Transition finance in the debt capital market

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Overview of the ICMA's Climate Transition Finance Handbook (2020; updated in 2023)

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- **Climate transition focuses principally on the credibility of an issuer's Greenhouse Gas (GHG) emissions reduction strategy, commitments, and practices.**
- Bonds aligned with the Green, Sustainability, or Sustainability-Linked Bond Principles (GSS Bonds) to be underpinned by organisation level climate transition strategies and disclosures **aligned with recommendations of the Climate Transition Finance Handbook 2023** (CTFH 2023).
- Notably, GSS issuance from issuers in **'hard-to-abate' sectors would be strengthened through alignment** with the CTFH 2023.
- **Issuers are encouraged to reference the CTFH 2023** and align with the elements contained therein to communicate their GHG emissions reduction strategy. This is especially pertinent to green, sustainability or sustainability-linked instruments designated as "climate transition" bonds (which may take the form of an additional climate transition label, as is the case in certain jurisdictions).

Key Elements of the Climate Transition Finance Handbook

1. Issuer's climate transition strategy and governance	2. Business model environmental materiality	3. Climate transition strategy to be science-based	4. Implementation transparency
The GSS financing should be directed toward enabling an issuer's GHG emission reduction strategy in alignment with the goals of the Paris Agreement.	The climate transition strategy should be relevant to the environmentally material parts of an issuer's business model.	An issuer's climate transition strategy should reference science-based targets and transition pathways.	Market communication should be transparent on the underlying investment program.

Sustainable Finance Solutions

Green and Sustainability Bonds
Focus on projects

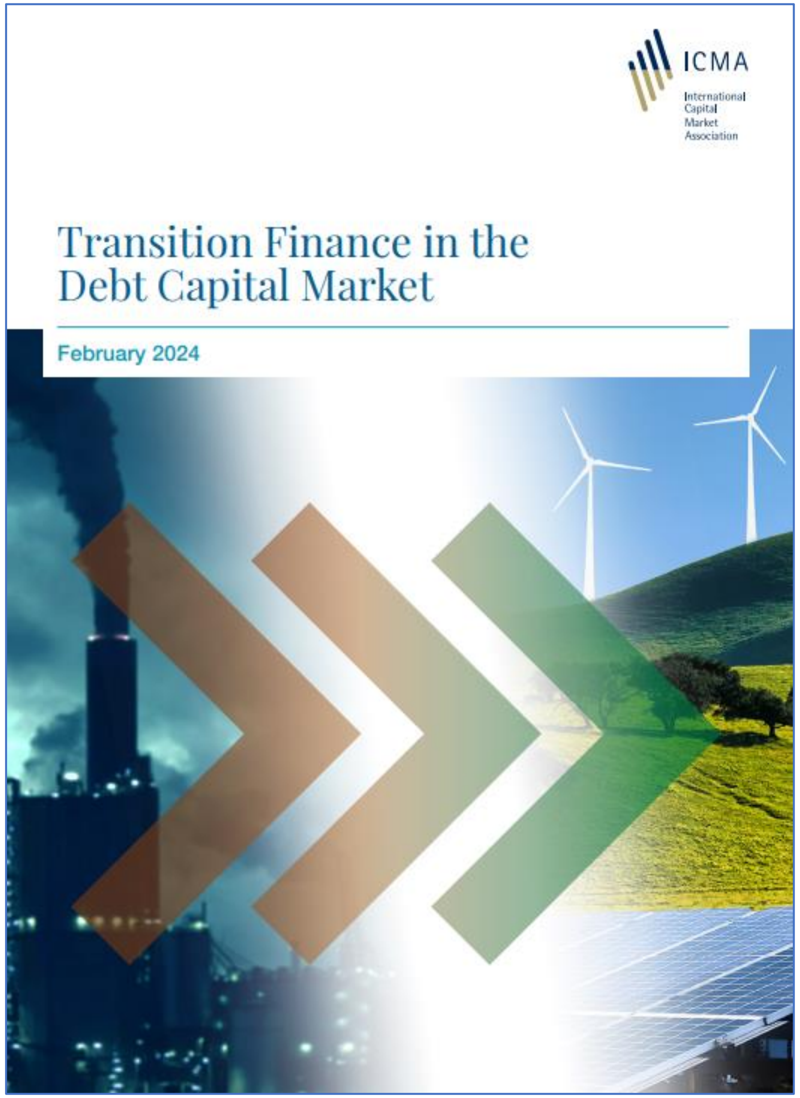
Type: Use of proceeds (UoP)
Guidance: Green Bond Principles and Sustainability Bond Guidelines
Projects: projects that will make a meaningful contribution to an issuer's GHG emissions reduction strategy. This can include environmental (green) projects that will make a direct contribution to an issuer's own GHG emissions trajectory, and/or projects (including social) tied to a "just transition".
Additional resources: See Annex 2 for a non-exhaustive list of wider official and market guidance for climate transition themed GSS Bonds.

Sustainability-Linked Bonds (SLBs)
Focus on the issuer's climate transition trajectory

Type: General purpose with KPIs and SPTs at the issuer level
Guidance: Sustainability-Linked Bond Principles
KPIs and Sustainability Performance Targets (SPTs): where one or more of the KPIs are monitoring GHG emission reduction metrics – either direct results (i.e., absolute/intensity GHG emission metrics) or supportive proxies (i.e., metrics that act as levers to advance GHG emission reduction targets). Targets to be science-based.
Additional resources: See illustrative KPI Registry and Annex 2 for a non-exhaustive list of wider official and market guidance for climate transition themed GSS Bonds.

Overview of the new ICMA publication

- **On 14th of February, ICMA published a staff paper which**:
  - Unpacks existing definitions of “transition finance”;
  - Demonstrates how sustainable bonds contribute to transition;
  - Highlights the relevance of official sector and market-based guidance and tools such as taxonomies, pathways, and roadmaps for further market development;
  - Points to transition plans as a real opportunity; and,
  - Promotes the early adoption of transition plans by also proposing a structure for an “integrated transition plan” that builds on the CTFH, IFRS S2, ESRS, the UK TPT recommendation.



Key messages of the ICMA's February 2024 paper

- **Transition finance is available but not yet where it may be most needed**: Sustainable bonds contribute at scale to climate transition. The greatest challenge of transition finance resides, however, with the fossil fuel and the hard-to-abate industries as illustrated by the modest amounts raised to date by issuers from these sectors.

- **Issuers can aim to overcome reputational concerns with official and market guidance:** The additional guidance in the form of taxonomies incorporating transition and sectoral decarbonisation pathways and roadmaps can provide significant comfort to issuers on addressing uncertainty on acceptable technologies, trajectories, and greenwashing.

- **The adoption of standardised transition plans could unlock the market:** Our paper encourages the early adoption of credible transition plans ahead of a potential regulation or a "de facto" requirement. We propose an "integrated transition plan" structure building on the CTFH, the ISSB standard (IFRS S2), ESRS E1, and the UK TPT recommendation.

Key actions & disclosures for an “integrated transition plan”

- ICMA’s paper presents (in its Appendix A) an “**integrated transition plan**” structure building on the CTFH, IFRS S2, ESRS E1, and UK TPT frameworks.

- While not exhaustive, it presents key actions and disclosures that can help **issuers align with all these frameworks in one go and policymakers ensure international consistency**.

Elements	Key actions & disclosures
Transition strategy, materiality & governance	• Adopt a Paris-aligned (ideally its 1.5°C objective) and quantitatively measurable climate transition strategy and targets using science-based pathways provided by recognised third-party sources, where they exist, and disclose methodologies and scenarios used, as well as any third-party certification. • Ensure that climate transition strategy is relevant to the environmentally material parts of the business model. • Ensure effective climate governance arrangements including senior management approval of the plan and accountability, remuneration/ incentive schemes linked to the transition strategy, and necessary skills and training across the organisation. • Where relevant, consider “just transition” and disclose broader sustainability policies addressing negative sustainability impacts and trade-offs. • Position transition plan as a standalone document sitting alongside financial reporting.
Science-based targets & metrics	• Disclose GHG emissions covering all material Scopes as formulated in absolute (gross tCO2e), economic output (per net revenue), and industry-based metrics. • Adopt and disclose absolute gross (tCO2e), and where relevant, intensity-based targets for all material GHG Scopes. When only intensity targets set, disclose also the associated absolute values. • Adopt short (ideally 3 years max.), medium, and long-term targets, and in any case for 2030, from which date baselines and targets should be updated every 5 years. • There should not be any reliance on offsets except for residual (approx. 5-10%) emissions in net zero targets, in which case they should be disclosed separately and include credibility proof.
Implementation transparency	• Disclose all the relevant information on (i) planned changes to the business model, operations, products, as well as relevant policies and processes supporting those; (ii) actions for short (ideally 3-years max.), medium, and long term; (iii) planned investments, financial resources, and other financial metrics; (iv) internal carbon pricing; (v) engagement strategy and actions for value chains, with industry, public sector, and civil society. • Provide a credible link between the various levers and the transition strategy and quantify the contribution from different levers to climate objectives at least on an estimated basis. • Where relevant, disclose potential adverse sustainability impacts and mitigating actions and expenses (e.g. for “just transition”).
Verification & reporting	• Obtain an external review assessing the credibility of the entity’s strategy, its alignment to the referenced science-based trajectories, and its climate governance alongside any potential jurisdictional requirement required for sustainability reporting (e.g., limited or reasonable assurance). • Report annually quantitative and qualitative information on the progress against transition plans, targets, and metrics. • Regularly update the transition plan (ideally every 3 years), and when there are significant changes.

Summary comparison of CTFH, IFRS S2, ESRS E1, & the UK TPT

- Appendix B provides a comparison of key transition-related elements and disclosures under CTFH, IFRS S2, ESRS E1, and UK TPT frameworks.

Elements		CTFH (ICMA)	IFRS S2 (ISSB)	ESRS E1 (EC)	UK TPT recommendation
Transition strategy, materiality & governance	Requirement	Alignment with the CTFH is a recommended voluntary best-practice which implies some behavioural and disclosure requirements.	Disclosure of transition plan and targets is contingent on reporting entities voluntarily having them in the first place.	Disclosure of transition plan and targets is contingent on reporting entities voluntarily having them in the first place. However, the CSDD Directive in the EU may make the adoption of 1.5 °C compatible transition plans mandatory for certain large EU and non-EU entities (including in the financial sector).	Subject to the FCA's upcoming consultation on transition plans (expected in H1 2024), it is expected that disclosure of transition plan and targets will be contingent on reporting entities voluntarily having them in the first place.
	Materiality	Climate transition strategy should be relevant to the environmentally material parts of an issuer's business model.	Subject to reporting entity's own materiality assessment.	Subject to reporting entity's own materiality assessment. However, if the entity concludes climate change is not material, it shall publish a detailed explanation.	Subject to reporting entity's own materiality assessment.

Elements		CTFH (ICMA)	IFRS S2 (ISSB)	ESRS E1 (EC)	UK TPT recommendation
Science-based targets & metrics	Carbon credits	Use of high-quality and integrity carbon credits for offsetting is allowed only to abate the residual emissions, and such needs to be justified while issuer carbon credit procurement policy and governance to be disclosed.	Disclosure of the planned use of and reliance on carbon credits to achieve the net targets, their type (e.g., whether nature or technology-based), third-party verification/certification schemes, and any other credibility and integrity disclosures.	GHG removals, carbon credits, or avoided emissions cannot be used to meet targets. However, in the case of a net-zero target, they can be used to neutralise the residual emissions (after reducing 90-95% of emissions), as supported with disclosures including to demonstrate credibility.	Disclosure on the use of carbon credits in achieving strategic ambition, alongside justification, third-party verification/certification, standard or methodology used, type of carbon credit, and other credibility and integrity factors. The TPT however states that good practice transition plans should prioritise decarbonisation through direct abatement over purchasing carbon credits.

Other tools to ensure decarbonisation credibility

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- While the implementation of a credible entity-level **transition plan is the backbone** of transition finance, there are **several other market-based or official sector tools and guidance** to ensure credibility and integrity towards investors.

- Usually, these are **not mutually exclusive** but can be used in combination and support the credibility of an entity's transition plan:

  - **Sectoral decarbonisation roadmaps and pathways** can be used to position an issuer's transition strategy and guide its allocations in green use of proceeds bonds and the targets' ambition in SLBs. The IEA scenarios and methodologies have been particularly influential and authoritative around the globe especially to demonstrate ambition.

  - **Taxonomies:** Appendix C of the ICMA's paper provides an overview of the transition related features of leading official and market taxonomies (e.g. the CBI Taxonomy, the MDBs-IDFC Common Principles, and the EU Taxonomy).

  - **Certification schemes,** such as those provided by the Science Based Targets Initiative and Climate Bonds Initiative, can be used to ensure investor confidence on the ambition of the issuers' decarbonisation targets and progress.

  - **Other official sector guidance** (e.g. OECD Guidance on Transition Finance and on preventing carbon lock-in and the European Commission's June 2023 Communication) are also relevant and helpful to guide issuers' transition.

Need for broader policies to support transition

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- **Transition finance is both a factor and contingent on the wider economic transition** necessary to align with the goals of the Paris Agreement.

- **GFANZ**: Action by **financial institutions, while critical, cannot substitute for, or succeed, without the necessary action by government**. In October 2021, it issued a Call to Action on G20 governments with specific policy requests and recommendations which includes economy-wide net-zero targets aligned to 1.5 °C; reform of financial regulations to support the net zero transition; phase-out of fossil fuel subsidies; pricing carbon emissions; mandatory net zero transition plans and climate reporting for public and private enterprises by 2024.

- The Transition Finance Framework of G20 SFWG (October 2022) separates policy measures, which are **needed to send correct market signals and incentivise and accelerate the transition into 2 categories**: (i) **the use of public financing, de-risk, or support/incentives** to improve the availability and affordability of climate transition finance; or (ii) **price and non-price-based policy tools** (such as certain incentives, regulatory measures, sectoral standards, etc.) designed to reduce emissions and accelerate the climate transitions by internalising the costs of firms and projects to inform the financial decision-making of market participants.

- **Creating further dynamics through fund regulation**: ICMA's SFDR consultation response (Dec. 2023) recommended to consider a uniform disclosure imposed on **all funds** (even those without a sustainability claim): **"(%) of the fund which is exposed to investees implementing a credible transition plan where climate risks are material"**. This may prove an easy-to-understand metric especially for retail investors and create a pressure on investees to adopt transition plans where this is not already required by law. As such, it may help reorienting capital flows towards credibly transitioning investees.