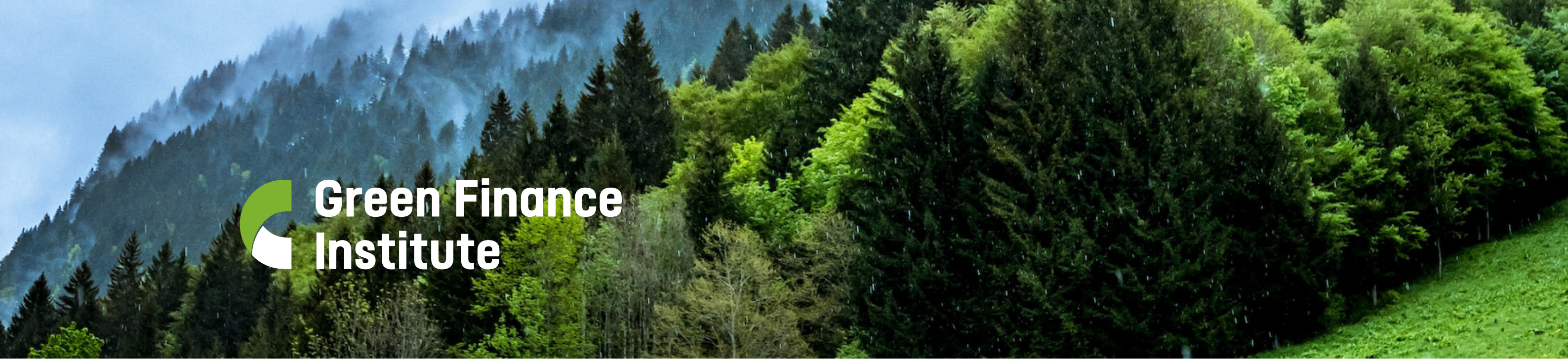
DECEMBER 2023

Green Finance Institute

# Transition Finance:
## New asset class or emperor's new clothes?




*By: The Green Finance Institute*

*Imprecise use of language and mismatched expectations and understanding have been a driver of greenwashing (and green hushing) in the ESG space for years. While transition finance has been a useful umbrella term to engage and inform financial institutions on the multifaceted nature of the global transition, rapid action now needs to be taken to sharpen up the use of the term. Terminology and definitions matter – and if transition finance is to avoid becoming the next frontier of greenwashing, and instead be used as a means to help close the net zero financing gap, clarifications are needed sooner rather than later. First, we propose finance going to companies and assets that are already net zero aligned should be simply labelled green, supported by reporting on levels of green taxonomy alignment. Second, and at the other end of the spectrum, we propose fossil fuel asset-decommissioning finance is excluded from transition finance and instead, an authoritative and science-driven 'non-green list', be established.*

*The term 'transition finance' should only be applied to corporate finance for companies that are credibly and demonstrably transitioning. To be eligible to access this type of finance they should be required to meet very robust transparency requirements, including publishing credible and assured Transition Plans and targets, and green taxonomy reporting. 'Claw back-style' clauses should be included in the T&C of transition finance provided – expressed as a contingent higher cost of borrowing to reflect increased risk in the event the client rows back on delivering its net zero commitments without reasonable cause.*

*All firms whose revenues come predominantly from fossil fuel sales should be excluded from accessing transition finance because of the risk of high carbon lock in. Instead, asset based green finance or ring-fenced finance for fossil-based asset decommissioning can be made available. However, of all the different types of finance discussed here, green finance - for companies and assets that are already net zero aligned – is the one that needs to most urgently scale and should be the priority focus for financial institutions. Ways and means are discussed in the sister deep dive briefing note: What next for risk sharing?*

This paper was developed as an output from the inaugural Finance Day at London Climate Action Week 2023, delivered in partnership with:

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# The opportunity

To avoid the most extreme effects of a changing climate, the global economy needs to transition away from one reliant on fossil fuels to one that deploys clean technology and nature-based solutions and services. The most recent Intergovernmental Panel on Climate Change (IPCC) Assessment Report – AR6, produced in 2022 – noted that without immediate and deep emissions reductions across all sectors, limiting global warming to 1.5°C is beyond reach.

This means – in simplest terms – investing in green technologies in order to replace and retire those causing climate change. In practice these emission cuts mean transitioning the economy away from one based on fossil fuel extraction and burning and nature degradation. Instead, we need clean technologies (existing and in development) and nature restoration, including re-establishing nature-based carbon sinks like forests and a range of other more durable carbon removals to tackle hard to abate sectors like agriculture.

Estimates of the increase in investment needed vary but, as a guide to the scale of the increase needed, BloombergNEF has found an average ratio of 4:1 of investment in low carbon versus fossil energy supply will be required by the end of the decade to limit global warming to less than 1.5°C (compared to the 1:1 ratio of investment today). McKinsey & Company analysis estimates that around $800bn in annual expenditures will be required between 2026 and 2030 to reduce emissions in the agriculture, forestry and other land use sectors[1].


There are now options in all economy sectors to at least halve emissions by 2030[2]. And in some, where the transition is further advanced, solutions are already cost-effective and getting cheaper. Since 2010 there have been sustained decreases of up to 85% in the costs of solar and wind energy, and batteries – all of which sit firmly on accelerating learning curves. Electrolysers – key to producing hydrogen and fuel cells – are set to join in seeing steep cost reductions. An increasing range of policies and laws have enhanced energy efficiency, reduced rates of deforestation and accelerated the deployment of renewable energy.

1. https://www.mckinsey.com/capabilities/sustainability/our-insights/the-net-zero-transition-what-it-would-cost-what-it-could-bring
2. AR6 report at https://www.ipcc.ch/assessment-report/ar6/


# The next few years are critical

We are at a crossroads. These successes now need to be replicated in other sectors – with the market and the public sector working together. As Jim Skea one of the authors of the AR6 said: “It’s now or never, if we want to limit global warming to 1.5°C. Without immediate and deep emissions reductions across all sectors, it will be impossible.”

In this context, the efficiency and equitability with which the transition is delivered really matters. Clarity of purpose and approach will be required to pull this off. This is being jeopardised by the loose use of language – in particular in relation to the term “transition finance” - which in some circles is being used in an increasingly generic and imprecise fashion to mean finance provided to any business embarking on a journey to become greener.

Lending to a company or an asset that should be transitioning is not the same as actually financing that transition – and yet a lot of transition finance only clears this very low hurdle.

Oil and gas companies, for example, should be transitioning but that doesn’t mean they are. As an example, The Guardian reported that in 2021, after receiving a £430m green transition loan, the international engineering company Wood Group grew its upstream oil and gas business by 17% so that it accounted for more than $3bn in revenue in 2022, up from $2.6bn in 2021. Over the same period, the Guardian reported, the company reduced the size of its renewable, hydrogen, and carbon capture business units by 35% so that they only accounted for revenues of $222.8m in 2022, down from $344.6m in 2021.

# Language matters

This issue of loose use of language as a way to justify BAU lending to companies that should be transitioning but are not is increasingly in the spotlight. In September 2023, the Glasgow Financial Alliance for Net Zero (GFANZ) Secretariat launched a consultation on its work to further refine the definitions of its transition finance strategies and support financial institutions to forecast the impact of these strategies on reducing emissions. At COP28 in December 2023, a technical note setting out 'voluntary, non-binding technical information for financial institutions to consider if they choose to incorporate the four key transition financing strategies in their net-zero transition plan' followed. This note identified five principles commonly found in climate change guidance that support the credible analysis of Transition Finance and quantification of decarbonisation contribution, summarised as:

- Be transparent and verifiable
- Link to net-zero transition
- Be consistent over time
- Balance conservativeness with science-based input and practicalities
- Support action in a timely manner

The concept of 'transition finance' - as these five principles suggest - recognises that the green transition is a complex process. As investment into renewables and zero-carbon infrastructure scales, other activity that is not yet net zero will also need to access finance to support its transition journey (to green operations or phase out). As GFANZ recognises, "consistent definitions of Transition Finance and well-developed mechanisms to capture decarbonization potential may help to close the funding gap." The trick – however - will be not to lock in high carbon pathways/risk unnecessary asset stranding. This is why clear and useful definitions, particularly in relation to the second bullet point 'link to net-zero transition' - matter so much.[4]

3. https://www.gfanzero.com/press/gfanz-delivers-on-the-year-of-the-transition-plan-with-continued-growth-and-progress-to-close-key-gaps-in-the-global-financial-system-and-accelerate-climate-investment/
4. https://www.gfanzero.com/press/gfanz-delivers-on-the-year-of-the-transition-plan-with-continued-growth-and-progress-to-close-key-gaps-in-the-global-financial-system-and-accelerate-climate-investment/

In 2022 GFANZ had set out four strategies necessary for financing a whole economy transition to net zero financing strategies; these were defined as:

1. Climate Solutions: The development and scaling of climate solutions;

2. Aligned: Assets or companies already aligned to a 1.5°C pathway;

3. Aligning: Assets or companies committed to transitioning in line with 1.5°C-aligned pathways; and

4. Managed Phaseout: The accelerated managed phaseout of high-emitting physical assets.

This is a logical demarcation as we do need to finance all of these to hit net zero. However, **categories (1) and (2) are also – simply stated – green finance for companies and assets that are already green. Bundling them under a transition finance banner while academically correct is confusing and therefore unhelpful. We propose these categories be dropped from the transition finance lexicon.**

**The real challenge lies in delivering credible solutions around categories (3) and (4), notably around advancing finance to entities that are not yet net zero but aspire to be.** This where clear governance, definitions, reporting and compliance requirements will be helpful, as are emerging through taxonomies for green assets, to ensure transition finance does not become the next frontier of greenwashing.

The greatest care of all needs to be taken when providing category 3 finance, which we propose should be the only type of finance carrying the label 'transition finance' and should explicitly not be made available to fossil fuel producers and potentially also distributors (with some carve outs where existing infrastructure can be converted for net zero-aligned uses e.g. biogas).
**For these firms - the bulk of whose revenues are drawn from fossil fuel extraction and distribution - one can only conclude that whole-company transition is no longer likely or credible in a world where global warming is limited to 1.5°C so going forward any transition-related finance needs to be limited to either asset-based green finance or ring-fenced finance for fossil-based asset decommissioning.**

**Category 3 should be out of scope for these companies since it is fraught with greenwashing risk.** This risk was set out in an article in Bloomberg published earlier this year. It notes that at an investor event in June, Shell set out an updated strategy that included cutting costs and doubling down on profit drivers like oil and gas. Bloomberg went on to say that what was omitted was any mention of the Shell's prior commitment to spend up to $100m a year on a pipeline of carbon credits, part of the firm's promise to zero out its emissions by 2050. Bloomberg also went on to state the company had confirmed goals for the offsets program had been retired, along with the plan to harvest 120 million carbon credits annually by the end of the decade from projects that sequester carbon with trees, grasses or other natural resources. Finally, the Bloomberg article also asserted that no mention was made at the investor event of a target to reach 500,000 EV charge points by 2025 and to have at least 10% share of global clean hydrogen sales[5]. A review of Shell's Capital Markets Day pack from June 2023 appears to confirm these points[6]. More importantly, any financial institution that might have advanced 'transition finance' in this context would now surely have to consider recategorising it.

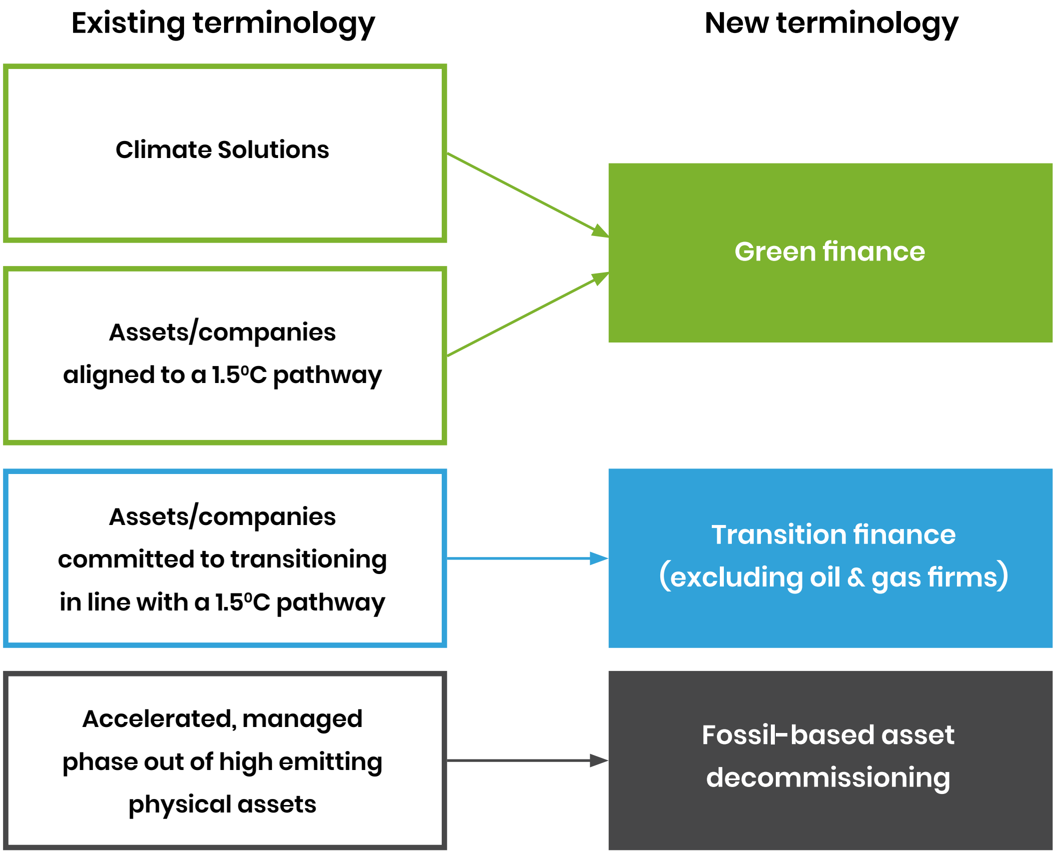
It is true there are examples of successful transitions within this industry: Orsted was once one of the most fossil fuel-intensive companies in Europe. Today it is a global leader in the transition to renewable energy. But the transition began more than 10 years earlier – and, at this point in market development[7] - seems a feat that will be a very significant stretch for other incumbents in the sector given the IPCC AR6 has stated emissions need to roughly halve on 201 levels by 2030.

**Category 4 is relevant and needs to be underpinned by an authoritative and dynamic list of asset types that fall into this category. This list, which GFANZ would be well placed to deliver, should be market-led and scientifically underpinned by IPCC data - rather than through current governments' policies, which in many cases are not aligned with delivering a 1.5°C future. We propose this should be renamed, simply, fossil fuel asset-decommissioning finance.**

For other firms at the forefront of the transition – aviation, auto, steel, cement, plastics and so on - whose products are still needed in the future net zero economy but the means of production needs to be decarbonised – categories 3 and 4 are both relevant and useful. However, for the term 'transition finance' to be useful and endure, we need a much a higher burden of proof moving from '*should be transitioning*' to '*is transitioning'.*

5. https://www.bloomberg.com/news/features/2023-08-31/shell-silently-abandoned-its-100-million-a-year-plan-to-offset-co2-emissions?srnd=green
6. https://www.shell.com/investors/investor-presentations/capital-markets-day-2023/_jcr_content/root/main/section/simple/text_1695238364_copy_695577015.multi.stream/1694678244041/8f8d13cd003263a1a8ba2272021140a460ee691c/CMD23-slides.pdf
7. It is worth noting the market cap of the largest renewables energy companies globally now matches that of incumbents such as BP, if not yet ExxonMobil or Shell.

## Proposed reallocation of GFANZ transition finance labels




To be eligible to access transition finance we propose very robust transparency requirements. Creating the conditions for this to happen effectively will require the emerging regulatory framework to develop at pace and be credible. Robust 1.5°C-aligned transition plans are crucial but need to be focused on net zero outcomes in absolute terms. This includes having audited net zero Transition Plans with short, medium and long term science-based targets, including net zero by 2050 at the latest. These need to be supported by strategic plans that clarify how these goals will be delivered and underpinned by green taxonomy-based reporting across both capex and revenues/turnover to objectively measure progress in achieving these goals. Decommissioning dates for fossils-based assets should also be stated. A robust transition plan will be honest about the market and regulatory dependencies that may stand in the way of their full realisation – and their remedies, which should be furthered through engagement with clients, customers and policy-makers. Disclosures need to be machine readable and comparable across jurisdictions to reduce labour and cost.

# Governance frameworks are emerging but need to develop faster

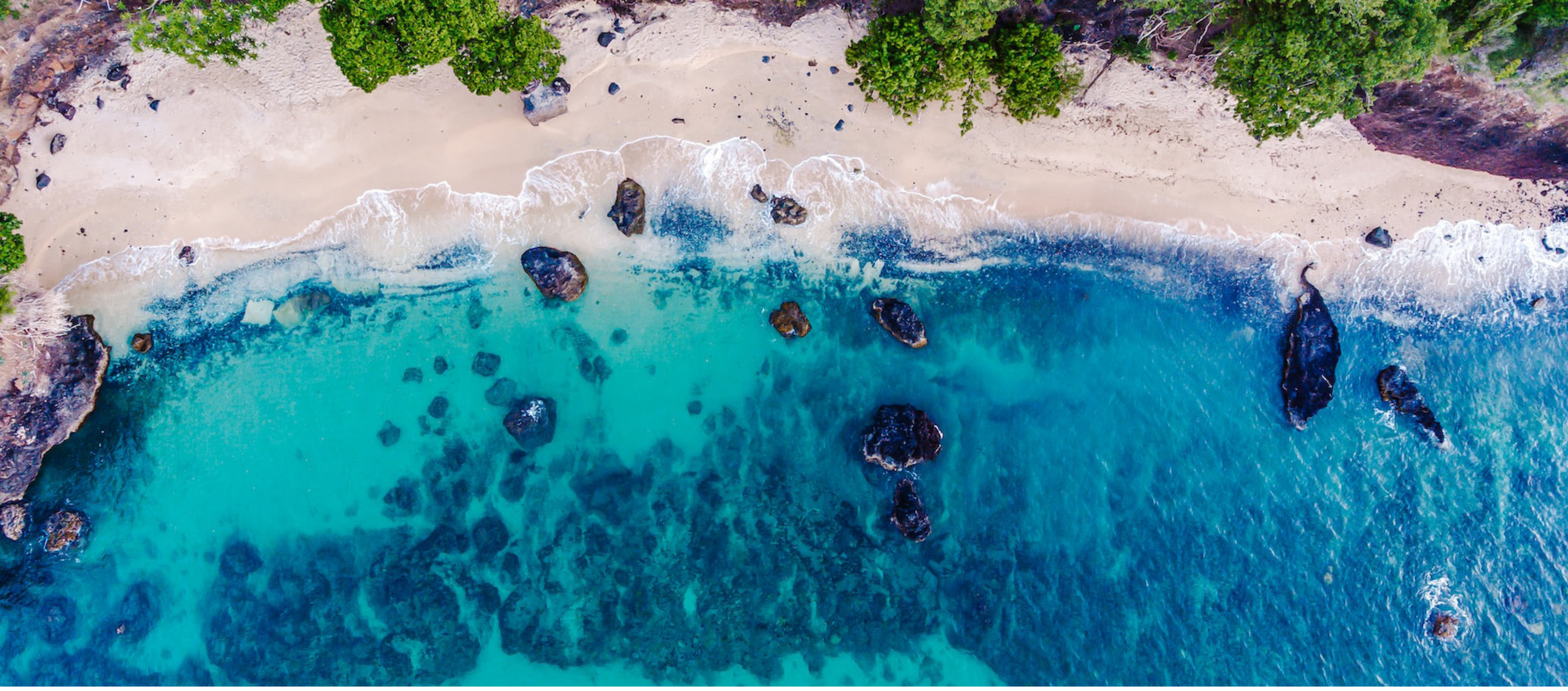
Creating the conditions for this to happen effectively will require the emerging regulatory framework to develop at pace and be credible. Attempts are being made to codify what a well-articulated transition plan for a company should look like. The frontrunner initiative, the Transition Plan Taskforce (TPT), is the most comprehensive to date and is a very welcome development. However, even this flagship initiative does not have a time and outcome-bound scientific endpoint (net zero by 2050) reporting entities must focus on working back from to deliver. Instead, the weaker ambition framing of: "Contribute to and prepare for a rapid and orderly economy-wide net zero transition," has been adopted.[8] In addition, the plans do not become mandatory until 2026, a timeline that urgently needs to be brought forward.

> Taxonomies are being introduced across the globe - 47 to date

Taxonomies are being introduced across the globe - 47 to date – the UK now urgently needs to publish its own and in doing so create a route to resolving usability issues identified in the market. This includes introducing useful and usable KPIs that enable corporates and financial institutions to report levels of revenue-based and capex-based taxonomy alignment – providing all important forward-looking climate-related financial disclosures the market seeks[9].

From the foundations of robust governance requirements, standardised terms & conditions can be developed by finance providers to ensure the capital provided underpins tangible contributions towards the transition to a net zero economy. In the banks, staff need to strengthen skills in interpreting the information provided by corporate clients on their transition plans. The focus should be on appropriate due diligence to assess the integrity of the proposed transition pathway (even if already assured) and opportunity but also its dependencies, responding appropriately in terms of the finance provided and the incentives and conditions attached to it.

8. https://transitiontaskforce.net/wp-content/uploads/2022/11/TPT-Disclosure-Framework.pdf
9. REPORT (greenfinanceinstitute.com)



As a pertinent aside, the story at BP underscores the need for greater due diligence capability within banks seeking to provide transition finance. In March 2023, BP lowered its scope 3 2030 emission reduction targets from 35-40% to 20-30% on 2019 levels. This was only nine months on from shareholders voting through the original emission reduction target. While the impact of this change in target will be offset – as BP states – by BP's decision to exit Russia following its invasion of Ukraine (forfeiting 1.1m barrels of oil/day of Rosneft production), it has led investors to cite significant governance concerns over the move. The complexities of making a call on this are further illustrated by BP having at the same time increased the capital committed to bioenergy, EV charging, hydrogen, renewables and power from $5bn in 2030 to $7-9bn.[10]

To mitigate against the risks of clients rowing back on net zero commitments without reasonable cause, 'claw back-style' clauses should be included, expressed as a contingent higher cost of borrowing to reflect increased risk. Guidance on such reasonable causes would be a valuable undertaking as part of a transition finance review.[11] Further, to price such risks - and transition finance in the round - properly, banks, asset managers and insurers need to embed a sophisticated understanding of climate risks and opportunities. All credit officers will need to understand how to factor climate risks into models. The way in which banks and insurers engage with clients is critical. Across these firms, the new business opportunities the transition brings need to be front of mind – as does clarity on what point business is turned away/relationships exited if insufficient progress is being made – which should be reassessed on at least a six-monthly basis, for transitioning firms.

10. https://www.bp.com/content/dam/bp/business-sites/en/global/corporate/pdfs/investors/bp-net-zero-progress-update-2023.pdf
11. https://www.bp.com/content/dam/bp/business-sites/en/global/corporate/pdfs/investors/bp-net-zero-progress-update-2023.pdf

# Climate solutions and green finance have to be the priority

There are very real questions about whether the debate about transition finance has been nothing more than an academic distraction at a time when the focus should be on prioritising the development of a new client base and revenue streams from financing the new climate solutions and business models critical to delivering a 1.5°C future (green finance). The debate now needs to be put to bed. Really, in our view, it's simple: there is green finance, there are green companies, there is fossil fuel asset-decommissioning finance and there is transition finance – tightly defined and controlled finance made available to firms that can credibly and are genuinely attempting to transition their businesses to be net-zero aligned.

Winning the fight against climate change will not happen while the best minds in the international community fret about the transformation of individual, highly polluting (and often influential) old economy companies. We now need to end the debate by bringing clarity as swiftly as possible and create space for the ingenuity and skills of the capital markets to be brought to bear to understand the new technologies and new business models that are needed to transform our global economy and more importantly how to finance them. Anything else is greenwash.