CORPORATE & INSTITUTIONAL

Financial Services ESG Insights

Accelerating decarbonisation and the role of financial services

Lloyds Bank and Baringa

September 2024

ESG Insights – September 2024

The transition to a low-carbon economy demands a fundamental shift in financial flows. The Energy Transition Commission estimates that $3.5 trillion[1], on average, will need to be invested until 2050 in order to develop net zero economies. Transition finance is at the forefront of this by directing capital towards sustainable projects and companies and a growing number of financial institutions are turning their attention to this area.

Transition finance arises at the intersection of the needs of those receiving finance — ranging from governments to companies — and the capacity of the financial services sector, including investors, banks, and insurers, to structure financial solutions that address these capital needs effectively.

The challenge is that transitional activities are not universally defined. Transition encompasses a wide spectrum of activities enabling the move toward net zero, including lower (but not zero) emission substitutes, re-skilling workforces to participate in a lower-carbon economy, adaptation to climate change impacts, investments in renewable energy infrastructure, circular economy practices, and policy changes to support the transition – all of which can be specific to the transition of a particular company or location. Reflecting the lack of consistency in transitional activities themselves, defining transition finance has also proven challenging, with new principles and approaches emerging across different jurisdictions.

This newsletter builds on our previous editions, including "Harnessing Transition Plans" (April 2024), which explores the role of transition plans in capital allocation, and "COP28 Key Takeaways" (January 2024) which recognises the need to scale transition finance as a key theme emerging from COP28. This analysis explores how various jurisdictions are implementing transition finance to achieve net zero. We highlight practical ways for companies to accelerate decarbonisation, and the role of capital providers in supporting these efforts.

"Transition Finance is understood as finance deployed or raised by corporates to implement their net-zero transition, in line with the temperature goal of the Paris Agreement and based on credible corporate climate transition plans,"

Organisation for Economic Co-operation and Development (OECD)[2]

Sources: 1) Energy Transitions Commission. (2024). Financing the Transition.; 2) OECD. (2022). OECD Guidance on Transition Finance.

As transition finance plans take shape, we are beginning to see jurisdictions and governments either adopt a 'Corporate-first' or a 'Financial-services first' approach. The former focuses on the underlying transitional activities needed to progress on climate goals, whilst the latter seeks to maximise the availability of capital for that transition. This is coupled with a domestic or global focus reflecting a jurisdiction's policy priorities. In some cases, a hybrid approach is being adopted.

Corporate-first approach

In a corporate-first approach, governments are implementing 'real economy' or sectoral policy measures that can either enable or restrict the transition of companies. These measures focus on influencing the demand for capital through policies that encourage companies to adopt sustainable practices.

Financial Services-first approach

With a financial services lens, governments are beginning to focus on the supply side of capital by establishing financial sector policy measures. These might include the development of taxonomies, setting labelling regimes, or even introducing differential capital treatments. These aim to guide the flow of capital toward transition activities.

When adopting this latter approach, governments are having to decide whether their actions are intended to support domestic transition needs or if they have broader global ambitions. This decision is crucial as it impacts how effectively they can foster a supportive environment for transition finance that aligns with their national or international goals.

Hybrid approach

A hybrid approach seeks to balance between the needs of corporates and financial institutions, seeking to define the actions required by corporates and then provide mechanisms by which the claims of financial actors can align to these. We will share a case study on how this has manifested.

Approaches adopted by jurisdictions for transition finance

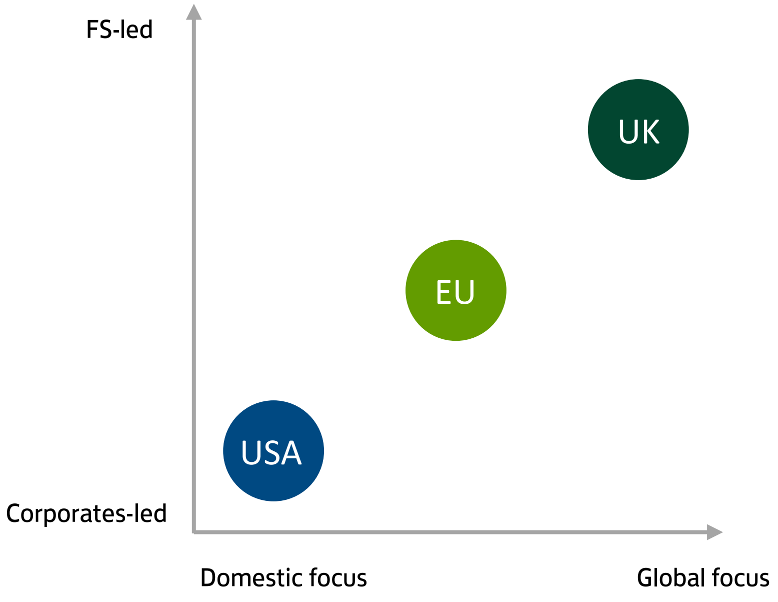
We will bring these philosophies to life by showcasing how the United Kingdom (UK), United States of America (USA), and European Union (EU), as well as case studies from Asia and the Middle East, are approaching transition finance. The examples demonstrate how financial institutions may need to adapt their strategies to play a role in each approach.

Examples explored in more detail are:

- **Financial services-led, global focus:** UK
- **Corporates-led, domestic focus:** USA
- **Hybrid approach:** EU

Examining in this way unpacks the opportunities and challenges that the financial sector faces and how we are seeing some of these strategies play out. By understanding the nuances between different approaches, financial institutions can better position themselves to contribute more effectively to transition across the jurisdictions in which they operate.

Approaches adopted by jurisdictions for transition finance

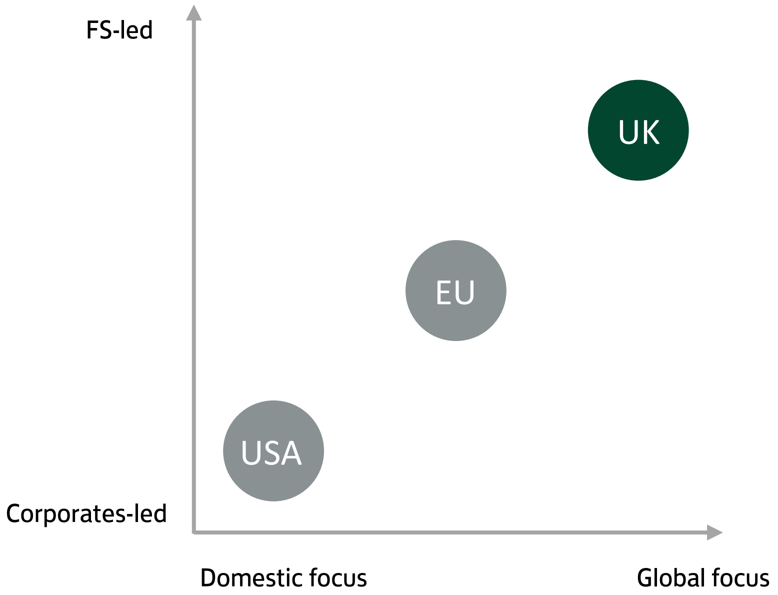


Approach adopted by the UK

The UK has embraced a financial services-led approach with a global outlook, seeking to leverage the strength of the UK's financial services industry to mobilise transition capital across the world through enabling a specific 'market' in transition finance. Jurisdictions that adopt this philosophy emphasise the enabling environment for financial services – for example the UK's leadership on transition plans (Including the launch of the Transition Plan Taskforce at COP26). This is a key mechanism to allow information to flow from companies to financial institutions and foster the right environment for financial services to provide the required capital to corporates.

Strengthened by its role in COP26 in 2021, the UK aims to be a global player in transition finance through an FS-led, globally focussed approach.

At the core of this strategy lies the UK Transition Finance Market Review (TFMR) first announced in the UK's 2023 Green Finance Strategy[1] and launched in early 2024. The UK Government's Green Finance Strategy outlines its ambitious goal of mobilising private investment towards net zero whilst aligning global financial flows with climate and nature objectives. As such, developing a robust market for transition finance products and attractive investment are critical components for the UK market. The new Labour Government's vision for financial services aligns with the government's broader strategy, emphasising the sector's pivotal role in driving economic growth. Key priorities for the new government include being a global leader in sustainable finance, which converges with the overarching goal of positioning the UK as a green finance hub.



Source: 1) GOV.UK (2023). Policy paper: Mobilising green investment: 2023 green finance strategy.

Although the UK has made substantial progress, the transition finance landscape remains complex and dynamic. A clear and universally accepted definition of transition finance is imperative to prevent greenwashing and ensure the effective allocation of capital. In May, the UK Financial Conduct Authority published anti-greenwashing rules.

The TFMR remains in its early stages, with key details still being finalised. The TFMR is expected to identify the key components for a successful transition finance market in the UK, beginning with a clear definition, it may include specific product types, regulatory frameworks, and data standards. Financial institutions should stay informed about key milestones in the TFMR process to identify opportunities to engage with the review and influence its direction. Trade associations in the UK, such as those from UK Finance[3] and TheCityUK[4], have responded to the TFMR's Call for Evidence by emphasising the UK's potential as a global leader in transition finance, but they highlighted the need for clear policy frameworks, credible standards, and addressing barriers to accessing and deploying transition finance.

The UK aspires to be a global leader in facilitating transition finance. Whilst progress has been made, the Environmental Audit Committee[5] report suggests that there is room for growth in terms of facilitating global transition finance at scale. By staying informed, engaging with the TFMR process, and taking proactive steps, financial institutions can position themselves to thrive in the evolving transition finance landscape.

Implications for financial institutions

Jurisdictions embracing a financial services-led approach have obvious appeal for financial institutions, as they are focussed on the needs of the sector, and thus creating enabling conditions in which transition finance scales. Challenges can be experienced when a desire for a global outlook conflicts with differing national-level definitions of transitional activities, leaving financial institutions and their clients facing interoperability challenges between raising capital in a global financial centre such as the UK, and local taxonomies and definitions of transition finance. It can also present a disconnect for domestic capital flows, if other jurisdictions (such as the US, explored in the next section) represent a more attractive destination for transition finance flows and therefore whilst a financial centre may be successful in raising transition capital, this does not accelerate a domestic transition.

Advocating for a clear definition of transition finance is important; financial services firms may also consider taking proactive steps. In the absence of a universally agreed-upon definition, firms (especially banks and investors) may consider establishing their own internal working definitions of transitional activities, aligned with best practices and evolving regulatory guidance. Investing in building internal expertise in transition finance will be crucial for firms to navigate the evolving landscape and identify opportunities.

Sources: 3) UK Finance. (2024). Transition Finance Market Review: UK Finance Response to the Call for Evidence.; *4)* TheCityUK. (2024). TheCityUK Response to Transition Finance Market Review Call for Evidence.; *5*) Environmental Audit Committee. (2024). The financial sector and the UK's net zero transition: Government Response to the Committee's First Report

Firms transacting globally, particularly banks, asset managers and sponsors, should be careful to monitor emerging transition finance definitions and ensure these promote rather than exclude capital flows to transition, especially in jurisdictions such as emerging markets where there is the greatest gap between needs and current finance flows.

These actors, together with insurers, data providers and ratings agencies, also need to ensure that approaches which are designed around a 'supply side' view of transition finance are also matched with 'demand side' measures by meeting the needs of companies who are transitioning. This can include easy and consistent access to transition plans as anticipated in the UK regime, but also needs to reflect the real economy policy environment in which that transition occurs for companies.

Japan case study

Japan's approach to transition finance mirrors the UK as it is FS-led, but it has a domestic focus. The Japanese Government established its 'Japanese Climate Transition Bond Framework in 2021 and issued the first tranche in February 2024. The government said that more than ¥150 trillion of public-private investment would be needed over the next 10 years.

Despite Japan's lead, the adoption of transition bonds on a global scale has been relatively slow. Several factors may contribute to this, one being the lack of standardisation in defining transition activities or projects. Japan's climate transition bond has also initially attracted domestic investors and attracting significant foreign investment may depend on factors such as global investor sentiment.

Source: Transition Finance / METI Ministry of Economy, Trade and Industry

Transition Finance Market Review: Overview

The aim of the TFMR is to make the UK a global leader in financing the transition to a net zero economy.

Key objectives of the review include:

Identifying barriers

To scaling up transition finance

Developing strategies

To support companies in their decarbonisation efforts

Creating a supportive environment

For innovation and growth in transition finance products and services through establishing a clear definition

Leveraging the UK's strengths

In finance, technology, and policy to build a thriving transition finance ecosystem

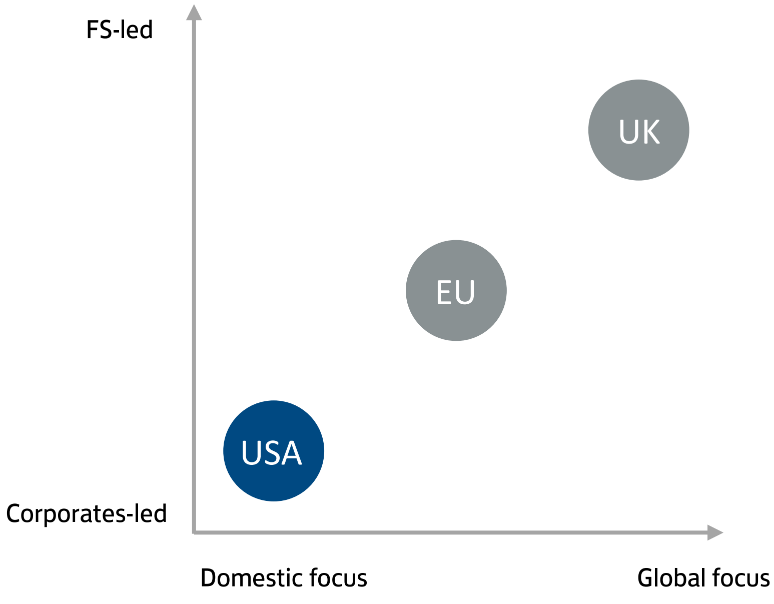
Approach adopted by the US

The corporate-led, domestic focussed approach to transition finance prioritises domestic economic growth and job creation through incentivising corporate activity in low-carbon activities, with a particular focus on the energy system. This aims to create a favourable business environment for domestic firms through mechanisms such as subsidies, regulatory support and tax relief. This philosophy typically warrants the role of the public sector in shaping the market.

The US's Inflation Reduction Act (IRA) brings this approach to life. Whilst the IRA does not explicitly define transition finance, it aims to stimulate domestic investment, foster competition and channel finances towards US industries involved in the energy transition.

For financial services, this means a significant opportunity to capitalise on a growing domestic clean energy market. This regulatory framework creates a robust and attractive investment landscape which may result in a surge in demand for financial products and services that are tailored to the specific needs of low-carbon energy projects. In turn, understanding this regulatory environment could lead to revenue growth and increased market share.

Although the IRA does not directly address financial institutions, it has significant implications for the sector. The creation of a robust domestic clean energy market, underpinned by a strong policy framework, would naturally stimulate demand for financial products and services tailored to the transition and establish the US as a global leader in key transition technologies.



Within the US, a significant area of growth for financial services – both banks and insurers – has been structuring to allow companies to sell tax credits they are eligible for under the IRA and thus accelerate nearer-term investment by bringing forward future cashflows. These and other developments under IRA present a substantial opportunity for financial services firms to increase market share and revenue growth.

Key milestones to watch include the implementation of IRA provisions, the evolution of the domestic clean energy market, and the development of related policies and regulations. Active engagement in industry associations, policy discussions, and client relationships will be crucial for seizing emerging opportunities.

US Inflation Reduction Act

The IRA was signed into law in August 2022. At its core, the legislation aims to tackle multiple issues, including energy security and climate change initiatives. Key areas of focus include:

Clean energy manufacturing

Support for domestic manufacturing of renewable energies and incentives for clean energy research and development

Tax credits and incentives

Production tax credits and investment tax credits for renewable energy source projects such as wind and solar, as well as tax credits for electric vehicles and battery products, and energy efficiency upgrades in homes and businesses

Energy security

Investments in clean energy technologies and infrastructure, and support for carbon capture and storage projects

Sources: Inflation Reduction Act | U.S. Department of the Treasury, Inflation Reduction Act | Baringa

Implications for financial institutions

Financial services firms play a pivotal role in facilitating the energy transition by developing innovative financial products and services that support the decarbonisation of the economy. This includes providing financing for renewable energy projects, energy efficiency upgrades, and clean technology development. Additionally, financial institutions can help to mobilise capital towards the transition by offering green bonds and other sustainable investment products such as sustainability-linked bonds, and sustainable insurance, as well as specific funds such as ESG funds, thematic funds and impact funds.

For sponsors and investors with higher risk tolerance, incentives for research and development may provide an opportunity to scale up nascent technologies, unconstrained by the need to align to pre-defined taxonomies or definitions of transitional activities. It is important to acknowledge that incentive schemes may change over time, again requiring risk transfer to help support long-term transition.

In markets where transition finance approaches focus on demand side, financial institutions need to demonstrate agility in responding to incentive schemes, rapidly innovating new structures to reflect these incentives. An example in the US has been tax credit insurance, designed to transfer risks associated with tax equity schemes and ensure they are accessible to investors with specific risk appetites.

Financial institutions also need to acknowledge that a supply-side approach does not define transition finance, and therefore they will need to take explicit steps to define this for themselves or assess the interoperability of taxonomies used in other jurisdictions, especially where financial actors such as investors are operating across jurisdictions and therefore distributing funds in markets such as the EU which contain internationally-originated assets.

Recent examples of financial services partnerships following the IRA's announcement

J.P. Morgan partnered with Ørsted to provide $680m investment in a tax equity financing deal to support solar and storage projects.

Lloyds Bank, Société Generale, ING, NatWest, and Allied Irish Bank provided a $348m financing package for Lightsource bp to support in the construction and operation of two utility-scale solar projects in Texas.

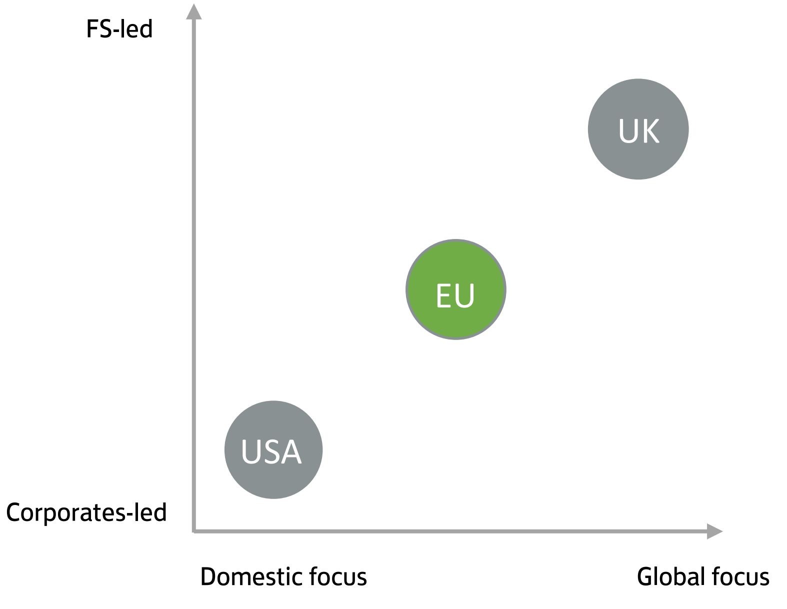
Sources: Powering New Investments in Clean Energy | J.P. Morgan (jpmorgan.com) Lightsource bp completes $348 million financing package for two utility-scale solar projects in Texas | Lightsource bp USA,

Approach adopted by the EU

Between the financial-led or corporate-led approach lies a hybrid approach which has been adopted by many regions or countries. To understand this approach in more detail, we will focus on the European Union, with a case study on the United Arab Emirates.

The EU's approach has primarily focussed on corporates and is rooted in creating a clear and robust regulatory framework that sets industrial strategy and thus the transition of the real economy. This translates into financial services with a similar focus on definition through structures such as the EU Taxonomy for sustainable activity, and a focus on claims by financial institutions and prevention of greenwashing. Its approach provides clear guidelines for financial institutions to assess and classify sustainable investments such as the Sustainable Finance Disclosure Regulation (SFDR), but it also imposes significant disclosure and reporting requirements on corporates, such as the Corporate Sustainability Reporting Directive (CSRD). This dual focus strengthens accountability and transparency.

The EU Taxonomy provides strict definitions of environmentally sustainable economic activities. It is a key part of the EU's broader effort to channel investments towards sustainable projects. By providing a clear definition of what constitutes a sustainable investment, the EU Taxonomy provides a common language for investors, financial institutions and companies to assess the environmental impact of their activities. It also provides more financing options for corporates who can demonstrate the progress and alignment of their transition to lenders. However, the EU has primarily focussed on domestic capital flows. The establishment of a robust framework has had a global impact on green taxonomies worldwide, with many regions adopting or considering their own versions, such as the UK Green Taxonomy (still in development) and the Singapore-Asia Taxonomy for Sustainable Finance.



Other mechanisms in the EU, such as 'Fit for 55' incentivise the transition to a low-carbon economy. Fit for 55 is a comprehensive set of climate policies, which includes the EU Emissions Trading System (ETS) and carbon border adjustment mechanisms. By pricing carbon emissions, these policies drive investment towards sustainable technologies and practices.

There are ongoing discussions as to whether the EU Taxonomy accurately reflects transitioning activities. The EU has stringent greenwashing regulations for financial institutions which are then complemented by disclosure requirements, but financing transition can be challenging due to ambiguous definitions. Whilst the EU has a robust framework for the real economy, it is prescriptive for financial institutions, making it difficult to identify transition activities, suitable assets, and effective capital allocation channels. Investors may be wary of making bold claims, which we have seen in the rollback of Article 9 funds – which under the SFDR, are financial products with a clear and sustainable investment objective, meaning they aim to make a positive impact on the environment and society – and a rise in 'greenhushing', where corporates downplay or avoid public disclosure of sustainability efforts. The EU's narrow definition of sustainable activities may therefore limit the scope of investable assets, further complicating capital allocation for transition projects.

Implication for financial institutions

With a clear focus on the end state of a net zero-aligned economy, the EU has taken a demand-side approach. Therefore, disclosures by banks on EU Taxonomy eligible and aligned activities, which focus on green outcomes, have been very low. With Green Asset Ratio disclosures required under the European Banking Authority's Pillar 3 regime from 2024 onwards, this is unlikely to change. As explained above, similar reactions have been seen from investors through the SFDR regime.

In response, markets such as the EU require a significant role for ratings agencies and data providers, enabling other financial institutions including banks and investors to effectively adhere to detailed regulation and disclosure requirements and to manage risks associated with these including greenwashing.

Their role then enables those mobilising capital – from sponsors to banks – to do so, and hopefully at increasing scale. However, the persistently low levels of alignment with the Taxonomy demonstrates difficulty in applying an analytically challenging process.

> *"Transition finance is about financing private investments to reduce today's high greenhouse gas emissions or other environmental impacts and transition to a climate neutral and sustainable economy,"*
>
> **European Commission[6]**

Sources: 6) European Commission. (2024). Overview of sustainable finance.

Banks, therefore, need to expand client outreach and data capture systems to help identify all eligible activity through personalised communication and dedicated client support.

Given ongoing debate about the extent to which the Taxonomy captures transitional activities, tools such as proprietary taxonomies are important for internal decision-making purposes and to support external communication and disclosure which effectively mitigates greenwashing risks.

These can also help support interoperability when financial institutions are working across jurisdictions with differing approaches.

Limited disclosures may also indicate lower levels of transitional activity to direct capital to, when compared to jurisdictions like the US which are taking a more aggressive incentive-led approach. This indicates a continued role for insurers in helping support risk transfer, and also for the official sector whether through direct incentivisation at a corporate level or via further support for financial institutions.

United Arab Emirates case study

The UAE's transition finance framework, whilst still developing compared to the EU's more established system, is showing similarities in its approach to labelling transition activities. Both jurisdictions recognise the critical importance of clear and consistent criteria for defining transition activities, which are essential for investor confidence and preventing greenwashing.

The UAE Central Bank is actively developing regulations and guidelines for sustainable finance, including a focus on transition finance, through initiatives like the UAE Sustainable Finance Working Group and the issuance of guiding principles. The government has introduced several key projects to support this growth, including the Sustainable Finance Framework (2021-2031), which outlines the strategy to mainstream sustainable finance practices and increase climate and green investments. Abu Dhabi Global Market, the financial hub of the UAE's capital, has introduced a comprehensive regulatory framework covering funds, portfolios, bonds, sukuks (Shariah-compliant financial certificates representing ownership in underlying assets), carbon offsets, and ESG disclosures.

Similarly to the EU, the UAE emphasises the pivotal role of financial institutions in driving the transition, empowering them with guidelines to develop and offer sustainable financial products. The UAE's approach is two-pronged, aiming to foster a conducive environment for both corporates and financial services. On one hand, the government is encouraging businesses to adopt sustainable practices and disclose their ESG performance through various incentives. On the other, the country is positioning itself as a regional hub for sustainable finance, attracting green bonds, sustainable funds, and other financial instruments.

In conclusion, the current landscape of transition finance is marked by a stark divergence in approaches, presenting a complex challenge for financial institutions. To navigate this complexity effectively, financial institutions seeking to mobilise or support capital flows must prioritise interoperability whilst acknowledging the unique characteristics of different regions. The pace of capital mobilisation will remain informed by a combination of demand-side (corporate) and supply-side (financial sector) measures and be greatest where these are in harmony and where transitional activity is therefore a driver of performance and returns.

A globally accepted definition of transition finance is unlikely to materialise, necessitating a tailored approach. Financial services should therefore be guided by the specific needs and circumstances of the geographies in which they operate. By building their own transition finance capabilities, financial institutions can play a pivotal role in driving progress.

ESG ratings agencies and data providers play a key role across all jurisdictions, enabling information flows whilst mandatory disclosure requirements are established. Banks, investors and sponsors need ways to take these information flows, and use them to identify transitioning sectors, companies and assets which align to their risk appetite. Greater certainty, stability and maturity across the market can help to support provision of investment capital, including retail demand enabled by asset managers and wealth managers. Against a backdrop of change and maturity, insurance companies will play an invaluable role in risk transfer and mitigation.

As key players in the market with a deep understanding of local nuances, financial institutions are uniquely positioned to foster interoperability and facilitate knowledge sharing. By recognising that transition finance is a globally accepted term without a universal definition, the industry can work collaboratively to develop common frameworks and standards that support a just and equitable transition.

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