FINANCIAL SECTOR ADVISORY CENTER (FinSAC)

Renewed supervisory challenges in light of tightened financial conditions and economic slowdown

May 9–10, 2023 | Vienna, Austria

Session 7: Climate risks: carbon transition plans, the real revolution?

Presentations by:

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Guan Schellekens – European Central Bank
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Contents

Carbon Transition Plans

Ismael Ahmad Fontan
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Transition Plans & The EU's Sustainability Disclosures Framework

Diarmuid Murphy
European Commission

How to set carbon footprint reduction plans of banks?

Gábor Szigel Tamás
OTP Bank

Basel Committee on Banking Supervision: Update on climate-related work

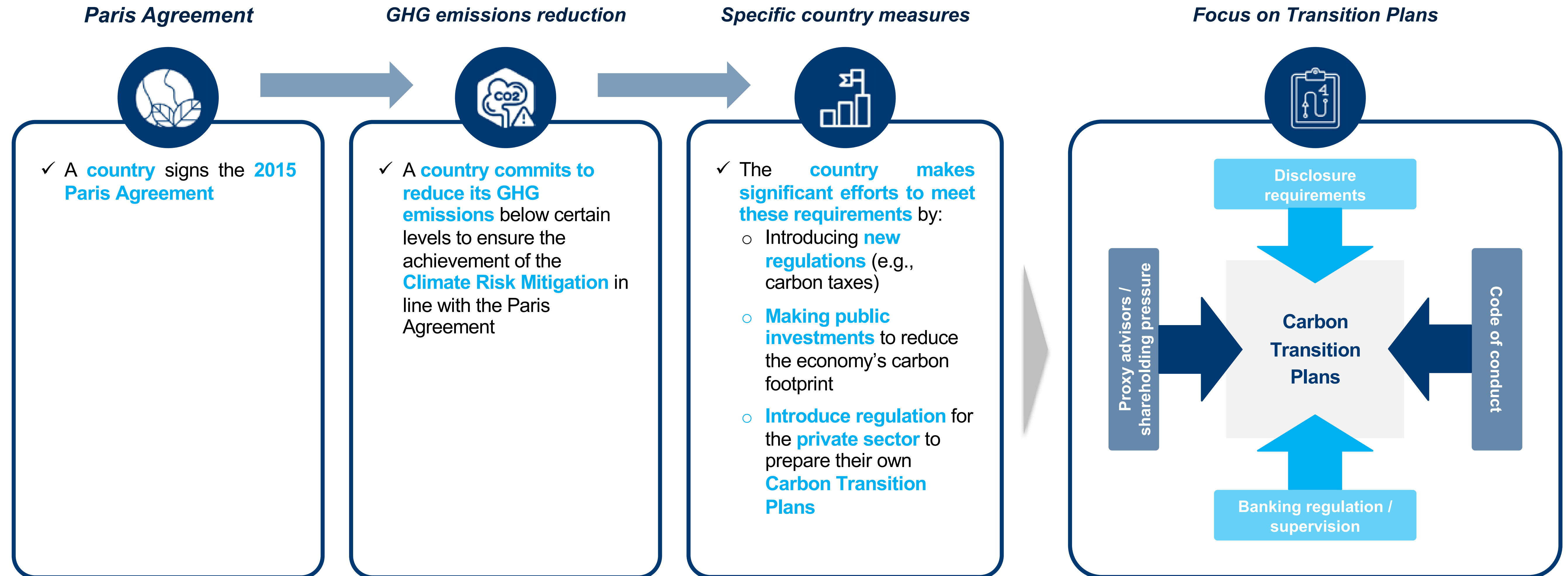
Pablo de Carvalho
Basel Committee on Banking Supervision Secretariat

Walking the talk: banks gearing up to manage climate and environmental risk

Guan Schellekens
Climate Risk Project Management Office

What is a Carbon Transition Plan?

Introduction



Introduction (cont.)

A plan for setting the short, medium, and long term GHG targets. To this end, a bank needs to:

Calculation of its carbon intensity

- Calculate the **carbon intensity of its activities**:
  - ✓ **Scope 1**
  - ✓ **Scope 2** (electricity consumption)
  - ✓ **Scope 3** – supply chain, lending portfolio and investments
- **Decarbonization paths**
- **Data infrastructure and methodologies** to make reliable calculations and setting credible targets are needed

Actions to reach the specific carbon targets

- **Changes in the operations** (less printing, electric vehicles, etc.)
- **Renewable sources of electricity**
- **Introduced amendments** in:
  - ✓ **Credit risk management**
    - Credit risk underwriting
    - Credit risk monitoring
  - ✓ **Market risk management**

Requiring clients their own transition plans

Governance

- **Governance and internal control framework for the target definitions and implementation**

Carbon Transition Plans

Regulatory / supervisory dynamics

Preparation of a Carbon Transition Plan

Supervision:

- ✓ Market discipline (shareholders / analysts)
- ✓ Banks / funding providers

X

Disclosure of CTP

Preparation of a Carbon Transition Plan

Supervisory review

X

4 / 20X1

- ✓ Submission to the supervisor
- ✓ Disclosure of CTP

- ✓ Review by the supervisor
  - ✓ Letter
  - ✓ Inclusion into SREP
- ✓ Market discipline (shareholders, funds, proxy advisors, etc.)

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Basel Committee
on Banking Supervision

Basel Committee on Banking Supervision: Update on climate-related work

Pablo de Carvalho, Member of the Basel Committee on Banking Supervision Secretariat

Renewed Supervisory Challenges in light of tightened financial conditions and economic slowdown, 10 May 2023

Agenda

- Overview of the TFCR 2023-24 work programme
- Work programme on Transition Planning

Task Force on Climate-related financial risks (TFCR) work programme

- Addressing climate-related financial risks to the global banking system is a key theme in the Committee's 2023-2024 work programme.
- Work will continue to:
  - Follow a **holistic approach** across all pillars of the Basel Framework (regulation, supervision, disclosure);
  - Be guided by the **Basel Committee's mandate;** and
  - **Leverage and complement** the work of other international financial standard setters and public sector bodies.
- Key milestones in 2022:
  - Principles for the effective management and supervision of climate-related financial risks (June 2022)
  - Frequently asked questions on climate-related financial risks (December 2022)

TFCR work programme: Regulation and Disclosure

- **Regulation:** Assess materiality of gaps in existing framework and consider potential measures to address gaps:
  - Consider possible policy measures, including those related to risk concentration
  - Forms part of the TFCR's holistic approach
- **Disclosure:** Build on work of ISSB (and others) to develop bank-specific Pillar 3 disclosure requirements:
  - Targeting public consultation in H2 2023
  - Work conducted in cooperation with ISSB to ensure interoperability of future standards.

TFCR work programme: Supervision

- **Monitor implementation** of the Principles for the effective management and supervision of climate-related financial risks (Principles)
  - Objective is to identify practical implementation challenges for banks and supervisors
  - Industry outreach (April 2023)
  - Work will help identify areas of future work/additional guidance.
- Complement work underway in other global forums (FSB, NGFS), including with respect to:
  - **Transition Planning**;
  - **Scenario Analysis**; and
  - Potential linkages to the Pillar 2 capital framework.

TFCR work programme: Transition Planning

- Intended to complement and build on FSB and NGFS work.
- Workplan includes:
  - The role of transition planning in banks' risk management and potential risks to banks (eg legal, reputational); and
  - The role of prudential supervisors in overseeing banks' transition planning.
- Key deliverables:
  - Industry outreach
  - Potential recommendations for additional supervisory guidance.

Potential Work on Transition Planning

- Leverage on information from the industry outreaches.
- Assess whether further supervisory guidance, complementing the Principles, is needed on the content and utilization of transition plans
  - Potential role of supervisors in the assessment of banks' transition plan
  - Interaction with other standard setting bodies on what transition plans should entail
    - Both clients' and banks' transition plans
    - Collective work within respective mandates
  - Role of transition planning in addressing some of the data challenges

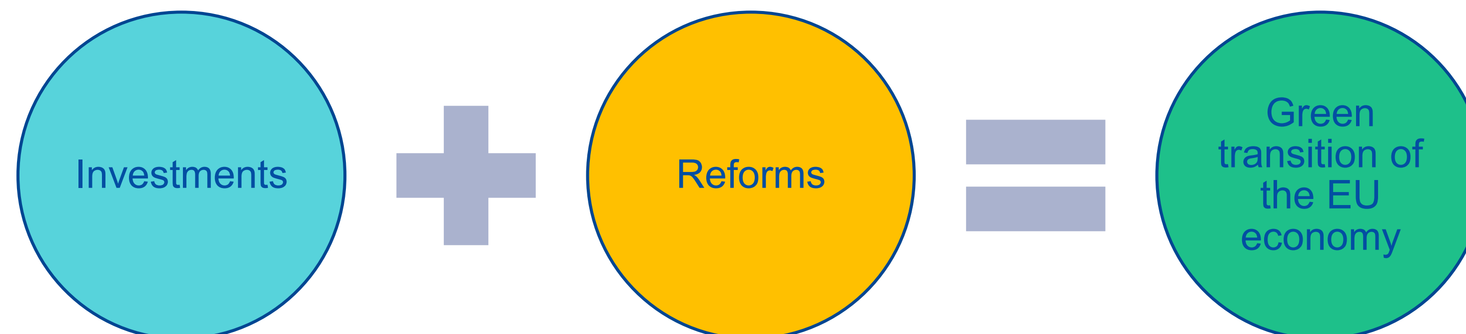
Questions and answers

Transition Plans & The EU's Sustainability Disclosures Framework

May 2023

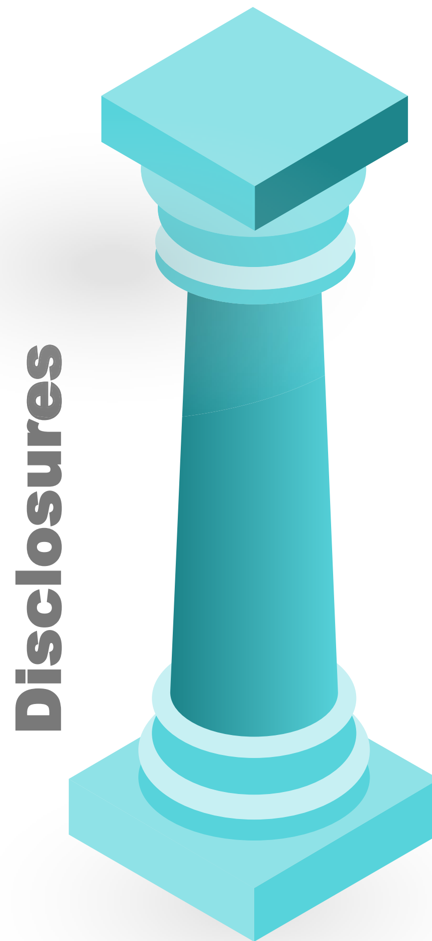
EU Sustainable Finance Framework

- The EU has set ambitious objective of **zero net emissions** of greenhouse gases by 2050
- On the way to 2050, our **2030 targets** are increasing too. Minus at least 55% (instead of 40% previously) greenhouse gas emission reduction is needed compared to 1990.
- **Additional investments needed** in the 2020-2030:
  - EUR 390 billion, over this decade, to meet its 2030 emissions-reduction target in the energy and transport sectors, EUR 130 billion for other environmental goals.
  - Additional investments of at least EUR 92 billion to enhance its share of global green technology manufacturing.
- **REPowerEU** communication from March 2022 & the **Safe gas for a safe winter plan** from July 2022

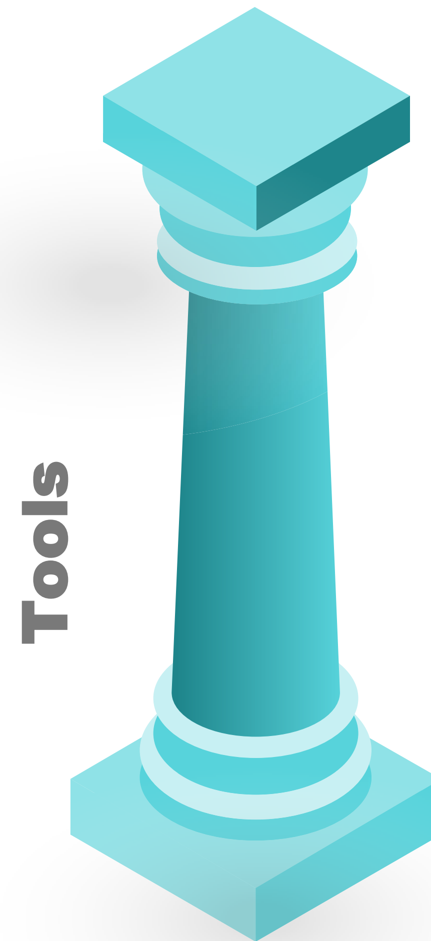


Three pillars of the EU sustainable finance framework

Taxonomy Regulation



Comprehensive disclosure regime



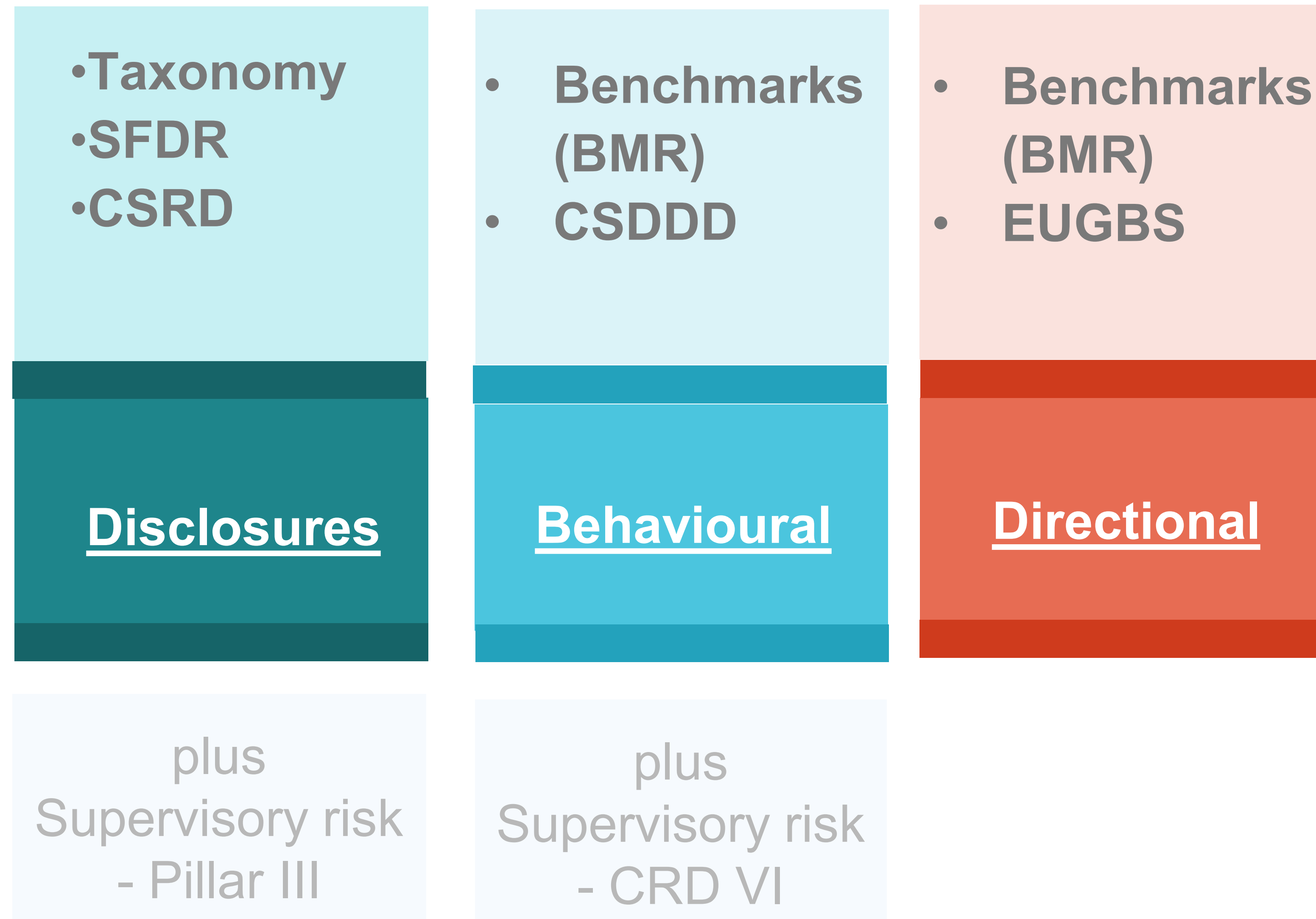
Toolbox for investors and investees

European Commission

A comprehensive EU disclosures/obligations regime…

EU sustainability disclosure regime for financial and non-financial companies				
Instrument	**Corporate Sustainability Reporting Directive (CSRD) proposal**	**Sustainable Finance Disclosure Regulation (SFDR)**	**Taxonomy Regulation**	**Corporate Sustainability Due Diligence Directive (CSDDD)**
Scope	All **EU large companies** and all listed companies (except listed micro enterprises)	Financial market participants offering investment **products**, and financial **advisers**	Financial market participants (**entities**); all companies subject to NFRD/CSRD	Large EU limited liability companies and certain Non-EU companies / third-country companies
Disclosure/ Obligations	Report on the basis of formal reporting standards and subject to external audit. **Disclosure of transition targets and plans**.	Entity and product level disclosure on sustainability risks and principal adverse impacts	Turnover, capital and operating expenditures **(KPIs)** from products or activities associated with Taxonomy	Large companies to adopt a **plan to ensure that their business model and strategy are compatible with the transition**
Status	Will apply from 2025	Applies from 10 March 2021 RTS do apply from 1 January 2023	Applies from January 2022	Proposed

Transition plans within the EU sustainable finance framework



European Commission

EU Taxonomy – defining sustainable

A classification system

Provides clarity on what is an environmentally sustainable activity and under which circumstances.

A measuring tool

Measures the degree of sustainability of an investment and the degree of green activities of companies

A transition tool

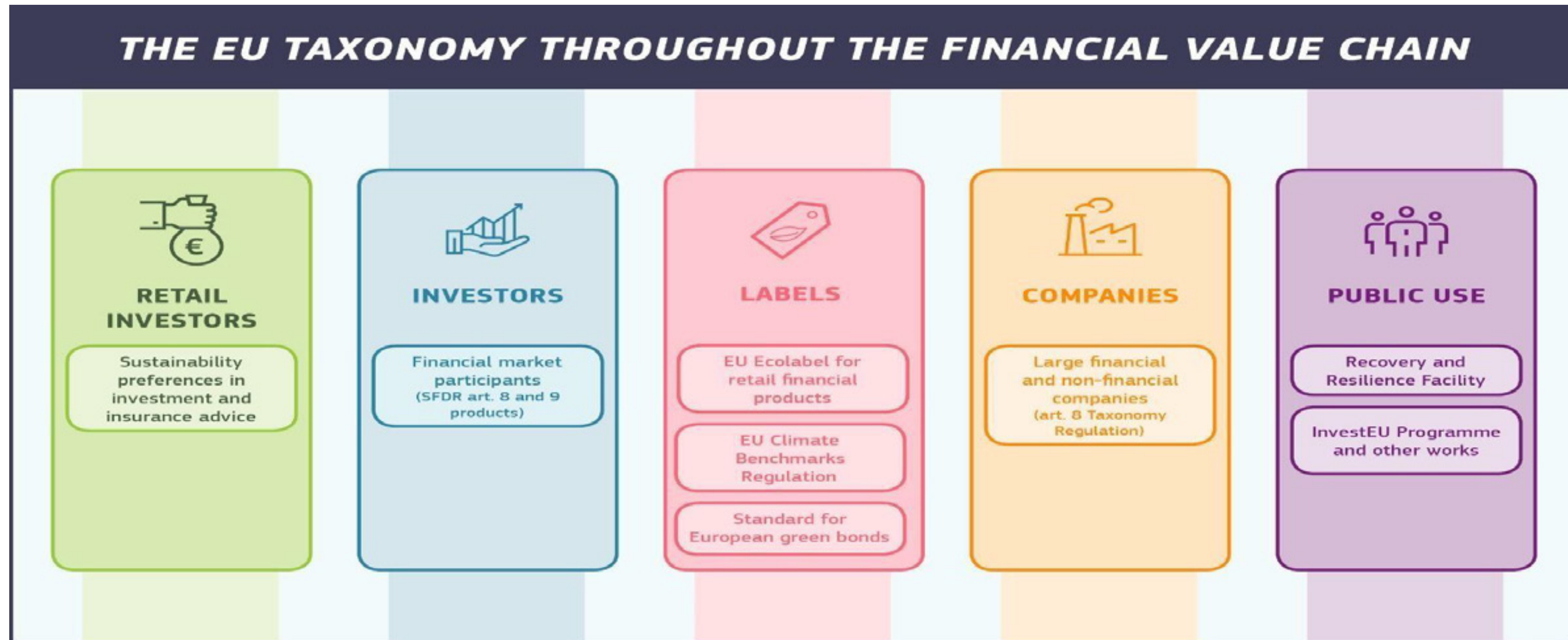
Helps investors and companies to plan and report on the transition. It sets the objectives and the direction of travel for different economic activities.

Ultimately, it helps raise the needed investments to build a net zero, resilient and environmentally sustainable economy.

What the EU Taxonomy is **not**:

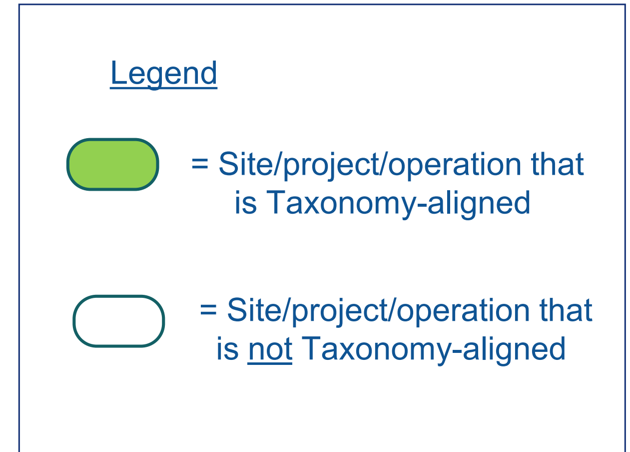
- It's not a mandatory list to invest in
- It's not a rating of the "greenness" of companies
- It does not make any judgement on the financial performance of an investment
- What's not green is not necessarily brown.

Taxonomy in the financial value chain



European Commission

Transition tool - how does it help companies to transition?



- By defining green economic activities, not companies
- The Taxonomy enables companies to transition by gradually increasing their share of green activities

Company Z

Share of green activities

2020 A B C D 20%

Factory A expands

Factory B increases energy efficiency

2025 A B C D 50%

Factory C activity transitions to E

2030 A B E D 70%

Source: Platform on Sustainable Finance

Firm level transition plans

- Transition plans (TPs) are a tool for companies to articulate and explain their transition targets and their investment needs:
  - TPs can also help minimise business disruption, creates new business & invest opportunities.
- Sustainable finance disclosures allow for transparency - investors can better understand, compare, and benchmark transition plans of companies.
- Sustainable finance disclosures focus on “double materiality” aspect and TPs can complement this approach.
  - managing ESG risks
  - translating EU sustainability goals into long-term financing strategies and decision-making processes

The link to prudential transition plans

- The proposed EU Banking Package - CRD6 and CRR3 - sets out new regulatory requirements for how banks manage ESG risks.
- ESG related amendments include:
  - Harmonised definitions and disclosures of ESG risks, with new mandatory requirements to develop (prudential) transition plans for ESG risks that may materialise in the medium to long term.
  - New supervisory powers to monitor and assess the bank's ESG risk management and their medium to long term plans (part of SREP).
- Further specifications for harmonisation to be defined by the EBA (e.g. minimum standards and reference methodologies; scenarios for stress testing).

Thank you

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EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Walking the talk: banks gearing up to manage climate and environmental risk

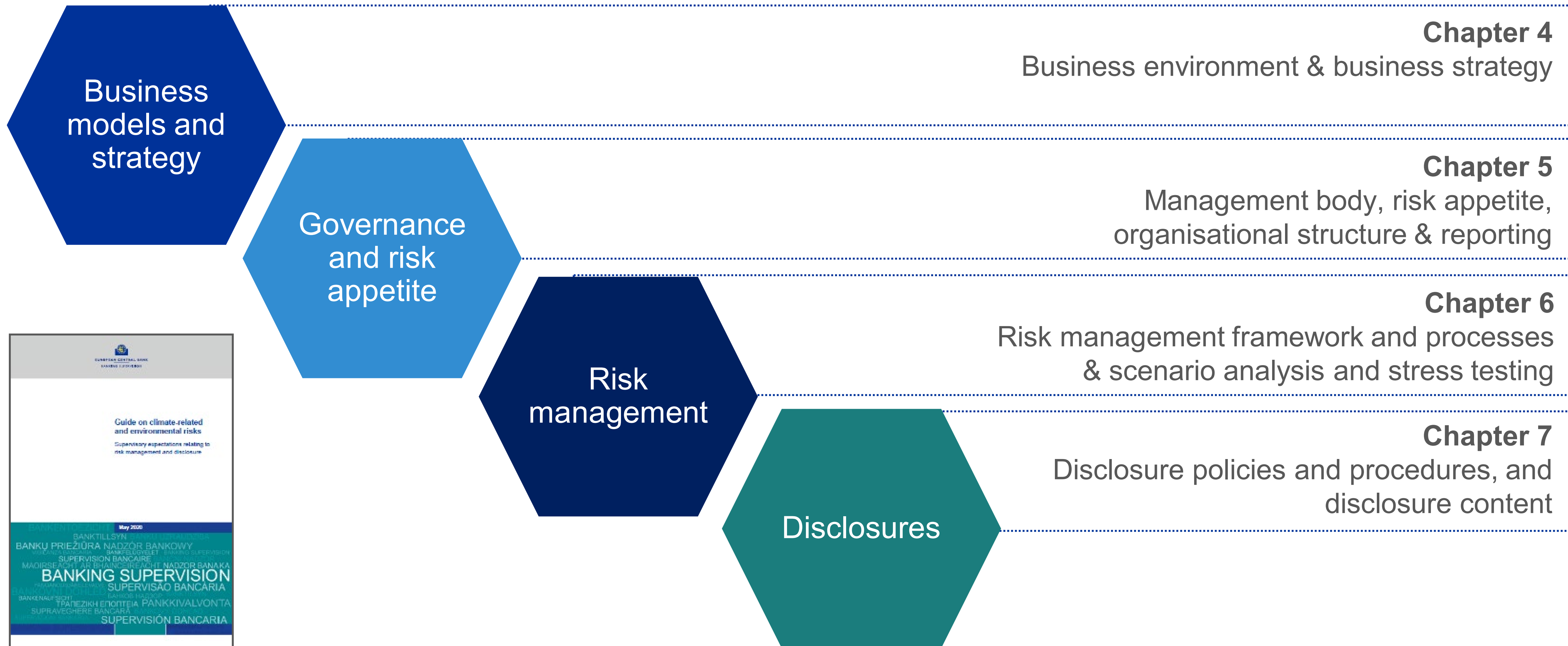
FinSAC Conference

Disclaimer: the views expressed in this presentation represent solely those of the presenter and not those of the European Central Bank

10/05/2023

Guan Schellekens,
Climate Risk Project Management Office

The ECB Guide sets out 13 supervisory expectations related to four key elements



Source: ECB Guide on climate-related and environmental risks, November 2020

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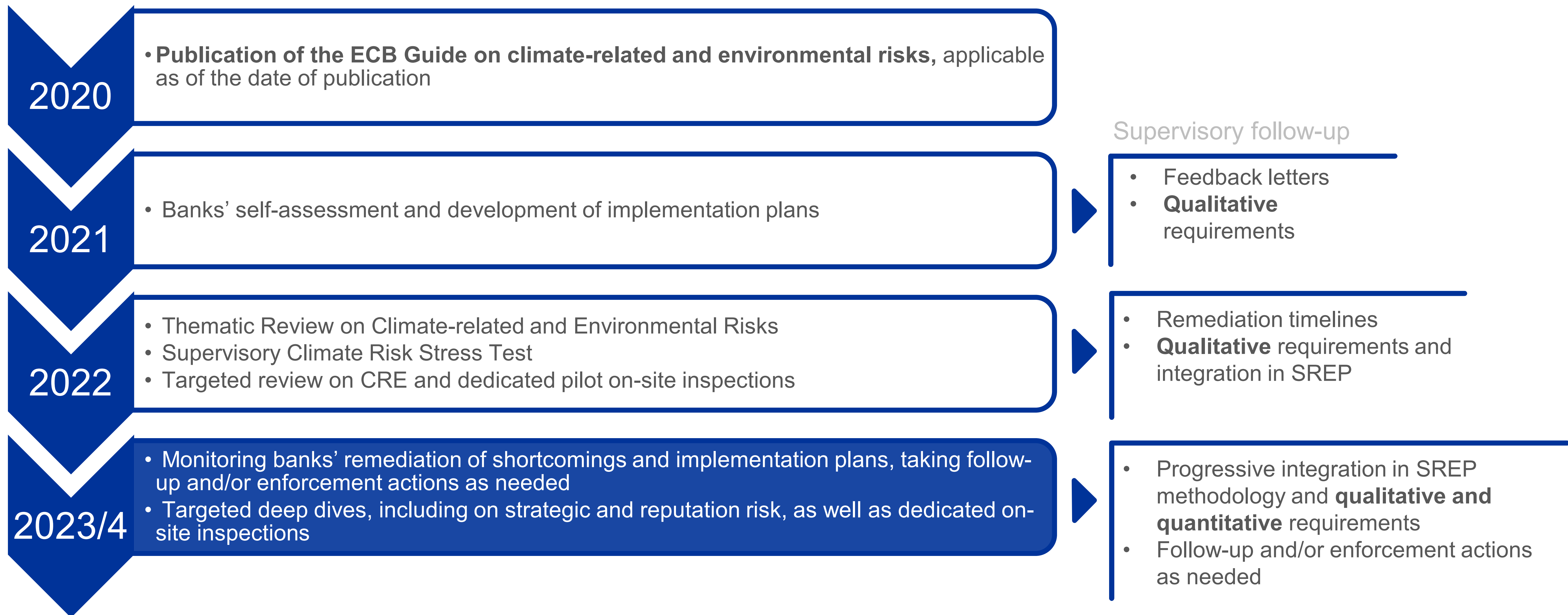
ECB supervisory road map on climate-related and environmental risk management



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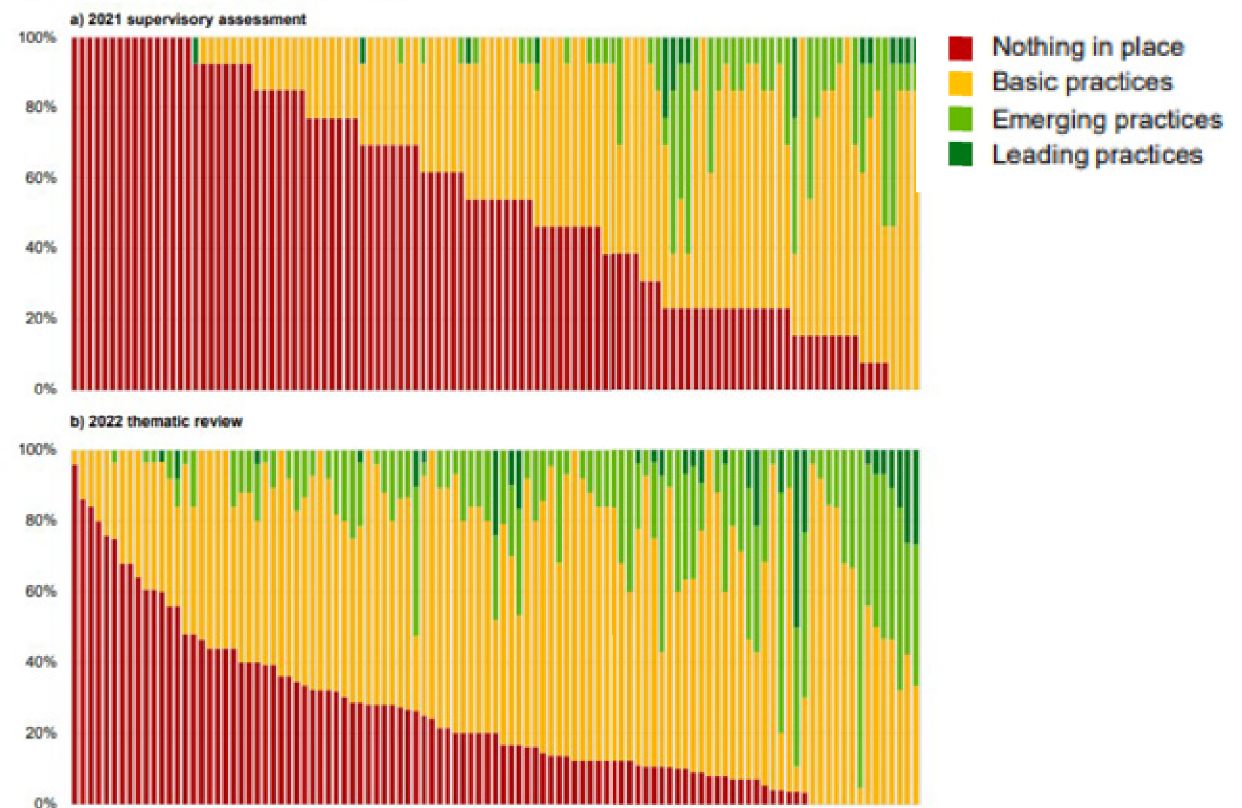
State of climate risk management in the banking sector in 2022 – overall results (1/3)

Results of the review

- Virtually all banks are now **out of the starting blocks** to identify and manage their C&E risks
- **Significant increase compared to last year**, as in 2021 half of the banks made no or little meaningful progress
- Over **85% of banks now have at least basic practices** in place for at least half of the expectations
- With a **group of banks paving the way**, having emerging practices and leading practices in a considerable number of areas

Chart 6

Bank-by-bank results of the 2021 and 2022 supervisory assessments



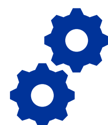
Notes: The 2021 supervisory assessment scores are taken as a proxy to indicate the level of maturity of institutions' practices in 2021. Owing to the updated assessment methodology used in the 2022 thematic review, direct comparison with the results from 2021 gives an indication only.

State of climate risk management in the banking sector in 2022 – selected results (2/3)

Materiality assessment: 80% of banks reported to be materially exposed to climate risks, up from 50% in 2021.

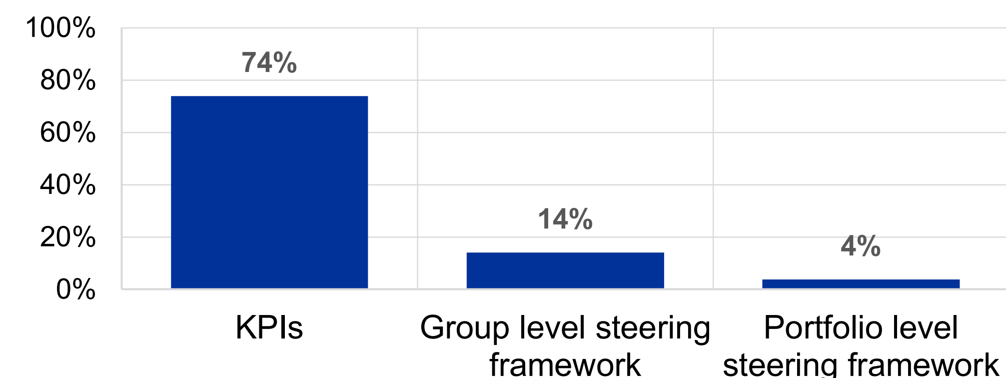
Strategy: Many banks have taken steps to understand how climate risks impact their business models, but their strategies do not yet address all risks comprehensively.

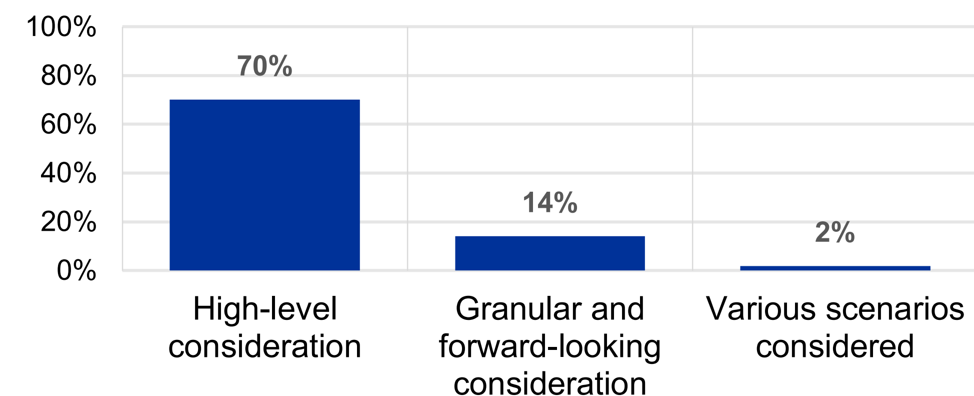
Governance: Banks have improved their organisational structures. However, they are still in the early stages of tackling climate risks in a granular, bank-wide and comprehensive manner.



Risk management: Almost all banks use at least basic quantification methods to measure climate risks, but only 25% have advanced methods.

Climate-related risk practices in business strategy
(percentages of banks)





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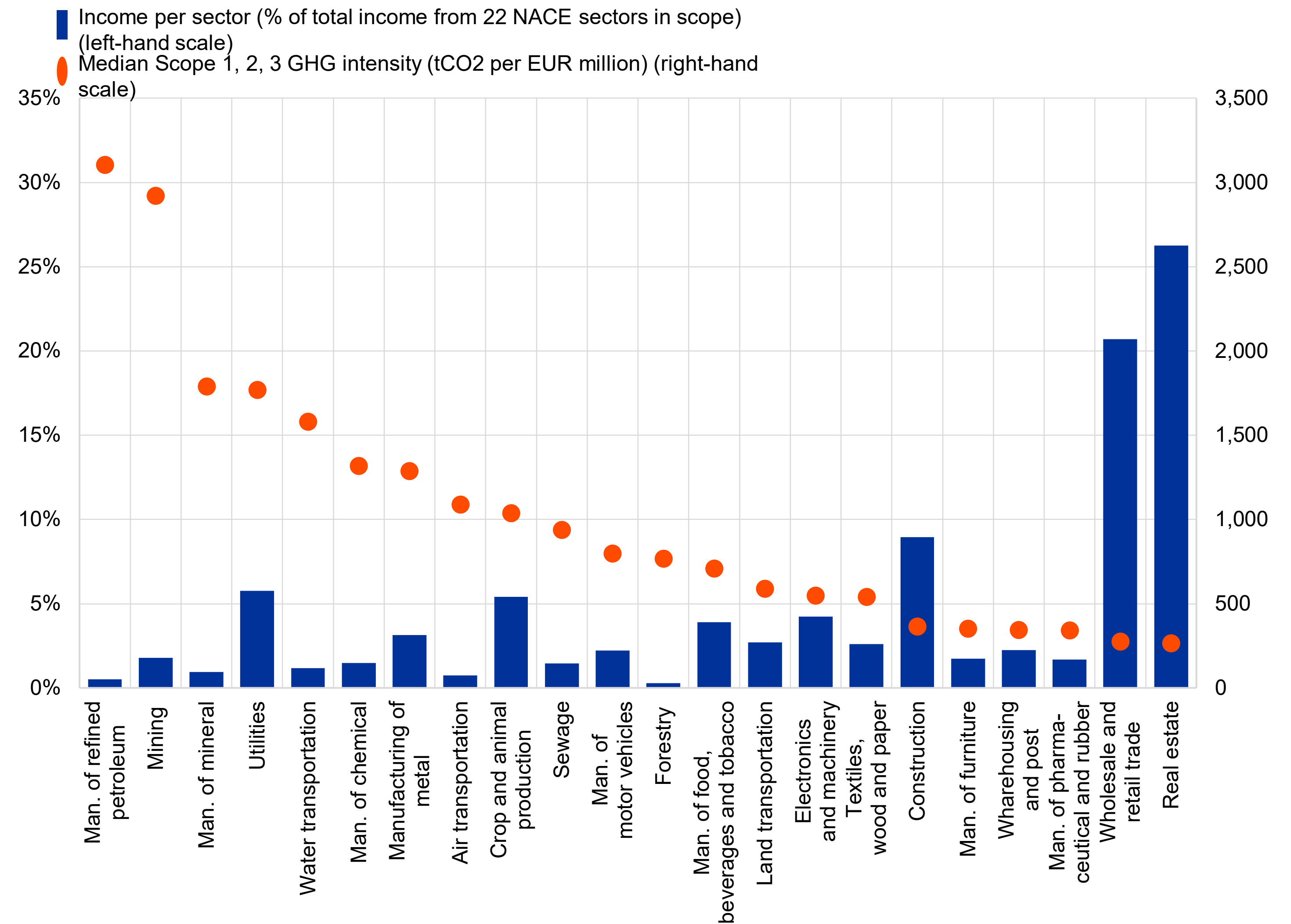
State of climate risk management in the banking sector in 2022 – stress testing frameworks (3/3)

Stock-take on income: Banks generate considerable share of their income from carbon-intensive sectors, amounting to more than 65% of the total from corporations.

Loss projections: While projections significantly understate the actual risk, projecting banks reported €70bn of aggregate losses under the 3 short-term exercises (3-year disorderly transition and the two physical risk scenarios).

Stress testing frameworks: 59% of banks have not integrated climate risk into their stress-testing framework



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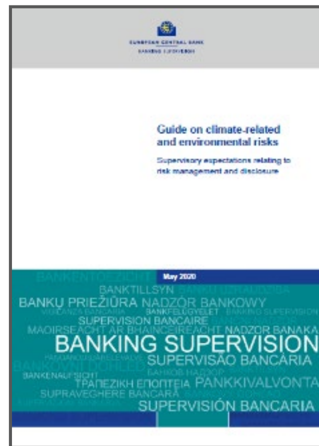
The ECB published various reports with good practices, demonstrating swift progress



ECB Guide

Risk management

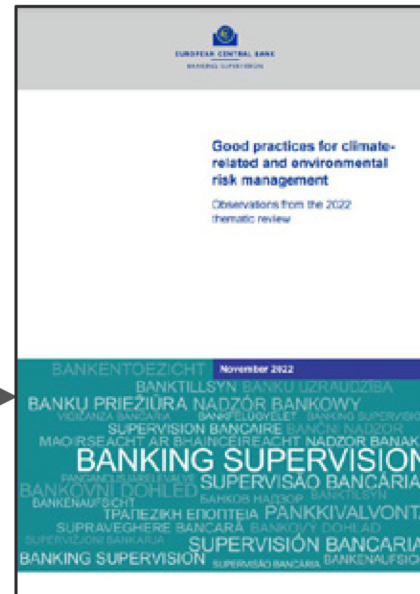
- 1. Business environment
- 2. Business strategy
- 3. Management body
- 4. Risk appetite framework
- 5. Organizational structure
- 6. Internal reporting
- 7. Risk management framework
- 8. Credit risk management
- 9. Operational risk management
- 10. Market risk management
- 11. Stress testing
- 12. Liquidity risk management

Disclosures

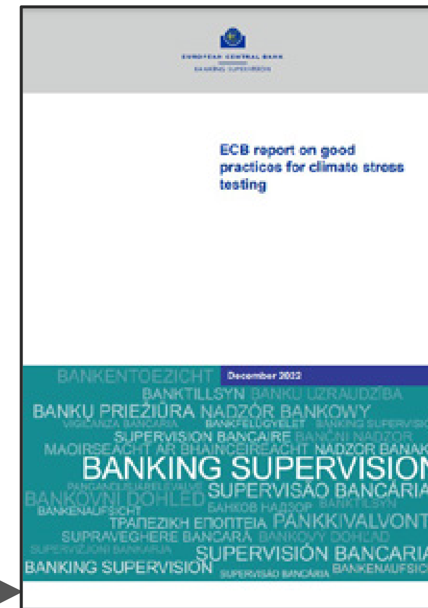
- 13. Disclosures

Good practices

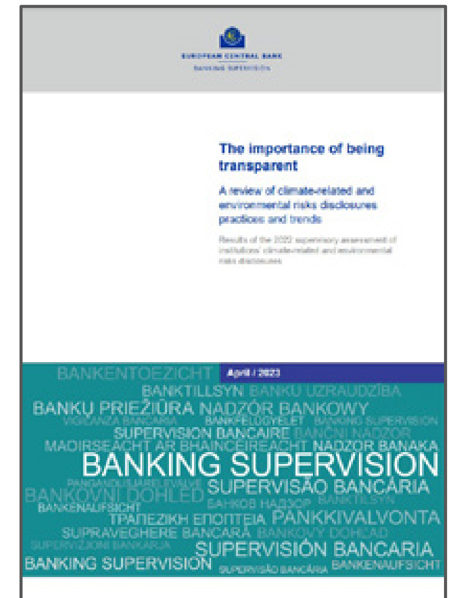
Governance, strategy & risk management



Stress testing



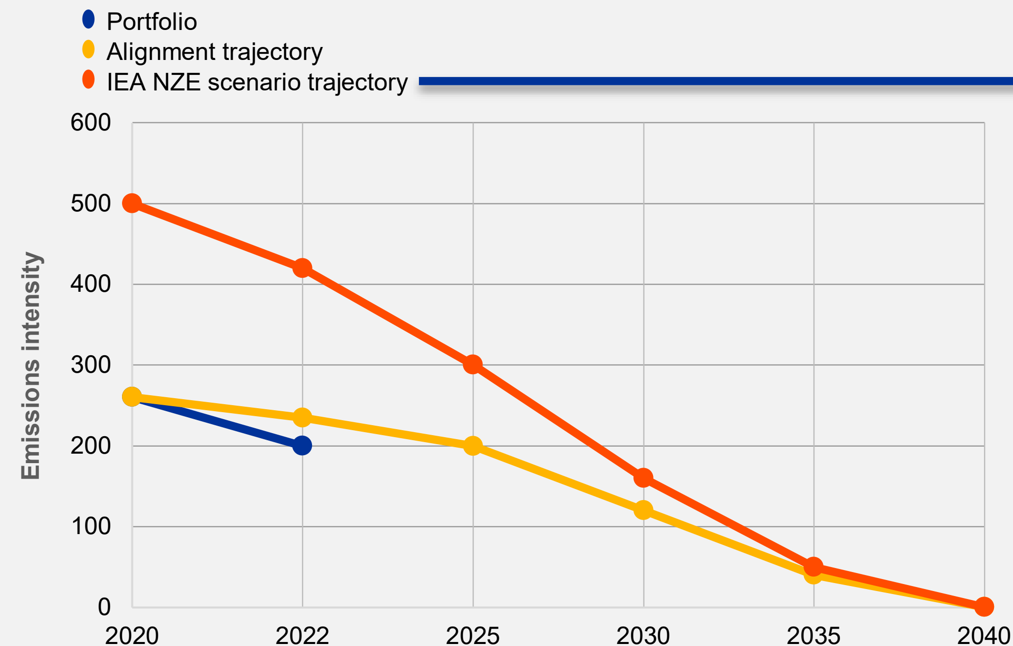
Disclosures



Example of good practice: transition planning (2/2)

Banks are integrating C&E risks in their strategic target-setting process

- As a starting point, they often exclude new financing of particularly **harmful and potentially risky exposures** such as coal-fired power generation.
- Banks that are more advanced in integrating transition risks into their business strategy also set **short, medium and long-term targets** showing **how their portfolios have to evolve** over time.
- Targets are usually set based on **forward-looking and science-based decarbonisation pathways**.
- Banks **align their Risk Appetite Statement** with the targets.
- Banks show **awareness** of the importance and consequences of **scenario choice** for target-setting.



Decarbonization pathway:

- Scenario choice has important consequences. Key aspects:

a) **Up-to-date** scenarios
b) **Ambition** (e.g. "well below 2° C" vs "1.5° C")
c) **Geographical relevance**
d) **Starting point** at base year
e) **Internal consistency** of choice

Risks:

- Banks with **net-zero claims not using scenarios that reflect objectives** are exposed to elevated risks (e.g. strategic, transition, reputational / litigation / liability risks)

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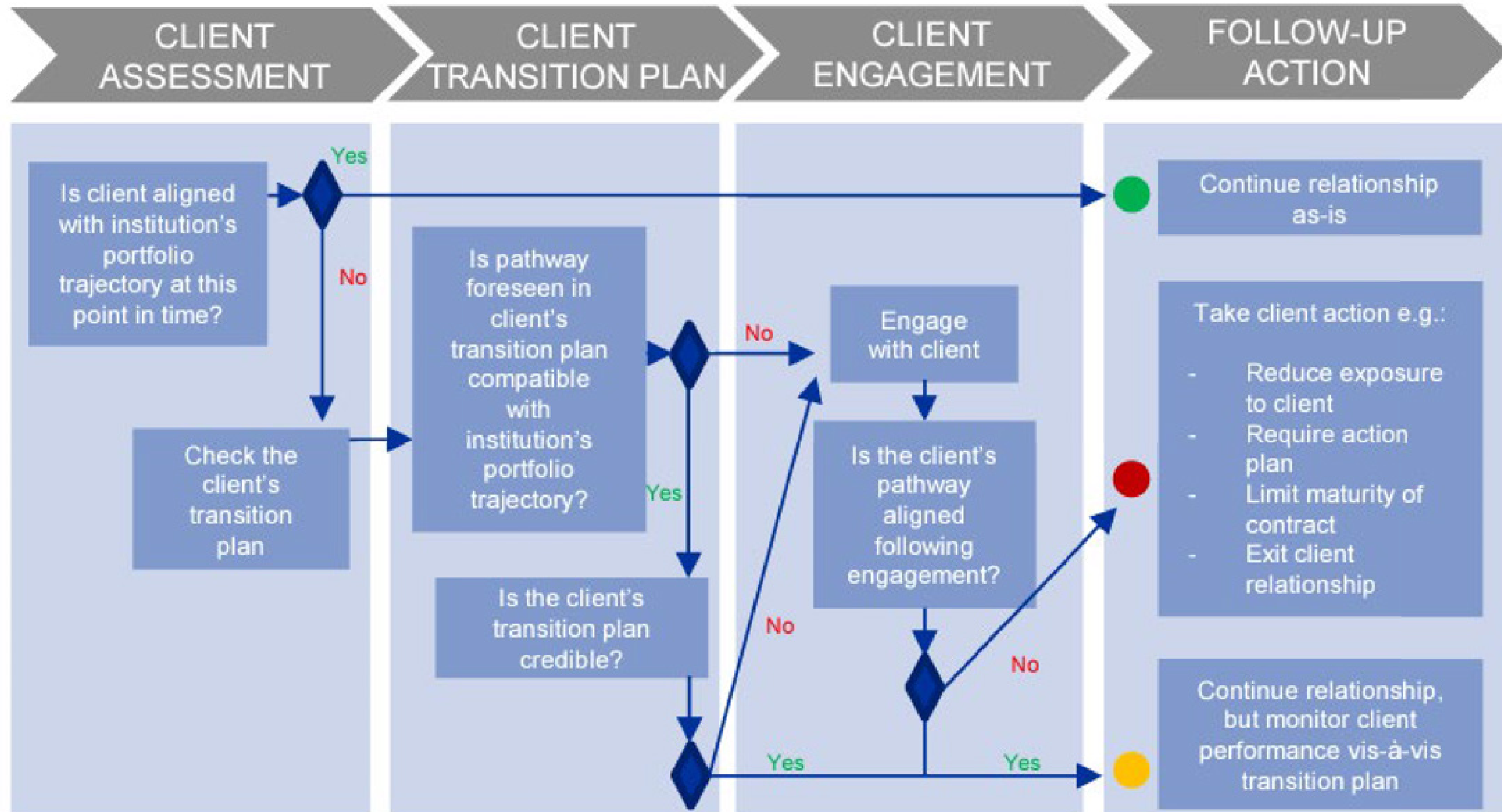
Example of good practice on transition planning (2/2)



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A few concluding remarks on prudential transition plans

- Prudential transition plans are a key tool to ensure resilience of banks' business models, avoiding excessive build-up of transition risk over time
- Foundational elements include:
  - Measurement of risk from misalignment over short, medium and long-term, reflecting science-based decarbonization pathway(s)
  - Ambitious and concrete timelines, including intermediate milestones cascaded down to individual business lines
  - Clear mitigation strategies, and decisive short-term action
  - Consistently integrated into strategy, planning and risk management framework
  - Transparency and appropriate disclosures

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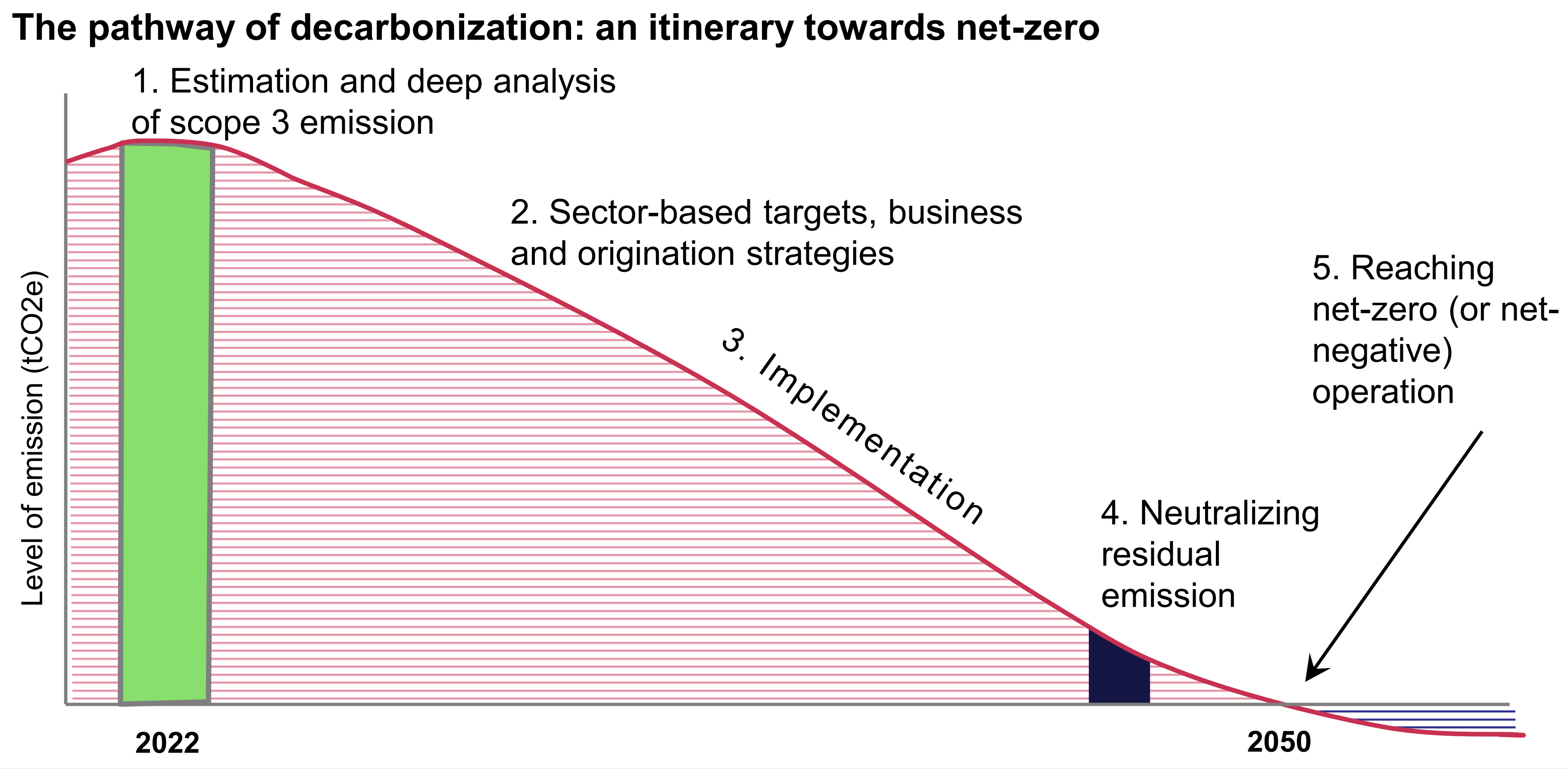
How to set carbon footprint reduction plans of banks? (Questions more than answers)

Gabor Szigel (Senior Internal Advisor)

Vienna Initiative, FinSAC Conference
Session on Carbon Transition Plans
May 10, 2023

Decarbonization plans – on a high level, it is clear what to do…



Net-zero operation and portfolio by 2050 also at OTP Group!

Carbon neutrality
=
Emission free transactions + transactions with negative emissions + transactions with inevitable emissions + offset of residual emissions

Steps of preparing a decarbonization plan (for the financed portfoio):

- Determining the detailed emissions attributed to the financed portfolio
- Elaborating activity-based plans to reach net-zero
- Composition of a net-zero financed portfolio:
  - Clients that are or can be carbon neutral
  - Clients in essential sectors with inevitable GHG emission: net-zero is not possible → only residual emissions!
  - Activities/clients that have negative emissions

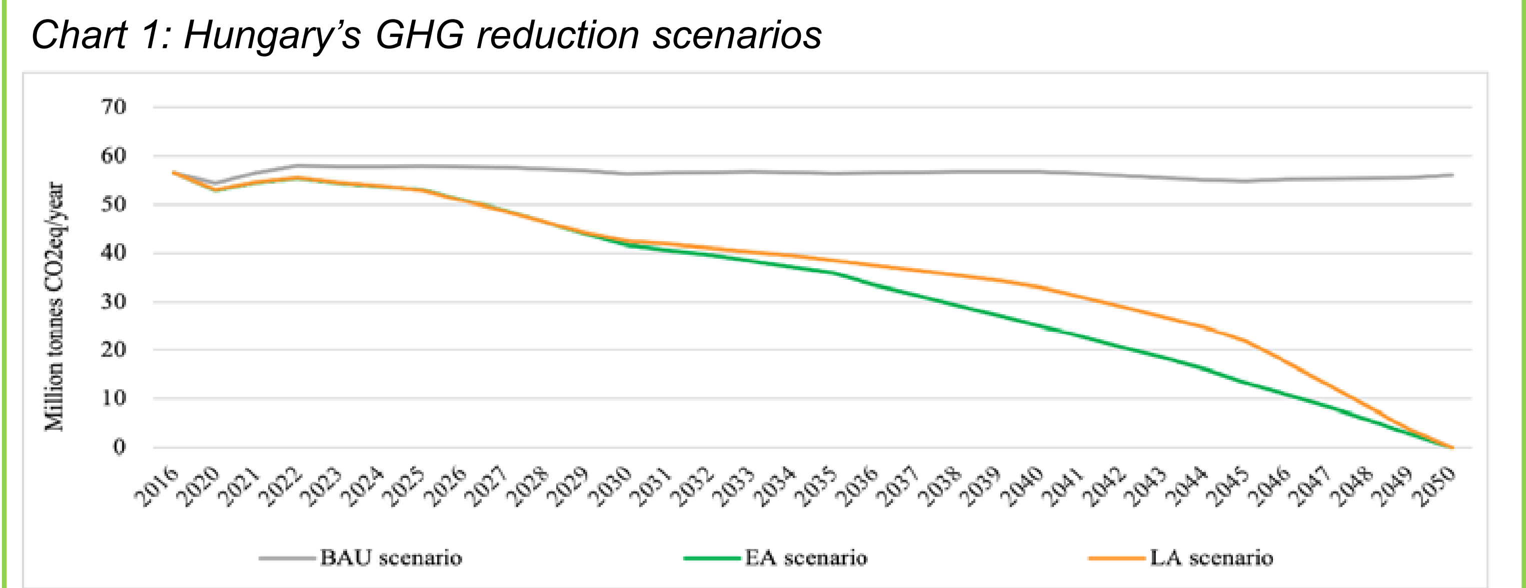
…but the devil is in the details: what is the ambition? How many targets? What to cover? How to align to national reduction plans?

Aspects to consider when setting banks' carbon reduction plans:

- Targets in line with national strategies? What is **our value-added** then?
- Targets more ambitious than national plans? Do we have the **competence**? (Transition risk)
- Setting one target (whole portfolio) or more (industries, countries, etc.)?
- Targets in annual breakdown? Data consistency issues might intervene (see later)
- Targets for selected dates (2030, 2050)? Harder to catch non-compliance timely!
- Bottom-up or top-down?
- Targets for financed Scope1-2-3 separately?

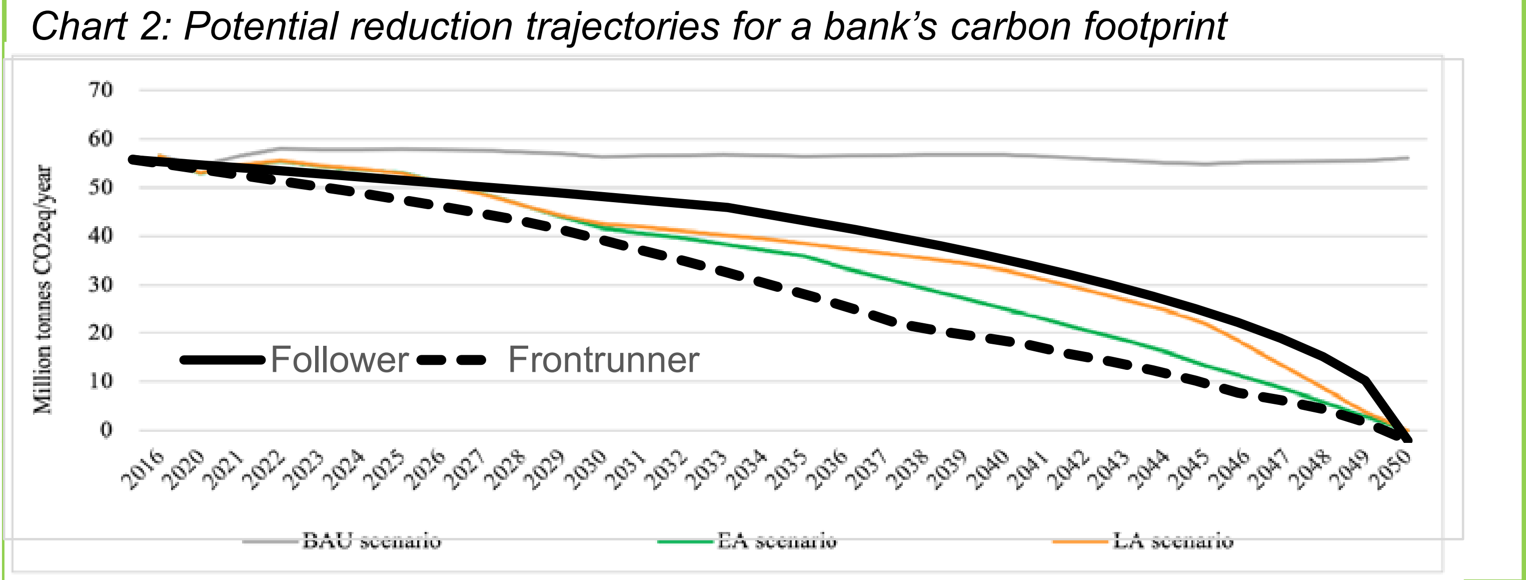
Illustration: Banks' reduction targets – follower or frontrunner?

Chart 1: Hungary's GHG reduction scenarios



Source: National Clean Development Strategy, 2020-2050 by the Government of Hungary

Chart 2: Potential reduction trajectories for a bank's carbon footprint



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Challenge with the consistency of estimations - prepare for many footnotes!

Consistency issue 1: divergence in approaches

- Emission estimates for the same borrower differ largely

Dispersion of reported Scope 3 GHG intensity by counterparty

Minimum
Maximum
Median
Interquartile range (25th to 75th)

S3 GHG intensity

8,000
7,000
6,000
5,000
4,000
3,000
2,000
1,000
0

Company 1, Company 2, Company 3, Company 4, Company 5, Company 6, Company 7, Company 8, Company 9, Company 10, Company 11, Company 12, Company 13, Company 14, Company 15

Source: ECB, Bottom-up climate stress test, 2022

Consistency issue 2: Expansion to Scope 3 emissions

- Bank's financed carbon footprint will be expanded to borrowers' Scope 3 emissions gradually

Table 5-2. List of sectors with required scope 3 emissions inclusion as defined by the EU TEG[48]

Phase in period	NACE Level 2 (L2) sectors considered
From 2021	At least energy (oil & gas) and mining (i.e., NACE L2: 05-09, 19, 20)
From 2024	At least transportation, construction, buildings, materials, and industrial activities (i.e., NACE L2: 10-18, 21-33, 41-43, 49-53, 81)
From 2026	Every sector

Source: PCAF

Consistency issue 3: Updates in estimation input data

- Input IO matrices get updated
- Updates come with delay
- Updates impact estimation results

Scope 3 emission of OTP Group's portfolio in Slovenia based on different IO table inputs

Based on IO of 2014 = 100

103
103
102
102
101
101
100
100
99
99

+0.3%
-2.5%

Based on IO tables from 2012
Based on IO tables from 2013
Based on IO tables from 2014

Source: OTP Bank

Consistency issue 4: using estimations made by the borrowers

- According to PCAF, banks should rely more and more on borrowers' own, physical activity based measures
- But better means also different
- This does not eliminate estimation inconsistencies – just „outsources" them to the borrowers
- No evidence for overall consistency

Characteritics of the borrower

?
Option 1
Option 2
Option 3

Assumptions and estimation methodologies

Source: PCAF

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How to account for country-level differences? How to „distribute” reduction targets across the members of a financial group?

I. Differences in national targets

- Countries’ national reduction plans are very heterogenous
- Some NDCs do not even envisage real decrease compared to 2020-levels
- Many countries do not provide annual breakdown of their reduction plans

II. Differences in relative position based on level of income

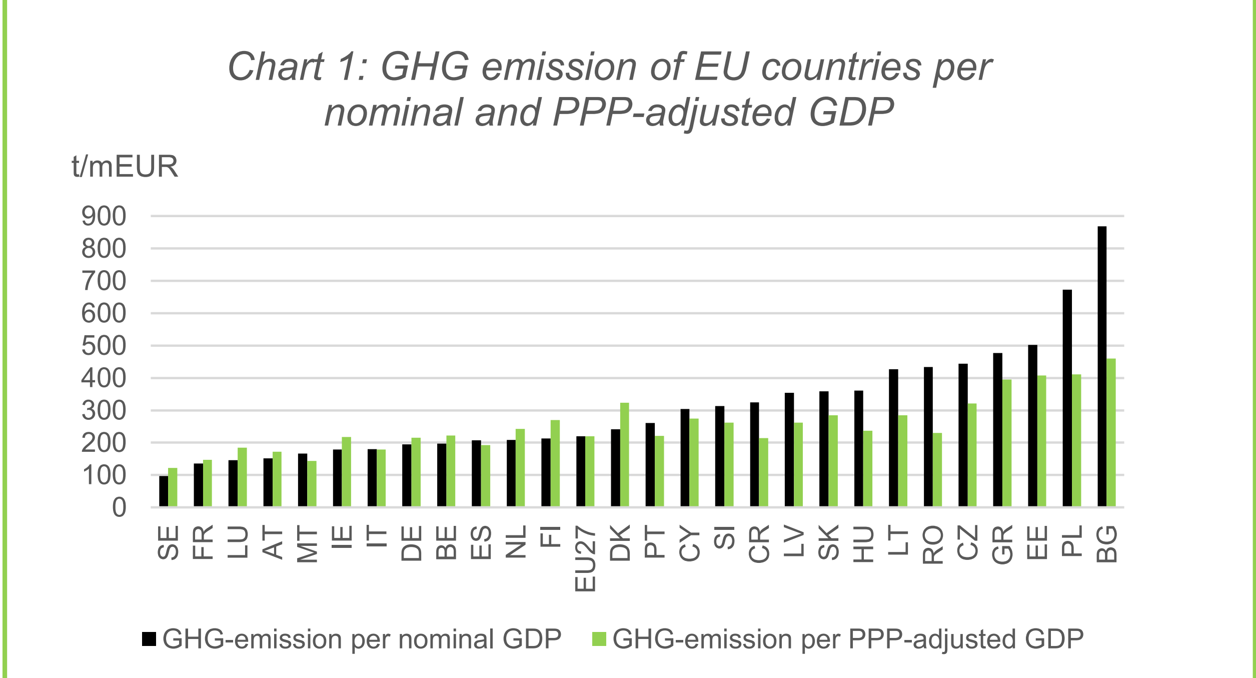

Illustration: EU Member States’ carbon reduction targets from 2018/842/EU

ANNEX I	
MEMBER STATE GREENHOUSE GAS EMISSION REDUCTIONS	
Member State greenhouse gas emission reductions in 2030 in relation to their 2005 levels determined in accordance with Article 4(3)	
Belgium	–35 %
Bulgaria	–0 %
Czech Republic	–14 %
Denmark	–39 %
Germany	–38 %
Estonia	–13 %
Ireland	–30 %
Greece	–16 %
Spain	–26 %
France	–37 %
Croatia	–7 %
Italy	–33 %
Cyprus	–24 %
Latvia	–6 %
Lithuania	–9 %
Luxembourg	–40 %
Hungary	–7 %
Malta	–19 %
Netherlands	–36 %
Austria	–36 %
Poland	–7 %
Portugal	–17 %
Romania	–2 %
Slovenia	–15 %
Slovakia	–12 %
Finland	–39 %
Sweden	–40 %
United Kingdom	–37 %

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Q&A

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