UK Finance

Transition Finance Market Review

UK Finance Response to the Call for Evidence

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UK Finance is the collective voice for the financial services industry. Representing around 300 firms, we act to enhance competitiveness, support customers, and facilitate innovation.

The Transition to Net Zero is one of our five priority workstreams, and we have a mandate to advocate for clear decarbonisation policies to support the achievement of financial services firms' sustainability goals. Since 2023, we have partnered with the Rocky Mountain Institute to convene monthly workshops with seven major banks on the mobilisation of transition finance, and supported a global call to action on transition finance alongside prominent NGOs. Our response to the Transition Finance Market Review (TFMR) call for evidence draws on this work, as well as engagement across our membership.

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Key recommendations

UK Finance supports the Transition Finance Market Review (TFMR) objective to make the UK a global hub for transition finance. The UK's combination of financial services expertise and climate leadership sets it up well for this outcome. Several other conditions will be important:

- **Agreeing a principles-based framework to maximise credibility:** Transition finance needs to avoid locking in long-term carbon emissions, and must be directed toward measurable emissions reductions. Without appropriate guardrails, its credibility will be reduced and it will be more difficult for financial services companies to deploy. The TFMR can help to shore up credibility by articulating the high-level principles that transition finance needs to adhere to. This should be informed by existing best practice.
- **TFMR should focus on hard-to-abate sectors:** Transition finance can include all sectors of the economy to the extent that they are part of a credible net zero transition. However, the TFMR should prioritise the flow of finance to high-emitting or hard-to-

abate sectors, since these sectors account for a large and challenging proportion of global greenhouse gas emissions.

- **Transition plans are important but not necessary for all relevant transactions:** Transition plans can play a significant role in the provision of transition finance but they cannot be used as the sole criterion/tool to direct transition finance, for example where transition planning norms are less well developed or in project financing circumstances where finance for decarbonisation is still urgently needed.
- **Collaboration between regulators and industry:** While regulators are rightfully deploying frameworks to mitigate risks of greenwashing and protect consumers, some communications from regulators have created additional uncertainty and risk leading to a contraction in the legitimate market for sustainability products. Regulators should work closely with industry to build a clear narrative for acceptable models of transition finance.
- **Recommendations for policymakers:** As UK Finance has set out previously, the efficient reallocation of capital toward low-carbon requires clear, consistent policy plans on a sector-by-sector basis. These should set out specific policy, spending and regulatory interventions to incentivise private investment and lending. TFMR should reiterate to government the policy measures needed to encourage financial flows towards the transitition to a greener economy. The TFMR should be clear on the role of the financial services sector as the providers of capital, within a clear policy framework set by government.

Chapter 2 – Scope of Transition Finance

Q1) Do you consider there to be a lack of clarity around the scope of transition finance? Why / Why not?

The wide variety of definitions of transition finance (e.g. those set out by the International Capital Markets Association, Organisation for Economic Cooperation and Development, Glasgow Financial Alliance for Net Zero etc.) demonstrate a lack of common understanding of its scope, albeit with some common threads such as a recognition of transition as an over-time process rather than static outcome.

There is a need for guiding principles and guardrails to drive credibility and integrity. From a financial services perspective, an absence of clear guardrails risks hampering deployment of transition finance as it generates greenwashing and other reputational, regulatory and liability risks.

The TFMR should provide a high-level, principles-based framework on what it considers to be included in the scope of transition finance, to increase transparency and clarity. Better

defining the scope of transition finance would also ultimately deliver benefits to customers, such as better access to finance, more competitive financing,etc. However, UK Finance supports the TFMR's view that it should not seek to propose a fixed definition or approach to transition finance. A fixed definition, with insufficient flexibility to adapt to changing contexts, technologies or scientific evidence, could be counterproductive and harm the deployment of adequate transition finance at this point. At the same time, transition finance shall also be science-based, and refer to net zero pathways. We set out further detail on this approach in response to chapter 3.

Definitions and scoping should focus on practicality and the TFMR should carefully consider the audience that will use them, including risk management functions, or corporate clients or the general public, and ensure any criteria are easy to use, to ultimately encourage capital deployment and mitigate greenwashing risks.

Q2) Have you faced challenges in accessing or deploying transition finance because of a lack of clarity around its scope?

Lack of clarity around the scope of transition finance is one of several barriers to its deployment, alongside other more significant issues such as lack of real economy policy drivers, shortage of credible projects and capability gaps (see question 20).

Many firms have reported challenges in deploying transition finance because of a lack of clarity around scope, including articulating how it differs from other categories of financing that firms are deploying to support the transition to Net Zero, formally or informally identified as such. This lack of clarity generates reputational, regulatory and liability risks, which hamper appetite to lend to or invest in high-emitting sectors and at the same time to label those activities "transition" related.

The lack of clear definitions also means that the boundaries across different types of sustainability-related financing can blur. Types of financing that could fall under the scope of transition finance according to the TFMR's review (see p.10) may, at times:

- also fall into the category of green or sustainable finance for similar purposes (i.e. "supporting an organisation to credibly decarbonise its activities, respond to any climate-related risks and opportunities, and to contribute to a global and economy-wide net zero transition"); or
- fall under more general pools of financing, without any related sustainability label.

Firms take different approaches to this for a variety of reasons, as set out in response to question 6.

Recent attempts to develop clearer definitions of transition finance have not been universally successful at putting in place appropriate guardrails and minimising greenwashing risks, or at attracting investor demand and industry consensus. For example, ICMA's Climate Transition Finance Handbook aimed to provide additional guidance for issuers seeking to utilise ESG-labelled bonds in support of their climate transition strategy.

In practice, however, products using the framework had limited uptake by issuers, because of the lack of asset owner/investment manager demand for 'transition' labelled securities, and the inability of some firms to 'prove' their alignment with the goals of the Paris Agreement.

Definitions need to balance providing clarity and certainty to all actors, while allowing for flexibility and changes in approach over time, so that finance can respond to changing industrial circumstances, the latest science, and the best innovations in deploying capital at scale. For the purposes of defining transition finance, it is particularly difficult to accommodate future and nascent technologies. Definitions should also be flexible enough to adapt to the different needs, capabilities and capacity between large corporates and smaller corporates/SMEs that financial institutions provide financing to.

Q3) Do you agree with the approach that transition finance includes all sectors of the economy to the extent that it is part of a credible net zero transition? Why / Why not? If not, please specify which should be excluded and why.

We agree that transition finance should include all sectors of the economy to the extent that they are part of a credible net zero transition backed by science-based net zero pathways. We agree that high-emitting and hard-to-abate sectors should be the primary focus of transition finance, given their need for capital to decarbonise, provided that this is done in a material and credible way, and avoiding carbon lock-in.

The following sectors merit specific attention:

Hard-to-abate sectors: While all sectors should be included, the TFMR should consider how its recommendations could prioritise the flow of finance to high-emitting or hard-to-abate sectors, including by looking at where the deployment of transition finance could be most effective at emission reductions, or where technological solutions are available. Hard-to-abate sectors account for a large proportion of global greenhouse gas emissions — the World Economic Forum estimates 40% for a collection of 8 key industries[1] — which could grow substantially in a business-as-usual scenario.[2] It is critical that finance to these sectors is facilitated if global temperature rises are to be minimised.

Built environment: For many UK Finance members, exposures to the built environment through mortgage lending makes up the largest share of their financed emissions. The review should look at examples in the built environment, whether commercial or residential, and how and whether transition finance can be deployed in this sector – noting that some transition finance frameworks have explicitly chosen not to include buildings. The housing

[1] WEF 2023
[2] Citi 2021

sector faces specific sets of challenges (e.g. lack of policy clarity causing demand and supply issues; unclear EPC standards, etc.) but wide scope for decarbonisation.[3]

Small-to-medium-sized enterprises (SMEs): SMEs make up a substantial portion of UK and global emissions, but face specific information, capability and financial challenges to decarbonise. We provide further feedback in response to question 27.

Q4) Do you agree that the primary focus of transition finance should be on a credible net zero transition in hard to abate and high emitting areas of the economy? Why / Why not?

In line with the response to question 3, we agree that addressing and providing financing for the transition of hard-to-abate and high-emitting sectors and activities should be the focus of transition finance.

Transition finance, by definition, should seek to bring a material improvement in reducing carbon emissions to areas of the economy that wouldn't be sustainable or green immediately. An orderly and just transition requires financial services firms to prioritise meaningful decarbonisation in the economy through support to their clients — avoiding paper decarbonisation by simply divesting from or terminating lending to sectors that most need to transition. In many cases, this will necessitate long-term engagement with hard-to-abate sectors.

In many cases, finance for hard-to-abate and other sectors will intertwine. For example, a loan to a low-carbon steel manufacturer might be considered a pure-green activity in itself, but could make a significant contribution to the wider transition of a hard-to-abate sector. This makes it challenging to set out strict boundaries for the definition of transition finance. Some firms have set restrictions on lending to sectors they do not consider compatible with Paris Agreement decarbonisation scenarios or 2050 1.5˚C International Energy Agency (IEA) pathways, or where they have judged that lending to those sectors could risk locking in long-term carbon emissions — though these vary.

Q5) Do you agree with the approach that transition finance includes all types of economic activity that are compatible with a credible net zero transition? Why?/Why not? If not, please specify which should be excluded and why.

The definition of transition finance should encompass all types of economic activity compatible with a credible net zero transition, provided this genuinely supports the transition

[3] Our report **'Net Zero Homes: Time for a Reset'** provides an analysis of those challenges and recommendations for policymakers and banks.

and minimises the risk of carbon lock-in. Further detail is included in responses to question 3 (sectors of the economy), question 6 (green finance vs transition finance) and questions 7-8 (types of financial products).

Q6) Do you agree with the approach to not demarcate between 'transition finance' economic activities and 'green finance' economic activities? Why?/Why not?

Firms take differing approaches to the distinction between transition and green economic activities, with some lenders and investors making a formal distinction in their products and others grouping them together.

In some cases, market participants argue that the market already differentiates between transition and green activities, and that there is value in preserving the distinction between activities already aligned with net zero commitments and those that are interim but nonetheless important to the transition. From this perspective, distinguishing between the two types of activities helps understanding of the specific goals and impacts of financing activities, and avoids confusion. Better guidance around what is transition finance (but not green finance) can help investment and debt flow to sectors facing large requirements to decarbonise. It also encourages companies in hard-to-abate sectors to propose credible transition plans.

However, in some cases, finance for "green" and "transition" activities will intertwine. For example, a general-purpose loan to a power utility with both fossil- and non-fossil fuel assets may aim to support "transition" activities, but be used primarily to increase renewable energy deployment – a more typically "green" activity. Similarly, an investment in a start-up specialising in sustainable aviation fuel (SAF) development might be classed as "green" but ultimately support the "transition" of the wider sector.

As the TFMR notes, we agree that a clear distinction between "green" and "transition finance" activities in practice may be challenging, and bear unintended consequences. We encourage the TFMR to consider providing further principles, guidance and examples of what activities could be covered by transition finance as opposed to green finance. Although there are activities or projects where the two will be intertwined, there will be sets of clear principles and examples that could help firms and other actors build a frame of reference, and adjust their own strategies. We refer above to the idea of improvement, or progress, towards decarbonisation which would be a clear area of reflection to develop and test in the context of the review.

Existing regulatory and reporting obligations, such as Sustainability Disclosure Requirements set by the FCA, should be considered when demarcating between "green" and "transition" finance. This will help investors understand how their existing activities relate to definitions and ensure confidence.

Q7) Do you agree that transition finance includes all types of financial products and services that support a credible net zero transition? Why?/ Why not? If not, please specify which should be excluded and why.

Q8) Please describe any concerns you have with the application of transition finance through certain types of financial products or services?

We agree that transition finance includes all types of financial products and services that support a credible net zero transition. Any way in which companies finance themselves should be in scope.

We support the inclusion of general-purpose financing if it is compatible with a credible net zero transition, ideally demonstrated in a robust transition plan (with certain exceptions – see response to question 10). This will help ensure the potential size and impact of transition finance is not stymied and its impact is maximised. Restricting the scope of transition finance only to project-based finance would limit the speed of decarbonisation in the real economy. Where general-purpose financing is used, credible transition plans will be an important tool to measure and assess progress.

For certain funds and portfolio investment products, products labeled as “green” or “transition”-aligned may need to include other financial assets such as derivatives or interest rate swaps as part of the diversified portfolio. These may provide no material reduction in carbon emissions but fufill important risk management functions for firms.

Q9) Do you agree with the approach that non-emissions-based and non climate-based considerations are included in the scope of transition finance? Why?/ Why not?

We agree with the approach that non-emissions-based and non-climate-based considerations should be included in the scope of the review, and we agree that the review should seek to understand how other factors, including nature and biodiversity, adaptation, etc. can be integrated into the approach to transition finance.

We would welcome further information on the Review’s references to ‘adaptation’ and how it connects or can be integrated into transition finance, as many sectors face challenges to address both mitigation and adaptation.

Chapter 3 – Ensuring the Credibility and Integrity of Transition Finance

Q10) Do you agree there is a significant role for good quality transition plans aligned with the TPT Disclosure Framework in the provision of transition finance? Why/ Why not? If yes, please describe this role?
We agree that transition plans can play a significant role in the provision of transition finance, with many financial services firms acting as both users of other companies' transition plans and producers of their own plans as a strategic tool to direct their transition. Transition plans can provide decision-useful information to lenders and investors, and be important enablers of transition finance by providing a baseline for assessing corporate transition progress over time. Governance, guidance and verification of what a "good" transition plan is will be key to maximising their value. However, transition plans cannot be used as the sole criterion/tool to direct transition finance, particularly in the following instances: • Many companies and activities will need transition finance to decarbonise, even where transition plans are not yet in place, or would not be proportionate. This could apply, for example, to directing finance to SMEs, or to companies or activities in geographies where transition plan requirements are not yet well established. Failing to provide finance in all cases where transition plans are not present could deprive some sectors of much-needed capital to decarbonise. • Transition plans are not a necessary monitoring tool for project-based transition finance, where assessing the decarbonisation trajectory of the project does not rely on the wider behaviour of the companies involved. Furthermore, even in the absence of formal transition plans, ratings agencies and assurance firms can plug the gap by helping lenders to assess a borrower's emissions and potential future decarbonisation trajectory. UK Finance welcomed the Transition Plan Taskforce (TPT) Disclosure Framework[4] and the work of the TPT more generally in developing a gold standard for transition plans. We note however that this remains an example of best practice and, although work in the UK is progressing to onboard TPT recommendations as guidance for firms' future disclosure obligations, the TPT specifically is neither adopted within UK regulatory expectations nor a global baseline. Transition planning practice is still nascent in a number of jurisdictions and sectors of the economy.

[4] See for instance our most recent response to the TPT's rounds of engagement on sector-specific guidance: 'UK Finance Response to the Transition Plan Taskforce banking sector guidance', December 2023

Q11) Which core transition principles, such as transition plan disclosures, science-based targets, and capital allocation plans, and other key metrics and tools for assessing the credibility and integrity of transition finance do you consider essential for its success? Please describe these in detail.
A clear articulation of how transition finance is used to achieve carbon reductions through adequate methodologies and metrics is essential for the successful deployment of transition finance. This should also look to ensure the avoidance of carbon lock-in. Intermediary short-term and medium-term emission reduction targets are also important parameters for assessing the quality of transition finance. As set out in response to question 10, transition plans should not be a necessary criterion to assess the credibility and integrity of transitions finance. Transition plans play a very different strategic function to the metrics and targets that will be relevant to financing an individual transaction. Nevertheless, some elements of the TPT disclosure framework will be helpful. These could include requirements to set out strategic ambition, assumptions and external factors, implementation strategy and metrics and targets. There is a connected risk in assessing the credibility and integrity of a counterparty, e.g. corporate clients, which could preclude many market players from accessing transition finance. While proper guardrails need to be in place, including by using tools such as transition plans, there is a risk of excluding a large portion of the economy that specifically needs access to transition finance.

Q13) Do you consider current guidance for transition finance to have credibility and demonstrate integrity from an economic, environmental and a broader sustainability perspective? Why / Why not?
We believe the existing guidance for transition finance suffers from a disparity of definitions which reduce their credibility and integrity. Many financial services firms have existing operational frameworks to provide transition finance; and while consensus on the importance of transition finance is growing, and taxonomies and principles have been put forth, common definitions are lacking. Clear definitions and guardrails would help boost the credibility and integrity of current guidance and help unlock the capital needed to finance the net zero transition. The TFMR should consider the efforts of the Glasgow Financial Alliance for Net Zero (GFANZ) as leading frameworks/definitions[5].

[5] GFANZ 2023

The lack of credibility and integrity of existing guidance can lead to firms being exposed to reputational risk, as the guardrails around transition finance are not clear. As the TFMR notes, transition finance needs to include high-emitting sectors, but without assurance provided by credible guidance, firms are exposed to accusations of greenwashing and litigation, which restrict investor confidence.

Cross-industry agreement over a principles-based definition for transition finance, backed up by government, would boost the credibility and integrity of existing guidance and enable financial services firms to support the decarbonisation of high-emitting entities and hard-to-abate sectors where credible pathways exist.

The lack of credibility and integrity is creating uncertainty, restricting transition finance and limiting investment opportunities that are critical to delivering on a just transition to a net zero economy.

Q14) Do you consider there to be a role for regional or national pathways to be incorporated in transition finance standards, frameworks or guidance? Why / Why not? Please describe any international examples.

Government and regional transition pathways are critical to building credibility and investor confidence in transition financing plans. Where government pathways are credible, we agree they can be used to set transition finance trajectories and act as a baseline against which the performance of transition finance can be assessed.

As an example of this, the financial services sector has welcomed the Japanese government's transition finance framework which links private financing plans to sectoral decarbonisation roadmaps for hard-to-abate sectors, set out by the Ministry for Economy, Trade and Industry (METI) and related departments.[6]

A challenge for the TFMR will be in articulating how the credibility of transition finance can be assessed against policy trajectories outside the UK, particularly in circumstances where reliable policies for decarbonisation are not yet in place. Internationally applicable sectoral decarbonisation pathways, such as those produced by the Transition Pathway Initiative, may offer an objective, scientifically informed baseline.[7] Countries' Nationally Determined Contributions (NDCs) under the UN climate process often lack sufficient detail, and are insufficiently ambitious against a Paris-aligned scenario, to act as appropriate financing benchmarks.

[6] Japan Ministry of Finance 2023
[7] Transition Pathway Initiative 2022

Q15) Do you consider there to be a role for taxonomies in the provision of transition finance? Why / Why not? If yes, please describe this role and consider any interaction with the role of transition plans?

"Taxonomy" refers to a range of different mechanisms for categorising or systematizing sectors or financing opportunities. UK Finance members have differing views on the value of a taxonomy for mobilising finance into low-carbon solutions. We ran a series of interviews with members in late 2023 to deepen our understanding of these views, with the following key messages emerging:

- **Green vs non-green taxonomies are not well suited to enabling transition finance:** As a binary tool, taxonomies on the EU model have struggled to account for transition finance – indeed, there is limited-to-no empirical evidence that the EU taxonomy has helped to redirect capital toward transition activities at scale.
- **Taxonomies may help improve policy clarity:** Taxonomies can have value as a tool to clarify what sectors and activities governments consider to be aligned with their policy objectives. However, this can also be served by other means, e.g. clear sectoral roadmaps.
- **Transition taxonomies aligned with sectoral pathways have greater value:** Transition taxonomies currently under development, for example in Australia (ASFI), may offer greater value in improving the credibility of transition finance. The emerging Australian model identifies sectoral pathways, and sets out how investors should link their financing with the pathways. The wide difference between the Australian and EU taxonomy examples demonstrates the need for further consideration and examination of existing taxonomies.
- **Value of data generated:** Some taxonomies, for example in the EU, are used as a basis for company reporting requirements. Firms have differing views on the value of the data generated by taxonomy-aligned reporting, when considering their roles both as a user of other companies' reported data and as a reporter. Many firms felt that the data generated would be less valuable than transition plan reporting or external assessments of corporate decarbonisation progress, for example from ratings agencies.
- **Design considerations:** Taxonomies need to be science-based, and aim to maximise international alignment, while accounting for regional and policy contexts. Language also needs to balance flexibility and adaptability to account for constantly evolving contexts, while remaining ambitious and avoiding moving the goalpost.

It is important that policy makers monitor the progress and approach of other jurisdictions as they consider developing taxonomies. Some international alignment will be necessary to avoid certain jurisdictions becoming havens for 'transition washing'.

Q16) What are the specific challenges in ensuring both the credibility and integrity of transition finance, whilst addressing the contextual needs of local decarbonisation pathways? What can the UK market for financial and professional services do to address these challenges?

This response focuses on the question of ensuring integrity and credibility for transition finance generally, while the response to question 17 focuses on challenges related to local decarbonisation and different jurisdictions.

There are several challenges with ensuring the credibility and integrity of transition finance. By its nature, providing finance to high-emitting industries, even where this finance is provided to help decarbonise, is controversial and appears to cut against the overall intended trajectory of the financed economy. These include:

- Absence of appropriate benchmarks and metrics against which to measure and demonstrate progress – this includes jurisdictional decarbonisation targets, as discussed in response to questions 14 and 17.
- Absence of narrative around what constitutes appropriate transition finance: Given the controversional nature of transition finance, there will inevitably be critical voices that seek to undermine companies engaging in this practice. Clear principles that help companies articulate the value of transition finance will help them navigate reputational risks. While there is a high degree of consensus on what constitutes "green" (e.g. aligning with frameworks like the EU taxonomy), defining transition activities remains a contentious issue. There are parallels here with the voluntary carbon markets, which have been repeatedly undermined by reputational issues, despite many examples delivering significant sums of capital to high-integrity carbon reduction projects.
- Regulatory challenges: The lack of a universal standard stems partly from the perceived restrictiveness of the regulatory environment. Financial institutions' efforts to deploy transition finance are often inhibited by the complexity of regulations, e.g. a recent focus on greenwashing, which while welcome in principle generates intensified risk of reputational damage and legal repercussions. This is partly why the market has not yet coalesced around a "transition framework", despite the considerable effort that has gone into this endeavour.

Policymakers have a pivotal role to play in fostering a conducive atmosphere for transition finance. Recognising the inherent ambiguities in transition finance – acknowledging that there are various pathways to net zero – is crucial. A rigid regulatory framework can stifle innovation and progress. Instead, a more nuanced, flexible approach that adapts to the multifaceted nature of transition activities is needed. Such a framework should not only accommodate, but also encourage, diverse methods of transitioning towards sustainability.

Regulators can further bolster this effort by endorsing market initiatives to develop transition frameworks. Public support from regulatory bodies can lend credibility and momentum to these market-led endeavours: a balanced, regulatory framework, one that is both supportive

and adaptable, can further the adoption of transition finance. This approach would mitigate risks, reduce complexity, and ultimately, facilitate the provision of transition finance.

Q17) Do you think there is a need for different approaches to transition finance across different jurisdictions, considering they may have different transition pathways?

There are several challenges with ensuring the credibility and integrity of transition finance when considering regional contexts and across different jurisdictions. Financing decisions will have to vary in different regions as the starting points and pace of the transition differ. The reputational risks to firms, the risk of litigation, and the political appetite for transition finance also all vary in different regions. For instance, India is committed to net zero by 2070, whilst the UK is committed to net zero by 2050; meanwhile, in the US, state-based legislators are mounting active challenges against firms that seek to support the decarbonisation of the economy, which poses vast litigation risks for firms operating in the US.

Differing national decarbonisation trajectories can cause imbalances with financial services commitments which are often set with a point-in-time net zero commitment that is different to jurisdictional commitments. In these cases, firms must carefully map and engage with their clients within those jurisdicitons to support their decarbonisation. Transition plans and cross-sector collaboration have a role to play in addressing these challenges. In some contexts, borrowers developing credible transition plans will be important to ensuring the credibility of transition finance. These will allow financial services firms to provide tailored products and services to support the transition globally. In others, for reasons covered in response to question 10, transition plans will need to play a less prominent part, but more project-based or other approaches must be used.

As mentioned in response to question 14, a challenge for the TFMR will be articulating how credibility of transition finance can be assessed against policy trajectories outside the UK, particularly where reliable policies for decarbonisation are not in place. Internationally applicable sectoral decarbonisation pathways, such as those produced by the Transition Pathway Initiative, may offer an objective baseline. Countries' Nationally Determined Contributions (NDCs) under the UN climate process often lack detail, and are insufficiently ambitious against a Paris-aligned scenario, to act as appropriate financing benchmarks.

Within the UK, the government can support firms by providing improved sector-by-sector roadmaps which set out specific policy, spending and regulatory interventions to incentivise private investment and lending. The government should also continue to work through the UN and other bodies to encourage development of investible NDCs worldwide.

Financial services firms can also work with policymakers, other sectors and NGOs to share best practice between regions to boost the credibility of transition finance.

Q18) What principles, considerations and common approaches are needed to ensure both flexibility and environmental credibility and integrity across diverse jurisdictions and sectors with varying transition pathways, ensuring global coherence and effectiveness?

The TFMR should aim to develop common principles and approaches to transition finance that could be shared and applicable globally, including in financial services companies' activities in different jurisdictions.

The TFMR sould consider how to avoid further proliferation of local standards, by using the UK's position in international fora, and engaging with existing global standards and bodies. There is also an opportunity to draw on the UK's academic leadership in climate science.

Some major jurisdictions like China and India have emissions reduction targets that reach net zero later than the UK's, and some jurisdictions have no credible emissions reduction targets at all. This creates challenges for financial services providers who have exposures in those jurisdictions, want to meaningfully support decarbonisation there, and have UK-aligned decarbonisation trajectories. The TFMR should explore ways to manage this tension. This could mean, for example:

- Identifying principles-based performance indicators for transition finance, even in jurisdictions where decarbonisation trajectories are slower. For example, where reference to jurisdictional targets puts credibility into question, the acceptable bounds for transition finance could draw on the latest widely accepted scientific evidence for a transition aligned with the Paris Agreement's goals, and avoid any carbon lock-in that is incompatible with that outcome (see response to question 20).
- For project-based transition finance, offering guidance or case studies on what acceptable financing might look like in jurisdictions that do not have UK-aligned net zero targets, which could be designed in collaboration with industry.
- For general-purpose corporate finance, setting out principles for companies to engage credibly with counterparties in emerging markets that do not yet have 2050 net zero-aligned transition plans.
- Industry solutions are available to measure transition finance activities when calculating financed emissions (such as Partnership for Carbon Accounting Financials, PCAF). The TFMR should look to provide support to those industry-led solutions.

The TFMR should also consider how to manage reporting of transition finance so that it is comparable and takes into consideration non-financial as well as financial outcomes.

We would welcome a clear recognition from the TFMR that financed emissions may increase – or decrease slower than expected – in the short term, as transition finance is provided to hard to abate sectors.

Q19) Are there any unintended consequences of scaling up transition finance in the UK or internationally that you are concerned about? If so, what can be done to avoid or mitigate them?
Expectations of the financial services sector in pursuit of decarbonisation should be proportionate. While the industry is playing an important role in providing the capital for the transition to a net zero economy, there are other critical factors. These include clear policy and incentives from government, the development of infrastructure and technology, and climate action across the economy.

Chapter 4 – Barriers to the Applications of Transition Finance

Q20) Do you consider there to be major barriers that currently limit your ability to access or deploy capital or financial services to support a credible net zero transition? Why / Why not? If so, what are these?
There are several major barriers that limit the ability for lenders operating in the UK to deploy capital to support a credible net zero transition, which is a key priority for the UK financial services sector: • **Lack of policy clarity and consistency** – Businesses and investors need commitment, policy and regulatory certainty to make long-term investment decisions to finance the transition. Messaging from the UK government on its approach to decarbonisation has shifted since September 2023, undermining business confidence which in turn makes lending and investment propositions riskier and less attractive. The government can help address this by providing improved sector-by-sector financing roadmaps which set out specific policy, spending and regulatory interventions to incentivise private investment and lending and provide the baseline for better corporate transition planning. • **Inadequate policy support** – Some specific sectors present challenges to delivering transition finance. For example lending to emerging technology is often higher-risk due to the uncertainty of long-term returns, while many changes needed for the energy transition are capital intensive and require long-term exposures. Policy can be deployed to lower the risk premium for these financing opportunities: risk-sharing between government and the private sector, e.g. through blended finance schemes. In a recent publication, UK Finance noted a series of instances

where such policy support programmes are not working as effectively as they should (pp.9-11).

- **Lack of commercially viable projects** – Lack of commercial viability of certain projects is a significant barrier and disincentive in providing investments or debt to technologies required for transition. Capital is available to support the net zero transition but a lack of both investible projects and investor confidence is holding it back. As it stands, transition-related projects in nascent technologies often do not have the right risk-return profile to satisfy banks' credit risk requirements.

- **Lack of credible corporate transition plans** – Transition planning is still an emerging practice for most businesses, but such plans are useful for lenders and investors in assessing the trajectory of potential counterparties. Increased production of transition plans will help build long-term confidence in investment prospects by offering transparency and certainty.

- **Risk of carbon lock-in** – Without clear and credible guidance there is risk that transition finance could extend the lifetime of high emission assets. The current lack of credibility and integrity of guidance, borne out of a lack of clear definitions and guardrails for transition finance, could lead to misuse of transition finance if transition plans are vague or guardrails not put in place.

- **Internal capability** – Increasing capital flows toward low-carbon and transition activities requires new sets of expertise, particularly in sectors were many banks do not yet have deep expertise. Many financial services companies are investing in building internal capability through recruitment and training, to address this gap.

- **Reputational, regulatory and legal risks** – Reputational risk is a barrier to unlocking transition finance due to the lack of clarity around definitions, which increases the risk to firms of accusations around greenwashing (see response to questions 1-2). Addressing this concern would help improve real economy impact. While the FCA's anti-greenwashing rule seeks to address some of the risks of greenwashing in financial markets, market participants remain cautious to engage in sustainable and transition finance, particularly where it touches on hard-to-abate or high-emitting sectors, as there remains little clarity or comfort on potential supervision and enforcement measures. The FCA's "Dear Head of ESG" letter on sustainability-linked loans (SLL) in June 2023 appears to have coincided with a material contraction in the UK SLL market compared with EU and global volumes, based on Dealogic bata.

- **Lack of international interoperability** – There is a risk of different countries setting different principles and standards; as much as possible, efforts should be made to align principles of transition finance with international best practice and drawing on existing work. The TFMR could for example draw from frameworks available in other jurisdictions, including the EU Framework for Transition Finance, adapted to a UK context. Whilst every jurisdiction will have unique net-zero challenges, principles should aim towards as much harmonisation and commonality as possible.

Q23) Do you consider risk to be a major barrier to accessing or deploying capital or financial services to support a credible transition? If so, please provide examples and highlight any supportive de-risking tools.
Yes, financial services firms must consider risk management when deploying capital for any transaction, including to finance the low carbon transition. Firms face a variety of risks when providing transition finance related to nascent technology, uncertain demand, reputation and regulatory risk, and uncertain policy frameworks. Many of our responses throughout this call for evidence suggest mechanisms to de-risk capital deployment, including agreed frameworks to strengthen credibility of transition finance. The most powerful tools to improve risk profiles will come from government, for example: • **Government should expand and utilise funding pools more effectively to derisk private lending and investment** by improving the capacity of the UK Investment Bank (UKIB) risk-taking capacity. This can be achieved by implementing targeted adjustments to its strategy, institutional design or mandate. Over the medium term, increasing other sources of public financing, and considering increasing the UKIB loan-book, could maximise the public sector's ability to derisk lending and investment across the whole economy. Widening the finance provided by the British Business Bank through schemes such as the Growth Guarantee Scheme towards decarbonisation would also help derisk private sector investment. The TFMR should encourage the more targeted use of the UKIB balance book and other tools, including contracts for difference (CfDs) to unlock private transition finance. • **Government should consider how the tailoring of state aid regulations could support the transition of the UK energy system in order to meet net zero targets.** This type of intervention proved effective when the temporary easing of the EU State aid regulation, in the wake of Russia's invasion of Ukraine, promoted energy security by catalysing the shift to renewable energy (or away from Russia dependency) via the Temporary Crisis and Transition Framework (TCTF). A more permanent version of this in the UK should be considered to help unlock transition finance. • **Government and regulators should revisit the design of financing programmes where issues are reported, for example simplifying complex funding programmes.** UK Finance identified several examples where redesign of funding programmes could help unlock additional private capital at minimal public cost in a paper, *Mobilising Capital for the Net Zero Transition*. • **Policymakers should accelerate electricity infrastructure development and connection** as financial services firms cite the inability to secure grid connections as a key risk when assessing the viability of projects for lending and investment.

Ofgem[8] and the Electricity Networks Commissioner have both provided recommendations on how this could be achieved.

- **Government should expedite development of low-emissions transport infrastructure**, which remains a barrier to uptake and deployment of electric vehicles, and poses a risk for lenders and investors in the sector.
- **Concessional finance, guarantees and other blended finance tools to deploy capital internationally:** A range of additional factors hamper deployment of capital internationally and to emerging markets and developing economies (EMDEs), including currency, political and investment environment risks. Efforts are already underway through a range of multilateral and national forums to apply international development tools to increasing the deployment of capital into decarbonisation activities in EMDEs. The UK should retain its strong historic commitment to climate finance through its International Climate Finance programming, which enables it to use public funding, partnerships with external agencies and collaboration with EMDE governments to address transition challenges around the globe. The UK should not further reduce its climate finance budget.

Q25) Do you consider there to be gaps in the provision of advisory or transactional services (e.g. legal, consulting, data provision, or analytical support services) that you need to support your approach to transition finance? If so, what are these and what recommendations would you have to develop these?

We would welcome clear and consistent guidance from legal advisors on greenwashing litigation risks, particularly risks arising if transition finance provided to clients does not result in material emissions reductions — even where best endeavours are undertaken.

We would also welcome external or third-party review of non-financial corporate transition plans, to support banks in undertaking appropriate due diligence. In absence of external advice and an independent stamp of approval, banks undertake their own reviews. As the use of transition plans becomes more widespread, mechanisms for assessing their quality will need to move away from the current heavy reliance on non-profit entities like the Science-Based Targets Initiative (SBTI).

Q27) Do SMEs face particular barriers to the access and deployment of transition finance? If so, please provide examples and highlight any good examples of efforts to address these.

[8] Ofgem's open letter on future reform to the electricity connections process is available here: https://www.ofgem.gov.uk/sites/default/files/2023-05/Open%20Letter%20Connections%20%28Final%2016.5.23%29.pdf

UK Finance will issue a report on banking and policy levers to support SME decarbonisation on 14 May, drawing on survey data through our SME Finance Monitor (in partnership with BVA BDRC) and qualitative focus group and interview data. We will share this with the TFMR in due course. Some of the key findings of this report:

- Between 2021 and H1 2023, appetite among UK-based SMEs to prioritise actions to reduce their carbon footprint fell from 27% to 17%.
- SMEs reported a range of factors inhibiting action to decarbonise, particularly identifying a lack of resourcing (in terms of capacity and information), poor linkage between available pools of funding and need, and policy uncertainty.
- Appetite to take on debt among SMEs is low, further hampering the influence of the banking sector in encouraging decarbonisation.

The complexity of the SME transition is underscored by the diversity of small businesses as a cohort. The actions they can take to prepare for a lower-carbon economy range from simply changing sources of electricity, through influencing commercial landlords to retrofit properties and making major capital investments (e.g. furnace replacement), to entirely changing their business models to respond to changing energy systems. SMEs stand to face some of the most acute negative distributional impacts of the transition.

We recommend a range of policy and private sector tools, including business mentoring schemes, best-practice sharing within industry, and the establishment of a taskforce to support SME-focused policymaking.

Chapter 5 – The opportunity for investments, products, and services to advance transition finance globally

Q28) What good examples are there of effective investments, products, mechanisms (e.g. results-based payments) and services for deploying transition finance to date? Are there opportunities to scale up or replicate these further?

The types of financial instruments for the provision of transition finance that are already available in the market are similar to those available for other forms of sustainable finance. These instruments include use-of-proceeds bonds, sustainability-linked bonds, general purpose lending, sustainability-linked lending, and equity investment. Market standards for bond and loan products are available, for example under ICMA Green Bond Principles and

Loan Markets Association (LMA) Green Loan Principles. All the financing products are therefore available for transition finance.

Q29) Are there any needs or use cases that are not being met by the current instruments? Are new or additional financing strategies, market tools, practices or products needed?

Shortcomings in existing blended finance offers: UK Finance supports the range of blended finance programmes already deployed by the Government. However, we have identified instances where finance is not flowing at scale due to the design of policy instruments. Government could address this and ensure needs are met by:

- **Simplifying funding programmes in the same sector:** Complex chains of incentives in the same sector often make investments and lending opportunities more challenging to implement, leading banks and investors to step away from the schemes. As an example, the UK programme to support waste-to-energy with carbon capture projects offers different funding incentives for different participants in an interconnected value chain. These incentives (e.g. contracts for difference and grants), are not designed in a streamlined fashion across downstream and upstream activities: This increases "interface" risk through reliance on an extended chain of actors. Simplifying these funding models will significantly lower risk and cost, and thereby increase the appetite of lenders to participate in the schemes. The government should seek to recreate successful schemes, such as the Transportation and Storage Network for carbon capture, in other areas.
- **Introducing post-completion tariff adjustment mechanisms for infrastructure projects**: Long financing periods are increasingly expensive and risky for bank lenders. In the UK, contracts often require financing for the entire lifecycle of a project even before factors like a grid connection are secured. Examples in overseas markets, for example the UAE, allow for tariff adjustment at refinancing (post completion) stage to absorb variations in rates that have occurred during the construction period. This allows the recycling of bank funding, which is optimal for construction funding, by refinancing in the bond market and shifting the long-dated (but relatively derisked) funding to institutional investors. This helps to make financing of large infrastructure projects more appealing.
- **Adjusting bidding requirements to avoid exclusion of financing instruments**: The current system for developing offshore transmission assets in the UK presents challenges for bond financing. In the UK, offshore wind farm developers are required to construct and sell transmission assets, which are then auctioned off and overseen by Ofgem. While these assets are typically low risk and have long-term contracts, making them suitable for bond financing, the existing process poses several barriers. As a result of these barriers, some banks are now declining to participate in these bidding processes and choosing to deploy this capital elsewhere.

Q30) Do certain 'labelled' transition finance instruments need to adopt additional requirements? Why and how could this be done in a way that is commercially viable?
There is a range of views on the effectiveness of "labelled" transition finance instruments, along the lines of the Financial Conduct Authority's (FCA's) "Improvers" label. While the FCA offers some evidence that retail investors are increasingly looking for opportunities to invest in sustainable funds, there is limited-to-no evidence that the same is true for "transition" labels, which are likely to be misunderstood by a large cohort of investors. There is also limited evidence that such labels will increase pools of investments at scale. For transition-labelled products to attract investors, there is a need for a far wider-ranging narrative on the importance of transition finance as a mechanism for generating real economy decarbonisation.

Q31) How should government, and other public bodies such as public finance institutions and local authorities, collaborate with industry, the finance sector and investors to create a supportive ecosystem for transition finance? Please considering factors such as i) the balance of public and private capital risk responsibility and ii) where expertise is located.
Approaches and needs in transition finance will evolve over time. While the TFMR provides a welcome launching pad to kickstart the UK's leadership, government should commit to ongoing engagement with industry. This could take the form, for example, of an industry council to develop and update the UK approach to fostering transition finance. Answers to questions 20, 23, 27 and 29 provide suggestions where we think the UK's policy frameworks and public finance instruments could be better deployed to unlock transition finance. There are several other ways the government could create a supportive ecosystem for transition finance, including: • Promoting favorable economic conditions and identifying technologies needed for the global transition to be scaled up. • Encouraging public/private sector partnerships for emerging and proven technologies. • Driving public engagement and education around the importance of energy related infrastructure to decarbonisation. • Communication around the successes of transition finance to foster a more informed dialogue around the realities of the transition. To strengthen credibility and ambition, transition finance frameworks could also seek to align with wider economic policy frameworks. For example, recognising the powerful potential of

industry clusters in decarbonising hard-to-abate sectors[9], a UK-based approach to transition finance could bring together net zero and "Levelling Up"/place-based agendas to encourage regional low-carbon industrial clusters around specific technologies in disadvantaged regions.

Q32) Are there any international examples of best practice in providing the right ecosystem for transition finance that can be drawn on?

While the UK can be lauded for its historic leadership on net zero policy, we are at risk of falling behind counterparts in transition finance if the right ecosystem is not created.

The US Inflation Reduction Act (IRA) and the EU's InvestEU Programme have both driven far greater investment into projects key to the transition, and are attracting investors away from UK markets. Increased investment in clean technology in the US and the development of public-private investment in the EU both demonstrate how policymakers have created stronger ecosystems for transition finance in their respective jurisdictions through these packages.

Japan and Singapore are both more advanced than the UK in creating the right conditions to stimulate the flow of transition finance. Both jurisdictions benefit from stronger government-endorsed frameworks to promote transition finance.

Japanese policymakers are building on these strong foundations. In February the Japanese government issued $10.7 billion of 'climate transition bonds', which were formally endorsed by the Climate Bonds Initiative (CBI). Meanwhile the CBI opposed a similar scheme in Europe[10].

Q33) How can the UK better leverage its existing financial and professional services expertise to support the growth of transition finance capacity and related activity and revenue?

The UK financial services sector has a key role to play to support the growth of transition finance capacity and related activity and revenue. The UK is a world-leading centre for financial services and is well placed to be a leader in transition finance. The UK benefits from a reputation for strong regulation, law, expertise and infrastructure. The UK has historically also been considered a leader in climate action and was the first major economy to pass into law a commitment to end its contribution to global warming. These conditions

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[9] World Economic Forum 2020

[10] As highlighted by the Financial Times on Unloved Transition Bonds are big in Japan. February 2024.

position us well to support growth in transition finance. Our success in this area is not guaranteed, and policymakers should leverage the expertise in the financial services sector through engagement and consultation with industry. Clear and consistent policy from Government would also improve the attractiveness of the UK as a centre for transition finance and better leverage financial services.

The 2023 Green Finance Strategy goal to position the UK as a green and transition financial services centre is the right one, but the pace and focus to achieve them has weakened. Government should renew momentum behind the deliverables already identified to deliver the Green Finance Strategy, in particular in the development of a robust and coherent framework informed through full industry consultation, and providing leadership to spur the development of innovative financial products and services that contribute to environmental sustainability.

The UK should maintain a balanced approach to the individual elements of the sustainable and transition finance framework, without placing undue emphasis on any single aspect. For example, the EU is currently experiencing challenges due to the significant legislative weight assigned to its Green Taxonomy, which has rendered the framework cumbersome amidst a rapidly changing external environment. Green finance regulatory requirements should be deployed in a proportionate manner, and avoid placing undue burden on organisations with more limited capacity, such as small-to-medium-sized enterprises.

Q34) Do you think the UK government could make better use of blended finance approaches to de-risk and scale up transition finance? Why / Why not? If yes, please explain.

Yes. See responses to questions 23 and 29, which include detail on:

- the potential to expand and utilise funding pools more effectivelt to derisk private lending, including improving the risk-taking capacity of the UK Investment Bank;
- concessional finance, guarantees and other blended finance tools to deploy capital internationally; and
- detailed suggestions to improve government blended finance programmes where private finance is not flowing at scale – for example, simplifying funding programmes in the same sector, introducing post-completion tariff adjustment mechanisms for infrastructure projects, and adjusting bidding requirements to avoid exclusion of financing instruments.

We welcome the creation of the HM Treasury / Department for Energy Security and Net Zero Blended Finance Unit, which has the opportunity to address many of these concerns.

Q35) Do you think the UK's public finance institutions could play a greater role to de-risk and scale up transition finance. If yes, please provide examples?

As mentioned in response to question 23, we strongly support an enhancement to the **UK Infrastructure Bank's (UKIB's)** risk-taking capacity to enable it more effectively to leverage private lending and investment. UKIB has a mandate alongside other UK development banks to lower risk for conventional investors and lenders in decarbonisation projects. However, its ability to fulfil this mandate was hampered in its early months by institutional design and capacity issues, as highlighted by the Public Accounts Committee in 2023. Firms noted that public funding was lacking in areas with high technological readiness but lower deployment levels, for example agriculture, where UKIB could play a critical role. We welcomed UKIB's Strategy Update published in September 2023, which sought to answer many of these issues. Over the medium term, we would like to see an uplift in the UKIB capitalization to build its capacity to unlock even greater sums of private capital.

The **British Business Bank**, with its strategic objective to drive sustainable growth through its support for smaller businesses, has a vital role to play in supporting businesses to consider reducing carbon emissions when they access funds. We welcome that new regional funds (e.g. the Northern Ireland fund) have sustainability considerations embedded into their design. This should be embedded across all British Business Bank products, especially the Start-Up Loan Scheme which could act as a demonstrator for what support, advice and messages shift behaviour. And while the Recovery Loan Scheme (which will be replaced by the Growth Guarantee Scheme) can already be used for green investment, the Bank should do more to promote this. We welcome the extension of the scheme to the end of March 2026 as part of the March 2024 Spring Budget.

Q36) Do you think there is a role for the UK to facilitate the development of global thought leadership on transition finance, and if so, what strategies could it employ to influence and facilitate this development?

Yes. The UK should leverage the power of its globally leading financial centre to facilitate the flow of greater sums of transition finance globally, and to promote international interoperability on approaches to transition finance. Mechanisms for doing this could include:

- Promoting industry dialogue and collaboration, particularly alongside non-profit sector actors, on the model of the UK Finance Transition Finance Alignment Forum.
- Leveraging UK regulatory leadership at international forums such as Network for Greening the Financial System, the G7 and G20.
- Retaining the UK's strong historic commitment to climate finance through its International Climate Finance programming, which enables it to use public funding, partnerships with external agencies and collaboration with EMDE governments to address transition challenges around the globe. The UK should not further reduce its climate finance budget.

- Exploring the potential to tie the mobilisation of private transition finance into COP29 discussions on the New Collective Quantified Goal, the future finance settlement, under the Paris Agreement.