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Prudential transition plans: what's next after the adoption of the Capital Requirements Directive?

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SUMMARY

The European Union has just adopted the **Capital Requirements Directive** (CRD) and introduced a new feature: **transition plans** will now integrate **prudential regulations**.

This paper looks at **the major opportunity** represented by prudential transition plans and the **decisive role that the European Banking Authority** will play. It explains why the Authority should adopt a **comprehensive definition of banking transition plans** and how **these plans should be consistent with the European directives** on Corporate Sustainability Reporting (CSRD) and on Due Diligences (CSDDD).

Lastly, this paper looks at **four key issues for the structural transformation of banks**:

- the link between prudential plans, European strategies and corporate plans,
- consistency of remuneration scheme,
- training and skills issues,
- stranded assets.

This post will be of particular interest to those actively following European banking and climate change news, especially banking regulators and supervisors.

The end of a political sequence, but the beginning of a decisive technical sequence

On Monday December 11th of 2023, the Council, Parliament and European Commission meeting in **trialogue** finalised a process that began in 2021: the transposition of the latest Basel agreements on **bank capital requirements**. The reopening of this regulation and directive, which are essential to the good functioning of the banking system, was an opportunity to incorporate climate and transition risk issues.

The first step has been taken: **banks will have to draw up prudential transition plans**. But what are the practical implications of these plans? The ball is now in the court of **the European Banking Authority**, which has a decisive role to play. It is the EBA, supported by the national supervisors, that will determine the nature of these transition plans. If it adopts a **definition of plans aimed at achieving climate neutrality by 2050, and covering all economic sectors**, then this will be a significant progress. A real step forward, both for European banking stability and for the mobilisation of banks to finance the transition.

The transition plans represent a major opportunity to initiate the transformation expected of banks in the light of the climate challenges

These prudential transition plans should **encourage banks to reflect on and transform themselves in the light of climate change issues**. This objective is a point of debate for supervisors, but it is indeed the one indicated by the co-legislators in the CRD: «The adequate adjustment of the financial sector, and of credit institutions in particular, is necessary to achieve the objective of net-zero greenhouse gas emissions in the Union's economy by 2050, while maintaining the inherent risks under control».

These plans are therefore an opportunity for banks to think globally: about their strategy for financing the transition of their customers – businesses and households – and about the climate risks that weigh on their activities. By way of example, the automotive sector is undergoing a major transformation, under pressure from regulations and changes in behaviour. Banks finance the entire industry, from manufacturers to subcontractors, dealers, garages and car buyers. Hence, banks need to **anticipate these developments** and the **financial risks** they entail, and plan an **appropriate financing strategy**.

The advantage of incorporating these plans into the **prudential framework** is that they go beyond the reporting level and enable the **supervisor** – the banking watchdog – to **monitor their implementation**. The supervisor will be able to take some **actions** and **sanctions** in the event of non-compliance with the transition plan. The aim is to be able to profoundly **transform** the way **banks are organised and structured**, as these institutions are currently struggling to reform themselves to take on board the new climate reality.

If these actions are not sufficient, the supervisor can also impose substantial **fines**. Frank Elderson, member of the Executive Board of the European Central Bank, recently mentioned the very high figure of a fine of up to 5% of the daily net banking income of a bank found not to be compliant. For a bank with annual revenues of €10 billion, the fine would therefore amount to a penalty of €1.4 million per day.

The European Banking Authority has a key role to play in ensuring that transition plans play their full part

The agreement reached in the trialogue on the Capital Requirements Directive (CRD) states that the **European Banking Authority** (EBA) will have to define the **content of these prudential transition plans**. It has just published an initial **document for consultation** setting out **its guidelines**.

This is a new and fundamental step forward, against a backdrop of **strong lobbying by financial players** (banks, insurance companies and asset management firms) and certain national governments to **exclude the financial sector from these regulations**, or to reduce their scope. Financial companies have already succeeded in being partially excluded from the Due Diligences Directive (CSDDD).

The EBA's drafting of guidelines for prudential transition plans will no doubt also be subject to intense lobbying by the banks, with the aim of **reducing the scope of the transition plan**. Indeed, the more the plan's obligations - in terms of sectors, portfolios covered, time horizon - are reduced, the less the supervisor will be able to act or impose sanctions.

There are therefore two possible choices:

- either **the EBA opts for consistency between the texts**. The prudential transition plan standards would then be consistent with the CSRD and the CSDDD, and opt for a **comprehensive definition, aimed at achieving climate neutrality in** 2050;
- or **the EBA favours a narrower risk approach** and moves towards minimum plans, which no longer really resemble to long-term transition plans, but which would focus on a short-middle term vision (3-10 years), centred on the few sectors considered to be at risk for the financial sector (mainly coal and oil) and covering only part of banking portfolios.

Only the first option would make it possible to manage the risks and promote the financing of the transition. These are two sides of the same coin: **avoiding a disorderly and delayed transition**, which would **only increase the physical risks and the risks of transition**.

This is why we are calling for the **definition of prudential transition plans to be broadened. These plans should not focus exclusively on managing climate risks. They should also aim to redirect banks' activity towards financing the transition**. They should be based on achieving climate neutrality by 2050, with sectoral breakdowns in line with European political objectives, intermediate emission reduction targets and offsetting strictly limited to residual emissions.

Some of these elements are partially taken up by the EBA in its document for consultation. They need to be completed and strengthened. This more comprehensive vision of transition plans would allow to take advantage of the legislative window. It could then be implemented proportionately by supervisors.

Prudential transition plans must be consistent with the rest of the European regulatory architecture

Prudential transition plans must be **consistent** with other European texts. A whole **European regulatory architecture is being built** around **transition plans** for financial and non-financial companies, within three key regulations: the **CSRD** (transparency for financial and non-financial companies), the **CRD directive and CRR regulation** (prudential regulation for banks) and the **CSDDD** (obligation to implement the transition plan for companies and banks).

The definitions of what constitutes a transition plan should be similar within the CSRD and the CSDDD. However, EBA seems to be moving towards a different definition for prudential transition plans. To date, the **CSRD** and the standards of EFRAG - the European Financial Reporting Advisory Group - provide a **broad definition of a transition plan**, with a vision focused on achieving climate neutrality by 2050 and European political objectives. But the scope of the text remains that of a reporting obligation, with moderate penalties if the transition plan is not robust or is not implemented.

The **CSDDD supplements this reporting obligation** by making the transition plan mandatory. This time, the system of penalties is significant: the company's civil liability may be brought before the court, or financial penalties may be imposed by a national administrative authority.

With regard to prudential regulation (CRD), **the texts drawn up by the EBA should ensure this consistency**, which would lead to real changes for banks.

Beyond the definition and scope of the transition plans adopted by the EBA, let us now explore **four issues** that will be **crucial** to **the scale of the transformation expected of banks**:

- the relationship between prudential transition plans and European and national plans on the one hand, and with corporate plans on the other;
- the consistency of variable remuneration policies;
- training and skills issues;
- the treatment of stranded assets.

Linking the different levels of transition plans: national and European strategies, transition plans for banks and businesses, etc.

To ensure that banks provide the best possible support for investment by businesses and households, transition plans must be designed to **take account of the challenges facing the real economy**. There are two ways of doing this:

- the banks must base **the objectives and sectoral trajectories** of their plans on **European and national policy objectives**, and not on major international targets as is currently the case;
- Banks need to be able to **assess the transition plans of the companies they finance**, and derive an **appropriate financing strategy** from them. Do the plans of large companies correspond to the bank's financing strategy for this sector? Are they coherent and sufficiently robust to prepare the company for the economic, technological and societal changes brought about by the transition? Banks need to ask themselves these questions when they elaborate their own transition plan, and when they decide whether or not to grant financing to companies.

Implementing a coherent variable pay scheme

The issue of **variable remuneration** is a particularly sensitive one, sufficiently so to have been dismissed during the trilogue negotiations. Yet it is crucial, and the supervisor must ensure that **remuneration schemes are consistent with the implementation of the plan**. To put it another way, no bank employee should have to give up their variable pay to implement the plan. Similarly, no employee should have an economic incentive to take decisions that run counter to the plan. Indeed, implementing the plan will mean reducing activity in certain sectors or refusing certain transactions in which employees might be interested in. **The supervisor must first check this overall consistency**, at **management level**, but also at **more operational levels**. This topic will be the subject of a specific I4CE publication in the coming months.

Acting on skills issues with 'fit and proper' tests and training

Skills and qualifications are essential to the **transformation of banking organisations**. How can we ensure that people in key positions are as objective as possible when it comes to climate issues? It only takes one or a few key people who do not take the climate issue sufficiently into account to have deleterious effects on the whole organisation.

To act on this lever, the inclusion of transition plans in Pillar 2 gives supervisors the power to activate '**fit and proper tests'**. These tests would verify that **the people in charge of governance and climate risk management are sufficiently competent in the subject**. The use of these tests is currently limited to executives and members of a supervisory body.

Beyond this small number of people, we also need to take action for **all bank employees.** If we are to meet the challenges of climate change, we need a **pool of suitably qualified people**, and that also means **training senior managers** and **operational teams**. Here too, it is up to the **supervisors to check** that the **banks have put the appropriate training in place**.

Broadening the understanding of stranded assets and integrating it into risk management

Whatever definition of transition plans is adopted by the EBA, the issue of **stranded assets** will have to **be included**. In the financial ecosystem, this issue tends to be reduced solely to infrastructures linked to fossil fuels. But in reality, this **analysis needs to be conducted more broadly**, and for a **large number of sectors (agriculture, real estate, industry, tourism, etc)**. Banks, which continue to assign a fixed value to these assets, need to have an appropriate discounting strategy, and incorporate it into their risk management. This topic will be the subject of a specific I4CE publication in the coming months.

Conclusion

The adoption of the transition plans within the Capital Requirements Directive (CRD) marks a major step forward, after 4 years of negotiations. The European Banking Authority (EBA) seems keen to move quickly on this issue, and some of the key elements of the transition plans are included in the first version of its guidelines.

Nevertheless, **the definition currently adopted by the EBA remains too focused on the management of short- and medium-term risks alone**. To truly manage climate risks, **transition plans should instead encourage banks to reorient their activities in favour of transition**.

The year 2024 will be essential for regulators to arrive at truly relevant prudential transition plans. The text of the CRD resulting from the trilogues is due to be adopted in plenary. At the same time, the European Banking Authority will collect **the responses to the consultation on the guidelines and draw up the final version of the document**.

This consultation should be an opportunity for supervisors, members of think-tanks and NGOs to get involved. Their responses will be essential if we are to achieve a **more balanced text that promotes regulatory consistency and a comprehensive definition of prudential transition plans**.

I4CE is a non-profit research organization that provides independent policy analysis on climate change mitigation and adaptation. We promote climate policies that are effective, efficient and socially-fair.

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