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AN EU FRAMEWORK FOR FINANCING THE TRANSITION



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INTRODUCTION

As recognized by G20 in its recent report, despite the rapid growth of the green and sustainable finance markets, financing efforts have mostly focused on green activities, while support to the broader range of investments needed for the whole economy's climate transition, including those undertaken by GHG intensive sectors and firms, has been limited. UNEP FI attributes this relatively limited amount of transition financing to two core issues: i) insufficient appreciation of the need to mobilize greater amounts of capital to carbon-intensive sectors to reduce emissions in line with net-zero goals, and) the absence of clearly defined labeling standards by existing initiatives and a lack of transition-specific taxonomies.

As further stated in the G20 report, an **effective framework for transition finance** can support the whole economy's transition and improve the ability of sectors or firms to gain access to financing to support their transition to net zero emissions, mitigating the potential negative effects of a disorderly transition. An effective framework can also reduce the risks of green and SDG washing.

Last year at COP27, more than 550 financial institutions committed, as GFANZ members, to align their financing activities with net-zero goals. Many European banks have joined initiatives such as the Net Zero Banking Alliance (NZBA) or the Collective Commitment to Climate Action organized by UNEP FI. Such voluntary commitments are assumed on a best-effort basis and **can only be successful through banks' collaboration with their customers and other stakeholders**, who must also play a key part.

Given that different counterparties have different starting points to become more sustainable or aligned with the taxonomies^[1], it is important to provide a **common framework - a clear Guidance**. Such Guidance would not only support and **underpin voluntary commitments** made under robust global frameworks that are subject to assessment and scrutiny of recognized international organizations but also **provide a clear understanding of what constitutes transition finance**. We believe such Guidance at EU level would not only facilitate the engagement with customers but also **diminish the risk of greenwashing**- a risk that is likely to disincentivize further uptake of voluntary commitments both by financial and non-financial entities.

[1] Such as the EU Taxonomy for sustainable activities



FINANCING BASED ON TRANSITION PLANS OF COMPANIES



Banks may wish to design financial products and solutions for companies based on their transition plans. These financing products could be considered complementary to the financing based on KPI targets or thresholds set at activity level. Such approach could also be considered for sectors that haven't been listed in the EU Taxonomy.

Activity-level, entity-level, and portfolio-level assessments are complementary, as lending portfolios are decarbonized by companies which decarbonize their activities following science-based transition pathways[2] and roadmaps[3]. As transition pathways will vary among regions and sectors, country-level and sector-level transition pathways and transition roadmaps are needed for banks to use as a benchmark when engaging in discussions with their clients.

[2] sector transition pathways represent the decarbonization CO2 curve of the sector.

[3] Sector transition roadmaps include technical measures that a company can take, often shown as an abatement curve



Portfolio assessment based on



Entity-level targets based on



Activity-level KPIs based on



Sector pathways based on



Science

To attain a long term reduction of emissions in the real economy, banks must be prepared not only to finance the development and scaling up of climate solutions but also to allocate capital to companies in GHG-intensive sectors in line with their credible plans to decarbonize. This support of clients, for instance in scaling up and adopting climate-change mitigation technologies, may lead to an increase in the exposure to companies in carbon-intensive sectors in the short-term – which can lead to a non-linear reduction in financed emissions.

TRANSITION FINANCE FRAMEWORK AT EU LEVEL

In the past, the financial industry already called for a **transition finance framework at EU level** to encourage, enable and incentivize the financing of companies that require capital to improve the environmental performance of their activities, which may not or may not yet reach the thresholds set by the “taxonomy of sustainable activities”, and therefore cannot be considered EU taxonomy aligned.

Such a framework is needed to enhance communication with customers, ensure financing on a level playing-field basis and improve comparability. We support accelerating further deliberation on how to better consider transition at both activity level and entity level in order to enhance the engagement with clients in a clear and comparable manner, based on a common transition finance framework that facilitates understanding transition trajectories and assessing progress over time.

For the above-mentioned reasons, a transition framework with intermediate performance thresholds (roadmaps), which are aligned with the science-based sectoral transition pathways, will need to be defined at EU level, while taking into account developing market initiatives.

For climate-related topics, such transition finance frameworks are currently being developed by international voluntary initiatives, including Race to Zero, GFANZ, and NZBA. A very useful reference for this transition framework is proposed by GFANZ in its report **Financial Institution Net-zero Transition Plans**, which identifies four ways to support the climate transition:

- **Climate solutions:** Financing or enabling entities and activities that develop and scale climate solutions
- **Aligned:** Financing or enabling entities that are already aligned to a 1.5°C pathway
- **Committed to Aligning:** Financing or enabling entities committed to transitioning in line with 1.5°C-aligned pathways
- **Managed Phaseout:** Financing or enabling the accelerated managed phaseout (e.g., via early retirement) of high-emitting physical assets. GFANZ has also published a specific paper (The Managed Phaseout of High-emitting Assets) on how to facilitate the early retirement of high-emitting assets as part of a just transition to a net-zero world

With the above considerations in mind, we would like to suggest that the **Commission issue a clear transition finance framework including guidelines and benchmark sectoral transition pathways and roadmaps** based on **existing initiatives (such as GFANZ)** to further support the transition of activities and companies, and their financing based on a harmonized framework.

Taking into consideration the existing voluntary initiatives and implementation efforts of financial actors would avoid doubling the efforts of market participants, as well as ensure that the Commission can use the existing initiatives as a basis.

To this extent we propose that the Commission:



AT ACTIVITY LEVEL

Define which transition pathways should be used for each economic activity per industrial sector with possible national specificities where relevant.

Such benchmark transition pathways should be science-based and aligned with both EU climate targets and the Paris Agreement objective to limit global temperature rise to 1.5°C. Sector transition pathways should be complemented by sector transition roadmaps.

Practical examples on how the current environmentally sustainable EU Taxonomy could already be leveraged for transition financing are included in the EBF/UNEP FI report – chapter C.[1] However, more guidance is necessary to define common transition pathways for each sector. A useful reference may be represented by the Japan METI's Technology Roadmap for Transition Finance included as a case study in the NZBA Transition Finance Guide [4].



AT ENTITY LEVEL

Standardize corporate transition plans at entity level (with 7 components as suggested by EFRAG including measures and – very important for banks – a capex/investment plan).

A common definition of both transition pathways, transition roadmaps, and transition plans is important as they could be leveraged by financial institutions for client's engagement.

[4] <https://www.ebf.eu/wp-content/uploads/2022/02/EU-Taxonomy-Report-2022-3.pdf>

ACTIVITY LEVEL

The EU Commission should define EU transition pathways at sectoral level, including transition roadmaps

The transition trajectory of all activities belonging to the same sector should be assessed using the same credible sectoral benchmark transition pathway. **This implies that the EU Commission should not only specify sectoral pathways in line with credible scenarios but also specify transition sectoral roadmaps, i.e., KPIs, intermediary targets (including intermediate technical screening criteria when relevant), and milestones by sector with possible national or regional specificities where relevant, so that corporates have clear benchmarks against which to define their own transition plans.**

Clear guidelines on transition pathways that could be implemented consistently at EU and international levels will be an effective tool to enhance and incentivize the efforts of companies to align their activities with the EU environmental objectives as well as to support the assessment of such companies' efforts. **While the same logic should apply for all environmental objectives, given the level of maturity of climate objectives, we propose that the EU Commission focus on climate first.**

Activities that need to transition

The **activities that need to transition** ("In Need of Transition activities - INT) could therefore be benchmarked against the relevant sectoral EU transition pathway (incl. roadmaps), resulting into two sub-categories: **activities that are aligned with their benchmark transition pathway, and activities that are not.**

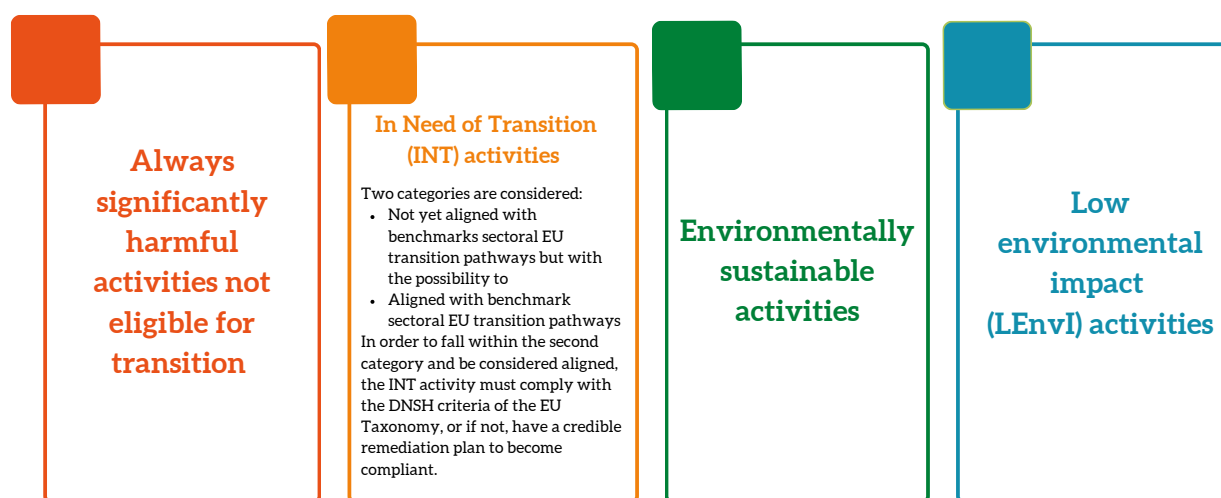
While we wish to keep the framework operationally simple, we believe that for **INT activities** there should be a further distinction **between those activities which are aligned with their benchmark sectoral EU transition pathway and those that may be in transition but are not yet aligned.** This differentiation will indicate that the environmental performance of the latter has the potential to improve but its **transition process has not been initialized yet or is lagging behind with respect to its benchmark sectoral pathway.**

A successful decarbonisation transition must also avoid harming the achievement of other objectives. At a minimum, there should be no unintended consequences to other environmental objectives. We, therefore, believe that for **activities in transition to be considered "aligned" with their benchmark sectoral EU transition pathway, they should also comply with the DNSH criteria of the EU Taxonomy, or if not, have a credible remediation plan to become compliant (e.g., within a maximum of 5 years[5]).**

[5] May diverge depending on the kind of activity

Activities that have no technological possibility of improving their environmental performance

We also believe it is necessary that the Commission **exclude from the transition finance framework activities that have no technological possibility of improving their environmental performance** to avoid significant harm (always significantly harmful). While such exclusion should be expected to be introduced for all environmental objectives, we recommend the Commission to commence with climate objectives. Under this approach, **only financing of de-commissioning or managing phaseout of activities not eligible for transition should be considered in the transition finance framework.**



In conclusion, all activities that neither can be classified as “environmentally sustainable” under the EU taxonomy nor are excluded from the transition framework as “not eligible for transition” should be recognized as **in need of transition activities** i.e., that have the **potential to become both aligned with the technical screening criteria and compliant with the DNSH criteria** of the environmentally sustainable Taxonomy at some point in the future. Supporting and considering carbon strategies and transition plans for the years ahead until 2050, including for companies which have activities causing significant harm, should be an EU priority. The purpose is to clearly show that companies must improve irrespective of their starting point

Activities with low environmental impact

If the Commission decides to develop the LEnVI category to address activities that are not covered by the EU Taxonomy as they are not able to substantially contribute to the environmental objectives due to their characteristics but are also not environmentally harmful, we suggest that it should take the form of a simple list of LEnVI activities that could be helpful in facilitating the understanding of GAR reporting and avoiding consideration of such activities in a negative way. This classification should not entail new regulatory reporting requirements and companies should be able to make reference to it on a voluntary basis.

Also, it should be clarified that the allocation of the main part of the EU SMEs in this category should not prevent SMEs from applying for funds or other supporting measures dedicated to improving the environmental performance of their activities. Strengthening Communication on the impact of the EU sustainable finance framework, including the EU Taxonomy, and further developments on corporates and SMEs should also be considered.

ENTITY LEVEL

Standardize corporate transition/remediation plans at entity level – alignment with sectoral pathways and roadmaps

Transition plans are usually defined at corporate level. The EFRAG proposal for transition plans foresees eight components for transition plans^[6]. Banks will have different dialogues with companies that are at different stages of their corporate transition plan. To keep this corporate engagement activity simpler and, to the extent possible, based on externally validated transition plans to enhance consistency, standardized components as proposed by the EFRAG of what constitutes a reliable transition plan is essential. **While the first element foreseen for the EFRAG transition plan (emission reduction targets) can be considered the transition pathway of the company and the second element (climate change mitigation actions) the technical roadmap**, to increase comparability and reliability, we believe that the **company should base its transition plan on the relevant sectoral transition pathways as specified by the EC (see point 1 above)**. For companies with activities across different sectors, their corporate transition plan should encompass all the relevant sectoral transition pathways and could be split by sector.

In this context and wherever feasible, banks should be able to rely on third party verification (as already contemplated in the CSRD) that a company's transition plan is credible and fully financed, whether it is aligned or not with its relevant benchmark sectoral transition pathway(s), and whether it complies with all DNSH criteria of the EU Taxonomy (or if not, it has a credible remediation plan to become compliant, e.g., within a maximum of 5 years). The alignment of a corporate transition plan is determined notably by whether it is meeting the intermediary milestones of the transition pathways for each of its activities and **the liability for the transition plans as well as fulfilments of the intermediary milestones should rest with the company**.

To increase financing of transition and/or remediation at entity level, **general purpose corporate financing should be considered as “transition finance” at inception in a proportion equal to the share of the corporate's activity that is both aligned with its relevant benchmark transition pathway(s) defined by the Commission and compliant with DNSH or having a credible remediation plan to become compliant, e.g., within a maximum of 5 years**.

For example, general purpose corporate financing provided by a bank to a company with 70% of its activity being aligned should be recognized in the bank's books as “transition finance” for 70% of the bank's exposure. ASH activities should always be excluded from the scope of transition finance with the exception of financing of de-commissioning or managing phaseout of such activities.

Although future investments in R&D or capex provide indications on the direction of a company's business model, we believe that considering the entire transition plan of a company as defined by EFRAG is paramount to understand: i) how such expenditures will be financed and ii) the business model of a company - in order to anticipate its future leverage ratios.

^[6] [https://www.efrag.org/Assets/Download?](https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FSiteAssets%2F08%2520Draft%2520ESRS%2520E1%2520Climate%2520Change%2520November%25202022.pdf)

[assetUrl=%2Fsites%2Fwebpublishing%2FSiteAssets%2F08%2520Draft%2520ESRS%2520E1%2520Climate%2520Change%2520November%25202022.pdf](https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FSiteAssets%2F08%2520Draft%2520ESRS%2520E1%2520Climate%2520Change%2520November%25202022.pdf)

CONCLUSION

We believe that our proposal for a transition finance framework would encourage the financing of activities that are not yet sustainable but in transition/remediation (on DNSH). Such framework would be a key tool enabling corporates to align with the EU climate objectives, while at the same time could represent an effective tool to counter greenwashing claims.

We also support the Commission's efforts to focus on the finalization of the environmentally sustainable Taxonomy by defining the science based environmental criteria for the remaining 4 environmental objectives as well as enlarging the list of activities under the two climate objectives as relevant.



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