Transition Finance:

New Opportunities and Challenges for Financial Institutions

Content

In Brief:

Energy transition is the most significant transformative change that the world is undergoing right now, leaving no sector untouched. A huge amount of capital is required to get economies on track for net-zero emissions by 2050. The amount of clean energy transition-related investment required before 2030 is estimated to be in the trillions of US dollars. The finance market is responding to this transformational change with new and innovative types of finance and funding structures.

Green and sustainability-linked bonds and loans have been the pioneer products in this space. Following their evolution in recent years, they are now well-established financing products commonly used to finance the energy transition. For example, "use of proceeds" green loans can be used to finance projects such as those relating to renewable energy and recycling; and sustainability-linked loans seek to encourage borrowers to strive for, amongst other ESG-related objectives, targets that are consistent with moving the economy ever closer to net-zero emissions by 2050.

However, a new concept of "transition finance" is emerging as the requirements for green and sustainability-linked financing products are often not met in the context of high emitting sectors looking to reduce emissions. According to OECD **guidance**, transition finance "is the dynamic process of becoming sustainable or reaching net-zero" by financing the higher emitting and harder-to-abate sectors of the economy as they transition. Nonetheless, the underlying nature of transition finance inevitably brings with it greater legal, regulatory and reputational risks. Top of the list is the taint of greenwashing, meaning that transition finance is still in its infancy as financial institutions work their way through the associated issues with caution and scrutiny. The essential foundation to transition finance is the development and agreement between the parties of a detailed, credible and testable long-view transition plan to engender confidence that the activities being financed are meaningfully contributing to the net-zero target.

In Detail:

Setting the scene

The concept of transition finance finds its origins in Article 2.1c of the Paris Agreement, which calls for "making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development." According to OECD estimates (and in line with the Sharm El-Sheikh Implementation Plan agreed at COP 27 in November 2022), the investment required to deliver on the Paris Agreement is approximately USD 5-7 trillion per year across the highest carbon-emitting sectors. As recognized in that agreement and more recently at COP 27, financial institutions are critical players in the transition to a carbon-neutral economy because of their role in allocating capital. This transition will require a transformation in the structures and processes of the financial system and its actors. In this regard, the financial sector has in recent years encountered, and continues to face, increasing commercial, stakeholder and competitive pressure to promote green and sustainability-linked finance, (i.e., lending that supports the greenest, cleanest and most ethical projects and businesses). Market and underwriter expectations and commitments around these considerations are changing the way global businesses operate and are at the very heart of decision making.

If net-zero goals are to be achieved, significant and rapid progress is required with respect to carbon intensive industries, for example, aviation, steel and cement among others. The position is more problematic still for the oil, gas and coal sectors. The Imperial College Business School argues in a 2020 **report** that the market for green and sustainability-linked finance is simply creating a "market for virtue without driving systemic changes in business operations." Instead, financial institutions, as capital providers, must look to the gray areas associated with transition finance, which comprises trillions of dollars in mainstream financial markets. At the same time, the financing of high-emission industries is coming under closer scrutiny with dis-investment policies by major institutional investors and campaigns by non-governmental organizations over fossil fuels. Against this, the Glasgow Financial Alliance for Net Zero (GFANZ), in a November 2022 **report** on financial institution net-zero transition plans, argues that financing or enabling "accelerated managed phaseout" of high-emitting physical assets, is preferable to divesting, e.g., leaving behind stranded assets.

The London Market Association's (LMA) **glossary** flags up that "Transitioning to a lower-carbon economy may entail extensive policy, legal, technology and market changes to address mitigation and adaptation requirements related to climate change. Depending on the nature, speed and focus of these changes, transition risks may pose varying levels of financial and reputational risk to organisations." Navigating the transition is, therefore, a complex proposition.

What is transition finance?

At a high-level, transition finance as a concept is clear. There is, however, no one common definition. Currently only a limited number of finance institutions have developed financing products let alone settled on a definition. As mentioned above, the OECD's **guidance** says it "is the dynamic process of becoming sustainable or reaching net-zero" by financing the higher emitting and harder-to-abate sectors of the economy as they transition. The Imperial College Business School considers it "is capital provided to economic agents to achieve a minimum rate of carbon emissions reduction," while according to the International Capital Market Association (ICMA), it "is the extent to which an issuer's financing program supports the implementation of its climate change strategy." GFANZ, in turn, in its November 2022 report suggests a wider concept that comprises several financing strategies:

- Enabling entities and activities to develop and scale climate solutions (e.g., the expansion of low-emission technologies and services)
- Supporting those entities that are already aligned to the net-zero target (e.g., businesses with a Science Based Targets initiative (SBTi) validated target substantiated by progress reports)
- Supporting entities committed to transitioning to net zero that have robust transition plans (e.g., a manufacturer implementing energy efficiency to reduce Scope 1 and 2 emissions or a retailer looking to reduce Scope 3 emissions in its supply chain)
- Enabling the accelerated managed phaseout, such as through early retirement, of high-emitting physical assets (e.g., the early decommissioning of a fossil fuel power plant)

Although the EU Taxonomy — an EU-wide classification system that provides businesses and investors with a common language to identify to what degree economic activities can be considered environmentally sustainable — does not specifically define transition finance, it refers to transitional activities as those for which there is no technologically and economically feasible low-carbon alternative and that "support the transition to a climate-neutral economy consistent with a pathway to limit the temperature increase to 1.5°C above pre-industrial levels, including by phasing out greenhouse gas emissions, in particular emissions from solid fossil fuels." Moreover, the EU Taxonomy sets out three conditions for an activity to qualify as a transitional activity:

- It has greenhouse gas emission levels that correspond to the best performance in the sector or industry.
- It does not hamper the development and deployment of low-carbon alternatives.
- It does not lead to a lock-in of carbon-intensive assets, considering the economic life of those assets.

There has been criticism of the EU Taxonomy, which is a key reference point for frameworks that determine whether a company's economic activity is sustainable. In summary, it is often said to be too binary. While this is to some extent true, its binary character is clearly mitigated by some of its transition-focused features. Most notably, capital expenditure invested into unsustainable activities can still be taxonomy-aligned as long as it is part of a "transition" plan to expand a company's taxonomy-aligned activities or to allow its unsustainable activities to become taxonomy-aligned – even if the underlying economic activity remains unsustainable for a number of years and/or is only considered to be eligible as a "transactional activity" – provided the plan meets certain conditions and this information is properly disclosed. Other taxonomies also potentially offer flexibility, such as Singapore's (which is currently being developed), which uses a "traffic light" system of classification, thereby facilitating the inclusion of transitioning activities.

In the absence of a single definition, a variety of approaches and frameworks have been put forward. Unsurprisingly, this means there is limited comparability between the pathways of different organizations, which creates uncertainty for lenders, borrowers and banking supervisors, potentially increasing costs. According to the OECD, many of its respondents rely on ICMA's Principles and Handbook, the Climate Bond's Initiative's (CBI) Framework, the EU Taxonomy and their own internally developed frameworks. While ICMA and the CBI are more associated with capital markets at this nascent stage, this is borne out in our experience by their standards being referenced in loan documentation.

While only a limited number of businesses have developed and published credible transition plans that allow their alignment with the Paris Agreement to be assessed, there are nonetheless a growing number of initiatives to support those that choose to do so. These include disclosure frameworks and other types of services, for example, validation, assessment, data collection and analysis to support the development and disclosure of plans. Transition finance is particularly attractive to borrowers in carbon intensive sectors, especially those with high-emitting assets, as they seek finance to assist in meeting their net-zero commitments.

Our anecdotal assessment of current market transactions is that many bear the hallmark of transition finance, but there is a reluctance to use and indeed embrace this label. This extends even to those financial institutions that are more developed in their transition finance thinking. Often, such transactions are still labelled sustainability-linked (or not at all) — possibly because it is a term more familiar to the market or that has less association with higher emissions.

What makes a credible transition plan?

To minimize the legal, regulatory and reputational risks from financing carbon-intensive industries, the importance of borrowers having credible and testable transition plans cannot be understated. A weak plan at best opens a finance provider up to criticisms over its commitment to net zero and, at worst could see it face accusations of being engaged in greenwashing. Such concerns were highlighted and the subject of recommendations in a **report** published during COP 27 from the UN High-Level Expert Group on the Net Zero Emissions Commitments of Non-State Entities. Key questions for a finance provider to ask include the minimum rate of reduction in carbon or similar emissions (e.g., plastics or chemicals), whether the borrower has adequate capital to carry out the plan and critically, if there are meaningful consequences where insufficient progress is made. In this respect, there is much read-across with key performance indicators used in sustainability-linked loans.

In September 2022, GFANZ published a **report** on its expectations for real-economy transition plans. It set out the components that financial institutions should look for from the companies they finance to inform their allocation of capital and services. According to GFANZ, a transition plan should "articulate a company's overall approach to the net-zero transition, including information regarding its climate objectives, targets, actions, progress, and accountability mechanisms." This enables financial institutions to assess the credibility of a borrower's climate objectives and compare them against sectoral and regional expectations, and against peers. Moreover, the transparency provided by the plan can act as a reporting mechanism to stakeholders. The UK government-backed Transition Plan Taskforce is currently consulting on a disclosure **framework** that makes recommendations for both companies and financial institutions to develop "gold-standard" transition plans. The implementation **guidance** refers to finance providers using such plans to better understand their exposure risks at portfolio level, especially an entity's credit risks, where exposure is driven by climate-related, operational, market, legal and reputational risks.

General guidance also comes from the OECD, which has identified 10 key elements for a credible corporate transition plan. These include the following:

- Measuring performance and progress through metrics and KPIs that should be independently verifiable
- Clarifying the use of carbon credits and offsets, where caution and extra scrutiny should be exercised
- Enhancing the credibility of the plan not only through mitigation via the OECD's Do-No-Significant-Harm Principle, but also through conducting risk-based due diligence for Responsible Business Conduct
- Supporting a "just transition" by taking steps to mitigate any negative impact on workers, suppliers, local communities and consumers that arise from the adoption of the pathway
- Disclosing progress on targets regularly — alongside sound governance and accountability — with third-party verification of the plan and targets

Borrowers seeking to access transition finance must ensure their transition plans are credible so as to access a larger number of prospective finance providers, as well as a wider selection of products and services that may be at a lower cost. Further, borrowers need to understand that if they fail to meet the undertakings made with respect to their transition plans, finance providers may impose more onerous requirements and increase the costs of finance. Therefore, the key question to unlock any proposed transaction is whether the borrower's transition plan is deliverable within the period of the financing.

What are the risks and challenges?

The main obstacles to assessing whether a borrower's transition plan is credible are incomplete information and a lack of comparable data. According to an OECD industry survey (see **guidance** at page 5), in order of significance, the key obstacles are the following:

- A lack of comparable data in corporate disclosures on climate-related data
- A lack of detailed information in the content of plans and their formats
- Uncertainty over what amounts to a Paris-aligned, country-level sectoral transition pathway
- A lack of definition of transition activities and use of inconsistent methodologies
- Uncertainty over how to assess the ambition of a corporate net-zero plan
- A shortage of commercially viable projects and companies

The fact that the shortage of commercially viable projects and companies is considered less significant than, say, comparable data is, in our view, a little surprising as the availability of credible proposals is surely a key precondition to the growth of transition finance.

In the absence of reported emissions, financial institutions typically rely on estimates, which vary in quality. While tools that allow financial institutions to set financed emissions targets are becoming available (e.g., the Paris Agreement Capital Transition Assessment (PACTA) and the SBTi guide for the finance sector), they do not yet cover all relevant business segments. The lack of emissions data from customers, however, is expected to improve, for example, in the EU with the implementation of a more exigent Corporate Sustainability Reporting Directive (CSRD). Under the CSRD, the disclosure of whether a business has a 1.5°C Paris-aligned climate transition plan will become mandatory for large EU banks and insurance companies and (EU and non-EU) listed* companies in 2025 (annual reports covering 2024) and for all large (even unlisted) EU companies in 2026 (for annual reports covering 2025). Unlisted non-EU entities with significant activities in the EU will also have to report on a group level in 2029 (annual reports covering 2028). While the obligation is limited to disclosure, not having a plan will not be an option for many companies from a PR perspective.

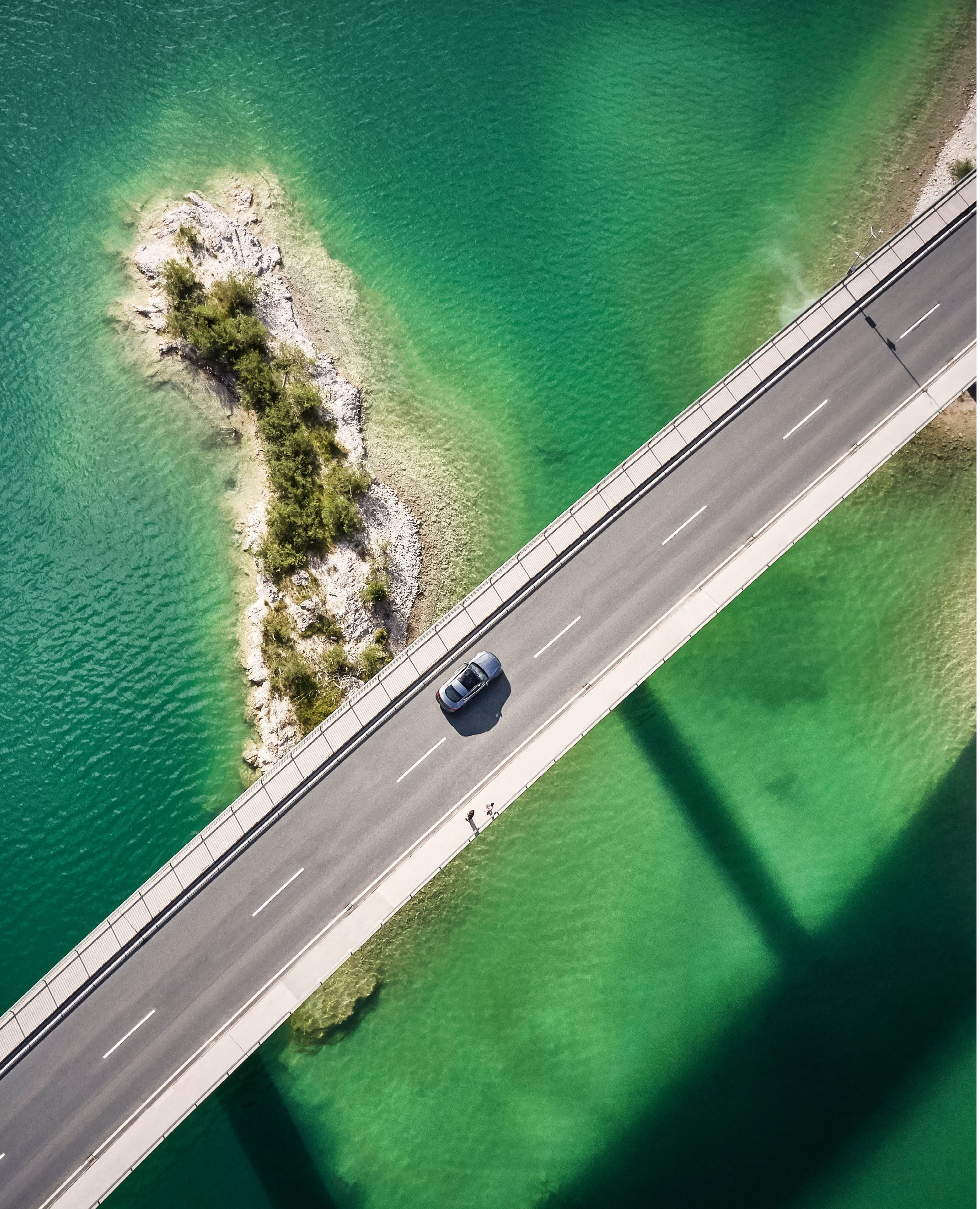
Finance providers must establish robust governance, effective procedures and processes, together with aligned reporting and disclosures to optimize their transition finance generally and to counter potential greenwashing allegations. Despite the challenges that it brings, the focus on increased transparency and accountability also brings the opportunity to be ahead of the curve, showcasing a financial institution's purpose, sustainability goals and progress toward them. Additionally, finance providers must focus on the quality of due diligence and other processes for selecting the businesses and projects it finances, monitoring that financing for the life of its outstanding loans, and explain how each financing aligns with their disclosed approach to providing ESG finance. In Europe, the EU's proposed Corporate Sustainability Due Diligence Directive will not only introduce formal requirements on customers, but equally on finance providers, as the disclosure of transition plans will also be mandatory under the CSRD for many financial institutions, with large EU banks (>500 employees) being captured in 2025 (for annual reports covering 2024). As bank transition plans build upon their customers' plans (as "financed emissions" are Scope 3 emissions for banks), this means that they will be under increasing pressure to ensure their customers develop credible plans to support their own.

* "Listed" means having securities on an EU regulated market.

What progress is the market making?

The Institutional Investors Group on Climate Change commissioned a **review** from the Transition Pathway Initiative to allow investors to assess banks, in particular, on the transition to net zero. The review looked at 27 bank members of the Net-Zero Banking Alliance. Banks' policies and engagement practices with high-risk sectors do not yet show that capital is being reallocated away from companies that are misaligned with a 1.5°C pathway. In fact, very few banks have, so far, disclosed comprehensive policies that would limit finance to high-emission sectors and activities. Furthermore, engagement with such businesses is limited to sectors such as coal and does not involve imposing financial conditions on businesses that are "lagging" in their transition. Rather, only a small number of institutions have established a bank-wide engagement strategy requiring transition plans from high-risk companies. The highest "score" on banks' decarbonization strategies was 56%, but the average was only 20%. The review recommends by way of next steps that banks should disclose explicit financing conditions for those clients whose transition plans are not aligned with a net-zero emissions pathway. The issue here, of course, is client confidentiality.

In our experience, while a number of financial institutions have invested significantly in transition finance as a concept from internal policies to external communication, the majority make little or no reference to it in present day transactions including contractual documentation. This does not mean, necessarily, that the sector is not using transition finance; rather, there may be caution over the use of the term and a preference for better known and simpler, less controversial, concepts such as sustainability-linked. We believe that as the scope of transition finance becomes clearer, better understood and, consequently, more accepted in the market, this will change. The market would be aided by the development of standard documentation or clauses that, for example, the LMA may develop and publish, especially a user guide.



Conclusion

The key implication of transition finance for the financial sector is that those borrowers with credible transition plans should increasingly be able to access new products and services at a lower cost. In contrast, those that do not have credible transition plans will face higher costs and/or restricted access to financial products and services (i.e., higher costs of capital) depending on the underwriting process of their finance provider.

Well-executed, credible transition plans should allow those finance providers that embrace the concept to enjoy a competitive advantage. In consequence, they will be able to expand their portfolios to businesses that otherwise would not have aligned with the expectations of their supervisors and financial institutions' own transition plans. In short, their financed emissions will remain aligned to the net-zero target.

Similar to the development of green and sustainability-linked bonds and loans, we expect industry-wide frameworks to be developed for transition finance, and finance providers and borrowers should actively monitor this space.

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