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Making finance serve society

Assessing transition risk in prudential transition plans

Principles to identify and manage deviation from Paris-aligned pathways

A Finance Watch Position Paper

June 2025

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Introduction

On 9 January 2025, the European Banking Authority (EBA) published guidelines on the management of environmental, social and governance (ESG) risks, including the development of CRD-based plans[1] – often referred to as prudential transition plans. The draft guidelines had already highlighted how the transition plan requirement under the Capital Requirement Directive (CRD) complements transition plan requirements under the Corporate Sustainability Due Diligence Directive (CSDDD) and the Corporate Sustainability Reporting Directive (CSRD): CRD-based plans do not require credit institutions to set specific objectives aligning with global climate goals, but instead constitute a risk management tool to assess the risks stemming from their activities and exposures.

In its final guidelines, the EBA further elaborated on the connection between the different transition plan references, noting that, "*institutions [...] need to understand the potential implications for their business models of the transition process and of the broader EU legislative framework and develop a strategic response to manage the risks associated with these developments as part of a unified internal transition planning exercise*". This principle echoes Finance Watch's recommendations to recognize that, even if a bank is not subject to the CSDDD, it should understand what it would entail for its business model to be compatible with the objectives of the Paris Agreement, as well as assess its potential deviation and the risks stemming from such a deviation.[2]

Yet, the EBA guidelines are principle-based and there is no commonly accepted methodology to recognise transition risk. Uncertainties therefore remain on how they will be applied by credit institutions and enforced by the national supervisory authorities. Assessing a transition plan's deviation from global and jurisdictional climate objectives and estimating the underlying risks is a complex and evolving exercise implying uncertainties, business particularities and a combination of counterparty and portfolio-level considerations. While this paper focuses on assessing the risk at counterparty level, the principles below also apply to risk management at portfolio level. Considering the current legislative framework, this position paper provides principles to support the development and supervision of CRD-based transition plans on the part of transition risk analysis. Finally, it aims at informing discussions on how the risks of exposures linked to unsustainable activities should be reflected in the prudential framework.

Key Takeaways

1. The European Commission should continue to clarify sectoral transition pathways, foster access to underlying data and guide companies on their use.
2. Supervisory authorities should enforce the EBA guidelines on the management of ESG risks by using complementary transition plan methodologies, accounting for the risk arising from deviation from a Paris-compatible trajectory – including delayed transition – and assessing ESG risks with adequate granularity.

[1] European Banking Authority, *Guidelines on the management of environmental, social and governance risks*, January 2025.
[2] Finance Watch, *Bringing legal certainty and comparability in an evolving prudential framework*, October 2024.

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I. Principle 1: assessing transition risk is a multi-dimensional exercise

In January 2024, the European Central Bank (ECB) published a report assessing the alignment of the European banking sector with EU climate objectives. In its report, the ECB noted that "*there are many possible pathways that can be chosen for assessing alignment. The choice of pathway has important consequences, as decarbonisation pathway scenarios can differ significantly*".[3] For its assessment, the ECB decided to use the Paris Agreement Capital Transition Assessment (PACTA) methodology.[4] This methodology compares the changes necessary in key sectors to minimize global temperature rises with the business model of financial institutions' counterparties.

The PACTA approach has several advantages:

1. The adoption of a perspective based on technological changes: PACTA translates global objectives into concrete targets built on the necessary technological changes to determine whether a transition plan is credible.
2. The distinction between transitioning activities and decreasing emissions: PACTA goes beyond greenhouse gas (GHG) emissions by providing early identification of transition investments, a leading indicator before an actual emission reduction.
3. The comparability of companies at sectoral level: PACTA allows investors to compare and aggregate their exposures in the same sector.

However, PACTA also has limitations:

1. The limited time horizon: The PACTA methodology considers a 5-year time horizon only, even if it relies on targets that are consistent with a longer term trajectory, As a result, long-term financing could deviate from the expected trajectory without being captured under this approach.
2. The staticity of the balance sheet: The assessment of the deviation considers the exposure of a financial institution at a certain point in time, but does not consider the changes in the balance sheet according to the banks' own transition planning.
3. The focus on the loan books: PACTA has been developed for loan exposures and does not allow a direct application of the methodology for other exposures.
4. The sectoral coverage: PACTA only considers 6 sectors with the assumption that the transition is driven by a technological shift (e.g. to renewable energies). While extending the methodology to other sectors could be considered, the approach may be less effective in sectors where the transition has a more complex nature.
5. The methodology ignores the actual GHG emissions reduction while a technological switch may imply different GHG emissions levels between companies.

These observations are not intended to question the relevance of the ECB assessment, but to underline that transition risk has several dimensions. A multi-faceted approach should therefore be adopted, considering the nature of the activities of a credit institution, its types of exposure and its long-term strategy.

[3] European Central Bank, *Risks from misalignment of banks' financing with the EU climate objectives: Assessment of the alignment of the European banking sector*, January 2024.
[4] *PACTA*.

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Finance Watch **recommends** that supervisory authorities encourage the use of a combination of complementary methodologies. These should assess actual GHG emissions, resource allocation and the evolution of business models – capitalising on the advantages of each approach, such as longer time horizons and wider sector and portfolio coverage, to develop transition risk proxies for institutions' portfolios.

II. Principle 2: the deviation from a Paris-compatible trajectory should be assessed based on a credible benchmark

Besides the selection of the deviation assessment approach(es), the selection of credible reference targets will be of fundamental importance to properly assess the level of deviation from a Paris-compatible trajectory. To reduce legal uncertainty and facilitate the application of the EBA guidelines, it will be important for supervisory authorities and the European Commission to foster consistency between the benchmark targets that credit institutions rely on and the transition plan guidance expected in accordance with Article 19 of the CSDDD. Particular attention should be given to the following points:

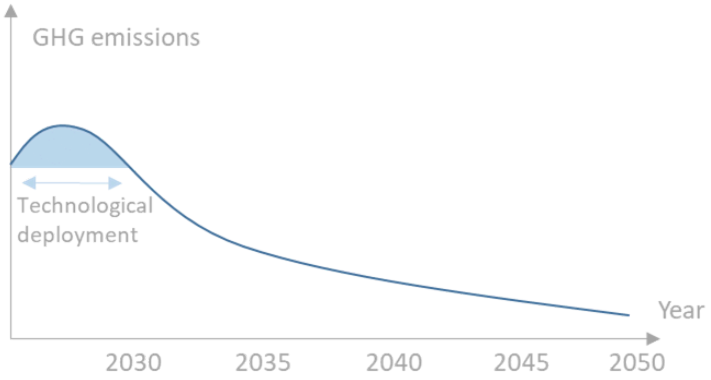
Developing clear sectoral pathways to assess the deviation. The use of widely recognised decarbonisation trajectories is a prerequisite to the design of credible transition plans. As mentioned by the Glasgow Financial Alliance for Net Zero (GFANZ), "*sectoral pathways provide the link between the science of the remaining carbon budget and the detailed steps that a specific sector could take to reduce GHG emissions to a particular level in a specified timeframe*".[5] Defining such pathways remains a complex exercise, given that geographical, technological and sectoral specificities influence the short, medium and long term GHG emission targets that should be defined. Yet, the limited availability of pathways data, the lack of granularity and the multiplicity of data sources remain important impediments to scale up and harmonize the development of consistent targets.

Banks need clear benchmarks to assess whether their own targets and planning, as well as those of their counterparties, are aligned/compatible with global and jurisdictional climate objectives. In addition, financial regulators and supervisors will also face huge uncertainty in defining a baseline for financial risk assessment, in particular taking into account the intertemporal dependency in the risk development, as delaying transition increases the risk of sudden repricing or even renders some transformations impossible. This uncertainty will impede the comparability and credibility of institutions' risk assessments (as the number of possible states of the world increases and there is no agreement on their probabilities) and, correspondingly, effective risk mitigation.

Finance Watch **recommends** that the European Commission (1) provide more clarity on sectoral transition pathways for all sectors (2) provide regional/country breakdowns, (3) endorse recognised pathways and (4) foster open access to the underlying data.

[5] GFANZ, *Guidance on use of sectoral pathways for financial institutions*, June 2022.

Allocating the source of GHG emissions. GHG emissions alone do not provide all the necessary information to assess whether a company is on track with a trajectory compatible with the objectives of the Paris Agreement. A company could for example report an increase of its GHG emissions to accelerate the deployment of lower emission technologies, which could result in an increase of GHG emissions in the short tem.



An increase of GHG emissions should therefore not necessarily be interpreted as an increase of the risk. While such scenarios could be reflected in the transition pathways, they may also be specific to a single entity. Thus it is important to understand where the GHG emissions are coming from. In theory, an allocation of GHG emissions to capital and operational expenditures would provide the necessary details to understand the evolution in GHG emissions, but it would imply operational challenges. Alternatively, the PACTA methodology can bring – despite its limitations previously stated – additional information on the investments made by companies to support the transition.

III. Principle 3: the risk of a delayed transition must be accounted for

Counterparties may decide not to follow a pace based on recognised transition pathways to the same 2050 target (or not to comply with the target altogether), which can result in an additional transition risk layer.

Considering the total GHG emissions over time. Decarbonisation pathways should provide credible sector targets to reach carbon neutrality, taking into account the emission budget of the sector until 2050. A deviation from these pathways could therefore lead to higher total emissions and increase transition risk in different ways:

- The development of transition pathways is a dynamic exercise and an increase of the total GHG emissions at sectoral level compared to the initial pathway may lead to the redefinition of stricter targets for individual companies, increasing the transition risk at the macro economic level.
- A higher individual carbon budget furthers uncertainty around a company's ability to meet its 2050 targets and increases the extent and risk of deviating from a CSDDD trajectory.

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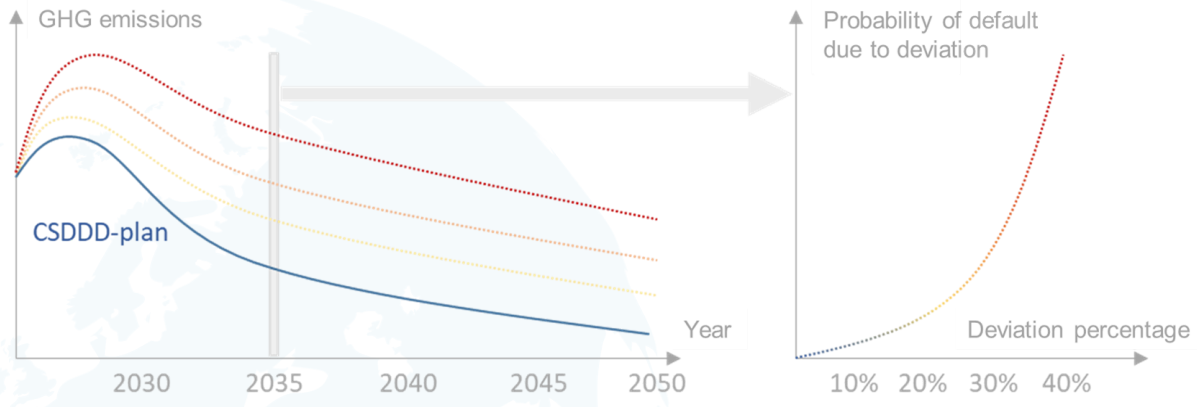
Finance Watch **recommends** that supervisory authorities ensure credit institutions take into account the total GHG emissions budget of their counterparties to determine their transition risk exposure. This exercise could be done by modeling the slope of the GHG emissions reduction trajectory in the risk assessment.[6]

Capturing the uncertainty of the planning. The level of intermediate targets is also a transition risk factor to be taken into account. Transition risk increases when a company decides to delay its planning to reduce GHG emissions, even if its plan meets the 2050 targets and the GHG emission budget foreseen under a CSDDD trajectory. In the case of a delayed transition, any deviation from the initial plan would be harder to resolve if only little time is left to reach the ambitions of carbon neutrality.

Finance Watch **recommends** that supervisory authorities ensure credit institutions take into account the uncertainty – and underlying risk – stemming from a delayed transition, with risk increasing as delays approach the 2050 target.

IV. Principle 4: a growing deviation from the Paris-compatible trajectory increases the transition risk more than proportionally

Once the deviation level of a portfolio, a counterparty or an exposure has been assessed, estimating the transition risk stemming from such a deviation remains a critical step. While a deviation from a CSDDD trajectory has been largely recognised as a risk factor, little has been said about its quantification. Conceptually, it is important to account for the non-linearity of the risk-deviation relationship introducing a potential cliff effect on carbon intensive companies: when a company sees its deviation level increase, its risk level increases more than proportionally until the asset becomes stranded.[7] Moreover, counterparties' growing deviation from a CSDDD trajectory increases the risk of a deviation at economy level, ultimately accentuating the systemic risk of disorderly transition.



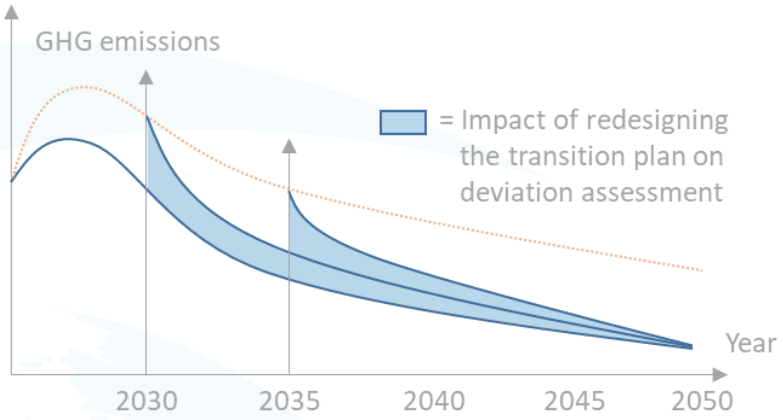
[6] This recommendation implies that transition risks are likely to materialise in more than 10 years and that credit institutions should adopt a risk management time horizon to 2050.
[7] I4CE, *From Stranded Assets to Assets-at-Risk: Reframing the narrative for European private financial institutions*, June 2024.

Finance Watch **recommends** that supervisory authorities ensure credit institutions integrate the non-linear relationship between risk level and deviation level into their risk appetite and risk assessment framework, and identify thresholds where exposures should be considered stranded.

V. Principle 5: the deviation risk must be iteratively reassessed

Companies implementing a transition plan are expected to monitor progress against their stated targets and revise these targets when necessary. Each time such a revision takes place, the updated plan can be compared to a revised CSDDD trajectory. As a result, the assessment of deviation risk is recalculated in reference to this new CSDDD-aligned trajectory. In practice, this means that if a company redefines its targets on a recurring basis – such as every five years – it effectively resets the baseline for measuring progress, treating the updated trajectory as if no previous deviation had occurred.

This process has significant implications for the evaluation of transition risks, in particular in cases where a counterparty consistently misses its targets. As long as targets are continually realigned with updated CSDDD-based pathways, transition risk methodology must therefore be reassessed at each iteration. This cyclical approach to target-setting and risk evaluation continues until a point is reached where compliance with a CSDDD pathway is deemed no longer feasible.



Finance Watch **recommends** that supervisory authorities ensure credit institutions integrate the feasibility of CSDDD-based transition pathways when iteratively reassessing their transition risk exposure.

VI. Principle 6: the granularity to assess deviation risk must be adequate

A key difference between CSDDD transition plans and CRD-based plans lies in the level of granularity required by the exercise. CSDDD-based plans focus on assessing the overall compatibility of a company's business model with global climate objectives. By contrast, the higher transition risk of a lagging counterparty cannot be compensated by exposures to counterparties that are more advanced in their transition. Prudential transition planning should extend the analysis to identify ESG risks stemming from misalignment, both at the individual counterparty level and in aggregated portfolio terms. Nonetheless, there are instances where a more granular assessment of alignment can also understate actual transition risks. For example, credit institutions may hold assets – such as green bonds or renewable energy project financing – that are directly linked to the transition. While these instruments help the credit institution to be compatible with the objectives of the Paris Agreement, they do not necessarily mitigate the broader transition risk of the counterparty if the counterparty remains largely misaligned with global and jurisdictional climate objectives. Allocating capital to labelled instruments or projects does not eliminate the underlying transition risk associated with the counterparty's overall business model.

Finance Watch **recommends** that supervisory authorities ensure credit institutions assess transition risk of their exposures at an appropriately granular level.

Author

Vincent Vandeloise, Senior Research & Advocacy Officer at Finance Watch

Contact

vincent.vandeloise@finance-watch.org
+32 2 880 04 37

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