Climate Transition Plans - The legal framework for banks

FRDO - CFDD Seminar: Climate transition plans of Belgian companies: financial, methodological and practical issues

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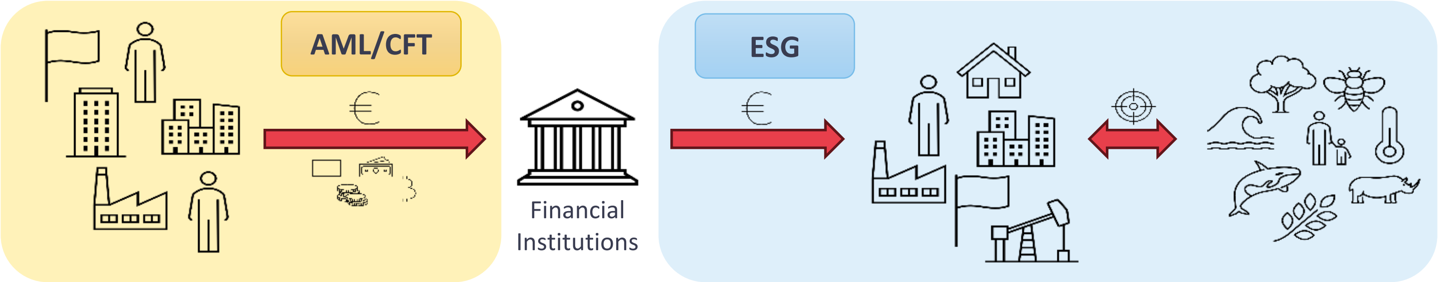
Banks as catalyst of the economy

- Financial sector has a unique position
  - with unique opportunities, risks and responsibilities

- Climate change and the societal need to transition to a carbon-neutral economy
  - poses specific opportunities, risks and responsibilities

- Economy in transition ➔ Financial sector in transition
  - **Develop transition plans to support and prepare for the transition**
    - From a double materiality perspective
      1. Financial materiality: risk, stability, resilience
         - Transition risk: Exposures to carbon-intensive sectors, stranded assets, real estate
      2. Impact materiality: supporting transition of clients



Transition plans in the EU legal framework

— For <u>all (large) companies</u>, so also for (most) banks

a) **CSRD: Disclose** in the management report - Art. 19a (2) + ESRS E1-1

- a) (iii) the **plans** of the undertaking, including implementing **actions** and related financial and **investment plans**, to ensure that its business model and strategy are compatible with the transition to a sustainable economy and with the limiting of global warming to 1,5 °C in line with the Paris Agreement and the objective of achieving climate neutrality by 2050 as established by the EU Climate Law, and, where relevant, the exposure of the undertaking to coal-, oil- and gas-related activities
- (b) a description of the time-bound **targets** related to sustainability matters set by the undertaking, including, where appropriate, absolute greenhouse gas emission reduction targets at least for 2030 and 2050, a description of the **progress** the undertaking has made towards achieving those targets, and a statement of whether the undertaking's targets related to environmental factors are based on conclusive **scientific evidence**

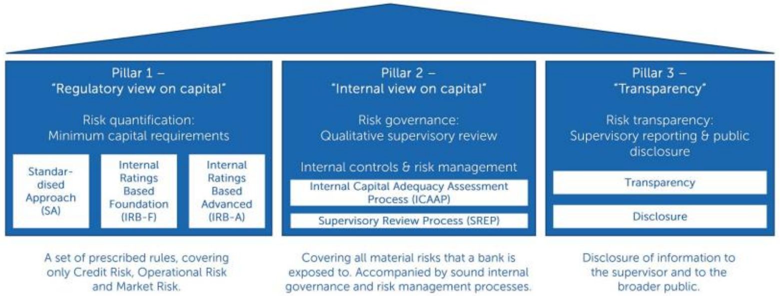
b) **CSDDD:** Requires companies to **adopt and implement** a transition plan - Art. 15

- adopt and **put into effect** a transition plan for **climate change mitigation** which aims to ensure, through best efforts, that the business model and strategy of the company are compatible … with the transition … and with the limiting of global warming to 1,5 °C …

— Specifically for <u>banks</u>: **monitor and address the financial risks** stemming from the transition

c) Prudential regulation: **Banking Package**

- Implementation of Basel IV via CRD6 and CRR3: ESG in Pillar 1, 2 and 3
- EBA Guidelines
- ECB Guidelines and Supervisory expectations



Banking package implementing Basel IV

- Agreement by EU Council and Parliament mid-December 2023
  - Capital Requirements Directives (CRD6)
  - Capital Requirements Regulation (CRR3)

- Stronger provisions related to Environmental, Social, and Governance risks (‘ESG risks’), e.g.:
  1. Banks will **have to draw up transition plans** under the **prudential framework** that will need to be **consistent** with the sustainability commitments banks undertake under other pieces of EU law, such as the Corporate Sustainability Reporting Directive (CSRD).
  2. Bank supervisors will oversee how banks handle ESG risks and include ESG considerations in the context of the **annual supervisory examination review** (SREP)
  3. ESG reporting and disclosure requirements will apply to **all EU banks**, with **proportionality** for smaller banks

‘Prudential’ (transition) plans

- CRD6 Art. 76(2)
  - The long-term nature and the profoundness of the transition may entail significant changes in the business models of banks and in the types and levels of risks they are confronted with. Thus:
    - Banks must set out plans to **monitor and address** the **financial risks** stemming from ESG factors, including those arising from the process of adjustment and transition trends towards national and EU objectives, esp. the objective to achieve climate neutrality by 2050
    - CRD ‘prudential’ transition plans must be **consistent with CSRD** plans, regarding criteria, methodologies, assumptions, and targets.

- EBA ‘Guidelines on managing ESG risk’ for practical implementation

Transition plans for banks

	CSRD	CSDDD	CRD
Scope	Larger (listed) banks	(Very) large banks	All banks, proportional
Application	2025 - …	2028 - …?	End 2025?
Context	**Disclosure**	**Governance**	**Risk management**
Obligation	Must report, if any	Must adopt & implement	Must adopt & implement
Plan	Plan to make business model and strategy **compatible** with the transition to 1,5C and net-zero	Plan for climate change **mitigation** (reduce adverse impact) and a business model and strategy compatible with the transition to 1,5C and net-zero	Plan to understand, assess and **manage** the risks of misalignment with EU sustainability targets and objectives

Consistent

Supporting

EBA draft guidelines on managing ESG risk

- The **principal reference** for financial institutions on ESG risk management
- Stipulates:
  1. Minimum standards and reference methodologies for the **identification, measurement, management, and monitoring** of ESG risks.
  2. Qualitative and quantitative criteria for the **assessment of the impact** of ESG risks on the risk profile and solvency of institutions in the short, medium, and long term.
  3. The content of **prudential transition plans**
- Part of **broader EBA work on ESG**
  - guidelines on loan origination and monitoring
  - guidelines on governance and remuneration policies
  - guidelines on stress testing and the SREP
- **Scope**
  - **All** credit institutions and some investment firms, with proportionality
  - Supervised by ECB (large banks) and BNB (smaller banks) and integrated in SREP
- **Timeline**
  - Consultation 18/1-18/4/2024 ➔ Final Q4 2024 ➔ Application Q4 2025?

EBA draft guidelines on transition plans

Definition

A **CRD-based (transition) plan** or **prudential (transition) plan** of a bank:

1. Gives an overview and articulation of
   - the **strategic actions and risk management tools** deployed by a bank
   - based on a **forward-looking business environment analysis**
2. Demonstrates how a bank ensures its **robustness and preparedness** for the transition towards a climate and environmentally resilient and sustainable economy.
3. Aims to ensure that a bank
   - **identifies, measures, manages and monitors ESG risks**, in particular environmental transition and physical risks, over long-time horizons, including through setting targets and milestones at regular time intervals.
4. Should be **embedded** in the bank's strategy and risk management
5. Addresses the **risks arising from the structural changes** that may occur within the industries and **counterparties** a bank is exposed to, according to the **transition pathways** and adaptation frameworks compatible with the legal and regulatory objectives of the Member States, EU, and where relevant other jurisdictions in which it operates.

EBA draft guidelines on transition plans

1. Key Principles of Transition Plans

- **Assessing Risks**
  - Banks need to identify significant ESG risks in their activities and portfolios.
- **Setting Goals**
  - Banks should set short, medium, and long-term goals, including a 2030 milestone to reduce greenhouse gas emissions by 55%.
- **Consistency**
  - Plans should align with the bank's overall business strategy and public communications.
- **Review and Documentation**
  - Regularly update and document plans based on new information.

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2. Governance and Responsibilities

- **Clear Roles**
  - Clearly define who is responsible for developing, implementing, and monitoring the plans.
- **Management Oversight**
  - The bank's management team should approve and oversee the plans.
- **Integrating ESG risks across 3 Lines of Defense**
  1. Business relationships officers
     - Engage with clients about their transition plans and assess alignment with bank’s plan
  2. Internal risk management and compliance functions
     - Ensure bank’s ESG risk limits are adhered to and are aligned with bank’s commitments and sector policies
  3. Internal audit function:
     - Review adequacy of bank’s plan and its effectiveness to address evolution of risk profile

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3. Defining Metrics and Targets

- **Setting Targets**
  - Define which activities and business lines are covered and set targets to manage ESG risks.
- **Regular Review**
  - Review and update targets regularly.
- **Key Metrics**
  - Track metrics like
    - financed greenhouse gas emissions
    - portfolio alignment with climate goals
    - income from high-impact sectors
    - real estate energy efficiency

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4. Climate and Environmental Scenarios and Pathways

- **Selecting Scenarios**
  - Use relevant scenarios to understand the potential impacts of climate and environmental changes on the bank's activities.
- **Consistency**
  - Ensure scenarios are consistent across the organization.
- **Sensitivity Analysis**
  - Understand how different scenarios affect the bank's risks and operations.

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5. Transition Planning Process

- **Engagement**
  - Engage with clients about their sustainability plans and integrate ESG criteria in lending practices.
- **Data Collection**
  - Gather and verify data to monitor and adjust plans.
- **Business Impact**
  - Assess how transition plans affect the bank's revenue and profitability and update risk management policies accordingly.

Specificities of CRD plans

- CRD plans are risk based, **no direct requirement to transition** only to comprehensively assess and embed forward-looking ESG risks considerations
- **No requirement to set out an objective of fully aligning** with national or EU sustainability objectives or a specific transition trajectory.
  - If not/slow transitioning, e.g. not reducing GHG-intensity of portfolios, then more measures needed to protect against higher transition risk.
  - Risk horizon: Short term (credit) risk vs long term transition
- **No obligation to exit or divest** from carbon intensive sectors
  - But banks should reflect on risks and opportunities of the transition, and should prepare or adapt accordingly
  - E.g. by engaging with and supporting their clients
- However, sound transition planning can help banks minimise the strategic and financial risks associated with the transition and provide clarity on their business strategy

Current practices in Belgian banks

- Focus on **transition of clients**
  - Retail
    - Targets and decarbonization pathways for **mortgage portfolio** (e.g. CRREM, SBTi Aligned Decarbonisation Pathways, national targets)
    - Financing and **incentivizing** net-zero buildings and energy-efficiency renovations
  - Corporates
    - Decarbonization **pathways** for high-emitting **sectors**
      - Focus and specific targets for e.g. cement, steel, aluminium, transport, energy, agriculture sectors
    - Relationship managers **engaging** with clients on their transition plans, targets, actions and follow up
      - Banks climate targets used to **steer** client engagement discussions and to **benchmark** client's GHG-reduction progress
      - Clients asked about **actions** taken e.g. to reduce CO2-emissions (real estate energy improvement, GHG-emissions action plans)
      - In some cases, new clients are only **onboarded** if their transition plans **aligned** with the bank’s climate target.
  - SMEs

Current practices in Belgian banks

- Decarbonization **scenarios and tools** used to measure and monitor alignment with the Paris Agreement
  - Science-Based Targets Initiative (SBTi)
  - Paris Agreement Capital Transition Assessment (PACTA)
  - Network for Greening the Financial System (NGFS) scenario's
  - IAE Beyond 2 Degrees scenario
  - Carbon Risk Real Estate Monitor (CRREM) scenario
  - Partnership for Carbon Accounting Financials (PCAF)
  - UNEP FI methodologies
- Climate **commitments** & **sectoral policies**
- Publication of **annual climate reports** to show progress

Challenges

- **Data availability and quality** needs to be taken into account
  - Availability and quality of data
    - Low availability of relevant environmental data from investees/borrowers to fully understand the transition challenges ahead
    - Initially much use estimates, proxies
    - Access to public databases (e.g. EPC), harmonisation between regions
  - Will improve with CSRD for large companies
  - Febelfin initiative on SME ESG data
- The expectations about the **link and consistency** between the **CSRD** transition plans (to support the transition) and **CRD** plans (for managing associated risks) needs clarification.
- The expectations on the **clients' transition plans** assessment need clarification.
  - At best only very large companies today have transition plans (SME's?)
  - Banks can develop methodologies to assess their counterparties transition plans but cannot bear final responsibility for the credibility of these plans. Banks should be able to presume that published CSRD-plans are credible, reliable, robust and sound.
    - Financial sector as catalyst and facilitator but not an enforcer of policy

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