Promises and challenges of prudential transition plans

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European Banking Institute

Frankfurt, 16 February 2024

What are transition plans?

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What is ‘Transition’?

Transition means a transition from **current climate and environmental performance levels** towards a **climate- neutral, climate-resilient and environmentally sustainable economy** in a timeframe that allows reaching:

(a) the **objective of limiting the global temperature** increase to 1,5 °C in line with the Paris Agreement and, for undertakings and activities within the Union, the **objective of achieving climate neutrality by 2050 and a 55 % reduction in greenhouse gas emissions by 2030** as established in Regulation (EU) 2021/1119 of the European Parliament and of the Council;

(b) the objective of **climate change adaptation**; and

(c) **other environmental objectives of the Union**, as specified in Regulation (EU) 2020/852 as pollution prevention and control, protection and restoration of biodiversity and ecosystems, sustainable use and protection of marine and fresh-water resources, and the transition to a circular economy.

European Commission’s Guideline 2023/1425 of 27 June 2023 on facilitating finance for the transition to a sustainable economy

What is a 'Transition Plan'?

A **transition plan:**

- is **a detailed <u>multi-year</u> account of <u>targets</u> and <u>actions</u>**
- that sets out **how a given firm will ensure that its business model and strategy are compatible with a <u>specific objective</u>**, such as the goal of limiting global warming to 1.5°C above pre-industrial levels in line with the Paris Agreement.*

*** Paris Agreement commits to "making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development." (Art. 2(2)(c))**

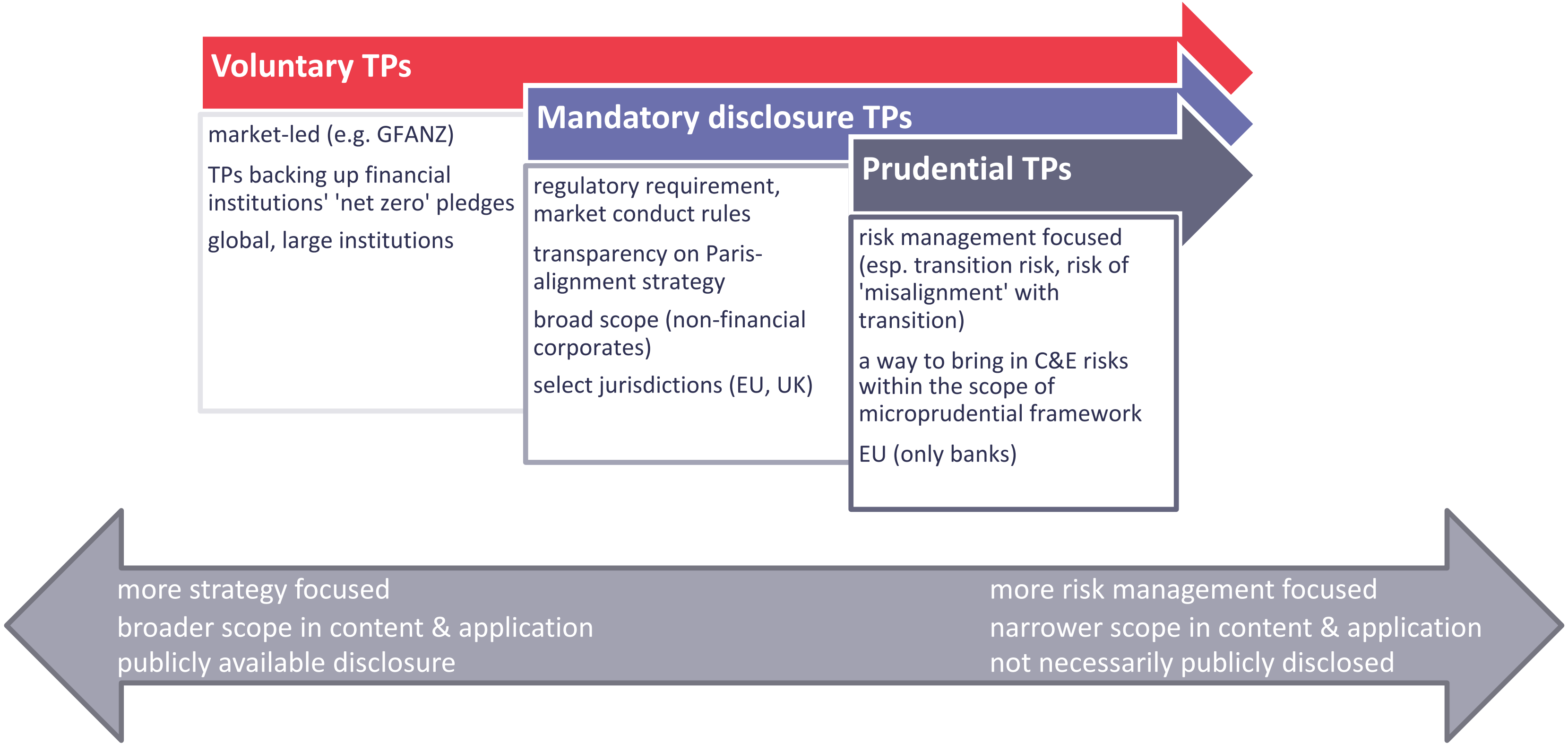
What is a 'Prudential' Transition Plan?

"the overview and articulation of the **strategic actions and risk management tools** deployed by institutions, based on a forward-looking business environment analysis, **to demonstrate how an institution ensures its robustness and preparedness for the transition** towards a climate and environmentally resilient and sustainable economy."

EBA, Consultation on ESG risk management, January 2024

What are the different objectives of transition plans?

Different Functions of Transition Plans



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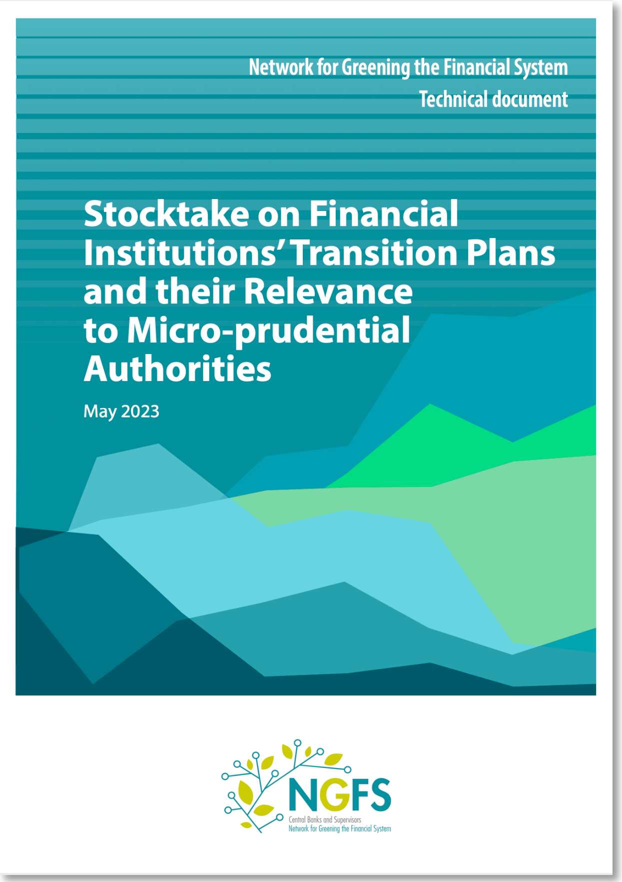
Transition planning vs transition plans

NGFS distinguished ‘transition planning’ from a ‘transition plan’

- Differentiating between what is an internal process and what is an external-facing document.
- ‘Transition **planning**’ is the **internal process** undertaken by a firm to develop a transition strategy to deliver climate targets and/or prepare a long-term response to manage the risks associated with a transition
- ‘Transition **plans**’ are a key **product of the transition planning process and are mainly used as an external- facing output for external audiences** (e.g. public stakeholders or supervisors) which represent the strategy of how firms plan to align their core business with a specific strategic climate outcome.

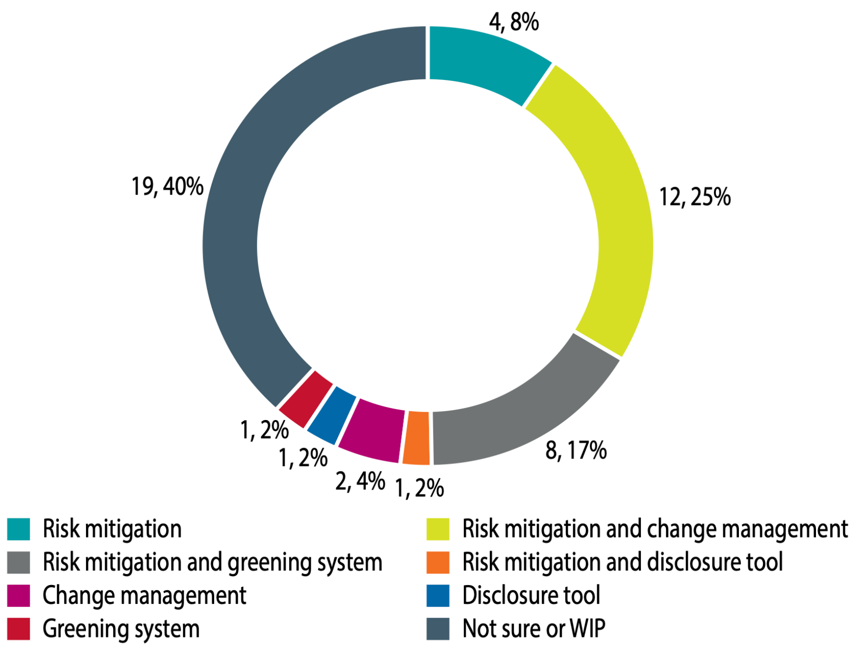


Purpose of Transition Plans

- **mandatory regime largely focused on (public) disclosures** that are more strategy focused, broader in scope and content ➔ but they can also be helpful in dealing with the complexities of C&E risks..,

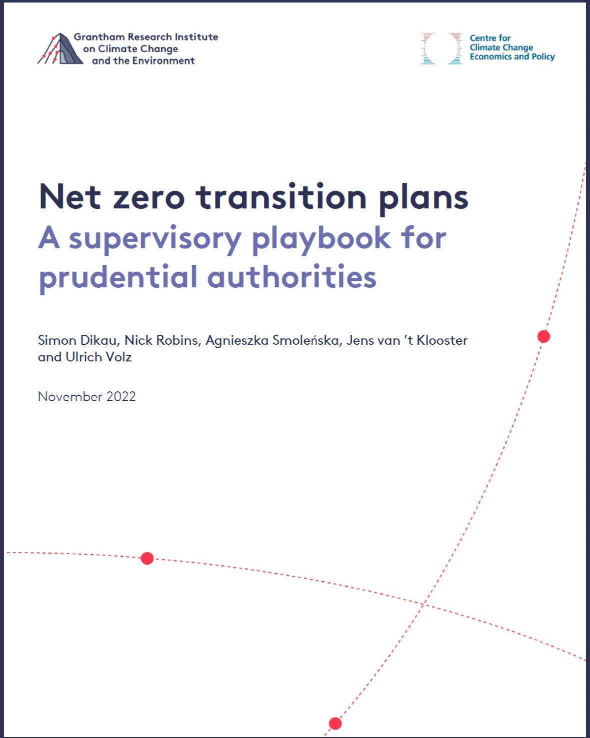
- **NGFS 2022 survey found that across the network:**
  - role of micro- prudential authorities in relation to transition plans **has not been defined**
  - no commonly agreed **definition**
  - **majority (52%) of respondents see transition plans as having a role to play in mitigating risk.**

Chart 1 **Purpose of transition plans**



Source: NGFS (2023)

What problems are prudential TPs meant to solve (in the EU)?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Net zero transition plans

A supervisory playbook for prudential authorities

Simon Dikau, Nick Robins, Agnieszka Smoleńska, Jens van 't Klooster and Ulrich Volz

November 2022

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Integrating C&E risk into the prudential framework

Basel Pillar	Overview	Progress
Pillar I – Regulatory capital requiremen ts	Banks and credit rating agencies improve their capacity to assign risk-weights to C&E risk (potentially subject to new regulatory standards). Also includes capital add-ons/buffers, large exposure limits, liquidity/leverage ratios and so on.	Discussions ongoing at legislative level in the context of microprudential reform. EBA (2023) recommendations for methodological adjustments.
Pillar II – Supervision	Banks set their strategy and risk management for C&E risk subject to supervisory evaluation and binding supervisory guidance.	C&E risk incorporated into the supervisory processes as part of 2024 CRR/CRD reform.
Pillar III – Disclosures	Disclosure rules for C&E risk together with metrics developed by banks and supervisors. Templates + definitions.	EU Pillar 3 Disclosures (2022 Pillar 3 ESG ITS).


EBI European Banking Institute

EBI Working Paper Series

2021 – no. 104

Agnieszka Smoleńska & Jens van 't Klooster

A risky bet: Should the EU choose a microprudential or a credit guidance approach to climate risk?

25/10/2021

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Source: Smoleńska and van 't Klooster (2022)

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Limitations to the management of C&E risks

- While C&E factors are drivers of traditional risk categories (credit, market) they have features that make them harder to catch within existing risk management and supervision frameworks due to:
    1. longer **time horizon** and **complexity**
    2. limited effectiveness of **backward-looking** risk management approaches
    3. lack of (quality) **data**

- **Supervisory assessment of bank transition plans can complement forward-looking scenario analysis and stress testing**

Three (prudential) functions of (prudential) transition plans

1. Prudential TPs could allow to identify any misalignment with net zero transition that may result in short- and medium-term risks **(overcoming tragedy of the horizon).**

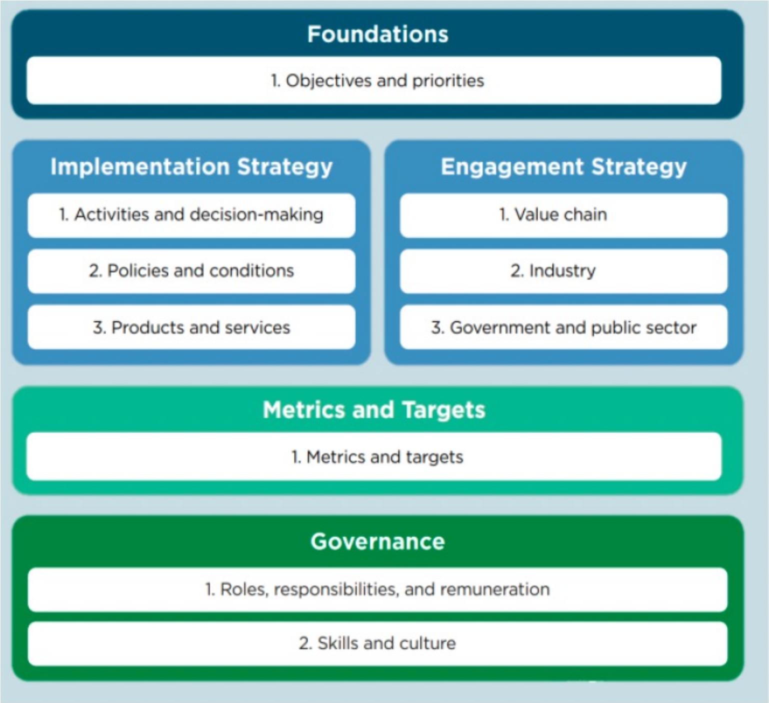
2. Prudential supervision focus on alignment could serve as a proxy for assessing banks' long-term risk **(micro-dimension).**

3. TPs could provide supervisors with a better understanding of aggregate alignment of the banking system as a whole **(macro-dimension).**

What do bank TPs currently look like?

Current practice: GFANZ

- **Foundations**
  - An articulation of the organization's overall approach to net zero across the four key financing strategies.
- **Implementation Strategy**
  - A strategy to align business activities, products, services, and policies with the net-zero objectives.
- **Engagement Strategy**
  - A strategy to engage with external stakeholders in support of the net-zero objectives.
- **Metrics and Targets**
  - A suite of metrics and targets to assess and monitor progress towards the net-zero objectives.
- **Governance**
  - A set of structures to oversee, incentivize, and support the implementation of the plan



Source: GFANZ (2022)

Current practice: ING 2022 Climate Report

The Terra toolbox

Table 3 Overview of approaches applied, output types and data sources

Sector	Outstanding in scope	Methodology used to measure portfolio	Scopes covered	Metric	Scenario / Pathway	Baseline		2021YE		Alignment score	Target vs. baseline	
						Year	Portfolio value	Convergence pathway value	Portfolio value		2030	2050
Power generation	€ 8.9 billion	PACTA	Scopes 1, 2	kg CO_2e / MWh	IEA NZE 2050	2018	335	289	223	-23.0%	-53%	-100%
Upstream oil and gas	€ 3.1 billion	PACTA Credit Application Paper	N/A	Outstanding amount in EUR million	IEA NZE 2050	2019	3,986	3,701	3,138	-15.2%	-19%	-69%
Commercial real estate	€ 10.9 billion	PCAF	Scopes 1, 2	kg CO_2 / m^2	Deltaplan DGBC	2019	51.4	48.1	43.7	-9.2%	-35%	-100%
Residential real estate	€ 297.0 billion	PCAF	Scopes 1, 2	kg CO_2 / m^2	CRREM 1.5° pathways/ IEA NZE 2050	2021	45.7	44.3	45.7	3.2%	-57%	-99%
Cement	€ 337 million	PACTA	Scopes 1, 2	t CO_2 / t cement	ISF-NZ	2020	0.704	0.681	0.709	4.2%	-31%	-69%
Steel	€ 2.9 billion	Sustainable Steel Principles	Scopes 1, 2	t CO_2 / t steel	IEA NZE 2050	2021	2.10	1.99	2.10	5.4%	0 * (~28%)	0 * (~94%)
Automotive	€ 2.4 billion	PACTA	Scope 3	kg CO_2 / km	IEA NZE 2050	2020	0.199	0.189	0.187	-0.8%	-49%	-98%
Aviation	€ 3.1 billion	PACTA	Scope 1	g CO_2 / passenger km	IEA NZE 2050	2019	88.2	82.9	130.4	57.3%	-33%	-87%
Shipping	€ 6.5 billion	Poseidon Principles	Scope 1	Alignment delta	Poseidon Principles	2020	-0.4%	0%	-6.0%	-6.0%	0% *	0% *

* Target for alignment score

Source: ING (2022)

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Current practice: HSCB 2024 Transition Plan

Overview of our financed emissions targets and sector transition approach

Sector		**HSBC on-balance sheet 2030 financed emissions targets** (versus 2019 baseline)[a]	**Key transition technologies and strategies**		**Sector approach**
Energy supply	Oil and gas	34 per cent reduction of absolute financed emissions (Mt CO_2e)	• Clean fuels • Clean electricity	• Carbon capture and storage	page 21
	Power and utilities	Emissions intensity of 138 tCO_2/GWh	• Clean electricity • Grid infrastructure improvements (inc. smart grids) and storage	• Thermal coal phase-out • Storage and flexibility • Carbon capture and storage	page 21
Transport	Automotive	Emissions intensity of 66 tCO_2/million vkm	• Electric vehicles and smart mobility • Smart mobility	• Infrastructure • Public transport improvements	page 26
	Aviation	Emissions intensity of 63 tCO_2/million rpk	• Sustainable aviation fuels • Electric, hybrid, and hydrogen-fuelled aircraft	• Improvements to operational and aircraft efficiency • Route optimisation	page 29
	Shipping	No target set; assessing data availability, methodologies and materiality of our portfolio.	• Clean fuels • Optimising vessel routes	• Improved vessel design • Clean port infrastructure	page 32
Heavy industry	Cement	Emissions intensity of 0.46 tCO_2/t cement	• Clean electricity • Clean fuels • Clinker substitutes	• Carbon capture and storage • Recycling • Energy efficiency	page 34
	Chemicals	No target set; assessing data availability, methodologies and materiality of our portfolio.	• Alternative feedstocks • Clean hydrogen • Elimination of single-use plastics	• Carbon capture and storage • Recycling	page 37
	Iron, steel and aluminium	Emissions intensity of 1.05 tCO_2/t metal	• Recycling and secondary production • Clean electricity • Carbon capture and storage	• Inert anodes • Clean fuels • Upgraded raw materials	page 39
	Mining	Thermal coal mining specific target of 70 per cent reduction of absolute financed emissions[b] Approach to be defined for other mining	• Thermal coal phase-out • Transition metals • Decarbonisation of on-site operations	• Clean electricity • CCS technology • Alternative beneficiation and extraction	page 42
Real estate	Commercial and residential	No target set; assessing data availability, methodologies and materiality of our portfolio.	• Energy efficiency • Low-carbon heating or cooling • On-site clean energy generation	• Reduce embodied emissions • Smart buildings/homes	page 45
Food, forests and other land use		No target set; assessing data availability, methodologies and materiality of our portfolio.	• Reduce Waste • Low-carbon consumption • Sustainable supply chains (preventing deforestation, low carbon)	• Nature restoration • Low carbon agriculture (precision agriculture; alternative proteins, pesticides and fertilisers; vertical farming)	page 48

[a] For further details of our financed emissions targets, see *Measuring progress* on page 84.
[b] Versus 2020 baseline.

Current practice: Deutsche Bank 2024 Transition Plan

Financed emissions

	Scope	Metric	Baseline (2021/22)	Target (2030)	Target (2050)
Oil & Gas (Upstream)	3	Absolute financed emissions ($MtCO_2/y$)	23.4	–23%	–90%
Power Generation	1	Physical emission intensity ($kgCO_2e/MWh$)	396	–69%	–100%
Automotive (Light Duty Vehicle)	3	Tailpipe (tank-to-wheel) emission intensity (gCO_2/vehicle km)	190	–59%	–100%
Steel	1 + 2	Physical emission intensity ($kgCO_2e$/t steel)	1,519	–34%	–92%
Coal Mining	3	Absolute financed emissions ($MtCO_2/y$)	7.9	–49%	–97%
Cement	1 + 2	Physical emission intensity ($kgCO_2e$/t cement)	731	–29%	–98%
Shipping	1	Poseidon Principles Portfolio Level Alignment Score (in %)	1.05[5]	0%	0%

What do ‘robust’ bank TPs look like?

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A CRD Transition Plan: Art. 76(2) CRD

‘Member States shall ensure that the management body develops and monitors the implementation **of specific plans, quantifiable targets and processes to monitor and address the financial risks arising in the short, medium and long-term from ESG factors, including those arising from the process of adjustment and transition trends** towards the relevant Member States and Union regulatory objectives and legal acts in relation to ESG factors in particular those set out in Regulation (EU) 2021/1119 (European Climate Law), as well as, where relevant, third country objectives and regulations.

The targets and measures to address the ESG risks included in the plans referred to in the first subparagraph shall consider the latest reports and measures prescribed by the European Scientific Advisory Board on Climate Change, in particular in relation to the achievement of the **climate targets of the Union**.

Where the institution discloses information on ESG matters in accordance with Directive 2013/34/EU the plans referred to in the first subparagraph shall **be consistent with the plans referred to in Article 19a or Article 29a of that Directive.**

In particular, the plans referred to in the first subparagraph shall include **actions with regards to the business model and strategy of the in**stitution that are consistent across both plans. …

A CRD Transition Plan: Art. 87a CRD

Competent authorities shall **assess and monitor developments of institutions' practices concerning their environmental, social and governance strategy and risk management, including the plans, quantifiable targets and processes to monitor and address the ESG risks arising in the short, medium and long-term**, to be prepared in accordance with Article 76(2).

This assessment shall take into account the institutions' **sustainability related product offering, their transition finance policies, related loan origination policies, and environmental, social and governance related targets and limits.**

Competent authorities shall **assess the robustness of those plans as part of the supervisory review and evaluation process**.

Where relevant, for the assessment referred to in the first subparagraph, Competent authorities may **cooperate with authorities or public bodies in charge of climate change and environmental supervision.**

Developing the framework for prudential transition plans

Expectations

- Minimum standards
- Timeline, targets, milestones, reference pathways
- Qualitative and quantitative assessment methods
- Stress test scenarios

Assessment

- Alignment of individual banks and risks from misalignment
- Alignment at the aggregate level and financial stability implications

Consequences

- Microprudential (Pillar II corrective measures, Pillar II additional capital requirements, Large Exposure Framework [Pillar I], Sanctions)
- Macroprudential (Systemic Risk Buffer [SyRB])

Source: Dikau et al (2022)

Conclusions

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Challenges of prudential TPs

- **opposition between risk management and alignment objectives?**
  - juxtaposing **business strategy vs risk management**
  - **viability of using Green Taxonomy** as a risk mitigation technique, links to **sectoral legislation**
  - single and double **materiality**
  - **internal governance** impact (whole of bank affair, lines of defence)
  - benchmarking '**robustness**' / '**credibility**'

- **cross-border cooperation and consistency?**
  - divergence of practices within the EU, in third countries and globally
  - physical/transition risk **trade-offs** across geographies

- **future telling?**
  - forecasts, trajectories, pathways, stress tests, scenarios, plans

- **scope?**
  - climate focus, but what's next?

Thank you!

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