

Scenario choice matters in prudential transition plans

By Gerdie Knijp and Gaston Bronstering / 14 August 2024



Many roads lead to Rome but beware to take the right pathway to Paris

While many banks now publish transition plans, large differences exist in terms of scope, target-setting methods and the measurement of misalignment with climate goals. This creates a need for standardisation and clarification on what a good transition plan entails.

Transition plans outline how financial institutions plan to align their portfolios with net-zero commitments. With the revised Capital Requirement Directive (CRD IV), [transition plans became part of the European prudential framework for banks](#). After public consultations closed in April 2024, the European Banking Authority is [currently working on guidelines](#) covering prudential transition plans and the supervisory process.

Financial institutions' degree of alignment with net-zero pathways allows financial supervisors to identify transition risks. As recently evidenced by the European Central Bank, [these risks can](#)

significantly impact financial institutions' credit portfolios. If designed in a standardised way, supervisors could compare banks' prudential transition plans and evaluate the degree of alignment for the whole financial system. These forward-looking risk estimations could be used for micro- and macroprudential policy.

While the debate on the shape and purpose of prudential transition plans has many open questions, transition scenarios have been identified as particularly relevant, marking the beginning of a longer-term project on prudential transition plans at the Sustainable Finance Lab. Transition scenarios represent the starting point for transition planning and can be understood as combinations of required transformations against which banks' transition is compared.

Relative convergence around the IEA Net Zero Emission by 2050 scenario

Comparing large European banks' most recent transition plans, we observe most banks use the Net Zero Emission by 2050 scenario from the International Energy Organisation. Other scenarios, such as the Pegasus Guidelines, the Dutch Climate Agreement and the Poseidon Principles, were used for aviation, agriculture and shipping.

However, banks implemented this scenario quite differently. Most notably, banks used baseline years from 2015 to 2023, and only a few included targets beyond 2030. Furthermore, banks use different emission scopes, emission types, metrics and portfolio measurement methods.

While these differences represent a noticeable obstacle to comparing transition plans, the most crucial point is that banks' choice and application of scenarios are often neither transparent nor understandable. Also, according to a recent Organisation for Economic Co-operation and Development study, it is unclear whether the scenarios used are consistent with the objectives of the Paris Agreement.

Uncertainty in measuring misalignment

As financial metrics and analyses are highly sensitive to scenario characteristics, the choice of scenario is very consequential. According to a recent OECD study, scenarios mainly differ regarding sector and geographical granularity and underlying assumptions.

Insufficient sector granularity can be problematic if the pathways provided are too aggregated to effectively inform the alignment assessment. Within the manufacturing sector, for instance, there are more polluting subsectors, such as cement and steel, and less polluting subsectors, such as textiles. Beyond impairing banks' ability to support their clients' specific transition, using scenarios with insufficient sectoral granularity risks misestimating misalignment as different pathways are averaged out.

The lack of geographical granularity is concerning since assessing banks' transitions using geographically inadequate scenarios poses the risk of misestimating the degree of alignment. The IEA NZW 2050, for instance, covers only 29 regions, of which 16 countries. As argued by a

[recent paper by De Nederlandsche Bank](#), the global scope of the IEA NZE 2050 scenarios occults that developed economies should phase out fossil fuels much faster than less developed countries. Hence, lacking geographical granularity also challenges equity.

Finally, scenarios are based on socioeconomic, technological and political assumptions. The IEA NZW 2050 scenario assumes an annual growth rate of 3% between 2022 and 2050 and that 35% of required carbon dioxide reductions will come from technologies at the demonstration or prototype stage.

Despite the risk of misestimating the degree of alignment, the uncertainty associated with these assumptions and sectoral and geographical granularity is currently not reflected in banks' choice and use of different scenarios.

Considerations for banks and supervisors

Banks must, therefore, address the uncertainty behind these scenarios and justify their scenario choice accordingly. This requires understanding the scenarios' assumptions and limitations and the real economy transition. Both matters are evolving rapidly and banks must monitor changes continuously.

Furthermore, banks should use sensitivity analysis to compare different scenarios and identify differences in misalignment. They could also rely on more than one scenario to minimise uncertainty. Being aligned with one scenario does not mean much if other scenarios lead to high misalignment numbers.

Supervisors should acknowledge the uncertainty associated with scenario differences and provide corresponding guidance. Like banks, supervisors should also build up expertise on different scenarios and their underlying assumptions. This requires sector- and activity-specific knowledge and includes collaboration with governments.

The Sustainable Finance Lab will contribute to this debate by developing guidance on scenarios and target setting and outlining potential perspectives for integrating prudential transition plans into the European Union's micro- and macroprudential framework.

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