bankenverband

# Position Paper

## Association of German Banks
## Considerations for an EU framework for Transition Finance

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## Summary of main messages

The sole focus on 'green' finance will not be enough to meet the EU Green Deal. Much greater emphasis should be placed on funding transitional activities. While the EU taxonomy has the potential to stimulate green finance markets, it is insufficient in guiding transition finance due to its binary nature (green vs. not green), incomplete coverage of economic activities, and restrictive definition of transitional activities.

Establishing a principle-based EU framework for transition finance is thus both a necessity and matter of urgency in the fight against climate change. The European Commission's Recommendation on "facilitating finance for the transition to a sustainable economy" is a welcome first step in this regard. While it primarily outlines high level guidance, it remains to be seen how the Recommendation is taken up by market participants and whether it is sufficient in practice.

To contribute to the evolving debate on how a robust transition framework could work in practice, this paper sets out high-level considerations of German private banks. While the Commission's Recommendation highlights several examples of types of transition finance, this paper primarily focuses on investments into undertakings or activities with a credible transition plan that are aligned with the Paris Agreement.[1]

Key recommendations include:

- The EU transition finance framework should be based on a voluntary set of principles that are science-based, user-friendly and holistic. It should initially be established for climate given the maturity of discussion in this field.
- The guiding framework should allow for tailor made approaches given that corporates, based on industry, size and location, will take different approaches to reach net zero. A one-size-fits-all approach is therefore not constructive.
- We propose a framework outside the scope of the EU taxonomy. In such a framework, transition efforts of corporates should be looked at both from corporate level, but also from activity level to allow for different forms of financing.
- This should for example be benchmarked against science-based sectoral transition pathways, ideally globally aligned. We call on governments to urgently provide such pathways, including relevant milestones / roadmaps, starting with the highest emitting sectors. The guidance should be developed together with the industry and sector experts.

[1] The Recommendation of the European Commission notes that other forms of investments, which could be regarded as transition finance, include for example: investments aligned with the methodologies of the EU climate benchmarks, investments into transitional activities as defined by the Taxonomy Regulation, or investments into Taxonomy aligned capital expenditure.

- The transition efforts of companies should then be documented in transition plans. Such plans should ideally have a high degree of commonality and standardization to facilitate application and to foster credibility. They should also include intermediate steps / roadmaps.
- Financing to companies with such transition plans could then count as transition finance in the following circumstances:
  - (1) The company shows in its transition plan that it is already aligned with the relevant sectoral transition pathway(s), or
  - (2) the company outlines the steps it is undertaking to be aligned with the relevant sectoral transition pathway(s) within a certain period that is still to be specified.
- Corporates should externally report against such plans on an annual basis to provide transparency. In the case of a breach, the related financing should qualify as transition finance up to the point that the breach is reported by the company.
- For as long as the relevant standards are not yet defined, transition finance should be "grandfathered", especially if the transition plan has been validated by a third party.
- Finally, transition finance should not be part of mandatory reporting requirements for banks to avoid additional reporting burden, but best-practice guidance for voluntary reporting would be welcome.

## 1. Transition finance is essential to fight climate change

Preventing climate change as set out in the Paris Agreement requires immediate action and above all significant investment. For the EU alone, the European Commission estimates an investment gap of 390 billion euros per year to ensure that the European economy achieves a sufficient reduction in carbon emissions.[2]

It will however not suffice to only providing finance for industries that are already low carbon. It is equally important to support high-carbon companies and 'hard-to-abate' sectors to implement long-term change and become significantly less harmful. In fact, every economic sector must transition towards a greener way of doing business.

This is precisely why transition finance is key. Rather than selectively focusing on corporates and activities that are already sustainable, transition finance promotes the journey of corporates and their activities towards more sustainability. Instead of a point in time assessment, transition finance captures the dynamic nature of the transition process. It thereby also allows for a holistic consideration of the whole economy. Transition finance is thus an important instrument within the larger toolbox of sustainable finance. It is essential to align our economic activities with the climate goals set out within the Paris agreement.

[2] To meet the overall climate and environmental objectives of the EU Green Deal and REpowerEU, 620 billion Euros will be needed, according to the Strategic Foresight Report 2023 of the European Commission.

While critical, public finance alone will not suffice to fill the vast investment gap towards net zero. To achieve the transformation of our economy, private finance needs to be mobilized at a large scale. In this context, we define transition finance as "financing that supports companies or certain activities, which are contributing to a reduction in greenhouse gas (GHG) emissions in accordance with a long-term net zero strategy aligned to the Paris targets".

## 2. The EU taxonomy is still insufficient to guide the transition finance

While the EU taxonomy has the potential to set relevant impulses to foster green and sustainable capital flows, the narrow scope does not allow for adequate guidance of transition finance needs. This is due to the following reasons:

- The taxonomy is mainly binary in that it only contrasts activities that are covered by it and meet the high environmental standards set by the delegated acts against those that currently do not meet these ambitious standards. It thus provides mostly guidance for funding investments in those economic activities that are already classified as dark green but is less suitable for assessing the transition need and potential of the remaining activities.
- The taxonomy currently only covers around 40% of all EU-based economic activities, according to the Commission's own estimates, and thus only part of the economy.
- Although transitional activities are in parts already reflected in the existing EU taxonomy, the concrete alignment with the Technical Screening Criteria is very burdensome and therefore not effective. Certain activities also get excluded, as the thresholds are simply too high. For example, transitional activities can only qualify as contributing substantially to climate change mitigation under the EU taxonomy if their greenhouse gas emissions are already substantially lower than the sector or industry average. The remaining activities would thus not qualify, while their need and urgency to transition is even higher.

Against this background, we have already previously highlighted that we regard the March 2022 recommendations of the EU Platform on Sustainable Finance to establish a traffic light system to steer the transition as too complex for practical implementation. For example, the dynamic nature of the different proposed categories could result in strong uncertainty about what kind of investments remain viable in the future from a sustainability standpoint.

The EU taxonomy with its very granular and prescriptive criteria, as well as the proposal of the EU Platform, risks effectively excluding corporates that cannot meet these objectives. Such exclusion may stigmatize companies or industries, making it more difficult for them to invest in their transformation, even though they may have the potential to substantially improve their environmental performance. Such stigmatization should be avoided. Corporates need to maintain access to finance via the regulated banking sector.

In this regard, we welcome that the June 2023 Recommendation of the European Commission takes a more pragmatic approach by clarifying the basic concepts of transition finance and the use of tools that can encourage greater uptake of private transition finance. It remains to be seen how the Recommendation is taken up by market participants and whether it is sufficient in practice. In our view, the high-level guidance of the Commission is a useful first step but will likely have to be supplemented with additional guidance with regards to sectoral pathways. In the following, we highlight key principles on which such a transition finance framework at EU level should be based on.

## 3. Towards a principles-based EU transition finance framework

### *a) Guiding principles*

Considering the above challenges, we call for the establishment of a principles-based transition finance framework for voluntary application outside the scope of EU taxonomy. Notably, we suggest a sustainable finance framework, which is based on the following guiding principles.

- **Science-based:** The framework should be based on the latest scientific evidence in setting out transition pathways and, where possible, provide guidance on how lock-in effects can be avoided.
- **User-friendly:** It is critical that the sustainable finance framework is suitable for practical use and designed in a proportionate and SME friendly way. The implementation effort by companies and financial market participants has to remain manageable. The sustainable finance framework should also not result in an even higher reporting burden.
- **Targeted flexibility:** The framework should build in targeted flexibility given that the means, targets, and timing might change and need to be adjusted. For example, companies transition efforts may need to be adjusted in case of the occurrence of new technological breakthroughs. A prescriptive one-size-fits-all approach should therefore be avoided.
- **Holistic:** The transition finance framework should allow all economic sectors to transition towards greater sustainability. It should create a level playing field between market participants and allow for greater comparability.
- **Globally aligned:** Efforts should be made to align the framework with international best practice. For example, in the UK the Transition Plan Taskforce (TPT) is already working on developing a standard for climate transition plans. Also, in Japan the Ministry of Economy, Trade and Industry (METI) has developed voluntary Climate Transition Finance Guidelines, which may serve as a useful example.

- **Climate-first:** While great urgency exists in tackling a multitude of environmental challenges, including the need to address the rapid loss in biodiversity, we suggest establishing a transition finance framework first for climate given the level of maturity of climate objectives and related instruments.

The transition finance framework should also reflect that companies undergo in their transition journey different phases to reach climate neutrality, reaching from transition readiness with a strategy in place, to transition execution and finally transition fulfillment. Hence, the framework should allow for tailor made approaches, given that corporates will take different paths and strategies to achieve their net zero objectives, based on their industry, size and location.

### *b) Concrete suggestions*

*Setting sectoral transition pathways at European level*

We ask governments to provide clear sectoral transition pathways, ideally globally aligned, including relevant milestones / roadmaps, which are aligned with the EU climate ambitions. Given the urgency of the climate crisis, pathways and roadmaps for hard-to-abate sectors should be prioritized. It could also be considered how until the establishment of such benchmarks, existing global standards such as the Science Based Targets initiative (SBTi) can be best leveraged. A clear political commitment will be key in this regard.

Transition efforts of companies can then be benchmarked against these science-based sectoral transition pathways and, whenever necessary due to geographic specificities, at national level as long as deviations between countries are considered in the EU legal framework.

*Developing guidance for transition plans*

The transition effort of corporates should be documented in transition plans. Notably, such transition plans should be based on the relevant sectoral transition pathways mentioned above and specify relevant intermediate targets and KPIs (roadmaps).

Currently, multiple initiatives have been initiated for the development of transition plans (e.g., CSRD, CSDDD). The plethora of initiatives risks creating confusion and fragmented approaches. Today’s regulatory initiatives are also mainly targeted at larger companies to alleviate SMEs from compliance burden. While this is a sensible approach, it also means that smaller companies are at risk of losing out on funding to finance their transition.

Considering the multiple initiatives out there, some central guidance would be helpful to define minimum features for transition plans to be credible. Notably, to allow for the assessment of transition plans, the European Commission should outline guidance on key elements for standardized corporate transition plans. A high degree of commonality and standardization would build confidence in the market and remove complexity and subjectivity. This would especially help smaller corporates in their transition efforts. The availability of standardized transition plans would also help banks to better assess such plans and ensure the alignment of their portfolios with their own climate ambitions.

It is key that such guidance is aligned with international initiatives to avoid fragmentation. For the banking sector, GFANZ has for instance provided practical guidance regarding the operationalization of transition plans for both corporates and financial institutions (link to documents). At European level, the EFRAG proposal includes disclosure requirements for transition plans by setting out eight key components (link to document, p.6-8) that could serve as potential guidance.

More in detail, in the case of companies operating in different sectors, the transition plan should incorporate all relevant sectoral transition pathways and could be broken down by sector. In case the relevant documentation is available only at group level but the financing is provided at company level, the transition plan at group level should be used as the basis for evaluation. The underlying logic is that if the group as a whole has a transition plan, the sum of its entities would also be aligned.

*Linking transition plans and transition finance*

Financing to companies who have issued transition plans in line with the above considerations should count as transition finance in the following circumstances: (1) The company shows in its transition plan that it is already aligned and will remain aligned with the relevant sectoral transition pathway(s), or (2) the company outlines the steps it is undertaking to be aligned with the relevant sectoral transition pathway(s) within a certain period that is to be defined.

With regards to the financing itself, one should distinguish between:

- General purpose financing to an entity with a credible, science-based transition plan as outlined above.
- Key Performance Indicator (KPI)-linked financing to an entity following a transition path to net zero, where the margins of the instruments are linked to achieve intermediate targets on the entities net zero roadmap.

Both forms of financing should be recognized as transition finance. As a result, also the decarbonization of individual activities, which supports the entity in its transition journey, can be financed accordingly.

*Communicating / reporting on outcomes*

Corporates should externally report against such plans on an annual basis to provide transparency on progress against relevant KPIs and actions outlined in the transition plan. If necessary, updates to these plans should be communicated. Otherwise, financial institutions risks having insufficient data for their own internal evaluations and reporting.

In case that transition finance has been granted based on a robust corporate transition plan but that a corporate entity fails to meet their declared targets, the respective financing should still qualify as transition finance up to the point the breach is reported by the corporate entity. To avoid moral hazard, guidance on covenants with termination rights or significant interest compensation should be given, so that banks have levers to incentivize companies to meet their transition targets.

For as long as the relevant standards are not yet defined, transition finance should be "grandfathered", especially if a corporate transition plan has been validated by a third party. This is critical so that the financial market can already develop without having to wait for the decisions at political level.

Finally, transition finance should not be part of mandatory reporting requirements for banks to avoid additional reporting burden that hamper related efforts. Yet, best-practice guidance for voluntary reporting would be welcome.

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