Finance Watch
Making finance serve society

# Safe transition planning for banks

## Bringing legal certainty and comparability in an evolving prudential framework

**A Finance Watch Policy Brief**

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# Contents

## Key takeaways

**1**

**A prudential transition plan must consider deviations from a Paris-compatible trajectory:**

All credit institutions should determine the targets for their business model to be considered as compatible with the objectives of the Paris Agreement and assess the risks associated with a deviation from those targets. The EBA should formally specify that designing CSDDD-based transition plans should serve as a starting point to manage ESG risks and implement prudential transition plans. The prudential supervisors should at least verify that targets for compatibility with the Paris Agreement are defined and that they have not been rejected by the reviewer or the authorities mandated under the CSDDD and CSRD.

**2**

**Sustainability must be better integrated in the variable remuneration of directors:**

Variable remuneration provisions for credit institutions should be further detailed in the EBA guidelines 2021/04 to promote long-term decision making, in particular with regard to the adoption of transition actions. The provisions should define, among others, a minimum weight for transition plans in the employees' KPI scorecard, intermediary targets to achieve the ambitions of transition plans and more robust malus and clawback mechanisms for sustainability factors.

**3**

**The prudential framework should be adapted to integrate transition plans and better anticipate climate risks:**

The EBA should further detail how credit institutions' and counterparties' transition plans should be integrated in the risk management framework. The risk management provisions for climate risk should, in turn, see the 10-year time horizon extended to 2050. When estimating the risk, greater use should be made of forward-looking estimations based on climate scenarios to prevent downplaying the risk of deviating from the objectives of the Paris Agreement

# Executive summary

The inclusion of legislative references to transition plans in the Corporate Sustainability Due Diligence Directive (CSDDD) and prudential rules for banks and insurers increases legal certainty for credit institutions required to publish their plan under the Corporate Sustainability Reporting Directive (CSRD). However, practical implementation challenges should be addressed to ensure transition plans are credible and to prevent duplicative efforts. Transition plans may consider differing purposes and scopes, which must be reconciled to avoid greenwashing accusations and conflicting interpretations.

Legislative references to transition plans reflect distinct perspectives, leading to uncertainties over the interaction between legislative requirements and necessitating adequate guidance. Transition plans may focus on financial materiality to manage risks stemming from climate and sustainability concerns, or address double materiality, taking into account the perspective of achieving a positive impact on the institutions' environment. These plans can also either focus on climate-specific issues or cover broader sustainability matters. Finally, transition plans may focus on transitioning the company's portfolio, for example through exclusion and divestment policies, or contributing to the transition of the economy with active engagement from financial institutions. The perspective adopted for the transition plans will therefore determine the leverage actions that should be taken by credit institutions and time horizons that should be considered.

In that context, positioning transition plans within the double materiality debate is fundamental. While prudential plans focusing on financial materiality do not oblige credit institutions to align with Paris Agreement objectives, deviating from those objectives implies a higher level of risk that banks should manage, taking into account their risk appetite. To manage this additional risk, credit institutions should understand how their business model, their portfolio and their exposures should look to be considered as compatible with the objectives of the Paris Agreement. Designing CSDDD-based transition plans should therefore still be seen as a prerequisite for the design of Capital Requirements Directive (CRD) transition plans, even for credit institutions falling outside the scope of the CSDDD.

The Network for Greening the Financial System (NGFS) has proposed elements to ensure credible transition planning, which may serve as a reference tool for the EBA to further detail its upcoming guidelines. Yet, additional provisions would help bring certainty over the quality and credibility of transition plans and would facilitate meeting the ambitions:

→ **Strengthen remuneration requirements:** The requirement for credit institutions to take into account ESG risks in their remuneration policies, as specified in the EBA guidelines 2021/04, leaves too much flexibility to ensure alignment with the long term interests of the institutions. For example, the current weighting approach on remuneration indicators allows directors to perform poorly on one

indicator but still receive a large portion of their remuneration envelope. The EBA guidelines should, among others, introduce a corrective factor that may affect the part of remuneration related to other criteria. Additionally, the guidelines should identify minimum sustainability performance indicators to prevent focusing solely on the already existing governance indicators. Finally, implementing a more prescriptive approach to malus and clawback mechanisms would ensure that deferred remuneration is effectively retained in case of poor performance during the deferral period.

→ **Implement a transition risk monitoring framework:** Another crucial element concerns the alignment of clients' and investees' transition plans with the credit institution's strategy and risk appetite. As recognised by the EBA and the NGFS, engagement is a powerful tool for investors to support the transition and mitigate ESG risks that would exceed their risk appetite. However, risk mitigation from engagement actions should only be accounted for once actual results have been observed. An appropriate monitoring framework is therefore necessary to avoid unexpected risk exposure.

→ **Extend time horizon for risk management:** Transition planning as a risk management tool would require an evolution of the existing prudential framework, which has not been designed to deal with the forward-looking nature of climate risk. Expanding time horizons for transition risk analysis to 2050 is necessary for a coherent risk management strategy, in line with the EU climate commitments.

Lastly, overlaps and gaps in the supervision of transition plans—particularly between the CSDDD, CSRD, and prudential rules—must be addressed. To prevent market fragmentation and clearly define potential pecuniary sanctions in case of breach, legislators should clarify enforcement measures and ensure consistent interpretation of the requirements related to transition plans across the EU Member States.

# Introduction

Since the Renewed Sustainable Finance Strategy was published by the Commission in 2021,[1] discussions around the sustainable finance framework have **progressively switched from providing transparency tools needed to enable the redirection of capital flows to setting adequate transition targets**. Providing the means for the transition was a necessary step to prevent greenwashing practices.[2] Yet negotiations on the revision of prudential rules and the Corporate Sustainability Due Diligence Directive (CSDDD) required agreeing on setting goals to equip the financial sector with the tools to manage the risk of transition and accelerate this transition.

The agreement in trilogue discussions on the CSDDD and the Capital Requirement Directive (CRD6[3]) led to the inclusion of legislative references to transition planning. However, these positive outcomes raise **concerns over the practical implementation of the new rules**, including the conceptual debate between financial materiality and impact materiality, as well as the conditions to invest in less sustainable businesses using the rationale that their transition must be supported.

**The revised prudential rules** require credit institutions to develop and monitor the implementation of specific plans with quantifiable targets and processes to address the financial risks arising from ESG factors, including those generated by the transition, to meet the objectives of the Paris Agreement. Crucially, this implies that the CRD6 does not require credit institutions to be compatible with the objectives of the Paris Agreement, but to manage the financial risk related to ESG matters, including the risks stemming from a deviation from the Paris-aligned trajectory. Clarity over the expectations for assessing the risks of such deviation is therefore necessary.

In that context, legislators mandated the EBA to issue guidelines on the content of the plans to monitor and assess the risks arising from ESG factors. The **EBA therefore launched a consultation process** on its draft guidelines which closed on 18 April 2024. The final guidelines are expected to be published by the end of 2024.

This policy brief builds upon Finance Watch's response to the consultation[4] and provides **recommendations on the content, format and credibility of prudential transition plans**. These include **how prudential transition plans can leverage transition plan requirements** in the Corporate Sustainability Reporting Directive (CSRD) and the CSDDD, as well as **how prudential transition plans can be integrated into the existing prudential framework of the CRD.**

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1 European Commission, *Strategy for financing the transition to a sustainable economy*, July 2021.

2 Finance Watch, *A guide to the next sustainable finance agenda*, January 2024.

3 Directive (EU) 2024/1619 of the European Parliament and of the Council of 31 May 2024 amending Directive 2013/36/EU as regards supervisory powers, sanctions, third-country branches, and environmental, social and governance risks.

4 Finance Watch, *Requirements for banks' transition plans under CRD should leverage on impact materiality (Consultation response)*, April 2024.

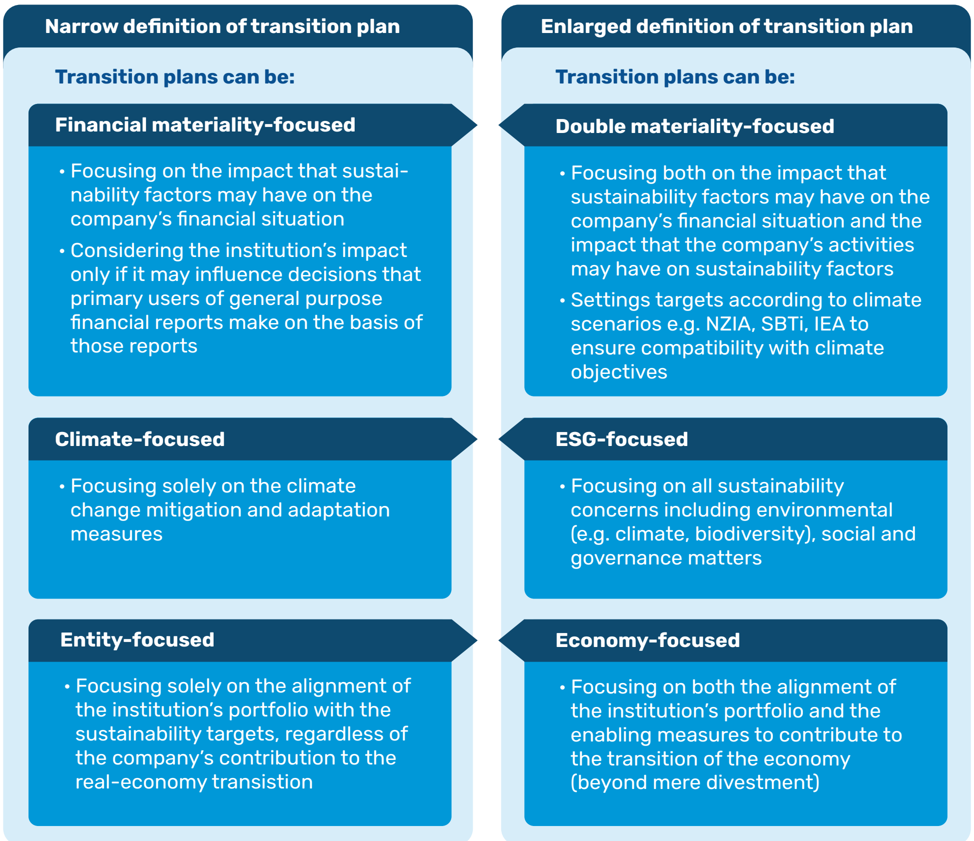
Furthermore, on 17 April 2024, the **Network for Greening the Financial System (NGFS) also published several reports on transition plans**. In one of the reports, the NGFS explores and discusses the role of micro-prudential authorities in supervising transition planning and plans. The NGFS document provides an overview of the proposed elements of credible transition planning and plans that are relevant to micro-prudential supervisors. This policy brief **will therefore take stock of the important work initiated by the EBA and the NGFS, comment on it and complete it with practical considerations**. Among others, the NGFS noted governance as an essential component of the development and implementation of credible transition plans in the context where the conflict between short-term interest in financial returns and the management of long-term climate considerations should be solved. The policy brief will build upon this consideration and address practical recommendations for the expected review of the EBA guidelines on sound remuneration policies.

# I. The concept of transition plan: A debate over double materiality and the contribution to the transition of the economy

As concerns over climate change, the role of different economic and financial actors and associated physical and transition risks have been rising, financial and non-financial undertakings have started voluntarily developing and disclosing transition plans. However, the **absence of a clear definition of a transition plan and, more widely, of transition finance has led to various interpretations** of what it entails. In its recent report "Transition planning for insurers", Finance Watch highlighted various definitions of transition plans that have been developed so far.[5]

In practice, transition plans reveal heterogeneous intentions that need to be reconciled to prevent debates and greenwashing accusations resulting from **conflicting interpretations of this concept**. Depending on the intention of the transition plan, financial institutions might focus on a specific perspective, which will determine their objectives and actions to reach these objectives. As described further, engagement may, for example, have a less prominent role for a transition plan that is entity-focused.

**Figure 1: The possible perspectives when defining transition plans**




5 Finance Watch, *Transition planning for insurers*, April 2024.

First, transition plans may focus on **the financial materiality or the double materiality principle**. The former will focus on managing the physical risk and transition risk arising from climate and sustainability concerns, in accordance with the currently existing prudential frameworks and time horizons. The latter will also take into account the perspective of achieving a positive impact on the institutions' environment.

Double materiality transition plans usually rely on climate scenarios or frameworks to define targets and achieve sustainability/impact objectives. Financial materiality transition plans also include transition targets but primarily consider the risk appetite of the institution, through careful determination of the acceptable level of sustainability risk. However, both targets overlap: managing the financial impact of ESG matters cannot be done by disregarding the institutions' impact on the environment. On the one hand, a global misalignment with the objectives of the Paris Agreement will exacerbate climate change and aggravate financial consequences on companies. On the other hand, the misalignment of a portfolio or investee companies will affect the institution's risk profile in the form of reputational risk, legal risk, transition-driven credit risk and market risk. This statement is also widely accepted by the International Sustainability Standards Board (ISSB) in its standards that focus on financial materiality.[6] Financial materiality transition plans will therefore also rely on scenarios to define what the possible economic impacts of climate change for a given greenhouse gas (GHG) emission trajectory and associated risks will be.

Second, transition plans may focus on the **climate topic or more broadly on all relevant sustainability matters.** The emergency stemming from climate concerns has indeed led financial institutions and policymakers to set the climate mitigation and adaptation objectives as a priority. However, legislative references to transition plans cover the broader range of sustainability matters, as outlined in the next section of this policy brief. For climate-focused transition plans, the Paris Agreement - despite the challenge to translate global climate targets into geographical, sectoral and corporate GHG emissions reduction targets - provides a quantifiable objective which can serve as a basis for drawing an action plan. However, transition plans covering a broad range of sustainability matters raise questions surrounding the identification of expectations for setting targets on other topics such as biodiversity, socially responsible policies and governance.

Third, transition plans may focus on **transitioning the company or contributing to the transition of the economy.** In its report "The problem lies in the net",[7] Finance Watch emphasises the crucial distinction between decarbonising portfolios and decarbonising the economy, considering the structural limits to shifting investments for the wider economy from higher to lower carbon assets. It explores the impact of decarbonising portfolios through carbon accounting techniques and divestments on the real economy transition. From an investor point of view, referring to an entity-focused

6 ISSB, *IFRS Sustainability Disclosure Standard S2: Climate-related Disclosure*, 2023.

7 Finance Watch, *The problem lies in the net*, 2022.

transition plan means focusing on decarbonising portfolios and extending this narrow logic to other activities (lending, facilitated emissions, investment advice, etc.).

This nuance is fundamental in order to identify the right leverage actions that should be taken by financial institutions and time horizons that should be considered. While transitioning a financial institution may be done through mere exclusion and divestment policies, transitioning the economy requires active engagement from financial institutions, identification of the financing needs and appropriate instruments to support the transition.

**Exclusion and divestment policies may partly incentivise** investee companies to carry out transition actions, based on the assumption that less sustainable companies will face an increase in the cost of capital.[8] However, questions remain on whether divesting from high-carbon emitters will have a sufficient effect on those emitters and therefore contribute to climate change mitigation (i.e. whether the decarbonisation of financial portfolios will lead to the decarbonisation of the world).[9] Currently, this does not seem to happen at scale and the effect of divestment policies may be limited.[10] Nevertheless, **mere divestment policies will still fall short** on several requirements:

→ The long-term horizon of the Paris Agreement, pitted against the short-term profit potential of unsustainable investments may lead companies to maintain a high exposure to fossil fuel and other economic activities that will not be able to transition and to divest (or terminate / not renew financing) before the exposure loses its market value. Such an approach would slow down the transition of the economy and exacerbate the risk of fire sales and financial crises.

→ The transition of certain sectors will require large investments and mere exclusion policies would widen the funding gap to support the transition (and indirectly limit possibilities to develop carbon neutral portfolios at scale). Based on existing estimates, Finance Watch noted that "climate change mitigation and climate change adaptation in the EU will require annual financing between €800 and €1,600 billion, i.e. between 5% and 10% of EU GDP".[11]

This debate between an entity- versus economy-focused perspective applies both to transition plans focusing on financial materiality and transition plans focusing on impact materiality:

→ From a double materiality perspective, a financial institution may decide to restrict its own negative impact and invest in sustainable activities for its business plan to meet – at a microlevel – the objectives of the Paris agreement. Or it may

8 Precious Okedele, "Do Divestiture Initiatives Raise the Cost of Capital for Fossil Fuel Companies?", October 2023.

9 Finance Watch, *The problem lies in the net*, 2022, p. 26.

10 Jonathan B. Berk, Jules H. van Bisbergen, "The impact of impact investing", October 2021.

11 Finance Watch, *Europe's coming investment crisis*, 2024, p. 21.

decide to invest in less sustainable companies to promote their transition and innovation projects that will support the transition of the economy.

→ From a financial materiality perspective, a financial institution may decide to reduce its exposure to companies or investments with a higher level of transition risk, or engage with companies to meet its risk appetite limits.

The nuance between the two approaches is particularly crucial as it will determine the possible level of ambition of the EBA guidelines for the development of prudential transition plans. Adopting an economy-focused approach for prudential transition plans is essential to ensure that the sustainability-related risks of companies in banks' investment and lending portfolios are in line with the institutions' risk appetite. Such an approach also recognises the fact that mitigating risk solely by taking into account an entity-focused perspective would eventually increase risks at a macroeconomic (systemic) level. Whether or not the institution still has exposures to companies that are not aligned with the objectives of the Paris Agreement, the institution is expected to be more exposed to macroeconomic risks, as a collapse of highly emitting sectors will impact their entire value chain as well as other financial institutions, leading to a potential contagion of the entire financial sector.

# II. The regulatory framework introduces references to a single transition plan but with differences in nature, scope and obligations

## a. References to transition plans and cross-references are integrated in the legislative framework

During the political mandate 2019-2024, several references to transition planning were added to the legislative framework that applies to credit institutions.

The **Corporate Sustainability Reporting Directive (CSRD)**[12] created an obligation for banks (and other financial and non-financial companies) to report their transition plan, including their implementing actions and related investment plans, to ensure that their business model and strategy are compatible with the transition to a sustainable economy and the objectives of the Paris agreement. The **delegated acts 2023/2772**[13] further specify the reporting requirements. For example, they require institutions in scope to report, together with their GHG emissions reduction targets, an explanation of how the undertaking's targets are compatible with the objectives of the Paris Agreement.

However, the reporting requirements remain principle-based and leave a high-level of flexibility when it comes to the kind of information that should be reported. There is, for example, little specification on the aggregation of GHG emissions reduction targets. This ambiguity may lead one company to publish aggregated targets without distinguishing its different economic activities and another to publish its targets segmented per activity. The reported reference years may also differ between companies. It is therefore likely that reported transition plans lack comparability, potentially generating an additional level of complexity when it comes to reusing the information contained in them. The current requirement also does not take into account sectoral specificities, notably the particular role financial institutions play as enablers of the transition. Acknowledging these concerns, the European Financial Reporting Advisory Group is currently developing **Transition Planning Implementation Guidance**.

The guidance should, in its current draft structure, answer a series of crucial questions on the preparation, operationalisation and reporting of transition plans:

- → What is needed to make a plan credible?
- → How is the baseline to be measured?
- → How can the scenario analysis and carbon footprint be reconciled?
- → How should the governance over the transition planning strategy be structured?

12 Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting.

13 Commission Delegated Regulation (EU) 2023/2772 of 31 July 2023 supplementing Directive 2013/34/EU as regards sustainability reporting standards.

- → How should the priorities, opportunities and dependencies be defined?
- → How should the implementation steps for transitioning be defined?
- → How should the engagement plan and intermediary targets be developed?
- → How should transition plans be disclosed?

Also, the CSRD requirement alone does not force companies to have a transition plan. The delegated acts specify that, in case the undertaking does not have a transition plan in place, it shall indicate whether and, if so, when it will adopt a transition plan.

The **Corporate Sustainability Due Diligence Directive (CSDDD)**,[14] published in the Official Journal of the European Union on 5 July 2024, solved the absence of clear requirements for companies to develop transition plans. On top of the requirement for companies to perform due diligence concerning human rights and environmental matters on the chain of activities, Article 22 specifies that companies should adopt and put in place a transition plan for climate change mitigation, through best efforts, for their strategy and business model to be compatible with the transition to a sustainable economy and with the objectives of the Paris Agreement.

The provision also specifies that companies that report a transition plan for climate change mitigation in accordance with Article 19a, 29a or 40a of Directive 2013/34/EU (CSRD) shall be deemed to have complied with the obligation to adopt a transition plan. The intention to link the CSRD and CSDDD is a welcome one but it requires careful legal analysis to prevent loopholes in the requirement, as specified in the next sub-chapter.

Finally, the review of the **Capital Requirement Directive (CRD)**[15] led to a provision for credit institutions to develop and monitor the implementation of plans and address the financial risks arising in the short, medium and long-term from ESG factors, including those arising from the process of adjustment in the context of regulatory objectives relating to ESG factors. Although the CRD does not formally make use of the notion of "transition plan", these will be defined as 'prudential transition plans' for the purposes of this policy brief.

### b. Legislative inconsistencies and differences on the focus of the legislative references lead to uncertainties regarding their interactions

The adoption of complementary and consistent transition plan provisions is a positive development. However, the legislative references differ in terms of scope, application timeline, enforcement and perspective. Several key concerns should be tackled to clarify the expectations behind each requirement and allow comparability, transparency and sound risk management.

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14 Directive (EU) 2024/1760 of the European Parliament and of the Council of 13 June 2024 on corporate sustainability due diligence and amending Directive (EU) 2019/1937 and Regulation (EU) 2023/2859.

15 Directive (EU) 2024/1619 of the European Parliament and of the Council of 31 May 2024 amending Directive 2013/36/EU as regards supervisory powers, sanctions, third-country branches, and environmental, social and governance risks.

### → Cross-references may lead to unintentional interpretations

The CSDDD states that companies will be deemed to respect the requirement to adopt a climate change mitigation plan to ensure their strategy and business model is compatible with the objectives of the Paris Agreement if the company reports a transition plan for climate change mitigation as per the CSRD.

However, Article 19a, 29a and 40a of the CSRD do not formally refer to the notion of "transition plan" and do not specifically focus on climate change mitigation. The CSRD refers to plans to ensure that the company's business model and strategy are compatible with the transition to a sustainable economy and with the objectives of the Paris Agreement. To find a reference to climate change mitigation transition plans, one must refer to the disclosure requirement E1-1 of the CSRD delegated acts.[16]

**So what's the matter?** While the CSRD clearly refers to the reporting of a plan to ensure compatibility with the Paris Agreement, the disclosure requirement E1-1 raises the question of whether a transition plan for climate change mitigation should always be reported, even if it is not compatible with the objectives of the Paris Agreement. This would mean that credit institutions are required to report their prudential transition plans. However, it may also lead to the interpretation that credit institutions will be deemed to comply with CSDDD-based transition plans simply by disclosing their CRD-based transition plan.

Ultimately, this would lead credit institutions to consider that they are not required to make their business model compatible with the objectives of the Paris Agreement.

**Finance Watch's policy recommendation:**

The European Commission should clarify that, on the one hand, the CRD transition plans should be reported under the CSRD and that, on the other hand, the CSDDD should always require companies in scope to have a transition plan for their strategy and business model to be compatible with the objectives of the Paris Agreement.

### → Legislative requirements do not yet clarify all perspectives

The legislative references to transition plans consider distinct perspectives presented in the previous section of this policy brief. The interaction between provisions referring to different perspectives leads to implementation challenges and adequate guidance is therefore necessary.

16 Commission Delegated Regulation (EU) 2023/2772 of 31 July 2023 supplementing Directive 2013/34/EU as regards sustainability reporting standards.

The CRD considers transition plans with:
- → A focus on **financial materiality**;
- → A focus on all **ESG factors**.

The CSDDD considers transition plans with:
- → A focus on **double materiality**;
- → A focus on **climate change mitigation**.

The CSRD considers transition plans with:
- → A focus on **double materiality**;
- → A focus on **all ESG factors**.

Although the CSRD considers all ESG factors, the CSRD delegated acts for the implementation focus on the climate change mitigation perspective, making the disclosure of transition plans on biodiversity voluntary, for example.

For each of the texts, the tug of war between decarbonising the economy and decarbonising the company continues, as it is unclear whether the legislative texts focus on the transition of the entities in scope or on the transition of the economy. The CSDDD and CSRD have indeed not been developed specifically for financial institutions and do not foresee this distinction. This means that credit institutions could, under the current rules, solely focus on transitioning the banks' portfolio, rather than supporting and enabling the transition of the economy.

**Finance Watch's policy recommendation:**

To prevent situations where credit institutions focus on transitioning their portfolio through a late divestment in 2030 and 2050, clear transition pathways per economic sector with regular milestones are necessary. Even if such a provision may not bring the capital flows where they are needed to support/accelerate the transition, it would have the benefit of progressively reducing exposures to high-impact sectors and reducing the risk of disorderly divestment.

### → The different scopes lead to different application scenarios and uncertainties

The legislative texts have different scopes and implementation timelines:

1. CSDDD-based transition plan requirements will be applicable to companies with more than 5,000 FTEs (Full Time Equivalent) and EUR 1.5 billion of net turnover and will ultimately apply to companies with more than 1,000 FTEs and EUR 450 million of net turnover;
2. The CSRD will ultimately apply to listed SMEs and companies meeting two of the three following thresholds: 250 FTEs, EUR 25 million on the balance sheet or EUR 50 million of revenue;
3. CRD-based transition plan rules will apply to credit institutions and investment firms in the scope of the CRD.

In most cases, credit institutions that are subject to the CSDDD will be subject to the CSRD but the opposite is not systematic. The CRD will, however, apply to almost all credit institutions. The table below illustrates the main situations that may occur in terms of application for credit institutions and the impact that this may have on their scope of responsibilities.

| Scenarios of applicable directives for a credit institution | | | Impact and uncertainties for credit institutions under this scenario |
|---|---|---|---|
| CRD | CSRD | CSDDD | |
| ✓ | ✓ | ✓ | **Impact:** Credit institutions will be required to develop double materiality transition plans that ensure that their business model is compatible with the objectives of the Paris Agreement and to report those plans. Credit institutions will also need to implement a prudential plan to consider the physical and transition risks related to climate change and the transition to a sustainable economy, taking into account their transition pathway.<br>**Uncertainties:**<br>• The supervision of the CRD is carried out by the EBA, ECB and national competent authorities while the supervision of the CSRD will be carried out by supervisors appointed according to the Transparency Directive (for the supervision of reports issued by listed companies). The supervisors for the CSDDD still need to be confirmed by Member States when transposing the Directive. This means that, while the three legislative texts refer to transition plans, their implementation may be supervised by three distinct authorities. It is therefore essential to clarify the role of each supervisor to prevent a gap - or an overlap - in supervisory responsibilities.<br>• The application of CSDDD transition plans and prudential transition plans leads to questions on how the two requirements will interact. Although there is a general consensus that convergence on the indicators and targets will simplify the application of the rules, different levels of granularity should apply in order to also account for the transition risk at the level of each counterparty. |
| ✓ | ✓ | ✗ | **Impact:** Credit institutions will be required to implement a prudential transition plan and report their transition plan. However, they will not be required to adopt a double materiality transition plan, which implies that their plan should not necessarily be compatible with the objectives of the Paris Agreement, but rather that the underlying physical and transition risks should be accounted accordingly.<br>**Uncertainties:**<br>• The scope of reporting of transition plans under the CSRD should be clarified. Currently, the CSRD does not require having transition plans and companies shall not be required to report on their transition plan if they do not have one. However, as noted above, different interpretations exist surrounding whether credit institutions that are required to adopt a prudential transition plan should report such a plan under the CSRD (knowing that they may not have the objective to be compatible with the Paris Agreement). |
| ✓ | ✗ | ✗ | **Impact:** Credit institutions will be required to implement a prudential transition plan, but will not be required to report them separately and adopt a double materiality approach. Yet, Article 449a of the Capital Requirements Regulation requires institutions to disclose information on ESG risks, including physical risks and transition risks in accordance with a disclosure format that will be specified by EBA through implementing technical standards. |

# III. Prudential transition plans require assessing the potential deviation from the objectives of the Paris Agreement

In the previous section, the ground has been set for a conceptual understanding of the transition plan references and the uncertainties related to the interaction of different regulatory requirements. The next sections further explore the concept and key elements of prudential transition plans, how the EBA guidelines can solve certain uncertainties and ensure convergence on the implementation of prudential transition plans. More specifically, this section will state fundamental principles on how prudential transition plans should leverage CSDDD-based transition plans to ensure consistent implementation. This would prevent duplicating work but also ensure that the credit institutions' targets adequately reflect their risk appetite. The following section will then provide targeted practical recommendations built on those fundamental principles.

## a. Transition risk can be broken down in three components

As prudential transition plans focus on financial materiality, they do not require credit institutions to ensure that their strategy and their business model are in line with the objectives of the Paris Agreement. **Banks will therefore not be required to meet the mandatory transition targets** related to the Paris Agreement.

Yet **deviating from the objectives of the Paris Agreement implies a higher level of risk**[17] that banks should manage. As recognized by the EBA in its draft guidelines, "*sound transition planning can help undertakings minimise the strategic and financial risks associated with the transition and provide clarity on their business strategy*". Conversely, alignment with those objectives does not protect companies from all transition risks and credit institutions should still consider appropriate risk management measures.

To better understand how decarbonisation trajectories can help assess transition risk, the exposure to transition risks could be broken down into several components:

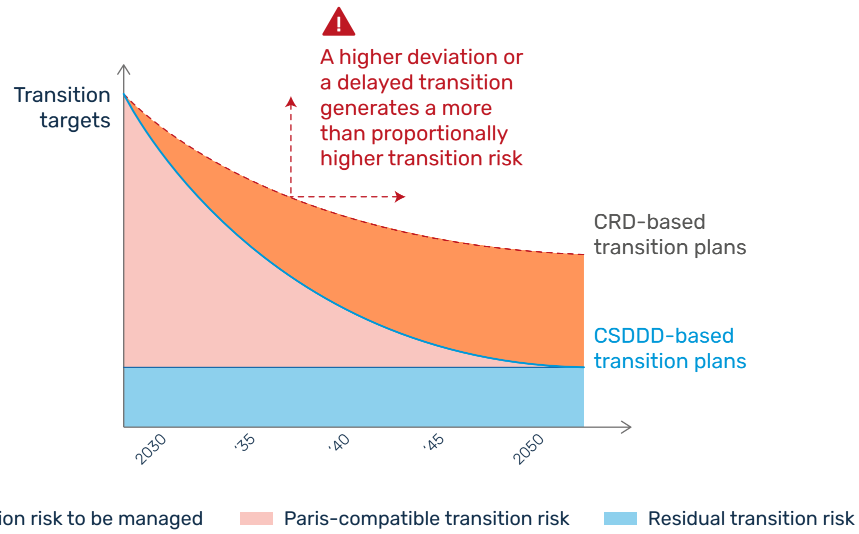
1. **The transition risk for a business model that would be off-track from a trajectory to be compatible with the Paris Agreement:** it combines the direct financial consequences of deviating from recognized pathways (e.g. controversies, legal actions, cost of capital, loss of business partners) and the risks related to deferred costs of a delayed transition, both at global level (e.g. rising costs from an increase of extreme climate events) and company level (e.g. upcoming investments that are still necessary to meet the GHG emissions reduction targets).

17 While the decomposition of transition risk presented in this section refers to micro-prudential perspective, a deviation from the objectives of the Paris Agreement may also lead to an increase in risks at macro-level as a delay in reaching carbon neutrality is expected to exacerbate the extent and consequences of climate change.

2. **The transition risk for a business model that would be compatible with the Paris Agreement**: in the case where a company has adopted a business model that is compatible with the carbon neutrality objective, the company remains subject to a residual level of transition risks stemming from uncertainties associated with future deviations from the Paris Agreement-aligned transition pathways as well as other economic factors. The development of new technologies to decarbonise the economy may, for instance, impact a business' profitability. A credit institution may finance sustainable projects to the benefit of a company that is still heavily exposed to highly emitting activities. A company may also suffer from the impact of transition on its business partners. More fundamentally, the financial stress that may arise from the collapse of sectors that would not be compatible with the objective of a carbon neutral economy would not only affect unsustainable businesses but would result in financial consequences for the entire economic system.

3. **The transition risk for a business model that would be on track (aligned with a trajectory) to be compatible with the Paris Agreement:** companies that have adopted or are adopting transition measures in accordance with transition pathways will fall in an intermediate situation where their transition risk will progressively decrease to reach the residual level of transition risk (as described above). The modelling of this risk remains crucial as the pace at which companies transition will determine their transition risk. A company that delays its transition by focusing on late divestment policies would therefore be subject to an additional level of risk that it should account for in its risk policies.

**Figure 2: The components of transition risks according to transition pathway**




## b. How to reconcile prudential transition plans and climate scenarios?

The different layers of transition risk therefore imply that the bank should assess its deviation from a Paris-compatible trajectory as well as the pace at which it is planning to implement its transition planning. This distinction is particularly important, both at entity and exposure level, given that the three layers of transition risks are of a different nature and should be accounted for and mitigated distinctively.

This distinctive approach should also be reflected in the supervision of transition plans. According to the NGFS, "*as a result (of the safety and soundness of financial institutions),* ***validating a financial institution's climate objectives and related target setting activities, such as setting GHG emission reduction targets, is generally outside micro-prudential mandates. However, micro-prudential authorities may derive insights and information from reviewing a financial institution's target setting****, especially when the activity could potentially affect the safety and soundness of the institution. That said, the NGFS recognizes the need to discuss the relevance of climate-related target setting to the micro-prudential perspective.*"

While Finance Watch agrees that validating the achievement of climate objectives is outside micro-prudential mandates, CSDDD-based transition plans should still be seen as a prerequisite for the design of CRD transition plans. Although not all financial institutions subject to the CRD are in scope of CSDDD transition plans, credit institutions need to understand how their business model, their portfolio and their exposures should look to be considered as compatible with the objectives of the Paris Agreement. Based on this, financial institutions that are not falling in the scope of the CSDDD should decide – based on their risk appetite – whether they will deviate (and to what extent) from such a plan.

As micro-prudential authorities should assess the deviation from the objectives of the Paris Agreement, it could still be argued that they should, theoretically, also validate the climate objectives and related target-setting activities that financial institutions should have for their business model to be compatible with the objectives of the Paris Agreement. However, Finance Watch acknowledges the practical challenges such a validation process entails, including the lack of resources, the development of climate expertise and the absence of a clear mandate. Therefore, prudential supervisors should focus on verifying if the targets have been set and whether these have been verified by a reviewer or the authorities mandated under the CSDDD and CSRD.

**Finance Watch's policy recommendation:**

The EBA should formally specify that designing CSDDD-based transition plans - assuming that these would be compatible with the objectives of the Paris Agreement - should serve as a starting point to manage ESG risks and develop and implement prudential transition plans. This reinforces the importance of clear rules for credible and comparable transition plans, both from a financial materiality and impact materiality perspective.[18]

The prudential supervisors should not verify the accuracy of the objective-setting, rather that targets for compatibility with the Paris Agreement are defined and have not been rejected by the reviewer or the authorities mandated under the CSDDD and CSRD.

On top of a common structure, both CSDDD and CRD transition plans should be completed with additional clarification as they serve several complementary purposes. For credit institutions, CSDDD-based transition plans require assessing the compatibility of a business model with the EU climate objectives overall. However, prudential transition plans should also require assessing ESG risks resulting from such misalignment both at the level of the counterparty and at the aggregated level, as reflected in points 30 to 39 of the EBA draft guidelines.[19]

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18 Comparing the institution's deviation from a CSDDD-based transition plan should however not be sufficient, in particular in the context where CSDDD transition plan focuses on climate mitigation while the CRD transition plan focuses on all ESG factors.

19 EBA, *Draft Guidelines on the management of ESG risks*, January 2024.

# IV. Recommendations to elaborate on the elements of prudential transition plans identified by the NGFS

The NGFS proposed a series of elements to ensure credible transition planning and plans that are relevant to micro-prudential oversight. While Finance Watch welcomes the work performed by the NGFS, it proposes completing this analysis with targeted recommendations for each of the 5 elements below:

| | Process: Transition Planning | Output: Transition Plan | Finance Watch's recommendations |
|---|---|---|---|
| **Governance** | Oversight from Board and Senior Management for developing, implementing, monitoring and updating transition plans. | Governance structure outlines the process for authorization, implementation, monitoring and updating transition plans. | Adaptation of the EBA variable remuneration guidelines for credit institutions. |
| **Engagement** | Active engagement with clients and investees, assessing the credibility of the transition plans of those that could be exposed to heightened climate risks. | Engagement strategy identifies the key clients and investees and outlines the process for collecting relevant information from them. | Integration of a notion of contribution through shareholder engagement and covenants. |
| **Risk Analysis** | Robust setting of risk appetite and risk assessment process to measure and profile all relevant climate risks. | Risk assessment result:<br>• of clients and investees and<br>• of the financial institution. | Integration of transition plans in the existing risk management framework and adaptation of existing rules to consider the nature of climate risk. |
| **Viable Actions** | Maintaining credible actions, including for financing clients and investees, with clear documentation and alignment with the overall strategy. | Action plans are developed by multi-disciplinary teams and are aligned with the risk management frameworks. | |
| **Monitoring and Reviewing** | Establish a monitoring and review process:<br>• to measure the effectiveness of mitigation and adaptation actions.<br>• for periodic review of transition plans. | Monitoring structure and metrics track the progress on a periodic basis. | Control on implementation of transition plans and regular updates based on the latest climate scenarios. |

## a. Governance: Remuneration provisions must be enhanced to promote long-term decision making

### → Remuneration

As coined by Finance Watch in its report on transition planning for insurance, "to create adequate behavioural incentives, a meaningful percentage of management remuneration should be linked to achieving transition goals in the entity's transition plan". The alignment of the remuneration and incentives of board and senior management with the operationalisation of transition plans are part of the foundational elements already identified by the NGFS.[20] Yet, influencing decision-making with regard to sustainability concerns can only be done if the rules are adequately implemented.

Credit institutions are already subject to remuneration requirements in Article 450 of the CRD and the EBA guidelines on remuneration 2021/04.[21] The guidelines require, among others, credit institutions to have remuneration policies that are consistent with the objectives of the institution's business and risk strategy, including environmental, social and governance risk-related objectives. However, there is a lot of flexibility left

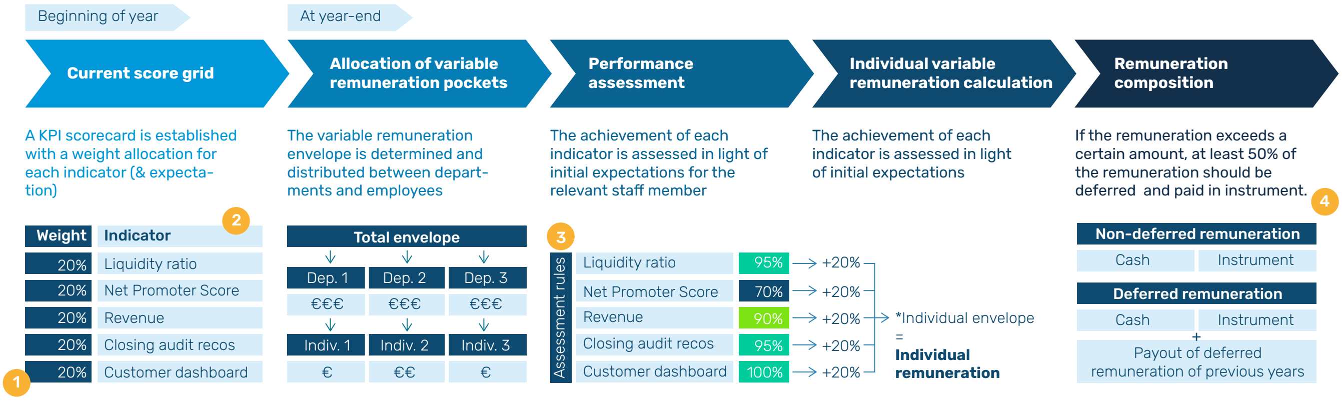
20 NGFS, *Credible Transition Plans: The micro-prudential perspective*, April 2024, p.12.

21 EBA, *Final report on Guidelines on sound remuneration policies under Directive 2013/36/EU*, July 2021.

for the institutions to develop remuneration policies that comply with the rules, including for the remuneration of risk takers and other identified staff.[22]

To understand the concerns, it is important to explain how variable remuneration for identified staff is usually defined. As a simplified representation, the process can be broken down into five key steps, some of which may take place simultaneously (see Figure 3). First, a weighted list of indicators based on which identified staff will be assessed is defined at the beginning of the financial year. The score grid will usually be approved by the remuneration committee of the credit institution to ensure that it promotes sound and effective risk management. At the end of the year, depending on the institution's performance, the remuneration committee will approve the total variable remuneration envelope and its allocation. In parallel, the performance of identified staff will be assessed based on the score grid in order to determine the percentage of the individual remuneration envelope that the employee is entitled to receive. Finally, as from a certain amount of remuneration and to promote longer term decision making, the variable remuneration should be partly deferred and partly paid in instruments subject to retention periods.

**Figure 3: Illustrative remuneration process for identified staff**




Taking this process into account, prioritising the long-term view on climate risk over the short-termism of profitability through remuneration would require considering the following:

1. Integrating new indicators in relation to climate and other sustainability matters will have the impact of reducing the weight of other metrics. More importantly, however, an assignment of weights – for a total of 100% of total weight – implies that **directors may perform poorly on one indicator but still receive a large portion of their potential envelope** (80% in the illustrative weighting). To prevent such a situation, financial institutions should introduce a corrective factor that may affect the part of remuneration related to other criteria. To do so, several options can be considered:

22 The notion of identified staff refers to staff members or categories of staff that have an impact on the institution's risk profile as per the qualitative and quantitative criteria set out in Delegated Regulation 2021/923.

→ Defining the remuneration weights so that a poor performance on one metric affects the remuneration attributed to other metrics. In the example of Figure 3, it could be decided that each indicator could lead to a decrease of 30% of the variable remuneration in case of a performance below a defined threshold, implying a theoretical decrease of 150% of the individual remuneration envelope. This means that the total remuneration would more rapidly decrease in case of mediocre performance on certain metrics.

→ Considering the sustainability criteria as separate indicators that would apply as a separate factor after calculation of the individual remuneration. Based on Figure 3, this factor could consist of a percentage of the eligible individual remuneration determined after the individual performance assessment. A director could, for example, only receive 80% of the individual remuneration if their department does not meet its climate targets, whether those targets are based on expectations of effort or expectations of results.

2. The definition of sustainability indicators should also be clear as the **term 'sustainability' may cover a large range of topics, including governance**. Without clear criteria, e.g. on targets for meeting the objectives of the Paris Agreement or contributing to the transition, credit institutions may simply consider that indicators related to risk management and internal audit are already part of the sustainability matters.

3. Beyond the selection of adequate criteria, the impact of not meeting the targets needs to be sufficient to incentivise long-term decision making. This means that an adequate **weighting of sustainability criteria needs to be complemented with robust provisions on the actual performance assessment**. In Figure 3, one could say that a department has performed poorly if half of the audit points are overdue. Yet, the decision could also be taken that half of the objectives have been met and that the director is entitled to receive half of the variable remuneration attributed to this indicator, which may seem unjustified for a poor performance. The manner in which the performance is assessed therefore has a major impact on the variable remuneration that staff members are entitled to receive, which ultimately affects the incentives for employees to act in the long-term interest of the company.

4. Currently, although credit institutions are required to defer the variable remuneration payment, it is rarely the case that the payment of the deferred amount does not happen, even when the credit institution or the employee does not perform well during the following years. A more prescriptive methodology for malus[23] and clawback[24] mechanisms should be considered.

23 A malus refers to an arrangement that permits the institution to reduce the value of all or part of deferred variable remuneration based on ex post risk adjustments before it has vested.

24 A clawback mechanism refers to an arrangement under which the staff member has to return ownership of an amount of variable remuneration paid in the past or which has already vested to the institution under certain conditions.

**Finance Watch's policy recommendation:**

The EBA guidelines 2021/04 should specify further variable remuneration provisions for credit institutions to ensure that they effectively promote long-term decision making, in particular with regard to the adoption of transition actions. The provisions should include a definition of the required weight for the achievement of transition plans in the employees' KPI scorecard, intermediary targets to achieve the ambitions of transition plans and the introduction of more robust malus and clawback mechanisms for sustainability factors.

### b. Engagement: Shareholders engagement and covenants can serve as risk mitigation tools if they contribute to the transition of counterparties

As a second element of prudential transition plans, the NGFS rightfully emphasises the importance of understanding how the clients' and investees' business and plans for the transition align with the strategy and the risk appetite of the credit institution. It refers to the need to collect information on their transition plans, assessing their risk profile and using engagement actions as risk mitigation means in the case the exposure to climate risks is not acceptable based on the credit institution's risk appetite. Engagement actions for shareholders would, for example, consist of using voting rights to push investee companies toward more sustainable behaviours while lenders, insurers and private investors can influence companies by imposing conditions and covenants in the financing agreements.

The EBA also identified engagement as a risk mitigation option in point 42 of its draft guidelines[25] and includes under this measure a requirement for banks to request and assess the soundness of at least large corporate counterparties' transition plans.

However, EBA should also clarify the **expected measures to encourage counterparties to mitigate ESG risks.** Institutions cannot consider having mitigated their ESG risks if engagement does not result in mitigating actions at the level of the counterparty or in the integration of the actual risk. Engagement, whether seen as an impact or as a risk mitigation tool, should therefore be carefully considered to ensure that the actions taken by the credit institution actually contribute to a change of counterparties' behaviour. By way of illustration, the use of voting rights to promote sustainable behaviours may only contribute to a very limited impact if the bank decides to:

1. Vote in favour of a resolution simply because it knows that other shareholders will also vote in favour of the resolution;
2. Vote in favour of a resolution simply because it knows that a majority of shareholders will never vote in favour of the resolution, which would therefore lead inves-

25 EBA, *Draft guidelines on the management of ESG risks*, January 2024.

tors to report a more sustainable engagement while knowing that it will not lead to any change in practice.

This means that, while engagement is a powerful tool for investors to support the transition, it may also lead to misleading statements on the actual sustainability level of voting decisions and the actual contribution to changing behaviour.[26] This raises an important difference between impact-focused transition plans and risk-focused transition plans: while the former should set obligations of means as shareholders and lenders do not have full control on the actual achievement of the transition targets of their investee companies, the latter requires setting targets as an obligation of results to consider that the risks have actually been mitigated. In the case the engagement actions would not lead to the expected transition risk decrease, the additional risk layer should be mitigated through other means (e.g. divestment or additional capital buffers).

As mentioned by the NGFS, engagement should be performed for companies that need to take further transition actions. A concentration of engagement with companies that are already sustainable would indeed not bring about a significant risk mitigation.

Engagement activities should therefore be linked to clear, time-bound objectives, an escalation process and a divestment strategy for off-track counterparties or counterparties with no sound and credible transition plans (assuming that the risk level of the counterparty exceeds the risk appetite of the credit institution). The use of engagement as risk mitigating action is only relevant if it results in an actual decrease of transition risk to meet the strategy and risk appetite of the credit institution. The risk reduction from engagement activities should therefore only be accounted for once actual results have been observed. Therefore, an appropriate monitoring framework is necessary to prevent unexpected risk exposure.

26 While the example refers to shareholder engagement, the same concerns apply for the inclusion of sustainability-related covenants for lending activities.

**Finance Watch's policy recommendation:**

The EBA should further detail how the mitigation of the ESG risk profile of counterparties should be accounted for in the risk assessment of the credit institution. The EBA should also specify how the credibility and the soundness of counterparties' transition plans and transition commitments (e.g. renovation of financed buildings) should be assessed in cases where those plans and commitments are not assured.

In the identification of priority counterparties where engagement should be carried out, Finance Watch also recommends that the EBA clarifies factors of criticality. The size of the exposures, but also the sector, the availability of transition plans, the location and the deviation from initial transition targets are factors that should be considered.

### c. Risk analysis: Risk management tools need adaptations to consider the nature of climate risk and should integrate prudential transition plans

As a third component, the NGFS refers to the need of assessing credit institutions' risk appetite for specific clients and investees depending on their exposure to climate risks. This requires a clear, scientific and robust methodology for setting the risk appetite and analysing the transition and physical risks of clients and investees as part of the creditworthiness assessment and ongoing monitoring. Several elements should be considered by the EBA to properly link transition plan scenarios to the risk management framework.

#### → Integration into ICAAP and ILAAP

Recognising transition planning as a risk management tool requires its holistic integration into institutions' governance, internal organisation and risk management framework, as well as capital and liquidity assessment processes (ICAAP and ILAAP). In this sense, transition planning should be seen as a specified tool to manage ESG risks.[27] Integration into risk management will ensure that transition planning is not treated as an "encapsulated" stand-alone exercise, but that transition-related risk drivers are considered by banks alongside all other risk types. This implies the following:

- → Materiality assessment of transition-related risks;
- → Setting of risk appetite, appropriate metrics and corresponding limits to define and monitor transition risks;
- → Establishment of risk assessment methodologies, processes to monitor and manage the risk on an ongoing basis (which could also mean integration into the existing processes);

27 Finance Watch, *Requirements for banks' transition plans under CRD should leverage on impact materiality (Consultation response)*, April 2024.

- → Consideration of transition-related (credit) risk drivers when building provisions for economic credit losses;
- → Estimation of the unexpected losses related to possible materialisation of transition risk and corresponding capital needs to cover these losses (i.e. internal capital);
- → Determination of the liquidity/funding needs for transition-related liquidity risk.

Integrating transition planning into the existing risk assessment and management processes is indispensable for the coherence of decision-making throughout the organisation. An example of incoherent treatment could be a situation where a credit analyst makes a credit decision without appropriate consideration of how the intended future risk exposure fits into the bank's overall transition strategy and planning.

Transition planning as a risk management tool would require an evolution of the existing prudential framework, which has not been designed to deal with this type of risk (drivers). In particular, certain aspects represent a challenge within the current design of prudential rules (these are further elaborated upon in the subsequent sections of this chapter), such as:

- → The forward-looking nature of transition risk, which necessitates a departure from historical data-based measurements towards reliance on forward-looking scenario-based assessments;
- → The need to expand to 2050 the time horizons of transition risk analyses to provide for a coherent view on transition risk in line with the global climate commitments.

Whilst some of these adjustments can be made by meaningfully interpreting the existing prudential rules, others necessitate broader adaptations of the prudential framework.[28] Furthermore, until now, efforts by financial institutions and supervisors have focused on the credit risk dimension of transition-related risk,[29] whereas methodologies to identify and assess transition risk drivers of market, liquidity and operational risk are much less developed. For none of these risk types are there established and universally recognised metrics and methodologies to assess transition risk, which leads to a disparity in the approaches adopted by financial institutions and does not yet enable comparison between risk profiles of different banks.

These considerations lead to the following conclusions:

- → Supervisors, in cooperation with the industry and other government entities responsible for the implementation of economic transition policies, need to facilitate the development and convergence of approaches to define transition risk me-

28 Finance Watch, *Lost Momentum: The evolution and challenges of Basel III*, September 2024 Chapter 7.

29 ECB, *Risks from misalignment of banks' financing with the EU climate objectives – Assessment of the alignment of the European banking sector*, January 2024.

trics and assessment methodologies.[30] Transition risk measurement should notably encompass the deviation of a company (asset) from recognized pathways aligned with the Paris objectives. Conceptually transition risk can be considered a sum of components, as presented in Chapter III of this policy brief.

→ The current focus of transition planning should be on preventive (precautionary) mitigation actions and whole economy transition (i.e. economy-focused transition planning), since late and disorderly transition represents a much more significant financial stability risk than timely and orderly transition. This puts client engagement and mitigation of negative climate impacts in focus, as explained above.

### → The time horizon for managing ESG risks

First, the deviation of companies' transition plans from the Paris Agreement implies an increasing risk over a period of more than 10 years. It is expected that the transition and physical risks for counterparties that do not have a clear plan for their business to be compatible with a low carbon economy will be progressively more acute. The 10-year time horizon proposed by the EBA therefore remains insufficient. A 2050 time horizon is necessary to take into account the transition risk perspective and the necessary transformations that need to happen to meet the objectives of the Paris Agreement.

### → The use of climate scenarios and stress-testing to assess the risks associated to counterparties' plans

The NGFS also notes that climate scenario analysis and/or stress testing could be key tools to measure the size and type of risks that can be accepted at both individual and sectoral levels for credit institutions' clients and investees. Using scenario analyses will allow to stress risk vulnerabilities and make sure sufficient risk-bearing capacity and plans for management actions are put in place for possible stress conditions. However, there needs to be a radical rethinking of the approach to climate scenario modelling. The scenario analyses conducted to date clearly concluded that orderly and timely transition is less costly for the economy and the financial sector, whereas disorderly or absent transition represent financial stability risk. Yet, in case of disorderly transition, the results have predicted only benign impacts of climate change on the financial system, giving a false sense of security to policymakers.

Such results are in stark contrast with climate science, which predicts major macroeconomic disruptions at warming levels above 2°C. The reason for this paradox lies in the economic models used for climate scenario analyses.[31] These models – known as dynamic stochastic general equilibrium models (DSGE) and integrated assessment models (IAMs) – were developed to deal with traditional financial risks and are not

30 Finance Watch, Response to the EBA Discussion Paper on Environmental Risks in the Prudential Framework, August 2022, Q5; Finance Watch, Response to the BCBS consultative document Disclosure of climate-related financial risks, March 2024, Q1-3.

31 Finance Watch, *Finance in a hot house world*, October 2023, p.13.

suitable for climate-related risks. They rely on historical data and make assumptions about economic equilibrium that may no longer apply, as climate-related impacts will be disruptive, unpredictable and permanent. Tipping points and feedback mechanisms are not modelled, whereas they could accelerate losses to levels far above those from recent financial crises. A major modelling flaw is the assumption that economic damages from climate change are a quadratic function of the warming level.

### → Applying proper risk analysis regardless of the risk appetite

Finance Watch argues that all institutions should implement ESG risk management approaches that reflect the materiality of ESG risks associated with their business model and scope of activities. In that context, all credit institutions should make use of their transition targets and the transition plans of their counterparties to assess their risk exposures and determine the necessary mitigating actions. Finance Watch acknowledges that proportionality should apply for small and non-complex credit institutions and less complex or sophisticated arrangements could be implemented, as proposed in points 20 to 23 of section 3 of the draft EBA guidelines.[32] Yet, the proportionality principle should not be based on the risk appetite of credit institutions.

On the one hand, institutions with a higher risk appetite could substantially deviate from the objectives of the Paris Agreement. However, it is important that the additional risk related to such deviation is adequately assessed and that credit institutions are in a position to identify, accurately measure the risk and ensure they are supported by sufficient risk-bearing capacity (own funds/capital). Therefore, a higher risk appetite should be supported by robust risk assessment, strategies to manage the risk and adequate resources to bear higher retained risk.

On the other hand, credit institutions with a lower risk appetite should also not benefit from more flexibility in their risk assessment to avoid overlooking or underestimating ESG risks and prevent taking risk for which the institution would not have adequate management processes and/or risk-bearing capacity. Since for certain business models or portfolios the materiality of ESG risks may be more limited, the risk management actions will be proportional to the actual risk exposure. However, this should not be a reason to implement less robust risk identification, or explicitly introduce a proportionality approach for risk assessment, engagement with counterparties, and internal reporting metrics.

Risk management measures and mitigating actions will naturally depend on the materiality and the level of ESG risks identified. The proportionality approach proposed in the draft EBA guidelines should therefore not be extended to the risk appetite and the business model of the institution.

32 EBA, *Draft Guidelines on the management of ESG risks*, January 2024.

### → The convergence on scenarios for a common baseline to risk analysis

In February 2024, the International Capital Market Association (ICMA) published the report, "Transition Finance in the Debt Capital Market" and proposed the convergence of best practices on transition plans. Finance Watch believes that this recommendation should be followed and that there should be greater convergence in terms of scenarios to be used by banks. Comparability is a pre-condition for supervisors to review and benchmark transition plans for the Supervisory Review and Evaluation Process (SREP). Finance Watch therefore encourages the EBA to work with other EU supervisory authorities - including non-financial authorities - to establish a set of scenarios for common use, as well as encourage further cross-institutional work on the sufficiently granular regional and sectoral pathways. The use of IEA scenarios – despite the need to solve the concerns around the lack of granularity – should be considered to ensure that transition plan targets are credible.

Moreover, there is a great deal of flexibility in how transition plans must be presented. Effective supervision alone will not resolve the comparability of transition plans. A consistent and standardised presentation of the information, targets and operationalising actions is therefore necessary to enable proper comparison and evaluation of these plans.

**Finance Watch's policy recommendations:**

- → The EBA should integrate requirements on the plans that institutions will have to establish and implement - in accordance with CRD Article 76(2) - into the existing governance and risk management framework concerning treatment of ESG risks. The time horizon of climate risk management should be extended beyond 10 years. When estimating the risk, greater use should be made of forward-looking estimations based on climate scenarios to prevent downplaying the risk of deviating from the objectives of the Paris Agreement.
- → In order to facilitate consistency of institutions' approaches to transition risk, as well as meaningful supervisory benchmarking, the EBA should work with other supervisory authorities and EU regulators to establish harmonised definitions of relevant forward-looking measures/metrics for transition-related risks.
- → The EBA, in coordination with other standard setters, should provide more granular instructions on the content and the format of transition plans in order to guarantee the comparability and the quality of the exercise performed by institutions. The key elements that render transition planning and plans credible from a micro-prudential perspective should be clarified. Convergence between financial institutions on the use of reference scenarios should be promoted.

### d. Viable actions: The importance of clear documentation and consistent financing actions

The NGFS emphasises the importance of clear documentation and alignment of transition planning with the institution's overall strategy. Financial institutions must be able to explain how their major future financing actions align with their climate goals and how relevant departments are involved in the development and execution of these actions. This is a prerequisite for the development of a consistent strategy and hence reaching the targets.

This requirement entails the need to integrate transition ambitions into the existing risk management processes. A coordinated strategy, combined with a decentralised implementation of financing targets and limits, will:

- → Promote the integration of consistent objectives within each department;
- → Foster the commitment of all relevant stakeholders to meet the targets;
- → Prevent deviations of aggregated exposures from the strategy and credit institution's risk appetite.

### e. Monitoring and reviewing: Transition planning is an iterative journey

Finally, the NGFS highlights the need for monitoring and reviewing by the institution, in particular the implementation of appropriate internal controls and monitoring processes, as well as long-term risk mitigation and adaptation metrics and/or KPIs to check whether the risk mitigation practices are executed.

Governance rules should also be defined for monitoring and review of transition plans to ensure that senior management is responsible for the oversight of transition plan implementation and to ensure proper execution of the targets' review. The monitoring of progress should also imply risk reassessment & corresponding corrective measures, if necessary.

**Finance Watch's policy recommendation:**

The EBA should further detail the role of senior management in the control of the implementation of prudential transition plans and ensure that the transition plans are regularly updated based on the latest climate scenarios.

# V. The role of supervisors and the limited visibility on the sanction framework

In the last section of its report, the NGFS explores the different mechanisms of supervision, including supervision by micro-prudential authorities and/or supervision by third party providers and their respective advantages and consequences. In the European context, supervision of transition plans will involve both micro-prudential supervisors and third party providers. On the one hand, prudential transition plans are referred to in the CRD6 and imply that certain elements of transition planning will have to be reviewed by the EBA. On the other hand, the disclosure of prudential transition plans as required by the CSRD would require their review by external auditors.

Although supervisory considerations are not the focus of this policy brief, it is important to note that several elements will have to be clarified to support the credibility of transition plans.

First, the requirement to develop prudential transition plans is linked to the CSDDD and CSRD and overlaps and gaps in the supervision of transition plans should be avoided. The EBA and authorities in charge of financial stability play a key role in the enforcement of prudential rules. For the supervision of the CSRD, the authority appointed in accordance with the Transparency Directive has to be referred to. Moreover, authorities in charge of the supervision of the CSDDD are still to be defined by Member States when transposing the CSDDD. It is therefore essential to clarify the roles of each supervisor.

Second, the level 1 legislative acts provide limited details on the supervision processes and how the credibility of transition plans should be assessed. Legislators should therefore specify enforcement measures to ensure rules are followed. Special attention should be given to how the rules are interpreted across different EU countries to avoid market fragmentation.

Third, there is uncertainty surrounding the consequences that companies will face if they breach sustainable finance rules. It is for example the case for the Taxonomy Regulation and the Sustainable Finance Disclosure Regulation (SFDR), where a link should be made with the sanction framework under the Unfair Commercial Practice Directive (UCPD). Disclosures that do not comply with the Taxonomy Regulation and SFDR would indeed be interpreted as unfair commercial practices. Consequently, the sanctions defined by Member States in the law transposing UCPD could apply. However, it remains unclear whether any breach of the two regulations should be considered as an unfair commercial practice, leaving legal uncertainties to be solved. In some Member States, such as Luxembourg, specific circulars have been published to clarify the potential sanctions for such breaches.[33] Thus it is important to clearly define the sanctions – whether pecuniary or non-pecuniary – that companies may face.

The CRD6 included institutions' prudential transition plans into the scope of the SREP so that supervisory powers given to the prudential supervisors by the Directive apply.[34] These powers (CRD Article 104) were explicitly extended to provide the competent authorities with the ability to "*require institutions to reduce the risks arising in the short, medium and long term from ESG factors, including those arising from the process of adjustment and from transition trends in the context of the relevant Union, Member States or third-country legal and regulatory objectives, through adjustments to their business strategies, governance and risk management for which a reinforcement of the targets, measures, and actions included in their plans to be prepared in accordance with Article 76(2) could be requested*". Clarification of the requirements on the scope and contents of prudential transition plans, as highlighted in the previous chapter of this policy brief, is thus necessary to better define the scope of the SREP review and provide legal certainty for prudential supervisors and banks on how supervisory powers per the CRD will be exercised.

33 Loi du 25 février 2022 portant modification du règlement (UE) 2019/2088 du Parlement européen et du Conseil du 27 novembre 2019 sur la publication d'informations en matière de durabilité dans le secteur des services financiers et du règlement (UE) 2020/852 du Parlement européen et du Conseil du 18 juin 2020 sur l'établissement d'un cadre visant à favoriser les investissements durables et modifiant le règlement (UE) 2019/2088.

34 CRD Article 97(9) was added to extend the scope of the SREP to stipulating that "institutions' exposures to ESG risks shall be assessed also on the basis of institutions' plans to be prepared in accordance with Article 76(2)."

# Conclusion

The outcome of recent legislative developments on transition planning is a major legislative milestone. Yet, it leads to many practical questions that will need to be answered during the mandate 2024-2029. While the work performed by the financial sector to develop their own transition plans through voluntary initiatives will support the identification of good practices, it should not limit the ambitions of the legislators and the supervisory authorities to clarify the expectations at a sufficiently granular level. Legal certainty and more precision on the expectations for the implementation of credible transition plans will ultimately enhance the comparability of the transition plans and facilitate their implementation in the longer term.

The early work from the EBA on the guidelines on the management of ESG risks will partially clarify the current expectations and the principles for consistent and documented prudential transition plans. However, the flexibility left by the draft guidelines and their current level of detail may undermine the quality of the exercise and could lead institutions to perform a purely administrative exercise to justify not changing their approach to the management of ESG risks.

Clear integration of transition planning in the risk management framework, a radical rethinking of the approach to climate scenario modelling, sound corporate governance practices supporting the achievement of climate targets and effective engagement with their clients and counterparties to contribute to changing behaviours are needed. These measures will be crucial to (1) prevent duplicative work through the development of transition planning as a separate exercise that would not be adequately considered in the existing risk mitigating tools, (2) assess the actual sustainability risk level that credit institutions are bearing and (3) align transition plans with the institutions' risk appetite.

## About Finance Watch

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Its mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large number of European citizens. Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society. For further information, see www.finance-watch.org

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