselves or by external entities such as audit firms, state agencies, or state labels, the definition and control of the implementation of the plans should remain in the hands of the supervisors.
- To face these new challenges, supervisors will have to strengthen their training and staffing. Priority can be given to the Joint Supervisory Teams as well as to the Colleges of Supervisors for subsidiaries of banks outside the euro area.

5.1. Clarification of the supervisors' mandate would facilitate the implementation of these recommendations

In the European Union, the main mandates of banking supervisors are to maintain financial stability in the EU and to ensure the integrity, efficiency, and proper functioning of the banking sector[86]. The analysis and consideration of climate risks in supervisory processes fit well with the mandate of supervisors to maintain financial stability, as demonstrated by the first climate stress testing exercises carried out in the European Union[87][88][89], and as recalled by Frank Elderson in his speech on 19 October 2021[90].

Many of the recommendations made in **parts 3.** and **4.** could already be taken into account within the framework of the current supervisory mandate. However, the current texts remain unclear on the level of integration of climate issues within the supervisors' mandate, and on their objectives in terms of promoting a gradual and orderly transition of banking actors.

However, the need to include climate change and a transition to a low-carbon economy within the mandates of supervisors is increasingly emerging in the public debate. In March 2021, the British Chancellor of the Exchequer Rishi Sunkak announced that the Bank of England's mandate would now be to foster a financial system that supports and enables the transition to a net-zero economy[91].

Within the European Union, the question arises of the need to adapt the mandate of supervisors to move away from a vision based purely on financial risks and to support in a more official and concrete manner the transition of financial actors towards a low-carbon economy. Clarifying this mandate in legislative texts could facilitate this implementation and reduce the divergent interpretations that the various national and European supervisory authorities may have on the subject.

If that were to happen, it would not be the first time that European supervisors would move away from a purely risk-based approach. At the European level, several examples already exist. The "SME supporting factor" introduced in the CRR[92] to reduce the capital requirement for loans to SMEs, was intended to facilitate access to finance for SMEs in the EU. Similarly, during the Covid-19 crisis, the ECB announced several measures to reduce prudential requirements on monetary policy and banking supervision actions to mitigate the impact of the pandemic on the euro area economy[93].

It would therefore be possible today to adapt the mandate of supervisors so that they can have all the necessary resources to best support the transition of financial stakeholders towards a low-carbon economy. The clarification of the supervisors' mandate would make the review of transition plans more legitimate *vis-à-vis* banking institutions.

86 European Central Bank, SSM Supervisory Manual.
87 EBA, '2021 EU-Wide Stress Test Results'.
88 ECB, 'ECB Economy-Wide Climate Stress Test'.
89 ACPR, 'A First Assessment of Financial Risks Stemming from Climate Change: The Main Results of the 2020 Climate Pilot Exercise'.
90 Elderson, 'The role of supervisors and central banks in the climate crisis'.
91 HM treasury et Rishi Sunak, « REMIT AND RECOMMENDATIONS FOR THE FINANCIAL POLICY COMMITTEE.
92 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Text with EEA relevance.
93 https://www.ecb.europa.eu/home/search/coronavirus/html/index.en.html

5.2. Certification of transition plans could be provided by various public or private institutions

It is likely that the imposition of a transition plan requirement for banking institutions will result in the publication of such plans. However, these will not necessarily be as robust, ambitious or science based as necessary, and this situation will require a system of certification of published plans. Secondly, it will also be necessary to ensure that the plans' commitments, once published, are met. To meet these two needs, it is therefore consistent to consider which institutions will be responsible for ensuring the certification of bank transition plans and counterparty plans.

Several institutions could oversee this certification task. To begin with, supervisors, whose mission could be extended to checking the content of the plans submitted by banking institutions. The work carried out by the supervisory authorities would then be risk-oriented, in line with their initial mandate.[94] Their aim would be to ensure that these plans sufficiently protect financial institutions from the climate risks to which they are exposed. One could envisage a form of quality assurance produced by supervisors, as it is already the case for internal models or risk management.[95] However, it is likely that this work would not be suitable for the human resources currently available within these institutions due to the time-consuming nature of such an undertaking, and the lack of specific training on climate issues. To address this concern, supervisors could initially focus on monitoring the implementation of bank transition plans after their creation. Progressive training efforts on climate issues could eventually allow supervisors to take control of the whole certification process in the long term. As for the certification of counterparty plans, this task cannot be entirely left to supervisors, since they do not possess both the competence nor legitimacy for this job. In any case, these plans will have to be certified by other institutions.

Second, it is also possible to consider entrusting this certification task to public agencies for the ecological transition such as ADEME in France, and its European counterparts, or to a multi-stakeholder group such as EFRAG, which gather public and private stakeholders, as well as civil society. Compared to supervisors, these public agencies are better trained in the challenges of the ecological transition of banks and would therefore be sufficiently qualified to take charge of the certification of their plans. ADEME is already doing similar work with the Assessing low Carbon Transition (ACT) initiative[96], from which the agency could easily re-use some elements. In its favour, the EFRAG is already working on defining the standards for large compagnies' transition plans.

However, their human resources are also limited in terms of available staff. Furthermore, their national dimension would have to be adapted to the prevailing European framework for financial regulation, which would require a great deal of coordination between these different agencies to ensure the uniformity of the criteria used in the certification of plans.

A third type of institution that could be considered as responsible for the certification of transition plans is audit firms. The auditors would be registered with European institutions such as the EBA or the ECB which would validate their status as external certifiers. This solution would make it possible to overcome the problem of human resources that could be mobilised on the subject and the training of teams. However, there is no standard metric that can be used to compare the results obtained by the various firms. A very detailed definition of the expected criteria would be necessary to ensure the effectiveness of such a certification method. Additionally, several conflicts of interest could also arise with such a solution, as audit firms have been criticised in the past.[97]

Finally, the last certification method considered would be a label system, as it is already the case for many regulations concerning the ecological transition, such as the low-carbon label[98] or the European green bond standard.[99] The public authorities would thus initiate the creation of the label but would delegate the verification of the plans to external certification bodies responsible for awarding the label. This system would move even further away from a risk-based logic, as opposed to certification granted directly by supervisors. The cost of setting up such a label system would also be significant, and it would be necessary, once again, to ensure the degree of precision of the criteria used in the construction of the label so that the certification is sufficiently demanding for the institutions concerned.

These four ways of handling the certification of transition plans each have their advantages and disadvantages, and it seems premature to make a final judgement on which one should be preferred. It would be possible to establish a compromise between the work of external entities focusing on the upstream validation of transition plans for banks and counterparties, and the work of supervisors responsible for

94 Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC.
95 European Central Bank, 'Internal Model Investigations'.
96 ADEME, https://actinitiative.org/
97 Albert, '"Big Four" : le scandale des comptables de l'ombre'.
98 French Ministry of environment, 'Label bas-carbone'.
99 European Commission, 'European Green Bond Standard'.

ensuring the implementation of plans downstream. This would allow supervisors to keep control of the transition process of banking institutions and to overcome the problem of the human resources needed to accomplish this task. In the longer term, a gradual increase in supervisors' skills could enable them to carry out all the stages of certification of the transition plans of banking institutions and their counterparties.

BOX: THE ROLE OF THE MARKET REGULATOR IN CERTIFYING ENGAGEMENT POLICIES AND USE OF INFORMATION

The objective of market authorities is to ensure the proper flow of information for investors, the smooth functioning of financial markets and financial stability.

The multiplicity of carbon neutrality commitments and the increasing demand for ESG investments leave the door open to greenwashing by financial and non-financial stakeholders. In order to continue to maintain the quality of information and transparency of stakeholders in environmental matters, several market regulators have decided to take up the subject. ESMA - the European Securities and Markets Authority - has made it one of its priorities in its Sustainable Finance Roadmap 2022-2024 100. In France, the ACPR and the AMF have been producing a joint report since 2020 to monitor the commitments of French financial institutions in the fight against climate change and the objective of carbon neutrality by 2050 101, and to identify the various existing initiatives among French financial players. The AMF's Climate and Sustainable Finance Commission published a report in October 2021 102 defining an initial framework for companies' carbon neutrality policies.

In a context where commitment policies are becoming more and more numerous and could one day be made mandatory within the regulations, the role of market authorities will also become essential to certify the quality of these commitment policies, their comparability, and the proper circulation of information.

5.3. Evolutions of human resources: specific training and increased staff numbers are needed

To cope with these new developments, supervisors will also have to transform their practices and structure. Several have already done so at the national level [103] [104] and at the European level, by reinforcing their teams and by setting up centres dedicated to climate issues. Nevertheless, this movement is very heterogeneous within the European Union. To ensure the coherence of the supervision of climate issues, major efforts to train and strengthen teams will have to be made by European and national supervisors. Two priority actions stand out to be implemented: targeting *Joint Supervisory Teams (JSTs)* within the euro zone and targeting supervisory colleges for banks outside the euro zone.

1. The essential role of Joint Supervisory Teams

The Joint Supervisory Teams (JST) play a key role in the development of the SREP. They are composed of members from the ECB – the European supervisor – and national supervisors. The ECB's teams have rapidly increased their expertise on the subject, with an acceleration since the arrival of Christine Lagarde.[105] This is less true within the euro zone supervisors, where there are significant differences[106] in the prioritisation of climate issues and in the interpretation of the supervisors' mandate. Targeting JSTs[107] with adequate training programmes and precise guidelines on the integration of climate issues within Pillar 2 would allow for a rapid evolution of the SREP analysis. It would also ensure an equal treatment of this issue within the euro area.

100 ESMA, 'Sustainable Finance Roadmap 2022-2024'.
101 ACPR and AMF, 'Sectoral policies and fossil fuel exposure of French financial market participants'.
102 The Climate and Sustainable Finance Commission of AMF, 'Companies and Carbon Neutrality: Initial Conclusions and Issues Identified'.
103 Banque de France, 'Green Finance: The Banque de France Launches Its Climate Change Centre (CCC) and Publishes Its 3rd Responsible Investment Report (SRI)'.
104 De NederlandsBank, 'Sustainable Finance Platform'.
105 European Central Bank, 'ECB sets up climate change centre'.
106 WWF, 'SUSREG Annual Report'.
107 De Schutter, 'Drain the Water from the Bilge: The Role of the ECB Supervision in European Climate Transition'.

2. Targeting Supervisory Colleges to reach out to non-euro area banks with greater exposure to fossil fuel sectors

For banks headquartered in the euro area but with subsidiaries outside the euro area, the supervisory colleges appear to be the second priority area. As the EU member countries outside the euro area are mainly Central and Eastern European countries, the banks or subsidiaries have more exposure to the fossil fuel sectors.

Several European banks have subsidiaries in smaller countries such as the Czech Republic or Poland. Even if their exposure to carbon-intensive activities is significant at the country level, their assessment at the level of a consolidated balance sheet will not necessarily highlight these risks.

It is important to focus on the supervisory colleges because these independent supervisors from non-euro area countries work together, but they can deviate from the general decisions taken by the euro area. It is therefore important to establish cooperation on these climate issues in order to reflect the reality of the domestic markets in these countries and to supervise the banking institutions adequately.

CONCLUSION

In conclusion, to ensure the implementation of an orderly transition, the integration of transition plans into Pillar 2 of prudential regulation appears to be an appropriate tool. To ensure the full implementation of these plans, significant changes in practice are expected from banks and supervisors alike. To accompany these changes, the current regulations must be strengthened and clarified. The European political deadlines surrounding the banking package should provide an opportunity to amend the legislative texts to provide supervisors with a common reference framework.

ANNEX
LIST OF INTERVIEWS

Banking sector

- **Crédit Agricole**, Aurélie BELLHASEN, Aurélia SMORTIEZ
- **European Investment Bank**, Tatiana BOSTEELS, Wouter MEINDERTSMA
- **French Banking Federation**, Karen DEGOUVE
- **Groupe BPCE**, Delphine BARTRE, Valérie DERAMBURE
- **BNP Paribas**, Marie-Laure AKA, Nathalie JAUBERT, Valérie ORMEZZANO, Catherine ROYERE
- **La Banque Postale**, Skender SAHITI-MANZONI, Zineb TAZI

Audit and consulting firm

- **PWC**, Julien GAUTIER, Olivier MULLER

Academics and Think Tanks:

- **Council on Economic Policies (CEP)**, Chiara COLESANTI SENNI, Pierre MONNIN
- **Yale University**, Nathan DE ARRIBA SELLIER
- **London School of Economics - Grantham Research Institute on Climate Change**, Simon DIKAU, Hugh MILLER
- **European Banking Institute**, Agnieszka SMOLENSKA
- **Jacques Delors Centre**, Sebastian MACK
- **International Monetary Fund (IMF)**, Charlotte GARDES

NGOS

- **Finance Watch**, Paul FOX, Julia SYMON
- **WWF**, Maud ABDELLI

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ABOUT FINANCE CLIMACT

The Finance ClimAct project contributes to the implementation of France's National Low Carbon Strategy and the European Union's Sustainable Finance Action Plan. It aims to develop new tools, methods and knowledge enabling (1) retail investors to integrate environmental targets into their investment choices, and (2) financial institutions and their supervisors to integrate climate issues into their decision-making processes and align financial flows with energy/climate objectives.

The consortium, coordinated by ADEME, also includes the French Ministry for the Ecological Transition, the Autorité des Marchés Financiers (AMF), the Autorité de Contrôle Prudentiel et de Résolution (ACPR), 2° Investing Initiative, Institute for Climate Economics, Finance for Tomorrow and GreenFlex.

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