



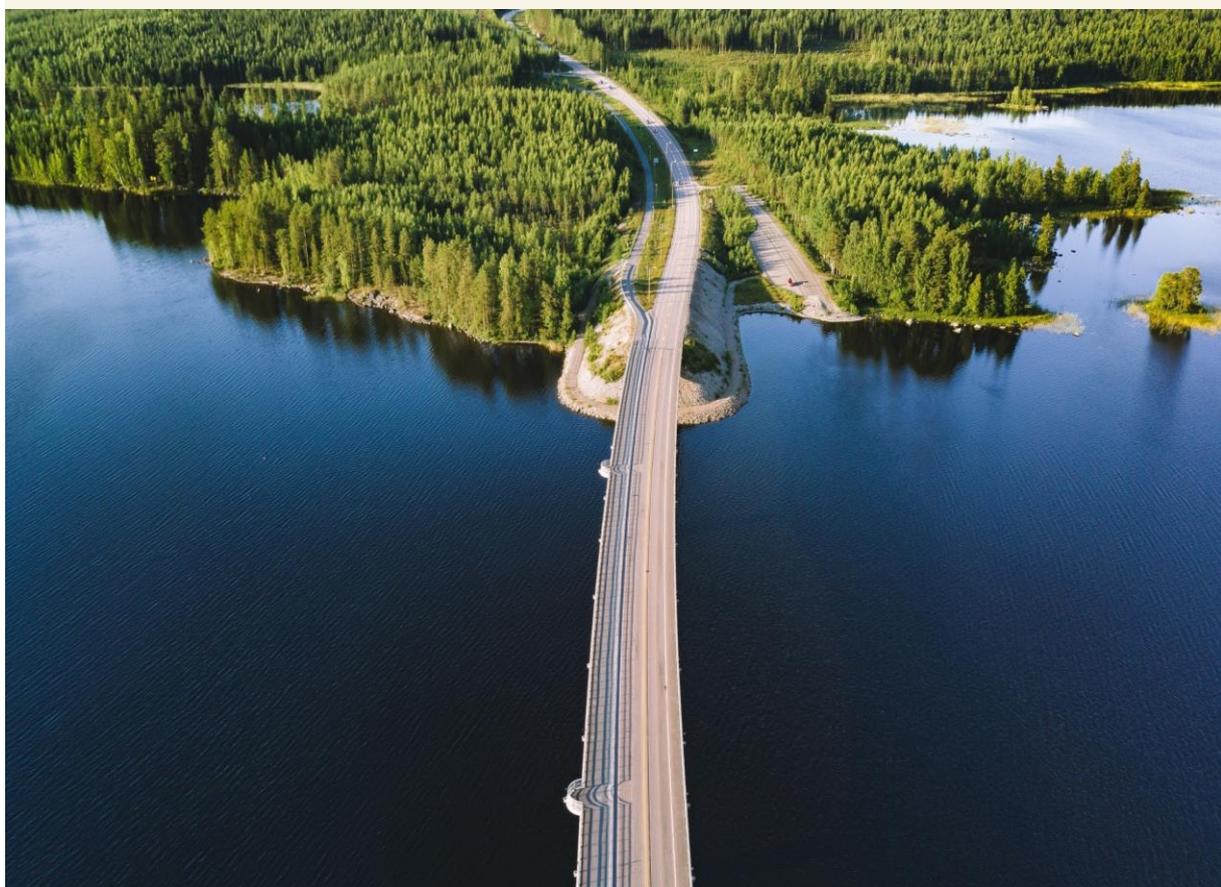
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REPORT NOVEMBER 2022

ACHIEVING A TRANSITION FINANCE FRAMEWORK IN THE EU

HOW TO ACCELERATE FINANCING FOR THE LOW-CARBON ECONOMY

**PIETRO CESARO, TSVETELINA KUZMANOVA, PIERRE GARRAULT,
JOHANNES SCHROETEN, JUREI YADA**





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E3G is an independent climate change think tank with a global outlook. We work on the frontier of the climate landscape, tackling the barriers and advancing the solutions to a safe climate. Our goal is to translate climate politics, economics and policies into action.

E3G builds broad-based coalitions to deliver a safe climate, working closely with like-minded partners in government, politics, civil society, science, the media, public interest foundations and elsewhere to leverage change.

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EXECUTIVE SUMMARY

The transition of the EU economy to climate neutrality is challenging and requires unprecedented investment. A just and equitable transition depends on finance flowing in directions that enable a low carbon future. This includes “transition finance”, for activities that are not “green”, but are in the process of becoming green.

Public and private actors at all levels need to work together to build a robust transition finance framework. A framework must incentivise both finance and businesses to develop transition pathways that match the targets in the European Green Deal. However, initiatives at the EU level are currently fragmented, creating regulatory uncertainty and hampering progress. This report explores how we can achieve an effective transition finance framework in the EU.

Chapter 1 identifies how the EU can move towards a coherent policy framework for transition finance by:

- > Establishing a common vision and understanding of what transition and transition finance mean at various levels and among different stakeholders, including recommendations for how to do this.
- > Articulating high-level principles for what transition finance is to guide policymaking and private sector efforts.
- > Identifying a governance structure for the EU transition that can be integrated into existing governance architecture without overlaps. Such a framework should bring coherence and coordinated action on the ground.

Chapter 2 looks at how public and private finance EU policies can optimally interact in a holistic transition finance framework. In particular, it looks at how public and private finance can leverage each other and makes concrete policy recommendations. A smooth and equitable transition depends on public investment and market interventions that are dynamic, to maximise their effectiveness and drive the transition forward. In this context, approaches such as mission-oriented investments that can leverage public and private collaboration can be a way forward.



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Chapter 3 examines the political narrative of the broader regulatory ecosystem. It examines how the EU could find support and consensus internally in order to both create and implement a successful transition framework, and to also drive developments globally. Creating awareness of the risks and opportunities of the transition will help secure support. The chapter also notes emerging global trends that will create uptake and support for a transition finance framework in the EU, and how the Union could navigate these developments.

Recommendations

The European Commission should adopt a set of high-level principles which provide a core European vision for transition finance.

- > These principles should define what transition finance is, in the context of existing EU transition policies. Transition finance investments should have an objective of climate neutrality by 2050 and should demonstrate additionality. They should enable de-risking while avoiding carbon lock-in effects, contribute to phasing out exposures to environmental risks, and refer to sectoral transition pathways.
- > Transition finance principles should also set out what a good transition plan looks like at EU, member state, sector and entity level. Transition plans should support the credibility of transition pledges. They should ensure accountability against these pledges by including timebound and target-based interim steps with strong monitoring processes, and by minimising reliance on offsets.
- > The European Commission should convene an EU-wide multi-stakeholder group to define transition finance. The membership should reflect the multiplicity of transitions across sectors and at EU and member state levels.
- > The Commission and member states should ensure that transition finance principles align with broader work from the G20 Sustainable Finance Working Group, the OECD and other international venues.



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EU institutions and member states should address both public and private sectors, to leverage their respective contributions to transition finance more coherently and to maximise synergies.

- > **Public finance:** the European Commission and member states should design EU-wide and national sectoral transition pathways and build links between transition planning and access to public support. This support could take the form of de-risking projects, co-financing models and technical support for progressive private actors committing to transition. EU institutions will need to adapt existing public funds to drive the transition, building ad-hoc funds dedicated to these objectives. Member states will need to modernise public procurement rules to support investments in line with net zero.
- > **Private finance:** EU institutions and supervisory authorities should mainstream transition planning and ESG data disclosure by private actors across financial regulations. EU institutions and authorities should make sure that data is easily accessible through a single access point. Use of ESG data by third parties (such as data providers) should be examined. Transition finance will also need clear top-down policy signals from the European Commission and member states that contribute to market-building. For example, extending the EU Taxonomy to include “amber” and “red” activities or designing criteria for sustainability-linked financial instruments to finance transition activities.

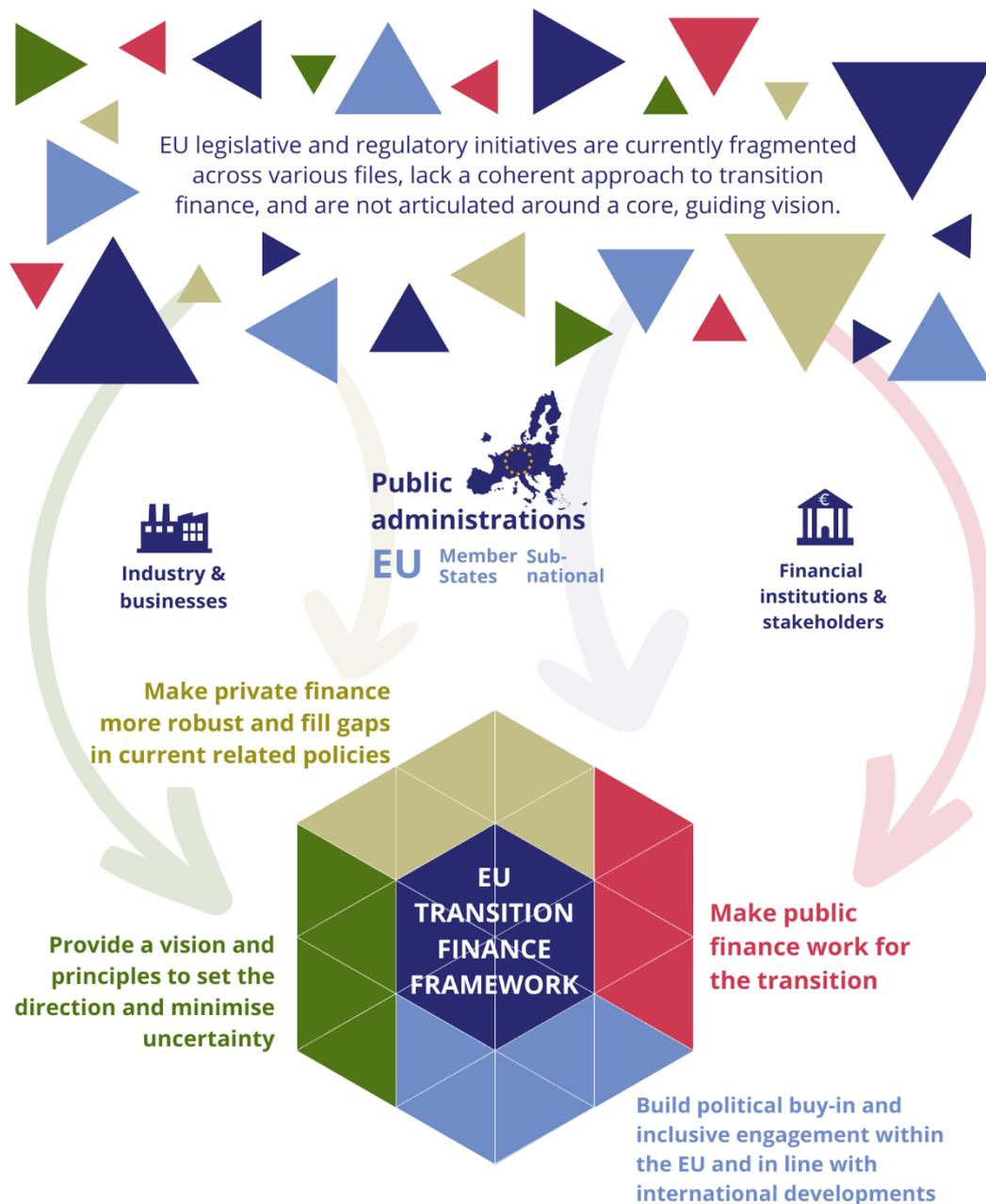
The European Commission should develop a domestic and international narrative and stakeholder engagement plan around its vision and approach to transition finance. This will build the political support and international alignment necessary to implement a comprehensive transition finance framework with multiple benefits for European businesses and society.

- > Political narratives will raise awareness, build understanding of the elements of the transition finance framework, create support for its uptake and streamlining across stakeholder groups, and facilitate its integration at different levels of decision-making. Adopting and mainstreaming such a framework will grant Europe early-mover advantages in terms of avoiding physical and transition climate risks. It will also gain a competitive advantage and international political leadership on the transition towards net zero.



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Figure 1. The need for a robust EU transition finance framework.



A robust EU transition finance framework that effectively coordinates and incentivises both finance and businesses to develop their own transition pathways within the political targets of the European Green Deal.



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INTRODUCTION

Europe faces an unprecedented crisis. The Russian war in Ukraine and the ensuing struggle to disentangle European reliance on fossil fuel imports have exposed major vulnerabilities of the European economy. With supply chains disrupted and inflation accelerating, the EU is on the brink of a recession. Transitioning the economy to climate neutrality is now as much a matter of security for the EU, especially for its eastern member states, as it is a question of economic competitiveness, creating new markets and geopolitical partnerships.

In this crisis, the EU needs to hold firm to its climate policy ambition, outlined in its Green Deal. The transition of its economy to climate neutrality offers a challenging but ultimately necessary path to ensure Europe's resilience and competitiveness and to sustain living conditions.

At the same time, the world is on the brink of an energy revolution. Recent reports suggest that renewable energies are even more economically favourable compared to fossil fuels than initially predicted.¹ This will have profound impacts on global markets, production, and societies at a speed that will cause significant disruption to the European economy.

The transition of energy, mobility, industry, housing, and agriculture – in short, the backbones of Europe's economies and societies – will not come about without disruptions. It requires unprecedented investment; estimates range between €260² and €300³ billion a year. Managing the transition so it is as smooth and just, but also as determined as possible, is key to maintaining social cohesion in Europe and leaving no-one behind. Success will depend on the EU's ability to materialise the necessary investments into the transition in times of rising capital costs and squeezed supply chains.

The transition challenge therefore requires smart and deliberate finance articulated around a coherent understanding of the transformation process ahead. Approaches to finance must recognise the value of investing now into

¹ Ives, MC, Mealy, P, Doyne Farmer, J, **Empirically grounded technology forecasts and the energy transition**, *Joule*, vol. 6, p2057

² PWC, **The EU Green Deal**

³ Bruegel, January 2020, **A trillion reasons to scrutinise the Green Deal Investment Plan**



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projects that will form the backbone of the European economy in just 20 years' time.

In this context, it is necessary to look at how financial flows can be channelled toward just and equitable transitions. This means understanding how to mobilise finance for economic activities and models that are not “green” under existing EU sustainable finance regulations, but are transit options towards lower-carbon options. We term this “transition finance”.

A central aspect of managing the transition is a financial system that can adequately project the dynamic process of becoming climate neutral by 2050 into investment decisions. The EU has made this clear in its Strategy for Financing the Transition to a Sustainable Economy.⁴ It must now move forward in achieving the necessary conditions to advance transition finance. This is necessary to minimise the future economic disruptions that the transition implies – and seize the opportunities associated with being an early mover in this space.

Yet currently, legislative and regulatory initiatives are fragmented across various files, lacking a coherent approach. They are not mutually articulated around a core, guiding vision of the nature and place of transition finance in the EU's financial regulation and the economy. This creates regulatory uncertainty across private and public markets, which hampers the progress of the transition. It also fosters continued fragmentation and overlaps between pieces of EU legislation, ultimately leading to additional regulatory and administrative burdens.

Public administrations at European, national, and sub-national levels, together with industry and finance, need to develop a common understanding of the transition and its implications for the European economic model. This can be achieved through a robust transition finance framework that effectively coordinates and incentivises both finance and businesses to develop their own transition pathways within the political targets of the European Green Deal.

This report looks at how we can achieve such a framework at the EU level.

⁴ European Commission, 2021, [Strategy for financing the transition to a sustainable economy](#)



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CHAPTER 1

“TRANSITION FINANCE” IN THE EU: MOVING TOWARDS A COHERENT FRAMEWORK

The status of transition finance in the EU

What is transition finance?

“Transition finance” refers to a relatively new set of tools and approaches emerging in sustainable finance and gaining traction in the EU and across the world. The OECD defined it as a financing approach that “focuses on the dynamic process of becoming sustainable, rather than providing a point-in-time assessment of what is already sustainable, to provide solutions for a whole-of-economy decarbonisation”.⁵ Contrary to green finance, transition finance intends to allocate capital to companies and activities that are not “green” but are in the process of “becoming green” (and therefore lowering their exposure to transition risks⁶), emphasising both inclusiveness and environmental integrity to avoid greenwashing.

The latest report from the G20 Sustainable Finance Working Group presents a set of high-level principles for transition finance. It states that such finance must be part of credible, time-bound and target-based plans that show which investments are necessary for the transition towards climate neutrality, as opposed to those that would adversely impact the transition.⁷ Other definitions of transition finance have also been developed by governments, research institutions and central banks. A common feature is the financing of activities that align corporates with a trajectory towards a maximum of 1.5 °C of global heating.⁸

⁵ OECD, 2022, **OECD guidance on transition finance: ensuring credibility of corporate climate transition plans – Executive summary**

⁶ Including policy and legal risks, technology risks, market risk and reputational risk for companies.

⁷ G20 Sustainable Finance Working Group, 2022, **2022 G20 sustainable finance report**

⁸ Japan METI, 2021, **Basic Guidelines on Climate Transition Finance**: “Transition finance refers to a financing means to promote long-term, strategic GHG emissions reduction initiatives that are taken by a company



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Yet, as transition finance is targeting economy-wide decarbonisation, it should not be considered a matter for the private sector alone. This report broadens the understanding of transition finance to cover **public and private financial flows into projects, procurement and innovation that actively transform production processes, business models and infrastructure to reflect the reality of a climate neutral economy.**

Transition finance provides the capital for companies, infrastructure and innovation to follow a path to climate neutrality. Furthermore, it is highly context-specific given the dynamic policy and socio-economic realities of transitions across jurisdictions, regions, industries and communities. What can work in one context may not be suitable or replicable in another. This report focuses on transition finance in the European Union, but also considers the broad international leadership and norm-setting power of the EU.

How is transition finance currently addressed in EU financial legislation?

A clear definition of transition finance has not yet been established in the EU. For the time being, transition finance is understood in the context of existing EU climate goals (Climate neutrality 2050, Fit for 55) and respective policies, in the absence of European wide transition paths. At the legislative level, the European Commission has initiated an array of proposals to enable a financial system that accelerates the transition of European economies. These instruments target different segments of the economy, including banks, institutional investors, listed corporations, and household consumers and investors. They also have varying purposes, such as transparency and disclosure, standardisation, or financial risk adjustment to adequately integrate the paradigm of the transition into financial and business decision making. Taken together, they constitute an emerging transition finance approach in the EU. Table 1 (next page) provides an overview of these legislative proposals.

The current financial regulatory initiatives place an emphasis on **transition planning** in the EU's approach to transition finance. Transition planning refers to private sector plans for how a company will reach climate neutrality in line with jurisdictional climate targets and the Paris-aligned 1.5 °C scenario. In the EU, transition plan requirements are mentioned in the Corporate Sustainability Reporting Directive (CSRD) and the Corporate Sustainability Due Diligence

considering to tackle climate change for the achievement of a decarbonized society"; Climate Bonds Initiative, 2021, **Financing Credible Transitions – A framework for identifying credible transitions**



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Directive (CSDDD), among others. In its Banking Package review, the European Commission also amends the Capital Requirements Directive (CRD) to require banks to draft plans as forward-looking climate risk management tools. These initiatives propose transition plan disclosure obligations on entities and allow for companies to lay out tailored pathways to reach the Paris Agreement goal. As transition plans under the CSRD and draft CSDDD are defined at the entity level, they represent an important way for climate and transition risks to be integrated in corporate strategies, while also identifying investment opportunities. Setting out credible transition plans therefore also addresses the risk of greenwashing, ensuring that more inclusive approaches going beyond “green” investments maintain environmental integrity.⁹

Table 1. Stocktake of current EU policy initiatives on private finance that mention transition

Policy file	Reference	Why it matters
Taxonomy Regulation	<p>Article 10 of the Taxonomy Regulation defines a “transitional” category of activities in which “greenhouse gas emissions are substantially lower than the sector or industry average, do not hamper the development and deployment of low-carbon alternatives and do not lead to a lock-in of assets incompatible with the objective of climate-neutrality, considering the economic lifetime of those assets”.</p> <p>Article 26 of the Taxonomy Regulation also mentions a future Commission report covering the extension of the scope of the Regulation. These provisions would cover the so called “no significant impact” activities and the “significantly harmful” activities. The Platform on Sustainable Finance published a report in March 2022 to inform the Commission proposing an extension framework.</p>	<p>The EU Taxonomy is referenced across several pieces of legislations (such as CSRD or SFDR) as the tool to quantify what proportion of companies’ activities or investors’ financial products are “green”.</p> <p>However, the current classification of transitional activities as “green” goes against the objective of the Taxonomy, which is to clearly categorise economic activities according to their sustainability impact. It also keeps sectors that are currently putting effort into phasing out damaging activities out of the Taxonomy Regulation.</p>

⁹ OECD, 2022, [OECD guidance on transition finance: ensuring credibility of corporate climate transition plans – Executive summary](#)



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Policy file	Reference	Why it matters
<p>Corporate Sustainability Reporting Directive (CSRD) and European Sustainability Reporting Standards (ESRS)</p>	<p>Article 19a of the Directive requires all listed companies, and companies with more than 250 employees and a balance sheet total in excess of €20 million and/or a net turnover in excess of €40 million to disclose their plan to ensure that their business model and strategy are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement.</p> <p>The European Financial Reporting Advisory Group (EFRAG) will draft the European Sustainability Reporting Standards (ESRS) backing CSRD's disclosure requirements. The final version will be shared with the European Commission in November 2022 for adoption by June 2023.</p>	<p>CSRD will cover about 50,000 companies in the EU. These companies will be required to publish climate transition plans.</p> <p>The ESRS will, among others, define the precise shape, content and overall ambition of the climate transition plans required under CSRD.</p>
<p>Corporate Sustainability Due Diligence Directive (CSDDD)</p>	<p>Article 15 of the proposed Directive requires companies with more than 500 employees to adopt a plan to ensure that their business model and strategy are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement.</p>	<p>CSDDD introduces new due diligence requirements related to climate for companies with more than 500 employees. This entails potential liability for companies mismanaging risk mitigation processes for human rights and environmental risks and impacts.</p>
<p>Capital Requirements Directive (CRD)</p>	<p>Article 76 of the Commission proposal requires member states to "ensure that the management body develops specific plans and quantifiable targets to monitor and address the risks arising in the short, medium and long-term from the misalignment of the business model and strategy of the institutions, with the relevant Union policy objectives or broader transition trends towards a sustainable economy in relation to environmental, social and governance factors"</p>	<p>This new legal requirement for banks would require them to prepare prudential plans to address climate-related and environmental risks arising from misalignment with EU policy targets. The proposal mandates supervisors to check these plans and to require banks to implement mitigating measures if misalignment between these EU goals and a bank's strategy leads to inadequate management of these risks.</p>



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Policy file	Reference	Why it matters
EU Green Bonds Standard Regulation (EUGBS)	This initiative proposes a framework specifying the requirements companies must follow to issue “green” bonds as well as the use of capital raised through these instruments, as a voluntary standard for both private and sovereign issuers to help finance sustainable investments.	The EU GBS would require that proceeds raised by the bond should be allocated fully to projects aligned with the EU Taxonomy or show how they intend to become aligned over time, which implies a notion of transition.
Benchmarks Regulation (BMR)	Amendments to the Benchmarks Regulation introduced two new categories: Climate Transition and Paris Aligned financial benchmarks. To benefit from the Climate Transition label, benchmarks must follow specific criteria to select, weight, or exclude underlying assets resulting in the benchmark portfolio following a decarbonisation trajectory.	Climate transition benchmarks can be used as a reference for designing or assessing the financial performance of investment products whose objective is to contribute to the reduction of carbon emissions.

The focus on transition planning in current EU financial regulation is important as it offers a way of understanding what transition entails in the first place. Entities, regional administrations, and national governments are faced with significant uncertainties on what technologies, innovations and infrastructure are needed in the coming decades. In order to shift and scale investment toward a climate neutral continent, it is necessary to **understand and communicate transition challenges not only at the entity level, but also at sector and whole-economy level**. Transition planning offers a way to move towards a more coherent understanding of transition.



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What is transition planning?

“Transition planning” means setting out a concrete plan to reach an environmental and/or climate target, for public and private entities that are not “green” already. An example is alignment with the temperature goal of the Paris Agreement. In the EU, the environmental target is to be climate-neutral by 2050, although this can differ between jurisdictions.

To meet the environmental target, steps should be taken in line with a strategy (which can change over time). Economy-wide, regional, member state, sectoral and entity-based transition plans are therefore transition strategies with related “planned” actions, implemented to meet the environmental target generally and the agreed interim steps specifically. The focus should be on entity-wide transformation covering sectoral and business models, operations, assets, and relationships to avoid “transition plans” that only consider the low-hanging fruits, for example marginal mitigation improvements. Robust accountability and supervision systems must ensure that all stakeholders actually implement the steps needed, to build trust in and credibility of the plans and related actions.

Beyond transition planning, current EU financial legislation aims to improve the disclosure of data on the sustainability of companies, activities, and investments.

A wide range of economic actors require information about companies’ transition towards climate neutrality:

- > Data from transition plans allows investors to make more informed decisions about the credibility of companies’ climate pledges and direct their investments accordingly.
- > Investors’ clients benefit from more transparency on their investments’ destination if investments in transition are better reflected under the Sustainable Finance Disclosure Regulation (SFDR).¹⁰
- > In financial institutions, information on how transition risks are integrated into the investment processes also helps financial supervisors to determine whether good climate risk management practices are in place as part of the

¹⁰ Under the SFDR investors must only disclose the “green” part of their investment portfolio. Currently, there is no incentive to finance activities that are not green, but are in transition. Reviewing the SFDR disclosure requirements to identify such investments is one example of what constitutes a coherent framework for transition finance in the EU.



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EU financial framework, and to assess the exposure of the EU to climate-related financial stability risk.

- > Public administrations could also use this data to help with infrastructure planning and to navigate labour market policies to avoid bottlenecks in the provision of public goods required in the transition.

Existing initiatives are tackling important aspects of clarifying and implementing finance for the transition in the EU, both top-down through regulation and bottom-up from markets through planning. **However, these approaches are stuck in silos and present significant limitations and gaps.**

- > Legislative initiatives mentioning the transition or transition planning are fragmented across various regulations. Diverse initiatives coming from different Directorates General or Units within the European Commission lack a coherent approach and sequencing to transition finance, and are not articulated around a shared, guiding vision of the nature and place of transition finance in the EU. Such a core vision would however benefit the EU's financial framework and economy by incentivising planning practices, including at member state level. This current lack of coherence, especially around disclosure of transition plans, creates regulatory uncertainty across private and public markets and hampers progress on the transition. It also fosters fragmentation and overlaps between pieces of EU legislation, ultimately leading to additional administrative burdens for companies and regulators.
- > The private sector is already drafting and disclosing voluntary approaches to sectoral transition planning. Financial services, power and fossil fuels are the three industries with the highest level of transition planning disclosure globally.¹¹ Nevertheless, these approaches vary significantly and often lack credibility or scientific validation. The EU legislative steer needs to work in collaboration with various stakeholders, including the private sector bottom-up initiatives, to ensure consistency, credibility, and a clear market guidance.
- > Links between transition planning and public investment support programmes are currently weak.¹² A multi-stakeholder approach where transition planning and support is organised across public and private financial and real economy actors at sectoral and entity levels will be needed to help scale up finance flows toward ambitious decarbonisation efforts.

¹¹ CDP, 2022, **Are companies being transparent in their transition?**

¹² There are though some good exceptions like the EIB PATH framework, the Just Transition Fund, the implementation of InvestEU, and so on.



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Public–private synergies have been insufficiently tackled in the EU’s Strategy for Financing the Transition, and this must now be addressed.

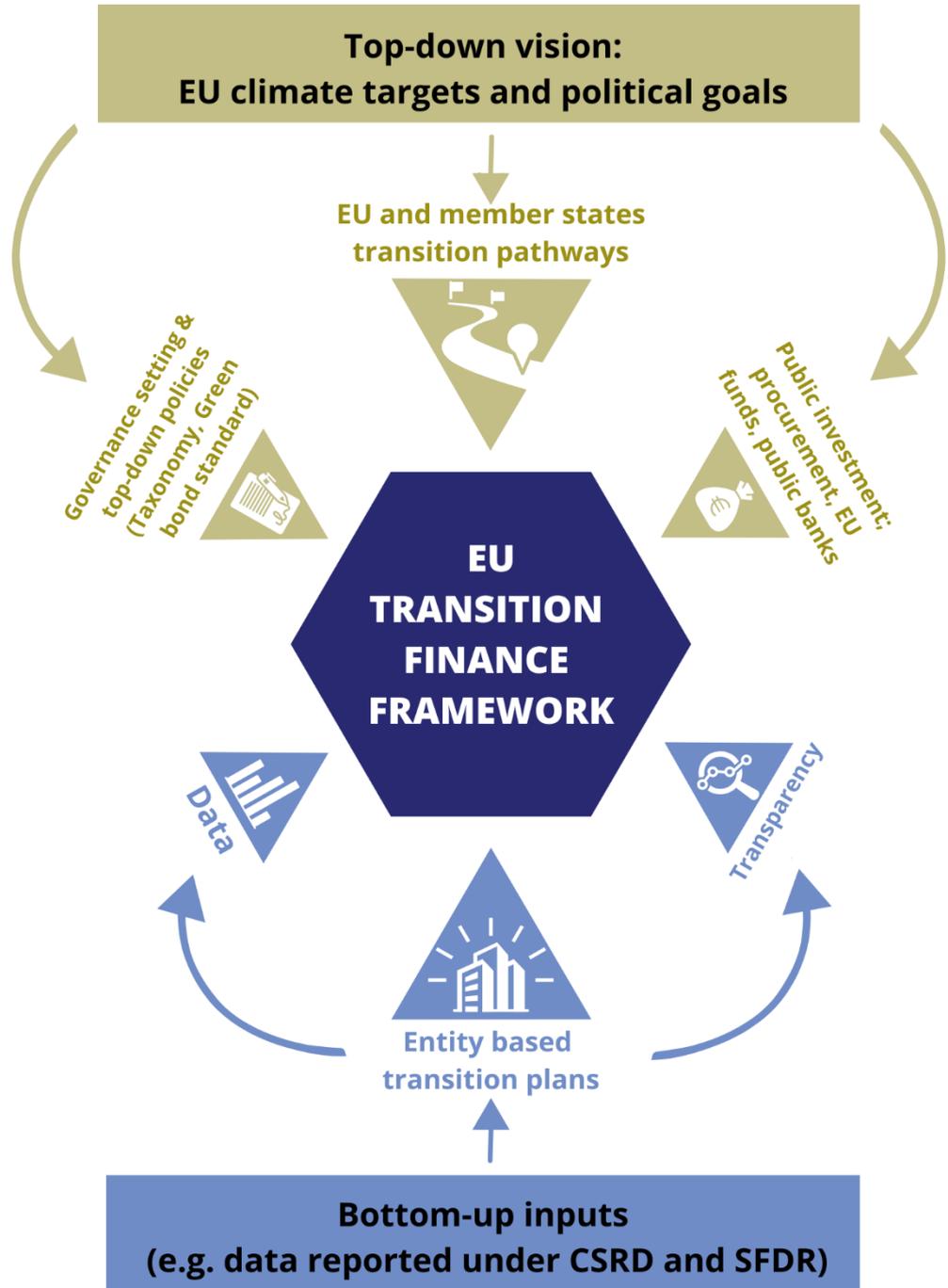
These limitations point to the lack of a clear narrative at the EU level on how different transition finance initiatives work together, informed by a coherent understanding of the purpose and instruments of transition finance in the EU context.

We therefore argue for a **combined effort by public administrations at European, national, and sub-national levels, with industry and finance, to develop a common understanding of the transition and its implications for the European economic model**. This can be achieved through a **robust transition finance policy framework** that effectively coordinates and incentivises both finance and businesses to develop their own transition pathways within the political targets of the European Green Deal. Such a framework would reduce uncertainty, provide a robust context with diminished transition risk for action by investors and businesses, and unlock public and private capital¹³ at scale in Europe through incentives and regulatory instruments.

What would constitute such a framework, and how can it be developed and adopted?

¹³ World Economic Forum, 2022, **Closing the investment gap: Policies to accelerate the net-zero transition**

Figure 2. Transition finance framework for the EU





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Setting out the basis for a common vision, principles, and governance for EU transition finance

The European Commission should take the initiative to set out a common vision for the transition in the EU. Financial legislation and market initiatives should be articulated around this vision, accompanied by governance arrangements to enable an understanding of the starting points and assumptions involved, and to support the adoption of common approaches.

High-level principles for EU transition finance

As a first step, the European Commission should develop a set of high-level principles that describe how the EU can accelerate investment by employing synergies between public and private finance.¹⁴ These are articulated below.

EU high-level principles for transition finance

Alignment: Transition plans, decarbonisation pathways and investments are aligned with a 1.5 °C scenario. Carbon lock-in effects are avoided.

Additionality: Investments labelled as transition finance actively contribute to the transition of the sector or entity and are linked to a robust benchmark framework.

Market creation: Investments proactively de-risk green or low-carbon technologies thereby creating markets. Systemic incentives are designed for ambitious decarbonisation in line with a 1.5 °C scenario.

¹⁴ It should be noted that such high-level principles are already emerging across the globe. Most notably, the G20 Sustainable Finance Working Group set out high-level principles in its 2022 report. They are based on five pillars:

1. identification of transitional activities and investments,
2. reporting of information on transition activities and investments,
3. developing transition-related finance instruments,
4. designing policy measures, and
5. assessing and mitigating negative social and economic impact of transition activities and investments.

G20 Sustainable Finance Working Group, 2022, **2022 G20 sustainable finance report**

An upcoming report on transition finance by the International Sustainable Finance Platform (IPSF) will also propose principles for transition finance.



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Integrating transition and climate-related risks: Investors and companies integrate environmental risks and impacts, as well as the (ideally systemic) risks linked to climate inaction into their business and investment strategies. Material interdependencies should be considered, including significant risks to, and opportunities for, the natural environment, workers, suppliers, communities, and consumers.

Sectoral pathways for benchmarking: A science-based, technology neutral pathway to climate neutrality aligned with a 1.5 °C scenario exists for relevant sectors at EU and member state level, as a reference point for the development and assessment of transition finance (including individual entity plans).

Having a set of high-level transition finance principles will allow the EU to:

- > Mainstream transition finance in European and international capital markets.
- > Identify a role for public investment instruments in systemically accelerating the transition and investing in the required infrastructure.
- > Outline coherent public and private regulatory instruments to ensure credible and ambitious planning toward climate neutrality at sectoral and entity level.

Furthermore, they can **inform the European Commission's work to clarify the scope of intervention of transition finance.**

These high-level principles will need to be further refined in a dialogue between finance, industry, and policy makers, not least to facilitate their operationalisation and uptake by entities subject to transition planning. They should also be aligned with the broader transition finance principles being developed within the G20 Sustainable Finance Working Group,¹⁵ the International Sustainable Finance Platform, the OECD and other international venues.

¹⁵ G20 Sustainable Finance Working Group, 2022, **2022 G20 sustainable finance report**



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Governance for transition finance in the EU

Making action-oriented transition reporting coherent and comparable requires an EU-wide understanding of the starting points and common assumptions on which a transition finance framework can be articulated. The EU also needs governance arrangements to enable that understanding.

The European Commission, member states and various regional and industry bodies, such as local regulators and business associations, should take the following steps to build this broader, common understanding of transition finance.

1. Develop a functioning and multi-layered governance setting

To ensure a coherent transition to climate neutrality, the EU should develop a governance mechanism that brings consistency across all existing legislative initiatives. This means aligning efforts, monitoring and financing mechanisms at all relevant levels – from European, through national and corporate levels, to small and medium size companies – especially in high-risk and high-impact sectors. New or parallel structures should be avoided, however. Under the EU Climate Law, the European Commission has to review the consistency of the EU-wide measures with climate neutrality targets.¹⁶ The Commission must not only align all efforts in a common transition narrative, but ensure financing tools and mechanisms are aligned too.

As a starting point for high-level transition planning at member state level, EU-level sectoral guidance would be relevant for approaching the countries' National Long-term Strategies (LTSS) for meeting the Paris Agreement commitments and the five-yearly National Energy and Climate Plans (NECPs). LTSS and NECPs have been useful tools that connect the EU climate targets with national commitments and performance against them. In the logic of mobilising transition finance, they enable member states to start thinking about and developing sectoral decarbonisation plans,¹⁷ thereby providing clarity and direction of travel for local industries and businesses.

¹⁶ European Union, 2021, **Regulation (EU) 2021/1119 of the European Parliament and of the Council**

¹⁷ One possibility is to use as a benchmark the EU transition pathways that the European Commission (DG GROW) is developing together with industry and stakeholders for 14 industrial ecosystems.



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2. Publish a set of sector decarbonisation pathways in the EU

The European Commission has a mandate under the Climate Law to engage with sectors of the economy to prepare indicative voluntary roadmaps for achieving climate neutrality.¹⁸ While more disclosure, reporting and common definitions already help increase both demand for sustainable investments and businesses' transition efforts, a more elaborate approach and guidance to the actual transition process is needed at the EU level. There is a need for clarity in terms of what a credible transition aligned with a 1.5 °C target would look like for different sectors in the EU economy. Voluntary bottom-up approaches to sectoral transition pathways are already emerging from the private sector. The EU Climate Law envisions that such voluntary sectoral roadmaps would need to be developed by the European Commission in collaboration with different stakeholders to provide guidance for policymakers and businesses.

Some initial steps in developing EU-wide transition pathways have already been undertaken through the European Industrial Strategy, starting with the tourism sector.^{19,20} Transition planning in the EU should not be a process mandated from the top. But the quality of transition planning can be improved by **providing guiding decarbonisation pathways in an open-source format to enable entities, regional administrations, and national governments to advance their own approaches toward achieving climate neutrality and conduct proper benchmark exercises**. Given the size of the EU market, having a set of sectoral plans will help to spur investments as it will reduce uncertainty for the bigger market and production networks.

Safeguarding the scientific integrity of such pathways for key sectors could be a task for the new EU Scientific Advisory Board on Climate Change, as the pathways must be science-backed and aligned with 1.5 °C scenarios.²¹ Such plans should be developed and constantly monitored from a whole-economy perspective, considering the different sectoral starting points and technological readiness.²²

¹⁸ European Union, 2021, **Regulation (EU) 2021/1119 of the European Parliament and of the Council**

¹⁹ European Commission, **European industrial strategy**

²⁰ European Commission, February 2022, **First transition pathway co-created with industry and civil society for a resilient, green and digital tourism ecosystem**

²¹ European Environment Agency, **European Scientific Advisory Board on Climate Change**

²² IEA, 2022, **Recommendations for the G7**: "Plans and policies should account for the nature of industry investment cycles, such as through retrofit-ready policies that require any unabated capacity added or refurbished in the next few years to have the technical capacity and space requirements to integrate near zero emission technologies when they become available"



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3. Make data available and comparable

Any form of reporting should be standardised and follow a set of common indicators to ensure efficient assessment of the effectiveness of transition planning. This standard-setting work is already underway in the EU (European Sustainability Reporting Standards, ESRS) and at the international level (International Sustainability Standards Board, ISSB) and we offer further recommendations on this point in Chapter 2 of this report. Similarly, providing a single access point for the data, for instance through the European Single Access Point (ESAP), would further enhance assessment and metadata analysis of the transition development in the EU. This requires that transition planning be done digitally in a format that can be uploaded to the ESAP in individual data points. The more data on transition pathways at entity, sector and economy-wide level is available in the EU, the more efficiently investment flows can be redirected toward transitional activities. But beyond that, the aggregated overview of transition planning may also provide crucial insights into what infrastructure and guiding frameworks from public administrations on local, regional, and national levels will be needed in the future.

4. Incentivise planning without overburden

The merit of transition planning lies in its ability to integrate the challenges of the climate transition into the strategies of entities and regional administrations, and to adapt to the reality of a climate neutral economy with increased climate impacts. However, this merit is dependent on the perception that planning requirements are easy to understand and implement.

A coherent transition finance framework therefore needs to ensure that entities are not faced with an array of reporting requirements. However, such regulation must be designed to cover the European economy in its breadth, in particular emission intensive sectors which will be affected by the transition. A large part of the EU's value generation is from small and medium sized enterprises, which are often of particular importance as regional employers outside economic centres. SMEs do face similar transition risks to listed companies and will be equally affected by shifts in energy prices, technology innovation and changing markets. Carving SMEs out from transition planning requirements would risk them falling behind in terms of innovating their operations and accessing transition-oriented capital. Transition planning regulation in the EU must therefore be designed to include both large corporations and SMEs, placing reporting burdens proportionate to the size and capacities of the entity. Smaller companies would also need additional assistance to build transition planning capacity. This support needs to be strengthened and accelerated at an EU level.



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5. Technical assistance

Development of climate expertise and capacity building would be required for all stakeholders in different sectors, but also in national and local governments. Alongside building a coherent EU policy framework for transition finance it will be important to support and incentivise member states to implement it. This can be done with capacity building programmes that can respond not only to national but also regional needs, as well as making access to funds conditional on delivering transition plans. The EU should bring the ideas, policies, knowledge and implementation processes closer to the people and foster a clear understanding of the direction of travel, risks and opportunities this would bring at national and local levels (see Chapter 3). Tailored, sector specific and region specific enhancing efforts are needed in different countries and communities to train stakeholders to understand the complex, multifaceted nature of green and transition projects. Although it should fall on the European Commission and authorities to boost and oversee such technical assistance, they could also utilise other existing channels for collaboration (e.g., EIB Technical Assistance facility for green energy transition and the Commission's own Technical Support Instrument programme through DG REFORM) or set up new ones, inspired by cross-member state knowledge sharing activities.



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CHAPTER 2

LEVERAGING EU TRANSITION FINANCE POLICIES

An EU framework for transition finance must be articulated around a common vision for the transition in the EU, as well as the necessary governance arrangements to establish a common understanding of the starting points and assumptions behind the transition.

At the same time, it must leverage existing mechanisms, instruments and policies for public and private finance to maximise the flow of finance into the transition – and fill gaps where these exist. This section examines the role of both public and private finance for the transition, how they can be enhanced, and what can be done to mutually leverage them in service of the EU’s transition.

Public investments craft the markets of the future

The role of public investment in the transition is twofold. On the one hand, it can actively shape the transition in a just and socially equitable manner, flattening out the bumpy path to resilient climate neutrality. At the same, public finance can actively shape and create new markets that are emerging in the climate neutral economy. Conceptualising public interventions only in response to market failures, without intervening proactively in the current European economic structure, will not meet the transformation needs of the EU’s economic model. One of the main challenges for the public sphere related to transition finance should be to solve²³ the current non-marketability of transition solutions, projects, and technologies.

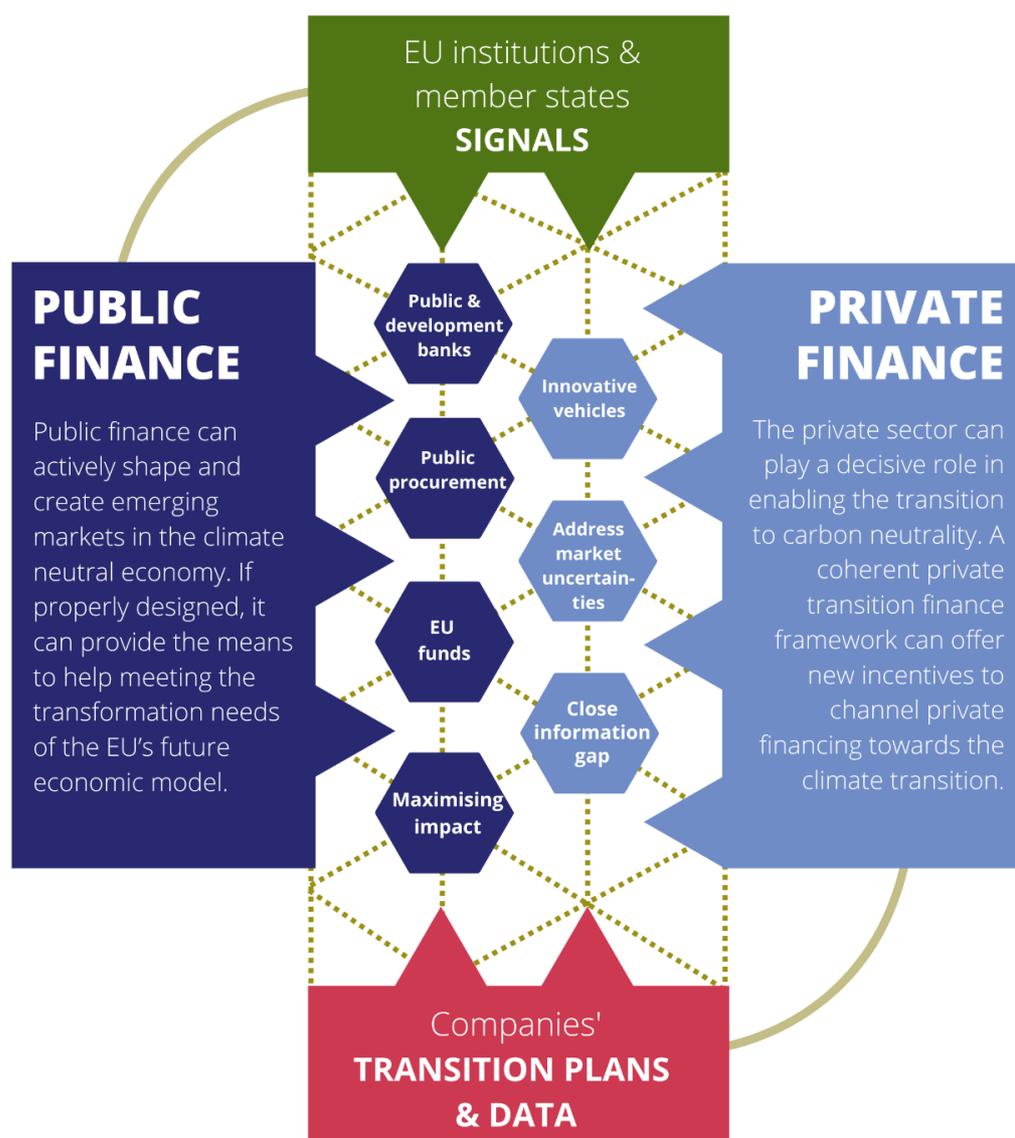
²³ Tools for significant emissions reduction are at an early stage of commercial development.



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The public sector and public banks in particular should take the lead in this context, actively developing and investing in markets of the future backed by a set of policies and tools. In fact, according to an OECD survey,²⁴ fragmentation of policy frameworks and fiscal policies represent a main bottleneck for kickstarting the transition.

Figure 3. Both public and private finance play important roles in making the transition happen.



²⁴ OECD, 2022, *OECD guidance on transition finance: ensuring credibility of corporate climate transition plans – The case for transition finance in the 'decade for delivery'*



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To optimise the use of public financial resources in the EU to usefully and effectively pave the way for increased future private investment in the transition, these four objectives should be pursued:

1. Maximising the impact of public investment in the transition through a “mission-oriented” approach
2. Designing EU funds to drive the transition
3. Integrating a transition logic into public expenditures through public procurement
4. Bridging transition policy intervention and private markets through European public and development banks

Maximising the impact of public investment in the transition through a “mission-oriented” approach

The investments needed for the transition require a strong interplay between private and public providers. This includes from the public side addressing issues such as de-risking, financing, possibly using instruments such as blended finance, transformative projects that could not obtain the investment from markets, and finally investing in public goods such as infrastructure. It is, however, less about the quantity of public finance, but rather about how its quality and impact can be adapted to reflect a transition logic.

The following five principles set out how the impact of public investments can be maximised. They are based on the idea that if governments are “patient enough and willing to bear the intrinsic risks related to innovative activities”, the best outcomes can be achieved by “mission-oriented” policies and spending rather than directing resources to market-based interventions.²⁵ Finance programmes at European, national, and regional levels, in particular for finance ministries, should be governed by these principles. As such, they can form a golden thread to reflect transition logic in public spending.

- > **Pick the willing:** Identify and promote those actors who are willing to implement innovative business models or production processes to drive progress towards carbon neutrality. Transition plan reporting requirements at entity level can help to identify strong and promising transitions.

²⁵ UCL Institute for Innovation and Public Purpose, 2021, **Mission-oriented policies and the “Entrepreneurial State” at work: An agent-based exploration**



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- > **De-risking:** Dedicated public investment actors, such as public banks or EU innovation programmes, must channel investments into potentially transformative projects that cannot be adequately financed on the private capital market.
 - > **Investment and impact maximisation:** Public investment alone will not be able to finance the transition. Thus, the objective is to crowd in private finance by leveraging public funds through co-financing models. In this way, public investment should shape and promote an environment for climate-friendly investment that can spill over into wider markets and other jurisdictions.
 - > **Innovation focus and dispersion:** Public administrations at EU level and in member states should ensure that their investments promote low-carbon solutions (technologies, manufacturing processes, circular economy), and financing and business models that accelerate the transition to a climate-neutral future. Government funding must flow into innovations that can have an impact beyond the direct beneficiaries, for example because climate-neutral business models can be replicated.
 - > **Technical and planning support:** Public banks are uniquely able to mix the financial and scientific knowledge necessary to find new investment markets. To that effect, they should support counterparts in the private sector in developing transition plans and expanding their technical capacities.

Designing EU funds to drive the transition

The EU's wide array of funds and public financing tools is an important resource to be mobilised to leverage private investments for the transition to climate neutrality. However, the EU needs a coherent and clear picture of how these tools, and private sustainable investments, complement and reinforce one another's objectives. Such a holistic overview should consider the multiplicity of transitions in the EU, taking into account the different starting points at sectoral and member state levels for the transition.²⁶

The European Union boasts a broad range of financial mechanisms and funds to foster economic development in its member states. These include the European Social Fund (ESF); European Regional Development Fund (ERDF); Cohesion Fund (CF); European agricultural fund for rural development (EAFRD); European

²⁶ Agora Energiewende, 2021, **Matching Monday with green ideas**: "EU funding could specifically allow Eastern and Southern European Member States to transition their industries"



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Maritime and Fisheries Fund (EMFF); Horizon Europe; LIFE fund, as well as dedicated climate-related funding mechanisms, such as the Just Transition Fund (JTF) and Innovation Fund (IF). A broad range of these instruments, not least the EU recovery funding under NextGenerationEU, already have climate neutrality funding mechanisms built in, as well as the “do no significant harm” principle enshrined in law.²⁷

Different EU funds understandably sit in different Directorates-General within the Commission, often resulting in different requirements, criteria, and technical assistance task forces. For example, transition planning is not addressed in most EU funds, with the exception of the JTF, which incorporates is the notion of transition planning at a region or sectoral level though the Territorial Just Transition Plans required for member states to access the funding.²⁸ More such streamlining of transition is required in EU funds, and to so there must be a **better overview of the available EU funding. This will help ensure that instruments are aligned, complementary and better geared towards economy-wide transition.**

Therefore, the question is whether EU funding and investment instruments can be more strongly aligned with a transition agenda that aims to incentivise key sectors to meet climate neutrality goals. It will be important to use the “top-down” steer of EU funds to channel resources and trust **towards transitional markets, so crafting the right ecosystems and capacity building skills with robust and dedicated advisory support.** Moreover, **untapping the transition component of EU public funds should specifically focus on using effective de-risking schemes when possible** (both through guarantee-based instruments like InvestEU, but also through sending policy certainty signals with the elaboration of transition pathways in a multi-stakeholder setting) to mitigate investment risks which are linked to these innovative solutions. While funding instruments are crucial in kick-starting investments and mitigating the initial risks with grants or concessional loans, the policy and market ecosystems need to be sustainable and crafted with clear long-term goals, so that initial investments will not be dispersed. In this context, public money is not enough: the challenge is to create the right incentives to also channel private capital towards new green markets.

²⁷ European Commission, 2021, ‘Do no significant harm’ – Technical guidance by the Commission

²⁸ European Commission, **Just Transition funding sources**



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Thus, the design and implementation of EU public funds dealing with the transition challenge becomes crucial for avoiding the “evaporation” of initial investment. To bring innovative technologies to commercial maturity the EU funds should focus on the following:

- > Identify, with the help of sectoral transition pathways at EU and member state level, the various stages and related challenges of the transition process sector by sector.
- > Design ad-hoc funding and incentive mechanisms in line with the stage of transformation of the various sectors,²⁹ with adequate and strategic risk allocation (for example, grants for risk mitigation, blended finance for innovation and early-stage investments, equity for middle stage, debt, bonds, and loans for advanced stage).³⁰

The right ecosystem for a successful transition is complex, mainly comprising policy makers and public and private banks betting on specific industrial processes and technologies together with industrial coalitions, therefore lowering the transition risk.³¹ Furthermore, early financing options, coming from EU funds, capital markets and bank loans, are still missing, which should be tackled by beefing up the EU capital market union (CMU). It becomes, therefore, important to design a credible and conducive framework for EU funds, where related technical assistance programmes are aware of and clarify the challenges related to access to capital for accelerating the transition. This implies tailoring technical assistance to the market stages of technologies and their respective capital needs.

With the EU legislative efforts on transition planning, improved data on transition needs, technology assumptions, material input and infrastructure requirements, EU funds can maximise their impact by responding to both entity-based transition planning and the aggregate expectations for the transition. Linking transition planning with EU fund priorities and spending can significantly improve efficiency and effectiveness.

²⁹ Technology-specific financing blueprints should be used or produced

³⁰ Important to avoid the “valley of death” trap for promising projects, where companies need follow-up investments (into innovative technologies and/or industrial process) after an initial injection of finance

³¹ Agora Energiewende, 2021, **Matching money with green ideas**, page 27: “30 to 50 per cent of industrial assets in the EU steel, chemical and cement sectors will reach the end of their lifetimes before 2030, a regulatory framework that allows the kickstarting of the sector’s low-carbon transition is necessary”



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Integrating a transition logic into public expenditures through public procurement

The volume of public procurement in the European Union is impressive, forming a significant share of overall spending in the EU every year. In 2017, it was estimated to be worth 13.3% of EU GDP or €2 trillion.³² Public procurement can therefore be an effective lever to accelerate the transition of the European economy. However, policy remains very much at the discretion of member states, in line with the EU's subsidiarity principle. Furthermore, the diverse purposes of public procurement pose a challenge to integrating all aspects of the transition. The question is therefore how a permanent transition logic can be built into public procurement without neglecting its general purpose to ensure the provision of public services. At the core, the challenge is to integrate transition considerations into the selection process of contractors, without overcomplicating tenders. One way to do so can be to choose corporate partners for contracts not only on their financial offer and compliance with current procurement rules, but also on the merit of their transition planning. More importantly, public procurement contracts could come with an incentive to transition, for instance through more favourable conditions.³³

Recently, greening public procurement has become a much-favoured tool in the industrial decarbonisation space. Governments procure huge amounts of steel, cement and other primary materials for infrastructure projects, and currently little to no distinction is made on the climate performance of these products. With Green Public Procurement (GPP), governments can stimulate the demand for lower-carbon steel or cement, by using their purchasing power to procure goods with lower emissions throughout the product life cycle. By imposing minimum emission requirements, governments would provide massive incentives for private companies to invest in lower-carbon production capacities to gain access to this new market, thus significantly contributing to the transition.

The complex nature of public procurement across various government levels (local, regional, national, European), makes it perhaps less wieldy than targeted economic interventions. However, shifting this ongoing stream of investment toward transition activities would be extremely powerful. To that end:

³² European Commission, **Public procurement**

³³ The US introduced a clean procurement model under the "Federal Buy Clean Initiative" in 2021: Office of the Federal Chief Sustainability Officer, **Federal Buy Clean Initiative**. This includes requirements for contractors to disclose climate information to the Council on Environmental Quality (CEQ).



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- > Governments should shift public procurement to actively purchase green and low-carbon products, thereby creating markets of the climate neutral economy.
 - > Public procurement in the EU must be complemented with an indirect, secondary purpose to support the transition.
 - > This should be based on long-term targets or decarbonisation pathways that enable public procurement to be responsive to KPIs in line with net zero targets.

Bridging transition policy intervention and private markets through European public and development banks

Europe has a large network of public banks and development finance institutions (DFIs). Public banks in Europe, especially those with specific transition and economic development mandates, are important providers of direct transition finance and indirectly deliver crucial support to the transition towards low carbon economies in several ways. In addition, the European Bank for Reconstruction and Development (EBRD)³⁴ and European Investment Bank (EIB) – two multilateral development banks (MDBs) – have an important role to play in supporting transitions in energy, transport, industry and agriculture in the EU, scaling up transition finance. These are outlined below.

Developing standards, tools, and methodologies

Public banks such as the French Development Agency (AFD), KfW, EBRD and EIB³⁵ have developed several new methodologies, tools, and standards for other financial institutions to follow. Public banks and MDBs have been among the first financial institutions to operationalise their commitments under the Paris agreement and have thereby played a crucial part as pioneers. Public banks such as KfW and the EIB have been among the first to phase out all coal finance, although exclusions for other fossil fuels follow complex rules that leave room for continued investments (e.g., gas). But the institutions are also setting precedents in terms of reporting, emission accounting and deployment of economic instruments to price in the social cost of carbon emissions. The EIB, for

³⁴ Although the majority of EBRD's activities are focused outside of the EU, the bank operates in many EU countries: Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, North Macedonia, Poland, Slovak Republic, Slovenia, Cyprus, Greece, Romania. For more information, see EBRD, **Where we are**

³⁵ For more information and Paris alignment assessments of public banks, see E3G, **Public Bank Climate Tracker Matrix**



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instance, has set an internal shadow carbon price that will rise to €250 per tonne of carbon by 2050. However, public banks could do more to both incentivise and push commercial banks, intermediary lenders or corporate clients to follow suit (see points below).

Financial intermediaries and counterparties

Public banks also accelerate the transition to low carbon and resilient economies through indirect means. By channelling credit lines through intermediary parties (such as commercial banks), public banks can multiply their impact in contrast to individual project finance. Linking such intermediary investment to transition requirements is an effective way for public banks to drive the transition through spillover effects. For instance, public banks are currently developing methodologies to determine the Paris alignment of their indirect and intermediated finance, implying that access to finance below market rates from public banks is subject to fulfilling transition-related requirements.

Case study: EIB's transition plan requirements

In 2021, the EIB presented its PATH framework for counterparties to support their path to align with the Paris Agreement. As such, the bank will encourage “counterparties to be ambitious in determining their alignment plans” while acknowledging individual routes that counterparties might take.

The EIB explicitly provides technical assistance for counterparties to develop transition plans. It highlights that “each counterparty will develop its own strategy, target, and processes on its pathway to align – reflecting the specific set of regulatory, technical, financial and economic constraints facing a particular business”. PATH is therefore a good example of how to address the challenge of devising individual transition plans that remain, however, aligned with broader climate targets and within the boundaries of the 1.5 °C scenario (Paris aligned).

In terms of scope, the PATH framework is applied to corporations (medium-sized to large) and significant financial intermediaries. SMEs are for the moment kept outside the scope, though the Bank notes that other alignment frameworks are in place.



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What remains unclear for now is in how far EIB will also link its investments directly to opportunities outlined in the transition plans or whether the PATH remains a tool to reduce transitional risks. Here, the EIB could be more explicit in supporting counterparties in identifying possible investment opportunities, thereby increasing the incentive to develop thorough, detailed and ambitious transition plans.

As part of its response in support of the REpowerEU package, the EIB has partly suspended the rollout of PATH, delaying it until 2027. This constitutes a step backward in the wake of mandatory transition plans being introduced in the EU and should be subject for reconsideration.³⁶

One of the key aspects of these methodologies is the requirement for financial intermediaries to develop “transition plans” that detail how financial institutions will become Paris aligned. They can cover key aspects of Paris alignment, such as minimum sustainability standards, strategic priorities for the development of climate expertise and capacity, and timelines. In addition, all financial intermediaries would be required to adopt new disclosure standards in line with the TCFD recommendations. As such, public banks would support the harmonisation of sustainability standards and in turn green the financial institutions they work with. If done right, these methodologies for indirect finance can have a tremendous impact on private financial institutions.

Pathways and strategies

Finally, public banks can play an important role in accelerating the transition of economies by developing accompanying investment plans for pathways for low carbon and resilient sectors and advising climate strategies, including long-term strategies. For instance, KfW in Germany published a study that assessed the financing requirements for the transition of the German economy, including possibilities for private and public investors.³⁷ Such exercises are useful to underpin the broader economic implications of the transition and position public banks as key assets in linking policy ambition with financial markets.

³⁶ European Investment Bank, 2022, **EIB boosts clean energy financing in support of REPowerEU plan**

³⁷ KfW, October 2021, **KfW Research: Klimaneutralität bis Mitte des Jahrhunderts erfordert Investitionen von 5 Billionen EUR**



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Private sector mobilisation

Although a significant amount of the required transition finance will need to come from public banks, the private sector will have to provide the majority. Public banks have the capacity to open up new markets for the private sector and thereby catalyse private finance for a low carbon and climate-resilient transition. Public banks are uniquely capable of doing so through providing finance below market rates and with long tenures. This concessional finance can enable the private sector in varying ways:

- > **Green, resilience, and transition bonds are key instruments in steering private sector investments towards low carbon, climate adaptation or other sustainability projects.** They support private investors in accessing concessional finance on international capital markets. The market for such bonds has seen substantial growth and is expected to continue to support the greening of the international financial system. Public banks in Europe have been critical for developing green capital markets through issuing green bonds and other sustainability-linked instruments.
- > **Public banks support policy and regulatory reforms through ongoing dialogue with their member governments.** This policy dialogue is provided to public stakeholders along with concessional finance and helps create the right economic environment, increasing the competitiveness of (high impact) sustainable technologies, products and services and thereby incentivising investments for transition. MDBs and large bilateral European banks, such as AFD and KfW, also play an advisory role in harmonising economic policies and financial regulations both within the EU and outside. In turn, this enables private investors to scale up sustainable cross-border investments.
- > **Public banks support the mobilisation of private transition finance through the creation and promotion of innovative blended financial products.** These aim to de-risk sustainable investments and can take many forms. Guarantees and first loss capital, for example, can help SMEs to protect against losses, giving these companies the confidence to invest in new technologies. Other instruments such as loan syndication or currency hedging can help investors access additional capital or to gain other benefits such as tax exemptions.

While public finance has a critical role to push the transition forward in the EU, both the **private and public sectors need to coordinate with each other in relevant fora, analysing and unpacking together the main challenges to then come up with credible implementation plans, whilst lowering the investment**



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risks by deciding on a common direction. Sectoral transition pathways should be based on real entities' opportunities and challenges, while entities' transition plans should integrate systemic and supply chains risks. There is a need for a feedback loop at different layers of governance, and such a feedback loop should be shortened as much as possible with transparency and constant communication. In this context, transition planning becomes a central element of good corporate and public governance, which will reduce uncertainty and release investment streams that previously might have been held back by inertia.

Shifting EU private finance in support of the transition

The private sector plays an important role in enabling the transition towards carbon neutrality and reaching the objectives of the European Green Deal. Private finance remains the main source of financing for climate projects, for example in Western Europe.³⁸

As a first step towards improving both the contribution of the private sector to the climate transition and phasing out its contribution to carbon-emission intensive industries, EU policymakers focused on ensuring the disclosure of sustainability information. Several initiatives were published as part of the 2018 European Commission Action Plan to Finance Sustainable Growth³⁹ and its follow-up 2021 Strategy to for Financing the Transition to a Sustainable Economy.⁴⁰

Some of these initiatives were designed to establish the criteria for determining green activities (EU Taxonomy) or improve transparency of sustainable financial investment products (Sustainable Finance Disclosure Regulation, SFDR) and are in their implementation phase. They were followed by initiatives aiming to improve corporate sustainability reporting (Corporate Sustainability Reporting Directive, CSRD) or to create a standard for EU green bonds issuances (EU Green Bonds Standard Regulation), which are still under discussion. These initiatives were fully integrated in the wider 2019 EU Green Deal strategy to ensure the European Union reaches the net zero carbon emissions objective by 2050.⁴¹

³⁸ Climate Policy Initiative, 2021, [Global landscape of climate finance 2021](#)

³⁹ European Commission, 2018, [Action plan: Financing sustainable growth](#)

⁴⁰ European Commission, 2021, [Strategy for financing the transition to a sustainable economy](#)

⁴¹ European Commission, [Finance and the Green Deal](#)



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Encouraged by the post-COVID context and the ongoing implementation of this transparency framework, investors' demand for products financing companies with (at least partially) green activities surged in recent months.⁴² **However, the EU does not propose a similar framework for activities that do not yet qualify as green but are in the process of becoming green.**

The EU institutions and member states need to take this essential second step for the success of the EU sustainable finance agenda. In addition to their actions stimulating public investments in transition (see section above) they must send clear policy and regulatory signals to private actors on their commitment to define and develop transition finance. In parallel and to complement this top-down approach, EU companies must fill the current sustainability information gap by feeding markets with easy-to-use, standardised data on their transition plans and overall sustainability performance. Both these approaches should be linked by developing the offer of transition investment vehicles backed by precise indicators and criteria.

A coherent framework for transition finance can offer new incentives to channel private financing towards activities actively contributing to the climate transition. This would unlock financing opportunities both in the short and long term, link private and public investments, and mitigate the actual and perceived risks of climate transition investments. In addition, this framework could assist financial institutions and non-financial companies in mitigating financial risks linked to climate change to their company value and in moving beyond climate pledges into concrete actions.

To achieve these goals, **three main objectives should be pursued.** These objectives should be tackled sequentially for a coherent implementation of a transition finance framework:

- > Fill the information gap: improve data availability and accessibility through sustainability reporting and robust transition plans across the EU
- > Address market uncertainties: identify what constitutes transition finance
- > Incentivise transition financing: design innovative transition-linked financial instruments with precise criteria

⁴² European Securities and Markets Authority, 2022, **The drivers of the costs and performance of ESG funds**



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Fill the transition information gap

[Solving the ESG data gap: improve sustainability disclosures](#)

Many investors' associations have said that the current lack of reliable sustainability information on European companies is the main hurdle to developing sustainable investments.⁴³ The availability, standardisation, and auditing of companies' information must be improved to give investors more clarity and encourage them to channel private capital towards sustainable activities.

This is the rationale behind the Corporate Sustainability Reporting Directive (CSRD), which is in this regard an important step forward. This review of the EU rules on sustainability disclosure requires a much wider range of EU companies to both report on the impact of E, S and G factors on their value, and disclose the impacts of their own activities on society and the environment.

Disclosure of standardised and audited sustainability information by companies will be extremely useful for investors to make informed investment decisions. Reporting back relevant information to their clients will be made easier, therefore encouraging the increasing demand for sustainable investments identified above. For EU companies themselves, disclosing their sustainability profile and their progress regarding the Paris Agreement objectives will be both a reputational incentive to commit to transition and, in doing so effectively and efficiently, a competitive advantage to attract investors.

[Transition plans are essential tools to increase transparency on companies' decarbonisation trajectories and incentivise investment in transition](#)

Under CSRD, companies will be required to make dynamic disclosures about their sustainability performance. In particular, they will be asked to disclose climate transition plans. These plans are defined as “the plans of the undertaking to ensure that its business model and strategy are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5°C in line with the Paris Agreement”.⁴⁴

⁴³ Eurosif, PRI, April 2022, [Joint letter on the necessity of net zero disclosures in CSRD](#)

⁴⁴ European Union, 2021, [Directive of the European Parliament and of the Council 2021/0104](#)



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Disclosure of companies' transition plans is particularly relevant as it allows for a more precise assessment of the credibility and timeframe of their commitment to emissions reduction targets. Transition plans are critically important in determining enterprise value: they give substance to entities' declarations of intent to get to net zero emissions. They allow companies to specify their transition pathways and resource allocation and provide transparency to investors wishing to integrate companies committed to the climate transition into their portfolios.

Transition plans are also a tool **to adequately assess the financial risks arising from companies' exposures to climate risks.** As such, they would also contribute to companies' capacity to capture the business opportunities that arise from an appropriate response to climate change. Companies should use stewardship and engagement, required under transition plans, to identify their exposures to assets that are likely to be stranded in the future, for example exposures linked to fossil fuels. Indeed, these exposures are likely to cause transition risks negatively impacting their financial value. Incorporating climate in risk management processes and clearly disclosing those risks will contribute, at the entity level, **to a divestment of these environmentally risky assets and a phase-out of both investors' and companies' exposures to these assets.**

The exact content of these transition plans will, as for the rest of the CSRD requirements, be defined by the European Financial Reporting Advisory Group (EFRAG)'s sustainability disclosure standards (European Sustainability Reporting Standards). Their final version is set to be published in November 2022 and should be adopted by the European Commission under the form of a Delegated Act to the CSRD in June 2023. **They should maintain a sufficient level of ambition and granularity and follow a set of principles for credibility (see below).**

It is important to note that international coordination is needed in this domain. The International Sustainability Standards Board (ISSB) is undertaking a similar effort to define international sustainability standards, including the shape of transition plans. The ISSB standards also incorporate transition plans as a central sustainability disclosure tool.

It is expected that most if not all EU member states will eventually adopt the sustainability disclosures approach that will allow the most interoperability and comparability at the international level.



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Both ESRS and ISSB standards should therefore be coordinated and aligned where they share the most similarities, on climate financial materiality. Indeed, a global baseline for reporting financial risks and opportunities is critical to providing consistent, comparable, and reliable information that meets the needs of investors and serves the public interest. The ISSB will provide this baseline on which ESRS could align. **The ESRS could build on this common approach to add further disclosure requirements in line with the topics covered (adding the rest of Environmental indicators, but also Social and Governance indicators) and the double materiality approach adopted in the EU.**

[What does a credible transition plan look like?](#)

Several EU legislative files are currently being developed and hint toward including transition finance, specifically under the shape of transition plans requirements.

The scope and level of detail with which these plans are spelled out, however, vary significantly across legislative initiatives and the current approach is scattered. The upcoming challenge for EU regulators will be defining the right standards considering the current and developing regulatory environment. **If they maintain a sufficient level of ambition and granularity, transition plans as defined by CSRD and its corresponding ESRS could be the foundation for transition planning requirements and the bedrock on which to build a coherent transition finance framework in the EU.**

EU climate transition plans should respect the principles set out in Table 2, drawing from EFRAG's initial proposals but also from international frameworks developed by the OECD, UK Transition Plan Taskforce, and GFANZ.



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Table 2. E3G's Principles for quality and credible transition plans in the EU

1. Alignment with an economy-wide transition to climate neutrality
Targets, emissions trajectories, and plans should be compatible with meeting a 1.5 °C low or no-overshoot scenario by 2050.
2. Commitment and action-oriented planning
Transition planning should set out short-, medium-, and long-term actions and “dynamic” ⁴⁵ interim milestones that can be used to assess progress and explain how these actions are in line with the transition to climate neutrality.
3. Monitoring progress
A verification process should be enabled to monitor progress through adoption of quantifiable and timebound key performance indicators (which should ideally also be standardised, forward-looking and dynamic). Robust governance mechanisms, with relevant incentivisation, reporting and accounting structures, should be developed for transition finance.
4. Minimum reliance on offsets
Offsets represent a reduction, avoidance or removal of emissions achieved elsewhere, and can in certain circumstances be used by companies to compensate for their own unabated emissions.
As by definition offsets do not lead to any emission reductions within the boundary of the company or sector in question, they should have a limited role in transition plans.
Offsets should ideally only be used to compensate for those emissions that are (nearly) impossible to abate.
Reliance on carbon offsets should be accounted for separately to ensure transparency over genuine emission reductions achieved within the boundaries of the company or sector in question.

⁴⁵ Corporate commitments and trajectories should evolve in coherence with the current and future EU understanding and definition of “transition”



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Ensuring wider accessibility of data and more transparency in its use

Increasing bottom-up data flows from EU companies on their sustainability performance and transition planning efforts will necessitate a global framework on the accessibility and processing of this information.

Disclosure requirements under CSRD should be strengthened by initiatives aiming to make companies' information easily accessible and comparable. This could happen via EU initiatives such as the **European Single Access Point (ESAP)**.

Such a framework would entail considerable work on the practical characteristics of these access points, including **agreeing on key data points, common metrics, a specific and consistent machine-readable electronic reporting format** or regarding their respective governance. This undertaking will lead to increased public access to companies' actual performance against their climate pledges and to more public accountability, which in turn will incentivise concrete commitments from companies to mitigate their reputational risks.

In parallel to the increasing demand for ESG data, **the use of ESG ratings has skyrocketed in recent years** as proxies for identifying companies' sustainability performance. In the absence of easily accessible ESG data, these ratings form the basis on which many investors make their investments decisions. However, these ratings are often based on opaque methodologies, and results for the same company vary widely between ESG data providers.⁴⁶ They also seem to not adequately represent the sustainability profile of companies.⁴⁷

As planned in its Strategy for Financing the Transition to a Sustainable Economy,⁴⁸ the European Commission must come forward with an initiative to implement a framework ensuring these ratings are based on reliable, science-based metrics and are easily comparable to avoid any possibility of involuntary greenwashing. Such a framework would also be supported by the financial industry and users of these ESG ratings.⁴⁹

⁴⁶ OECD, 2022, **ESG ratings and climate transition**

⁴⁷ Bams, D, van der Kroft, B, 2022, **Tilting the wrong firms? How inflated ESG ratings negate socially responsible investing under information asymmetries**

⁴⁸ European Commission, 2021, **Strategy for financing the transition to a sustainable economy**

⁴⁹ EFAMA, October 2022, **The market for ESG ratings should be transparent and competitive**



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Address the market uncertainties around transition financing

Making the EU Taxonomy fit for transition: identifying an “amber” category of activities

The current EU Taxonomy classifies activities as either green (EU Taxonomy compliant), and non-green (not respecting the technical criteria defined in the Taxonomy). The EU sustainability disclosure framework, including disclosures on the sustainability characteristics of investment products (SFDR), reflects this binary state and only focuses on disclosing the Taxonomy-aligned (or “green”) part of investments.

According to the latest estimates and proxies available, EU financial products are poorly aligned with the EU Taxonomy. As a general indication, ESMA’s 2021 quantitative study revealed that only 3% of EU funds’ portfolios had a 5% or more alignment with the EU Taxonomy.⁵⁰ This focus on the specific subset of “green” activities, along with the gaps in data availability from companies, are detrimental to meaningful sustainability disclosures, as it results in these low figures which are difficult to interpret. Indeed, these numbers can reflect both the ESG data gap cited above, but also a low level of green activities in the EU. For disclosures against the EU Taxonomy to truly have meaning, they must be reliable, but also more granular and comprehensive. Therefore, in addition to solving the ESG data gap, policymakers should improve the EU disclosure framework for activities that are in transition towards being green, and for those that are harmful to the climate transition.

The EU Taxonomy Regulation includes a category of “transitional activities”, which are considered “green” and as contributing significantly towards climate change mitigation. These activities are considered to have substantially lower greenhouse gas emissions than the sector or industry average, not to hamper the development and deployment of low-carbon alternatives, and not to lead to a lock-in of assets incompatible with the objective of climate-neutrality, considering the economic lifetime of those assets. **However, the current classification of transitional activities as “green” goes against the objective of the Taxonomy, which is to clearly categorise economic activities according to their environmental impact.** This lowers the ambition of the technical screening criteria (TSC) for transitional activities and keeps sectors that are currently putting an effort in phasing out damaging activities out of the Taxonomy Regulation.

⁵⁰ ESMA, 2021, [Advice on Article 8 of the Taxonomy Regulation](#)



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EU institutions need to send clear regulatory signals on what they want to encompass and incentivise a wider range of investments to support the climate transition. The European Commission must follow the advice given by its Platform on Sustainable Finance (“the Platform”)⁵¹ and extend the Taxonomy Regulation to include an “amber” category of transitional economic activities. An extended Taxonomy clearly identifying environmentally harmful activities (“red” category), transitional activities (“amber” category) and activities reaching the green standard (current “green” category) could be one of the ways to give clearer signals to investors on the destination of their investments, in complement to transition plans. The extension would have to be long-term and evolve to stay relevant across sectors and over time.

The Platform proposes that activities that are already listed under the EU Taxonomy, but do not yet qualify as “green” while respecting the Do No Significant Harm (DNSH) principle, would be included in the “amber” category. Activities that do not respect the DNSH principle should be included in the “red” category. Financial and non-financial companies under the scope of CSRD will be required to disclose the part of their turnover/CapEx/OpEx aligned with the EU Taxonomy starting from 2024. Adding an additional layer of detail to quantify the “amber” and “red” parts of their activities would improve market transparency on the non-green, transitional parts of companies’ activities. These disclosure requirements should be closely linked to these companies’ transition plans.

[Linking transition planning and an extended Taxonomy](#)

This additional layer of detail in disclosures would also be beneficial for investors and for their clients. Transition plans are in this case essential to contextualise the company’s transition trajectory. They would show, over time, how a company can improve its sustainability performance by developing green activities or phasing out environmentally harmful activities. This would concretely result in reporting the share of companies’ activities that do not respect the Do No Significant Harm principle (“red category”), are in line with the Do No Significant Harm principle (“amber” category), or contribute to the Taxonomy climate and environmental objectives (“green” category) and how their relative proportions vary over time.

⁵¹ Platform on Sustainable Finance, 2022, [The extended environmental taxonomy](#)



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Transition plans can link the EU Taxonomy’s focus on economic activities with CSRD’s entity-based reporting. They can be the source of information for building and assessing pragmatic interim steps for reaching various transition milestones at activity-level, and identifying the right incentives for meeting them at entity-level.

More granular disclosures would also be beneficial for investors and for their clients. Currently under the Sustainable Finance Disclosures Regulation (SFDR) investors must only disclose the “green” part of their investment portfolio. Among the non-green part, there is no reason for investors to focus more on transition activities, as there is no way for them to identify and promote such investments towards their clients. Reviewing the SFDR disclosure requirements to identify the part of these investments financing “amber” activities would be a way to incentivise financing towards these activities.

Clarifying what constitutes a transition investment would also be helpful to the overall transparency of the EU sustainable finance framework. In 2021, 33% of SFDR Article 9 products had exposures of more than 5% to fossil fuel companies.⁵² Identifying an “amber” category would contribute to enhancing transparency towards end investors on whether these companies’ activities are on a decarbonisation trajectory, with legacy environmentally harmful exposures. An additional “red” category of harmful activities could also improve the visibility of investors towards activities that are, by opposition, continuously harmful to the environment.

Developing innovative transition-linked financial vehicles

[Incentivising equity financing and venture capital investments in transition](#)

Financing the transition of companies towards a net zero trajectory requires investments from all the main categories of financial instruments. Indeed, transition covers the entire life cycle of projects and companies: venture capital/private equity for the R&D and growth phase, public equity and debt instruments for the commercialisation and consolidation phases.

⁵² Eurosif, 2022, [EU sustainable finance & SFDR: making the framework fit for purpose](#)



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However, the lack of equity financing remains a fundamental issue in the EU.⁵³ With initiatives such as the Capital Markets Union⁵⁴ dedicated to stimulating equity investments, a transition finance framework could create a virtuous circle by developing both equity finance and transition finance in the EU.

Equity investing will benefit in particular from both the uptake of transition plans at entity level and the increased transparency brought by an “amber” category of the EU Taxonomy at activity level. As CSRD requirements apply to all EU publicly listed companies, an overall framework for transition finance would also spur equity investment in listed companies with the most credible sustainability disclosures and climate transition plans.

In the EU, some innovative sectors and technologies will need financing to scale up. The main financing needs for these companies or projects come in the early stages, between research and pre-commercialisation. Private equity and venture capital are the tools of choice for this. However, firms benefiting from these investments, would likely not be included in CSRD’s scope. For these firms, adopting comprehensive transition plans and sustainability disclosures may be a disproportionate administrative burden.

The transition finance framework can here be used as guidelines to incentivise a wider adoption of proportional but robust transition plans and sustainability disclosures. Smaller firms detailing their contribution to climate transition to the best of their capacities will facilitate corporate research for investors and contribute to attract financing. This could help innovative companies to cross the well-known investment gaps already identified earlier in this report, between research and pre-commercialisation or between the launch of an innovative sustainable product and the generation of revenue.

[Develop sustainability-linked debt instruments for the transition](#)

The EU economy is mainly financed via debt instruments,⁵⁵ among which loans are the most prevalent. However, loans intervene at a later stage of business or project development. Developing innovative capital markets instruments, linked to the sustainability profile of the investee company, would be a good way to channel the general appetite of investors for sustainable products.

⁵³ Bruegel, 2021, [Europe should not neglect its capital markets union](#)

⁵⁴ European Commission, [Legislative measures taken so far to build a CMU](#)

⁵⁵ Bruegel, 2021, [Europe should not neglect its capital markets union](#)



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The EU Green Bonds Standards Regulation is in this case intended to develop the offer of green bonds in the EU. The Commission’s initial proposal incorporated a requirement for the proceeds of these instruments to be either Taxonomy-aligned or on an alignment trajectory with the EU Taxonomy. The EU Green Bond Standard Regulation would benefit from a review clause for this alignment trajectory to refer directly to the “amber” category once the EU Taxonomy is extended. Discussions on this policy file are still ongoing between EU institutions, and could also lead to green bond issuers being required to draft robust transition plans. Regardless of the final results of these negotiations, **the notion of transition is extremely important and must be maintained in the final EU Green Bonds Standards.**

In addition to EU Green Bonds, the European Commission could incentivise the development of various **sustainability-linked instruments** to create a wider variety of channels between private investments and transition activities and projects.

Sustainability-linked instruments are currently the fastest growing segment of sustainable debt market.⁵⁶ In particular, issuances of **sustainability-linked bonds (SLBs)** have grown exponentially since their inception to attain \$109 billion internationally in 2021. Sustainability-linked bonds can be defined as “any type of bond instrument for which the financial and/or structural characteristics can vary depending on whether the issuer achieves predefined sustainability or ESG objectives”.⁵⁷ The issuer can be both a private and a public entity. Their attractiveness for issuers comes from their flexible characteristics.

- > **The issuing company can currently choose the KPIs and targets applying to the whole organisation.** SLBs are often linked to a restricted number of KPIs (most often greenhouse gas emissions), with forward-looking targets at the discretion of the issuer.⁵⁸
- > A common use of SLBs is to **incentivise meeting these targets by increasing the bond’s interest rate in case of failure or diminishing it in case of success.** This conditions the cost of indebtedness for the issuer to its sustainability performance on its set of KPIs and targets, as well as investor’s decision on capital allocation.

⁵⁶ OECD, 2022, **OECD guidance on transition finance: Ensuring credibility of corporate climate transition plans – 2.2 Taking stock of transition-related financial instruments**

⁵⁷ ICMA, 2020, **Sustainability-linked bond principles – Voluntary process guidelines**

⁵⁸ Environmental Finance Data, **Sustainability-linked bonds and loans – key performance indicators (KPIs)**



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- > **Use of proceeds from the sustainability-linked bonds can be allocated to general purposes.** Contrary to green/sustainable bonds, there is no obligation to use these proceeds to finance or refinance green or transition projects, and the tracking mechanisms are milder because of the focus on the results linked to agreed KPIs.

In consequence, these instruments are useful tools **to raise capital on markets at a lower cost using a company's relative sustainability performance over time**, both from developing companies but also well-established ones.

Case study: Enel, first issuers of sustainability-linked bonds

Enel was the first company to adopt, in 2019, a framework that established a set of KPIs, targets and principles for bonds issuance that were linked to the group's overall sustainable strategy (sustainability-linked bonds). These issuances currently form part of Enel's global use of sustainability-linked instruments (including bonds, loans, credit lines and commercial papers), amounting to €63.2 billion in July 2022 (i.e., about 57% of the company's total debt). Enel designed its SLB to have an interest rate linked to the achievement of industrial targets for reducing direct greenhouse gas emissions and for growing of installed capacity powered by renewable sources. Enel submitted their first issuance of SLBs to an objective of having 55% of their installed capacity in renewable energy sources by 2021, which the company achieved.

Sustainability-linked finance has become an integral part of Enel's financing strategy and the company intends to bring its share of total gross debt financed by sustainability-linked instruments to around 65% in 2024 and more than 70% in 2030.

In addition to their use for financing private entities, SLBs could be useful in linking public and private finance, as several public institutions, including the ECB, started favoring purchasing corporate bonds from issuers with a proven sustainability track record.⁵⁹ Another example could be multilateral institutions developing private SLB purchase programmes backed by specific criteria and requirements to further incentivise the private sector transition towards net zero. It should also be noted that countries like Uruguay and Chile are already

⁵⁹ European Central Bank, 2022, [How are we decarbonising our corporate bond holdings?](#)



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issuing SLBs, with Uruguay linking the cost of financing to its Nationally Determined Contribution and the coverage of native forests in the country.⁶⁰

However, **the additionality of these instruments for the climate transition is highly dependent on the actual commitment of issuers.** Sets of general industry-based principles exist for SLBs, published by the International Capital Markets Association (ICMA)⁶¹ and the Climate Bonds Initiative (CBI).⁶² However, KPIs and targets are still largely left to the appreciation of companies themselves. This entails potential gaps in ambition and comparability across issuers and markets, bringing down the potential of these instruments to finance the climate transition and bringing up their risks of greenwashing.

Separating these harmful practices from the virtuous issuers committing to a climate transition should be facilitated at a policy level. In its Strategy for Financing the Transition to a Sustainable Economy,⁶³ the European Commission proposed to adopt a framework for sustainability-linked or transition-linked instruments. This could be a sensible way to introduce common minimum criteria for the emission of transition-linked debt instruments and to ensure sufficient commitments from their issuers.

As part of their mandate on avoiding greenwashing in EU markets, we encourage the European Supervisory Authorities (ESAs) to investigate the sustainability-linked instruments markets. According to the results of such a study, the European Commission could propose a unified framework for these instruments.

E3G strongly recommends the creation of such a framework, setting EU high-level guiding principles on what constitutes sustainability-linked instruments. This would include identifying a set of relevant and common KPIs issuers could choose from, aligned with KPIs present in other pieces of EU regulations such as CSRD and SFDR. This framework could also present proportional criteria to ensure a minimum level of ambition in target setting, proportional to the size of the issuer. **Issuers of SLBs should be required to draft credible transition plans including these KPIs and targets to justify their progress over time.** Finally, such a framework should guarantee transparency in the use of proceeds. Increased

⁶⁰ Responsible Investor, October 2022, [More sovereign SLBs 'on the way' after landmark Uruguay deal](#)

⁶¹ ICMA, 2020, [Sustainability-linked bond principles – Voluntary process guidelines](#)

⁶² Climate Bonds Initiative, 2022, [Transition finance for transforming companies](#)

⁶³ European Commission, 2021, [Strategy for financing the transition to a sustainable economy](#)



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transparency and comparability among sustainability-linked instruments would stimulate their uptake in EU markets while avoiding greenwashing.

[Address the myth of high risk/low return of sustainable investments](#)

Both bottom-up sustainability and transition data and top-down policy signals must be complemented by rigorous analysis and transparency on the characteristics of sustainable markets and products.

Despite their recent take-off in the EU, sustainable investments are still perceived by markets as having a specific high risk/low return profile.⁶⁴ However, current empirical evidence does not support such claims within the EU. European Supervisory Authorities (ESAs) have conducted several analyses on both the relative cost and performance of ESG investment funds⁶⁵ as well as their risks.⁶⁶ The ESAs concluded that compared to “traditional” products, sustainable investments products were relatively cheaper, performed better, and offered greater resilience.

These assessments are still preliminary and must be read with the caveat of low data availability for these relatively new financial products. However, they reflect a growing trend in mainstreaming sustainable investment and a shift in risk/returns ratio that is more adapted to attracting investors. From a public policy perspective, they also contribute to this trend by providing an objective analysis in support of sustainable investments.

A framework on transition finance should also include a mandate for the European Commission and ESAs to undertake similar analysis for investments in transition activities. Transition investments could also potentially benefit from this revised appreciation of risks and returns associated with sustainable investments. Such analyses can complement the policy signalling from the EU and governments outlined in previous sections of this report, together presenting credible messaging on the direction and actual levels of attractiveness of transition investments.

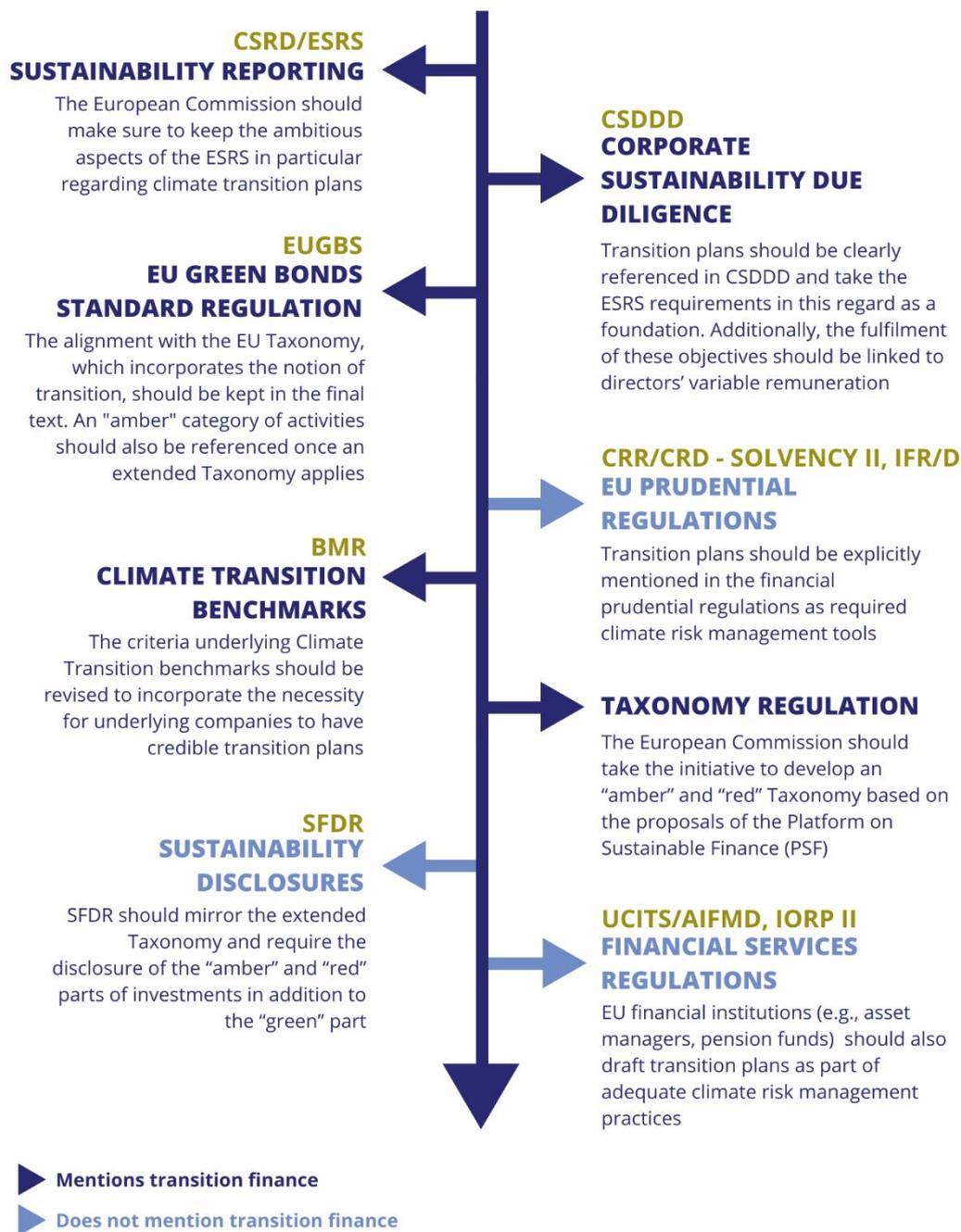
⁶⁴ ESMA, 2022, [Performance and costs of EU retail investment products](#)

⁶⁵ ESMA, 2022, [The drivers of the costs and performance of ESG funds](#)

⁶⁶ ESMA, 2022, [TRV risk monitor no. 2](#)



Figure 4. Overview of EU policies in the Sustainable Finance Strategy related to transition finance and recommendations





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CHAPTER 3

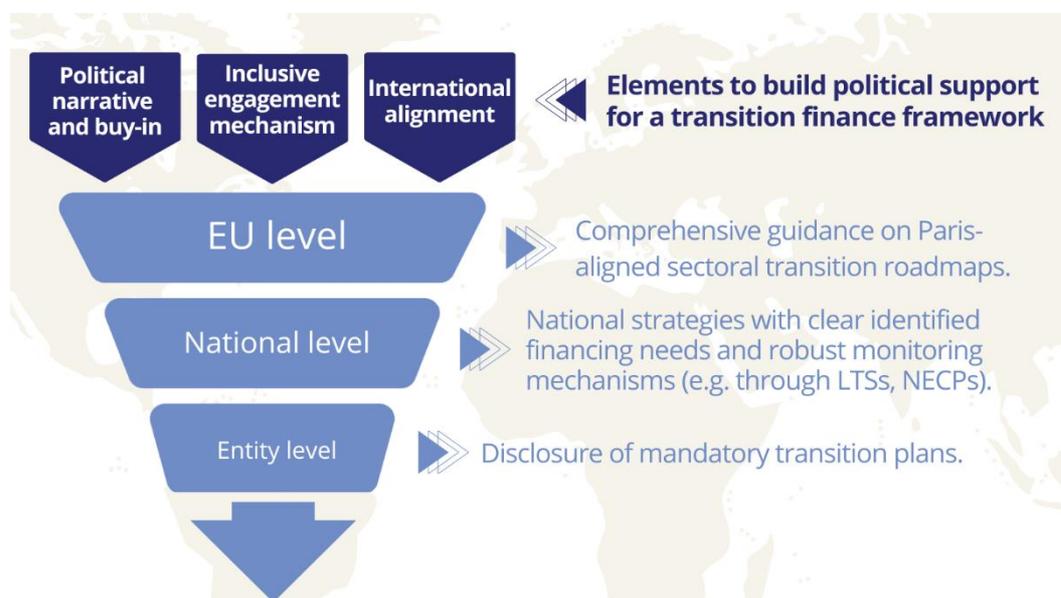
MAKING THE EU A LEADER ON TRANSITION FINANCE

Achieving a coherent transition finance framework and implementing it successfully in the EU will be challenging. There will be a tightrope to walk between actively steering the financial flows in the EU toward transitional activities and leaving ample space for investments to find their own path toward efficient and effective solutions. These are the parameters that a transition finance framework will have to navigate to design successful multi-layered engagement frameworks in which both public and private action will be needed to build the optimal balance. In addition, it is necessary to consider and acknowledge that the transition will look different among member states and EU regions. However, if well designed, such engagement frameworks can help the EU to influence international fora and partners, gaining relevance in different contexts such as the International Platform for Sustainable Finance (IPSF), G20, G7, and others.

Finding consensus and support for the efforts required to achieve and implement a transition finance framework in the EU is predicated on getting political buy-in for its goals and benefits. This can be done by developing the right political narratives, the engagement mechanisms needed to shape and test them with an inclusive range of stakeholders and achieving alignment with international developments on transition finance.



Figure 5. Political support for an orderly transition



Political narrative for an EU transition finance framework

The amount of planning needed on all political and entity levels along with nurturing a market for transition might be difficult for those who favour a market-led approach, especially when it requires market interventions and introduces additional administrative burdens for companies. Climate-related policymaking has proven to be politically difficult. Therefore, **alongside a coherent framework for transition there also needs to be a critical mass of support. There must be clear understanding of the business advantages and societal benefits of the transition, and the associated risks if it is not done in an orderly fashion.**

An EU transition finance framework would be as much a nudging tool to think about the transition as one supporting concrete planning. Identified below are a range of benefits for business entities, financial actors, and public institutions to support implementation of the efforts needed to feed a political narrative for a transition finance framework.

- > **Reducing risks of a disorderly transition:** The climate transition will have fundamental implications for the European economy and its society. This will not happen without deeply reshaping sectors, in particular carbon intensive ones. As can be seen in the energy sector, the transition will inevitably push



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technologies and products out of markets, while creating space for new ones. The transition will not come about without structural changes to labour markets as well. The more smoothly the transition can be designed, both at entity and macroeconomic levels, the smaller the disruption on job and production markets will be. Transition planning is therefore a key tool to provide indications on where individual entities and entire sectors might be moving towards, helping governments, investors, and associated sectors (such as suppliers) to adjust their own transition responses. Concretely, an early communication of indicative transition planning, for example in the steel industry, could help investors to identify suitable technology solutions, suppliers to alter their business models to coincide with the new production methods, and governments to plan the needed infrastructure for such a structural production shift. As such, economic risks stemming from a disorderly transition could be mitigated. Moreover, an orderly transition can help ensure the economy will adapt and be resilient towards climate risks.

- > **Matchmaking for investors:** The transition will require not just a large quantity of investment but also a variety of financing mechanisms. A transition finance framework could help to match transition-supporting projects with investors. Early technology deployment and innovation is relevant for venture capital or public investment programmes, whereas transition of established business projects will be financed by banks and institutional investors respectively. Public support through blended financing will also be necessary for de-risking less profitable but strategic big projects. A framework that requires disclosure of transition planning would allow such investments to be identified early on and in cooperation with investors. Untapping private investments to finance the transition would also contribute to developing the transparency, depth and diversity of EU capital markets.
- > **Indicative market development:** Aggregated private sector transition plans could deliver key data points on how markets might develop in the coming decades, how demand for certain input material may shift and what infrastructure is required in the climate transition and beyond. Public administrations can let such data points flow into planning of infrastructure, subsidy support schemes and public investment decisions, and avoid crowding out private investments. At the same time, the EU can help member states, regional and local administrations, and entities to assess and qualify transition planning efforts, for example through Europe-wide sectoral decarbonisation pathways. As such, the top-down pathways and aggregate analysis of transition planning could help to steer through the transition.



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Inclusive engagement mechanisms for the transition finance framework

As outlined in the first chapter, the transition will have a fundamental impact across the economy and society globally. A transition finance framework would enable this dynamic to be fully taken into account. It depends on broad co-ownership of national and regional public administrations, businesses, financial institutions, and civil society.

> Therefore, the EU's efforts to incentivise transitional thinking stands and falls with the **ability to clearly explain the merit of that exercise to key stakeholders**. For transition planning to have a transformative impact, it has to become a key element of public administrative planning and private sector management. This requires engagement and strategic dialogue, using arguments such as those outlined below highlighting the gains to be had from tackling the transition in a proactive manner.

> In the context of the legislative efforts, the European Commission should engage with national industry, financial sector and civil society associations to develop an accompanying narrative for transition planning. The goals of this engagement should be two-fold:

First, create a general awareness for transition planning as a critical tool to ensure that the European economy limits the disruptive implications of climate change and energy transition, and successfully walks the path to climate neutrality and resilience.

Second, the engagement should also function as a learning exercise to understand how regulatory requirements for the transition can be designed and implemented in an effective and efficient manner.

At the same time, guidance will be key. The European Commission should explore setting guideposts for transition planning and supporting this with proposals on linking public finance in particular (procurement, public banks) with transition key performance indicators. The European Commission should provide data-related and methodological support to those subject to transition planning disclosure, in the form of technology-neutral, science-based sectoral pathways that can help to both develop and assess transition plans. This could, for instance, be delivered by the EU's scientific advisory board on climate change and then be reflected at member state level.



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EU and international dynamics on transition finance

Competitive advantage in the EU market would be clearly contingent on transition trajectories of companies and sectors. The transition is already gaining pace internationally and European companies need to be able to evaluate how it will affect their market attractiveness and position in the market, both in Europe and internationally. At the same time, investors would also need to be able to factor in transition developments in their short-, medium-, and long-term investment horizons and predict market trends.

Similarly, the EU market is not operating in a vacuum and is already being affected by transition developments picking up pace in other jurisdictions. As the private sector is making net zero pledges, jurisdictions are following by creating certainty, clarity and redrafting the rules of the game. GFANZ (Glasgow Financial Alliance for Net Zero), for instance, comprises over 500 major financial institutions from more than 45 countries. Earlier this year, GFANZ published its recommendations on transition plans including best practice guidance for the financial sector and a discussion paper on phase-out of high-emitting assets.^{67,68} At COP27 GFANZ is expected to publish transition plan guidance and financial sector expectations for companies in several high-emitting real economy sectors. Proper action to back businesses' net zero commitments, however, requires not only a reasonable level of transition planning, but also proper government mechanisms for transparency and monitoring progress.

The G20 Sustainable Finance Working Group has also recently developed a set of high-level principles for transition finance, stating that such finance must be part of credible, time-bound and target-based plans that show which investments are necessary for the transition towards climate neutrality, as opposed to those that would adversely impact the transition.⁶⁹

Different jurisdictions are already picking up on the trend and following suit with regulatory measures. The UK government for instance requires large companies and financial sector participants to publish their transition plans from 2023 and has set up the Transition Plan Taskforce (TPT)⁷⁰ to facilitate the process and

⁶⁷ GFANZ, 2022, **Recommendations and guidance – Financial institution net-zero transition plans**

⁶⁸ GFANZ, 2022, **The managed phaseout of high-emitting assets**

⁶⁹ G20 Sustainable Finance Working Group, 2022, **2022 G20 sustainable finance report**

⁷⁰ UK Transition Plan Taskforce (TPT) Secretariat is being provided by the UK Centre for Greening Finance and Investment (CGFI) and by E3G



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provide guidance for disclosure.⁷¹ The TPT is to develop granular transition planning templates to be incorporated in the UK regulatory frameworks. The government also requires transition plans from public procurement companies for contracts over £5m.⁷² If the EU does not move in creating a coherent transition finance framework, the UK may set the global standards in the meantime.

Other jurisdictions are also moving forward with transition planning. Under Japan's new Clean Energy Strategy,⁷³ one of the key financial pillars is transition finance, linked to sector transition roadmaps developed by the Japanese government. Moreover, through international fora such as the IPSF (International Platform on Sustainable Finance) Japan is co-leading the work stream on transition finance, together with Switzerland and the EU. Launched in 2019, IPSF has been initiated and largely led by the European Commission to support and influence a common approach to sustainable finance globally. The EU has largely hit the brakes on high ambition cooperation following the EU Taxonomy crisis, which was marked by serious political divisions internally. **On transition, however, the EU has an opportunity, not only through the IPSF, but in other international fora such as the G20, G7, OECD, to be back in the driver's seat and participate actively in the emerging trends and deliberations.**

Europe driving some of these developments on transition finance thinking internationally is not a mere stretch of EU Green Deal diplomatic efforts or a demonstration of EU political capital globally. Capital markets are global too and regulatory measures in one jurisdiction spill over to other markets, which is precisely how the EU can influence the global transition.

Even when EU financial regulatory measures are seemingly designed for EU private market participants, they often have provisions and thus implications for stakeholders outside Europe with operations in European markets. The development of the EU Taxonomy eventually set into motion similar processes in over 20 other jurisdictions and the creation of a Common Ground taxonomy through the IPSF. CSRD, which will not come into effect until 2023, is already making its ripples across the world. For big international banks it will mean

⁷¹ Transition Plan Taskforce – [About](#)

⁷² Cabinet Office, 2020, [Transforming public procurement](#)

⁷³ The Government of Japan, June 2022, [Clean energy strategy to achieve carbon neutrality by 2050](#)



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reporting on businesses across multiple regions and much larger than some EU-based entities.⁷⁴

EU policies meant to shape and navigate transition finance also come down to the **competitiveness of European businesses and financial market players internationally**. Unlike other areas in which the EU has had a first-mover advantage, like taxonomies and corporate disclosures, transition finance and transition planning is already underway in other jurisdictions. Moreover, the patchy legislative landscape and lack of coherent and clear direction of travel for the EU, member states and European companies is the perfect recipe for another agenda that will be tough to agree, let alone sell internationally.

Once the right governance framework is in place encompassing all EU levels, this needs to be properly communicated within the EU and different member states, local communities and businesses. Lack of understanding of the risks and opportunities and more broadly what transition would entail for companies' competitiveness in Europe and abroad could easily result in a public and political backlash, especially from parts of the Union that do not recognise the goals of the Green Deal as their own.

To achieve all this, the EU itself should start planning for the transition.

⁷⁴ Financial Times, August 2022, [Global scope of EU's greenwashing crackdown spooks Wall Street](#)