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Financing the transition is not only about investing in green

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Why do we need the “Transition” and what is it?

Several scientific organisations have flagged that our collective economic behaviour is putting the planet, the society and the global economy at risk (The nine planetary boundaries - Stockholm Resilience Centre). Economic expansion over the last century has brought humanity to the current situation where our actions have a bigger impact on the environment and society than what our planet can bear. In the long term, if we don’t change our behaviour, the shortage of raw materials, reduction in biodiversity, changing climate conditions, social unrest and inequality will further negatively impact our society, the environment and economic growth.

The world is at a tipping point, consequently we need a multi-dimensional transition into the Safe and Just Operating Space for humanity (Cardano Sustainability Policy). The Just Transition to a sustainable world is about developing pathways that reduce negative impact and are supported by innovation and new products and services. Pathways that take into account and minimize potential negative impact of the transition (Why a just transition is crucial for effective climate action | Thought leadership | PRI) itself. The frameworks of the Planetary Boundaries and Sustainable Development Goals hints to the fact that further and larger scale transition is needed. It is not only about climate, but also about biodiversity, land use, waste, social and human capital.

Consulting regulators

At the end of 2022, the European Securities and Markets Authority (ESMA) published a consultation paper on guidelines for naming funds using ESG or sustainability-related terms. As we, Hilde Veelaert and Niina Arkko, are both part of a CFA EMEA working group on ESG investing sharing information to the CFA Advocacy and Regulatory Outreach teams, we looked in depth into the consultation and discussed potential consequences and impacts of the proposal. While reflecting on what is needed to transition to a sustainable world and comparing this with the proposed guidelines in the consultation, it became apparent that crucially the guidelines on "transition" are not getting enough attention.

This gap between what we believe needs financing to evolve to a sustainable world, and what EU regulation and the recent ESMA consultation focusses on, concerns us. Financing only green or sustainable companies alone will not lead us to a sustainable economy. Why is that? Being classified as sustainable or impact is an important driver for capital inflows[1] for a fund or strategy. In our opinion, transition being absent from the final guidance and regulation could jeopardize inflows in transition funds and strategies and would hold back the much-needed financing for these transition companies. The risk of transition washing comes on top of the risk of lack of financing. Transition funds and strategies could also be vulnerable for transition washing if guidance is lacking. Investors need clarity and mutual understanding on what is qualified as a credible transition plan for a company, a transition company[2] and when an investment strategy can be considered as a transition strategy.

Financing the transition

The transition to a sustainable world needs in our view financing for two kinds of companies to maximise real world impact: companies that offer products or services that contribute to solutions, such as renewable energy, healthcare or education, and then what we call transition companies. These are companies that are not sustainable today but that can deliver a material impact to achieving the Safe and Just zone by changing the way they operate. On both sides, trillions of dollars of investment are required to finance the impact companies as well as the transition companies in order to reach a more sustainable economy.

In addition to financing, investors can also take direct action and support companies in transition via stewardship. Via engagement investors can support companies to have better understanding of best practices and making better and more credible transition plans. Engagement can also mean investors being more demanding and requiring certain action such as a decarbonization strategy, to be eligible as an investment.

So why is the ESMA consultation not proposing guidelines for transition funds? Maybe an explanation is that it is not so easy to assess or define a transition company. It cannot be done without a qualitative assessment on top of screening available data. Assessing a transition company is not only about assessing pledges and targets but also about assessing transition plans and evaluating execution of the plans. Investors need confidence that the net zero pledges made by the assets they hold are credible and subject to a well thought transition plan. Currently this is not always the case. For example, CA100+ Initiative's Benchmark Assessment suggests some companies' real-world activities do not yet demonstrate any meaningful shifts in business models to align with the Paris Agreement. Similarly, a study published in Nature Communications shows that out of ten high emission electric utility companies and ten cement companies, only one was currently Paris-compliant.

1 See appendix box 1 for information on capital inflows
2 See appendix box 2 for definition of improver and impact companies

Credible transition frameworks needed

There are some initiatives to support investors in assessing company transition plans such as the Science Based targets (Ambitious corporate climate action - Science Based Targets) initiative. However, this framework is mainly based on target setting and not the action plans companies are taking. To help investors investing in transition companies, we need more guidelines on assessing the necessary practical steps needed for transition.

The good news, however, is there are some examples of developing transition frameworks available already[3]: IIGCC Investor Expectations of Corporate Transition Plans: From A to Zero framework recognises the need for adequate data to assess transition risks and track progress consistently. It defines the key components of a credible transition plan consistent with net zero targets. The sector neutral framework is designed to cover both high and low impact companies. It provides guidance both to companies preparing transition plans, and to investors attempting to assess the disclosure. Both corporate and investor frameworks need to be aligned to streamline information flow and optimise capital allocation.

The five key components of a credible corporate transition plan are:

1. Comprehensive, aligned emissions targets.
2. A credible strategy to deliver those targets.
3. Demonstrable engagement to accelerate the transition.
4. The contribution to “climate solutions”.
5. Supporting emissions and accounting disclosure.

Portfolio perspective

The current focus of many investors on sustainable and impact companies comes as well with different styles and sector exposures versus the broader market. Companies classified as sustainable often carry certain characteristics such as growth, quality, non-listed or small cap, and only have exposure to a few sectors. ESG benchmarks, such as the EU Paris Aligned Benchmark and the EU Climate Transition Benchmark, have big sector and style exposures versus generic benchmarks. In 2022, it was a difficult year for sustainable strategies and benchmarks. The strong performance of not so sustainable energy, defence and mining Industries in combination with the negative effect of rising interest rates on growth and quality, drove weak performance.

Many asset owners on the other hand, carry low risk investment mandates and therefore, prefer a broader investable universe exposed to various asset classes and different investee characteristics, such as stable value companies, which tend to describe many of the current transition companies. Would it not be better from a portfolio perspective to diversify with sustainable and transition companies? With this approach, you can create a more balanced portfolio covering all sectors and styles while having more real-world impact through financing the companies that offer solutions and engaging the companies that need to improve (Ilmarinen using climate index as benchmark and Scientific Beta: Fossil fuel divestment and the energy transition | Financial Investigator).

3 See appendix box 3: Other transition framework examples

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More work is needed to help investors assessing transition and to help regulators incorporating transition in regulation.

Conclusion

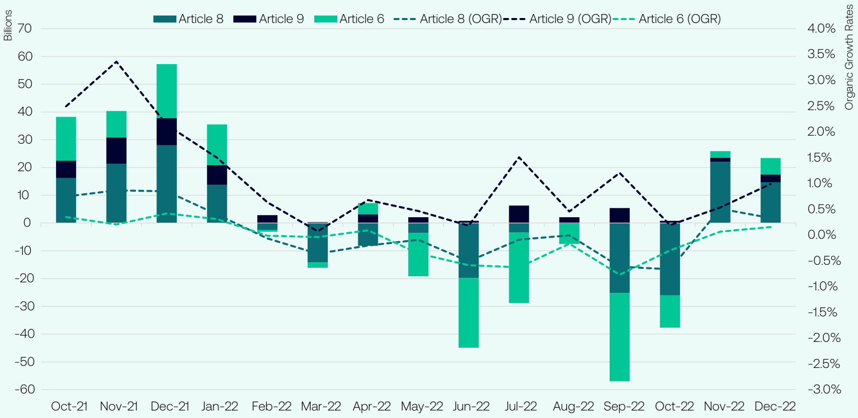
However, is this not a chicken and egg story? Experience from the last few years has shown that companies and strategies get the most attention and financing if they are already seen as sustainable. Industry organisations and regulators are focusing on defining sustainable and impact companies. Could it not be the case that if regulation incorporated Transition as a flavour of sustainability that there would be more attention on transition companies? And with that more effort would be put into developing frameworks and guidance on how to assess transition plans. Financing transition companies will have a major impact on the speed in which we collectively move to a more sustainable world.

Appendix

Box 1: Capital inflows

Morningstar has investigated the flow data and has found that the organic growth rates of Article 9 funds have been consistently positive over the last 15 months while those for Article 8 and Article 6 funds have been much lower or even negative over the most part of the year.

Exhibit 2 Monthly Flows Into Article 8 and Article 9 Funds Versus Article 6 Funds (EUR Billion) and Organic Growth Rates (%)



Source: Morningstar Direct. Data as of Dec. 31, 2022. Based on SFDR data collected from prospectuses on 98.2% of funds available for sale in the EU, excluding money market funds, funds of funds, and feeder funds.

Box 3: Other examples of transition frameworks:

- EU platform of sustainable finance report 2022, Platform on Sustainable Finance's report on environmental transition taxonomy (europa.eu)
- In UK, TPT sector neutral transition framework TPT-Disclosure-Framework.pdf (transitiontaskforce.net)
- Home - Transition Pathway Initiative possible to monitor aligning companies
- **CA 100+** company benchmark Net Zero Company Benchmark | Climate Action 100+
- **CIFF** eight essential components
- **ACT** assessment frameworks for over 10 emissions intensive sectors and a sector neutral framework
- **CDP** eight elements of a credible transition plan
- **GFANZ** five themes framework

Box 2: Definitions

The FCA has proposed in its consultation on Sustainability Disclosure Requirements and investment labels a definition for improver or transition companies as well as for impact companies:

Improver company =
a company that, while not currently environmentally or socially sustainable has the potential to become more environmentally and/or socially sustainable over time, including in response to stewardship influence.

Impact company =
a company that provides solutions to environmental or social problems, often in underserved markets or to address observed market failures.

CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels | FCA

Plan Taskforce launched in April 2022 Transition Plan Taskforce | Setting a robust standard