

TWIN PEAKS: TRANSITION FINANCE AND THE AGENDA FOR GROWTH

28 October 2024

“Transition finance” has been in successive UK Governments’ sights as an opportunity for the UK. An ambition to make the UK a global leader in transition finance was part of the Sunak Government’s 2023 [Green Finance Strategy](#). The Transition Finance Market Review (TFMR) was subsequently mandated in early 2024 to conduct an independent review of the barriers to scaling transition finance.

This ambition has gathered momentum since the election. Labour’s vision for a “[modern industrial strategy](#)” earmarks the growth potential of the UK’s financial services sector and notes its role in the race to net zero. The development of a robust transition finance market, with London at its heart, is an opportunity to scale the twin peaks of economic growth and effective decarbonisation.

Earlier this month, the TFMR reported on its findings. Its [Report](#) (the **Report**) articulates an ambitious range of strategies, policies, pathways and investment signals, all aimed at bringing investors and companies together such that volumes of “transition” finance increase. The Report is thoughtful and comprehensive, but not an easy read. This reflects the complexity of the task, which now sits with Government and other stakeholders to digest and take forward.

The TFMR’s numerous recommendations will impact corporate funding options, in that the policy and financial sector response will shape capital flows. The Report looks at unlocking transition capital at “activity level” (specific purpose financing). It also looks at how the financial sector can support decarbonisation in the context of “entity level” general purpose financing, including for higher emitters.

In this briefing we highlight the implications of the Government’s ambitions for the “transition finance market” for finance and treasury teams, including the key elements of the Report’s recommendations to consider monitoring or engaging with in more detail.

1. Transition finance as a path to growth

Indications of the amounts of “transition finance” currently in play are difficult to assess. Transition-labelled finance is currently categorised according to a patchwork of guidance collated into proprietary “Transition Finance Frameworks” developed by individual banks and investors. Bloomberg data, noting the definitional uncertainties, suggests transition labelled debt issuance so far in 2024 (to October) totals just under \$21.5 billion globally. Current labelled issuance is heavily focussed on “activity level” financing.

“Transition finance, in the broadest sense, incorporates the financial flows, products and services that facilitate an economy-wide transition to net zero consistent with the Paris Agreement.”

TFMR Report, October 2024

The TFMR considers transition finance in its broadest sense, as shorthand for the finance required to support the achievement of global net zero ambitions within Paris Agreement timelines. Annual estimates of these amounts vary; suffice to say all are in the trillions, hence the opportunity for the financial sector.

“Transition” finance in this broad sense is not limited to finance for energy transition projects. It includes, but is not limited to, financing directed specifically to decarbonisation activities. At its widest, it includes entity level general purpose financing that supports a whole-business decarbonisation strategy. In that sense, transition finance is relevant across the economy and to all sectors.

The Report identifies the lack of any broadly applicable consensus or policy framing the scope of “transition” as one of the key barriers to scaling the transition finance market. While transition finance (as discussed further below) is not limited to finance labelled as such, the gap between billions and trillions, indicates that the concept of transition finance is at present, too tightly drawn.

2. Clarifying the scope of transition finance

Why it is necessary to be able to categorise “transition” finance? As discussed in our recent briefing [Sustainable Finance Re-examined](#), the financial sector is under increasing pressure to apply its financial firepower to sustainable ends. If it fails to do that - or fails to do so with sufficient rigour and diligence - stakeholders and regulators will be quick to hold it to account.

The TFMR’s findings indicate that greenwashing concerns are a key barrier to scaling the transition finance market. The financial sector needs a clear view of what transition finance is so it can track it and disclose to its own stakeholders how the capital is being deployed. This is particularly important in unlocking finance for higher emitters with credible decarbonisation strategies. The development of a clear understanding of what constitutes credible transition finance is suggested as a priority.

The TFMR’s feedback advocated for a flexible approach to framing transition finance. Transition is, by nature, forward looking and dynamic. Decarbonisation technologies and options are developing at pace. Transition financing must be similarly agile.

The challenges many companies are experiencing in implementing the EU Green Taxonomy and other elements of the EU sustainable finance regime indicate that where flexibility, dynamism and agility are required, hard law may not be the optimal solution. An approach which starts with soft law (in the form of industry-level voluntary guidelines that are built on consensus and widely adopted), that may turn into hard law over time, has had demonstrable success in the context of sustainability. The Transition Plan Taskforce Framework for transition plans is another good example (discussed further below).

The Report therefore puts forward an illustrative “Transition Finance Classification System,” which articulates the potential range of finance falling within the categorisation, as the funnel for transition finance. The Classification System includes five illustrative categories of transition finance.

This Classification System (set out below) is supported by Guidelines for Credible Transition Finance for the financial sector. The Guidelines (which are laid out in the Report) are a starting point for a common framework for assessing when financing an activity or entity credibly amounts to transition finance (or in other words, the credibility of a transition activity or transition strategy). They do not include technical criteria but provide a principles-based framework that can be used alongside existing frameworks, pathways and policy tools (including taxonomies).

TFMR Transition Finance Classification System

Category 1 Specific purpose financing for climate solutions and enablers: Financing climate solution activities (e.g. the generation and storage of renewable/low carbon fuels) and activities which enable climate solutions (e.g. transmission and distribution of renewable/low carbon fuels).

Category 2 Entity level financing for climate solutions and enablers: Financing “pure play” companies where a minimum of 70% and a maximum of 90% of revenues or assets are derived from Category 1 activities.

Category 3 Activity level financing to support alignment: Financing activities which support an entity in aligning to a credible decarbonisation pathway as defined in the supporting Guidelines e.g. lower carbon retrofit of buildings.

Category 4 Financing for entities which are aligned/aligning (i.e. higher emitters): Financing entities which are aligned/aligning and result in abatement in line with credible transition strategy as defined in the supporting Guidelines (e.g. for steel, cement, aviation). Specific purpose financing now; moving to general purpose entity level financing.

Category 5 Specific purpose financing for early retirement of higher emitting assets: Financing activities which lead to early retirement of higher emitting assets which would otherwise continue to produce emissions (e.g. repurposing/early retirement of coal plants).

The Guidelines are intended as a pragmatic interim solution for creating “integrity and credibility” parameters while corporate transition plans and other levers which go to the credibility of transition activities or strategies (for example, external assurance options, ratings, and taxonomies) are developing. The Report proposes that the Transition Finance Council engages with stakeholders on these Guidelines (a process which we understand has already begun).

The idea is that individual institutions can build the Classification System and Guidelines into Transition Finance Frameworks (in a similar way to how the Loan/Bond market principles for green and sustainability-linked loans are linked into Sustainable Finance Frameworks), to provide legitimacy to their categorisation and facilitate transparent reporting.

3. Policy levers and sectoral pathways

The challenge of transition planning lies in the identification of the most appropriate and effective

decarbonisation strategies and activities. If financing is required, banks and investors must assess whether the proposed strategy is credible. From a credit perspective, is this the best or the right way to proceed? Here, the TFMR's findings indicate that there is demand from the financial sector and the private sector for clearer policy signals from Government, in other words, transition planning from the top down.

National transition planning requires sectoral prioritisation supported by policy incentives which allow the financial sector and corporates alike to allocate capital to key sectors. The success of the Japanese model, with its policy focus on high emitting sectors representing the bulk of the current labelled transition finance market was highlighted by a number of respondents to the TFMR Call for Evidence.

To those ends, the Report's key recommendation is the articulation of granular sectoral pathways to decarbonisation, developed under the umbrella of a re-invigorated Net Zero Council, alongside the development and communication of national transition planning and related policy levers.

The [Net Zero Council](#) comprises representatives from government, business and finance and was formed under the previous Government to formulate cross-cutting strategy across major business sectors to deliver the UK's net zero target. Its key objectives include working to ensure business sectors have robust pathways to net zero and relieving roadblocks, as well as addressing financing challenges. The Report suggests that it is reinstated by the end of this year.

Mark Carney has expressed the view that finance needs to "go where the emissions are". It is not clear whether or how the UK Government will choose to prioritise or differentiate between sectors for the purposes of implementing the policy recommendations of the Report. Clearly, decarbonisation pathways and roadmaps are already developed in certain sectors (road transport being one example), but in others, perhaps less so.

Also relevant here is the sustainable finance regulatory framework, which prioritises the financing of "green". Net zero goals are undermined if the financial sector is disincentivised from financing the transition of higher emitters. This leads to the recommendation that the further development of this framework (including the use of financed emissions as a dominant disclosure metric for the financial sector and any further UK green taxonomy) proceeds with transition priorities in mind.

The Report's emphasis on sectoral pathways and planning being developed in partnership with industry is a key

takeaway for the real economy. Immediate action points for corporates to consider include:

- Refreshing views on existing pathways and roadmaps relevant to their sector (if they exist).
- Researching the most appropriate path for engagement with the Net Zero Council.
- Monitoring announcements with sectoral relevance, individually or by maintaining engagement with industry peers and trade associations.

The related action point for treasury teams is to maintain engagement with those responsible for these workstreams within the business. These roadmaps will shape transition planning, which in turn is expected to become increasingly relevant to credit decisions.

4. Public finance options

Decarbonisation strategies may involve emerging technologies or some form of external dependency (e.g. the need for distribution infrastructure or offtake risk) which may inhibit transition without policy support. This is particularly pronounced in instances where upfront development costs are significant. CCUS solutions are a case in point, involving material levels of upfront investment which are not feasible without government support for transport and related infrastructure and in securing offtake.

Commercial viability challenges were identified as among the most significant barriers to financing transition activities. The Report acknowledges the need for public finance institutions to provide catalytic capital and financing solutions to support priority transition activities which are not currently commercially viable. Here, there are a number of initiatives already in play (including the newly launched National Wealth Fund). The TFMR is focussed on making better use of those resources and in addressing the gaps in the landscape to facilitate greater risk appetite for transition.

The Report includes various proposals, including for the establishment of a Transition Finance Lab, housed in the Green Finance Institute, for the testing of financing solutions for sector specific challenges. The Report also flags the potential for insurance solutions and aggregation mechanisms (such as securitisation structures) in improving the bankability of certain transition activities.

It is relevant here to note the difficulty of locating information on policy commitments and developments relating to decarbonisation, in particular, an overall snapshot of progress. This point is not overlooked by the

Report, which recommends that the Government improve both communications and the accessibility of all relevant information, including public finance options for all stakeholders, ideally via a “single point of entry”.

5. Supporting credible transition: transition plans, ratings and more

The UK Transition Plan Taskforce (TPT) was tasked with creating a sector-agnostic gold standard framework for corporate climate transition planning. The Transition Plan Taskforce Framework (TPTF) was launched in 2023. In essence, it requires companies to consider what transition means for their business from a risk perspective and in terms of opportunities and value creation.

The TPTF underlines that a transition plan is a dynamic and iterative business strategy, rather than a disclosure process. For most companies this involves emission reduction targets, but also the development of new business lines and in some cases, transformation. The incorporation of transition plans as part of business strategy is important in the context of understanding how they feed into credit assessments and investment decisions, as well as how the concept of transition finance is developing. The need to facilitate investors’ ability to categorise transition finance if it is to scale, means these plans (supported by sectoral pathways) can be expected to assume increasing importance in investment decisions.

Although the disclosure of climate transition plans is not (yet) a regulatory requirement in the UK or the EU, the direction of travel is clear. The UK Government made a manifesto commitment to mandate financial institutions and FTSE 100 companies “to develop and implement credible transition plans”. Mandatory transition planning is part of the requirements of the CSDDD regime in the EU.

The Report recommends that transition plans are made mandatory for “a wide set of financial and non-financial companies”, via a consultation. It goes on to recommend that this consultation should address “the sequencing of implementation and any requirements for alignment with 1.5°C to avoid unintended consequences”. The Report also recommends that ways of incentivising the disclosure of high-quality, forward-looking data in transition plans should also be explored. This includes focus on improving external assurance capacity of forward-looking data (through ICAEW and ICAS) and the regulatory underpinning of transition ratings alongside the work already done and developing on ESG ratings more generally (the UK’s Voluntary Code of Conduct for Ratings Providers and related regulatory proposals).

Transition planning is a live topic among larger corporates. Many have already developed transition plans which are

being made publicly available. For others, this remains work in progress. The TFMR touches on a wide range of issues here that will, in time, develop into regulatory requirements. These aspects will be particularly important to monitor as Governments and regulators take their next steps.

In the context of transition plans specifically, the TFMR further emphasises the TPTF as best practice. The work of the TPTF is due to conclude at end of this month. It is understood that to mark the end of the process, there will be a publication that takes stock of progress and highlights areas for future policy development. The disclosure aspects of the TPTF have been transferred to the IFRS Foundation with a view to streamlining and consolidating frameworks and standards for transition plan disclosures.

6. ESG-labelled finance - where does transition finance fit in?

Transition finance requires categorisation and to a degree, definition, but it is important to understand that scaling the transition finance market is not about scaling a labelled market. There are instances where a transition “label” might be considered helpful in terms of signalling, reputation, or sometimes economic factors. However, challenges of the labelled product in terms of documentation, disclosure and comparability suggested limited appetite to push forward a labelled product at policy level.

“Transition” labelled loans and bonds exist, but in the absence of standalone global loan or bond market principles as exist for green, social and sustainability-linked instruments, are rare. Most transition labelled issuance stems from Japan, where, as mentioned above, the Japanese government has developed a specific national framework.

“Transition” objectives can be financed using the existing labelled instruments to an extent. Green use of proceeds instruments may overlap with a few activities within the TFMR’s Transition Finance Classification System, in particular, those in Category 1. Sustainability-linked instruments are expressed as a transition tool, available to borrowers and issuers of all types. In practice, greenwashing concerns tend to inhibit the use of these labels to the financing of transition activities and entities.

With a view to facilitating transition lending, the loan market trade associations (the LMA, LSTA and APLMA) formed a taskforce earlier this year to consider the development of principles and guidance for transition labelled loans, which is now underway. The TFMR notes that this could encourage the development of transition bond principles in time. For now, ICMA and the Climate

Bond Initiative have published guidance and frameworks for disclosing and assessing transition, which aim to facilitate the use of sustainable finance for transition purposes.

The mixed feedback received by the TFMR resulted in relatively muted recommendations in terms of growing the universe of “transition” labelled loans and bonds. However, the emergence of sectoral policies and pathways, mandatory transition plans and related measures aimed at ensuring the credibility of transition activities and strategies as recommended in the Report may have the effect of opening up existing sustainable finance products to transition themes.

7. Concluding thoughts and next steps

The development and implementation of the TFMR’s recommendations, if successful, will strongly incentivise the financial sector to develop the transition finance market. For transitioning higher emitters, the policy initiatives that may flow have the potential to re-shape the nature and sources of finance on offer.

For corporates generally, the policy goals underpinning the TFMR’s mandate underline the need to accelerate the development of transition plans and to articulate weaknesses and challenges that need to be built into policy offerings and sectoral pathways.

Perhaps the Report’s central message is that clarifying the perimeter of “transition” (and therefore “transition finance”) requires policy guidance. This might suggest that the implications of the Report for particular corporates depend to an extent on the official sector response. However, the Report is also a call to action. It emphasises that the further development of policies to unlock funding support for the net zero transition requires collaborative effort. Government, regulators and the financial sector need detailed input from the real economy in order to shape the strategies that will direct the flow of transition finance.

The timeframes suggested in the Report for implementing its recommendations are short: between 6 months and 3 years. Announcements regarding the Government’s next steps in this area and an indication of how those measures might impact the decarbonisation journeys of particular sectors and corporates are expected in the short term (Q1 2025), alongside the Industrial Strategy and the UK’s revised carbon budgets. Given the emphasis in the Report on the need for engagement from the full range of stakeholders (including the real economy) in parallel, market and industry-led initiatives may start to mobilise sooner.

It follows that the implementation of measures designed to remove the barriers to scaling transition finance (the substance of the TFMR’s recommendations) will impact all corporates, regardless of the status of their transition to net zero. We would recommend that corporates take the time to familiarise themselves with the detail of the Report and consider the aspects they should monitor and/or engage with. There will be opportunities as well as requirements to comply with.

Engagement on strategic transition planning may fall outside the treasury remit. However, as the interface between the financial sector and the business, treasury has a critical role to play in the development of transition finance policies and products. Transition strategies, weaknesses, risks, and investment needs are likely to feed into all financing discussions in the years to come. We would urge more treasurers to engage with and contribute to the development of financial products and public support mechanisms that are relevant to the business.

For further information about the issues highlighted in this briefing, please contact any of the lawyers listed below or your usual adviser at Slaughter and May.

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FURTHER INFORMATION

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