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Introduction

This paper explores an emerging policy proposal to deal with stranded assets in the context of the low-carbon transition: the **idea of a "climate bad bank"** (CBB).

Like historical bad banks, such an institution **would house the assets most exposed to transition risks to their avoid systemic development, and allow financial institutions to focus on funding low-carbon projects**. Yet, this idea is still incipient and is yet to be examined in detail.

In particular, **we explore how far the comparison with past bad banks can go, and what could be the challenges** that a climate bad bank could face. We follow by proposing an exploratory climate bad bank blueprint best able to handle the challenges we identify. By doing so, we contribute to the literature on finance-oriented policies for the low-carbon transition.

Data and methods

We first perform a **literature review on 50 historical bad bank case studies**.

This allows us to derive a typology of the main bad bank features that we cross with an identification of the **challenges faced by bad banks in terms of:**

- **Efficiency:** how to avoid moral hazard (i.e. banks buying future stranded assets knowing that they will be saved) and minimise costs?
- **Justice:** whose assets should be bought and who should pay for it?
- **Governance:** who should run the CBB and with what controls?

Finally, after a **review of existing bad bank proposals**, we apply this typology to **derive a climate bad bank blueprint best able to deal with the challenges** the institution would face, both as a sub-type of bad bank, and as a policy instrument for the low-carbon transition.

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Results

Timing: *Ex ante*

Given the uncertainties surrounding transition risks and the dire need for climate action, the CBB buying the stranded assets before transition risks unravel, with a well-defined schedule, could represent a precautionary approach.

Ownership: *Public-private*

The public participation can allow a public monitoring of the stranded assets being rescued (given the equity issues at stake), while private participation reduces the cost to public finance and induces greater compliance.

Incentives: *haircut and credible stranding*

Assets should be purchased with a discount, potentially increasing with time, to tame moral hazard. To be consistent and justified, haircut schedules should be accompanied by a credible, inflexible commitment to climate policy. Otherwise the scheme could be made mandatory.

Climate bad bank

Funding: *Imbricated system*

Private funding should be sought first, and public government debt used as a second option, when when all affordable private funding opportunities are exhausted .
Central bank monetisation could be used as a last resort when States themselves are constrained.

Strategy: *Extinctive management*

The CBB would aim to organize the extinction of carbon-intensive assets instead of trying to re-sell them for profit. This could entail finding renegotiating creance terms with debtors, like reducing interest rates while, in the meantime, shortening maturities

Width: *Coordinated network*

Given the broad scope of transition-risk exposed assets and transition exposures being quite concentrated in large, systemic Financial institutions, the CBB could be a network of small entities aimed in priority at most exposed agents, coordinated with an umbrella organisation.

Conclusions

A climate bad bank, if rightly targeted and tuned adequately, could represent a helpful tool for the low-carbon transition. By defusing transition risks *ex ante*, it would give free rein for the implementation of bold policies. It would also help the financial sector reorganise in an orderly way around the transition, by avoiding that financial agents transfer their exposures to weaker or less regulated institutions. By cleansing balance sheets in exchange of liquidity, it could finally favour the funding of green activities on certain conditions.

Of course, our proposal remains highly abstract and begs application to a concrete case. A real-world study on a particular geographical zone, like Europe, could be performed by considering how our broad blueprint would apply. In particular, challenges in terms of governance, accountability and justice of such an institution should be given close scrutiny.

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