PRIORITIES FOR DEVELOPING TRANSITION FINANCE

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The necessity and challenges of transition finance in the current environment

The first global stocktake of the implementation of the Paris Agreement in 2023 highlighted that current efforts to mitigate and adapt to climate change are insufficient. There is an urgent need to implement appropriate pathways to deliver the required reductions in global greenhouse gas emissions through increased and accessible financial support, capacity building and technological advancements.

Europe is the fastest warming continent in the world and has long been a leader in climate action. The implementation of the relevant EU policies and mechanisms, such as the Green Deal and the Fit-for-55 package, as well as the EU Emissions Trading System aim to mitigate climate change and shape the direction of future growth, creating both challenges and opportunities for individuals, corporates, as well as the financial system and the economy as a whole.

In particular, transition finance facilitates the flow of capital towards activities that are more sustainable and supports high-emitting activities to decarbonise, while creating value for the private and the public sectors. Thus, transition finance can act as a catalyst towards a future of sustainable economic growth.

In recent years, significant efforts have been made at the global, European and national levels to scale up transition finance. From a policy and regulatory perspective, different tools have been put in place, including (i) policies, such as the Paris Agreement, (ii) strategies, such as the national and sectoral transition plans, and (iii) regulatory frameworks, such as the EU Taxonomy Regulation and the Corporate Sustainability Reporting Directive.

However, transition finance is not yet at the level required to meet the ambitious targets towards net-zero emissions, not least because of insufficient global political will and the uncertain geopolitical and economic environment. Moreover, shortcomings in the functioning of the financial system hinder the flow of investments towards sustainable economic growth. These relate to the lack of clear definitions of transition finance and of the products, activities and sectors, which may be eligible for transition financing. In addition, enforcement of the existing regulatory framework is inconsistent or weak, partly due to the voluntary application of standards. At the same time, the financial sector does not fully incorporate sustainability issues in decision-making processes, business models and risk management. Financial institutions have yet to develop the necessary processes, tools and competences to be able to assess the transition pathways of counterparties and manage the risks in their own portfolios that may arise from the process of adjustment towards climate neutrality by 2050.

To overcome these challenges, regulators, policy-makers and the financial sector should be more proactive. There is a need for more decisive political action globally, together with more regulatory clarity on the sector transition pathways, for the financial sector to be able to assess the alignment of financial portfolios to these pathways. The coverage and consistency of application of existing regulation, such as the EU Taxonomy and the disclosure standards require improvements, in order to promote transparency and trust in markets. The financial sector also needs to develop the appropriate structures and policies, engaging with stakeholders, in order to be able not only to manage the risks of the transition, but also to harvest the opportunities that stem from it.

Transition finance as the catalyst towards a more sustainable economic future.

The transition requires vast amounts of investments and therefore the mobilisation of all sources of funds, both public and private. All available financial tools and instruments – such as sustainable bonds and loans, equity and blended finance – as well as innovative financial instruments, can be useful in financing the transition under certain circumstances. The issuance of these instruments should be supported by robust controls, frameworks, and disclosures that will further promote trust and transparency in markets and reduce greenwashing risks.

In parallel, efforts should be made to improve the conditions for deepening the markets of financial instruments to facilitate the financing of transition. To that end, it is necessary to advance the completion of the Capital Markets Union (CMU). A unified, deep and liquid CMU with harmonised rules and transparency, can promote the free flow of funds, foster innovation and facilitate the cross-border flow of investments and savings. This, in turn, allows the efficient use of available funds in the EU, which are much needed for meeting the EU's greenhouse gas emissions reduction targets.

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Overcoming the barriers of transition finance

Governments, companies and financial institutions globally have committed to carbon neutrality, which requires a huge amount of investment and an economy-wide transition. According to several sources, between 0.9 and 1.6 trillion euros are needed annually in the EU to reach this objective, which calls for the participation of both the public and private sectors.

Transition finance provides an excellent opportunity to raise capital from both sectors to achieve net-zero. Three main barriers however interfere with the development of the transition finance market.

First is the lack of consensus around the perimeter of transition activities and the regulatory definition of transition finance. On the one side, although several international organizations have created their own guidelines and taxonomies promoting sustainable finance, certain sectors do not have technologically or economically feasible low-carbon alternatives yet, hence are not able to fit under standard sustainable finance's criteria. On the other side, as the market lacks concrete definitions and regulations, investors' confidence toward transition finance instruments is affected by the risk of greenwashing and disinformation.

Second is the absence of transition plan obligations under sustainability reporting standards for corporates, worsened by the lack of country/regional-specific sectoral roadmaps.

Third is the absence of standardization regarding Environmental, Social and Governance (ESG) data, which makes their collection, assessment, and comparability an arduous process.

The implementation of an array of tools, including globally or regionally-accepted transition finance guidelines, taxonomies, roadmaps, standards, assessment tools and standardized ESG-related data reporting, is essential in unlocking the potential of transition finance. Regulators will thus have a major role in promoting credibility and transparency by taking into account market best practices and rely more on well-established and globally accepted guidelines (e.g. the principles by the International Capital Markets Association /ICMA/ or the EU or Climate Bonds Initiative /CBI/ Taxonomies).

A common definition and under-standing of the scope of transition finance is needed to lift the first abovementioned barrier. Guidelines including "Basic Guidelines on Climate Transition Finance" by the Japanese Ministry of Economy, Trade and Industry acknowledging the role of transition labelled instruments is a great example in that regard.

Additionally, taxonomies must establish how specific transition activities can align with the Paris Agreement across various regions, considering that some activities currently lack viable low-carbon alternatives. For instance, the EU Taxonomy includes transitional activities, and the Climate Bonds Taxonomy permits financing for hard-to-abate sectors such as cement and chemicals.

Making the adoption of transition plans in line with the Paris Agreement mandatory for corporates, such as under the EU Corporate Sustainability Due Diligence Directive (CSDDD), could address the second challenge by reducing the risk of disinformation. Meanwhile, establishing national or regional technology roadmaps would offer a clear transition trajectory for different geographies. Based on these sectoral roadmaps, corporations could develop robust transition plans, set targets aligned with the Paris Agreement, and issue credible transition labels.

Specialist ESG data providers can bridge the third challenge by evaluating ESG-related data, validating sustainability disclosures and reports, offering insights on ESG risk management, and providing second-party opinions on labelled transition finance instruments to ensure that proceeds are used appropriately. In this sense, the implementation of regulations akin to "Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities" and ICMA's "Code of Conduct for ESG Ratings and Data Products Providers" are essential in ensuring that ESG data providers are providing credible, reliable and high-quality data.

Transition finance's necessary further development is vital to achieve net-zero.

Overall, transition finance is crucial for achieving net-zero, and its necessary further development should not be underestimated. Several initiatives, including the setting of guidelines, assessment tools, frameworks, road-maps, labelled financial instruments, taxonomies, and regulations concerning ESG data providers, aim to improve the transition finance market. However, numerous shortcomings still hinder its growth. In order to enhance transition finance and unlock its full potential in the process of achieving net-zero, market-based regulations need to be developed.

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Supporting an orderly transition: putting the pieces together

The EU sustainable finance architecture is now in place, resting on three pillars: the EU Taxonomy; disclosure, with the CSRD and the European Sustainability Reporting Standards as milestones to enhance the availability of harmonized information; product regulations, including climate-related benchmarks, the European green bond standard and the regulation on ESG rating providers. The ambition for Europe is to become the first climate-neutral continent by 2050.

This requires significant amounts of investment, both from the private and public sector, and in this context transition finance emerges as a key topic requiring a coordinated approach from all stakeholders. A number of companies cannot immediately change their models to become fully climate neutral but have the ambition to do so. Developing transition finance requires giving financial intermediaries and investors sufficient and comparable information to differentiate between projects and direct investment flows in line with sustainability objectives, while preserving the competitiveness of our economy.

Indeed, companies will need to transform their business models and develop procedures to gather and report the required information. Transition plans cannot become a mere check-in-the-box exercise and should become part of the corporate culture, with a sound governance framework. This will enable our companies to grasp the opportunities offered by the new model.

In order to preserve the credibility of the framework the following elements are key:

Common definitions: in their absence, investors are unable to compare across companies, with a risk of losing trust. The definitions should be preferably global, but the EU can lead the way and set a standard in the single market to preserve the level-playing field.

Sector-specific reference scenarios and pathways, compatible with EU climate and environmental objectives, against which individual companies' progress can be measured, preferably developed by sectorial associations. Without clear targets, investors will lack information on the degree of ambition of a company's targets set out in their transition plan.

Harmonized reporting standards to ensure comparable information. Sustainability disclosures streamline the exchange of information between financial intermediaries and corporates in transition and protect fair competition. In this respect, the Directive on Corporate Sustainability Reporting is a milestone in ensuring the transparency and accountability of information.

The EU has made progress towards defining transition finance with the Commission Recommendation of 2023 providing guidance to clarify basic concepts and to determine individual transition targets, as well as with regards to financing instruments. The latter involve green or sustainability loans and bonds, with competitive rates depending on the envisaged environmental performance and proceeds dedicated to projects supporting the transition. However, some investments entail higher risk-taking, with more innovative technologies and procedures and call for equity financing and specialised lending. Their development is closely linked to the Capital Markets Union and is a timely reminder of the urgency of adopting the necessary measures.

A final element to take into account is the support to SMEs in their transition planning and the principle of proportionality adapted to their size, administrative capacity and resources. Bank lending will play a larger role and banks can draw on close client relationships to provide guidance and offer specific transition-related financing solutions linked to climate or environmental targets. SMEs should be aware that, even though formally excluded from a number of regulatory requirements, they will also be impacted by the framework in order to benefit from a number of opportunities, notably the integration in the value chains of larger corporates.

With a sustainable finance framework in place we now need to support an orderly transition.

At the national level, Spain is developing a Green Book on Sustainable Finance, with a focus on supporting SMEs in transition. The proposed actions will support the implementation of the sustainable finance framework through the dissemination of relevant information and sharing of best practices, by fostering the dialogue with supervisors within a green sandbox and promoting the development of sectoral guidelines with business associations. To support a close dialogue and coordination, the Green Book envisages the creation of a Sustainable Finances Board, with relevant representatives from all stakeholders, in order to steer the proposed actions.

The transition to a climate neutral economy entails significant challenges, but also opportunities for the EU economy in terms of competitiveness and strategic autonomy. The key to reap the full benefits will be an orderly transition that ensures fair competition and leaves no one behind, with a constant dialogue and close coordination between all stakeholders involved, including cross-border coordination among authorities.

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Financing the transition – Setting the path with transparency and standards

Transition finance should finance companies and projects to enable a timely transition to a sustainable and climate-resilient economy and society and to meet Paris Agreement goals. It covers investments to help greenhouse gas-intensive companies reduce their emissions and transform their business models. It also includes necessary infrastructure investments (such as energy supply, transportation systems etc.) to enable the transition of the economy. According to the WEF's estimates in 2023, there is an additional capital expenditure until 2050 of USD 370 billion annually needed for decarbonization of steel, cement, aviation, shipping, trucking, aluminium, and ammonia industries. Put starkly, solely financing the development of (already) green activities will fall short in delivering the net-zero objective by 2050.

Transition plans are therefore an important tool for translating climate or environmental goals at company or economic activity level into specific measures and associated financing and investment plans. They also form an important basis for communication with financial market players and are relevant for financial institutions to assess the physical and transitory risks of counterparties and financial products. The requirements for transition finance are already being legally defined by the EU taxonomy (disclosure of green investments), the CSRD and CSDDD (development and disclosure of transition plans).

Earlier this year, EBA held a public consultation on Guidelines for the management of ESG risks and prudential transition plans. Beyond the scope of CSRD/CSDDD, which only focus on the disclosure of transition plans, prudential transition plans will become a supervisory risk management tool for credit institutions under the CRD. On EBA level, the Austrian Financial Market Authority (FMA) is contributing to the finalisation of the Guidelines. Importantly, especially for our Austrian market, the principle of proportionality should be applied. That means, when preparing transition plans, proportionality applied based on a company's exposure to sustainability risks rather than on size of the company.

The FMA is also implementing the growing importance of transition finance in regulatory guidance. To help facilitate supervised entities' efforts to integrate sustainability and climate-related risks in their processes, in 2020 we published an FMA Guide on Handling Sustainability Risks addressed to the Austrian financial market. Due to the dynamic nature of sustainability risks, we are currently updating the Guide, expected to be published by the end of 2024, to also include specific guidance and supervisory expectations on transition planning and transition plans, highlighting the growing importance of transition finance.

Credible transition plans and a definition of transition financing activities essential for success.

In the draft version of our updated FMA Guide, we highlight that the management of a company has the prime responsibility for implementing and monitoring credible transition plans. Furthermore, a robust governance structure and its implementation at process level throughout the institution are a key element of an effective transition plan. In this regard, it is important to ensure appropriate documentation and accountability. This also includes quantifiable goals (including KPIs and KRIs) and appropriate processes to address ESG risks in the short-, medium-, and long term. In this context, assessing the credibility of transition plans will be a very relevant criterion. For example, considering whether business activities and the development and forecasts for business segments match the goals and KPIs set out in the transition plan.

Besides credible transition plans by companies, we still need a regulatory framework that effectively facilitates **transition financing**. In my opinion, suitable disclosure and harmonised product classifications in transition finance are the most effective strategies for preventing greenwashing and promoting transparency. In this regard, I strongly support the policy proposals highlighted in the Joint ESAs Opinion from June 2024, namely that the Commission should consider the introduction of a product classification system and adapted disclosure for financial products that promote sustainability and transition. There should be a clear, simple and transparent definition of the economic and financing activities that are covered by transition finance. This ensures the quality of financial products in relation to transition finance to promote market transparency and to facilitate the flow of funds towards transition. This helps investors navigate the broad selection of financial products and supports the full transition to sustainable finance

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Principles, communication and coordination are key to transition finance success

Like many issues in the early stages of discussion, transition finance remains open-ended and can encompass different meanings to different people across different jurisdictions. What one should or should not consider for purposes of this discussion has become a subject of debate within the U.S. and across the globe (for example, climate risk, protection gaps, inclusive finance, DEI). While having a universally accepted definition could help facilitate consistency and commonality, given the variety of differences and needs across jurisdictions, having sufficient flexibility along with communication and coordination are imperative to moving the issue forward.

In the insurance industry, there have been calls on insurance supervisors to take a leading role in transition finance and take actions such as strengthening rules around the types of industries that can be underwritten and in which industries insurers can investment. While insurance supervisors have a role in the discussions around transition finance and climate risk, it remains important to note that an insurance supervisor's role is to ensure that insurers are solvent and can cover their obligations to policyholders.

As insurance supervisors consider their other roles in these discussions, it is important to have a mix of strategies and tools that can help address holistically transition issues. This includes acknowledging the risks and challenges insurers face when trying to govern their underwriting, investing, or other business decisions - regardless of where they may come, whether climate-related or otherwise. It also involves working on climate risk, race and insurance, corporate governance, and other related factors generally included in the discussion around transition finance, to the extent they directly pertain to the responsibility to protect policyholders and supervise the financial condition of insurers.

With the differences in jurisdictions across the U.S., we are addressing transition finance by taking a high-level approach rather than a prescriptive one – essentially providing a framework to guide the efforts of the NAIC and its 56 members to address the future of insurance in the face of evolving climate risks, protection gaps, and inclusive finance.

That framework, the *National Climate Resilience Strategy for Insurance* ("the Strategy"), approved by U.S. state insurance supervisors in March 2024, outlines our goals in the near to medium term, including closing protection gaps, promoting risk mitigation efforts across the industry, and understanding risks by gathering comprehensive data.

Notably, the Strategy prioritizes pre-disaster mitigation and includes creation of a common roadmap for state insurance supervisors to contribute to risk mitigation programs that would reduce future losses and promote insurance availability in their jurisdictions.

Regarding protection gaps, state insurance supervisors are conducting a national data collection on the availability and affordability of insurance, empowering NAIC members to better understand each jurisdiction and regional trends. State insurance supervisors will also be implementing tools that analyze future scenarios to understand solvency issues for the insurance sector. These actions address the challenges we face in a forward-looking, comprehensive and coordinated way.

Likewise, we continue to stress the interrelated issues with diversity, equity, and inclusion, in finance that affect every insurance department and the NAIC, spanning across various insurance lines and impacting multiple facets of the insurance system. This includes rating, underwriting, fraud detection, and marketing – aspects of insurance supervision that we can find common ground on among the states as well as our counterparts abroad.

Agreed-to principles, communication, and coordination are keys to success in transition finance.

Finding ways to navigate these issues in a changing insurance sector does not occur in a vacuum. Collaboration among insurance supervisors globally can help ensure risks are being addressed in an effective and timely manner. The International Association of Insurance Supervisors, the OECD, and the UN Sustainable Insurance Forum have a variety of workstreams focused on these evolving risks and are taking steps to finalize important policy developments, some of which have been incorporated into our ongoing efforts.

In the U.S., insurance supervisors appreciate that the conversation on transition finance is evolving. We are also aware that each state will see these issues manifest in different ways and, thus, take specific actions to address their respective challenges. As such, in the U.S. we have found that agreed-to principles, communication, and coordination are keys to success in transition finance.

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Sustainable Finance needs now to come to age, but it can not do it alone

Sustainable finance has expanded rapidly in the last few years. As Bloomberg reports, sustainable bond issuances went from almost nothing in 2013 to over 1 trillion USD in 2023. The sustainable loan market is also very active, and even though most of the issuance is in Europe, all regions have seen significant growth.

The European Union has also created a comprehensive set of regulations. It has, among other things, established what counts as sustainable (the EU Taxonomy), what needs to be done to support sustainable fund allocation (SFDR, MIFID/IDD) and how to produce reliable and standard sustainable data and information (CSRD). This regulatory activity has made sustainable finance a priority for all companies in the EU and abroad.

Many financial and non-financial companies have set net zero goals and there is now widespread awareness of sustainability issues among businesses and various stakeholders. All this has been achieved in a short span of time, and there has probably never been before such mobilization both from the market and public authorities to address an emerging new problem.

A lot has been done, but it won't be enough. We are just at the beginning of a profound transformation of our economies and the more challenging work lies before us. While we have established a foundation and raised awareness, we need now to look at the concrete steps for the transition of the whole economy, not just a part of it. Two levers could be used to do so: regulation and transitions plans.

Regulation is a powerful tool to drive transformation provided it is clear and it is translated in the day-to-day operations of companies. The sustainable finance regulation should be simplified precisely to make it clearer and operationalize it. Simplification should not mean reducing regulation or replacing old regulation with new regulation but rather evaluating existing regulation, adjusting what need to be adjusted and providing further clarification and precision on the requirements to make them more operational. This should be done by taking the time to learn from implementation challenges and best practices to feed the changes in the regulation. This would apply to the entirety of the sustainable regulation, which has been developed in a short period of time on a new and immature topic. The regulation couldn't be perfect from the start, and we should recognize that a process of continuous improvement should be applied at least in the beginning.

This is particularly true for the CSRD, which is the cornerstone of all sustainable finance regulation. The foundations have been laid for a robust Sustainability Reporting with CSRD but many areas of the CSRD will require further work and clarification and doing it right will be key to make CSRD a real transformative tool and not a pure compliance exercise. Implementing CRSD is a journey, and we should allow all stakeholders to ride that journey.

We need to look at the concrete steps for the transition of the whole economy, not just a part of it.

The second lever is to focus on transition plans, since the challenge is essentially about transitioning the economy. Finance has a key role to play in this transition but it will not drive the whole economy transition on its own, and unless we address this in a comprehensive manner, all the efforts will ultimately have a marginal impact. The sequencing should be the following. Countries and jurisdictions should provide stable rules of the game to economic actors through targets, regulation, taxation or incentives. Then the real economy should implement credible transition plan. Finally, the financial sector should finance these plans and build its own transition plan. Credible transition plans along this value chain will be the backbone of the transition, they will be even more important that significant uncertainty (such as international coordination, political commitments, technology developments ...) will remain for many years and should be included and assessed in these plans. The AEFR (Association Europe Finances Regulations) suggested in a recent debate paper twelve recommendations on how to ensure credible transition plan ("Transition Plans: ensuring their comparability, credibility, and effectiveness to accelerate the low carbon transition"). It emphasizes among other things on the importance of setting clear public policies, their coordination and monitoring, on the transparency and monitoring of assumptions of the climate scenarios and on clear guidelines on what constitute good and robust transition planning.

The challenge of sustainability affects the economy extensively and profoundly. The transition finance is crucial in tackling the sustainability issue, given that the appropriate conditions are established. This includes having credible transition strategies from both public and private sectors and practical, relevant regulations.

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Beyond green or brown: importance and challenges of transition finance

2023 was the warmest year on Earth in 170 years since direct observations began, and Japan also marked most number of "extremely hot days" with temperatures above 35 degrees Celsius. Also, UN Secretary-General Guterres has stated that "the era of global boiling has arrived," making the response to climate change an increasingly urgent global issue.

To realize just and orderly transition to a decarbonized society, utilizing both transition and green technologies is essential and will require a large amount of funding. Pathways to decarbonization vary widely depending on the characteristics of each region, such as geography and industrial structure. In reality, there are cases where decarbonization from brown to green cannot be achieved in one step, so it is important to work toward low-carbonization at the same time. Therefore, a binary approach of green/non-green and a just divestment from non-green assets does not work, and transition finance is essential.

Since it released Carbon Neutral Declaration in October 2020 with an aim to reduce overall greenhouse gas emissions to zero by 2050, the Japanese government has been actively working to expand transition finance. In May 2021, the Japanese government formulated its Basic Guidelines on Climate Transition Finance. These guidelines address Japan's unique characteristics, such as by incorporating the government's sector-based roadmaps into the 'science-based' climate transition strategy disclosures. To date, the government has disclosed roadmaps for the electric power, oil, gas, iron and steel, cement, chemical, pulp and paper, shipping, and aviation sectors.

Furthermore, in February 2024 the Japanese government started to issue the Climate Transition Bonds worth 20 trillion yen over 10 years as the world's first sovereign bond labeled as transition bond. It intends to raise funds for GX investments from a wide range of investors, foster understanding of Japanese GX policies, and serve as a catalyst for the expansion of transition financing in Japan and abroad.

Since the International Capital Market Association released its Climate Transition Finance Handbook in December 2020, Japanese firms have taken a leading position in fundraising under the transition finance framework, both in the number of deals and amount. One major reason for this is that firms have been provided with some clear benchmarks for deciding their decarbonization plans, due to the government clarifying its technological milestones up to 2050 in its sector-based roadmaps. Also, companies may feel an incentive to gain approval for aligning their decarbonization strategy with that of the government through using the government's transition finance framework.

Even so, the issue remains of how to address various uncertainties that exist in the development of transition finance. For example, in December 2017, the Japanese government announced the world's first national hydrogen strategy, the Basic Hydrogen Strategy, which aims to realize a hydrogen society. It also goes without saying that 2050 hydrogen demand estimates assume the establishment of new supply-side and demand-side technologies, such as those for hydrogen power generation, and hydrogen steelmaking. However, these technologies' realization is not guaranteed and financing for these technologies involves various risks such as technological risk, development risk, reputational risk, or political risk. Because of this, in moving forward transition finance, it is essential for financial institutions to carefully assess and appropriately allocate these risks. In this way, blended finance is one of the useful methods to make highly uncertain projects more bankable and to mobilize private capital.

Mizuho is taking proactive steps in the area of transition finance, where we have become a global leader. We have long maintained a front-runner position in the sustainable finance market, and been establishing a leading position in transition finance as well. Aside from this, we have also announced the Sustainable Business Strategy in 2024, in which Mizuho aims to lead the structural transformation of industries toward decarbonization and to proactively support the transitions of our clients. In this way, we revised the Environmental and Social Management Policy and established an exception clauses so that we could consider financing and investing to the early retirement of existing coal-fired power plant.

A binary approach of green or brown is not enough to achieve carbon neutrality.

Mizuho is a financial institution with more than 150 years history and has supported the development of heavy industries since our establishment, inheriting our founder's DNA of pursuing prosperity for customers, economy and society, which leads to a sustainable future. We will continue to support clients' transitions from both financial and non-financial perspectives in a consistent manner, aiming to achieve carbon neutrality. We will not be held back by short-term increases in financed emissions when they are part of us fulfilling our duties as a financial institution.