Prudential transition plans and the role of supervisors

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Institute for Climate Economics

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#Mission

The Institute for Climate Economics (I4CE) is a non-profit research organization that provides independent policy analysis on climate change mitigation and adaptation.

We promote climate policies that are effective, efficient and socially-fair. Our 40 experts engage with national and local governments, the European Union, international financial institutions, civil society organizations and the media. Our work covers three key transitions – energy, agriculture, forest – and addresses six economic challenges: investment, public financing, development finance, financial regulation, carbon pricing and carbon certification.

Comprehensive transition plans for banks

- **Long-term goal** of carbon neutrality by 2050 ;
- Determination of a **global decarbonisation strategy** for the bank, broken down into **sectoral decarbonisation pathways;**
- Sectoral pathways **in relation with national and European transition plans;**
- **Interim targets** of sectoral GHG emission reductions with a **focus on supporting the transition efforts of clients**
- Use of **carbon offsetting for residual emissions.**

→ The plan ensures that internal processes are consistent with this vision.

What role for the supervisor : making sure the bank is on track

- Assessing the **bank's transition plans soundness and robustness**
- First transition plans by banks have proven quite deceptive → **key role of supervisors**
- Study from NGO Reclaim Finance that found out :

  - Banks have set up **unnecessarily complex and opaque mix of target types**, most of which fail to create a direct link between achieving targets and reducing corporate emissions.

  - Only **two of the 13 distinct types of targets** used by the 30 banks are likely to be effective in driving decarbonization.

What role for the supervisor ?

- EBA's position : prudential transition plans with a risk focus
- Assessing that bank's structure and processes are consistent with the plan
  - Targets connected with national or EU trajectories → actual impact on the real economy
  - Risk management process
  - Evolution in human ressources : general training + specific profiles
  - Collection of appropriate data
  - Coherence of remuneration scheme

Making sure the bank is on track

Using the **appropriate tools** to allow the **structural transformation of banks** :

- General training for executives, board members, risk committee members and managers;
- Governance evolution,
- Fit and proper tests
- Concentration limits
- Strengthening of risk management
- Revision of the variable remuneration policy
- Capital add-ons

Focus on variable remunerations

- With the introduction of transition plans, banks have to review their internal governance to make sure the transition plan is enforced

- One of the key lever to implement the transition plan is remuneration policies

- Remuneration policies and transition plans objectives are not yet consistent
  - Teams can be incentivised against the TP
  - A good remuneration scheme could accelerate the implementation of the TP

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