Priorities for developing transition finance

1. The promotion of transition finance is necessary

The Chair suggested that complete sustainability requires a pragmatic approach and a gradual shift from high carbon to greener activities. In this context, the sector must develop priorities for and a greater understanding of transition finance. Transition finance can help to reduce greenhouse gas emissions and rising temperatures.

An official noted that the Spanish Treasury has a team dedicated to green finance and clear targets it seeks to achieve. The climate transition is both a necessity and an opportunity to improve competitiveness through the building of new, sustainable, productive models and to achieve strategic, European energy autonomy. Corporates should view the transition not as a burden imposed by public authorities, but as a demand from consumers. The transition should be driven by demand. Some sectors will not be able to become fully compliant overnight and will require time to develop the necessary technologies and business models and to reduce cost. Nevertheless, green transition is an optimal economic policy.

A regulator observed that the role of supervisors is to protect consumers and, in doing so, they must ensure that insurance is affordable and accessible. In the U.S., insurance availability in some regions is limited because of recent catastrophic losses and other stressors. As such, increasing premiums is no longer the answer and supervisors must seek new solutions, especially reinforcing and strengthening resilience efforts.

Forcing insurers to eliminate either coverage or investments in coal, gas, oil and other "brown" industries is short-sighted as it could have adverse effects on the economy at large, especially as the need for those fuels remains while transitioning to a carbon neutral economy. While fossil fuel and other high-risk industry participants are voicing their struggles in seeking financing and insurance, newer green technology firms are also lacking coverage as insurers consider them "too new," and potentially exposed to tail liability.

As insurers and supervisors consider a new transition they should consider green technology firms as a new customer base for the insurance sector. Pragmatism will be key to ensure that there is no domino effect on transportation, healthcare, education or food security.

In terms of the Japanese viewpoint, an industry representative highlighted that, in pursuit of decarbonisation, there must be a balance struck between transition and green technology. Funds should be provided through public and private sector collaboration. The Kishida administration in Japan issued basic guidelines on climate transition finance, clarifying sector-based roadmaps with a science-based disclosure framework while recommending how nine specific industries should transition. ¥20 trillion of climate transition bonds are to be issued in the coming 10 years. Public sector investment of this kind will induce private sector involvement. Immediate transfer from brown to green energy is not possible. There is no clear path between the two and there will be challenges ahead. Transition finance will therefore be key.

2. The challenges of transition finance and the ways forward

An official observed that the green transition is to take place in a context of increasing uncertainty. More equity financing and new sources of financing are required. Companies' transition plans must represent a change in their corporate culture, not solely be a check-box exercise. Support for small and medium-sized enterprises (SMEs) will be key, as the challenges of transition finance are compounded in such cases. The transition also imposes upon SMEs additional competitive pressures, because they must be able to integrate into the value chains of larger corporates.

Transition finance presents challenges for both business and finance actors to address. Finance providers will increasingly be required to ask SMEs for the information needed for climate reporting. SMEs will require capacity building and access to finance. Banks can play a role in accompanying their clients. The Chair added that we need to acknowledge that significant progress has been made so far, yet challenges remain in terms of the development of climate and sustainability-related financial instruments to support the transition. Such challenges must be identified and recognised before they can be addressed.

A regulator agreed that there is no clear path from brown to green energy, making the transition period all the more important. As a supervisor, the Austrian Financial Markey Authority's first consideration is the Corporate Sustainability Reporting Directive (CSRD). Transition plans are a vital tool through which financial information can be collected for publication and disclosure. Regulators, usually accustomed to overseeing and challenging such information, will be required to consider transition plans and ensure their consistency with financial reporting as a whole. A transition plan must be credible in its climate objectives. The European Securities and Markets Authority (ESMA) has useful guidelines on enforcement, but more practical approaches are necessary.

Another consideration is the Capital Requirements Directive (CRD). EBA's consultation demonstrated the difference between prudential transition plans and those plans included with financial statements. The former represent a powerful tool for supervisors. The supervisory approach to challenging key performance indicators (KPIs) will develop over time, with some preferring to see one plan with various additions. In terms of insurance, the solvency sustainability plan is included in the revised Solvency II framework. The International Organization of Securities Commissions (IOSCO) is working on transition plans in the interest of consumer protection and the Austrian Financial Market Authority is preparing its own complementary guidance in support of institutions' transition planning.

An official noted that there is a lack of consensus on the definition of transition finance. It may also include sustainable finance or focus only on the highest-polluting sectors. Transition plans must be aligned at both the corporate and sovereign level. Data standardisation will allow investors and lenders to operate on a level playing field. Many yet-to-be-transitioned assets sit on corporate balance sheets, while others sit on government balance sheets or represent contingent liabilities. These are the potential issuers of debt.

Issuers and lenders must understand what they are financing, for how long and the disclosures required. Beyond debt financing, there is the matter of equity financing. Given that investors are not providing capital for free, returns must be discussed. Such returns can be reduced only if risk is reduced. Transparency, disclosure and clarity of definition all play an important role in risk reduction and, without these factors, lenders will be reticent to be involved. Uncertainty must be resolved in a timely manner. Rating agencies and banks have roles to play in this regard.

An industry representative shared that, in Japan, around ¥150 trillion of both public and private sector investment is needed to achieve the green transition in the next 10 years. There must be a clear pathway to encourage private sector involvement and the guidelines compiled by the Japanese government are a step in the right direction. For instance, Kyushu Electric Power recently issued a transition-linked loan, targeting capex investment and utilising the interest rate subsidising mechanism issued by the government for the sector. Such initiatives are vital to ensure that transition projects are funded and that the inherent technology, development, reputational and political risks are overcome.

An official concurred that policies by which corporates' access to finance can be improved are crucial. The single market, banking union, capital markets union, equity and new financial instruments all have a role to play. The EU exports 2.5% of its GDP annually. The public sector can contribute by disseminating and promoting best practice. The Spanish administration, for example, intends to launch a green book on sustainable finance, focused on the promotion of transition finance within SMEs. A green sandbox will foster dialogue with supervisors.

The Spanish administration also plans to create a sustainable finance board, made up of relevant stakeholders, to facilitate the development of sectoral guidelines. The private sector is more aware of the technology available to support transition planning, and such awareness must be transferred to the public sector. There will furthermore be a role for the Spanish Treasury in issuing green bonds. An official noted that Hungary has been an issuer of green bonds since 2020 under the International Capital Markets Association (ICMA), though alternatives, such as sustainability-linked bonds, were considered. Governments have contingent liability towards yet to be transitioned assets and it is therefore natural for them to be involved in financing, without crowding out the private sector.

National and corporate level transition plans must align. In Hungary, the issuance of green bonds has enhanced alignment of internal processes within governmental infrastructure. There are differing political views on the topic, but transition financing would ensure that government action is institutionalised irrespective of the party in power. It is the government's task to determine how supranational development banks might play a role in transition finance, provided that there is clarity and the appropriate data.

3. Possible changes to the European sustainability framework

An industry representative stated that, though the sustainable finance framework has its merits and is relatively comprehensive, there should be a change in approach. The framework is not perfect and never will be, despite widespread awareness and continuing implementation of Articles 8 and 9. The underlying issue is highly technical and constantly changing. These factors must be taken into account in the design of regulation, with more emphasis placed on testing and learning from practitioners. Enhanced flexibility will improve the utility of regulation.

Additionally, the CSRD requires targets to be set as absolute figures, even when they are centred on intensity. Banks engaged in the Net-Zero Banking Alliance (NZBA) have intensity-based targets, which are therefore somewhat at odds with the CSRD. It is critical that sectoral guidance, such as that included in the CSRD, provides clarification and enhances utility. The CRSD is built around the double materiality assessment, a subjective process that can lead to a variety of results within the same company. Biodiversity and nature, for example, can fall under both the material and non-material classifications. Such classification determines the necessity of transition planning. There must be a discussion as to how the European framework can be adjusted.

Cross-jurisdictional consistency is needed

A regulator noted that cross-jurisdictional consistency remains a key concern for US state insurance supervisors. Any framework developed to match such a diverse market must be a living framework that can be changed and adapted as new situations arise. The National Association of Insurance Commissioners' (NAIC) has 56 member jurisdictions, each with its own challenges. So, there is no one-size-fits-all approach. The most beneficial path forward for US insurance supervisors is a broad, non-prescriptive framework that facilitates consistent but independent rulemaking in each jurisdiction. This goes hand-in-hand with information sharing and other coordination across borders.

The NAIC provides the necessary tools for that communication, online resources, dashboards, and training for its members and other interested parties. Also, the NAIC collects data across sectors to identify, monitor, and address challenges to the industry. Recently, state insurance supervisors launched a data collection effort across property markets to better understand each states' markets. That has yielded close to an 80% response rate, and once analysed, the data will provide insights into closing protection gaps (unique to each state's market) and strengthening the market as a whole.

4. How can greenwashing be addressed?

The Chair recommended that the panel consider how to address the issue of greenwashing, in order to enhance the credibility of transition planning. An industry representative agreed that certainty, transparency and credibility are essential.

A recent Association Europe Finances Régulations (AEFR) debate paper comments on the credibility of transition plans and makes 11 recommendations. The first is that there must be clear public policy upon which transition plans can be built, as per the Japanese example. Secondly, there should be one internationally consistent transition plan and transition planning guidelines. The CSRD is a positive starting point, but there are also prudential elements to consider.

Occasionally, the need for action is forgotten in favour of a focus on disclosure. Implementation must be made central, through scenario development and planning and identification and monitoring of external factors. It is not possible, nor is it useful to disclose every detail of the transition plan. Public guidelines in this space could help supervisors be certain that the planning process is sound.

A regulator added that a report produced by the three European supervisory agencies (ESA) provides a clear definition of and a starting point on greenwashing. ESMA recently published guidelines on fund names, covering both environmental, social and governance (ESG) concerns and the green transition. If a fund has 'transition' in the name, quantitative minimum requirements of 80% apply. Despite these developments, there remains no clear definition of transition finance. The three ESAs' report and the recent ESMA opinion on the SFDR underscore the need for such a definition. In the past, there was also no formalised definition of greenwashing. Another, similar initiative led by the three ESAs might provide a solution. It is vital for the elimination of greenwashing that the use of transition finance be clarified, and this is of particular importance to investors.

In terms of how national and European authorities might contribute, an official emphasised the role that the public sector should play in the setting of clear transition targets. Clarity on this should encourage investment. There must be a taxonomy defined and a common understanding reached to facilitate the creation of a reliable, credible framework.

Recent progress on reporting standards in Europe has been promising, reducing transaction costs and enhancing credibility. There are more specific policies facilitating public sector intervention, but the limited fiscal space means that such interventions must be well designed, carefully targeted and focused on the additive power of the private sector, building on its capacity to create a broader ecosystem.

5. Conclusion

The Chair noted that it is evident that clear policies, appropriate regulatory guidance and credible transition plans will be key elements in the scaling up of transition finance. There is an initial sustainable finance framework in place and Europe is playing a leading role, but there is more to be done. There are steps that need to be taken by regulators, policymakers and the financial sector and collaboration between these parties, as well as with relevant stakeholders, will be essential, both within and across borders. Where there is a will, there is a way.