

## Workshop Summary Note

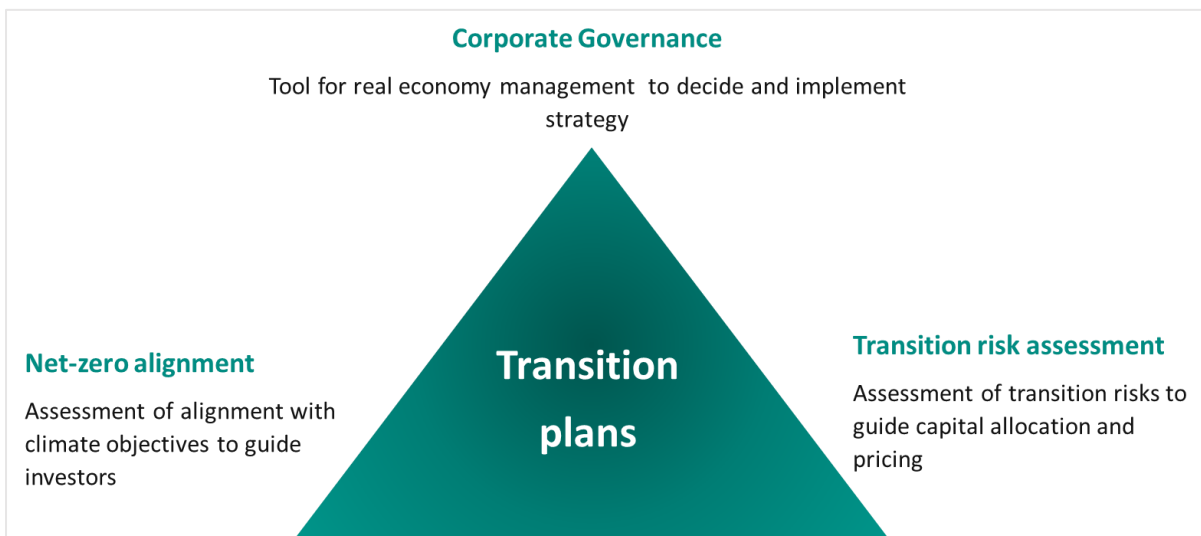
### Making transition plans work – Research and practice perspectives on transition plans and transition risks assessment

Tuesday, 24 September 2024 | 09:00-16:00 CET

Expectations are high that transition plans (TPs) will drive the decarbonization of the economy. However, companies often lack clarity on how their transition plans are utilized. **Strengthening the alignment between transition plans of financial institutions and businesses is crucial to ensure consistent climate action across sectors.** Additionally, there is a gap between the ESG and/or transition metrics reported by corporates and financial metrics used by financial institutions. Bridging this gap requires deeper collaboration and dialogue between the financial sector and corporates.

In our joint workshop we discussed **with representatives from academia, banks and corporates three use cases of TPs** and how these perspectives can be better aligned in the future:

- For corporates, transition plans should be a strategic management tool, not only a reporting exercise
- The financial sector needs credible information for their own strategic decisions and net-zero alignment
- Financial institutions (and financial regulators) need TPs to assess climate transition risks in their portfolios to reduce (systemic) financial risks and guide capital allocation and pricing



Five main areas of improvement were discussed and emphasized. For each solution, the main discussion points are summarized below.

## 1. More guidance on underlying scenarios

Global scenarios need to be broken down at sector and country level, with sector specific metrics and scenarios. However, establishing common sectoral scenarios for each country will imply difficulties for niche industries. **In addition to implied temperature rise or CO2 pathways, policy scenarios beyond only carbon pricing need to be considered.** This broader perspective will provide a more comprehensive understanding of the potential impact on business and sectors and will allow firms to better anticipate developments and design a suitable strategy.

While scenarios from the Network for Greening the Financial System (NGFS) offer a usual starting point for most actors, they are not suitable to assess transition risks and opportunities at company level – e.g. how would a firm respond to an economy wide accelerated transition to climate neutrality. Some banks are addressing this by developing their own (stress-test) scenarios, leveraging firm-level data and adopting a credit rating approach where possible.

Currently, global climate scenarios have limited relevance in practical terms: For businesses, the immediate impact on operations is low, and for financial institutions, the effects on their gross domestic product are minimal, especially in the short term. To effectively evaluate potential transitions risks stemming from more stringent climate policies, the introduction of an **accelerated transition scenario** may be necessary. Companies can use this scenario to demonstrate their resilience and readiness for a faster transition pathway (see also 5).

## 2. Improving data availability and access

Relying solely on reported or estimated emissions data at the company level, which often involves varying standards and scopes, is insufficient to capture the dynamics of the transition at the firm level. **Asset-level data can offer a more precise understanding of emissions, particularly when paired with sector- and country-specific metrics and scenarios.** This level of detail, although challenging to assess, may help to better measure and track developments of different industries and regions, albeit on its own is likely insufficient to assess transition risks.

## 3. Better harmonization of EU regulation on transition plans

Better harmonization of EU regulations on TPs (e.g., CSRD, CSDDD, and CRD) is crucial to streamline the compliance process and enhance clarity for businesses and financial institutions alike. **Accessible implementation guidance across these regulatory frameworks would significantly reduce complexity.** This could reduce the reporting efforts for real economy firms that are otherwise approached with a variety of questionnaires and reporting demands. From a business perspective, disclosure of financial details beyond what is required by regulation could be a competitive disadvantage, leading to concerns about confidentiality and exposure of sensitive information. **A common framework for TPs covering the expectations from investors and banks would thus be helpful to ensure equal treatment.**

## 4. Highlighting the case for transition risk assessment at firm level

In the long-run, public policy frameworks are expected to be aligned with international climate objectives, as defined in the Paris Agreement, and TPs will need to be aligned with the policy framework.

However, **so far national policy frameworks are not aligned with the Paris climate objectives as the global stock take of the UNFCCC just concluded.** Hence, even if aligned with the current national policy frameworks, firms' strategies will be insufficient to reach the Paris climate objectives and **transition risks and opportunities will materialize for these firms, if the public policy framework is strengthened.** This will likely be correlated across many countries, for example in response to a major climate disaster capturing public attention.

If systemic risks materialize, the government and therefore the public must bail out individual financial institutions (and corporates) to secure the financial system. This anticipated bail-out undermines the incentives for proper risk management for financial institutions.<sup>1</sup> The current situation may be one of the reasons that financial institutions

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<sup>1</sup> See also Carney, M. (2015). Breaking the tragedy of the horizon—climate change and financial stability. Speech given at Lloyd's of London, 29, 220-230.

primarily utilize TPs for engagement and alignment, and not for risk assessments and capital pricing. The existence of systematic risks can be a justification for regulatory requirements and monitoring of transition risk management.<sup>2</sup> Financial institutions can then respond to transition risks by engaging with real economy firms, or, alternatively, adjusting volumes or altering pricing strategies to manage transition-related risks. In turn, this would incentivize and support firms to implement effective net-zero strategies to thus reduce transition risk.

## 5. Guidance to facilitate comparable quantitative assessment of transition risks

**To date, financial institutions and regulators struggle to quantify transition risks at the asset and company level. Hence, they primarily use economic models that estimate transition risks at the sector level.** Moreover, the GDP effects projected in global scenarios, such as those from the NGFS, are minimal and need to become more detailed and better account for carbon cost pass-through and changes in demand and market shares. **Hence, a quantified transition risk score at the company level is necessary for risk management.**

Temperature ratings of companies are a good tool from an alignment perspective, but the data is – even if at high quality – not fully correlated with transition risk exposure of a firm and thus insufficient to serve as a financial risk score. Likewise, the carbon footprint of a firm has been explored as indicator for transition risks scores but exhibits similar shortcomings. A transition risk score requires information on the response strategy a company can implement to respond to an accelerated transition to net-zero. This would allow for an assessment, not only of direct carbon costs, but of potential changes to the markets a company is serving and its capability to meet the changing demand.

**Overall, TPs are not only a reporting exercise but are vital for corporate strategy and as tool to engage with stakeholders, including investors and policymakers. Investors and banks have a key role in engaging with and supporting companies' TPs, helping drive progress toward climate goals.**

### Organizing partners

- DIW Berlin: Karsten Neuhoff, Catherine Marchewitz, Franziska Schütze, Anja Engelhardt, Fernanda Ballesteros
- Frankfurt School of Finance & Management: Karol Kempa, Ulf Moslener
- I4CE: Julie Evain
- London School of Economics, CETEx: Agnieszka Smoleńska, Simon Dikau
- University of Oxford: David Kampmann, Gireesh Shrimali
- University Gießen: Alix Auzepy, Christina Bannier

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<sup>2</sup> Currently, climate stress tests are pursued under Pillar II and ICAAP (Internal Capital Adequacy Assessment Process) for risk quantification and capital adequacy. For financial institutions there may remain incentives to downplay transition risks, especially since those risks are perceived as low and potentially of systematic nature. This short-term view may lead to an underestimation of the long-term risks associated firm level strategies inconsistent with Paris climate objectives. It is therefore important to explore, how the regulatory framework under Pillar II might be improved and how, such risks could be assessed under Pillar I.