Climate transition finance: consensus on the objectives, challenges and ways forward

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The financing of "green", climate-related projects and activities in line with the Paris Treaty, has been developed in the last ten years both through market developments (Green bonds, Sustainable bonds, Sustainable linked-bonds, Green loans etc) and through regulation (the EU sustainable finance regulation including climate taxonomy, the ISSB climate-related standards etc).

A growing economic, financial and political consensus is to focus now also on the transition of "brown", energy-intensive economic actors towards the Paris objectives. To support this goal, there have been different attempts to create, define and develop a sub-sector of sustainable finance, called transition finance or climate transition finance. This article intends to focus on climate transition finance, a concept which is simpler and clearer than transition finance, which can encompass other objectives than climate like environmental ones.

The financing of climate transition is faced with two kind of difficulties :

- Climate transition relies on research and development, innovations, strategies built on scenarios which are unsure, and is therefore riskier than the continuation of "business as usual"; public finance may help to minimise those risks, but the continuity of this support over the medium-term is unsure;
- Transparency is needed to attract sustainable finance, but the undertakings which embark on climate transition will also continue some business as usual and both activities should be clarified to prevent greenwashing or greenwashing controversies.

This note tries to describe the current attempts of developing climate transition finance, which are stepping stones which will need to be consolidated and scaled up, notably through the implementation of the regulatory and supervisory agenda of the European Union.

1. A large consensus for the development of transition finance, with differences in the definitions and the modalities

1.1 In the European Union

In the regulatory framework on green transparency, the priority of the European Commission, advised by the Platform on sustainable finance, has been to establish a green taxonomy. The objective was to induce financial investments in climate-friendly and environmental-friendly corporates and projects, such as renewable energies, building new houses respecting high-quality standards etc. Hence Regulation 2020/852 of June 2020 and its first delegated act.

However justified it may seems, this démarche has a significant shortcoming : it adresses only a limited segment of the economy, the already "green one", and ignores the most important challenge, which is to align the large part of the economy emitting a significant volume of greenhouse gases to the objectives of the EU in line with the Paris Treaty: net zero in 2050 and -55% of GHG in 2030. The implementation of SFDR shows that only a few % of financial assets are deemed "green" according to the EU taxonomy.

The communication of the European Commission in July 2023 recognizes the needs of climate transition finance going further than financing only "green" projects and activities:

"EU efforts have predominantly focused on supporting investment flows towards economic activities that are already environmentally sustainable and towards plans to make them environmentally sustainable. A more supportive framework is needed to address the challenge of financing interim steps in the urgent transition of activities towards the EU's climate neutrality and environmental objectives.

"Finance for the transition to a climate-neutral and sustainable economy is needed today for those undertakings that want to become sustainable but cannot shift in one step to a fully environment-friendly, climate-neutral performance model. Transition finance will be necessary over the coming years to ensure a timely and orderly transition of the real economy towards sustainability while ensuring the competitiveness of the EU economy. Not all technologies are yet available for a sustainable economy and economic actors can reach these objectives at different pace."

This Communication is accompanied by a Recommendation to all interested parties (enterprises, including SMEs, financial actors, governments, supervisors) to help the development of transition finance.

1.2 Climate transition finance in Japan

Japan has built a strategy implying its government, the private financial and non-financial sector, to achieve the transition of carbonated activities in industrial sectors, transport and buildings. This strategy relies on transition pathways for these activities in line with the Paris objectives, supported by public and private finance, including the issuing of Climate-transition bonds.

To support this strategy, Japan has issued in February 2024 a Transition bond of $5,5 Bn. The bond has earmarked 55% of its user of proceeds to R&D, including 18% for the utilisation of hydrogen in the steel making process and the decarbonisation of the thermal process. The remaining 44.5% of the bond's UoP is earmarked to support decarbonisation objectives, including subsidies for low-carbon transport and batteries, subsidies to improve the insulation performance of houses, and subsidies to promote the introduction of clean energy vehicles. The largest subsidy allocation is directed to silicon carbide power semiconductors for renewable energy, clean transport, electricity storage batteries, electricity transmission and distribution, and to strengthen supply chains for critical materials in the manufacturing of storage batteries.

The Japan government announced plans to raise €124 Bn for its climate-transition programme over the next decade.

It is to be noted that some Japanese NGOs, notably Climate integrate, are not fully supportive of this national strategy of transition. They fear that some technological innovations could be not environmental-friendly, like the so-called "clean coal" (co-combustion with ammoniac). For Climate intergrate, "the challenge would be that investors could really assess the consistency of the transition bonds with the Paris objectives."

1.3 At the international market level

The International Capital Markets Association (ICMA, which is notably behind the Green Bonds and the Sustainable Bonds Principles) has published "The Climate transition finance handbook" in July 2023 and "Transition finance in the debt capital market" in February 2024, which give a description of what is climate transition finance in the financial markets and key recommendations to adequate issuing of climate transition bonds.

Today Green bonds and Sustainability-linked bonds are the tools which are the most used to finance climate transition. There are been some issues of Climate transition bonds, but they remain rare up to now.

The main recommendation of ICMA, for the issuers is:

- to adopt a Paris-aligned and measurable climate transition strategy,
- to use and disclose science-based targets and metrics,
- to disclose all the relevant information (for instance on planned changes to the business model and, if relevant, potential adverse impacts and mitigating actions),
- to obtain an external review confirming the credibility of the transition plan and to report annually on the transition plan, targets and metrics.

1.4 The definition of transition finance

There are different definitions possible as recognised by ICMA or the OECD.

The most extensive includes all the finance which supports the transition to a more sustainable economy and to the Paris objectives, including the finance considered as "green" by the EU taxonomy.

The more focused is in Japan, where only "hard to abate" sectors transitioning on the climate objectives of the Paris Treaty are concerned.

For the purpose of this note, we will take the following approach:

- to focuse on climate and not on other environmental issues (for which the concept of transition is much less clear);
- and to focus on the financing of activities and projects which are not "green" per se, but which will enable the undertaking concerned

to align its ges trajectory on the Paris objectives. This will include the "hard to abate" sectors, but also other significantly carbonated activities.

The relationship between green and transition finance over time is described by the Commission in Annex 1.

2. Challenges

2.1 There are two major challenges

- The concern of greenwashing
  For an investor which wants to finance sustainable projects or corporates, it is crucial to avoid greenwashing or even greeanwashing controversy. But how to be reasonably confident that a corporate which says publicly that it is aligned on the Paris objectives is really aligned ? How to assess the growing part of climate transition activities vis-à-vis the continuation of "business as usual?"
- **The lack of convergence at the international level :** How to deal with different levels of ambition in corporate and investment practices across juridictions? And with different requirements of climate-related reporting?

2.2 For banks, there is another difficulty : the financing of SMEs and households, economic actors for which it is much more difficult to have adequate data and transition pathways

And the part of these banks' customers in the emission of greenhouse gases is important: SMEs' emissions of CO_2 represent 63% of the emissions of all the businesses in the UE.

3. The ways forward

3.1 Well-documented climate transition plans should be the cornerstone of climate transition finance

The core objective of climate transition plan is to describe the transition of carbonated undertakings to the net zero objective of the Paris Treaty.

In the EU, financial and non-financial companies must establish a transition plan, based on the EU regulation (SFDR, CSRD, ESRS and CS3D). Financial supervisors will also look at the transition plans of the banks and insurances according to the EU regulation.

In the UK, transition plans disclosures will be mandatory in January 2025 ; they should follow guidance from the Transition Plan Taskforce (TPT), which published a "Disclosure framework" in October 2023.

To ensure the credibility and follow up of transition plans, there is a certain consensus between the regulators and market participants as reflected in ICMA recommendations (*see Table in Annex 2*), in line with EU regulation, TPT and ISSB. These recommendations can be summed up as follows:

- The transition plan must describe strategy, governance, objectives, KPIs, including Capex and Scope 3,
- It must be audited by a third party,
- It must be reviewed year after year, being understood that all the KPIs for instance will not be available the first year and also that revisions can reveal worse results/objectives than the year before, given the new data added.

3.2 The governments and international organisations should support transition planning by financial and non-financial actors

The undertaking cannot build its transition plan in isolation.

First, public authorities should develop transition planning guidelines, as recommended by l'Association Europe Finance Régulation (AEFR), and these should specifically include guidance on assumptions, execution, and monitoring. The Chartered Financial Analyst Institute (CFA Institute) recommends that governments and regulators harmonise transition plans disclosures and require economic feasibility disclosure. It asks also for the development of a transition taxonomy, but this recommendation seems difficult to implement, given the long, complex and rather frustrating development of the green taxonomy by the EU.

Secondly, the transition plans must rely on economic scenarios both sectoral and national. There are transition pathways or scenarios at the international level designed by international organisms like the International Energy Agency (IEA), the Glasgow Financial Alliance for Net Zero (GFANZ) or the Network for Greening the Financial system (NGFS), which are more or less precise and accepted by the undertakings concerned.

But they should be complemented by sectoral and national plans, which are generally lacking with a few exceptions (Japan, France...). For the EU, national and sectoral plans should be scrutinised and harmonised at the EU level.

Finally, coordination and monitoring of the transition at EU level must be developed and EU supervisory and regulatory entities should align their approach on transition plans.

3.3 The regulation on disclosures, but also ratings and labels could help

In its consultation on SFDR, the Commission presented a proposal of creating a specific category of disclosure of financial products "with a transition focus aiming to bring measurable improvements to the sustainablity profile ot the asset they invest in..." This orientation has been supported by a large majority of the respondents, would help individual investors to navigate the investment product land-scape and attract funds to finance the transition.

Transparency about transition plans by corporates and financial actors could be also comforted by a specific task of sustainable rating agencies and/or sustainable labelling organisations. A proposal for a "good transition label" was made in the Eurofi Regulatory Agenda of February 2024.

3.4 International convergence is required

The publication of transition plans is an obligation in the EU and the UK starting in 2025. It should become the rule for all the big corporates in the world, which are encouraged to do so by numerous international organisms (OECD, GFANZ etc). The pressure of public authorities and of financial supervisors (including IOSCO), but also of the markets, should help. Already over 4.200 companies have set targets approved by the Science-based Targets Initiative (SBTI). ICMA is already providing an efficient support.

Conclusion

The development of climate transition finance is necessary to reach the objectives of the Paris Treaty. Given the challenges recalled in this note, it should be seen in a multi-year perspective. The publication of consistent and credible transition plans by corporates and financial actors should improve year after year, notably through increase of the availability of data, but also through comparability and benchmarking.

Recent developments are encouraging, both at political levels, notably in the EU, the UK and Japan, and at the market level.

The public authorities have a rôle to play by providing transition planning guidelines and by publishing national transition scenarios.

In the EU, harmonisation of transition planning and its supervision are needed at the EU level. The reform of SFDR should also give the opportunity to introduce a specific disclosure category devoted to transition finance, while rating agencies and labelling organisations could develop useful tools, in order to attract the necessary funds from financial investors.

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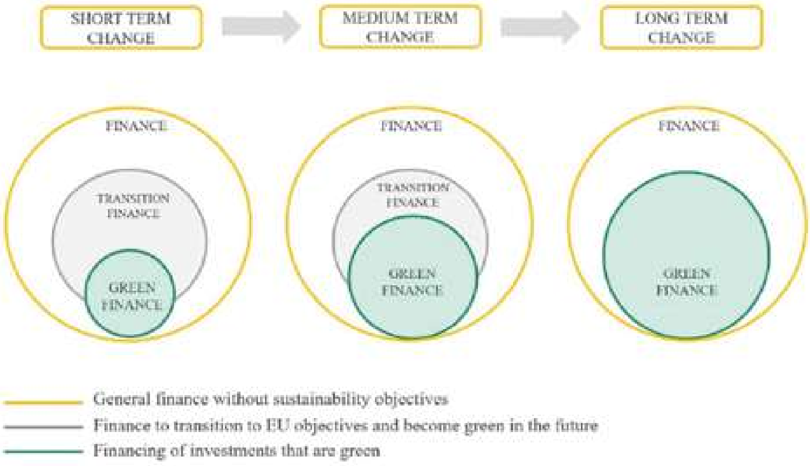
Annex

ANNEX 1.
Relationship between green and transition finance over time



Source: European Commission: Recommandation of 27 June 2023, Table 1

ANNEX 2.
ICMA recommendations on transition plan disclosures

Elements	Key actions & disclosures
Transition strategy, materiality & governance	• Adopt a Paris-aligned (ideally its 1.5°C objective) and quantitatively measurable climate transition strategy and targets using science-based pathways provided by recognised third-party sources, where they exist, and disclose methodologies and scenarios used, as well as any third-party certification. • Ensure that climate transition strategy is relevant to the environmentally material parts of the business model. • Ensure effective climate governance arrangements including senior management approval of the plan and accountability, remuneration/ incentive schemes linked to the transition strategy, and necessary skills and training across the organisation. • Where relevant, consider "just transition" and disclose broader sustainability policies addressing negative sustainability impacts and trade-offs. • Position transition plan as a standalone document sitting alongside financial reporting.
Science-based targets & metrics	• Disclose GHG emissions covering all material Scopes as formulated in absolute (gross tCO2e), economic output (per net revenue), and industry-based metrics. • Adopt and disclose absolute gross (tCO2e), and where relevant, intensity-based targets for all material GHG Scopes. When only intensity targets set, disclose also the associated absolute values. • Adopt short (ideally 3 years max.), medium, and long-term targets, and in any case for 2030, from which date baselines and targets should be updated every 5 years. • There should not be any reliance on offsets except for residual (approx. 5-10%) emissions in net zero targets, in which case they should be disclosed separately and include credibility proof.
Implementation transparency	• Disclose all the relevant information on (i) planned changes to the business model, operations, products, as well as relevant policies and processes supporting those; (ii) actions for short (ideally 3-years max.), medium, and long term; (iii) planned investments, financial resources, and other financial metrics; (iv) internal carbon pricing; (v) engagement strategy and actions for value chains, with industry, public sector, and civil society. • Provide a credible link between the various levers and the transition strategy and quantify the contribution from different levers to climate objectives at least on an estimated basis. • Where relevant, disclose potential adverse sustainability impacts and mitigating actions and expenses (e.g. for "just transition").
Verification & reporting	• Obtain an external review assessing the credibility of the entity's strategy, its alignment to the referenced science-based trajectories, and its climate governance alongside any potential jurisdictional requirement required for sustainability reporting (e.g., limited or reasonable assurance). • Report annually quantitative and qualitative information on the progress against the transition plan, targets, and metrics. • Regularly update the transition plan (ideally every 3 years), and when there are significant changes.