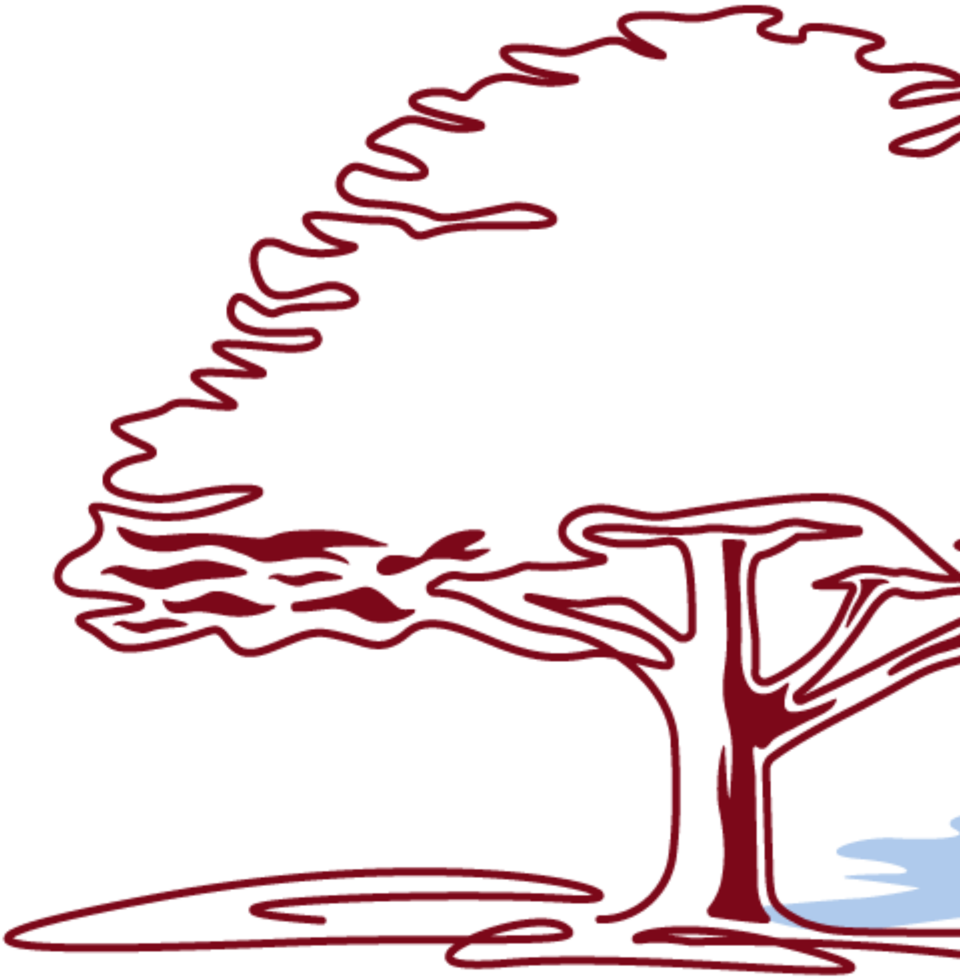
Blog

Dark green initiatives alone won’t suffice

18.01.2023
von

Lange, Frederik_EN



Transition finance is an essential factor in the fight against climate change

Why is it not enough to simply focus on supporting activities that are already green?

Despite two weeks of intense negotiations, the declaration put forward at the recent UN Climate Change Conference (COP27), held in Sharm el-Sheikh in November 2022, did not contain many specifics regarding the reduction of greenhouse gas emissions. It is true that participating countries once again confirmed their commitment to the 1.5-degree global warming goal laid out in the Paris Agreement. But it is also true that they are (very) unlikely to achieve that goal. Not only that, if participating countries only fulfil their current commitments, the average global temperature will rise by 2.4 degrees Celsius by the year 2100 (calculations from Climate Action Tracker).

Preventing climate change as laid out in the Paris Agreement thus requires immediate action, and above all significant investment. For the EU alone, the European Commission has estimated a need to invest an additional 390 billion euros each year in order to ensure that the European economy achieves a sufficient reduction in carbon emissions. However, simply providing funding for industries that are already green will not be enough. Every economic sector must transition to a greener way of doing business. This applies in particular to industries such as steel, cement and aluminium. And yet in these cases, greenhouse gasses emitted as part of industry processes are considered hard to abate because the companies in question either do not (yet) have the necessary technologies or because the costs are very high.

How will transition finance help us to reach our climate goals?

This is precisely where transition finance comes in. Instead of selectively focusing on activities that are already sustainable, transition finance focuses on promoting activities that are moving towards more sustainability. Transition finance thus allows for a comprehensive treatment of entire economic sectors. Even more crucially, it includes companies that are currently emitting large amounts of CO2 and supports them on their journey towards more sustainability based on specific, scientifically sound transition plans. Because of this, transition finance is an important instrument within the larger toolbox of sustainable finance. This instrument can and should be implemented in order to bring our economic activities in line with the climate goals set out within the Paris agreement.

What problems is transition finance currently facing?

Transition finance represents a process, so it just isn't all that easy to come up with a set of defining criteria – a method partly applied to dark green activities. Whether or not transition finance can be defined as suitable for achieving climate neutrality depends, among other things, on the company, location, national frameworks, geographical circumstances and when the finance is needed.

Because the definition is hard to pin down, financial market participants may be faced with uncertainty and hesitate to even provide transition finance. For example, it may be unclear how a bank can go about evaluating whether or not a company is credibly committed to meeting the Paris Agreement climate goals. The OECD Industry Survey on Transition Finance from 2022 confirms this reluctance, with 62 percent of those surveyed saying they had hesitated to provide transition finance. Institutions are thus quickly at risk of being accused of green washing.

Another challenge facing transition finance is avoiding what is known as the lock-in effect for carbon intensive technologies. Lock-in effects can result from investment in new, yet carbon-intensive industrial plants with long lifetimes. This is the case when these plants do in fact emit less carbon than existing plants, but will remain in operation long after installation, making new investments in more environmentally friendly technology unprofitable over the long term.

Can the EU taxonomy help promote transition finance?

In order to adequately respond to these challenges, we need a clear transition finance framework. It’s true that the EU taxonomy already provides a classification system for ecologically sustainable economic activities within the European Union. However, until now, EU efforts have been concentrated on funding investments in economic sectors that are already classified as dark green. That is to say that in its current form, the EU taxonomy has exactly the issue described above; it simply does not adequately reflect dynamic transformation processes, to say nothing of funding them. Not only that, the existing taxonomy covers only part of the overall economy. According to the European Commission, around 40 percent of listed companies are currently included within the taxonomy.

The European Commission therefore charged the Platform on Sustainable Finance with considering options on how to expand the taxonomy in order to better reflect transition finance. The Platform’s final report was published in March 2022. The Association of German Banks welcomed this initiative, however, we must note that the current solution, from a practical standpoint, is far too complex to be implemented. In particular, the dynamic development, as well as the increasingly stricter screening and do no significant harm criteria envisaged in the report, which are to be used to classify economic activities as sustainable/unsustainable, will cause a great deal of uncertainty and create a considerable burden due to having to constantly adjust the taxonomy. In the medium to long term, this might mean that it would be more and more difficult to predict which investments are opportune when viewed from a sustainability standpoint. In this case, even activities of a company that will significantly advance their efforts on climate action are at risk of being relegated to the red category.

How can we overcome these challenges?

As transition finance is highly dependent on the circumstances in question, the dynamic process towards increased sustainability, also known as greening the economy, should not be managed via a multitude of highly complex technical assessment criteria. A principle-based approach would be far more prudent. In this approach, transition finance might, as an example, be based on credible transition plans as put forward by companies. This is also the approach recommended by the Organisation for Economic Co-operation and Development (OECD) in their OECD Guidance on Transition Finance report, published in October 2022.

Instead of introducing four additional categories, as suggested by the European Commission's Platform on Sustainable Finance, we could choose a simpler, more practical approach. In addition to the existing dark green taxonomy, it would suffice to create a list of activities that cannot be considered eligible because they cannot transition, a category known as Always Significantly Harmful, or ASH. This would create legal certainty for all participants. For all other activities that cannot be considered dark green but do not fall into the ASH category, there would then be the opportunity and indeed the necessity to begin moving towards greener methods. Transition finance should be guided by company transition plans, which in turn should be centred on industry-based and scientifically sound transition principles.

Looking ahead

Transition finance has, it seems, become less of a priority for the European Commission since the Platform report was published. However, given its importance and the fact that we are running out of time to prevent climate change, we must treat transition finance as essential. We need to accelerate our efforts. The European Commission must make developing a clear, practicable framework for transition finance a priority. After all, a green economy can only be achieved if we focus on greening the economy.