Transition investing: key challenges and opportunities

BETTER FINANCE

The European Federation of Investors and Financial Services Users

Fédération Européenne des Épargnants et Usagers des Services Financiers

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"If a 'brown' company changes its polluting emissions by just 1%, that would be much more meaningful for the environment than an already existing green company, which changes its emissions by 100%."[1]

Professor Kelly Shue, Yale University

Executive summary

Transition investing refers to capital needed to improve economic activities, that are not environmentally friendly at present. Such capital supports the development of innovation and infrastructure, enabling current activities to eventually achieve climate neutrality.

The European Commission's release of the transition finance 'Recommendation'[2] emphasised the importance of such investments for Europe's pursuit of environmentally conscious goals. Despite the efforts in bringing more clarity on how to use transition finance tools, (such as climate benchmarks, green loans, bonds and equity financing), the Recommendation is non-binding with voluntary nature. This creates inconsistencies for undertakings, financial intermediaries, Member States and investors alike.

With this thought leadership piece, BETTER FINANCE assesses the current transition investing framework in the EU and beyond; identifies key drivers for transition; compares the current decarbonisation pathways of Member States and sectors; and ultimately looks at the ways in which pension savers and individual ("retail") investors, can participate in, and benefit from transition investing, while improving the current environmental narrative.

Design and disclosure of credible plans - outlining planned steps to achieve climate neutrality by 2050 - are of utmost importance. While cognisant of some data limitations for all pertinent stakeholders, further supplementary research is necessary to provide a thoroughly comprehensive assessment of the transition investing landscape across the European Union.

[1] Shue, K. (2022) 'Counterproductive sustainable investing: the impact elasticity of brown and green firms', Yale University.

[2] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32023H1425

What is transition investing?

Transition investing represents a set of emerging tools and strategies within the realm of sustainable finance, gaining traction both in the EU and globally. The Organisation for Economic Co-operation and Development (OECD) defines it as a financing approach that emphasises the ongoing process of achieving sustainability, rather than merely assessing existing sustainability[3]. This approach aims to provide solutions for a comprehensive shift towards a decarbonised economy.

The foundation of the concept of transition finance can be traced back to Article 2.1 c) of the Paris Agreement[4], which underscores the need to align financial flows with a path toward reduced greenhouse gas emissions, and climate-resilient development. In simpler terms, transition finance is essential to achieve net-zero objectives, as it facilitates the reduction of carbon-intensive industries. This involves not only reshaping business practices on a systemic level, but also expediting the phase-out of high-emission assets, to prevent the accumulation of stranded assets in the market.

Various definitions of transition finance have been put forth by governments, research institutions, central banks and the current landscape of transition financing theories and practices, also vary from country to country, with the common denominator being that of keeping global warming to 1.5 °C.[5] Thus, accelerating the transition from a ‘brown’ economy to a green one should be the top priority for all stakeholders, including investors who want to contribute to the fight against climate change and other environmental, social and governance issues.

“The necessary transition towards climate-neutrality is going to improve people's well-being and make Europe more competitive. But it will require more efforts from citizens, sectors and regions that rely more on fossil fuels than others.”

Former Executive Vice-President for the European Green Deal, Frans Timmermans

[3] https://www.oecd.org/environment/oecd-guidance-on-transition-finance-7c68a1ee-en.htm
[4] https://unfccc.int/sites/default/files/english_paris_agreement.pdf
[5] https://www.energy-transitions.org/publications/keeping-1-5-alive/

Transition investing framework in the EU

The European Commission has launched a range of tools to facilitate a financial framework that expedites the transition to a greener European economy. The various parts of legislations, including the EU Taxonomy[6], Corporate Sustainability Reporting Directive[7], European Sustainability Reporting Standards (ESRS 1 climate)[8], Corporate Sustainability Due Diligence Directive[9], EU Green Bonds Standard[10], and many others, form a framework that encompasses elements of transition plans, disclosures and transparency.

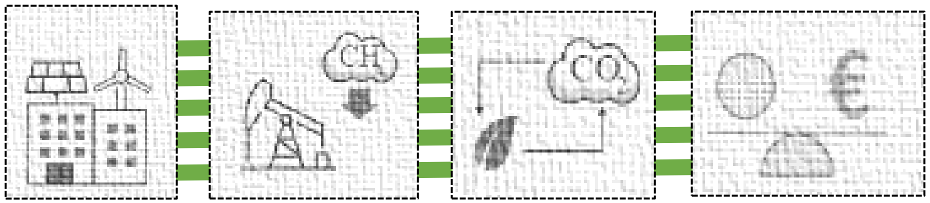
However, clear transition plan requirements across the financial services legislation which includes among others, banks and insurers, would need to be strengthened in order to ensure that all undertakings and financial intermediaries are able to reduce legal uncertainties and by extension create an even level playing field that can benefit end-users and consumers as well as the environment in the long-term.

While the Commission plans to promote the uptake and international inter-operability of transition finance framework, there is only a limited number of businesses that have developed and reported with credible transition plans[11], backed by scientific evidence and aligned with the Paris Agreement for example. Effective transition plans enable companies to outline their specific transition paths and allocate appropriate resources for the materialisation of net-zero trajectory. In turn, this also offer transparency to investors who seek to include transition committed companies in their portfolios.

Accompanied by continuously evolving legislative landscape, transition investing remains at the helm of progressive sustainability measures. However, in the absence of a single definition and holistic framework, there is limited comparability between concepts and practices of transition financing in general. Therefore, the European Commission should consider introducing a Directive or a Regulation specific to transition investing, accompanied with a set of detailed parameters.

"European climate law makes reaching the EU's climate goal of reducing EU emissions by at least 55% by 2030 a legal obligation. EU countries are working on new legislation to achieve this goal and make the EU climate-neutral by 2050."

Council of the European Union



[6] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R0852
[7] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32022L2464
[8] https://finance.ec.europa.eu/regulation-and-supervision/financial-services-legislation/implementing-and-delegated-acts/corporate-sustainability-reporting-directive_en
[9] https://commission.europa.eu/publications/proposal-directive-corporate-sustainability-due-diligence-and-annex_en
[10] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0391
[11] https://cdn.cdp.net/cdp-production/cms/reports/documents/000/006/785/original/Climate_transition_plan_report_2022_%2810%29.pdf?1676456406

Transition initiative: Europe and beyond

The myriad of transition initiatives can be helpful only if a level of harmonisation is kept between them, in order to allow businesses and end-users compare the ways in which transition methodologies are applied. Though not an exhaustive list, some of the leading transition initiatives include the OECD's Guidelines on Transition Finance[12], the G20 Framework for Transition Finance[13], the Report on Transition Finance from the International Platform on Sustainable Finance[14], and the Report of the United Nations High-Level Expert Group on the Net Zero Emissions Commitments of Non-State Entities[15].

The following illustrates a non-exhaustive list of initiatives targeted at economies, corporates, financial institutions and investors:

- Net-Zero Banking Alliance
- Glasgow Financial Alliance for Net Zero (GFANZ)
- Net Zero Asset Managers initiative (NZAM)
- Network for Greening the Financial System
- Investor Group on Climate Change
- Climate Action 100+
- Climate Bonds Initiative
- UNEP FI Principles for Responsible Banking
- Paris Agreement Capital Transition Assessment (PACTA)

Currently there are over 20 guidelines and frameworks with focus on transition finance, but most do not take into account assessment of transition plans.

"Everyone has to take their responsibility. In the EU, we will cut our emissions by at least 55% by 2030. We will become the first climate neutral by 2050. And we will continue to support our partners to speed their climate transition."

European Commission President, Ursula von der Leyen

Europe

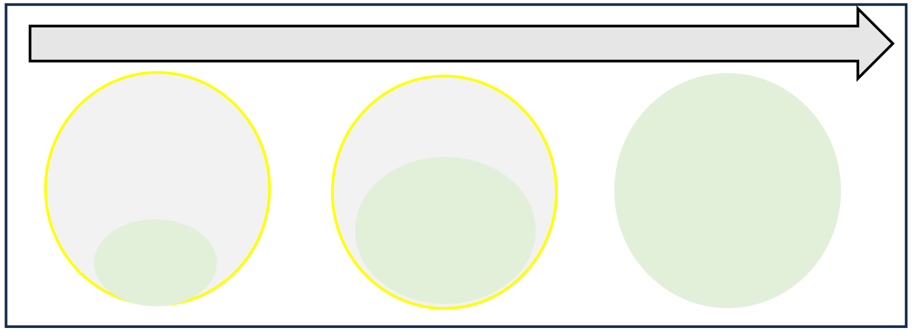
At a European level, it has been identified that over €700 billion are needed annually to decarbonise the economy in line with the net zero targets.[16] In order to provide some clarity on how this can be achieved, the European Commission recently issued a non-binding set of Recommendations[17], shedding light on how companies can use the various tools of the EU sustainable finance framework on a voluntary basis, to channel the investments into the transition and manage their risks stemming from climate change and environmental degradation.

While this is encouraging, it only confirms that investors, as well as financial intermediaries, can contribute to the financing of the transition by reflecting transition funding objectives in their lending or investment strategies. The voluntary nature of the Recommendations, however, do little in terms of ensuring coherent financial approach to transition, since it is left to companies to determine whether the recommendations are applicable to them on one hand, and the extent to which they do, on another.

[12] https://www.oecd.org/environment/oecd-guidance-on-transition-finance-7c68a1ee-en.htm
[13] https://g20sfwg.org/wp-content/uploads/2022/10/2022-G20-Sustainable-Finance-Report-2.pdf
[14] https://finance.ec.europa.eu/system/files/2022-11/221109-international-platform-sustainable-report-transition-finance_en.pdf
[15] https://www.un.org/sites/un2.un.org/files/high-level_expert_group_n7b.pdf
[16] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32023H1425
[17] *Ibid*

Despite this, one of the promising elements in the Recommendations, is the clear link between green and transition finance whereby the latter is not associated with green performance in the immediate term, but nonetheless aligns with climate and environmental objectives during a medium- and long-term change.

Relationship between green finance and transition investing



Financing investments that are green

Transition to EU objectives, becoming green in the future

Since the objective is to facilitate transition finance to companies that do not necessarily have strong sustainability records (yet), credible transition plans and targets to improve sustainability performance need to be measured in a coherent and transparent way, otherwise retail investors nor others alike will benefit from such practice and instead see a rise of greenwashing claims with no substantiated evidence or metrics.

United Kingdom

The UK created the so called 'Transition Plan Taskforce'[18] which is aimed at setting a standard for private sector climate transition plans. In addition to including transition plan disclosures as part of its general-purpose financial reports, the TPT regards it as good practice for an entity periodically to publish its transition plan in a single standalone document that sits alongside its general purpose financial reports. This means that the TPT provides additional recommendations on what a good practice climate transition plan should cover, which goes beyond the International Sustainability Standards Board final climate-related financial disclosure requirements. The TPT framework consists of five key elements:

1. Strategic Ambition – company objectives and impact in value chain
2. Implementation Strategy – actions to ensure business operations are providing transition based outcomes
3. Engagement Strategy – disclosing engagement procedures
4. Metrics and Targets – specific targets/metrics used to monitor progress
5. Governance – embedding transition in company structures

The TPT is also engaging with countries and multilateral organisations that are developing disclosure and transition plan frameworks. The EU should consider harmonising its approach to transition investing together with others like the TPT, but also IOSCO and other global financial regulators.

[18] https://transitiontaskforce.net/wp-content/uploads/2023/10/TPT_Disclosure-framework-2023.pdf

Are investors interested in transition finance?

There is a need here to distinguish between investment professionals (investment funds, pension funds, insurers, etc.) and end-investors, most often "retail" investors. Professional investors have prominently focused on assets categorised as "green", stemming from a heightened societal and environmental awareness. The emphasis has been compounded by increased ESG regulations and improved transparency surrounding financial risks associated with sustainability. Green investing has solidified itself as a recognised asset category.

To illustrate, in 2021 alone, green bonds reached a cumulative debt issuance of over $500 billion[19] and projections from the Climate Bond Initiative suggest they could reach $5 trillion by 2025. This shift toward green funding has led to the emergence of social and sustainability-linked lending mechanisms, which are evolving as subsets within sustainable finance. However, the success experienced in green finance hasn't been mirrored in transition finance, which is perceived as a riskier alternative to green funding.[20]

A key concern is the risk of greenwashing: investors focused on ESG factors are cautious about financing industries or activities that are considered undesirable. Many of these investors have committed to divestment to avoid potential damage to their reputation. Explaining funding for an oil company compared to a solar panel farm is more challenging, even if the intention behind the funding is dedicated to decarbonization. Additionally, the absence of standardized labelling for transition finance exacerbates the situation.

According to the Network for Greening the Financial System (NGFS)[21], greater coordination across regulatory agencies and standard setters across financial and non-financial sectors, both within jurisdictions and internationally, is needed to leverage respective resources in assessing transition impacts from a transition and physical risk perspective. Since there is no consistent approach to whether transition plans address both the mitigation and adaptation aspects of transition[22], financial institutions such as banks, insurers and corporates often express interest in supporting transition finance efforts but identify the lack of data and limited role in facilitating a real economy evolution to transition investing.

However, when financial institutions develop credible transition plans and proactively engage with their stakeholders and value chain, this can lead to a greater consensus to also drive up collective transition efforts. In turn, this stimulates the need for collaboration across supervisory jurisdictions and their institutions to ensure interoperability of transition plans, and reduction of regulatory fragmentation as well as costs. In order to uphold the objectives of the European Green Deal, it is crucial that the increased transparency leads to enforceable and binding actions preventing banks from funding high-carbon projects that are likely to significantly devalue during the transition to a green economy.

In order to better stimulate both institutional and retail investors with transition investing, incentives like improved regulatory landscape can ensure clarity in terms of benefits, impact and choice of transition-linked investments in general. With the Sustainable Finance Disclosure Regulation for example, activities in transition should be included to better inform a comprehensive transition investing framework across Europe.

[19] https://www.climatebonds.net/2022/01/500bn-green-issuance-2021-social-and-sustainable-acceleration-annual-green-1tn-sight-market
[20] https://joint-research-centre.ec.europa.eu/system/files/2022-01/jrc128099.pdf
[21] https://www.ngfs.net/sites/default/files/stocktake_on_financial_institutions_transition_plans.pdf
[22] https://www.e3g.org/wp-content/uploads/E3G-Report-Achieving-a-transition-finance-framework-in-the-EU.pdf

As the deadlines for achieving net-zero commitments draw closer and regulatory pressure intensifies, transition investing is anticipated to become more significant for both companies and market participants.

Demand side investment on energy transition for example, currently outweighs the supply side.[23] According to Bloomberg studies, global energy transition investments in 2022 reached over $1,1 trillion, which is a clear indicator for the rise of transition investments in comparison to previous years. This trend is similar to other types of financial instruments, including green private equity, debt, venture capital and infrastructure funds among others.[24]

To enhance the offer of transition-based products and services, European and global coherence regarding key metrics and targets of transition plans should be prioritised.[25] With total financial assets of European households exceeding €33 trillion[26], transition finance instruments can benefit from this pool of capital which is mainly comprised in equity and investment fund shares, as well as pension funds.

With the current global trends of transition investing, it is evident that retail and professional investors are cognisant of its importance to a net-zero future. It is also clear that data limitations are one of the main barriers to presenting credible transition plans. However, the first steps of guidance and recommendations can only achieve a small part for any investor, if no binding requirements are set for providers of financial services and products.

The private sector is actively formulating and revealing voluntary strategies for sectoral transition planning. Among the industries, financial services, power, and fossil fuels stand out as the three sectors globally with the most extensive disclosure of transition planning[27], but more uniform approaches are necessary.

[23] https://assets.bbhub.io/professional/sites/24/energy-transition-investment-trends-2023.pdf
[24] https://www.mckinsey.com/capabilities/risk-and-resilience/our-insights/financing-the-net-zero-transition-from-planning-to-practice
[25] https://climateandcompany.org/publications/investor-impact-in-transition-finance-learning-from-ecolabels/
[26] https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Households_-_statistics_on_financial_assets_and_liabilities#:~:text=Highlights&text=Total%20financial%20assets%20of%20households,at%20%E2%82%AC9%20350%20billion.
[27] CDP (2022) 'Are companies being transparent in their transition?'

Transition investing strategies: role of engagement, stewardship, and divestment

Despite the intricate environmental and social consideration linked to transition financing, there is an opportunity for investors to systematically incorporate decisions that blend social, governance and environmental factors. The financial sector has a relatively nascent history of engaging with sustainability concerns[28], and policymakers as well as industry representatives concur that a move toward sustainability can only materialise through a rapid expansion in financing. To achieve this, investors are presented with several sustainable investing strategies, including thematic, best in class, exclusion (negative screening), impact and engagement among others.[29]

Exclusions/negative screening	Thematic investing	Best in class
exclusion from a fund or portfolio of certain sectors, companies, countries or other issuers based on certain criteria	investing in companies or assets specifically contributing to sustainable solutions (e.g. sustainable agriculture or green buildings etc.)	positive ESG performance relative to industry peers **ESG integration** inclusion by investment managers of ESG factors into financial analysis

Only incentivising divestments from certain industries can have unintended consequences, related to the simple consequence of selling: divesting from one side involves investments from another.[30]

Impact investing	Engagement and stewardship
requires measuring and reporting against ESG impacts, demonstrating the intentionality of investor and underlying asset/investee, and demonstrating the investor contribution	shareholder power to influence corporate behaviour, including through direct engagement, and/or proxy voting to steer improved ESG guidelines and practices within the company

Engaging with companies offers investors an avenue to enhance their long-term investment performance by gaining deeper insights into critical ESG matters affecting these companies. It also enables an evaluation of the strategies these companies have in place to address these issues. The act of engagement remains crucial regardless of the subject at hand. This is a primary tool that investors possess to reshape the business models of companies and align them with pathways leading to net-zero goals. Employing a range of strategies, including stewardship, capital allocation, and interaction with policymakers, investors can facilitate tangible transformations in the conduct and performance of invested companies and other assets. This approach can also extend to the broader systems within which companies and investors operate, ultimately yielding more favourable sustainability outcomes and impacts.

Retail investors expect their "green" investments to have an impact, and the demand for impact is increasing steadily across Europe. In order to respond to increased demand, enhanced use of impact strategies can better address legitimate preference and minimise greenwashing.

[28] https://www.riacanada.ca/content/uploads/2021/07/GSIR-2020.pdf
[29] https://betterfinance.eu/publication/shifting-the-trillions-why-will-private-investors-play-a-key-role/
[30] https://betterfinance.eu/publication/better-finance-position-on-the-classification-of-investment-funds-regarding-sustainability/

Considering that more than 90% of CO^2 emissions are generated outside of Europe,[31] both investments professionals and end-investors should thoroughly diversify their investment outside of Europe too, and steer companies to greener business models. Given the borderless nature of climate change, achieving real impact should become one of the most prominent investment strategies and actions in practice.

Importantly, there are differences between investments managed by financial intermediaries and those who actually own the investment in terms of economic real ownership. Investments managed by professional asset managers are often classified as either retail or institutional. Retail assets are personal investments by individuals in managed funds purchased in banks or through investment platforms with relatively low minimum investment levels, while assets classified as 'institutional' are managed on behalf of institutional asset owners such as pension funds, and insurers through investment products with higher minimum investment levels.

The recent Recommendation by the European Commission rightly acknowledges that, while formulating transition targets and constructing approaches for transition finance within portfolios and investment or lending strategies, financial intermediaries can encourage guidance and engagement as integral components of their transition finance strategy. While engagement effectively instigates changes within companies and enhances impact, particularly in scenarios necessitating substantial transition finance, the European Commission could potentially introduce a mandate for a unified engagement mechanism. Such mechanisms might encompass aspects like evaluating material sustainability effects, addressing climate and environmental impacts and risks, determining timeframes for lending or investments, outlining the underlying transition pathways, and ensuring that lending or investment strategies align with transition objectives, while broadly assessing the risk of stranded assets.

While financial participants have the option of steering their portfolios toward alignment with net-zero goals by withdrawing funds from carbon-intensive industries, this approach would not effectively channel capital towards companies genuinely engaged in transitioning to net zero. Divesting may enhance emission-related metrics, but its broader impact could be relatively limited if the activities or companies divested from are acquired or supported by other investors. Determining the timing and equilibrium of divestment strategies could hold extensive ramifications for the economy, society, and financial stability. Nevertheless, prolonged discussions that yield no discernible effects do not contribute significantly to driving the transition forward either. Thus a structured and more harmonised approach to engagement and its measurement is necessary.

This is supported by studies confirming that the investment approach focused on exclusion – encompassing negative selection or disengagement – as the least effective, while the most effective investment strategy derives from engagement. At the same time, the prevalence and importance of transition also poses a fundamental question regarding the role of companies in transition from heavily polluting industries for example. Should they be perceived solely as

[31] https://ec.europa.eu/eurostat/web/products-eurostat-news/-/ddn-20220524-1

contributors to the problem, or can they also play a vital role in solving it? The research by Yale Professor, K. Shue found that there are considerable limits to negative selection/exclusion in the fact that further investments in already "green" companies will do little to improve GHG emissions in the long-term, while engagement in "brown" companies and impact investing will achieve more net positive impact on the emissions being produced by certain companies for example. [32]Apart from not investing in new projects for fossil fuel industry, the existing assets can have a net positive impact on the environment if they transition away to renewables and other clean sources of energy, by avoiding the correlated issues with potential stranded assets for example. Thus, clear, measurable and easy to understand transition plans, active and measured engagement between financial counterparties and investors, as well as harmonised binding requirements from jurisdictions, the transition to net-zero can be materialised successfully by currently heavily polluting companies and industries.

In the specific case of energy firms, apart from not investing in new projects for fossil fuel industry, the existing assets can have a net positive impact on the environment if they transition away to renewables and other clear sources of energy, by avoiding the correlated issues with potential stranded assets for example. This is especially true for large oil companies, which generate very large cash flows from the oil business that can be at least partly used to accelerate redeployment of renewables. For example, BP and Total Energies became this year the biggest investors in sea wind power capacities in Europe, wining a €13 billion bid from Germany.[33]

Thus, clear, measurable and easy to understand transition plans, active and measured engagement between financial counterparties and investors, as well as harmonised binding requirements from jurisdictions, the transition to net-zero can be materialised successfully by currently heavily polluting companies and industries.

If such underlying assets can be labelled as 'transition assets', even if currently they might remain qualitative at best, this could fill the current gap in the demand-supply side on one hand and provide a better perspective as to which activities are still very harmful even with credible transition.[34] This will require policymakers to design a precise definition of those assets or activities that may qualify as transitioning. For example, the future the EU Taxonomy can be extended to distinguish between activities in transition and their levels of conformity to climate goals. This approach is taken by the UK's Financial Conduct Authority, which proposed three categories of sustainable investment product labels: sustainable focus, sustainable improvers and sustainable impact.[35]

Sustainable focus high sustainability levels by ensuring at least 70% of the product's assets meet credible standards	**Sustainable improvers** products whose objective is to deliver measurable improvements in the sustainability	**Sustainable impact** industry-standard to performance measurement, reporting against KPIs that capture the investor contribution

[32] *Op. cit* Shue. K (2022)
[33] https://www.reuters.com/business/energy/bp-total-win-14-billion-german-offshore-wind-site-tender-2023-07-12/#:~:text=FRANKFURT%2FLONDON%2C%20July%2012%20(,of%20renewable%20assets%20across%20Europe.
[34] https://www.amf-france.org/sites/institutionnel/files/private/2023-02/AMF%20SFDR%20minimum%20standards%20EN.pdf
[35] https://www.fca.org.uk/news/news-stories/fca-updates-sustainability-disclosure-requirements-and-investment-labels-consultation

How to assess progress and what remains challenging?

In Europe, companies can determine their transition finance needs by voluntarily using the Taxonomy, alongside other science-based reference points, when setting transition targets for specific economic activities in economic sectors. When emissions data isn't available, financial institutions usually rely on estimates, which can vary in their accuracy. While tools are emerging that enable these institutions to establish emissions targets for their funded activities (such as the Paris Agreement Capital Transition Assessment[36] and the Science Based Targets Initiative[37]), these tools don't encompass all relevant sectors. Emission data is anticipated to improve through initiatives like the EU's Corporate Sustainability Reporting Directive and the associated European Sustainability Reporting Standards. These make it obligatory for large, listed companies to disclose plans that align with the Paris Agreement and address climate transitions.

Similarly, professional investors and other asset owners can develop analogues approaches for their own assets by utilising disclosures and documents that accompany the issuance of green, transition, and sustainability-linked bonds or equity. But this is not realistic for "retail" , non-professional individual investors, who have to rely on summary environmental and other ESG Key Performance Indicators, communicated by the issuers (in case od direct investments into securities such as stocks and bonds), or by the financial provider (in case of packaged retail investment products or "PRIIPs" and pension funds).[38] Nevertheless, a significant global challenge remains: credible and comprehensive information regarding transition plans is still in its nascent stages. Comparable data is scarce, resulting in substantial uncertainty surrounding the assessment of the ambition of corporate net-zero plans.

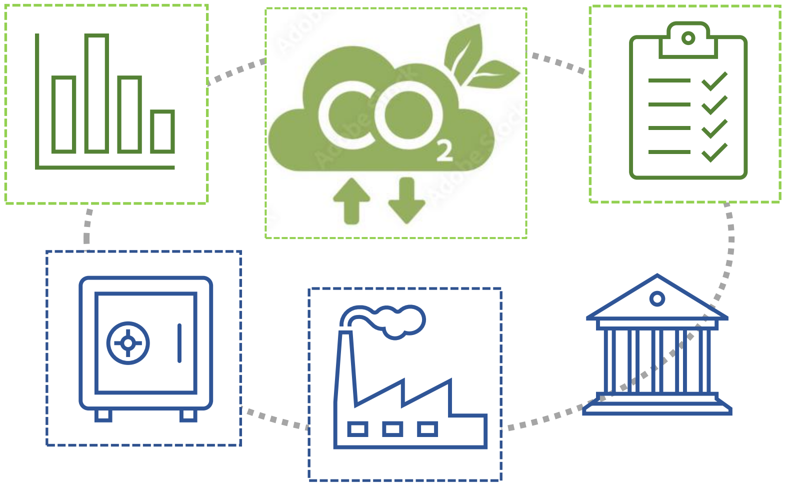
Such methodologies (once developed and available) can aid in shaping individual strategies at either the company or project level, assist in setting transition targets, and help in determining the necessary transition finance. To maintain the credibility of the engaging institution, it's essential to consider both the timing and balance of engagement and divestment strategies. In any of the cases, companies should be at the very least encouraged to develop a transition plan to net-zero emissions by 2050 or sooner before divesting.

[36] https://www.transitionmonitor.com/
[37] https://sciencebasedtargets.org/
[38] https://finance.ec.europa.eu/consumer-finance-and-payments/retail-financial-services/key-information-documents-packaged-retail-and-insurance-based-investment-products-priips_en

Decarbonisation assessments: case studies

In the previous year, the Transition Pathway Initiative revealed that banks' efforts to transition to a net-zero state have yet to indicate a significant shift of capital away from companies not aligned with the 1.5-degree pathway[39]. Additionally, engagement with such businesses remains limited, primarily targeting sectors like coal, and lacks the implementation of financial conditions on companies lagging behind in their transition efforts. A small portion of institutions have introduced all-encompassing engagement strategies mandating transition plans from high-risk companies. The highest score achieved for banks' strategies for reducing carbon emissions was 56%, while the average stood at 20%.[40]

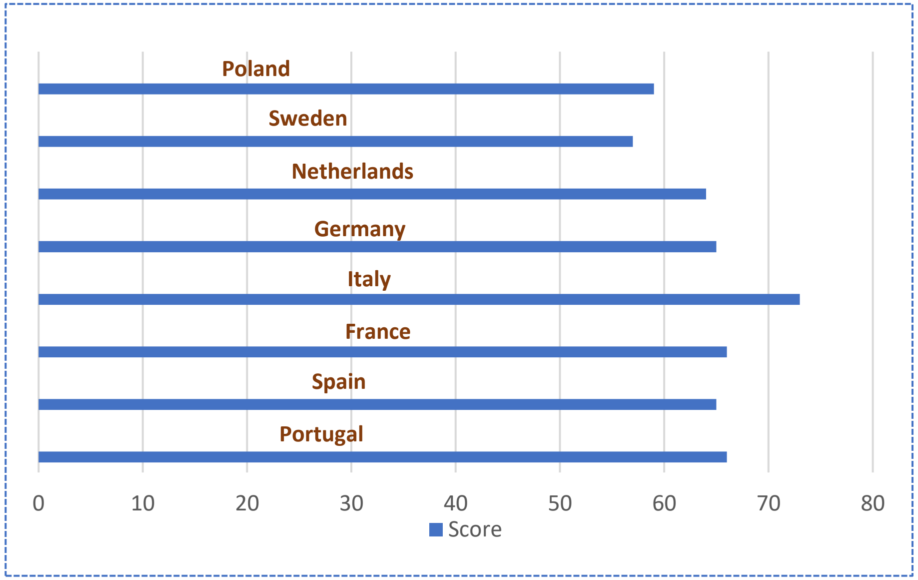
Although certain financial entities have made substantial investments in transition finance[41], concerns related to damaging their reputation and a preference for less contentious subjects such as sustainability-linked tools dominate the landscape. As the concept of transition finance becomes clearer and more comprehensible, it is likely to gain wider acceptance in the markets. Consequently, this will lead to a greater adoption of practices centred around assessing and reducing carbon emissions. Additionally, with the growing number of disclosure frameworks, validation tools, and other analytical services supporting data collection and disclosure of transition plans are being developed. One such tool includes the European Single Access Point[42] (ESAP) offering an EU-wide access to information on activities or products provided by entities when this information relates to capital markets, financial services, or sustainable finance.



A successful decarbonisation can be achieved through transition plans, transparent data and involvement of financial institutions, industry and Member States. According to the Transition Performance Index[43], the EU is a strong transition performer and shows progress rates (4.9%) above the global average (4.3%) in the last year. Forty-four countries as well as the EU-27 and world averages are leaders or strong performers in emissions reduction. Over the period 2011-2020, the EU has progressed with 7.6%, meaning that gross greenhouse gas emissions have decreased, but it ranks below the world average. Only three EU-27 countries (Hungary, Latvia and Lithuania) have increased their emissions over the last decade.

[39] https://www.transitionpathwayinitiative.org/publications/2021-tpi-state-of-transition-2021-report.pdf?type=Publication
[40] https://www.ran.org/wp-content/uploads/2023/04/BOCC_2023_vF.pdf
[41] https://unctad.org/publication/world-investment-report-2023
[42] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52021PC0723
[43] https://research-and-innovation.ec.europa.eu/strategy/support-policy-making/support-national-research-and-innovation-policy-making/transitions-performance-index-tpi_en

Table 1. Transition per country (*economic and environmental*)

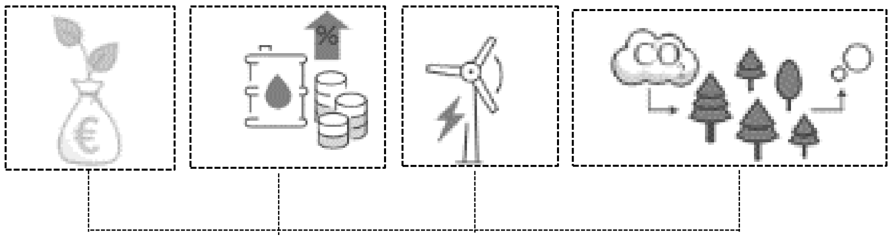


Interestingly, the Index identifies the Netherlands, Sweden and Poland as "Good Transition" with scores [55-65] and Portugal, Spain, France, Italy and Germany as "Strong Transition" with scores [65-75]. The TPI also shows that the EU average score based on environmental transition is currently at 68/100, while the world average score lags behind at 51/100.[44]

However, the Climate Action Tracker for example identifies that EU policies and action, Nationally Determined Contributions (NDC) and targets as well as climate finance is overall insufficient.[45] Such findings reinforce the need for clarity on transition finance and how best to assess its evolution from the perspective of Member States. In cases where contradictory evidence on transition persists, assessing decarbonisation will become even more difficult to complete and would result in multiple unintended consequences, including distrust and lack of investments that can help reach the net zero pathways.

Similarly, looking at transition finance from the lens of financial institutions and industries, a large disparity between investments in green, sustainable and transition tools can be observed, which limits the scope of quantifying concretely what role and importance is attributed to transition finance by itself.

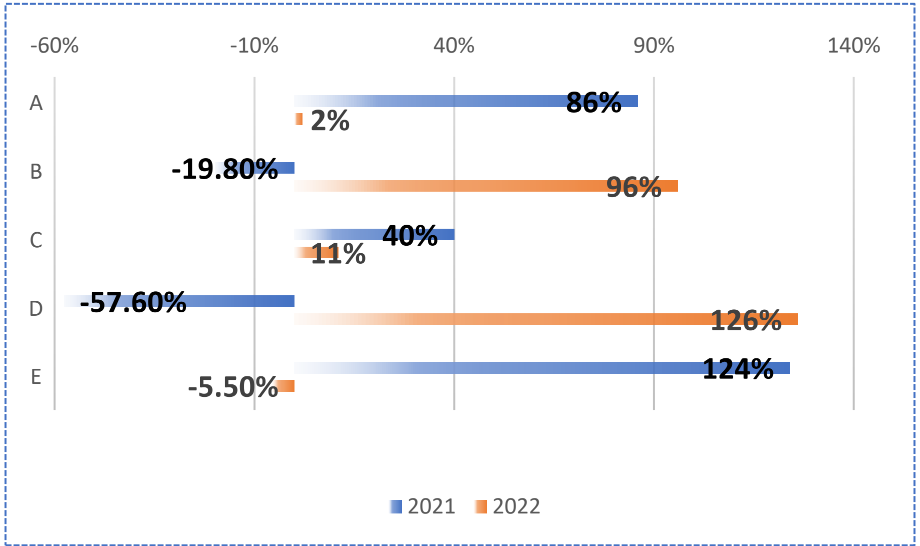
To find out, we took a closer look at the reporting of 5 large companies encompassing banks, insurance providers and independent asset managers. The data used comes from annual reports and the respective home markets of these companies include the UK, Spain, France and Italy. The five companies were selected due to their geographical scope of operations as well as their top performance in terms of profits from within their respective industries.



[44] The index consists of 28 internationally comparable indicators and helps people see how their country is progressing towards the 6 priorities of the Commission. The transition is measured on 4 dimensions: economic, social, environmental and governance.

[45] Climate Action Tracker quantifies and evaluates climate change mitigation targets, policies and action. It also aggregates country action to the global level, determining likely temperature increases during the 21st century.

Table 2. Changes in green, sustainable, responsible and transition investing (AuM) per company



Source: Companies' Annual Reports[46] 2020-2022, own calculation

The companies under scope report on collective investments that encompass green, sustainability linked and transition financing and often refer to this type of investments as Socially Responsible Investments (SRI). Despite some of their reporting on specific transition tools, for example issuing of transition bonds, the majority of SRI investments are focused on the green element, which leaves limited scope for a fully developed strategy on financing the transition of highly emitting industries and sectors.

The baseline for SRI related investments of the companies under scope in 2020, ranges from as low as €5,9bn in one, to as high as €378bn in another. The highest percentage change in such investments in 2021 is seen with Company E, with a change of 124%, while in the same year Company D reduced its SRI related investments by over -57%. The figures in 2022, show that Company D has the highest jump in SRI related investments with recorded 126% in comparison to the preceding year, and Company E records its lowest SRI related products with over -5% decrease.[47]

Opportunities of transition investing

Regulatory-backed transition planning will enhance investors' ability to distribute capital more efficiently among enterprises that possess viable strategies for reducing their carbon footprint. This will bolster their confidence in avoiding instance of greenwashing. In this context, transition plans hold substantial influence. In essence a transition plan acts as a valuable tool for investors to gauge whether a company or project is suitable for investment. The same principle applies to financial institutions, which are both creators and beneficiaries of transition plans.

Research shows that European "retail" investors are barred from exercising their voting rights cross-border within thee EU[48] , and from fully utilising consistent and strong engagement practices with the companies they invest in, which is quite detrimental both in terms of missing out on the opportunity for active share ownership aiming in particular at increasing the focus of the corporate investment plans, and business models towards a lower carbon pathway. Real economy changes for transition investing can be materialised through efficient engagement and impact orientation, but further efforts are necessary to stimulate this development.

[46] The companies under scope include HSBC, Santander, AXA Group, Generali and Amundi. The A,B,C,D and E represent the companies (in no particular order). Annual reports can be found online on their respective websites.

[47] The average percentage change in SRI related investments for the 5 companies in 2021 comes to 34%, while the following year this figure jumps to 46%.

[48] https://betterfinance.eu/publication/barriers-to-shareholder-engagement-srd-ii-revisited/

Recommendations: retail investors' perspectives

The European Union should embrace a collection of overarching principles that outline a fundamental European perspective on transition finance in particular:

1. creating **clear transition plan requirements** for firms (starting with listed ones), across the financial services legislation and consider introducing a Directive, or a Regulation specific to transition investing with a set of 'Transition KPIs';
2. introducing **a mandate for a unified engagement mechanism**, which would ensure common practices and evaluation of engagement, reduce greenwashing and enable timely phase-out of highly emitting sectors without risking to create stranded assets, or merely shifting them at a low price to non-European buyers by simple exclusion and divestment and;
3. **reviewing and harmonising existing legislation** (ESRS, SFDR, CSRD, CSDDD) and ensure that "green" investment products, indices, ratings, and labels claiming ESG benefits are reserved only to investments actually helping and accelerating the environmental transition from a largely brown economy to aa green (disclose **performance indicators and measures** to track these impact goals)
4. **mandating supervisors** to **monitor transition** plans, **impose enforcement** measures and **sanctions** whenever necessary.

In order to truly encapsulate the current changes and impacts of transition investing per industry, much more comprehensive research is required, going beyond a handful of large companies. Refining the assessment of the most effective - and least prone to greenwashing - transition investment strategy is also urgently required.

About BETTER FINANCE

BETTER FINANCE, the European Federation of Investors and Financial Services Users, is the public interest nongovernmental organisation advocating and defending the interests of European citizens as financial services users at the European level to lawmakers and the public in order to promote research, information and training on investments, savings and personal finances. It is the one and only European-level organisation solely dedicated to the representation of individual investors, savers and other financial services users.

BETTER FINANCE acts as an independent financial expertise and advocacy centre to the direct benefit of European financial services users. Since the BETTER FINANCE constituency includes individual and small shareholders, fund and retail investors, savers, pension fund participants, life insurance policy holders, borrowers, and other stakeholders who are independent from the financial industry, it has the best interests of all European citizens at heart. As such its activities are supported by the European Union since 2012.

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