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# The Role of The Financial Sector in the Net Zero Transition: Assessing Implications for Policy, Supervision and Market Frameworks

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## Executive Summary and Summary of Recommendations

**Understanding the financial system's enabling role in support of the net zero transition:** Recent debate amongst private sector, official sector, and civil society actors has revealed a diverse range of views on the role of the financial sector in supporting the net zero transition, with some stakeholders seeing the financial sector as a primary driver of change. There is limited common understanding of the capacities and limitations of the role of financial institutions in this context, nor is there agreement on the level of direct and indirect influence they can have on real economy decarbonization outcomes. While the financial sector has a critical role to play, its ability to support the transition will depend significantly on whether the conditions are in place to enable the real economy to transition, thereby creating opportunities for finance and investment to support such activities. Over-reliance on the financial sector and its regulators to deliver the net zero transition risks diverting attention from the fundamental policies needed to catalyze actions across the entire economy.

**Critical role of economy-wide policy frameworks:** The IIF and its members firmly believe that strong, pro-growth policy frameworks at the national and global levels are key to providing the foundation, long-term orientation, and market conditions for effective private sector action in support of a net-zero economy. Key considerations include: i) Providing policy clarity and certainty, ii) Providing incentives, iii) Developing infrastructure, iv) Addressing the supply and demand sides of emissions reduction, v) Pricing carbon emissions, and vi) Promoting a just transition, job creation and economic growth.

**Transition planning as business strategy**: Transition planning is a dynamic business exercise to operationalize a firm's strategic targets and commitments to achieve its low carbon goals. Transition planning is inherently strategic in nature, given that it reflects a financial firm's competitive positioning to navigate key business model risks and opportunities arising from the broader transition of the real economy. Transition planning can produce internally relevant information, as well as some externally

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relevant information of interest to investors and the wider public (for example, in cases where a firm has made a relevant public commitment). The externally relevant aspects of a firm's current transition planning process can be summarized as a point-in-time disclosure with a forward-looking perspective, which is often what is referred to as the transition plan (for example, in the context of disclosure frameworks or requirements). In this regard, transition plans can inform market actors about a firm's competitive positioning in relation to business opportunities and strategic risks. However, the forward-looking nature of transition plans—and the wide range of exogenous factors beyond the control of financial firms—implies a high degree of uncertainty about contingencies which may affect transition goals.

**Reliance on clients and counterparties for data on real economy transition**: As both producers and users of transition plans, financial firms must rely on client and counterparty data to inform their own transition strategies. Information about client, counterparty or investee transition planning can help in assessing the decarbonization trajectory of a financial institution's portfolio vis-à-vis its own decarbonization targets. Client transition plans can provide information on clients' decarbonization profiles and objectives—which can also help financial institutions identify opportunities to finance and invest in transition activities**.** However, such plans are still nascent, their quality is variable and often inadequate, and key data points are lacking, making them of limited current use.

**Efforts to scale up finance for real economy transition activities are raising strategic challenges and trade-offs for financial institutions:** Financial institutions must balance multiple objectives, imperatives, and expectations with respect to financing strategies that can help achieve transition plan goals.

**Important distinction between financial institution transition planning and climate risk management**: Climate risk management and transition planning are distinct processes that should not be conflated. While financial institution transition planning aims to operationalize a firm's strategic targets and commitments to achieve its low carbon goals, climate-related financial risk management is part of broader financial risk management. Metrics that are being proposed to measure progress towards transition targets or commitments are often different to those being developed to evaluate the impact of climate-related financial risks. However, transition planning by a financial institution may help to reduce the expected strategic and transition risk exposure of an institution over the medium to long term. Finally, financial institutions may choose to refer to the transition plans of their clients, counterparties and investees as part of client engagement and an input to assessment of strategic opportunities and risks to a given firm.

**Proliferation of frameworks, guidance and criteria creates challenges for financial firms**: Multiple sets of frameworks, guidance, recommendations, and criteria for net zero target setting, transition planning and transition plan disclosure have been put forward by different market-based initiatives and third-sector entities; standard setters and official sector authorities in certain jurisdictions are beginning to develop their own frameworks or translate aspects of existing voluntary frameworks into standards, policy and requirements.

**Understanding the motivation behind official sector engagement on transition planning:** Central banks, supervisors, and other financial policymakers and regulators have demonstrated increasing interest in financial institutions' transition planning, including from the perspectives of disclosure, microprudential supervision, macroprudential policy, market conduct, and setting substantive requirements or guidance on transition planning. This is raising questions about the appropriate use cases for transition plan information, and concerns about potential regulatory and supervisory fragmentation. Moreover, the

sheer breadth of these use cases could create unrealistic expectations about what financial firms' transition planning can deliver.

As described in this report, **IIF members recommend that the core motivations for engagement by prudential authorities or policymakers on transition planning should reflect (i) their remits, and (ii) the boundaries of the financial sector's role as a *supporter and enabler, but not a driver*—of real economy transition.** Clearly, the intent of different authorities in engaging on financial institution transition planning may differ and be context-specific. However, as noted in 2021 IIF report, "Prudential Pathways,"[2] it is important that regulators and supervisors do not pursue an "active transition" objective through requirements on financial institution transition planning– what the IIF has described as the use of financial sector policy tools to regulate and incentivize the financial system to actively steer the low-carbon transition of key sectors in the real economy, via the provision and pricing of financial products and services. Not only does this present a range of challenges, including undermining the credibility and efficiency of prudential tools, it also assumes that financial institutions have direct influence over their clients' ability to transition and ignores the need for more direct policy levers and incentives which are required to catalyze investment in the transition.

**Recommendations to banking and insurance supervisors**: This report puts forward specific recommendations for microprudential supervisors and macroprudential authorities on how to engage on financial institution transition planning. These recommendations are intended to be helpful at the current juncture, as supervisors and authorities in many jurisdictions consider how to engage with and support financial institutions on these issues. IIF members believe that an effective supervisory approach would entail: (i) acting based on the authority's prudential mandate, and accounting for the strategic nature of transition planning; (ii) approaching the topic from a global perspective and through the global standard-setting bodies to avoid the emergence of fragmented regulatory approaches, which contributes to additional complexity; and (iii) avoiding a directive approach to individual financial institution's business decisions or transition strategies, rather than seeking to drive certain real economy outcomes via supervised institutions. More specifically:

- Supervisors could account for transition planning in a **holistic way** and assess any material **interactions with prudential objectives** as part of the supervisory review process, or Pillar 2 for banks. This would contribute to supervisors developing an understanding of a financial institution's business objectives and strategies, and the implications for strategic, reputational or legal risk, or the institution's ability to remain in business over the medium to long term.
- **Supervisory engagement on transition planning should be distinct from engagement on climate-related risk management and should be higher level and less granular considering the strategic nature of transition planning.** Supervisory engagement should also account for the inherent dependencies on external factors and uncertainties involved in transition planning.
- As far as possible, supervisors should **refer to publicly available information** on a bank or insurer's transition plan if it has one. As transition plans are strategy documents and not risk-related documents or prudential tools, specific prudential disclosure requirements would not be necessary.

[2] Institute of International Finance. (2021, January). *Prudential Pathways: Industry Perspectives on Supervisory and Regulatory Approaches to Climate-Related and Environmental Risks*.

- **Supervisors are not readily equipped to fully assess the credibility of a financial institution's transition plan** and should avoid going beyond their remits and areas of expertise.
- **Home-host supervisory coordination should be explored, with engagement at group level:** Home and host supervisory authorities should coordinate their interest and any information requests in relation to transition planning, and account for the generally group-wide nature of transition planning. If supervisors across jurisdictions can take a common, principles-based approach to engaging with financial institution transition planning in a way that is aligned with their supervisory mandate and the recommendations set out above, this would benefit home-host supervisory coordination.

**Macroprudential policy responses, including climate-related financial stability assessment, could potentially draw on information contained in financial institutions' transition plans – but near-term applications are limited.** As part of the future development of climate scenario analysis, it may be possible to analyze financial institutions' intended climate finance and investment plans to better model real economy interactions and feedback effects. However, it is not clear that simply "adding up" individual financial institutions' transition plans—which as business strategy documents are not directly comparable—to get an aggregate view of activity during the transition would be meaningful or informative. Aside from referring to transition planning information, macroprudential authorities could monitor relevant macrofinancial variables during the transition to gauge whether the financial system is keeping pace with the credit and financial services needs of companies and households.

**Growing questions on who should be responsible for evaluating transition plan credibility:** It is essential that any discussion of whether a (financial or non-financial) firm's transition plan may be considered credible clearly outline what is being assessed with respect to 'credibility' and the purpose for that assessment. The term 'credibility' is increasingly used as a catch-all term for a variety of different considerations, including whether a firm's decarbonization target is science-based, the ambition level of a firm's transition plan, the feasibility of a firm's transition plan, and whether a firm is disclosing all of the information of interest to a specific stakeholder or set of stakeholders.

**Several dimensions of credibility may be relevant for stakeholders evaluating transition plans, including i) scientific integrity; ii) technological reliability; iii) financial and economic feasibility; and iv) strategic and competitive viability.** However, while financial institutions may use information included in transition plans in multiple ways, it is not clear that they as private companies should be seen as solely responsible for evaluating the credibility of other firms' transition plans. Considering this, IIF members do not think that financial institutions can be reasonably expected to be wholly responsible for assessing the credibility of real economy firms' transition planning. In addition, prudential supervisors are not readily equipped to fully assess the credibility of a financial institution's transition plan on all the above-described dimensions.

**Public-private collaboration could help enable common approaches for determining credibility:** Different net zero/transition planning frameworks could be brought together in support of the shared objective of supporting the transition, thereby helping to address the risk of a fragmented landscape of multiple overlapping sets of approaches and expectations—which could have negative unintended consequences. Allowing for market testing of available frameworks should shed light on which are the most useful and allow for adaptation and adjustment to market needs. Recognizing the range of factors which may affect how credibility should be determined, market-based initiatives could work together to coalesce around common pillars and consider formulating common evaluation criteria through an appropriately representative, sequenced and accountable review process.

**Bottom line: the financial sector, real economy, governments, regulators and civil society must unite in pursuit of shared goals.** To achieve a sustainable low-carbon economy, countries, sectors, and individual companies—including financial institutions—must all work towards common and essential goals of transition, including reducing and mitigating GHG emissions and strengthening climate resilience. The financial services industry supports clients in this transformation via investment decisions, capital intermediation, risk management, market-making and advisory services. Mischaracterization of this role is creating new risks (such as litigation risk) which may disincentivize net zero transition. Uniting in these efforts and working towards these common objectives will help unlock innovation, create jobs and drive the strong economic growth necessary to achieve a just net zero transition.

## Introduction and Context

**Achieving a rapid transition to net zero emissions across the global economy is the defining challenge of our time.** According to the Intergovernmental Panel on Climate Change (IPCC), the global surface temperature between 2011 and 2020 had already reached +1.1°C above pre-industrialization levels,[3] and trends in 2023 have underscored the imminent threats posed by global warming. The World Meteorological Organization has confirmed that July 2023 was the hottest month ever recorded with temperatures of around 1.5°C warmer than pre-industrialization levels.[4] Furthermore, the increasing frequency and severity of heatwaves, wildfires, and other extreme weather events—even below a 1.5 to 2°C level of global warming—indicates the severity of the risks posed by current Greenhouse Gas (GHG) emissions trends. These risks cannot be understated: climate change, if left unabated, will pose existential threats to human civilization as we know it. Resolving this dire situation will require action by all stakeholders in the economy, including policymakers, regulators, private sector businesses, financial institutions and consumers.

**An important debate has emerged on 1) the role of private financial institutions in supporting the net zero transition; 2) how to maximize the net decarbonization impact of transition finance and related financial services across the economy; and 3) the broader economy-wide factors and constraints that determine the boundaries of the financial sector's role.** At a high level, official sector groupings, industry initiatives and civil society groups may share a similar theory of change about the role of the private financial sector which is that, by aligning their business strategies with net-zero decarbonization pathways, financial firms can enable a more rapid transition of the entire economy towards net zero than would otherwise be achieved through a purely reactive stance to the transition. This will require change across business lines and functions, including capital allocation, advisory services and underwriting and risk management.

**However, official sector, private sector and civil society actors can have divergent views on key details of the financial sector's role—including on how much direct and indirect influence private financial institutions can have on real economy decarbonization.** In particular, there are often different assumptions about how much responsibility the financial sector bears for their client and counterparty activities. In practice this is resulting in widely different expectations, as reflected in frameworks and

[3] Intergovernmental Panel on Climate Change. (2023). *Summary for Policymakers. In: Climate Change 2023: AR6 Synthesis Report.*

[4] World Meteorological Organization. (2023, August). July 2023 confirmed as hottest month on record [Press release].

guidance developed by non-governmental organizations (NGOs), market-based initiatives like GFANZ and, increasingly, official-sector entities.

**Over the past few years, there has been a rapid proliferation of non-regulatory frameworks and guidance and criteria aiming to set out common approaches for financial institutions to define their role in supporting the net zero transition—including the development and implementation of their own transition planning.** While such frameworks can be helpful, this proliferation is contributing to a lack of clarity on how to evaluate the quality and credibility of financial institutions' transition plans and financing instruments. The lack of a common yardstick and the inherently forward-looking nature of such plans raises concerns about greenwashing accusations,[5] making it increasingly complex for global financial institutions to develop a transition strategy that maximizes the impact of their activities while minimizing reputational, legal and regulatory risks. It is also creating a lack of clarity for regulators and prudential supervisors about the appropriate way to engage with financial institutions on transition planning and finance.

**Overestimation of the financial sector's role in the net zero transition may distract attention from the urgent need to implement strong, comprehensive frameworks which catalyze transition across the entire economy.** The urgent need to reduce emissions in line with net zero pathways calls for a swift, broad, and deep response across the economy. However, any misinterpretation or overestimation of the core role of financial institutions—their capacity, comparative advantage, and limitations—could create costly frictions in transition planning and the mobilization of finance. Moreover, over-reliance on the financial sector could divert attention away from other actors with key roles in the net zero transition, from firms in high-emitting sectors, to consumers and governments.

**Recognizing these challenges, the IIF and its global members have developed this report to offer perspectives on how financial institutions see their role in transition planning and finance.** We highlight industry views on the practicalities of implementing transition strategies in a globally competitive marketplace, with competing sets of stakeholder expectations and a multitude of frameworks. We also set out perspectives on how a financial institution's contributions towards net zero objectives can be appropriately evaluated, and how risks stemming from misaligned views on 'what good looks like' can be addressed. Given the critical role of policy frameworks in creating an enabling environment and incentives for transition across all sectors of economy, the report includes some recommendations for governments and policymakers. Considering the high level of interest in transition planning among supervisors and regulators, the report also provides recommendations on potential supervisory and regulatory approaches to transition planning. In addition, recognizing the need for aligned frameworks, guidance, and criteria, the report contains suggestions for market-based and third-sector initiatives on how to advance in a way that supports transparency and enables the development of a shared understanding of transition plan credibility.

**The topics addressed in this report are relevant across the global financial services industry including to the banking, insurance and asset management sectors.** However, we recognize that there are important sub-sectoral differences and aim to distinguish between different business models in their approach to

[5] In terms of the robustness and credibility of financial institutions disclosed transition plans, as well as the integrity of different types of transition-related financial instruments, solutions, and other business activities (including advisory) in the context of net zero commitments.

transition planning and finance, and between prudential approaches for banks and insurance companies, as relevant.

**The remainder of this report is organized as follows:**

# 1. The role of the financial sector in the context of the net zero transition

## 1.1 Factors affecting the financial sector's impact on the real economy transition

**The financial sector's ability to support the net zero transition is fundamentally dependent on whether the conditions are in place which enable transition across the real economy, and thereby create opportunities for finance and investment to support transition activities by corporates and across value chains.** Much of the 'theory of change' behind the net zero alignment agenda is based on the premise that the financial sector can serve as an effective primary lever to drive transition outcomes in the real economy, in terms of the strategic actions and investment choices of corporates. However, the ability of corporates to successfully transition, and for financial institutions to facilitate and finance these transitions, is dependent on whether firms have economically viable opportunities to decarbonize their businesses – which may be affected by economy-wide policies, sectoral incentives, supply and demand dynamics, and connectivity across value chains.

**The global financial sector has a key role to play in supporting the net zero transition, including through the allocation of capital, intermediation, risk management, underwriting, investment management and stewardship, market creation, and advisory services.** IIF/McKinsey joint research suggests that private financial institutions could provide roughly 40% of the $9.2tn per annum of investment needed between now and 2050 to support a global economy-wide transition to net zero.[6] While potential economic opportunities associated with decarbonization may be significant, finance and investment in support of the transition depends on whether a given transition-relevant economic activity can be financed or invested in with a risk-return profile acceptable to private capital.

**Financial institutions act as intermediaries, and can support their client and portfolio companies' own decarbonization efforts through the provision of financial products and services.** These can include new financial solutions; debt and equity finance; advisory services for clients (e.g., on strategic M&A); institutional investment and stewardship; the provision of insurance and underwriting services, including new types of insurance; and management of household savings and investments for retail clients. These financial services can be supplied in response to demand from real economy firms, which underscores the need for clear enabling conditions for the real economy transition.

**While the financial sector will clearly play a significant role during the transition, it is important to recognize that financial institutions have limited direct influence over the emissions reductions of their clients and investees**. The degree of influence that a financial institution may have on the climate-related choices made by a given client, counterparty or investee is affected by multiple variables. Financial institutions are highly regulated, for-profit enterprises that can only support real economy activities that meet a commercially viable return profile, and cannot responsibly decide to extend capital beyond their risk appetite thresholds to achieve climate ambitions or social objectives.

**The enabling real economy conditions that will drive the feasibility and success of client, counterparty or investee transition activities will be driven by many different factors beyond the control of the financial sector.** The ability of corporations to transition, and therefore for financial institutions to facilitate and finance the transition, is dependent on whether they have economically viable opportunities

[6] Institute of International Finance & McKinsey & Company. (2023, January). *Financing the Net-Zero Transition: From planning to practice*.

to transition their business strategies. This will be dependent on government policy incentives, build-out of clean energy infrastructure, technological developments, and consumer demand shifts, among other external factors. Without these supporting factors to establish an enabling environment, there will not be client demand for financing of the transition.

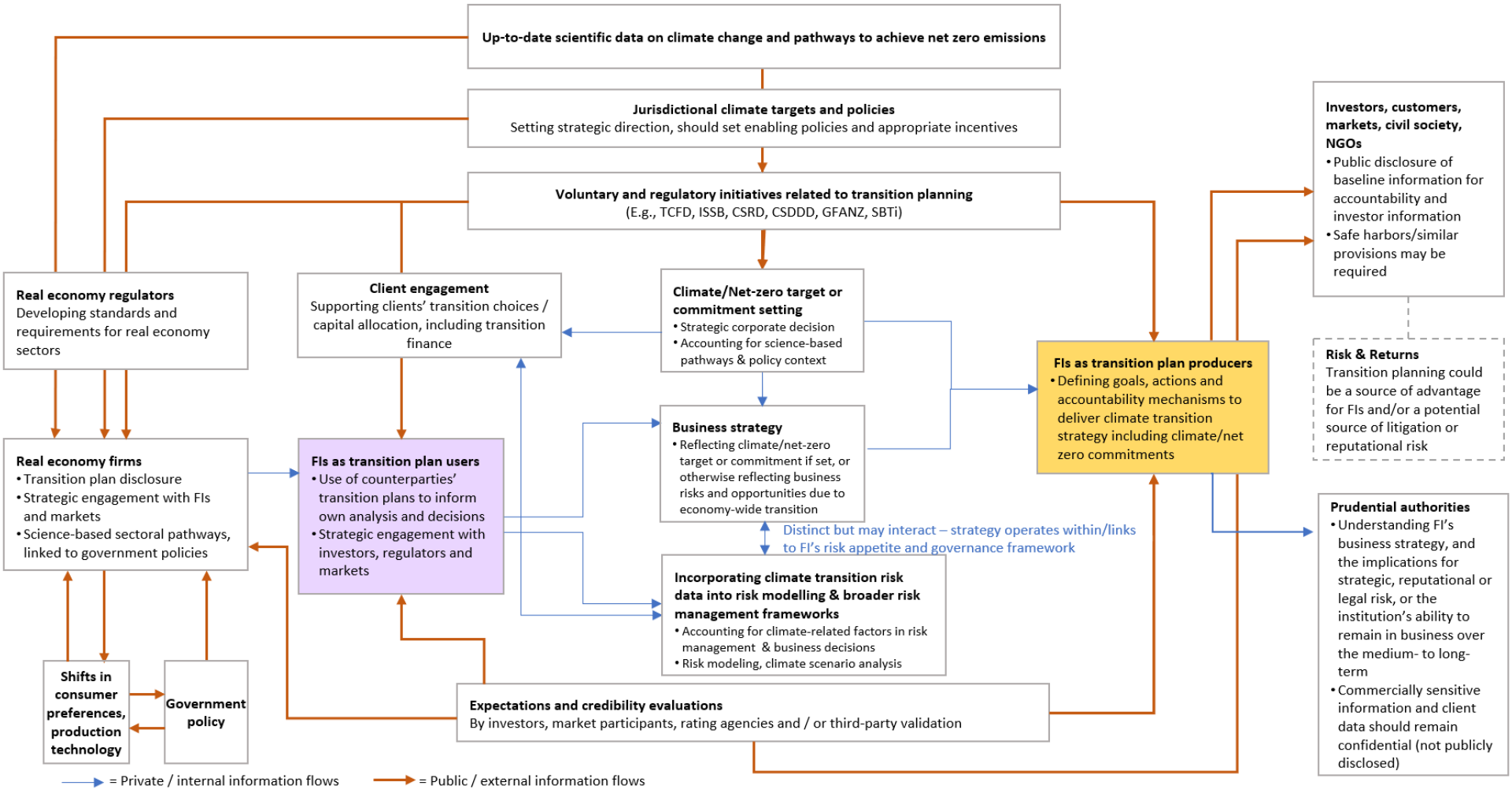
**Reflecting the importance of this shift, many IIF members report varying levels of uptake for transition finance instruments, products and services, developed with the aim of helping clients, counterparties and investee firms' transitions, depending on the comparative strength and scope of jurisdictional policy frameworks.** These range from capital markets services (structuring and underwriting or sustainability-linked financial products) to financial products tied to energy performance, investments in energy efficiency or retrofitting (such as green mortgages). At the same time, **many IIF members report meaningful increases in opportunities to finance and facilitate transition-relevant investments in response to the introduction of targeted incentives aimed at stimulating sectoral transition and technology change.** This highlights the significance of government economy-wide policies (such as fiscal policies) as a catalyst for creating strong and stable economic demand for net zero-aligned products and services, through the provision of incentives across sectors and value chains, and development of supporting infrastructure that can facilitate the adoption of low-carbon technologies.

**The ability of financial institutions' activities to support the net zero transition will therefore depend in large part on whether the necessary enabling environment for real economy transition is in place**. For transition activities to be economically viable, clear commercial incentives are needed for action to be taken across the real economy, alongside regulations and legislation that can directly influence corporate behavior in sectors with high impacts on the environment. Fiscal policy (e.g., tax credits, consumer subsidies) may be used to provide incentives for consumers and firms across the value chain. By leveraging market mechanisms, carbon pricing provides the most efficient and cost-effective way of shifting the underlying economics of transition investments, while also generating tax revenues that can be used to fund other aspects of the transition. Equally, as long as high-emitting, highly polluting activities which are unaligned with net zero transition goals continue to be profitable, they will continue to attract capital from investors that are seeking returns.

**For financial institutions, current and planned government policies play a fundamental role in assessing the future dynamics of key economic sectors, alongside technological and market factors that affect the transition strategies of their clients, counterparties and investees.** High levels of uncertainty about economy-wide and sectoral transition policies can complicate financial sector transition planning by making it difficult to assess key factors which may inhibit or enable achievement of transition milestones.

**These transition factors will influence the extent to which financial institutions can support real economy emissions reductions.** Factors within the realm of direct and indirect influence of financial institutions must be managed in an environment of elevated policy, market and technological uncertainty. The relationships between these different factors, commercial and stakeholder relationships, and capital and information flows in the context of financial institutions' activities to develop and implement strategies to support their clients', counterparties', and investees' net zero transition is visualized in Figure 1 below.

**Figure 1:** Schematic diagram of interactions between internal and external factors influencing financial institutions (FIs) as users and producers of transition plans




Source: IIF, 2023.

## 1.2 Recommendations to Governments and Policymakers to Enable a Whole-Economy Transition

**Appropriate government action will be critical to providing the economic incentives and sector-specific policies to drive an economy-wide transition.** Government regulation and policy incentives will be needed to advance the net zero transition and drive the demand and supply-side transformations required to bend emissions curves towards net zero pathways. With the implementation of significant policy packages in some major jurisdictions, such as the U.S. Inflation Reduction Act (IRA), the European Union (EU) Net Zero Industry Act, and Japan's Green Transformation (GX) Basic Policy, government action to catalyze the net zero transition has accelerated notably in some parts of the world. Governments are using a range of different instruments – including tax incentives, trade policies, research and development and environmental performance standards — as they seek to meet their commitments to a net zero transition and climate resilience, while also seeking to achieve socio-economic goals of competitiveness, growth, and job creation. Jurisdictional policies are beginning to prove impactful in certain sectors; one year on from the implementation of the IRA, U.S. companies have already invested USD 110 billion in clean energy manufacturing, creating more than 170,000 new jobs.[7]

**While certain jurisdictions are moving ahead, the strength and scope of transition-related climate policy approaches remains uneven across major economies; furthermore, there are significant gaps in policy architecture between developed and emerging market and developing economies (EMDEs)**. National-level economic models—encompassing the balance of key sectoral contributions to GDP, the energy mix, levels of infrastructure development, domestic production and trade characteristics, and financial market structure—will have a significant impact on the effectiveness of a given set of policy instruments, and one size will not fit all jurisdictions as they prepare their economies and societies for the net zero transition.

**The IIF and its members firmly believe that strong, pro-growth policy frameworks at the national and global levels are key to providing the foundation, long-term orientation, and market conditions for effective private sector action in support of a net-zero economy.** While specific tools such as carbon pricing and other market-based mechanisms to incentivize emissions reductions are an essential component of the broader policy response, such policies are often politically sensitive and to date have not been broadly implemented internationally. However, using the financial system as the primary driver of change in the real economy is unlikely to be a successful alternative. Financial institutions do not have a mandate to dictate energy or industrial policies; efforts to motivate transition activities through divestment could indirectly lead to unintended economic consequences (such as energy price volatility), which could in turn create barriers for the transition (for instance, waning social support for policies due to perceived impacts on the cost of living).

**From the perspective of financial institutions, strong and well-coordinated policy frameworks at the national, regional and international levels are needed to support real economy transition, which will provide opportunities for financial institutions to provide supporting finance and investment.** Key factors to be considered include:

i. **Policy clarity and certainty, underpinned by scientific evidence:** To provide clarity and certainty to market players across industries, government policies and standards should be

[7] White House. (2023, August). *WHAT THEY ARE SAYING: One year anniversary of the Inflation Reduction Act* [Press release].

signaled clearly and consistently. The clarity and certainty of the policy and regulatory environment is critical to long-term planning, especially in large-scale investments with long payback periods. In turn, those policies should be based on the best available science and climate scenarios, while being dynamic and data-driven.

ii. **Providing incentives**: It is becoming evident that long-term incentives for key transition activities and sectors—including fiscal incentives, R&D grants, direct subsidies, and other measures—are needed to shift the economics of transition activities. Alongside pricing of negative externalities such as carbon emissions, incentives are needed to enable technological and product innovation that is not yet commercially viable, to catalyze transition-related investments across sectors and value chains, to support the development of new industrial and manufacturing hubs, and to spur the growth of related service industries. Among other factors, blended finance vehicles and other types of risk sharing and guarantee mechanisms can have significant impacts on the attractiveness of transition investments.[8]

iii. **Developing infrastructure:** For the world to meet climate goals, new infrastructure will need to be built at a rate that society has not experienced. Investments in infrastructure, including in electricity grids, energy storage, transportation networks, and $CO_2$ sequestration, are needed at scale to address physical and technical barriers to decarbonization, and enable uptake of new technologies across value chains. One of the critical barriers to building clean energy capacity at the pace required is network infrastructure. A recent positive example is the announcement by the German Federal Government that it will develop efficient hydrogen infrastructure, including 1,800 km of converted and newly built hydrogen lines in Germany and around 4,500 km of lines across Europe.[9] While gaps in infrastructure persist, we must also recognize the need to balance energy security, affordability, and accessibility with the need to decarbonize. Shifting too quickly away from traditional energy sources without sufficient scaling of clean energy technology and infrastructure could exacerbate energy scarcity and create broader negative impacts to the economy.

iv. **Addressing both the supply and demand sides of emissions reduction**: Innovative technology and climate solutions will need both supply-side investment initiatives as well as targeted demand-side incentives. New technology typically needs a critical mass of users to make use of either economies of scale or to galvanize further improvements originating from a "learning by doing" approach. For example, the U.S. Department of Energy has launched an initiative to foster demand for regional clean hydrogen hubs.[10] At the global level, the World Economic Forum (WEF) has developed a "First Movers Coalition" of companies in different sectors using their purchasing power to create early markets for new clean technologies across eight hard to abate sectors.[11]

v. **Pricing Carbon Emissions**: There is ample academic research attesting to the fact that economy-wide policies to internalize economic externalities, including carbon emissions, are

[8] For further discussion on how to scale blended finance for climate action, please refer to this IIF research: Institute of International Finance. (2023, July). *Scaling Blended Finance for Climate Action–Perspectives from Private Creditors*.

[9] German Federal Ministry for Economics Affairs and Climate Action. (2023, July). *Accelerate the ramp - up of the hydrogen market the Federal cabinet decides to update the National Hydrogen Strategy* [Press release].

[10] US Department of Energy. (2023, July). *Biden-Harris Administration to Jumpstart Clean Hydrogen Economy with New Initiative to Provide Market Certainty and Unlock Private Investment*.

[11] For more information see: *World Economic Forum: First Movers Coalition*.

the most effective measures to shift market pricing.[12] The IIF and its members broadly support measures to develop and introduce carbon pricing in jurisdictionally appropriate ways, including through the implementation of public schemes and market mechanisms. Pricing emissions is also a critical tool to raise revenues for investments in the transition.[13] Carbon pricing can also support the scaling of voluntary carbon markets, as well as market creation for new and innovative carbon removal technologies.[14] Similarly, removing other market distortions, such a fossil fuel subsidies, would support efficient market pricing.[15] How a carbon price is implemented, and which other policies accompany it, will be extremely important to its success; for example, innovation funding to reduce the cost of lower carbon technologies and ultimately counter the price effect of the rising cost of higher carbon energy sources can help to reduce opposition to carbon tax due to impact on the cost of living.

vi. **Promoting a just transition, job creation and economic growth:** The climate challenge is immense and complex; addressing it entails transforming global supply chains and energy systems. These systems are the foundation of the global economy and need to be treated with care. Industry, policymakers, and finance need to remember that the path to the world's climate goals is dependent on ensuring affordable, reliable access to energy and food while generating economic growth. To be effective and ensure social support for action on net zero priorities, policy frameworks need to ensure access to affordable and reliable access to energy, generate economic growth and sustain jobs, and recognize the community-level impacts of the transition. As one example, strong policy frameworks will contain job creation strategies that bring along the workers and communities in both developed and developing countries which will be disproportionately impacted by the transition. Only with a comprehensive approach—and broad-based cooperation of public and private institutions—will a just transition with sustainable economic growth be possible.

## 2. Approaches to transition planning & transition plan disclosure: an evolving landscape

### 2.1 The Strategic Relevance of Transition Planning: Concepts and Definitions

**As noted above, debate on potential policy, supervisory and regulatory approaches to financial institution transition planning and/or the disclosure of transition plans is advancing rapidly in multiple jurisdictions and at the level of global standard-setting bodies.** However, there are many open issues emerging as this field is evolving, including a lack of consensus on the core purpose of financial institution

[12] Recent analysis of global carbon pricing trends can be found in World Bank. (2023, May). *State and Trends of Carbon Pricing 2023*.

[13] Recent IMF analysis has estimated that relying solely on public spending measures to achieve net zero goals could significantly increase public debt. See International Monetary Fund. (2023, October). *Climate crossroads Fiscal policies in a warming world*.

[14] The Integrity Council for Voluntary Carbon Markets (ICVCM) has issued a set of Core Carbon Principles as a global benchmark for high-integrity carbon credits that set rigorous thresholds on disclosure and sustainable development.

[15] The IMF has documented that fossil fuel subsidies have recently hit their highest level in years as a result of government support after the COVID-19 pandemic and the war in Ukraine. See International Monetary Fund. (2023, August). *Fossil fuel subsidies surged to record $7 trillion*.

transition planning, the relationships between transition plans, transition finance and risk management, and potential relevance of transition plans to different stakeholder objectives and use cases. This section conveys perspectives from the global financial sector on key concepts, definitions, and other important issues, with the aim of contributing to the resolution of open questions.

**IIF members consider transition planning to be a dynamic business exercise to operationalize a firm's strategic targets and commitments to achieve its interim and end-state low carbon goals**. Transition planning is inherently strategic in nature, given that transition plans reflect a financial firm's competitive positioning to navigate key business model risks and opportunities arising from the broader transition of the real economy; many firms now view it as a key element of long-term business strategy. Transition planning reflects an assessment of the likely future dynamics affecting key sectors of the economy, including government policies, changes in technology and market factors including clients', counterparties' and investees' own transition planning. In this regard, transition plans can provide information about a firm's positioning in relation to short- and medium-term business opportunities and strategic risks. However, the forward-looking nature and high number of exogenous factors contribute to a high degree of uncertainty about contingencies which may affect a financial institution's transition goals, including the speed and scope of real economy transition pathways. The strategic nature of transition planning, and relevance of transition plans to business strategy, is currently reflected in market-based frameworks, emerging jurisdictional frameworks (such as the one being developed by the UK Transition Plan Taskforce, TPT), and global standards for disclosure of climate-related risks and opportunities, including the ISSB's IFRS S2 standard.[16]

**Financial institutions are both producers and users of transition plans – they conduct their own transition planning, and also rely on the transition planning conducted by their clients, counterparties and investees as summarized in their transition plans (see Box 3).** Implementing a transition plan across business lines and organizational functions can address multiple aspects of a financial firm's response to climate change and the net zero transition *from a strategic perspective* – for instance, market strategy, risk strategy, client engagement and advisory strategies.

**Transition planning is a dynamic process that can produce internally relevant information, as well as some externally relevant information of interest to investors and the wider public (for example, in cases where a firm has made a relevant public commitment).** The externally relevant aspects of a firm's current transition planning process can be summarized as a point-in-time disclosure with a forward-looking perspective, which is often what is referred to as the transition plan (for example, in the context of disclosure frameworks or requirements).

**As financial institutions have different business models and comparative advantages in supporting a net-zero economy, and given that transition planning is ultimately an idiosyncratic strategic exercise, transition planning approaches must be adaptable to the specific needs and priorities of individual firms** (see Box 1)**.** Development of a common core framework for transition planning is possible, drawing upon common elements of those that have been put forward to date.[17] However, given that transition planning is inherently an internal exercise specific to each company's circumstances, including industry, sector, and

[16] International Financial Reporting Standards. (2023, June). *IFRS S2 Sustainability Disclosure Standard: Climate-related Disclosures*.

[17] Further discussed in Section 2.4.

geography, any framework for transition planning must provide for appropriate flexibility for firms to develop a transition plan that appropriately reflects its strategies, activities, and levels of uncertainty – including uncertainty associated with real economy transition outcomes that they may seek to finance, underwrite, or otherwise support through commercial activities. Transition planning approaches will also differ depending on the market, political and social contexts in which financial institutions operate. Nevertheless, to the extent that information about transition planning is disclosed, it is important to ensure that the transition plans of financial institutions – just like any other type of firm – meet a reasonable standard of comparability for purposes of utility, for instance, through the use of common formats and inclusion of key pieces of information. The ISSB S2 Standard provides an initial global baseline for common disclosure of transition plan information.

**Box 1:** How different types of financial institution may contribute to the net zero transition

**Financial institutions' transition strategies may involve a spectrum of activities aimed at facilitating and supporting transition of real economy clients and investees,** including, but not limited to, developing new expertise, expanding new green and transition-related activities, products and services, and investing in the managed reduction and phase-out of high-carbon technologies and assets.

**The specific set of financial services that are relevant for transition activities will vary by sector, in different parts of the value chain, and in different markets.** As such, while there are some common activities and strategies available for all financial institutions**, a given transition-supporting financial activity may be more or less relevant to a financial institution depending on its business model and geographic footprint.** This is also indicated by the formation of sector-specific alliances beneath the GFANZ umbrella organization: the Net Zero Banking Alliance (NZBA), Net Zero Insurance Alliance (NZIA), and Net Zero Asset Owners Alliance (NZAOA). Understanding the comparative advantages of different types of financial institutions – banks, insurers and asset managers/investors – in terms of how they interact with the real economy is an important step towards a more nuanced understanding of how financial institutions may identify opportunities to support real economy decarbonization. For example, financial institutions may differ as to how they engage with their clients, with some engaging directly and others (e.g., commercial insurers) generally engaging through intermediaries or brokers. Indirect engagement, in turn, impacts the degree of influence a firm may have on its clients' transition pathways. A high-level heuristic representation of the factors affecting how different types of financial sectors may be able to support real economy transition outcomes is set out in **Table B1.1** below. While the table provides a general overview, the activities listed below are by no means exhaustive.

*(Table overleaf)*

**Table B1.1** Factors affecting real economy interactions of financial institutions (banks, insurers, asset managers) and implications for products and services offered during the net-zero transition

| | Banking activities | Insurance underwriting | Asset management/ Investment |
|---|---|---|---|
| **Common relationships with corporate sector** | Long-term engagements with clients through revolving facilities, short-term lending, commercial real estate lending, project finance, debt and equity underwriting; M&A services | Time-limited insurance policies with annual repricing; climate-related catastrophe insurance. In general, through intermediary/broker channels | Long-term investments, short-term trading and investments, development of indices<br><br>Relationships with investee firms, voting rights if a large shareholder, other stewardship responsibilities |
| **Common relationships with household sector/consumers** | Home mortgage lending, auto lending revolving credit (e.g., credit cards), deposit-taking, checking services | Time-limited insurance policies with annual repricing. Sometimes direct interactions and sometimes through intermediary/broker channels | Investment products and funds including pension funds, money management |
| **Examples of potential options to address transition priorities through client-facing activities** | - Identifying financing opportunities with new and existing clients to help them realize their transition objectives.<br>- Offering expertise and advisory services.<br>- Offering new financial products to support specific activities or behaviors (e.g., green bonds, SLBs).<br>- Linking funding terms and conditions to climate or sustainability-related performance indicators.<br>- Financing managed phase-out of high-emitting assets.<br>- Participating in blended finance vehicles and transactions | - Developing and offering insurance and reinsurance products and solutions for low-emission and zero-emission technologies.<br>- Linking new policy design, underwriting criteria or insurance coverage to climate-related risk factors.<br>- Identifying financing opportunities with new and existing clients to help them realize their transition objectives.<br>- Developing insurance solutions for managed phase-out of high-emitting assets. | - Engaging with investees to encourage climate-related transition planning<br>- Net zero stewardship activities, including voting and engagement.<br>- Reducing portfolio investments in high-emitting firms and sectors over time, if not aligning.<br>- Offering ESG-linked investments and indices.<br>- Engaging in blended finance activities. |

## 2.2 Industry perspectives on the relationship between transition planning and transition finance

**Real economy transition plans developed by corporates may be a helpful source of information in identifying opportunities for the financial sector to provide finance and investment in support of real economy transition.** Corporate transition plans can provide information on clients' and investees' decarbonization profiles and objectives, which can help financial institutions identify opportunities to support clients' and investees' transition objectives with finance and investment.

**While a significant share of finance and investment in support of real economy transition will likely be deployed via more traditional means, such as general corporate purpose finance and capital markets activity, transition-specific financial products will have a role to play.** Recognizing this, it is important to move towards a common understanding of how transition finance should be understood, how specific types of transition-relevant financing should be defined (and thereby able to be quantified), and how existing definitions, frameworks, and standards can be aligned.

**There are many different definitions of financial products that constitute "transition finance,**" including those proposed by the International Energy Agency, GFANZ, OECD, and United Nations,[18] covering products such as:

- Sustainability-linked loans and revolving credit facilities, with interest margins linked to emissions performance
- Sustainability-linked bonds, with emissions-linked performance targets
- Labelled financial products (e.g. transition bonds), allocating capital towards a specific transition or sustainability-related objective.

**Definitions of transition finance are generally focused on financial instruments and related services extended with the aim of reducing emissions of key sectors and economic activities that will be economically essential through the transition, even if they are high-emitting today**. Some definitions of transition finance reflect principles of additionality, substitutability, and the aim of contributing to net decarbonization outcomes over time. Market-based standards, such as the ICMA Climate Transition Finance Handbook, provide guidance and expectations on the practices, action and disclosures to be made by issuers when raising funds for transition activities, including use of proceed instruments and general-purpose sustainability-linked instruments.[19] Recently, GFANZ has opened a consultation on Defining Transition Finance and Considerations for Decarbonization Contribution Methodologies, which sets out proposals for identifying and segmenting four categories of transition finance according to a refined set of definitions and attributes.[20]

**Multiple approaches to the development of information architecture for the net zero transition are being considered across G20 member states, including transition planning frameworks, transition**

[18] For further information, see the "Challenges for financial institutions" section of: Institute of International Finance & McKinsey & Company. (2023, January). *Financing the Net-Zero Transition: From planning to practice*.
[19] International Capital Market Association. (2023, June). *Climate Transition Finance Handbook.*
[20] Glasgow Financial Alliance for Net Zero. (2023, September). *Defining Transition Finance and Considerations for Decarbonization Contribution Methodologies.*

**taxonomies, and other types of alignment evaluation methodologies.**[21] In some jurisdictions, top-down frameworks such as taxonomies are being developed to provide a set of sectoral parameters or thresholds for transition-relevant economic activities; these may provide guidelines or definitions for what may be considered as transition finance in a given sector (see Box 2). Other jurisdictions are setting out guidance for approaches to transition finance, focusing on sectoral pathways; in Japan, the Ministry of Economy, Technology and Industry has released an overarching set of Guidelines on Transition Finance, which are now being complemented with sectoral roadmaps.[22] Aspects of these approaches are being applied by financial institutions in parallel, depending on their strategies, existing supervisory expectations and policy frameworks, and stakeholder expectations.

**Box 2:** Transition Taxonomies and Links to Transition-related Financial Products

**Classification instruments such as market-based or regulatory taxonomies for green and sustainable finance may also influence the development of transition finance products.** As discussed in IIF (2022),[23] a wide variety of market-based and official-sector classification instruments—including taxonomies for identifying, verifying, and aligning investments with sustainability goals—have emerged as central components of sustainable finance frameworks in some jurisdictions. Classification instruments –which are often jurisdictional and vary across jurisdictions— can influence the characteristics of sustainable finance products. Jurisdiction-specific classification approaches can create variations which affect the capacity for common approaches to be implemented across markets.

Based on experience with regulatory taxonomies in some jurisdictions to date, IIF members believe that it is important to be clear about the goal of such an instrument, which is to classify and label whether an activity or investment meets certain climate or sustainability criteria. In and of itself, a taxonomy does not change the characteristics of the underlying activity or the underlying real economy incentives to undertake one activity rather than another.

Furthermore, there are many complexities and considerations when designing a classification instrument such as a taxonomy. Among other things, an overly narrow approach to defining a taxonomy can be constraining for financial institutions, for example, if they put too great an emphasis on green vs. transition activities. They can become extremely complex and difficult to navigate and are typically static by their nature requiring them to be revisited and reassessed over time. If used to develop summary indicators (such as 'green ratios'), they may give a misleading indication of what is represented in the taxonomy and about the stance and objectives of the firm with respect to the net-zero transition. To the extent that taxonomies are jurisdiction-specific, interoperability is an important consideration particularly for cross-border financial institutions.

[21] International Monetary Fund & World Bank & Organisation for Economic Co-operation and Development. (2023, September). *Activating Alignment: Applying the G-20 Principles for Sustainable Finance Alignment with a Focus on Climate Change Mitigation*.

[22] See, for example, Government of Japan Ministry of Economy, Trade and Industry. (2023, March). *Technology Roadmap for Transition Finance in Automobile Sector*.

[23] Institute of International Finance. (2022, February). *Integrity through Alignment: A 2022 Roadmap for Global Standards and Market-led Approaches in Sustainable Finance*.

**While real economy corporate transition plans will be a source of information as the industry extends finance during the transition, such plans are still nascent, their quality is variable and certain key data points are lacking, making them of limited current use.** At a basic level, the presence or absence of a transition planning process and document, or commitment to develop one, can provide a high-level indicator of a counterparty's level of ambition. Transition plans, if appropriately detailed and comprehensive, could provide valuable information on the robustness, credibility, financial means, and management skills of a corporate to reach its net zero targets and ambitions (see Box 3). In practice, financial institutions may consider how a clients', counterparties' or investees' decarbonization profile may be relevant in the context of any net zero targets and commitments the financial institution may have made; however, this may be contingent upon the level of detail and quality of data included in a counterparty's transition plan.

**Box 3:** Financial institutions as producers and users of transition plans

**As both producers and users of transition plans, financial firms must rely on client and counterparty data to inform their own transition strategies**. Some financial institutions have begun to develop approaches to gather and process client, counterparty or investee transition planning and other transition-relevant information. **In theory, the current and forward-looking information contained in a corporate transition plan can be a useful input to a financial institution's assessment of a counterparty's GHG emissions trajectory, adaptive capacity, and potential future competitiveness. In this way, transition plans could serve as an input to a financial institution's client engagement, assessment of business opportunities, as well as assessment of strategic business risk to a counterparty.** Information about client or investee transition planning can help a financial institution to assess the client's or investee's decarbonization profile and projected pathway, including vis-a-vis the financial institution's broader portfolio, and any transition targets or commitments. However, financial institutions must rely on available public or privately gathered information about their counterparties' transition planning and progress to monitor progress against their own transition plan goals. To the extent that failure of a client or counterparty to meet its goals may affect a financial institution's targets or commitments, use of transition plan information may also be relevant to the management of strategic or reputational risk to the financial institution.

**At present, the majority of client and investee transition plans are at early stages of development and often not disclosed and, as such, require significant bespoke dialogue and analysis to engage with and evaluate.** For example, CDP data show that while a growing number of corporates in different industries are now undertaking transition planning, a very small proportion of firms (less than 1% of 18,600+ organizations submitting CDP surveys) is providing detailed information on all of the key indicators that CDP has identified;[24] furthermore, there is significant geographic variation in terms of the location of companies developing transition plans.[25] In the future, greater experience with transition planning and the resolution of key methodological and data issues (for example, around GHG emissions reporting and other KPIs), as well as greater and more standardized disclosures, should

[24] CDP has developed its own definition of credibility in terms of number of key indicators disclosed using the CDP questionnaire.

[25] For example, the US, China, Japan, UK and Brazil are each home to at least 1,000 CDP disclosure preparers, which is significantly more than most other jurisdictions and accounts for around 55% of the sample of CDP preparers globally.

benefit financial institutions as users of transition planning information. From a disclosure perspective, the IFRS S2 standard, if implemented and adopted widely, should support greater consistency in terms of the format, scope of contents, metrics, and relationship to financial reporting.

Consistent with the very early stage of development of transition strategies by companies, and disclosure of key elements of their initial transition plan, **financial institutions currently face a number of challenges in using clients' and counterparties' transition plans,** including:

- **Nascency** – corporate transition plans are generally at an early stage of maturity and still evolving with little track record to show correlation between plans and actual outcomes or performance against the plan over time.
- **Quality and comprehensiveness** – there are varying degrees and amounts of information, including metrics, disclosed by corporates which can affect financial institutions' ability to properly assess their transition plans; some corporates are very transparent while others do not disclose much. This challenge is particularly acute among private companies.
- **Comparability** – different baselines including climate warming assumptions and targets, scopes, metrics and other factors make it difficult to compare client, counterparty or investee transition plans to each other.

**Due to these current constraints, many financial institutions are limited in the degree to which they can take account of client/counterparty or investee transition planning information in their business decisions today. It would be beneficial for policymakers to focus on addressing these issues in relation to real economy transition plans as this would, among other things, benefit financial institutions as users of these plans and as they develop their own transition planning.** In the meantime, a large part of the burden of gathering information, interpreting and evaluating corporate transition plans falls on financial institutions.

In an effort to overcome some of the issues associated with the current state of transition plan disclosures and related information, **some financial institutions are developing their own bespoke approaches for data gathering and evaluation of client and investee plans**, or are referring to external frameworks in certain cases (see section 4.1). However, assessing a counterparty's plan often requires expert judgement, informed by market and sectoral analysis, to form a view on the likelihood of a firm delivering on its targets. In particular, the inherent complexity around identifying metrics for assessing transition, both at the level of clients' plans but also at portfolio levels within financial institutions, is exacerbating this challenge.[26] Looking ahead, as transition plan disclosures become more commonplace – either as a result of investor and stakeholder expectations, or through disclosure requirements – there should be greater and more consistent information available to financial institutions. However, a degree of expert judgment will remain necessary, given that much transition plan content relates to future outcomes and developments and is therefore potentially variable and uncertain. For related reasons, financial institutions are cautious in their efforts to apply transition plan information at a granular level in lending and investment decision-making.

[26] Institute of International Finance & WTW. (2023, May). *Emissions Impossible: Quantifying financial risks associated with the net zero transition*.

Importantly, while financial institutions may use real economy transition plan information to assess and disclose progress against their own net zero targets, **it would not be appropriate for expectations to emerge that financial institutions are wholly responsible for assessing whether transition plans disclosed by clients and investees can be considered credible.** Different approaches for evaluating the credibility of transition plans are being put forward by several initiatives; the lack of a common approach is leading to an array of challenges for financial institutions and supervisors and could potentially hamper efforts to evaluate credibility (for further discussion, see section 4).

**As developers of their own transition plans, financial institutions must balance multiple objectives, imperatives, and expectations with respect to their engagement across the economy in support of the transition.** Three key issues are emerging as relevant for financial institutions, as they seek to develop and implement transition plans in the context of broader strategic goals:

- **Financing both green and non-green sectors and assets:** If financial institutions are to effectively support an economy-wide net zero transition, there should be as much focus on client engagement and the provision of capital and services that facilitate emissions reductions as on efforts to reduce the financial institution's financed emissions.[27] IIF research has illustrated that average annual investment under the Network for Greening the Financial System (NGFS) Net Zero 2050 scenario will require $6.4 trillion of investment in low-emissions assets, but will also require $2.8 trillion of continued spending on high-emissions assets – such as in power, transport, industry, and other sectors – to enable the economy to transition smoothly.[28] Investments in the energy transition may range from purely green technologies to the transitioning of high-carbon assets and business models. Despite increases in renewable energy capacity and other low-carbon technologies, fossil fuels continue to comprise approximately 80% of the global energy mix;[29] recognizing this current reality, the transition of business models in high-emitting sectors is fundamental for any chance of materially reducing emissions. As such, financial institutions will likely need to finance a mix of green activities and non-green activities in need of transition. For instance, high-emitting activities in the mining sector – where lower emitting modes of production face technological and cost-based barriers – will need to continue in order to deliver sources of minerals to enable transitions in other sectors (e.g., electrification of transport).[30]
- **Ensuring that continued financing of high-emitting sectors does not inadvertently slow the transition to net zero:** Due to their size, geographic diversification, and engagement across sectors, global financial institutions are considering how to ensure investments do not exacerbate barriers to the transition by constraining market potential for low-carbon alternatives. Investments which pose a risk of carbon lock-in – for instance, infrastructure with long lifespans

[27] There is a growing body of evidence looking to estimate and calibrate the impact of different financial institution engagement approaches. See, for example, Berk and van Binsbergen (August, 2021), Broccardo, Hart and Zingales (June, 2021), and Green and Vallee (April, 2023).

[28] Institute of International Finance & McKinsey & Company. (2023, January). *Financing the Net-Zero Transition: From planning to practice*.

[29] International Energy Agency. (2022). *World Energy Outlook 2022.*

[30] See International Energy Agency. (2023). *The role of critical minerals in clean energy transitions;* Banque de France. (2023). *The Stumbling Block in 'the Race of our Lives': Transition-Critical Materials, Financial Risks and the NGFS Climate Scenarios*.

and payback periods, e.g., coal-fired power plants – must be carefully evaluated, considering the complexity and costliness of early decommissioning.

- **Ensuring appropriate support across the economy for an orderly and just transition:** Initiatives to reduce emissions, including through the phase-down or phase-out of technologies and entire sectors, need to be balanced with social impacts including the need to ensure an orderly and just transition. As experience of the COVID-19 pandemic and war in Ukraine has illustrated, major economic disruptions – including shocks to the prices of key economic inputs, such as energy, commodities, food, and consumer goods – can change the near-term prioritisation of political objectives, which may impede the development of necessarily ambitious, economy-wide climate policies, and reduce incentives for investments in the transition. Furthermore, large-scale strategic shifts by financial institutions can lead to significant distributional impacts across sectors and levels of the economy; in the context of climate change, such actions may lead to positive outcomes from an emissions perspective, but also may create risks of unintended negative economic and social impacts.

## 2.3 Industry perspectives on the relationship between transition planning and climate risk management

**As noted above, transition planning is fundamentally a strategic exercise and an element of overall business strategy. Concurrently and separately, banks and insurers across the world are embedding governance and risk management approaches for the assessment, measurement, and management of material climate-related financial risks within the context of the existing financial risk categories and enterprise risk management frameworks**. This work, which has been underway for several years within many financial institutions, has been driven by business decisions and supervisory and regulatory expectations – and is reflective of guidance provided by the global standard-setting bodies including the BCBS's *Principles for the Effective Management and Supervision of Climate-related Financial Risks* (June 2022)[31] and the IAIS *Application Paper on the Supervision of Climate-related Risks in the Insurance Sector* (May 2021).[32]

**Importantly, climate risk management and financial institution transition planning are distinct processes that should not be conflated.** The recent NGFS Stocktake Report[33] suggested that there are different types of transition plans, with some being "strategy-focused" and others being "risk-focused" (see NGFS's Key Finding 1). However, this does not align with the practice and understanding of IIF member banks and insurers. Specifically, IIF members consider that their own transition planning is not undertaken for climate-related financial risk management purposes, and that transition plans are not a summary of a bank's risk management response to potential transition (or physical) risks – although a financial institution's risk function may be involved in governance and oversight of transition planning and

[31] The Basel Committee on Banking Supervision. (2022, June). *Principles for the effective management and supervision of climate-related financial risks.*

[32] International Association of Insurance Supervisors. (2021, May). *Application Paper on the Supervision of Climate-related Risks in the Insurance Sector*.

[33] Network for Greening the Financial System. (2023, September). *Stocktake on Financial Institutions' Transition Plans and their Relevance to Micro-prudential Authorities*.

in understanding the impact of business strategy with respect to risk. The reasoning for this is expanded in the following paragraphs.

- **Financial institution transition planning and climate-related financial risk management have fundamentally different objectives:**
    - Transition planning is a strategic business planning exercise and an element of overall long-term business strategy for a firm, driven by the Board and management, which generally aims to operationalize a firm's strategic targets and commitments, and may involve how the firm plans to achieve its low-carbon goals, with interim milestones.
    - On the other hand, climate-related financial risk management is intrinsically linked to broader financial risk management, which is led by risk functions within the financial institution. It aims to monitor, manage and mitigate potential risks to the firm's going concern resilience, and relates to the prudential time horizon for managing material risks, which varies depending on the risk type and can range from days to up to approximately 3 to 5 years for most banks and insurers.
    - Scenarios and emissions pathways referred to in the context of transition planning vs. climate-related risk management may differ, both in terms of the scenarios themselves, as well as time horizons employed. In a transition planning context, the use of emissions pathways is primarily relevant for assessing alignment with a specific net zero outcome, where the aim is to align to *aspirational, long-term* net zero goals, and what can be considered the *most likely* emissions pathways and scenarios towards those goals as indicated by current global emissions and policies in place. For climate risk management, climate scenario analysis is a tool to assess and understand potential vulnerabilities and financial impacts under alternative probable and plausibly adverse climate scenarios. Risk management decision-making is consistent with the time horizon of the risk exposure (e.g., credit risk management decisions consistent with average length of a bank's loan book). These divergences in objective and time horizon reinforce the need to consider transition planning as a complementary, but fundamentally different, activity to climate risk management.
- **There is a danger of distorting financial institution transition planning and climate-related financial risk management approaches by conflating them:** Prudential authorities in market economies generally do not seek to influence a supervised firm's choice of (legitimate) business activities.[34] Furthermore, research and analysis to date into whether or not there is a 'green-brown' risk differential, by the NGFS and others,[35] has not found strong evidence of generalized risk differentials for different exposure types. Therefore, considering that transition planning is undertaken primarily in the context of long-term business strategy, **a financial institution's**

[34] The Basel Committee on Banking Supervision. (2023, July). *Core Principles for Effective Banking Supervision* note that: *"Effective market discipline depends in part on adequate flows of information to market participants, appropriate financial incentives to reward well managed institutions and arrangements that ensure that investors are not insulated from the consequences of their decisions. … Market signals can be distorted and discipline undermined if governments seek to influence or override commercial decisions, particularly lending decisions, to achieve public policy objectives."* The IAIS Insurance Core Principle 7.2 states that an insurer's board is required to set and oversee the implementation of the insurer's corporate culture, business objectives and strategies for achieving those objectives, in line with the insurer's long-term interests and viability.

[35] Network for Greening the Financial System. (2022, May). *Capturing risk differentials from climate-related risks*; European Banking Authority. (2022, May). *The role of environmental risks in the prudential framework*.

**transition planning and implementation process do not seem to be directly relevant from a risk management perspective in a supervisory context**.

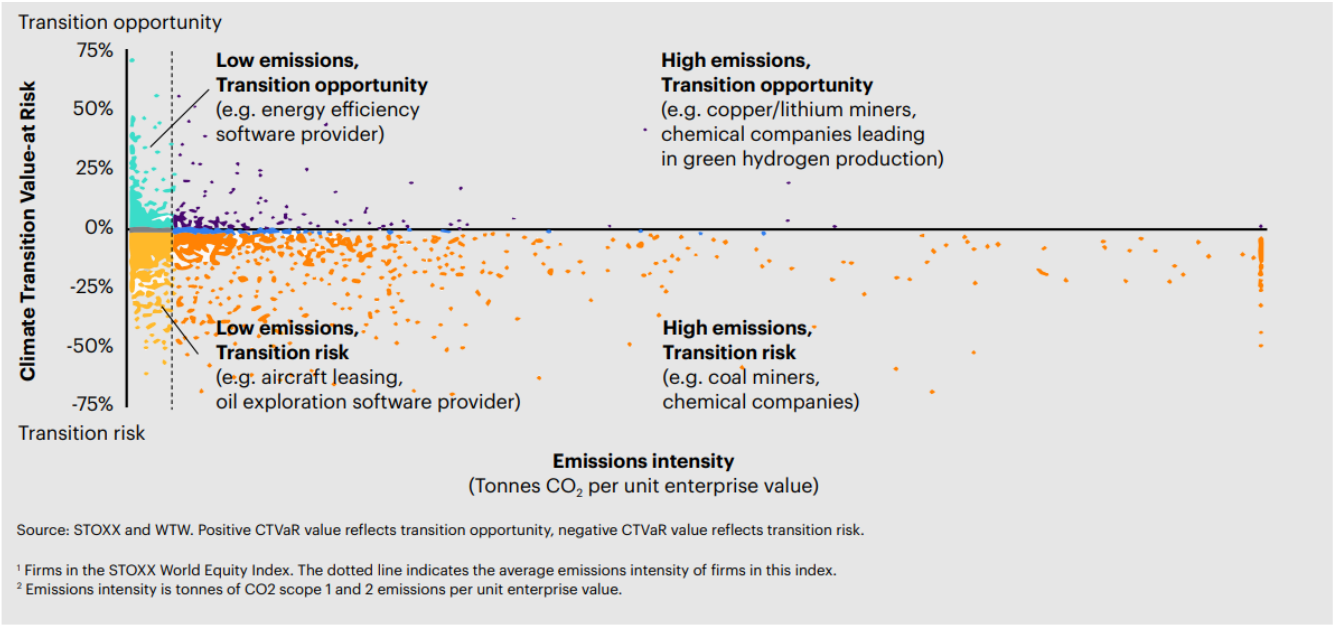
- In time, **financial institutions may refer to information about a client's or investee's transition planning as an indicator of their strategic orientation, adaptive capacity and resilience in the context of the broader risk assessment process** – for example, credit or reputational risk. If so, this information would be one factor considered among several others. At present work to understand how client or investee transition plans can be used to assess potential risk in various contexts is still in early stages, such that the majority of financial institutions have not explored the degree to which client and investee transition plans will be an important input to their risk assessment process.
- **The relevant metrics for transition planning and climate risk management differ:** Metrics that are being proposed to measure progress towards transition targets or commitments are often different to those being developed to evaluate the impact of climate-related financial risks, such as scenario-contingent financial losses, adjustments to internal ratings, climate-adjusted probability of default or loss-given-default, and probable maximum loss on an insurance policy. To give a specific example, one of the emerging metrics for financial institutions as part of transition planning is Scope 3, or financed, emissions. IIF/WTW research[36] demonstrates that emissions-based metrics are not a comprehensive measure of, or direct proxy for, transition risk to a financial institution because many currently emissions-intensive activities are projected to remain profitable under plausible transition scenarios (e.g., lithium mining, shipping); at the same time some low emissions activities may not be profitable (e.g., emerging green technologies with an unproven risk profile) (see Figure 2). Financed emissions are unlikely to linearly decrease even if a financial institution develops and implements a science-based transition plan, if it extends transition finance or investment to carbon-intensive sectors – which may be an effective channel for the financial institution to help support real economy decarbonization.
- **While they have fundamentally different objectives, the process of developing and implementing a transition plan, including the use of transition plans and other information from clients, counterparties and investees, may be relevant to the risk management process, and therefore contribute to the overall degree of business model risk to a financial institution over the medium to long-term:** To the extent that having a transition plan orients a firm towards the direction of travel of the real economy and prepares it for future changes in policy, consumer demand and technology as a result of the net zero transition, it could contribute to reducing the expected strategic and transition risk exposure to an institution over the medium to long term. However, this can only be determined *ex post* and would rely on the firm making appropriate judgments and decisions over time in response to external factors. Climate-related financial risk management, on the other hand, is designed to reduce potential financial risk exposure to an appropriate level *ex ante.*

**More broadly, it is important to consider that all financial institutions are, in essence, risk managers – in the sense that every strategic decision taken by an institution is based on, or otherwise informed by, an assessment of risks.** Whilst not the core objective, a financial institution's transition plan should still be aware of and aim to minimize the climate-related risks to the institution. The financial institution may

[36] Institute of International Finance & WTW. (2023, May). *Emissions Impossible: Quantifying financial risks associated with the net zero transition*.

refer to its internal assessment of climate-related risks and opportunities when determining its strategic transition plan, although the risk analysis is likely to be on a shorter time horizon than the transition plan strategy. In addition, implementation of a bank's transition plan still needs to operate within the risk appetite and governance framework of the financial institution, and not be in conflict with its climate risk policies and approaches. Importantly, **prudential supervisors can account for the potential impact of transition planning on strategic risk in their engagement with financial institutions without distorting the concept of transition planning**; some early engagement by a few supervisory authorities across the world appears to align with this approach (see Section 2.5).

**Figure 2:** The empirical relationship between operational emissions intensity and climate transition risk[37]




Source: IIF/WTW, 2023.

**The above-described considerations illustrate why financial institutions see the rationale for distinct supervisory discussions regarding (i) the details of a supervised financial institution's climate-related risk management approaches, and (ii) its strategic approach to transition planning.** Prudential supervisors should have access to the necessary information to have informed discussions with firms about financial risk management and business strategy to the extent that it could influence safety and soundness, or policyholder protection or fair, safe and stable insurance markets, in the medium to long term. In time, the ISSB standards will provide a rich source of publicly disclosed data that will speak to both topics. However, not all information about a firm's transition planning may be appropriate for public disclosure due to commercial sensitivity, in which case additional supervisory reporting or information sharing may be needed. Equally, transition plans will not contain detailed information about the climate-related risk management efforts of a financial institution. Some financial institutions are concerned that prudential authorities may set expectations around financial institution transition plan disclosure or transition planning itself with the aim of driving safe and sound risk management practices, when in effect

[37] Figure 3, Institute of International Finance & WTW. (2023, May). *Emissions Impossible: Quantifying financial risks associated with the net zero transition*.

such action would amount to supervisory involvement in business strategy. Recommendations in Section 3 provide suggestions on how prudential authorities could consider and interact with financial institution transition planning in an effective way.

## 2.4 Surveying the rules of the road: frameworks, guidance, recommendations, and criteria

**Multiple sets of frameworks, guidance, recommendations, and criteria for Net Zero target setting and transition planning are being put forward by different market-based initiatives and third-sector entities; official sector authorities in certain jurisdictions are beginning to translate aspects of these frameworks into policies and legislation.** Financial institutions are becoming subject to an increasing number of informal expectations and formal requirements pertaining to the development, nature and disclosure of their transition plans, which can vary in terms of focus areas, specific expectations and format. The independent development of frameworks with overlapping sets of rules and expectations for 'what good looks like' can present several challenges for financial institutions, particularly those operating in different markets.

Frameworks, guidance, recommendations, and criteria for the development and assessment of net zero targets and transition plans (hereafter "NZ/TP frameworks" for brevity) can be broadly differentiated into **economy-wide frameworks**, intended to be applied by firms in different sectors, and **sector-specific frameworks**, which are designed for certain sectors. Both types of frameworks may be relevant for financial institutions in the context of either producing their own transition plans, or in using clients', counterparties', or investees' transition plans. NZ/TP frameworks for financial institutions have been developed or are being considered by three main groups of stakeholders, which have different objectives and areas of focus:

i. **Market-based industry initiatives**, including GFANZ and its constituent entities;
ii. **Third-sector entities**, including NGOs (e.g. SBTi, CDP, etc.), multilateral bodies (e.g. UN HLEG NZECNSE), and other organizations.
iii. **Jurisdictional authorities and global standard-setters**, including government authorities (e.g. as in the case of the UK TPT), central banks, supervisors, official sector alliances (including the NGFS) and global standard setting bodies (including the Financial Stability Board (FSB), Basel Committee on Banking Supervision (BCBS) and the International Association of Insurance Supervisors (IAIS)). These are the focus of Section 2.5.

In addition to these three sources, guidance on transition planning may evolve in the context of global disclosure standards, for example under the auspices of the ISSB.

**Many of the specific NZ/TP frameworks that have emerged to date have originated from market-based industry initiatives or third-sector entities, with most jurisdictional authorities and global standard-setters generally at an earlier stage of engagement on transition planning**.[38] Some of the leading frameworks have similar, but subtly different, objectives and approaches – see **Annex 1** for a more detailed comparison of some leading NZ/TP frameworks. They also differ in terms of their overarching

[38] There are some jurisdictional exceptions. For example, in the European Union transition planning is expected to become mandatory and EU sustainability disclosure requirements already explicitly refer to transition planning (see Annex Table 1).

focus, the stage of the transition planning and implementation process they relate to (from target setting to implementation and disclosure), and their target audience. Expectations for one part of the transition planning process, or from one key stakeholder group, can influence a financial institution's overall strategic approach to Net Zero target setting and transition planning. We note that 'risk management' does not generally feature as a pillar of NZ/TP frameworks,[39] nor is transition planning is included within the risk management pillars of broader frameworks (such as the ISSB standards), which reflects the important differences between strategic transition planning and climate-related financial risk management activities.

## 2.5 Emerging policy and supervisory approaches to financial sector transition planning

**Official sector interest in financial institutions' transition plans is increasing significantly, with questions raised about potential use cases for transition plan information and potential for regulatory and supervisory fragmentation to emerge.** Authorities across the world have started to investigate multiple different channels through which requirements for the development and disclosure of transition plans could emerge at the economy-wide and financial sector levels. Current options under consideration are summarized in Table 2.

**Table 2:** Official sector interest in transition planning across the world[40]

| Observed Category of policymaker Interest/Approach | Description | Official-sector authorities taking, proposing or commenting on given approach |
|---|---|---|
| **Disclosure -** Financial sector & Economy-wide[41] | Setting requirements or expectations for financial (and non-financial) corporates to disclose transition plan information, either linked to voluntary or mandatory transition planning requirements; with a view to increasing the consistency of how information on transition strategies and action is disclosed to market participants and other stakeholders and providing accountability against any public commitments. | • Australia (government)<br>• Bank of Italy<br>• EU CSRD/ESRS, EU CSDDD (draft)<br>• European Banking Authority Pillar 3 Templates[42]<br>• European Central Bank<br>• ISSB IFRS S2 Standard<br>• Korean Financial Supervisory Service<br>• Monetary Authority of Singapore<br>• New Zealand External Reporting Board<br>• Discussed in NGFS May 2023[43]<br>• South Africa, Johannesburg Stock Exchange |

[39] The only exception is CDP, which is a framework designed to understand the environmental performance of a company; it is not specifically a transition planning framework or standard.

[40] Information from various sources, including those cited plus the University of Oxford. (2023, September). *Net Zero Regulation Stocktake*, and UK Transition Plan Taskforce. (2023, July). *Building momentum for transition plans: Status update from the Transition Plan Taskforce*.

[41] Authorities in jurisdictions that will implement the ISSB standards would also, by extension, introduce ISSB-based disclosure requirements related to transition planning.

[42] No explicit reference to transition plans but qualitative information requirements could relate to transition planning information.

[43] Network for Greening the Financial System. (2023, May). *Stocktake on Financial Institutions' Transition Plans and their Relevance to Micro-prudential Authorities*.

| Observed Category of policymaker Interest/Approach | Description | Official-sector authorities taking, proposing or commenting on given approach |
|---|---|---|
| | | • Turkey (Capital Markets Board, Istanbul Stock Exchange)<br>• UK Transition Plan Taskforce<br>• U.S. SEC Proposed Rule |
| **Microprudential** | Interest in a financial institution's response to the transition (alignment/misalignment) including any transition plan developed, with a view to assessing factors that could affect safety and soundness. Could also relate to expectations around client engagement and use of client transition plans. | • Referenced in BoE / UK PRA[44]<br>• ECB 2022[45]<br>• Potential mandate for EU supervisors in CRD6 proposal<br>• ECB (2022; Elderson)<br>• Question included in IAIS Consultation March 2023[46]<br>• Discussed in NGFS May 2023<br>• OSFI (Canada)[47] |
| **Macroprudential** | Interest in financial institutions' transition plans to assess the overall orientation of the financial sector with respect to the net zero transition. This could involve: assessing the degree to which the pace of the financial sector transition is aligned or misaligned with the pace of the real economy transition; the degree to which financial system net-zero alignment and transition financing may support longer-term real economy alignment; identifying risk transmission channels with the real economy and between financial sub-sectors; and examining potential risk concentrations in financial markets. | • Referenced in BoE / UK PRA<br>• BIS Financial Stability Institute[48]<br>• Being investigated by FSB<br>• Discussed in NGFS May 2023 |
| **Governance and Market Conduct** | Setting requirements or standards for entity-level sustainability claims and commitments (e.g., Net Zero alignment or GHG-reduction targets or commitments), which may involve disclosure or other tools, from a market conduct or consumer protection perspective. | • EU CSDDD (draft)<br>• Discussed by European Banking Authority (EBA)[49] and European Securities and Markets Authority (ESMA)[50]<br>• Discussed in NGFS May 2023<br>• UK Financial Conduct Authority |
| **Substantive requirements or guidance on transition planning** | Setting substantive requirements, expectations or guidance for financial institutions related to adoption and/or implementation of net zero transition plans. | • Central Bank of Brazil[51]<br>• EU CSDDD (draft) |

[44] Bank of England. (2023, March). *Report on climate-related risks and the regulatory capital frameworks*.
[45] European Central Bank. (2022). *Good practices for climate-related and environmental risk management: Observations from the 2022 thematic review*. Transition planning was reviewed as part of bank business strategy / strategic approaches.
[46] Question 5, International Association of Insurance Supervisors. (2023, March). *Public Consultation on Climate risk supervisory guidance – part one*.
[47] Office of Superintendent of Financial Institutions Canada. (2023, March). *Guidline on Climate Risk Management*.
[48] Bank for International Settlements. (2023, April). *Macroprudential policies for addressing climate-related financial risks: challenges and trade-offs*
[49] European Banking Authority. (2023, May). *Progress Report on Greenwashing Monitoring And Supervision*.
[50] European Securities and Markets Authority. (2023, May). *Progress Report on Greenwashing*.
[51] Central Bank of Brazil. (2021, September). *Resolução CMN n° 4.945 de 15/9/2021.*

| Observed Category of policymaker Interest/Approach | Description | Official-sector authorities taking, proposing or commenting on given approach |
|---|---|---|
| | | • Monetary Authority of Singapore (TBD)[52]<br>• US Treasury (voluntary principles)[53] |

**Table 2 explores five different categories of policymaker interest or approach in relation to transition planning, which we have observed to date.** The table includes examples of jurisdictional or global authorities that have taken, are proposing or have commented on the various approaches, spanning: Disclosure; Microprudential; Macroprudential; Governance and Market Conduct; and Substantive requirements or guidance on transition planning. As Table 2 demonstrates, Disclosure and Microprudential approaches are the most commonly observed and discussed themes at this time, although a wide number of different applications have been advanced by different authorities.

- ***Policy developments and debate on Disclosure***

**Disclosure requirements or expectations addressing transition plans and transition planning activities are a leading policy approach,** which has been established at the global level through the TCFD framework and now taken up by the ISSB's climate disclosure standards (IFRS S2). Disclosure policies are generally intended to increase the consistency of how information regarding transition strategies and implementation activities is disclosed to market participants and other stakeholders and, from a conduct perspective, to provide accountability against any public commitments. While all jurisdictions that will seek to implement the ISSB standards and/or currently reference the TCFD framework will likely consider transition plan disclosure expectations in due course given their position in those frameworks, several jurisdictional authorities have already proposed or implemented disclosure expectations for financial institutions pertaining to net zero targets or commitments or transition plans.[54] Disclosure expectations can be agnostic as to whether or not a firm undertakes transition planning, or whether transition planning is mandatory or not in the jurisdiction. The ISSB and several jurisdictional approaches, such as the proposed U.S. SEC climate disclosure standards that were released for consultation in June 2022, only require disclosure of transition plan information *if an entity has a plan*. Disclosure can also be a means to an end for other policy objectives, such as ensuring high-integrity market conduct or minimizing climate-related litigation risk. An important aspect of disclosure requirements or expectations relates to the specificity of the framework and the type and amount of information which is expected to be disclosed. At the global level, the ISSB's disclosure expectations in IFRS S2 are high-level and non-prescriptive.[55] They also include a provision for commercially-sensitive information about climate opportunities to be

[52] Monetary Authority of Singapore. (2023, June). *MAS to set expectations on credible transition planning by financial institutions* [Press release] announced "*that it will set supervisory expectations to steer financial institutions' transition planning processes to facilitate credible decarbonisation efforts by their clients*" and will consult later this year.

[53] U.S. Department of The Treasury. (2023, September). *Treasury releases principles for Net-Zero financing & Investment, applauds $340 million philanthropic commitment and other pledges* [Press release].

[54] There are examples of specific requirements targeted at financial institutions only and affecting financial institutions as part of broader requirements on public companies.

[55] International Financial Reporting Standards. (2023, June). *IFRS S2 Sustainability Disclosure Standard: Climate-related Disclosures*.

excluded from public disclosures. However, some existing jurisdictional approaches are far more prescriptive and granular in their requirements, e.g., the proposed UK Transition Planning Taskforce (TPT) framework.[56] In July 2023, the European Commission adopted the European Sustainability Reporting Standards (ESRS)[57] for companies subject to the Corporate Sustainability Reporting Directive (CSRD). These standards include requirements for mandatory transition plan disclosure such that a firm's strategy and business model are in line with limiting of global warming to no more than 1.5°C. The ESRS await final validation by the EU Parliament and Council.

- ***Policy developments and debate on the interaction with Microprudential supervision***

**There is a growing interest by microprudential supervisors in transition planning by supervised financial institutions.** A May 2023 stocktake report by the NGFS summarized the range of views on the role of microprudential supervisors in relation to bank and insurer transition planning, and the differences of views on how useful the information they contain will be to supervisors over and above information already obtained from the embedding of existing guidance on management of climate-related financial risk. The majority (52%) of NGFS members responding to a survey for the aforementioned stocktake report see transition plans as having a role to play in mitigating risk, and the NGFS report proposes a distinction between "strategy transition plans" and "risk transition plans". But the report indicates that supervisors around the world currently have different views on the relevance of transition plans to risk management and safety and soundness, which we also observe by reviewing the details of individual supervisors' approaches on this issue to date. Of note is that many have focused on links to business model risk and long-term strategic risk. For example, OSFI's 2023 supervisory expectations state that the institution *"should develop and implement a Climate Transition Plan, in line with its business plan and strategy, that guides the FRFI's actions to manage increasing physical risks from climate change, and the risks associated with the transition towards a low-GHG economy."* The approach proposed by the BoE/UK PRA is similar. This indicates that some supervisors may approach financial institutions' transition planning from the perspective of medium- to long-term business model or strategic risk management, rather than near-term climate-related financial risk management. However, the final CRD6 agreed by the European co-legislators, and speeches and reports by the ECB, indicate that public authorities in Europe see a stronger expected link between transition planning and climate-related financial risk management.[58] The

[56] Institute of International Finance. (2023, March). *IIF Response to the UK Transition Plan Taskforce (TPT) consultation*.

[57] See link to European Sustainability Reporting Standards (ESRS) Annex 1: *"The objective of this Disclosure Requirement is to enable an understanding of the undertaking's past, current, and future mitigation efforts to ensure that its strategy and business model are compatible with the transition to a sustainable economy, and with the limiting of global warming to 1.5 °C in line with the Paris Agreement and with the objective of achieving climate neutrality by 2050 and, where relevant, the undertaking's exposure to coal, oil and gas-related activities."*

[58] For example, Frank Elderson at the ECB remarked in October 2021 that *"Transition plans should become the next addition to banks' risk management practices. But they in no way pre-empt the supervisory dialogue with banks on their risk management capabilities. They are simply another, albeit crucial, element to ensure that banks manage all material risks, one we have been insisting on specifically with regard to C&E risks since 2020."* And in November 2022, Elderson remarked that *"…the banks under our supervision need to step up their game and truly manage climate-related and environmental risks in the same way we expect them to manage any other material risk. This is why we support the European Commission's proposal that banks should be legally required to put in place prudential transition plans which enable them to assess their risk exposures and the effectiveness of their risk controls in a world that is transitioning to net zero."* European Central Bank. (2022). *Good practices for climate-*

Banque de France Governor, François Villeroy de Galhau, also drew a link between transition planning, climate stress testing and firm-specific capital requirements in a 2022 speech.[59]

- ***Policy developments and debate on the interaction with Macroprudential policymaking***

**To date, there has been relatively little published analysis by the official sector as to the potential macroprudential use cases for financial institutions' transition plans.** The FSB has recently created a new working group to further investigate the topic, which has been raised by the BoE/UK PRA, NGFS and BIS Financial Stability Institute. The FSB aims to address *"the role that firm's transition plans could play in providing information for monitoring transition and physical risks, which links with work being undertaken on data and vulnerabilities analysis, and as a tool for mitigating some of those risks."*[60] The BIS Financial Stability Institute has suggested that transition plans could be used to identify which firms (not only financial institutions) should be subject to more stringent macroprudential requirements in a forward-looking way based on their projected emissions profile. In the EU, the final CRD6 text agreed by the co-legislators requires authorities to take climate risk into account when setting the Systemic Risk Buffer, which could potentially introduce a macroprudential link to transition planning depending how it is interpreted. Section 3.4 discusses the potential macroprudential interest in financial institution transition planning in more detail.

- ***Policy developments and debate on Governance and Market Conduct aspects***

**There is a growing interest in ensuring robust governance and integrity in market conduct in relation to climate and sustainability-related claims, and the avoidance of "greenwashing" or "transition washing"**. This is often discussed in the context of specific products and services, however it can also relate to entity-level claims and commitments such as those related to net zero alignment or GHG-reduction targets and commitments. Through a transparency and market discipline channel, requiring published transition planning information can aim to boost accountability and monitoring of publicly stated climate-related targets and commitments. For example, once the UK's TPT publishes its final Transition Plan Framework, we anticipate that the FCA/UK government will then consider how to incorporate requirements relating to publishing TPT-compliant transition plans in UK legislation. Others, such as the European Securities and Markets Authority (ESMA), have expressed an interest in transition plan requirements. Separately, some prudential authorities may consider the interactions between transition planning and governance in the microprudential context (for example, the role of transition plan disclosure to minimize risks of greenwashing has been discussed by the European Banking Authority, EBA).[61]

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*related and environmental risk management: Observations from the 2022 thematic review* examines transition plans within the context of business strategic approaches, and tools for strategic engagement with clients.

[59] *In Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at the Climate Finance Day, Paris, 27 October 2022 "The question now is how to «operationalize» these stress tests and transition plans. In my view, the simplest and most international way forward is to integrate them into Basel capital requirements, in Pillar 2 on risk governance, as a first-stage approach. Regulations should explicitly cater for additional own fund requirements in case banks' individual transition plans appear deficient or misaligned. This will raise a number of methodological questions, to be addressed by the EBA in Europe."*

[60] Section 2.3.2, Financial Stability Board. (2023, July). *FSB Roadmap for Addressing Financial Risks from Climate Change Progress report*.

[61] European Banking Authority. (2023, May). *Progress Report on Greenwashing Monitoring And Supervision*.

- ***Policy developments and debate on Substantive requirements or guidance on transition planning***

**In some jurisdictions, authorities are setting out requirements, expectations or guidance for financial institutions on how they undertake transition planning, or to mandate it.** For example, in September 2023, the U.S. Treasury Department released a set of voluntary *Principles for Net-Zero Financing & Investment* for financial institutions to promote consistency and credibility in approaches and encourage adoption of what they consider to be emerging best practices in market approaches to date in an effort to *"support financial institutions in their efforts to execute on their commitments."*[62] In other cases, the authority is explicitly setting requirements or expectations for financial institutions to undertake transition planning in order to influence the wider economic transition to a low-carbon economy via their business, activities and stakeholder relationships. For example, Brazil's Central Bank and National Monetary Council adopted several resolutions in September 2021 in relation to ESG responsibility and considerations, which include a requirement to *"include actions to transition to a low-carbon economy, as well as to reduce the impacts of weather-related events"*. In the European Union, the draft Corporate Sustainability Due Diligence Directive (CSDDD) would mandate that large corporates, including financial institutions, have a business strategy that is aligned with the Paris Agreement in order to help the EU to *"achieve a successful and just transition towards a sustainable future"*[63] The Monetary Authority of Singapore has announced that it will develop supervisory expectations to *"steer financial institutions' transition planning processes to facilitate credible decarbonization efforts by their clients."*[64]

## 2.6 Implications for global firms, markets, and supervisors

**Ultimately, the financial industry, public authorities, and civil society stakeholders share mutual interests with respect to transition planning and implementation, and any associated disclosures.** Transition plan goals should be **credible**, including in terms of the scientific basis of any net zero emissions pathways used to set targets, the technical and economic feasibility of transition actions identified within a plan, and the likelihood for key milestones and targets to be achievable. There should ideally be a degree of **consistency in regulatory and supervisory expectations on transition plan disclosures**, in terms of structure, scope, and coverage, while also recognizing the boundaries between what is externally relevant vs. internally relevant information and allowing sufficient flexibility for approaches to transition plan disclosure (for example, metrics) to evolve over time. **However, standardizing financial institutions' long-term business strategies with respect to the net zero transition would not be a desirable outcome**.

**It is important for all stakeholders to recognize that financial institutions' progress against actions and targets identified in transition plans will depend on the practical realities of competitive markets, uncertainty about factors affecting the feasibility and likelihood of successful transitions of their clients, counterparties and investees, and other exogenous factors.**

The frameworks and approaches that have emerged as resources to guide financial institutions in the net-zero target setting and transition planning processes have played an important role in supporting

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[62] U.S. Department of Treasury. (2023, September). *Principles for Net-Zero Financing & Investment*.

[63] European Commission. (2022, February). *Directive of The European Parliament and of The Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937*.

[64] Monetary Authority of Singapore. (2023, June). *MAS* to set expectations on credible transition planning by financial institutions [Press release].

individual institutions as they grapple with these technical, complex and impactful business-wide decisions. **However, the independent development of frameworks has resulted in a fragmented landscape, which can be daunting and potentially confusing for market participants and other stakeholders.** Nor is there a clear mapping between the expectations or reporting expectations within existing frameworks.

**This situation creates complexity for financial institutions, especially for global firms which are currently working towards alignment or compliance with multiple non-regulatory NZ/TP frameworks, while also preparing for forthcoming regulatory requirements in the areas of transition planning development and disclosure.** The presence of multiple frameworks can complicate the transition planning process itself, given the impacts that a voluntary framework, or a disclosure framework, can have on the way the whole strategic exercise is approached by a firm – as many are designed to inform strategic decision-making across the entire organization, not only what and how a transition plan disclosed. Even frameworks that are explicitly related to transition plan *disclosure*, such as the UK TPT, include implicit expectations about the transition planning *process* itself and its relevance to business strategy. If frameworks have slightly different expectations or requirements on key aspects such as implementation strategy, metrics, or the role of carbon offsets, it can put financial institutions in a position where they cannot perform favourably against multiple frameworks at once. As a result, the fragmented landscape for NZ/TP frameworks may obfuscate efforts to evaluate the credibility of financial institutions' –or other firms'— transition plans, as the presence of multiple "rules of the road" combined with divergent stakeholder expectations can lead to disagreement on what a transition plan should contain in order to be considered credible. The development of approaches to determine credibility is an important issue which requires near-term prioritization, and is addressed in greater detail in section 4.1.

**The current complex landscape of non-regulatory frameworks makes it a challenging arena for regulators and supervisors to enter, as evidenced by the diversity of approaches being considered in different jurisdictions.** Global standard-setting bodies and coalitions have begun by stocktaking efforts and industry engagement to understand current transition planning efforts, which is an essential first step as they develop an understanding of financial institutions' transition planning and how it might relate to their mandates. However, some jurisdictional authorities are already taking steps to mandate the development and/or disclosure of transition plans, including through both economy-wide and financial sector-specific requirements. Authorities are facing choices as to how market-based frameworks could be referenced and in what ways, and how criteria to evaluate credibility could be developed.

**Looking across jurisdictions, three key trends are emerging:**

1. Transition-planning related requirements are being very actively pursued by authorities around the world for several distinct, and sometimes multiple (for example, in the EU), use cases.
2. There are differences of views among authorities on the importance and role of financial institution transition planning and, relatedly, on the role of financial regulators and supervisors.
3. The issue is not just theoretical – requirements have already emerged on multiple continents, which is giving rise to a fragmented operating landscape for financial institutions, which could inadvertently create challenges for global decarbonization efforts (e.g., through impacts on financing and investment in developing countries and impacts on clean energy supply chain financing and investment).

**The precise intentions of different authorities in relation to their engagement on financial institution transition planning and/or transition plans are likely to differ and be context-specific. However, in some**

**cases, policymakers may be taking or considering an "active transition" approach to their interest in financial institution transition planning** – what the IIF has described as the use of financial sector policy tools to regulate and incentivize the financial system to actively steer the low-carbon transition of key sectors in the real economy, via the provision and pricing of financial products and services.[65] Not only does this present a range of challenges, including undermining the credibility and efficiency of prudential tools, it also assumes that financial institutions have direct influence over their clients' ability to transition and ignores the need for more direct policy levers and incentives which are required to catalyze investment in the transition.

**If financial sector regulators and supervisors conclude that there is to a role for regulatory and/or supervisory engagement in relation to financial institution transition planning, it is extremely important that this approach reflects the a given financial sector authority's remit as well as the boundaries of the financial sector's role as *supporting* rather than *driving* the transition, and the array of exogenous factors and uncertainties which may affect a firm's ability to achieve transition targets.** At a high level, this would entail: (i) acting based on the authority's prudential mandate, and accounting for the strategic nature of transition planning; (ii) approaching the topic from a global perspective and through the global standard-setting bodies to avoid the emergence of fragmented regulatory approaches, which could create additional complexity and potentially undercut global decarbonization objectives; and (iii) avoiding a directive approach to individual institution's business decisions or transition strategies and not seeking to drive certain real economy outcomes via supervised institutions. Specific recommendations for authorities responsible for oversight of different types of financial sector institutions are included in Section 3.

## 3. Industry perspectives on regulatory and supervisory engagement on transition planning by financial institutions

This section puts forward specific recommendations for microprudential supervisors and macroprudential authorities on how to engage with financial institution transition planning. These recommendations are intended to be helpful at the current juncture as many prudential authorities are determining how to engage with and support financial institution transition planning.

### 3.1 Industry views on potential supervisory approaches in the banking and insurance sector

**A bank or insurer's own transition planning, and the information summarized in transition plans, may provide some information to the supervisory review process.** Prudential supervisors have an interest in understanding and discussing business strategy with supervised banks as part of holistic risk assessment, which covers, among other things, business model, strategic, reputational, and legal risks. However, they do not have a mandate to intervene in supervised institutions' strategy setting to align it with specific objectives.

**Transition planning should not be considered as a prudential risk management tool for financial institutions, or supervisors.** The inherently strategic nature of transition planning and important differences from climate-related risk management should be accounted for as supervisors engage on the topic. Specifically, supervisory authorities should continue to focus on prudential outcomes rather than

[65] Institute of International Finance. (2021, January). *Prudential Pathways: Industry Perspectives on Supervisory and Regulatory Approaches to Climate-Related and Environmental Risks*.

climate outcomes, and should refer to information about an insurer's strategic transition planning in the context of understanding the firm's business strategy. There is a concern that supervisors may seek to *drive* the real economy transition through the financial system via transition plans, which is typically beyond their mandate, outside of their area of expertise, and could potentially lead to serious unintended consequences.[66]

Although there are important differences between transition planning across different types of financial institutions, IIF members deem that these general considerations relate similarly to banking and insurance supervisory approaches.

**Industry recommendations on the prudential treatment of bank and insurer transition planning:**

- Where transition planning has been undertaken by a bank or insurer, supervisors could account for this in a **holistic way** alongside other factors and assess any material **interactions with prudential objectives** as part of the supervisory review process, or Pillar 2 for banks. For example, such an approach could aim to understand the institution's business objectives and strategies, and the implications for strategic, reputational or legal risk, or the institution's ability to remain in business over the medium to long term. This should be in the context of general oversight of the financial institution's business strategy, consistent with how supervisors currently engage with business strategy at present.
- **Supervisory engagement on transition planning should be distinct from engagement on climate-related risk management, and should be higher level and less granular considering the strategic nature of transition planning.** Supervisory engagement should account for the inherent dependencies on external factors and uncertainties involved in transition planning. Any guidance should carefully consider the implications of supervising an institution's business strategy in this context and should recognize that transition plan requirements that constrain financial institutions' business strategies and activities could in fact create significant macroeconomic risk, particularly if supervisory expectations are out of step with the progress of the transition in the real economy.
- In the first instance, prudential authorities should **refer to publicly available information** on a bank or insurer's transition plan, if it has one, for example, the information that is expected to be published in future as part of ISSB-aligned disclosures. As transition plans are strategy documents and not risk-related documents or prudential tools, **specific prudential disclosure requirements would not be necessary, for example within Pillar 3 in the BCBS banking framework.** However, supervisors may require additional, commercially sensitive information which would not be published,[67] as part of the confidential supervisory review process designed to evaluate a firm's financial risks.

[66] As discussed in greater detail in Institute of International Finance. (2021, January). Prudential Pathways: Industry Perspectives on Supervisory and Regulatory Approaches to Climate-Related and Environmental Risks.

[67] International Financial Reporting Standards. (2023, June). *IFRS S1 standard: General Requirements for Disclosure of Sustainability-related Financial Information* allows a disclosure preparer to omit commercially-sensitive information on its sustainability-related opportunities (but not risks) even if material, if certain conditions are met. See Paragraphs B34 to B37.

- As recognized by the NGFS,[68] **supervisors are not readily equipped to fully assess the credibility of a bank's or an insurer's transition plan.** Considering that there is not a coherent set of standards for credibility determination that reflect market practice, and the divergent views being put forward by multiple stakeholder groups at present, supervisors would be required to make numerous independent judgements on the technical and economic feasibility of aspects of a financial institution's transition planning, which would go beyond supervisors' remits and areas of expertise.
- **Encourage home-host supervisory coordination, with engagement at group level:** Most banks and insurers see transition planning as a group-wide process reflecting the fact that most climate-related targets and commitments are made at the group level. Home and host supervisory authorities should coordinate their interest and information requests in relation to transition planning, and account for the generally group-wide nature of transition planning (for example, by not requesting bespoke sub-group level information). More broadly, if supervisors across jurisdictions can take a common, principles-based approach to engaging with financial institution transition planning in a way that is aligned with their supervisory mandate and the recommendations set out above, this would benefit home-host supervisory coordination.

## 3.2 Industry views on potential macroprudential considerations

**Climate-related financial risks can give rise to macroeconomic risks, which could potentially transmit to the financial system**. Likewise, the financial system response to climate-related financial risks can generate impacts in the real economy. This interrelationship is at the heart of macroprudential policymaking.[69] In the context of the climate transition, financial stability could be negatively affected if financial institutions *en masse* change the rate at which they supply credit and other products and services to the real economy more quickly or more slowly than demand for credit, products and services changes. Financial stability could also be negatively affected if the financial system suffers significant losses due to transition-related factors. For example:

a) If regulated financial institutions withdraw lending, investment or insurance underwriting to a particular sector, such as fossil fuel power generation, while businesses or households are still reliant on fossil fuel energy sources. In this example, the real economy could suffer an energy shortage as a result, which could affect economic and monetary stability. And/or unregulated institutions could step in to provide credit or insurance coverage to the fossil fuel power sector given its continued profitability, but competition in the market would be lower and there could be associated financial stability issues with increased reliance on unregulated institutions.

[68] See Box 1, Network for Greening the Financial System. (2023, September). *Stocktake on Financial Institutions' Transition Plans and their Relevance to Micro-prudential Authorities*.

[69] Multiple definitions of financial stability exist, but they broadly center on the ability of the financial system to facilitate the demand and supply and credit and other essential services to the real economy, for the financial system to be resilient to shocks and to not adversely affect monetary stability.
See: World Bank Group. (2017, November). *Financial stability;* Bank of England. (2022, November). *What is financial stability?*; European Central Bank. (2023, April). *Financial stability*; Reserve Bank of Australia (2023, March*). About financial stability*.

b) If regulated financial institutions continue lending and investing in a particular sector, such as fossil fuel power generation, at a constant rate while business and household fossil fuel energy demand falls. In this case, the financial sector could suffer losses on its lending and investments and become straddled with so-called "stranded assets".

These examples demonstrate that a key aspect is real economic activity and realized demand for financial services. While this could align with and be indicated by jurisdictional transition targets and commitments, what matters as the ingredient for financial stability is realized demand.

In theory, market signals should help calibrate supply and demand for financial services over time, but sometimes market failures occur, and distortions are introduced. For example, if broader strategic objectives or commitments drive financial institutions to exit certain "brown" sectors or seek to do a greater amount of business with "green" sectors in a way that is not fully justified on the basis of market signals or profit motivations alone. Or if there are herding effects with firms adopting similar policies as each other for fear or being at a competitive disadvantage if they take a different approach.[70]

***Could microprudential policy address these types of market failures?***

Microprudential interest in transition planning should relate to engaging with individual firms' strategic business decisions to the extent that they relate to safety and soundness to a material extent, similar to how supervisors generally engage with firms on business strategy. In example (a), above, there may not be a near-term risk to individual firm safety and soundness of withdrawing lending or underwriting to those sectors even if they would have been profitable activities. In example (b), the impact on any individual financial institution may not be very significant if they have a diversified balance sheet, so it may not be a cause for concern from a microprudential perspective. There is also a risk that microprudential policy or supervisory approaches could exacerbate certain macroprudential risks. For example, if microprudential supervisors pursue an "active transition" approach or otherwise are more lenient towards activities considered to be supporting the net-zero transition (perhaps because of secondary objectives), or if there are unintended effects of certain microprudential policy measures (such as diverging supervisory approaches which constrain firms' business strategy and reduce the flow of transition finance, or increased economic and financial risk if supervisory expectations are out of step with how the real economy is transitioning).

Macroprudential authorities are considering how to monitor these potential risks during the transition. An important tool for this is supervisory climate scenario analyses and stress tests. To date, numerous supervisory exercises have concluded that the impacts of climate-related risks on financial stability are likely to be generally moderate and manageable over the short to medium term, with the potential for more significant risks arising over the longer term under different scenarios.[71] The potential impacts of climate change on the financial system are comparable to, and in certain cases may be smaller, than other financial stability risks which are considered in the context of macrofinancial stress testing – and climate risks and impacts are projected over a much longer horizon. However, it is important that these exercises

[70] Several authorities, including the IMF, have argued that an economy-wide price of carbon could help to equilibrate the demand and supply for carbon-intensive assets through market forces.

[71] Institute of International Finance. (2022, July). *Climate and Capital: Views from the Institute of International Finance* ; Institute of International Finance. (2022, July). *Navigating Climate Headwinds: Reference Approaches for Scenario-based Climate Risk Measurement by Banks and Supervisors*.

continue to mature and reflect the latest data and modelling techniques, also to avoid concerns such as potential underestimation of second-round effects.[72]

***Can financial institutions' transition plans help macroprudential authorities monitor risks during the transition?***

As part of the future development of climate scenario analysis, it may be possible to account for financial institutions' stated capital allocation plans, or financial sector trends observed through transition planning information, to better model the real economy interactions and feedback effects. However, it is not clear that simply "adding up" individual financial institutions' transition plans to get an aggregate view of activity during the transition would be informative. Transition plans are firm-specific and intended to make sense in the context of an individual firm's business strategy. Separately, they are usually predicated on multiple assumptions and subject to updating and revision as conditions change over the course of years. Further, science-based transition plans are designed relative to scientific projections of what action would be required to limit global warming to a certain level (e.g., 1.5°C or below 2°C by 2050). However, unless the necessary policies, consumption shifts and technological developments come to pass, the real economy will not align with those scenarios and implemented transition plans would not guarantee financial stability.

Aside from referring to transition planning information, macroprudential authorities could monitor relevant macrofinancial variables during the transition to gauge whether or not the financial system is keeping pace with the credit and financial services needs of companies and households. It would be valuable for macroprudential authorities to consider whether new indicators could be valuable to reflect the potential for risks to emerge from climate-related transition or physical risk factors.[73] For example, commodity/energy prices, carbon prices (where available), property & casualty insurance coverage and premia for corporates and households.

## 4. Open question: Credibility Determination

**It is essential that any discussions around whether a corporate or financial firm's transition plan may be considered credible clearly outline what is being assessed with respect to 'credibility', and the purpose for that assessment.** The term 'credibility' is increasingly used a catch-all for a variety of different considerations, including whether a firm's decarbonization target is science-based, the ambition of a firm's transition plan, the feasibility of a firm's transition plan, and whether a firm is disclosing all of the information of interest to a specific stakeholder or set of stakeholders. While greater scrutiny of transition planning via published transition plans can strengthen market discipline and promote good practices, the presence of multiple overlapping frameworks and guidance from different sources can create confusion about what an entity's transition plan should look like.

**At present, there are several yardsticks being developed by different initiatives that aim to assess whether a transition plan is credible**. Multiple market-based initiatives have set out criteria for the

[72] For example, as discussed in: Financial Stability Board. (2022 November). *Climate Scenario Analysis by Jurisdictions: Initial findings and lessons*.

[73] This could be an extension of current monitoring activities and macroprudential indicators which can include variables such as aggregate credit/GDP, corporate and household lending terms, and financial system variables. For example. see Bank of England. (2022, July). *FPC Core Indicators;* or European Central Bank. *The Macroprudential Database (MPDB)* .

assessment of financial institutions' transition plans, in terms of overall level of ambition, coverage, and the comprehensiveness of information included in a plan. While there is some degree of alignment in basic aspects, divergences in analytical underpinnings of a transition planning – such as the choice of scenarios used to inform assessment of sectoral transition pathways – could result in a firm's transition plan being considered as consistent with one set of criteria, but not with another.

As noted in Box 2, some financial institutions are developing bespoke approaches to the evaluation of transition plans, and determination of the credibility of information they contain, or are referring to external frameworks in some cases. There may be **several different dimensions that could be relevant from a credibility perspective in the context of strategy, risk assessment, or capital allocation decisions**:

- **Scientific integrity**: An entity's transition plan should be grounded in a scientifically robust understanding of its overall decarbonization potential, in the context of sectoral pathways which are aligned with specific temperature outcomes. In this regard, adhering to common science-based underpinnings in developing a transition plan – such as sectoral pathways developed by reputable international organizations – can help strengthen the foundation of a plan. One key issue related to scientific credibility pertains to the accuracy and precision of Scope 1, 2, and 3 GHG emissions data provided by clients, counterparties or investees; considering the well-recognized issues associated with such data, external judgements and inferences may be needed particularly in relation to forward projections. As such, work to develop common benchmarks or parameters for assessing scientific integrity would need to reflect data issues, as well as jurisdictional differences in sectoral pathways, both of which are significant issues for financial institutions seeking to assess transition plan credibility, particularly in emerging market and developing economies.
- **Technological reliability**: The actions set out in a transition plan need to reflect the current state and likely development of technologies that could be used to decarbonize processes and value chains; in this regard, a plan which relies significantly upon early-stage or unproven technological solutions may be considered as less credible than one which relies upon existing solutions. The evaluation of technical feasibility should reflect current and potential future technical solutions available to a given sector, which vary.
- **Financial and economic feasibility**: In the case that an entity can access proven technological solutions which can facilitate decarbonization in line with a scientifically-robust decarbonization pathway, the next credibility consideration that may arise is that of the financial and economic feasibility of a plan. For example, if a plan is unlikely to be achievable without a level of investment that would be considered untenable in the context of existing capital stocks, capital raising opportunities and plans, or revenues, it is unlikely to be financially feasible.
- **Strategic and competitive viability**: The credibility of a transition plan will be affected by factors exogenous to the firm, including the plans of its competitors, its level of access to technologies or economic inputs (such as critical minerals), and the degree of strategic reorientation required to align its business model with the needs of a net zero economy.

**While financial institutions may use information included in transition plans in multiple ways, it is not clear that they as private companies – or that third-sector initiatives – should be considered as solely responsible for evaluating the credibility of other firms' transition plans.** A central interest of financial institutions with respect to credibility is to analyze how a commercial relationship with a client may be relevant to their own transition planning, implementation, monitoring and reporting. Financial institutions may assess clients' current emissions profiles, and information included in transition plans to understand where they sit vis-à-vis their targets, and then use this insight to help identify commercial opportunities

to finance or facilitate a firm's decarbonization objectives. While financial institutions as users of transition planning information may perform due diligence on that information, they are not necessarily equipped to make definitive credibility assessments on all the dimensions described above.

**Considering this, IIF members do not think that financial institutions can be reasonably expected to be wholly responsible for assessing the credibility of real economy firms' transition planning. In addition, prudential supervisors are not readily equipped to fully assess the credibility of a financial institution's transition plan on all the above-described dimensions.** As the NGFS concluded in its May 2023 report on transition planning, prudential supervisors "do not have the appropriate resources or skills" to make credibility assessments, and it may not even fall within their microprudential mandate if the concern is about greenwashing.[74] However, several prudential authorities are interested in understanding supervised institutions' transition plans and may therefore be interested in their credibility from a perspective of engaging on their strategic and competitive viability, or potential reputational or legal risk to the institution. So it will be important that supervisors provide clarity on how they expect to review financial institution transition plans, and any consequences of certain expectations not being met.

**Now is an appropriate time to reflect on how different NZ/TP frameworks can be brought together, in support of the shared objective of ensuring credibility of transition plans, and the broader aim of maximizing the effectiveness of financial sector action to support the transition.** Recognizing the critical importance of aligned views on credibility, and the factors which affect how credibility should be reasonably determined, market-based initiatives should work together to coalesce around common pillars, and develop a set of shared transition plan evaluation criteria, through an appropriately representative and accountable review process. It could also be helpful for financial institutions and other market actors to assess what types of verification and assurance mechanisms may be appropriate in this context. Increasing the alignment of these frameworks and guidance in relation to important details, while maintaining the necessary scope and flexibility for individual financial institutions to decide on their own strategic approaches, would reduce doubt about what transition planning should entail and support greater confidence in financial institution transition planning overall.

## 5. Conclusions

**Countries, sectors, and individual companies, including financial institutions, must all partake in achieving our common and essential goals of transitioning towards a sustainable, low carbon economy, reducing and mitigating GHG emissions and strengthening climate resilience.** What varies are the different roles these stakeholders can and must play in this transition. The greatest task for the real economy will be to transform business models and to innovate to reach the climate goals embedded in the Paris Agreement. This is a long-term exercise accompanied by a high degree of uncertainty, which needs to be accounted for in internal planning and decision-making processes. The financial services industry supports its clients in this transformation through various means such as allocating and

[74] Network for Greening the Financial System. (2023, September). *Stocktake on Financial Institutions' Transition Plans and their Relevance to Micro-prudential Authorities* notes: *"At present, micro-prudential authorities do not have the appropriate resources or skills to make these assessments and provide the rigorous challenge required. Being tasked with this assessment would require significant capacity building. Furthermore, the above definition is founded on the need to minimise greenwashing risks, which can be outside some microprudential authorities' remit."*

intermediating capital, managing and underwriting risks, creating markets, providing advisory services and investment management and stewardship. However, while the financial sector will clearly play a significant role during the transition, it is important to recognize that financial institutions have limited direct influence over the emissions reductions of their clients and investees.

**Transition planning by financial institutions is an important component of the broader response to climate change – however, no amount of voluntary private sector action can make up for a lack of policy leadership, and over-expectation regarding the financial sector's role in this regard risks being counterproductive for the shared goal of reducing emissions.** Mischaracterization of the financial sector's influence on real economy decarbonization has resulted in the promulgation of unrealistic expectations regarding the impact of financial sector net zero transition activities, which have in turn created new risks – such as heightened litigation risk – which may disincentivize net zero efforts and could inadvertently reduce available capital for transition-related activities.

**The fragmented landscape of market-based, third-sector, and official-sector frameworks for transition planning is creating an array of challenges; further independent development of frameworks is likely to create additional costs for financial institutions, which could direct resources away from transition plan delivery.** The fragmented landscape for NZ/TP frameworks may obfuscate efforts to evaluate the credibility of financial institutions' – or other firms' – transition plans, as the presence of multiple "rules of the road" combined with divergent stakeholder expectations can lead to disagreement on what a transition plan should contain in order to be considered credible. Recognizing the range of factors which may affect how credibility should be determined, market-based initiatives could work together to coalesce around common pillars and consider formulating common evaluation criteria through an appropriately representative, sequenced and accountable review process. A rationalization of the voluntary frameworks and guidance could help to streamline efforts but, given that they originate from different groups of stakeholders with different focus areas and interests, this may not be likely in the near-term. Allowing time for firms, including non-financial institutions where the frameworks/guidance are more broadly applicable, and markets to gain experience with target setting and transition planning using alternative frameworks should shed light on which are the most useful.

**If financial sector regulators and supervisors deem there to be a role for regulatory and/or supervisory engagement in relation to financial institution transition planning, it is extremely important that this is approached in the right way.** At a high-level, this would entail: (i) acting based on the authority's mandate after careful review; (ii) approaching the topic from a global perspective and through global standard-setting bodies to avoid the emergence of fragmented regulatory approaches that impede strategic planning by financial institutions; and (iii) not seeking to take a directive approach to individual institution's business decisions or transition strategies in order to drive certain real economy outcomes.

**Financial institutions across the world are taking steps to finance the transition to a net zero economy, supported by market-based efforts and encouraged by policymakers and regulators.** However, several fundamental challenges and obstacles persist which can inhibit the degree to which capital is efficiently deployed to reduce and mitigate GHG emissions, strengthen climate resilience, unlock innovation and create jobs to achieve a just net zero transition. Now is the time to rejoin forces and work towards our common objectives to reach these imperative goals.

## Annex 1: Key features of selected NZ/TP frameworks that can apply to financial institutions

**Annex Table 1 summarizes the origins and characteristics of six voluntary or regulatory frameworks that were either developed explicitly for net zero target setting and/or transition planning, or which contain elements that relate to them including disclosure expectations (referred to collectively as "NZ/TP frameworks" for brevity).** The sample of frameworks was selected based on significance in terms of degree of uptake or referencing by financial institutions and other stakeholders including the official sector; it is not meant as an exhaustive overview of all existing frameworks. The table was completed by reference to publicly available information; any errors are the fault of the authors.

**Key Characteristics, Similarities, and Differences across surveyed NZ/TP Frameworks**

**Definitions and Structure:** At a high-level, the frameworks are reasonably aligned in terms of key definitions and expectations for Net Zero targets and transition planning. Key common elements include: i) an orientation towards a timebound net zero goal, ii) requirements for interim milestones and targets, iii) an emphasis on the use of metrics and key performance indicators, (iv) encouragement for targets and planning to cover a large and increasing amount of the firm's activities and portfolio, (v) recognition of the importance of transparency and disclosure of targets and progress. The frameworks reviewed are organized and presented differently, but several share some common pillars which can be traced back to the suggested treatment of transition plans within the 2021 revised recommendations and guidance of the TCFD (even for NZ/TP frameworks that are not purely disclosure focused). Several, but not all, frameworks include a focus on governance, metrics/targets, engagement, and implementation strategies. We note that 'risk management' does not feature as a pillar of any of the reviewed frameworks apart from CDP, which appropriately reflects the important differences between strategic transition planning and climate-related financial risk management activities (as discussed in Section 2, above).

**Science basis**: The frameworks and criteria reviewed generally center around a requirement that net zero targets and transition plans are compatible with 1.5°C-aligned scenarios and sectoral pathways, with low or no overshoot whenever possible. Most frameworks refer to the IPCC pathways (CDP, NZBA, IIGCC/TPI), but often in a non-prescriptive and non-exclusive way. The UK TPT sub-element on sensitivity analysis refers to the TCFD guidance which is to use multiple scenarios for the purpose of sensitivity analysis that are consistent with a 2°C warming or lower scenario. Some of the organizations have released separate guidance on sectoral pathways (GFANZ, SBTi). The ISSB, as a global disclosure standard, does not require a specific science-basis for transition plans but requires the disclosing entity to publish information about the underlying assumptions.

**Expectations for financial institution net zero targets and implementation:** There is a common emphasis on the individual financial institution aligning aspects of their business model with a low carbon economy,[75] with the aim of enabling or otherwise supporting real economy emissions reductions – as opposed to the decarbonization of portfolios, with little real economy impact. Most frameworks or criteria related to financial institutions have a focus on financed GHG emissions (Scope 3) as well as direct emissions. In general, the frameworks acknowledge that financial institutions will be required to use different strategies to meet net zero targets, including decarbonizing their portfolio and supporting the growth of net zero-aligned activities. However, they vary in terms of the specific guidance on different transition strategies and emphasis on the provision of transition finance versus decarbonization and

[75] See discussion of science basis in Section 4.

limiting new business with high-carbon sectors. For example, the GFANZ framework highlights four key net zero financing strategies –climate solutions, aligned, aligning and managed phaseout— but does not prescribe a specific balance of activity or focus between the different strategies, and recognizes that firms' available opportunities and approaches will vary. The UK TPT, although primarily a disclosure framework, suggests that decarbonization priorities should be informed by a materiality assessment and encourages direct abatement approaches rather than the purchase of carbon credits. SBTi is more prescriptive in its expectations that GHG emissions targets should be driven 90% by GHG reduction and only 10% by permanent GHG removal for which carbon credits can be counted, and sets out specific expectations for "disclosure, arrest, transition, and phase out" of fossil fuel activities. The IIGCC/TPI framework also includes time-bound criteria and commitments for the treatment of fossil fuels by banks.

**Accountability:** Given the different objectives of the frameworks shown in Table 1, they also differ in terms of their approach to accountability mechanisms, including independent assessment of some or all of a plan (e.g. SBTi, CDP), direct assessment by investors, or general disclosure-based accountability. For example, SBTi is an organization that independently assesses and approves companies' Net Zero targets based on disclosed information; similarly, CDP scores companies based on disclosed information to provide a snapshot of a company's environmental disclosure and performance to market participants. The NZ/TP frameworks or criteria provided by these organizations can therefore have a high degree of leverage on companies, including financial institutions, because they can influence these specific market-based, third-party assessments of credibility or performance. Similarly, the IIGCC/TPI investor expectations for the banking sector may also be influential for banks if some of their key investors use that framework to assess and benchmark the bank. ISSB IFRS S2, the ESRS and GFANZ framework rely on a traditional disclosure-based model to deliver accountability; the final application of the UK TPT is to be determined, but the UK government appears to be taking a disclosure-based approach there as well.

**Annex Table 1:** Key features of a sample of NZ/TP frameworks applying to financial institutions

| Issuing entity | Publication Name & URL link | Originating Institution Type | Aim/ Focus | Sectoral applicability | Core Pillars | Science basis for scenarios/ pathways | Expectations for targets/ Commitments | Policies or guidance for high-carbon sectors | Transparency & assurance |
|---|---|---|---|---|---|---|---|---|---|
| **CDP** | CDP Technical Note: Reporting on Climate Transition Plans | NGO/non-profit charity | Guidance on how organizations disclosing through CDP can demonstrate that they have a credible climate transition plan in place. | Sector neutral | 4: Governance, Strategy, Risk management, Metrics and Targets *[With 8 sub-elements]* | Alignment with 1.5°C world, as defined by IPCC. | Time-bound, science-based targets in line with the latest climate science are essential, including halving emissions by 2030 and achieving net-zero by 2050. An annual, verified Scope 1, 2 & 3 emissions inventory for transparency and accuracy. A credible climate transition plan should adhere to six guiding principles: accountability with clearly defined roles, internal coherence integrated into the organization's strategy and financial planning, forward-looking considering short- and long-term goals, time-bound and quantifiable key performance indicators (KPIs), flexibility with regular reviews and stakeholder feedback, and completeness covering the entire organization and value chain with minimal exclusions. | A climate transition plan should include actions to decarbonize business processes (and those of its value chain), with time-bound KPIs. This includes three distinct elements: (1) value chain engagement; (2) increasing share of revenue from low-carbon products and services; and (3) implementing emissions reduction initiatives for its direct and indirect operations. No references to the treatment of specific high-carbon sectors. | CDP scores companies based on their disclosures.<br><br>CDP expects that a climate transition plan should be accompanied by an annual Scope 1, 2 and 3 emissions inventory that is complete, accurate, transparent, consistent, relevant, and verified by a third-party. |
| **European Sustainability Reporting Standards (ESRS)** | ESRS E1 Climate change | Government | European sustainability disclosure requirements which include a requirement to disclosure an entity's transition plan for climate change mitigation. | Part of ESRS cross-cutting standards, which apply to entities in all sectors (sector-agnostic). ESRS standards apply, in a phased manner, to a wide range of firms with securities listed on the EU regulated markets. | ESRS S1 contains four pillars, but transition plans only included under Strategy pillar. | Transition plan is meant to be predicated on reaching climate neutrality by 2050. | The objective of the Disclosure Requirement is to enable an understanding of the undertaking's past, current, and future mitigation efforts to ensure that its strategy and business model are compatible with the transition to a sustainable economy, and with the limiting of global warming to 1.5 °C in line with the Paris Agreement and with the objective of achieving climate neutrality by 2050 and, where relevant, the undertaking's exposure to coal, oil and gas-related activities.<br>Information should include (among other things): GHG emissions reduction targets, climate change mitigation actions, decarbonization levers, mitigation actions, assessment of potential locked-in GHG emissions, an update on the entity's progress in implementing the transition plan. In case the undertaking does not have a transition plan in place, it shall indicate whether and, if so, when it will adopt a transition plan. | ESRS S1 is a pure disclosure standard; does not entail expectations on the content of targets or commitments. However, requires disclosure of a qualitative assessment of the potential locked-in GHG emissions from the undertaking's key assets and products. This shall include an explanation of if and how these emissions may jeopardize the achievement of the undertaking's GHG emission reduction targets and drive transition risk, and if applicable, an explanation of the undertaking's plans to manage its GHG-intensive and energy-intensive assets and products. | An entity can disclose if relies on any European data standards and the extent to which data and processes that are used for sustainability reporting purposes have been verified by an external assurance provider and found to conform to the corresponding standards. |

| Issuing entity | Publication Name & URL link | Originating Institution Type | Aim/ Focus | Sectoral applicability | Core Pillars | Science basis for scenarios/ pathways | Expectations for targets/ Commitments | Policies or guidance for high-carbon sectors | Transparency & assurance |
|---|---|---|---|---|---|---|---|---|---|
| **Glasgow Financial Alliance for Net Zero (GFANZ)** | Financial Institution Net-zero Transition Plans Fundamentals, Recommendations, and Guidance (November 2022)<br><br>*At the time of publishing this report, GFANZ is consulting on refine this guidance.* | Industry alliance of financial institutions | Framework for transition planning. | Financial-sector specific (bank, asset manager, insurer). Additional guidance for banks/asset managers/insurers through member alliances. **Separate guidance for corporate transition plans.* | 5: Foundations, Implementation Strategy, Engagement Strategy, Metrics and Targets, Governance. | Calls for credible science based, 1.5°C-aligned scenarios and sectoral pathways; low or no overshoot scenarios whenever possible. GFANZ released guidance on sectoral pathways.[76] | Specific expectations across all five pillars. Financial institutions expected to set clear objectives, create coherent strategies, and establish near-term interim targets for emissions reduction. Identify the priority financing strategies of net-zero transition action to enable real economy emissions reduction. Regularly review and update transition plans. | Framework suggests four key strategies: supporting climate solutions, financing aligned entities, enabling entities committed to transitioning and facilitating managed phaseout of high-emitting assets. Framework calls for establishment of policies and conditions on priority sectors, such as thermal coal, oil and gas, and deforestation. Include other sectors and activities that are high-emitting, or otherwise harmful to the climate, to define business boundaries in line with the institution's net-zero objectives and priorities. | Assurance not required, but financial institutions should consider seeking external validation for their GHG emissions targets from third parties. Encourages transparent disclosure of transition plans. |
| **Institutional Investors Group on Climate Change (IIGCC)/ Transition Pathway Initiative (TPI) Investor expectations for the banking sector** | Net Zero Banking Assessment Framework | Industry alliance (investors) and non-profit collaboration | Standard for investor expectations and framework of indicators / benchmarking tool for investors to evaluate banks' overall performance in managing the low-carbon transition and mitigating the impacts of climate change. | Banking sector | 10: Net zero commitments; Targets; Exposure and emissions disclosure; Historical emissions performance; Decarboniza-tion strategy; Climate solutions; Climate policy engagement; Climate governance; Just Transition; Annual reporting, accounting and audits. | 1.5°C pathway, as defined by IPCC.<br><br>Financial statements should include sensitivity analysis against different climate scenarios (1.5°C and higher warming scenarios). | Banks must commit to achieving net-zero financed and facilitated emissions by 2050, aligning with a 1.5°C scenario. They should set short-term, medium-term, and long-term emissions reduction targets consistent with a 1.5°C pathway, while comprehensively disclosing their target-setting methodology. Banks should also disclose their exposure to high-emission sectors and emissions from all material activities. Additionally, they need to disclose strategies for decarbonization, scaling up finance for climate solutions, and engaging in 1.5°C-aligned climate lobbying positions. Climate governance, scenario analysis, Just Transition integration, and adherence to reporting and auditing recommendations are essential aspects of ensuring effective climate action. | Outlines a series of criteria and commitments related to the treatment of fossil fuels by financial institutions. Banks encouraged to consider policies of how they will avoid financing or facilitation of new coal-fired power stations and new coal mines, and phase out financing of the use of unabated thermal coal by 2030 in advanced economies and 2040 globally; phasing out various oil and gas projects to be consistent with the electricity sector reaching net zero emissions by 2035 in advanced economies and 2040 globally; and Commodity-driven deforestation or other natural ecosystem conversion as soon as possible, and no later than 2025. It also encourages that all resource-related activities should have appropriate protections for socially or environmentally sensitive areas. | IIGCC/TPI has used the framework to assess a global sample of large banks on an ad hoc basis.<br>Compliance with TCFD disclosure recommendations encouraged.<br>External auditors should test management assumptions and judgements for consistency with climate-related disclosures, material climate-related impacts and the credibility of the 1.5°C sensitivity provided in the Notes to the published accounts. |

[76] Glasgow Financial Alliance for Net Zero. *Guidance on Use of Sectoral Pathways for Financial Institutions.*

| Issuing entity | Publication Name & URL link | Originating Institution Type | Aim/ Focus | Sectoral applicability | Core Pillars | Science basis for scenarios/ pathways | Expectations for targets/ Commitments | Policies or guidance for high-carbon sectors | Transparency & assurance |
|---|---|---|---|---|---|---|---|---|---|
| **International Sustainability Standards Board (ISSB)** | IFRS S2 Standard for Climate-related Disclosures | Global sustainability accounting standards setter | Global standard for an entity to disclose information about its climate-related risks and opportunities that is useful to users of general purpose financial reports in making decisions relating to providing resources to the entity. Transition plans included among other topics for disclosure. | Sector neutral baseline, with sector-specific additional guidance | IFRS S2 contains four pillars, but transition plans only included under Strategy pillar. | Not specified, but an entity must disclose information about any key assumptions used in developing the transition plan. | IFRS S2 is a pure disclosure standard; does not entail expectations on the content of targets or commitments.<br>With respect to disclosure, the entity should include information about how the entity has responded to, and plans to respond to, climate-related risks and opportunities in its strategy and decision-making, including how the entity plans to achieve any climate-related targets it has set and any targets it is required to meet by law or regulation. Information about how the entity is resourcing, and plans to resource, these activities. It should also disclose quantitative and qualitative information about the progress of plans disclosed in previous reporting periods. | Not applicable. IFRS S2 is a pure disclosure standard; does not entail expectations on the content of targets or commitments. | Third-party assurance is encouraged but not required by the ISSB global standards. |
| **Science-Based Targets Initiative (SBTi)** | Financial Institutions' Net Zero Standard (Draft) | Collaboration of environmental NGOs | "Financial Institutions Net Zero (FINZ) Standard": Criteria and guidance for financial institutions to establish targets consistent with net-zero emissions by 2050. | Financial-sector specific | 4: Criteria, Guidance, Tools, Metrics and Methods | 1.5°C pathways, with no or low overshoot. SBTi has published separate information on their approach to determining 1.5ºC-aligned pathways for target-setting.[77] | Net-zero targets should address and incentivize the following three outcomes via criteria and metrics: stop financial flows that support the development of new high-emitting assets; focus efforts on decarbonization of existing portfolio holdings through transition financing; and support the growth of net-zero aligned activities. SBTi expects consistency between near-term (2030 and every 5 years) and long-term (2050) targets. Financial institutions are expected to align a growing share of their climate relevant asset classes over time. | Fossil Fuel Finance criteria addressing the “disclosure, arrest, transition, and phase out" of fossil fuel-related financial flows: the framework requires financial institutions to disclose annual information on fossil fuel activities, including absolute emissions, financial exposures, and forward-looking transition plans. It calls for an immediate cessation of new financial flows to the coal value chain, except for decommissioning, and unabated oil and gas activities. Financial institutions must establish targets at the company and portfolio levels, engaging fossil fuel companies to transition along 1.5°C pathways with clear commitments for no new expansion and the phasing down/out of production. Additionally, a transition to reduce methane emissions from all fossil fuels by at least 75% by 2030 is required as a milestone for near-term targets. The framework also mandates a commitment to phase out financial activities linked to unaligned companies and projects within specified timeframes. Overall, the goal is to increase | SBTi independently assesses and approves companies' targets. Detailed disclosure of targets according to SBTi criteria is expected for transparency. |

[77] Science Based Targets Initiative. (2021, October). *Pathways To Net-Zero SBTi Technical Summary*.

| Issuing entity | Publication Name & URL link | Originating Institution Type | Aim/ Focus | Sectoral applicability | Core Pillars | Science basis for scenarios/ pathways | Expectations for targets/ Commitments | Policies or guidance for high-carbon sectors | Transparency & assurance |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | transparency, reduce support for fossil fuels, and align investments with a 1.5°C pathway to combat climate change effectively. | |
| **UK Transition Plan Taskforce (TPT)** | UK TPT Disclosure Framework (draft), TPT Implementation Guidance, Technical Annex | Official-sector entity | Framework for transition plan disclosure. | Sector neutral (sector-specific guidance to follow) | 5: Foundation, Implementation Strategy, Engagement Strategy, Metrics and Targets, Governance *[same as GFANZ]* | Sensitivity analysis expectations refer to TCFD guidance to use multiple scenarios consistent with a 2°C or lower scenario. | A transition plan should outline ambitious objectives and priorities for contributing to and preparing for a rapid and orderly economy wide net zero transition. The plan should cover the whole entity, consider the full range of levers that the entity has available, and emphasize actions that can be expected to make significant contributions to an economywide transition. Entities should take a strategic and rounded approach to design, development and disclosure of transition plans including: decarbonization, responding to climate-related risks and opportunities, contributing to economy-wide transition. The actionable steps set out in the transition plan should be underpinned by quantified and timebound metrics and targets that are reported against on an annual basis, within general purpose financial reporting. Companies are referred to the SBTi guidance on setting Net Zero targets and says that companies may choose to have their targets independently verified by SBTi. | Recognizes that decarbonization prioritization will vary across firms, geographies, business models. Suggests that decarbonization prioritization is informed by materiality of emissions profile and 'strategic levers assessment' and should focus on most material sectors first. Any emissions reduction target should consider Scope 1, 2, and 3 emissions and should prioritize decarbonization through direct abatement over purchasing carbon credits. | Assurance not required, but requires disclosure of information if parts of transition plan are subject to external assurance. |