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Defining transition finance and embedding it in the post-Covid-19 recovery

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ABSTRACT

While Transition Finance is increasingly entering the sustainable finance discourse, particularly among practitioners, it is often poorly defined, and there is currently no agreed definition in the literature. I propose a definition for Transition Finance and outline some of the potential benefits associated with the use of this definition. I also argue that Covid-19 related stimulus and bailouts, with the attendant increase in government backed financing facilities for counterparties, could ensure Transition Finance is embedded into the design of these financing facilities. Doing so would accelerate the wider adoption and mainstreaming of Transition Finance.

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To deliver the objectives of the Paris Agreement on climate change and the UN Sustainable Development Goals (SDGs) it is a necessary condition that finance and financial services be provided in a way that supports, enables, and encourages companies and countries to transition towards those objectives. Unprecedented post-Covid-19 recovery stimulus and bailouts will provide both short- and long-term financing facilities to different sectors of the global economy. How should such finance be provided so that it proactively supports such a transition? Could the Covid-19 stimulus and bailouts be an opportunity to clarify how this can be done and thus become a positive long-term legacy?

I argue that finance provided as part of post-Covid-19 stimulus and bailouts, and indeed by all private and public financial institutions in the future, needs to ensure ‘transition finance’ is centre stage. While transition finance is increasingly entering the sustainable finance discourse, particularly among practitioners (for example, see Duteil 2019; HSBC 2020; Takatsuki 2020), it is often poorly defined, and there is currently no agreed definition in the literature.

Transition finance is currently used interchangeably to describe ‘use of proceeds’ financing for polluting companies to fund cleaner activities or governments to fund activities that can support climate mitigation; financing that incentivises better sustainability performance by counterparties; or access to funding and finance for developing countries as they develop while tackling environmental and social challenges.

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Several terms confuse funding or public expenditure with finance and investment, and the transition can variably refer to making progress towards climate, broader environmental, and/or social objectives across different time horizons and over varying geographical scales (i.e. local, sub-national, national, supra-national, and global).

Some of the focus among practitioners is on extending ‘use of proceeds’ guidelines for green bonds so they can more readily include companies operating in ‘transition’ sectors that are very polluting, such as extractives, heavy industry, and fossil fuel power generation. The idea being that if companies in these sectors raise capital and use the proceeds for activities that help them reduce pollution, then this is supporting their transition in a way that could potentially be compatible with climate and other environmental or social objectives.

Robins (2020, 2018) argues for the use of proceeds model for countries raising capital, where ‘just transition’ bonds are issued by sovereigns with the proceeds hypothecated to government expenditures that can help to address just transition challenges. This could include, for example, subsidising polluting companies to invest in cleaner new technologies or paying for training in new skills for those made unemployed as polluting industries close down. There have been other such proposals to hypothecate the proceeds of sovereign bonds, with the identified priorities for government expenditure changing as fashions and interests wax and wane (for example, see: Hussain 2020; Walker 2019). This is little different from war bonds issued during both world wars, although the investors in this case are not being asked to invest at below-market rates.

In addition to the use of proceeds, there is also growing and, in my view, much more fruitful interest in linking sustainability performance to the cost of capital, again through bonds and also through bank loans, with the aim of supporting the transition. These could take the form of this generalisable example: Company A secures a lower cost of capital from the bank if it achieves ambitious, predetermined carbon reduction targets. A lower cost of capital is possible because Company A has calculably lower credit risk due to less energy use resulting in lower energy bills and lower potential future carbon price liabilities. The lender can share some of that reduction in credit risk with the borrower, creating a win-win where the borrower secures a lower cost of capital and the bank makes more money.

ICMA has been developing sustainability-linked loan and bond standards (ICMA 2019, 2020). Both sustainability-linked loans (SLLs) and sustainability-linked bonds (SLBs) attempt to incentivise the borrower’s or issuer’s achievement of ambitious, predetermined sustainability performance objectives (Ibid.). Use of proceeds is not a determinant in the categorisation of SLLs and SLBs and in most instances they will be used for general corporate purposes, though in some cases borrowers and issuers can combine them with use of proceeds approaches such as the ICMA green bond or sustainability bond guidelines (Ibid.).

In contrast, the OECD (2019) defines what it calls transition finance as the, ‘... journey towards the 2030 Agenda and the achievement of sustainable development, and transition finance the financing of that journey ... As countries transition through the development continuum, they lose access to certain types of financing, but gain access to a broader variety of actors, tools and instruments.’

This definition is focused on the development pathways that developing countries take and their access to finance as they develop, with a particular focus on access to Official Development Assistance (ODA). While this is an important topic and one particularly

relevant to the international climate negotiations, it is not directly relevant to firms and is less concerned with financial products and services and more interested in government access to funding, particularly aid from developed to developing countries.

As a result of this lack of clarity, and the urgent need with Covid-19 stimulus and bail-outs to know what we mean and what we're trying to achieve, I propose a more precise and consistent definition: *Transition Finance is the provision and use of financial products and services to support counterparties, such as companies, sovereigns, and individuals, realise alignment with environmental and social sustainability.*

There are a number of benefits of this definition and some of the key ones are outlined here. First, while it includes and encompasses the aforementioned SLLs and SLBs, it takes a wider view of the gamut of financial products and services that can contribute to counterparties aligning with sustainability objectives over time. Many have argued, for example, that engagement and active ownership are important ways of supporting investee companies (and indeed governments) transition, and in some asset classes (such as listed equities) this may be among the most important contributions that financial institutions can make (Caldecott 2020; Çelik and Isaksson 2014; Dimson, Karakaş, and Li 2015; Klein and Zur 2009; Sandberg 2013; Skancke et al. 2014).

We are bound to see packages of financial products and services with differing levels of complexity and duration designed to help counterparties transition. Many of these exist already or are emerging and could encompass everything from swaps to smart contracts to new prediction markets and perhaps also include new forms of public and private partnership. These will be developed and tailored by sector and geography with solutions across different asset classes. Transition Finance should, therefore, be viewed as a much richer and more diverse arena than simply SLLs and SLBs, critical those these are.

Further, such an approach is a necessity given the scale, complexity, and duration of the transition challenges facing many counterparties. For example, achieving net zero emissions in any sector of the global economy throws up a series of dilemmas and difficult choices, with different financial products and services needed at different times to support in different ways.

Mutually reinforcing packages of financial products and services will also be necessary for counterparties dealing with the impacts of Covid-19. Commercial or concessional financing since the crisis began will likely need to be restructured and refinanced, potentially repeatedly over many years, and if public finance is involved policymakers ought to consider the direction counterparties should be heading in and what broader policy objectives they can support as they go.

Second, we need to be clear that transition finance is applicable to all counterparties. While I focus on firms and governments here, this also needs to include individuals, whether that is homeowners looking to retrofit their homes, retail investors seeking to contribute to the transition through their investments, or workers needing to retrain as industries change and evolve. It should also encompass state-owned enterprises, often side-lined in sustainable finance literature and practice. All of these types of counterparty are also on the front line in terms of the economic impacts of Covid-19.

Third, Transition Finance should encompass environmental and social objectives, in the spirit of the UN SDGs, not least because in many cases there are important inter-relationships, cross dependencies, and also trade-offs between the pursuit of different environmental and social outcomes. Focusing solely on one narrow, albeit critically important objective, will sometimes mean these relationships are ignored, potentially

with significant negative consequences (think diesel gate and the focus on carbon emissions at the expense of air quality). Covid-19 is also a brilliant example of how environmental and social issues are inter-related: a zoonotic disease created by unsustainable human interactions with the natural world.

Fourth, this definition, I think, will help spur the market (as well as researchers) to think more expansively and creatively about Transition Finance and the ways we can and should use finance to support borrowers and issuers to transition. Sustainable Finance is, if it is anything, ultimately about enabling the company, government, or individual to raise the capital or access the financial services needed to change things in the real economy for the better. A more precise, but also a more suitably broad definition of Transition Finance, can foreground this key point.

The Covid-19 related stimulus and bailouts, with the attendant massive increase in government-backed financing facilities for counterparties, creates an unprecedented challenge and opportunity. We need to ensure Transition Finance is embedded into the design of these financing facilities as soon as possible. Doing so will accelerate the wider adoption and mainstreaming of Transition Finance.

If polluting incumbents are supported with debt and equity without a focus on Transition Finance it will expose taxpayers and government balance sheets to the risk of Stranded Assets, as well as lock-in externalities that will make achieving the SDGs impossible. If, however, we instead work systematically to create and provide effective Transition Finance to these same counterparties, we can tackle many of the causes of pollution and help ensure companies have a successful financial and economic future after the crisis.

One simple step that could be taken now, without much difficulty, is requiring all Covid-19 loans backed by governments to be SLLs, with a series of simple off the shelf sustainability performance indicators tailored to sectoral and country benchmarks. We know what ESG scores attempt to measure, albeit with varying degrees of success, and the various indicators they use. While SLLs tied to ESG scores from the main providers could result in some gaming of the system, it would be better to roll out such approaches quickly and then refine them, rather than let the pursuit of perfection be the enemy of the good. It is, however, important to be ambitious and counterparties should be incentivised to ratchet up ESG scores quickly, not least because of emerging evidence of how better firm-level ESG performance in a country can enhance growth and reduce unemployment in that country (Zhou et al. 2020).

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