Where are the people in transition finance?

Transition finance – designed to help polluting companies deliver long-term strategies to reduce their carbon footprint – is a relatively new addition to the suite of sustainable finance instruments. ***Sabrina Muller*** *and* ***Nick Robins*** *explain how and why the 'just transition' to net-zero, an inclusive process that takes into account the impacts on all people and places, needs to be fully incorporated.*

This article is part of a series by LSE's Grantham Research Institute on Climate Change and the Environment.

Sustainable finance is set to be prominent again in 2022, not least to speed action on climate change and clean energy. The Communiqué of the G20 Finance Ministers and Central Bank Governors Meeting in February highlighted sustainable finance as being "critical to a green, resilient and inclusive global economic recovery" from COVID-19]. One area of focus for the G20's Sustainable Finance Working Group (SFWG) this year is transition finance, with finance ministers pledging to "take actions to enable transition finance to support orderly, just and affordable transitions towards a low-greenhouse gas emissions and climate-resilient economy".

Supporting the shift from unsustainable activities

A relatively new tool, transition finance is focused on supporting firms in emissions-intensive and hard-to-abate sectors to decarbonise, rather than on allocating capital to activities that already meet green standards. It is typically structured as a use-of-proceeds bond, so issuers need to demonstrate that proceeds are used for activities that contribute to decreasing carbon emissions.

The transition bond market is still nascent compared with other types of sustainable finance. In the first three-quarters of 2021, 14 transition bonds were issued, accumulating to US$5 billion, according to the Climate Bonds Initiative. In September 2021, the volume of transition bonds stood at US$9.9 billion, with 31 issuances in total. In comparison, green bond issuances grew to US$354.2 billion in the first three-quarters of 2021, bringing the total volume to US$1.4 trillion.

The sceptical view on transition finance questions if these instruments are truly moving companies beyond business-as-usual, or simply 'transition-washing'. To build market trust, robust frameworks are needed that are both science-based and build on essential international standards for environmental, social and governance (ESG) performance. The OECD published a stocktake of emerging approaches and financial instruments in 2021, showing a growing number of transition finance frameworks from collective initiatives and individual institutions that aim to lay out what 'good' looks like and define what ambitious decarbonisation targets entail.

Japan has established the Taskforce for Formulating Roadmaps for Promoting Transition Finance in the area of Economy and Industry, which will prepare sector-specific roadmaps for reducing greenhouse gases, to be used as a basis for developing and assessing transition strategies. The Japanese government is also collecting good practice examples of transition finance, applying its Basic Guidelines of Climate Transition Finance, for which it offered to subsidise up to 90 per cent of external review costs.

The EU is currently working on defining activities that are significantly harmful to the environment, along with those that have no significant impact, to support the transitions of companies that currently have a negative effect on the planet. The Commission is exploring options to integrate these activities into the green taxonomy, as well as the possibility of consolidating the environmental and social taxonomies.

As part of this market creation process, the G20's Sustainable Finance Working Group has been tasked with developing a high-level framework for transition finance in 2022.

Factoring in the just transition

As the G20 Finance Ministers pointed out last month, successful transitions need to be "orderly, just and affordable". This builds on the major shift made at COP26 when the just transition moved into the mainstream of climate policy and finance, with at least 10 new initiatives launched that had a direct or indirect focus on making the just transition a reality. Indeed, the Glasgow Financial Alliance for Net Zero (GFANZ) has recognised the just transition as a 'best practice' component for the transition plans of both the real economy and the finance sector.

Emissions-intensive and hard-to-abate sectors are arguably where the social risks and opportunities connected to climate action are greatest in terms of the potential impacts on workers and communities. For example, the Glasgow COP underscored the need to accelerate the phase-down of coal power and a growing number of initiatives are developing mechanisms to deliver the 'responsible retirement' of coal assets, including fair treatment of workers and communities.

Transition finance would seem an obvious tool to advance the environmental and social dimensions of decarbonisation. However, the growing recognition of the just transition as a critical success factor is not yet reflected in current transition finance guidance or practice. Of the eight selected transition finance frameworks presented in Table 1, only two explicitly cover the just transition: ICMA's Climate Transition Finance Handbook recommends: "where a transition may have negative impacts for workers and communities, issuers should outline how they have incorporated consideration of a 'just transition' into their climate transition strategy, and may also detail any 'social' expenditures that are considered relevant within the context of transition finance." The Japanese Government guidelines take a similar approach.

Table 1. Consideration of the social dimension in selected transition finance frameworks

Organisation	Transition finance framework	Consideration of jus
International Capital Market Association (ICMA)	Climate Transition Finance Handbook	Explicit guidance on
Japanese Government	Basic Guidelines of Climate Transition Finance	Explicit guidance on
AXA Investment Managers	Guidelines for Transition Bonds	Disclosure of enviror impact; just transitio addressed.
European Bank for Reconstruction and Development (EBRD)	Green Transition Bond Framework	Social dimension as a additional eligibility transition not directl
Standard Chartered	Transition Finance Framework 2021	Just transition menti guidance.

DBS Bank	Sustainable & Transition Finance Framework & Taxonomy	Use of proceeds: Jus dimension not addre Company in transitio as a potential additic criterion; just transit addressed.
Climate Bonds Initiative and Credit Suisse	Financing Credible Transitions – A framework for identifying credible transitions	Just transition/social addressed.
Climate Bonds Initiative	Transition Finance for Transforming Companies	Just transition/social addressed.

Three frameworks speak to the integration of social considerations more generally, albeit in a very limited capacity. AXA's guidelines include the disclosure of the "estimated environmental and social performance and impact" as part of good practice. The EBRD framework covers the social dimension as a potential additional criterion for eligibility but does not give further detail on how this could be applied. In addition, projects are expected to comply with EBRD's Environmental and Social Policy. Similarly, Standard Chartered's guidance includes a reference to its Environmental and Social Risk Management Framework defining minimum safeguards.

The remaining three sets of guidelines do not consider any social elements of the net-zero transition. While the DBS definition includes a company diversifying through the acquisition of a socially positive business as one reason to classify it as a 'company in transition', it does not mention social factors in its description of a use-of-proceeds instrument. The Climate Bonds Initiative documents expressly acknowledge the importance of delivering a just transition and sustainable development but deliberately limit their scope to climate mitigation exclusively.

Closing the gap

With growing numbers of banks and investors committing to support the just transition, we expect transition finance frameworks and practice to evolve fast.

One group that could be early movers are the multilateral development banks, who published their Just Transition Principles at COP26. Since 2019, the EBRD has issued a handful of transition instruments under its Green Transition Bond Framework. The proceeds are used to support projects improving energy and resource efficiency, as well as sustainable infrastructure in sectors that are highly dependent on fossil fuels. This is particularly relevant in the EBRD regions, as they count among the most carbon-intensive economies globally. In early 2021, the EBRD issued an AU$ 280 million transition bond, which was bought in full by Japan Post Insurance Co as part of its commitment to supporting environmental sustainability and a just transition. On a strategic level, the EBRD is aiming to link its hitherto separate policies to support green and inclusive transitions through its Just Transition Initiative. An obvious next step would be to apply this to its bond issuance programmes.

Corporate issuers could also take a step forward, not least in the energy sector, where a new Just Transition Energy Framework was published in 2021. Italian utility Snam is a repeated transition bond issuer, for example, and it has a goal to increase its share of sustainable finance to 60 per cent by 2024 to support the business in becoming carbon-neutral by 2040. Most of Snam's transition bonds have reached more than three times oversubscription by investors. These and other energy companies could also issue transition bonds that support decarbonisation through a just transition, ensuring that employees and the regions where they operate are not left behind as fossil fuel assets are closed.

This year, the G20's Sustainable Finance Working Group has a real opportunity to strengthen transition finance by incorporating the just transition. It could set the standard for other individual and collective initiatives. Incorporating explicit guidance, targets and reporting for workers, communities and consumers would help to ensure that the social opportunities of the transition are realised and the risks mitigated. By taking this purposive approach, transition finance can fulfil its role as an important contributor to a truly inclusive shift to net-zero.

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Notes:

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