Network for Greening the Financial System

Technical document

Credible Transition Plans: The micro-prudential perspective

April 2024

Central Banks and Supervisors
Network for Greening the Financial System

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Executive Summary

The discussion around the relevance of transition planning and plans of financial institutions has recently been a focus area of financial markets and micro-prudential authorities. The NGFS has been actively exploring and discussing the role of micro-prudential authorities on transition planning and plans. The first output of the work, 'Stocktake on financial institutions' transition plans and their relevance to micro-prudential authorities'[1] was published by the NGFS in May 2023.

This report builds on that and explores the issue of credibility of transition planning and plans of financial institutions from the micro-prudential perspective, and the potential role of micro-prudential authorities to provide regulatory oversight (recognizing the varied mandates)[2].

This report should be read in conjunction with NGFS report, 'Connecting Transition Plans: Financial and non-financial firms', given the relationship between transition plans of financial and non-financial firms. This report addresses credibility of transition planning and plans framed along two dimensions:

i. The key elements that render transition planning and plans credible from a micro-prudential perspective; and
ii. For micro-prudential authorities who may mandate transition plans – the roles and responsibilities for assessing credibility and related considerations.

The NGFS defined "transition planning" and "transition plans" in the Stocktake report, which are adopted in this report. "Transition planning" is the internal process undertaken by a firm to (i) develop a transition strategy to deliver climate targets that firms may voluntarily adopt or that are mandated by legislation or the appropriate authority, and/or (ii) prepare a long-term response to manage the risks associated with its internal strategic planning and risk management processes undertaken by a financial institution to prepare for risks and potential changes in business models associated with the transition to a low emission and climate-resilient economy. "Transition plans" are a key product of the transition planning process and are an external-facing output for external audiences, such as investors, shareholders and regulators.

For the purpose of the NGFS work, transition planning and transition plans capture climate mitigation and adaptation. From the NGFS perspective, for completeness transition plans should reflect an entity's integrated approach to reducing its emissions (climate mitigation) and simultaneously adapting to the impacts of climate change that will arise even where the goals of the Paris agreement are met (climate adaptation).

This paper describes the proposed elements of credible transition planning and plans from a micro-prudential perspective, with a view to understanding how financial institutions maintain safety and soundness in the face of climate risks. The proposed elements are summarized in the following chart and include the elements of Governance, Engagement, Risk Analysis, Viable Actions, and Monitoring and Reviewing. While the left column contains actions and processes related to transition planning, the right column contains means and practices to describe the former in an outward-facing publication, or a transition plan, when they are appropriate for disclosure.

1 Stocktake on Financial Institutions' Transition Plans and their Relevance to Micro-prudential Authorities (ngfs.net).

2 This report is published alongside 2 other reports on Tailoring Transition Plans: Considerations for EMDEs and Connecting Transition Plans: Financial and non-financial firms, which offer complementary perspectives on related topics and help to establish further foundational understanding on the relevance of transition planning and plans for micro-prudential authorities.

Figure 1 **Overview of the proposed elements of credible transition planning and plans that are relevant to micro-prudential supervisors**

	Process: Transition Planning	Output: Transition Plan
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.
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.
Risk Analysis	- Robust setting of risk appetite and risk assessment process to measure and profile all relevant climate risks.	- Risk assessment result: • of clients and investees and • of the financial institution.
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: • to measure the effectiveness of mitigation and adaptation actions. • for periodic review of transition plans.	- Monitoring structure and metrics track the progress on a periodic basis.

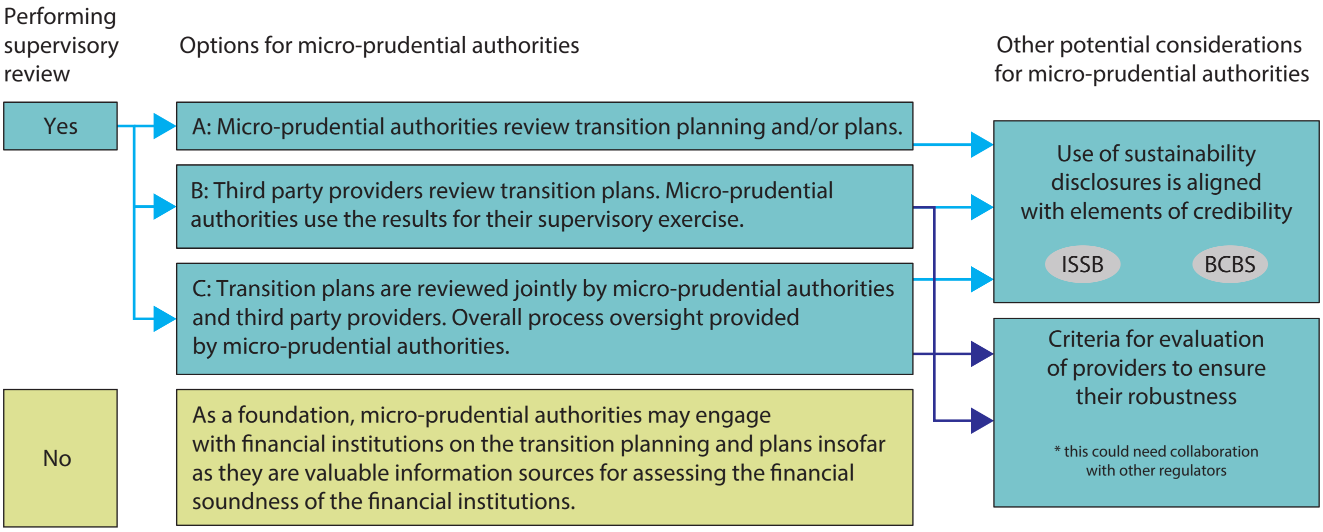
This paper also outlines the options for micro-prudential authorities on the use of transition planning and plans, using a building block approach depending on the scope of their respective mandates. As a foundation, transition planning information of financial institutions can provide important insights to micro-prudential authorities on the institution's strategic approach to addressing climate change and business transformation. Where micro-prudential authorities may be users of available transition plans, rather than regulators requiring financial institutions to develop them, they could engage financial institutions on their transition planning and plans to inform their assessment of the safety and soundness of financial institutions.

Depending on mandates, some micro-prudential authorities may also perform supervisory review of the transition planning process and plans. For those authorities, there are several considerations to operationalise an efficient supervision approach. These considerations include the implementation of an appropriate review and monitoring approach and ensuring sufficient resource capacity with appropriate knowledge to adequately guide, review, and challenge financial institutions' transition planning process and/or plans. The development of this supervision approach across micro-prudential authorities could be a time consuming process. In the meantime, there is an opportunity for these authorities to consider using the expertise of third-parties[3] while the holistic processes are under development. Figure 2 shows the overview of the options for micro-prudential authorities in their supervision of transition planning and plans.

Lastly, this paper outlines some areas for further work on enhancing credibility of transition planning and plans including the relevance of target setting activities by financial institutions.

3 This paper supposes that the relevant third-party evaluation providers are public or private actors, such as certain ministries or public authorities, or private actors such as verifiers, including but not limited to auditors, consultants, or specialist climate advisory firms.

Figure 2 **Overview of the options for micro-prudential authorities in their supervision of transition planning and plans**



1. Introduction

In 2021, many major global financial institutions committed to goals to achieve 'net zero greenhouse gas emissions'. Since then a number of financial institutions have published transition plans with more expected to publish transition plans in the coming years. Significant attention has been paid to the credibility of transition plans, especially since G7 Financial Ministers and Central Bank Governors agreed to "encourage the public and private sectors to enhance availability and credibility of science-based, transition-related information including through transition plans supported by credible pathways" in their joint communiqué in May 2023[4]. Simultaneously the G20 Sustainable Finance Working Group, under Brazil's presidency, has adopted a priority for "Advancing credible, robust and just transition plans" for both financial and non-financial firms, with the goals of " (i) develop[ing] high level principles for transition plans, and (ii) reflect[ing] on what defines a 'just' transition and provide guidance on how financial institutions and corporations can deepen the 'just' component of transition plans"[5].

The NGFS has been studying the role of transition plans to enable the financial system to mobilize capital and manage climate-related financial risks ("climate risks") and their relevance to micro-prudential supervision. This is in accordance with the NGFS' broader goal to enhance the role of the financial system to manage risks and to mobilize capital for green and low-carbon investments in the broader context of environmentally sustainable development and follows initial work published in the May 2023 NGFS Stocktake Report on 'Financial Institutions' Transition Plans and their Relevance to Micro-prudential Authorities" (the "Stocktake")[6].

Since the Stocktake was published, various international fora are assessing the relevance of transition plans in relation to their objectives.

- Basel Committee on Banking Supervision (BCBS): In its programme and strategic priorities for 2023/24[7], the BCBS articulated that it plans to consider the need for potential work on climate related transition planning.
- Financial Stability Board (FSB): As laid out in its 2023 Progress Report[8], the FSB launched the Transition Plan Working Group to consider the relevance of transition plans and planning by financial and non-financial firms for financial stability.
- International Association of Insurance Supervisors (IAIS): The IAIS conducted a public consultation on climate risk supervisory guidance in March 2023[9] and proposed a question to the public on whether IAIS should include a question on transition plans in the future consultations. Also, Sustainable Insurance Forum (SIF), a United Nations backed forum for insurance supervisors is collecting inputs from supervisors on their thinking of transition plans.
- International Organization of Securities Commissions (IOSCO): In its 2023-2024[10] Work Programme, IOSCO states that it has a plan to consider the role of market and security regulators on transition plans with regard to market integrity and avoidance of greenwashing.

In its Stocktake, the NGFS noted that (1) transition plans could be a useful source of information for micro-prudential authorities; (2) jurisdictions may engage with transition plans differently (i.e., some may be users alongside other stakeholders whilst others may require them as part of their regulatory expectations or through legislation[11]); and (3) notwithstanding the varied approaches, it would be important to further explore the concept of credibility from the micro-prudential perspective. In particular, Box 1 of the Stocktake noted: *"One theme that arose over the course of the stocktake but was outside of the scope of the literature review and survey, was*

4 G7 Finance Ministers and Central Bank Governors Meeting Communiqué.

5 G20 Sustainable Finance Working Group Presidency and Co-chairs Note on Agenda Priorities.

6 Stocktake on Financial Institutions' Transition Plans and their Relevance to Micro-prudential Authorities.

7 Basel Committee work programme and strategic priorities for 2023/24.

8 Progress Report on Climate-Related Disclosures (fsb.org).

9 Public consultation on climate risk supervisory guidance – market conduct and scenario analysis - International Association of Insurance Supervisors (iaisweb.org).

10 IOSCO 2023-2024 Work Programme.

11 EU revised Capital Requirements Directive (CRD VI) will require banks to develop prudential plans to address climate-related and environmental (C&E) risks when adjusting to the process to become climate neutral by 2050.

the importance of "credibility" in transition plans. Specifically, the NGFS discussed the importance of understanding how credibility of a transition plan is determined or defined, and who is best placed to assess it."

As a follow-up to the Stocktake, this report explores the concept of credibility from the micro-prudential perspective and the related factors that micro-prudential authorities could consider, including:

i. The key elements that render transition planning and plans credible from a micro-prudential perspective; and
ii. For micro-prudential authorities who may mandate transition plans - the roles and responsibilities for assessing credibility and related considerations.

Why credibility matters to micro-prudential authorities?

As highlighted in the Stocktake, most available guidance and literature on transition plans are market-oriented, generally applicable to all industries and sectors, and disclosure-focused. Typically, their main objective is to enhance transparency and provide information to shareholders, investors, and other external audiences about an individual corporate's transition strategy and provide comfort on the credibility of its net zero/transition-related commitments. This report intends to lay out additional elements of credibility that could assist micro-prudential authorities in executing their role regarding climate risk mitigation and adaptation.

Regardless of whether micro-prudential authorities are the potential users or regulators of transition planning and plans (a factor that may differ between jurisdictions reflecting national approaches and regulatory mandates), the planning processes and plans need to be reliable and credible to become a relevant source of information or tool for supervisory work.

In other words, micro-prudential authorities could use the information on planning processes and plans where they are credible and valuable as an input to effectively assist their oversight of the safety and soundness of financial institutions and the climate risks.

From the perspective of NGFS, transition plans should reflect an entity's strategy to respond to transition (climate mitigation) but also how it will adapt to the impacts of climate change (climate adaptation). Having a credible transition plan means financial institutions understand and are prepared to deal with both transition and physical risks. Therefore, the credibility of a transition plan could be broadly defined as the quality and completeness of the described actions to mitigate and adapt to climate risks.

The structure of this report

This report follows the "building blocks approach" first introduced in the Stocktake report.

Recognizing the spectrum of regulatory objectives and mandates, the report proposes elements of credibility that micro-prudential authorities could look for when engaging with transition planning and/or plans. Furthermore, where relevant for micro-prudential authorities who supervise transition planning and/or plans, it proposes potential ways forward to assess their credibility. Notably, this report does not examine whether public disclosures of those plans itself is an aspect of credibility. Public disclosures of transition plans are subject to different variables, not least regulatory mandates, and jurisdiction-specific legislation, thus outside the scope of this report.

Following this introduction, Chapter 2 of this report introduces existing guidance and literature review of various elements of transition plans. Chapter 3 of the report outlines the elements to ensure the credibility of transition plans and planning from the micro-prudential lens. The last chapter provides possible options for micro-prudential authorities, where relevant to the authorities' mandate, to assess credibility. It also proposes potential next steps that the NGFS and wider communities working on transition plans could consider.

2. Current Landscape around the elements of credible transition planning and plans

2.1 Definitions: transition planning and plans

This report builds on the definitions drawn in the earlier Stocktake where "transition planning" is the internal strategic planning and risk management processes undertaken by a financial institution to prepare for risks and potential changes in business models associated with the transition. A "transition plan" is a key product of the transition planning process and an external-facing output for external audiences, such as investors, shareholders and regulators.

The NGFS recognises that a transition to a low emission world will give rise to both transition and physical risks. Accordingly, this report uses transition plans in a broad sense as an articulation of a financial institutions' approach to climate change and the transition to a low emission world, which encompasses both transition and physical risks. Unless otherwise stated, references to transition plans also encompasses transition planning.

2.2 Review of existing guidance and literature for relevant elements that contribute to credible transition plans

A number of existing guidance documents and literature have identified elements of credible transition plans. However, because they serve different objectives, how "credibility" is defined could also differ. Although the purpose of these guidance and literature may vary from the interests of micro-prudential authorities, they serve as a useful reference framework for micro-prudential authorities. The NGFS is not endorsing any of these specific frameworks, but rather, distilling relevant information to inform the report.

Examples of these frameworks include:

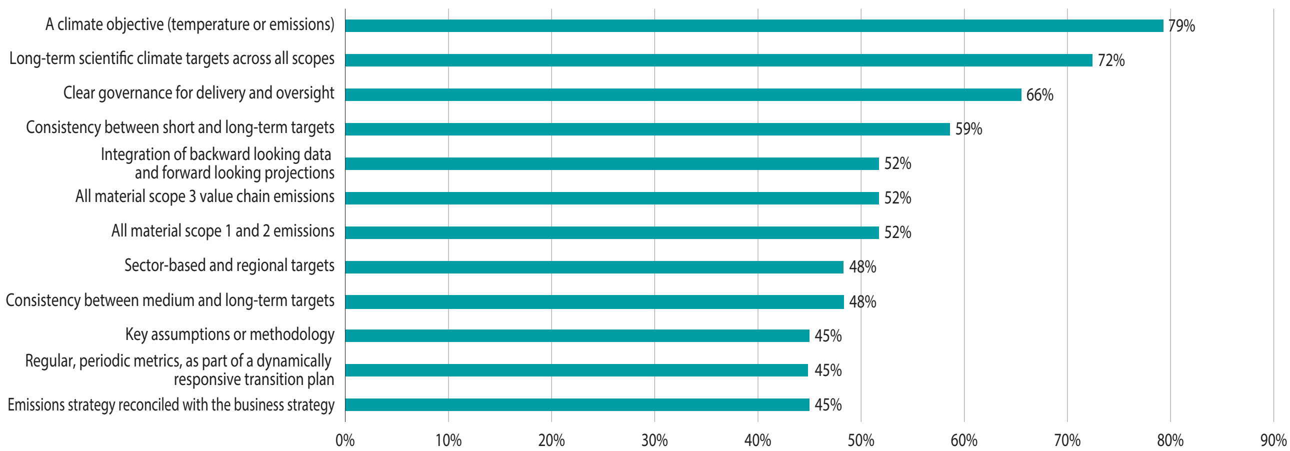
- Task Force on Climate-Related Financial Disclosures (TCFD) and International Sustainability Standards Board (ISSB): The TCFD Guidance on Metrics, Targets and Transition Plans identified that **governance, strategy, risk management, and metrics and targets** are often referenced as part of assessments on the preparedness of the entities towards climate risks. ISSB IFRS S2 describes transition plan as an aspect of an entity's overall strategy that lays out the entity's targets, actions or resources for its transition towards a lower-carbon economy. Credibility here is about the accuracy of relevant information for, amongst others, shareholders and investors.
- Glasgow Financial Alliance for Net Zero (GFANZ): GFANZ's objective is to ensure the accountability of financial institutions committed to net zero and to accelerate their transition to net zero. Elements of credible transition plans identified by GFANZ include **Foundations (objective and priorities), Governance, Engagement Strategy, Implementation Strategy, and Metrics and Targets.** Credibility in this context is about the actions to deliver a voluntary net zero emission target.
- International Capital Market Association (ICMA): For climate transition related bond issuers, the verifiers could assess the alignment of issuing corporates' strategies against ICMA's Climate Transition Finance Handbook 2023 (ICMA's Handbook) to provide confidence on the credibility of the issuers' transition. The Handbook also established metrics for independent review, assurance and verification to assess whether the issuers are aligned with the climate goals. Specifically, the Handbook requests verifiers to assess the **alignment of issuers' greenhouse gas (GHG) emission reduction targets including short, medium and long-term targets to relevant regional and national GHG emission reduction targets and credibility for issuers' strategies** to attain the targets. In addition, with the acknowledgement of the technical challenges associated with the service provision, the Handbook stipulates that the verifiers can assess **absolute amount of green or transition spending and expected GHG emission reduction by the increased amount of the spending.** In February 2024, ICMA published another report, "Transition Finance in the Debt Capital Market" and proposed the convergence of best practices on transition plans. Based on their review of the ICMA's Handbook, International Financial Reporting Standards (IFRS) S2, European Sustainability Reporting Standards (ESRS) E1 and UK Transition Plan Taskforce (TPT), have the key elements as **Transition strategy, materiality and governance, Science-based targets and metrics, Implementation transparency, and Verification and Reporting.**

- Consulting service providers: Notably, accounting firms have also started to provide consulting for developing the corporates' transition plan, albeit more in consultation work capacity. Whilst there is some variation in the service offering for transition plan development, common review areas and measures of credibility across the accounting firms have been observed. As an indicative example, the Deloitte published a working paper on their view of climate transition plans and addressed elements such as **ambition of the firm, data robustness, target settings, governance and credibility, transition pathway and scenarios, investment and financing, and progress monitoring and reporting**[12].
- Non-profit assessment providers: These providers have also used similar frameworks for their assessment around companies' decarbonisation targets. Namely, The High-Level Expert Group on the Net Zero Emissions Commitments of Non-State Entities proposed the five principles and ten recommendations to attain net-zero target successfully that include the establishment of transition plans and transparency and accountability. At the same time, frameworks such as the Climate Bonds Initiative (CBI) and Carbon Disclosure Project (CDP) look at: **time-bound GHG emission reduction targets** based on the latest climate science, **actions and financial plan** that will enable the assessed entity to reach their targets, **appropriate governance** with the executive board oversight over the transition plan and its continuous execution and renewal, and **verification and disclosure** on the emissions and the other elements. CBI aims to ensure that the certified entities are aligned with Paris Agreement goals, ambitious and inclusive with these elements and mobilize transition finance. Lastly, Science Based Target initiative (SBTi) encourages corporates that are willing for their GHG emission reduction targets to be validated by the initiative to develop a transition plan which includes **appropriate governance and incentive structure, explanation of how the transition plan is aligned with a sectoral pathway, financial plans to implement the relevant actions, results of third-party evaluation,** etc.

2.3 Common credibility elements of transition plans suggested by the existing guidance and literature

Approximately 30 guidance documents and literature were reviewed to identify elements that are relevant to different purposes (e.g., providing transparency through disclosures vs. accomplishing climate goals)[13]. The review counted the frequency of an element being mentioned in a document at least once, and highly ranked elements appeared in most of the literature. As shown in Figure 3 below, **Target setting and governance elements ranked high** in the relevant literature.

Figure 3 **Percentage of literature reviewed that included specific transition plan elements**



12 Working paper: "Our view on climate transition plans", Deloitte NL, March 2023.

13 Please refer to the end of the report for the list of literature reviewed.

It is important to note that a large part of the literature reviewed focuses on achieving decarbonisation goals, and does not explicitly consider other climate-related objectives, such as addressing physical risks. Nevertheless, in summary the common elements include:

1. **Target setting:** setting of GHG targets and assessments gauging how the GHG reduction targets are aligned with the wider economy GHG emission reduction targets, taking the latest climate science into consideration.
2. **Appropriate governance:** articulation of executive boards' responsibility and accountability (including remuneration considerations) in the development, implementation, and monitoring of transition plan.
3. **Financial planning and associated GHG reduction:** transition plans and the business strategies that are supported by the financial and spending plans and estimation of how much GHG emissions are expected to be reduced with the financial plans.
4. **Data robustness:** development of transition plan with the actual and estimated data calculated by credible methodologies as well as the controls related to the data input.
5. **Independent assessment, monitoring, and disclosure:** ensuring credibility through third party assessments. Disclosure of a transition plan could reinforce the accountability of these plans and provide forward-looking information to investors and other stakeholders for their assessments of risks associated with the transition to a low emission world.

Box 1

Relevance of a financial institution's target setting activities to its safety and soundness

Micro-prudential mandates focus on the safety and soundness of financial institutions and do not typically include meeting broader climate objectives, such as decarbonizing a supervised entity or the economy. As a result, 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. This box is a first exploratory attempt to initiate the discussion around the issue.

Considering metrics used in targets as a source to develop a key performance indicator

Financial and non-financial firms use key performance indicators to measure progress against their business or strategic objectives or assess their risk management processes. From micro-prudential authorities' standpoint, financial institutions could demonstrate how their risk management measures remain adequate under different transition scenarios (such as different temperature status) using specific climate-related metrics. Accordingly, financial institutions can set their KPIs and/or risk management metrics to manage risks over the long term based on these scenarios.

Although outside the scope of this note, whether and how micro-prudential authorities could engage with financial institution's climate-related target setting is an area that could be further explored.

3. Proposal for the elements of credible transition planning and plans

3.1 Proposed elements of credibility for micro-prudential objectives

This Chapter uses the relevant elements identified in Chapter 2 as a starting point to assess commonality between elements of credibility in existing guidance and literature and micro-prudential interests.

There are some relevant considerations to note before setting out the elements of credible transition plans:

- As noted in Chapter 2, existing literature is primarily aimed at supporting disclosures and accelerating financial institutions' support of decarbonisation.
- Addressing physical risks and adaptation in transition planning is in a nascent stage and NGFS acknowledges that more work is needed to mature the thinking. For the purpose of this report, a few basic elements are highlighted for illustrative purposes. Practical challenges around integrating countermeasures against the physical risks in one transition plan alongside transition risks remain, especially for those risks on a balance sheet stemming from clients and investees.
- There are unique aspects to climate risks that makes transition planning different from the typical strategic planning process. For example, given the long horizons financial institutions should consider for climate risks and the uncertainty that comes with those timeframes, new processes and actions may be needed to maintain the robustness of the transition plans beyond the established "regular" strategy setting process.

Figure 4 below sets out the proposed core elements of transition planning and plans that can contribute to their credibility. While financial institutions are operating in different regulatory environments and use different business models, this report considers the following elements as jurisdiction and sector agnostic. At a high level, the elements of credible transition plans are broken down into five segments.

Figure 4 **Overview of the proposed elements of credible transition planning and plans that are relevant to micro-prudential supervisors**

	Process: Transition Planning	Output: Transition Plan
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.
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.
Risk Analysis	- Robust setting of risk appetite and risk assessment process to measure and profile all relevant climate risks.	- Risk assessment result: • of clients and investees and • of the financial institution.
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: • to measure the effectiveness of mitigation and adaptation actions. • for periodic review of transition plans.	- Monitoring structure and metrics track the progress on a periodic basis.

3.2 Elements of the transition planning process relevant for credibility

Micro-prudential authorities could consider the following foundational elements when assessing the credibility of financial institutions' transition planning process. Furthermore, it is important that transition planning is integrated with the financial institutions' risk management practices and internal strategic planning processes.

Governance

- This element refers to the need to set an appropriate governance when developing a transition strategy and plan. The plan should be reviewed and approved by the board, and the senior management should be held responsible for the execution of the transition plan.
- The roles and responsibilities of senior management and relevant departments in developing, executing, reviewing and updating a transition plan are clearly defined and documented.
- Both the board and the senior management should have suitable capacity and expertise in assessing climate risks.
- When appropriate, the remuneration and incentives of board and senior management are aligned to the success of the operationalising the transition plan.

Engagement

- This element refers to the extent to which financial institutions engage with their clients and investees[14] to assess their exposure to climate risks and the credibility of their transition plans, considering the following sub-elements:
  - Understanding the alignment of clients' and investees' business and supporting financial plans for the transition with the strategy and risk appetite of the financial institution. This understanding could be supported by scenario analysis and the assessment of future climate risks of the clients and the investees[15].
  - Collecting information from clients and investees to assess their risk profile and inform the financial institutions' own transition plan. Information such as the clients' and investees' Scope 1, 2 and, where material to the clients, Scope 3 GHG emissions, and their future business plans, as well as exposures to physical risks, could be taken into consideration.
  - Using estimates or proxies to bridge the data gap to some extent, where climate-related data and information (such as client transition plans) are unavailable. It is good practice for the estimates or proxies to be based on robust methodologies and reasonable assumptions.
  - Varying the intensity of engagement and implementing escalation processes as needed. For example, the financial institution may have escalated engagement procedures for clients and investees whose exposures to climate risks are not managed to an acceptable level.

Risk Analysis

- This element refers to the robustness with which financial institutions sets and assesses the risk appetite for specific clients and investees depending on their exposure to climate risks[16], taking the following into consideration:
  - The application (or not) of a clear, scientific and robust methodology for setting the risk appetite and analysing the transition and physical risks of the clients and investees. Climate scenario analysis and/or stress testing could be one of the key tools to measure the size and type of risks that can be accepted at both individual and sectoral levels for its clients' and investees.
  - Assessment of climate risks of clients and investees could be informed by the alignment of the designated time-bound emissions and hazard status in the future, based on up-to-date climate science (e.g., sectoral, regional, and national emission targets and pathways (if any), scenarios as well as roadmaps and taxonomies). The selection of benchmark and/or KPIs can be made by considering the financial institutions' vision, targets,

14 Refer to the NGFS Technical Document on 'Connecting Transition Plans: Financial and non-financial firms' for more detailed deep-dive on client engagement aspects.

15 This report does not presuppose that the current high emitting companies are considered financially vulnerable immediately. At the same time, there are companies that are not emitting much but have business segments exposed to transition risks due to the societal transition and technological shift.

16 As an example of physical risks, long-term mortgages lending for properties on the coast that are vulnerable to sea level rise could be included in the risks analysis. While low in emissions, they could be highly vulnerable to physical risks.

forecasts, scenario analysis, and the maximum risk allowance of transition and physical risk. Scope 3[17] emissions and carbon credit usage of clients and investee companies could be referenced if they are material from the perspective of reputational risk, etc[18].

Viable Action

Maintaining credible actions, including for financing and offering financial services clients and investees, with clear documentation and alignment with the overall strategy taking the following aspects into consideration:

i. Specifically, that financial institutions can explain how major future financing actions are consistent with the climate goal of the financial institution as well as managing associated financial and reputational risks.
ii. Whether the personnel from all relevant departments (e.g., risk management, sales, sustainability department) are involved in the development and delivery of these actions, and employees are aware of the significance of these actions and their responsibilities[19].

Monitoring and reviewing

- Establishment of appropriate internal controls and monitoring process, as well as long term risk mitigation and adaptation metrics and/or KPIs[20] to check whether the risk mitigation practices are executed as planned and potential climate risks are mitigated. This should also be aligned with the other internal monitoring processes within the financial institutions.
- Periodic review of the transition plan when up-to-date climate science is updated and when it is necessary for the financial institutions to revise the existing plans to effectively manage their climate risks. For example, if the global GHG emission reduction targets and benchmarks are updated, or if significant deviation from the original reduction projections is expected, the transition plan should be updated as appropriate (subject to the appropriate guardrails as highlighted in the 'governance' segment) as the transition risk of the financial institution changes. Likewise, if physical risks are assessed to have changed, this should also trigger a review.

3.3 Elements of transition plan relevant for credibility

A credible transition plan, which is the output of transition planning, could contain the following elements. Where possible and relevant, the earlier elements of credible transition planning could be also disclosed as the process undertaken for developing the transition plan[21].

- Governance structure that stipulates the process for authorization, implementation, monitoring and updating the transition plan.
- Sector and hazardous area specific engagement strategies stipulating the sectors for which financial institutions need specific engagement. The plan could include the data proposed to be collected from the counterparties with the accompanying description of the estimates and proxies (along with methodologies and assumptions) used.
- Risk assessment result articulating the financial institution's risk appetite and clients' and investees' risk profiles and estimated climate risks. Examples include outlining the results of financial institutions' scenario analysis and/or stress tests.
- Action and financing strategies with regard to the clients and investees that are exposed to climate risks.
- Training and educational measures being undertaken to ensure that responsible and relevant employees understand the potential climate risks associated with their roles and responsibilities and are able to contribute to the development of corresponding actions.

17 Scope 3 emissions could include not only financed emissions but also facilitated emissions depending on the types of financial institutions and their major businesses.

18 If clients of financial institutions rely heavily on the use of carbon credits, they could be exposed to reputational risks, and therefore the risk could be transferred to the financial institutions. In the event that clients significantly deviate from the appropriate benchmarks in their climate goals, they could potentially endanger the financial institutions' financial soundness.

19 Having various departments involve in the process of developing viable actions, the existing actions and risks management frameworks could feed in a transition plan and lay the viable actions accordingly.

20 The preliminary example of monitoring metrics against the transition and physical risks could include the alignment of the clients' and investees' climate risks that with financial institutions' future risk appetite, the proportion of companies that are taking risk mitigation actions and the proportion of business with clients who are located in high physical risk area based on hazard maps.

21 The elements proposed from the micro-prudential perspective can be established when the necessary information become available. It is also noted that the proposal does not limit other elements to be included for different purposes.

- Monitoring structure and metrics and/or KPIs that financial institutions use to track the progress and success of engagement and risk management measures, including supporting clients' and investees' climate transition.

3.4 Illustrative Additional Considerations for Micro-prudential Authorities

Although the following considerations do not directly fall under the proposed elements, they could add credibility to transition plans depending on the transmission channel considered by each micro-prudential authority. They include:

- The method and structure employed by the financial institutions for avoiding possible greenwashing activities, such as undue reliance on the clients' inappropriate deployment of low quality carbon credits or simply allocating the carbon credits to the estimated Scope 3 GHG emissions. A lack of actual Scope 3 GHG emission reduction plans could also indicate that the transition plan needs improvement for reducing the exposure of the financial institutions to the potential transition risks.
- The extent to which the financial institutions incorporate consideration of nature-related/loss of biodiversity related risks as climate change and nature loss are deeply intertwined.
- The extent to which the financial institutions consider broader just transition aspects, which could speak to the community and societal level fragility and, in turn, contribute to additional financial risks for the institutions.

The above mentioned elements are not meant to be exhaustive and micro-prudential authorities are encouraged to continue exploring the relevance of the additional elements of transition planning and plans in their supervisory work.

It is also acknowledged that further work is needed to overcome some practical challenges to increase the credibility of transition plans. For example, micro-prudential authorities need to also consider how to improve availability of data and reliability of the financial institutions' clients' and investees' plans, how financial institutions can integrate considerations such as nature and social justice aspects into one transition plan, unintended consequences on (dis)incentivising financing, and the possible differences between advanced economies and emerging and developing economies[22].

22 More work on the consideration for EMDEs can be found in the NGFS Technical Document on 'Tailoring Transition Plans: Considerations for EMDEs'.

4. Options for micro-prudential authorities to supervise the credibility of transition planning and plans (subject to varied mandates)

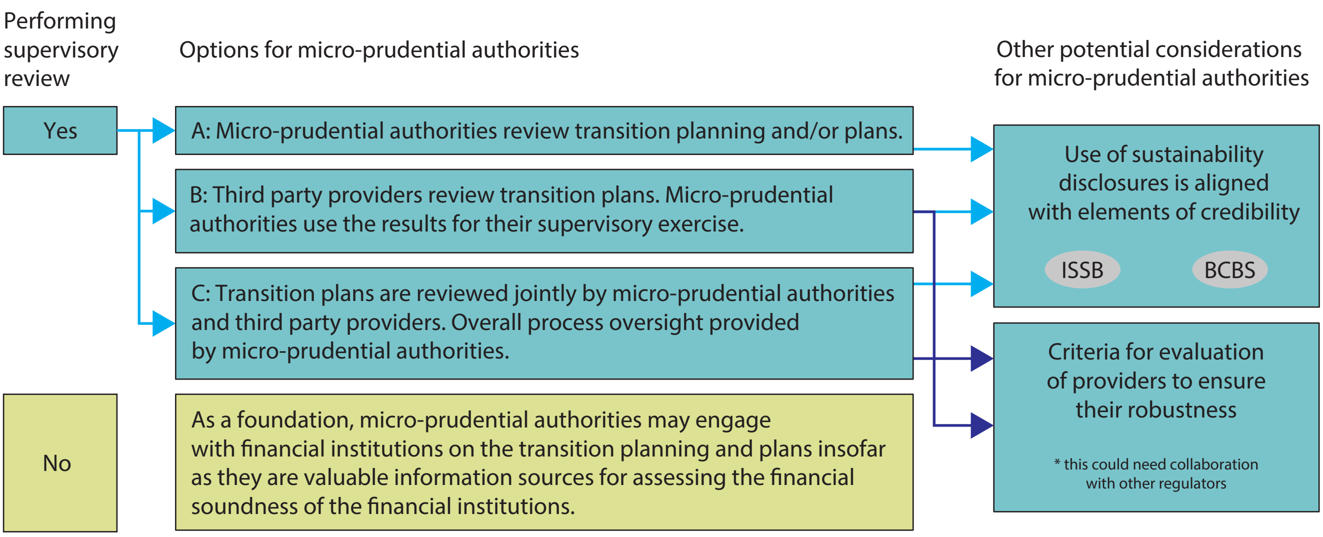
As discussed in Chapter 1, micro-prudential authorities may engage with transition planning and/or plans as part of their overall assessment of financial institutions' safety and soundness as a foundation[23]. This engagement can range from being users of available transition planning information and plans to regulators requiring financial institutions to undertake transition planning and develop transition plans. However, regardless of whether micro-prudential authorities are users or regulators of transition plans, the plans need to be reliable and credible to become a relevant tool for supervisory work.

The preceding chapter, Chapter 3, outlined proposed elements that could contribute to the credibility of financial institution transition planning and plans, which could be relevant to all authorities who engage with these plans. Chapter 4 explores potential ways forward for micro-prudential authorities who supervise transition planning and/or plans to assess their credibility.

For micro-prudential authorities tasked with supervising transition planning and/or plans, there are several considerations to operationalize supervision. These include implementation of an appropriate monitoring approach, and ensuring availability of resources with the capacity and capability to adequately review and challenge transition planning and/or plans as needed.

The development of this supervision approach across the micro-prudential regulators could be a time consuming process. As a result, this chapter explores three potential ways forward to operationalize the review process, including using or relying on third-party evaluations. See Figure 5 for an overview of these options.

Figure 5 **Overview of the options for micro-prudential authorities in their supervision of transition planning and plans**



23 NGFS recognizes that the authorities' commitment or signal for engagement activities to the voluntarily prepared transition plans of financial institutions might discourage financial institutions to develop such plans and these plans may still lack good quality data to ensure credibility and be developed for accomplishing emission reduction targets.

4.1 Options for micro-prudential authorities to monitor transition planning and plans

A. All elements of transition planning and plans are reviewed by the micro-prudential authorities

Micro-prudential authorities could directly ensure that financial institutions adequately manage climate risks and test their long-term resilience to negative impacts over various time horizons. Through this direct review, micro-prudential authorities could proactively evaluate and monitor the planning and plans, their ongoing progress, and risks arising from the adaptation of the business model of the financial institution. Finally, micro-prudential authorities could be more empowered through this direct engagement to require financial institutions to adjust their risk management practices and governance strategies based on first-hand analysis.

Major Challenges:

- **Capacity building/Expertise:** Authorities might need to build a specific set of skills and capacity to make accurate assessments.
- **Consistency/Level-playing field:** Ensuring consistent evaluation criteria and standards to review the planning and plans across all sectors could be difficult, especially where financial institutions have to meet regulatory expectations or legislations in different jurisdictions.
- **Resource Intensity:** Reviewing all elements of transition planning and plans requires significant time and resource commitments from micro-prudential authorities.
- **Striking a balance between engagement and burden for financial institutions:** Increased engagement with financial institutions for proactively and thoroughly reviewing their transition plans may be perceived as additional regulatory burden by the industry.

Micro-prudential authorities might need to collaborate with other government agencies, such as the Ministry of Finance and the Ministry of the Environment and other related sectoral ministries (Energy, Agricultures etc.), to ensure that the micro-prudential authorities understand the broader environmental context and other relevant policies that form the basis for development of the transition plans by financial institutions. Collaboration with climate and environmental scientists, economists, and academia could also enhance the depth of analysis.

B. Reliance on third party evaluation organizations' review

Assessment conducted by third-parties could ease the burden on micro-prudential authorities. If third-party evaluators are involved, they need to conduct impartial and rigorous evaluations of the transition planning and plans, ensure that evaluation criteria are standardized and applied consistently across all financial institutions and maintain transparency in the evaluation process, allowing for scrutiny and validation of their assessments.

Micro-prudential authorities could assess the need to use the services of third-party providers, and decide if such services are needed. In this case, micro-prudential authorities should ensure they have a sufficient understanding of the sources, data and methodologies used by third-party providers, including the understanding of the assessment results.

Major Challenges:

- **Independence:** Ensuring the independence and impartiality of third-party evaluators is vital for credibility. The third-party provider could provide an independent review and objective assurance of the quality and effectiveness of the overall transition planning and plan.
- **Standardization and reliability:** Having reliable and standardized evaluation criteria that third parties must follow is crucial to provide assessments of appropriate quality. Evaluation standards will depend on the jurisdiction in which the financial institution operates and the contents of planning and transition plan. There is currently no international framework for accreditation of verifiers for transition planning and plans[24]. It should also be highlighted that the current practices and methodologies of the third-party evaluators are mainly for validating the alignment of corporate GHG emission reduction targets to broader climate goals and for evaluating the robustness of strategic actions of financial institutions to accomplish the climate goals.
- **Cost:** Cost implications for both financial institutions and micro-prudential authorities for hiring reputable third-party organizations is also a consideration.

24 OECD, OECD Guidance on Transition Finance.

In light of these challenges, micro-prudential authorities or, depending on the jurisdiction, standard setting regulators would need to collaborate with third-party evaluation organizations to develop standards for reviewing transition planning and plans and ensure that reviews are conducted to a high standard.

C. Joint review by micro-prudential authorities and third party evaluators

This could be considered as a balanced approach to assess the credibility of transition planning and plans. However, its feasibility would depend on the applicable legislation in the respective jurisdictions. This option leverages the expertise of third-party evaluators while giving micro-prudential authorities an active role in oversight of transition planning and plans to ensure they align with financial regulations and do not pose undue financial risks. This option would also allow micro-prudential authorities to tailor their approach to supervision based on the level of risk posed by each financial institution. Here again it is important for supervisors to fully understand the results of the third party evaluation, in order to be able to use it for their subsequent supervisory processes, (e.g., monitoring).

Major Challenges:

- **Transparency:** The third-party evaluators would have to describe a holistic methodology for the evaluation of the process and/or system controls and data. They should have in place sound data processes to collect, verify and aggregate the data needed to inform the formulation of the financial institutions' transition planning and plans and monitor the implementation of such plans.
- **Cost:** Cost implications for both financial institutions and micro-prudential authorities regarding hiring reputable third-party organizations need to be considered.
- **Coordination/Timeliness:** Seamless coordination between third-party evaluations and ongoing supervisory activities is needed. Micro-prudential authorities and third-party providers should regularly review the transition plans considering updated information such as new materiality assessments of climate and environmental risks or new available or improved scenarios, benchmarks and sectoral pathways.

In the light of these challenges, micro-prudential authorities will need to collaborate with third-party evaluation organizations to decide the roles and responsibilities clearly for reviewing transition planning and plans and coordinate the review process.

4.2 Other items to consider

Utilization of disclosure for supervision

Micro-prudential authorities might be able to refer to the disclosed information for their supervisory activities, if relevant and useful from micro-prudential perspective. Also, assurance could be utilized for ensuring the credibility of the information disclosed by the financial institutions.

A number of existing initiatives are ongoing that would require financial institutions to disclose information that could be helpful for supervisory purposes, and such information is expected to become more reliable over time through assurance. While they are solely dedicated to the disclosure for the investors, the ISSB finalized standards for a global baseline of sustainability disclosures and different jurisdictions are beginning to implement disclosure regulations to corporates including financial institutions. Moreover, BCBS recently consulted on a Pillar 3 climate-related financial risks disclosure framework, proposed to be implemented from January 2026. In terms of assurance, International Auditing and Assurance Standards Board (IAASB) has launched the discussion on requirements for Sustainability Assurance Engagements. Other examples include jurisdictional approaches such as UK TPT and individual supervisory guidance on climate risks.

Criteria for qualified third party evaluation providers

For micro-prudential authorities who would use third party evaluators, setting certain guiding principles would help in choosing appropriate providers.

As an illustration, the following high level criteria may help in choosing third party evaluators;

a. **Expertise:** The evaluation provider must be equipped with the knowledge on practices of financial institutions' measurement of financial risks, climate change and the relationship between the two. The documentation and methodologies used by the evaluation provider should be shared with the micro-prudential authorities.

b. **Objectivity:** The evaluation methodologies must be rigorous and systematic, validated by the experts and reviewed continuously to improve its accuracy.

c. **Independence:** The evaluation providers must be independent from any economic or political entities and pressures. When the evaluated financial institutions pay for the service, the independence must be strictly ensured from any pressures and requests from the financial institutions to improve the evaluation and/or ratings (e.g., the provider must not use unsolicited evaluations). All conflicts of interest should be appropriately managed.

d. **Disclosure/Transparency:** The purpose of evaluation, its key elements, and the alignment of the methodologies with the micro-prudential regulation should be made available publicly. This will not necessarily include the confidential information or evaluation result.

e. **Cooperation with the authorities:** The evaluation provider should inform micro-prudential authorities of significant changes to evaluation methodologies and ensure access is provided to the data used for the assessment and the methodologies.

4.3 Next steps for NGFS

- Building on the work done in this report, the NGFS will continue to further its work on transition plans, such as in terms of understanding the interaction between scenario analysis and transition planning, strategy setting, and understanding target setting from supervisory perspectives

Acknowledgements

This document on "Credible Transition Plans: The micro-prudential perspective" is a collaborative effort of the members of the Workstream on Supervision of the NGFS.

This document was prepared under the auspices of Saori Takahashi (Japan Financial Services Agency), serving as lead of the sub-group, with support from Timothy Rawlings (Bank of England) and Vivian Yu (Office of the Superintendent of Financial Institutions), the co-leads of the sub-team on transition plans, the Chair of the Workstream, Tolga Yalkin (Office of the Superintendent of Financial Institutions), and the NGFS Secretariat – Rachèle Sannier (Banque de France), Laj Gajwani (Australian Prudential Regulation Authority) and Jasper Chan (Monetary Authority of Singapore).

This document relies on the analysis and drafting work of a dedicated team composed of Workstream members. The NGFS is especially thankful to the drafting team, comprising Joanna Chang and Ivan Chan (Australian Prudential Regulation Authority), Valeria Lionetti (Banca d'Italia), Carine Bastos (Banco Central do Brasil), Safiye Bayazit (Deutsche Bundesbank), Alexandre Foucault (European Central Bank), Uli Agustina, Afif Alfarisi and Nisrina Qurratu'ain (Otoritas Jasa Keuangan Indonesia).

Other team members included Sarah Kaber and Stephen Lecourt (Autorité de contrôle prudentiel et de résolution), Kathleen McTaggart (Central Bank of Ireland), Niklas Schmeyer (Deutsche Bundesbank), Fabian Regele (European Insurance and Occupational Pensions Authority), and Guilan Cals (European Securities and Markets Authority).

The NGFS is also grateful to its other members and observers as well as other members of the Secretariat for providing comments and contributing materials to this document. The contents of this publication do not necessarily reflect the position or opinion of the above-mentioned institutions.

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