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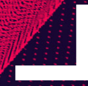
Transition Finance:
Briefing Update



This update considers the European Commission's recommendations to both businesses and the financial sector to support their adoption of transition finance.

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Introduction:

Earlier this year Baker McKenzie published a **briefing** on the progress of transition finance looking at the opportunities and challenges for financial institutions. This update considers the European Commission's **recommendations** to both businesses and the financial sector to support its adoption.

In Detail:

Setting the scene

To meet the goals set out in the EU's European Green Deal, compared to the last decade, additional investment of EUR 700 billion annually is required in the 2020s, the majority of which needs to come from private funding. To this end, the Commission has updated its sustainable finance package first published in 2018. While this contains new measures such as environmental additions to the EU taxonomy and a proposal to regulate ESG ratings providers to improve their quality, it focuses on improving the usability of the existing regime. Transition finance is front and centre with the Commission publishing voluntary recommendations aimed at businesses, financial intermediaries and investors on how to use the tools already available under the EU Sustainable Finance Action Plan to best align economic activity with the transition to net zero emissions by 2050.

Transition finance: Increasing awareness and making it work on the ground

The Commission recognises that the legislative and rule-making sprint of the EU in recent years may have overburdened businesses. Despite efforts internationally to promote transition finance, take up has been slower than hoped for. There is a reluctance in some quarters to use and embrace the transition finance label. This is not just because sustainable (green) finance is a more familiar concept, but over concern about greenwashing allegations should transition plans be found wanting or insufficiently credible. Nor has the absence of a common definition of transition finance helped in this regard, a point which the recommendations now seek to address. For this reason, these new recommendations (relevant to both climate and environment transition) do not impose any further obligations but try to increase awareness and educate the market (including supervisory authorities) to boost adoption. They also serve as a reminder that finance to transition is available from green or sustainability-linked bonds and loans to equity financing and specialised lending. In this regard, the recommendations give practical examples on transitioning using the EU's sustainable finance toolkit. Although they are non-binding, and we are told that businesses may disregard them if they so choose, nonetheless they provide helpful practical guidance.

Proportionate approaches

Transition finance is for businesses that aim to become sustainable but require time, adaption and investment to do so. It is the "process by which undertakings translate their environmental and climate ambitions into actions…". Typically, these are companies from high emission or hard-to-abate sectors of the economy such as aviation, steel and cement. To emphasise this point, the Commission explains that sustainable finance is not just for those businesses with the highest sustainability credentials but as it diplomatically states "those with different starting points that have clear sustainability targets." Moreover, the Commission is mindful of the administrative burden and wishes to help smaller companies by acknowledging more "proportionate approaches" than, for example, the need to draw up fully-fledged transition plans. This is apparent from the definition of transition finance used in the recommendations being the "financing of investments compatible with and contributing to the transition . . . including investments in:

- portfolios tracking EU climate transition benchmarks and EU Paris-aligned benchmarks.
- taxonomy-aligned economic activities.
- undertakings or economic activities with a credible transition plan at the level of the undertaking or at activity level.
- undertakings or economic activities with credible science-based targets, where proportionate, that are supported by information ensuring integrity, transparency and accountability."

A credible and testable transition plan is important but there are other approaches as set out above. EU climate transition benchmarks are especially relevant when designing portfolios with decarbonisation objectives, and science-based targets can be deployed for highly impactful economic activities which are not yet covered by the EU Taxonomy, where there are no low impact alternatives.

The EU Taxonomy as a transition finance tool

The recommendations (and **annex**) explain that the EU Taxonomy can be used not only to disclose taxonomy-aligned activities and capital expenditures, but to define transition targets and to identify the finance required to meet them. According to the Commission, the EU Taxonomy may be employed as "a forward-looking tool … using [its] criteria as reference points for setting targets." Additionally, it can also be a measuring tool to compare current with planned environmental performance and a communication tool to articulate transition finance needs. As the EU Taxonomy refers to environmentally sustainable economic "activities" and not "undertakings", businesses may transition gradually by increasing their share of such activities.

Given that many transitioning businesses will be in high emission or hard-to-abate sectors, the Commission accepts that in the short term any improvements may not achieve green performance targets.

Over the long term, however, if aligned with the EU Taxonomy, relevant economic activities will be considered either green or low impact with the disclosure and reporting advantages this entails. This approach recognises that not all technologies necessary for a sustainable economy are yet in place.

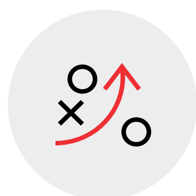
To see how this works in practice let us look at some examples. Investments (capex) in so-called transitional activities (i.e., investments in the best available technologies) are capable of recognition as taxonomy-aligned, provided they do not cause long-term carbon intensive lock-ins or prevent the development of greener technologies. These are economic activities where no alternative technology currently exists and where the performance is on a transition path to climate neutrality in the future. However, they must be reviewed every three years to take account of new technologies and fresh scientific evidence.

Also, investments made to reach taxonomy alignment in five (or exceptionally 10) years can be recognised as capital expenditure that is fully aligned with the EU Taxonomy, if accompanied by a capital expenditure plan (a form of activity-level transition plan). Where taxonomy alignment over this timescale is not achievable, it is still open to businesses to align an asset or economic activity with taxonomy performance criteria over a longer period, provided they develop an activity-based transition plan that justifies the additional time and explains how taxonomy alignment will be achieved. In this case however, capex would not be taxonomy aligned, but it would be a first step. Businesses should of course be transparent over their planned capex and opex to deliver their proposed climate transition strategy.
Additionally, for activities which do not satisfy the "do no significant harm" (DNSH) criteria in the EU Taxonomy and, where investment will not make a substantial contribution within a 5 (or 10) year horizon, businesses may seek to improve their environmental performance beyond levels defined by the DNSH criteria. Again, an activity-based transition plan could be drawn up explaining the position and how taxonomy alignment will be reached in due course.

Credible transition plans

In the EU, transition plans remain voluntary. The Commission points to their emergence as one of the key tools that businesses can use to set targets and anticipate financing needs and, in this respect, the disclosure obligations in the Corporate Sustainability Reporting Directive provide a convenient framework. In due course, it will be compulsory to adopt such plans under the proposed Directive on Corporate Sustainability Due Diligence that is currently in trialogue with the co-legislators. In comparison, in the UK, the rules for listed companies and large regulated asset owners and asset managers require disclosure of transition plans as part of their Task Force on Climate-Related Financial Disclosures-aligned disclosures, initially, on a comply or explain basis.

In our earlier briefing we discussed the key criteria behind the credibility of any transition plan. The Commission for its part suggests that this can be strengthened by adopting a structured set of short-, medium- and longer-term targets and actions. Additionally, by identifying and allocating sufficient resources and, finally, by avoiding long-term carbon lock-ins to greenhouse gas intensive or environmentally significantly harmful activities. Banks contemplating providing finance should be especially mindful of transition and physical risks along with the relevant provisions in the Capital Requirements Directive. Businesses are encouraged when planning their transition to set transition targets based on relevant transition **pathways** developed by the Commission for various industry sectors.



Interoperable international rules

Uncoordinated ESG regulation can create barriers to cross-border investment and finance. UK Finance has recently made a **call** for coherent and interoperable international rules to promote a sustainable transition. Encouragingly, the recommendations build on leading global initiatives for transition finance, such as the OECD **guidance** and, therefore, should meet international market practice facilitating cross-border operations.

Future developments

On the horizon, businesses and financial institutions should be mindful of the advice under preparation by the European Banking Authority and further work by the Platform on Sustainable Finance – the expert group which advises the Commission on the EU Taxonomy – on identifying relevant market practices. We should also expect the Commission to increase its engagement with international stakeholders and authorities to increase the take-up of transition finance and improve the interoperability of international standards.

International co-operation continues with the development of detailed transition plan recommendations suitable for incorporation into regulatory frameworks. These include initiatives involving the UK's Transition Plan Taskforce, the Glasgow Financial Alliance for Net Zero and the International Sustainability Standards Board (ISSB). Many jurisdictions are likely to follow the ISSB's sustainability-related reporting **standards** (published in June 2023) which will act as a global baseline.

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