Transition finance: What is it and why is it needed?

Access the podcast at:
https://doi.org/10.1787/93a3fcbb-en

Please cite this podcast as:

OECD (2022), “Transition finance: What is it and why is it needed?”, *OECD Podcasts*, Duration: 21:08, OECD Publishing, Paris, https://doi.org/10.1787/93a3fcbb-en.

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Duration: 21:08
Date: 27 September 2022

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Intro [00:00:02] Welcome to OECD Podcasts, where policy meets people.

Robin Allison Davis [00:00:08] Climate change calls for us to put our money where our mouth is. Corporations and governments have committed to sustainable finance. Is that enough to help us meet the net zero emissions goal of the Paris Agreement? If not, what more can be done to bridge this gap? That's where transition finance steps in. I'm Robin Allison Davis. And today we're discussing transition finance with Kate Levick, Associate Director of Sustainable Finance for the E3G think tank, and Elia Trippel, OECD Policy Analyst on Green Finance and Investment. In the coming days, the OECD is releasing their Guidance on Transition Finance ahead of the OECD Forum on Green Finance and Investment. But first, what is transition finance?

Robin Allison Davis [00:00:57] Let's start a bit more broadly when it comes to the environment and finance. There's a lot of different terminology out there. We know about green finance, sustainable finance. Kate, can you explain to our listeners what transition finance is and why it's so important?

Kate Levick [00:01:13] Sure. Well, the world needs to undergo a massive economic transition to achieve a resilient, net-zero emissions state. And a huge amount of investment is needed to create that transition. Actually, a great deal of the investment is not only in things that are already green, but in the kind of improvements and changes that we need to get to the net zero state. So this is really why the concept of transition finance has become so popular now. People have been working in green finance for a long time and realised that green finance does not cover the entirety of the kind of investments that need to be made. And that often when we talk about transition finance, we think of what encompasses the whole spectrum. That includes all the investments we need a long way to get to that end state.

Robin Allison Davis [00:02:01] You work for the think tank E3G. How does your work at E3G contribute to advance the transition finance agenda?

Kate Levick [00:02:08] Yes so E3G is a think tank that focuses on the politics of the climate transition. It’s headquartered in London and has worked in Europe for a long time and at international level. We also have an office in Washington, D.C. It is really focused on how the political decisions are made that will enable the worlds to reach that climate safe transition. Now that plays out in a number of different spaces in the world of diplomacy and in the world of risk and security, in energy transition, for example. That includes the world of finance, and I lead our programme of work around sustainable finance. So we're looking at national and regional policy change and regulations. We're looking at international standards and the political dynamics of those.

Robin Allison Davis [00:02:53] As we hear from Kate, transition finance aims to fix the challenges of sustainable finance. Elia Trippel, OECD analyst, explains what they are. What are some of the challenges of sustainable finance? How does transition finance work to fix them?

Elia Trippel [00:03:09] So there is a worry that existing sustainable finance approaches don't always include all the sectors that they need to include. And they might leave some countries behind, and in particular, emerging markets and developing economies. And that's because sustainable finance often ends up being a bit limited to being this kind of point in time assessment of things that are already sustainable today. So one classic example is renewable energy. Everybody agrees that wind power is good for the climate, and that is something that we can see. Today we assess a project that might be an investment in a wind farm and we can say, okay, well, this is clearly aligned with our Paris objectives. Transition finance, on the other hand, and the way that we define transition finance in the OECD guidance is really about the dynamic process of becoming sustainable rather than a point in time assessment of what is already sustainable. And that allows us to look at all sectors in the economy in quite an encompassing way. So that means we can also bring in companies that are today quite polluting and have high emissions and help them reduce their emissions over time based on a credible company-wide transition plan that can get them to net zero.

Robin Allison Davis [00:04:34] The OECD 2022 Industry Survey on Transition Finance found that there's an emerging risk of greenwashing. Could you explain what greenwashing is just in case people don't know?

Elia Trippel [00:04:45] So the term greenwashing emerged when sustainable finance and environmental, social and governance investing, also called ESG investing became more prominent in financial markets. And the idea is that some may claim that the financial instruments that they offer and the investments that they offer have a positive environmental or social benefit. But in reality, they don't. So it's kind of a marketing ploy in order to sell more financial products and get investors to invest into certain projects. And that's what we then call greenwashing. There are variations of that. And there's also social washing, for example, which is a term to describe the same phenomenon of mislabeling, something as having a positive social contribution, when in reality it doesn't.

Robin Allison Davis [00:05:38] Why is there a risk and how could it be mitigated?

Elia Trippel [00:05:41] So transition finance is very particular because it tries to be very inclusive of different sectors and different geographies which sustainable finance doesn't always manage to do. For a number of different reasons, and unfortunately, this inclusiveness can come at the cost of environmental integrity. So, for example, you might have a company that invests into a fossil fuel infrastructure, which could lead to what we call carbon intensive lock-in. And that is the type of transaction that might typically happen in some existing transition finance transactions. And that is because transition finance tries to provide an avenue for decarbonisation for companies that we consider today to be very polluting. But those decarbonisation investments, depending on how they are done, they can actually be more harmful than they do good. So one example of that may be a company that issues a transition finance instrument like, for example, a bond to improve their greenhouse gas emissions performance. So in theory, that's great. But if the company is quite polluting today, an improvement in emissions performance might just be that they are replacing one polluting asset with another polluting asset that is maybe a bit less polluting than the original asset, but still polluting. So the bottom line is that they are still having very high emissions. It's just that they showed some kind of improvement of, I don't know, 10% or 15%, but the bottom line is still pretty bad.

Elia Trippel [00:07:27] So you could, for example, replace a coal-fired process with a gas-fired process. So using natural gas instead of coal. And that way you save a lot of emissions. But that new gas infrastructure will be online for many decades to come. So you need to have a plan to phase out those emissions, too. And existing transition finance approaches, or the transactions that we see in the market today, don't always have that. And that's where the OECD Guidance comes in and essentially stipulates that you need to have an entity wide plan that can get you to net zero overall and not just have these incremental improvements that you may have when you issue a certain type of financial instrument.

Robin Allison Davis [00:08:14] Many public and market initiatives have recently been set up to help companies develop, assess or disclose their transition plans. The UK government launched a Transition Plan Taskforce. Kate Levick explains the need for this task force and her work with them.

Kate Levick [00:08:30] The UK Government has picked up on the increasing interest in transition finance and particularly the concept of transition planning, which is something that E3G has been working on for a while. So it was a very natural step for us to support the UK with this. The UK has said it is going to become a net-zero financial centre and has also said that it will put forward a sustainability disclosures regime. So it's made of a very comprehensive set of expectations for companies and how they should be reporting on sustainability issues. They said that within that they will expect initially listed companies and financial firms to report on their transition plans. And because there really isn't an awful lot of established best practice in transition plans. It also said that it will create a taskforce essentially to advise on what a good transition plan looks like for these companies.

Robin Allison Davis [00:09:25] And how's the work going. Is there a little bit of pushback?

Kate Levick [00:09:28] We have tremendous support from the companies that we are working with on the taskforce. It's really been very impressive the level of support that we've had. We started work earlier in 2022 and so there's been a tremendous rate of work and we've really been supported in that by the companies that are involved. The steering group, the officially appointed task force members, are mainly corporate CEOs. We also have the Financial Conduct Authority involved. So we've had companies approaching us, wanting to find ways to be involved in the various work streams and working groups. And we're looking forward to working with more companies as we put out our sector-neutral framework to start testing it and doing a bit of road testing.

Robin Allison Davis [00:10:17] The OECD Transition Finance Survey also found that there are a lot of barriers for transition finance, including lack of comparability and transparency and difficulties in measuring sustainability performance, which you just mentioned. Are these findings matching everything that you're seeing?

Kate Levick [00:10:33] I think yes. We recognise that picture as well. I think what I'd say in terms of why we think transition times is so interesting is that when we talk about green finance, we sometimes talk about the economic activities that perhaps shouldn't be financed anymore. It's easy to come up with a list. Well, not easy, but you can see conceptually how you could come up with a list of things that are compliant with net zero and things that are not. Transition finance is financing a process and it's not so easy to come up with a list-based approach. Defining what is valid transition finance for net-zero is highly context-dependent. It depends on the company and even the site that you're talking about. It depends on the national context, it depends on the geography that you're in, and it depends on the time and how long we have to meet the carbon budget. So there are so many factors. You can't do this in a list-based approach and I think the market finds it very difficult because they want to almost go to take checks and go: this is and this isn't. But you really have to go into the detail and decide in a context-based way. So what transition plans do is they give that responsibility to companies to set out that context, make the judgements on what will be the best decisions to make that transition. And then by publishing that plan, they enable a wider set of stakeholders, including their shareholders and perhaps civil society organisations as well as the wider financial data analysis community to all make a judgement. Is this a robust enough transition plan and if it is, it is going to be a good sign that this is a good investment opportunity.

Robin Allison Davis [00:12:13] These barriers to transition finance, like a lack of coordinating guidelines, is what the OECD sets out to fix with their guidance on transition finance. Elia Trippel is the lead author of this guidance.

Elia Trippel [00:12:25] The guidance on Transition Finance tries to address some of these problems, and in particular the problem of greenwashing and comparability by saying that all transition finance transactions, so all of those financial instruments and all the different transactions in the market should always be anchored in the real economy, and they should always be based on credible transition plans by companies. And those transition plans, they need to be aligned with the Paris Agreement and the temperature goal of the Paris Agreement. And to do that, they need to contain company-wide, very robust decarbonisation strategies, and that can then form the basis of financial instruments. And so the guidance sets out ten key elements of credible corporate transition plans. And the idea is to provide direction to market actors and to support policymakers who might want to develop policy frameworks in the area.

Robin Allison Davis [00:13:26] We have the OECD Forum on Green Finance and Investment coming up. Can you tell me a little bit about what we can expect to see and hear?

Elia Trippel [00:13:34] So the Green Finance and Investment Forum is an annual OECD flagship event, and it is now in its ninth year. And we will have the next one on the 5th, 6th and 7th of October of this year. And it will take place virtually. So it means that anybody can register, anybody can listen in. And I think we will have quite a strong focus on transition finance, but also on other topics that are related to sustainable and green finance more broadly. This year, we're planning on having a series of quite high-level plenary sessions and different types of parallel sessions around the broader theme of moving from commitments to actions in what we call the decade for delivery. And we really want to focus on impactful, green and sustainable finance. So the idea is to bring together the most influential global actors, both from the public and the private sector, and to discuss different policies and changes that are required to make sure that sustainable and green finance actually delivers what it promises and actually has an impact in the real economy.

Elia Trippel [00:14:48] We will have a high-level plenary on the way forward for transition finance where we will of course also talk about the OECD guidance. And that session will be followed by another high-level plenary, high-level meaning that it tends to be CEO level participants in the panel, and that second plenary will be on improving market practices to finance a climate transition and strengthen ESG investing. And on that same day, at the end of the day, we will have a session on the responsible retirement of polluting assets and how to finance that. And we are going to ask the question of whether a just transition – a transition that is just for communities and workers and anybody affected – whether that can also be profitable for investors. So we have a ton of information on our forum website, which is in the description of this podcast, I believe. And so anybody who is interested is very welcome to visit the website to see the forum agenda and obviously to register to take part in the forum and to listen in on the sessions.

Robin Allison Davis [00:15:56] What do you see as the next important development in this space? What more is needed?

Elia Trippel [00:16:02] So to achieve the goals of the Paris Agreement and in particular the temperature goal of the Paris Agreement, which is to limit global temperatures to below, well below, sorry, well below two degrees Celsius, aiming for 1.5 degrees Celsius. We need to unfortunately find a solution to ongoing fossil fuel processes. So there are very clear conclusions from the Intergovernmental Panel on Climate Change, the IPCC, that show that we should not be continuing our investments in unabated fossil fuel infrastructure. That will not get us to this temperature goal of the Paris Agreement. And there are quite clear scenarios that they have set out that show that we need to be retiring some of our existing fossil fuel assets and retrofit most of them in order to get to net zero, because 1.5, and also well below two degrees in any event, implies that we need to get to net zero emissions at a certain point in time globally. 1.5, generally, meaning that we need to get there by 2050.

Elia Trippel [00:17:16] I I think that one key question in this space and one that the market and different actors that are active in this space are starting to talk about will be how countries whose economies are very reliant on fossil fuels can ultimately transition. And a part of that is, of course, the question of how to transition the oil and gas sector as a whole, but also how to manage the responsible retirement of assets that today are very emitting. And fortunately, there is really a large amount of what we would call legacy assets that we think will continue to pollute for decades to come. If we don't find a way to retire them early and maybe retrofit some of them to be zero or near-zero emissions, depending on the type of asset. So, for example, we know that in Asia, existing coal-fired power plants on average are only 13 years old. And those assets can operate for 40 or 50 years, which, you know, gets us, of course, much beyond 2050. So we need to find a solution for those assets and a solution that, of course, is responsible and is just, and takes into account also the impact on local communities and on workers and helps them helps to retrain and reskill them, for example. So that is a big frontier at the moment in transition finance, I would say.

Robin Allison Davis [00:18:49] Kate, what do you see for the future, for transition finance?

Kate Levick [00:18:52] Well, I think transition plans clearly are a growing international norm. So I do expect to see them passing through into national regulation in numerous countries in the next few years, whether it's in a direct way as the UK is currently trying to do, or whether it's through then passing into international standards like TCFD and ISSB and then being picked up by countries through that route, for example, when they adopt the ISSB framework. I think that also the market will mature in terms of other instruments to invest in transition. I think there'll be more of an understanding, for example, that when you're looking at sustainability bonds, that's a credible approach to transition within that as part of sustainability.

Robin Allison Davis [00:19:43] What are some of the misconceptions or things that people need to know about transition finance?

Kate Levick [00:19:48] It's extremely important to remember that transition finance is not only about decarbonisation and about reaching those net zero emissions targets in the sense of adjusting high-emitting activities and finding ways to stop doing them. Transition finance is absolutely about identifying and scaling up the net zero opportunities and new industries and new solutions because of the way the net zero targets take on lines in terms of decreases over time. It's very easy for them not to be centered, but actually transition plans and transition finance is all about scaling up and getting to that point. What actually will finance is my maintenance.

Robin Allison Davis [00:20:32] Thank you so much for joining me.

Kate Levick [00:20:34] Thank you.

Elia Trippel [00:20:34] Thanks so much for having me.

Robin Allison Davis [00:20:36] Thank you for listening to OECD Podcasts. To learn more about the OECD's work on Transition Finance and read the OECD guidance on transition finance, go to OECD.org/cgfi. You can also register to virtually attend the OECD Forum on Green Finance and Investment, taking place October 5th through 7th.

Outro [00:20:59] To listen to other OECD Podcasts, find us on iTunes, Spotify, Google Podcasts and SoundCloud.com/OECD.