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Centre for Economic Transition Expertise

Research and Policy at **LSE**

Integrating bank transition planning in prudential supervision

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20 May 2025

THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

Grantham Research Institute on Climate Change and the Environment

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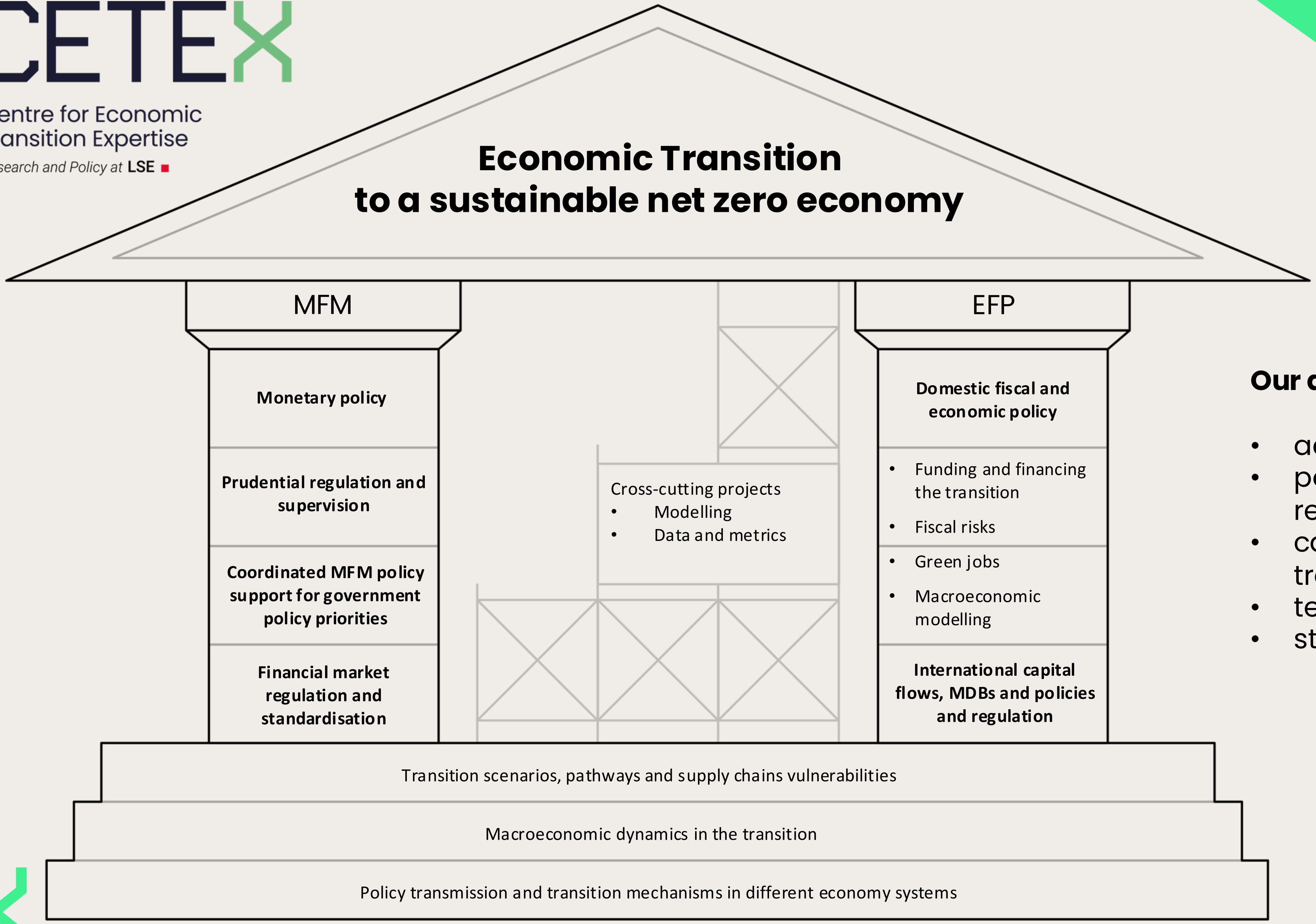


Our activities:

- academic research
- policy analysis, blueprints, reports and briefings
- capacity development and training
- technical assistance
- stakeholder engagement

State of climate change risk integration in the banking sector and the potential of bank transition plans

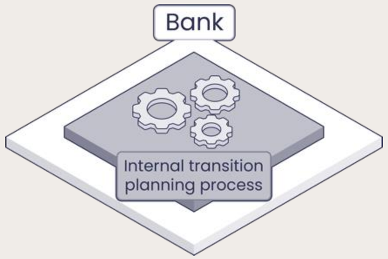
- Climate and environmental risks are **material to banks and other financial institutions.** Evidence suggests **that banks currently underestimate these risks, and therefore manage them inadequately.** This has **financial stability implications across Europe including in Germany** (ECB, 2022, ECB/ESAs, 2024, D'Orazio, Hertel, Kasbrink 2024, Gross et al 2025) and distorts the pricing incentives in the transition.
- Past work has shown that **TPs** are a valuable new source of forward-looking information that is relevant to **banking supervision** (Dikau et al. 2021, Dikau et al. 2024, NGFS 2024).
- EU has introduced a suite of regulatory tools to improve risk governance and facilitate flows of capital to transition by reducing information asymmetries. These tools:
    - close data gaps
    - extend time horizons
    - support emergence of new financial instruments targeted for the transition

Transition Plans

State of climate change risk integration in the banking sector and the potential of bank transition plans

- Past work has shown that **TPs** are a valuable new source of forward-looking information that is relevant to **banking supervision** (Dikau et al. 2021, Dikau et al. 2024, NGFS 2024).
- Transition plans [**TPs**] are increasingly recognised as a tool with many use cases in the governance of the low-carbon, climate-resilient transition.
- However, their success hinges on consistent implementation and supervisory practices.
- **"Integrating bank transition planning in prudential supervision"** outlines how transition plans and transition planning can be practically integrated in existing supervisory practices, supporting:
    - regulatory efficiency
    - financial stability
    - public policy objectives related to the transition

Key concepts: Transition plans vs. transition planning*



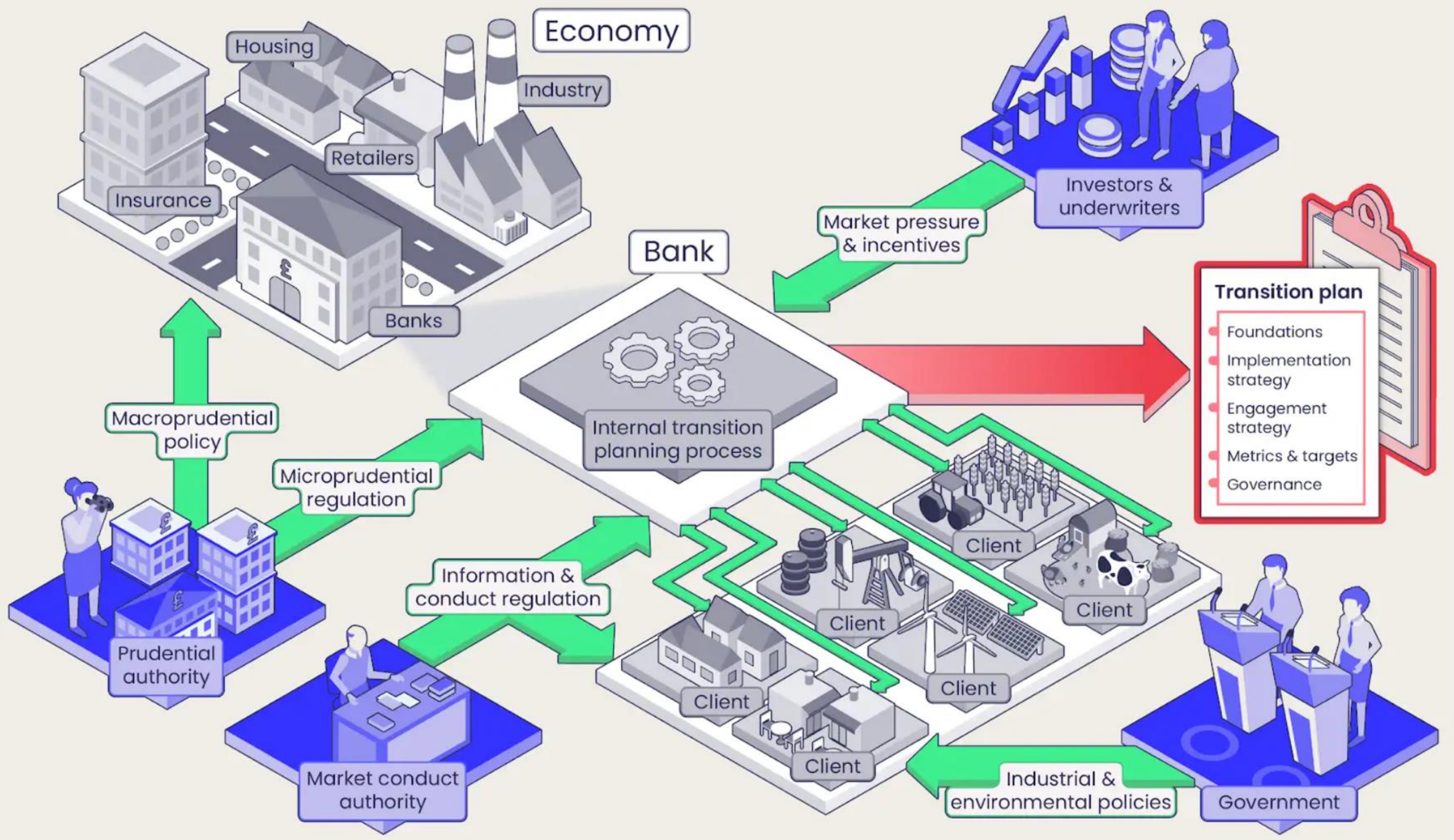
Transition planning is a firm's iterative process of developing, implementing, monitoring and adjusting its strategy and physical and transition risk management frameworks.

Transition plans are the publicly disclosed outputs of (a) transition planning process(es) used to communicate the key aspects of this strategy to a wide range of internal and external audiences.

For banking supervision, both are of interest.

**Adapted from NGFS (2023) Stocktake on Financial Institutions' Transition Plans and their Relevance to Micro-prudential Authorities*

The emerging governance landscape around Bank TPs



Principles for integrating bank transition planning into prudential oversight

- Principle 1: Integrate transition planning across the supervisory review processes
- Principle 2: Focus on substance, not form
- Principle 3: Assess transition and physical risk identification and mitigation measures
- Principle 4: Value qualitative information and use it to supplement existing assessments
- Principle 5: Remain proportional
- Principle 6: Coordinate assessment with other relevant authorities

Integrating bank transition planning in prudential supervision

Foundations
- Strategic objectives and long-term goals
- Scope
- Coverage
- Assumptions and Dependencies
- Scenarios

Implementation Strategy
- Business operations
- Products & services
- Policies & conditions
- Financial planning

Engagement Strategy
- Public policy engagement
- Client engagement

Metrics & Targets
- GHG metrics & targets
- Financial metrics & targets
- Other metrics & targets

Governance
- Board oversight
- Roles & responsibilities
- Incentives
- Internal capacities
- Data systems
- Assurance

Supervisory Review and Evaluation Process (SREP/Pillar 2)

Business model and risk analysis

Internal governance and institution-wide controls

Risks to capital [credit, market, operational]

Supervisory outcomes

Transition planning information for credit risk assessment

Credit risk mitigation (adequacy of controls and risk management)	**Implementation strategy: business operations, policies and conditions**	**Does the bank adequately take into account potential impacts of forward-looking climate-related risks on the value of collaterals and guarantees when assessing its ability to realise collateral or execute guarantees?**
	Implementation strategy: business operations, policies and conditions **Engagement strategy**: client engagement	Are climate-related risk assessments adequately integrated in **loan origination** processes, e.g. by applying specific conditionalities (e.g. related to CapEx) and contractual obligations (e.g. related to the implementation of client TPs)?
	Implementation strategy: business operations, products and services Governance: roles and responsibilities	Does the bank adequately **monitor the changes in client exposure to transition risk over time** as part of due diligence procedures?
	Foundations: strategic objective, scope and coverage, assumptions and dependencies	Are climate-related factors adequately integrated into the **bank's overall credit-risk strategy,** e.g. by informing existing factors of this strategy such as exposure type, sector, geographic location or concentration limits?
	Implementation strategy: products and services, financial planning	Does the bank take into account **clients' climate-related risk exposures and transition plans** in deciding financial and pricing terms?
	Foundations: coverage **Implementation strategy**: business operations	How is any **sectoral approach** articulated in the TP translated into loan origination procedures?
	Foundations: coverage, strategic objective **Implementation strategy**: policies and conditions	Does the bank have **sectoral policies in place to address any concentration of exposures in sectors vulnerable to transition or physical risk** (e.g. exclusion policies)? Does the bank have sectoral policies in place to address **any concentrations of dependencies** (e.g. on key decarbonisation technologies)?

Recommendations and outlook

- **Banking supervisors should integrate transition planning information into supervisory assessments.**
- **Regulatory uncertainty makes adequate risk management of climate change risks even more challenging, but even more critical.**
- **Robust transition planning across the economy supports financial stability and financial innovation for the transition.**
- **Supervisors should provide clear criteria and identify best practices for integration on transition planning in bank strategy and risk management**, e.g.:
  - Adopting a forward-looking approach
  - Grounding transition planning in a robust materiality assessment
  - Including broad coverage and a broad scope of transition planning
  - Providing clarity around key assumptions and dependencies
  - Ensuring internal consistency
  - Including high-quality supporting evidence
  - Relying on science-based targets

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Thank you!

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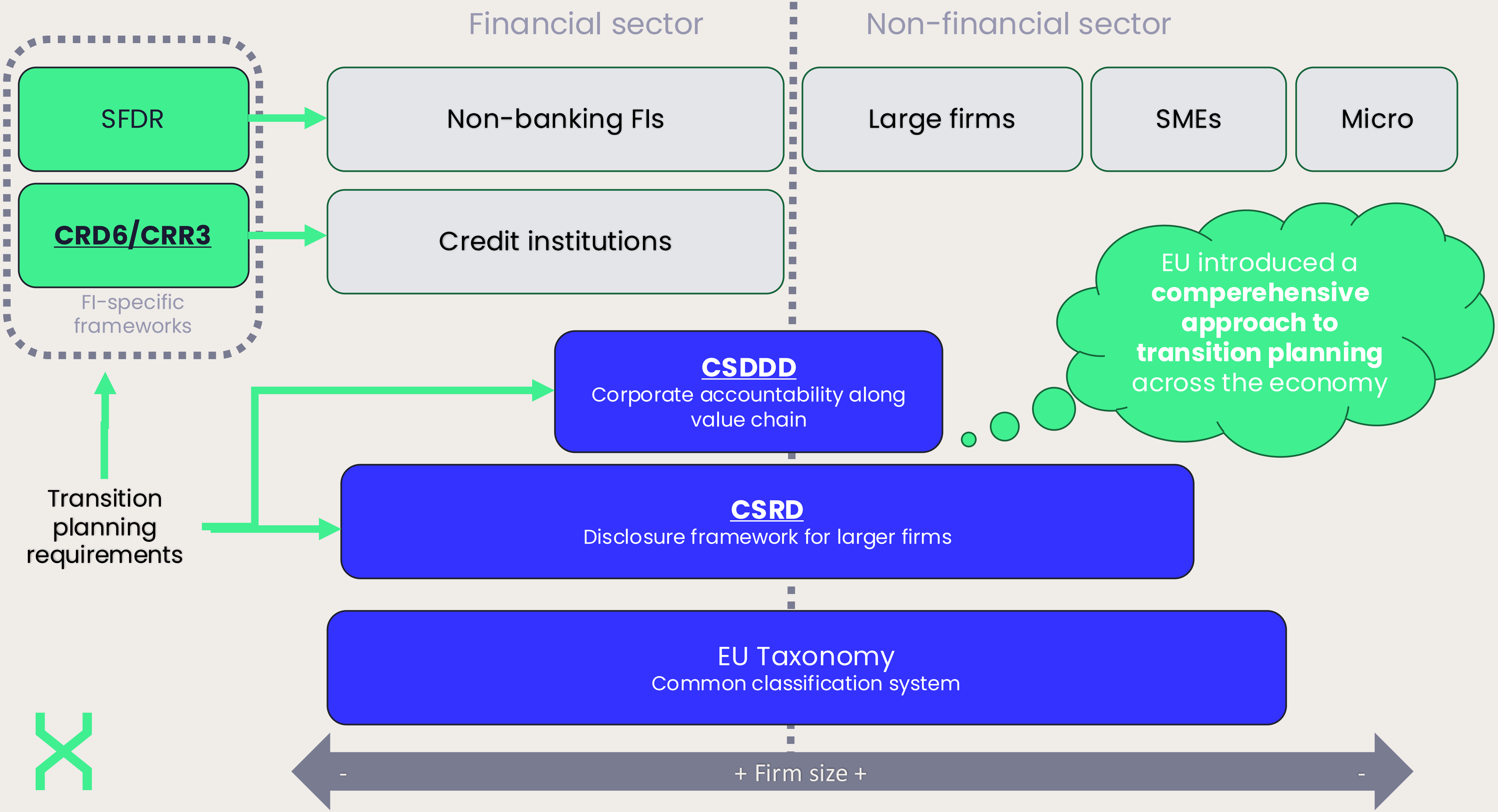
Background & context

- Transition plans [**TPs**] are increasingly recognised as a tool with many use cases in the governance of the low-carbon, climate-resilient transition.
- Climate and environmental risks are **material to banks and other financial institutions.** Evidence suggests **that banks currently underestimate these risks, and therefore manage them inadequately.** This has **financial stability implications.**
- Past work has shown that **TPs** are a valuable new source of forward-looking information that is relevant to **banking supervision** (Dikau et al. 2021, Dikau et al. 2024, NGFS 2024).

In this report we go further in exploring the 'how'. We:

- take stock of the **emerging governance landscape** around Bank TPs and summarise **common TP elements**
- identify **TP elements** which are likely to have prudential relevance
- propose **6 principles** for the effective integration of Bank TPs into prudential frameworks
- explore the relevance of TPs to the assessment of *business model risk*, *internal governance* & *risks to capital*
- recommend that banking supervisors should **integrate transition planning information into supervisory assessments** and clearly communicate the **criteria** they will apply when doing so.

Our approach is applicable to jurisdictions globally that have implemented the Basel framework, but it has **special relevance in the EU** given the advancement in **prudential use case of bank transition plans** & the **interlinkages with broader sustainability governance** framework (e.g. CSRD/CSDDD).


Financial sector
Non-financial sector
SFDR
CRD6/CRR3
FI-specific frameworks
Non-banking FIs
Credit institutions
Large firms
SMEs
Micro
EU introduced a **comperehensive approach to transition planning** across the economy
CSDDD
Corporate accountability along value chain
CSRD
Disclosure framework for larger firms
EU Taxonomy
Common classification system
Transition planning requirements
- + Firm size + -

Transition planning in EU banking rulebook (CRD6)

Motivations and definitions

- Clear link to EU policy with regard to **climate change mitigation and environmental degradation prevention** (recitals)
- definitions (ESG risk)
- time horizon extension (10 years)

Requirements imposed on financial institutions

- **Governance** arrangements (including remuneration aligned with ESG-risk appetite, Art. 74 CRD6)
- **Strategies** for taking up, monitoring, managing and mitigating ESG risks (Art. 76(1) CRD6)
- **Transition plans** (also vis-à-vis environmental objectives) (Art. 76(2) CRD6)
- Responsibilities of **risk committee** (Art. 76(4) CRD6)
- **Management body** suitability and subsequent training (Art. 91 CRD6)
- **supervisory reporting** (Art. 430 CRR3)
- Physical/immovable property **collateral** requirements (208, 210 CRR3)
- **Stress tests** for capital adequacy (177 CRR3)

New supervisory powers (Art. 87a, Art. 98, Art. 104(1)(m) CRD6)

- **Supervision** of governance arrangements
- **Stress testing** resilience
- **Supervision** of transition plans
- Integration of assessment of ESG risk management under **SREP**
- Require institutions reduce their exposures to ESG risks through *"through adjustments to their business strategies, governance and risk management for which a reinforcement of the targets, measures, and actions included in their [transition] plans … could be requested;"*

CRD6 introduces a comperehensive approach to ESG risk management