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Transition Finance and its Relationship to Green Finance

To avoid catastrophic effects of climate change and to stabilize temperatures globally, it is critical for economies and organizations to rapidly implement plans to decarbonize. One way to incentivize rapid decarbonization is to provide financial resources to organizations at lower cost but conditional on their alignment with a commitment to rapidly decarbonize. The use of finance in this manner is colloquially referred to as "transition finance."

Interest in transition finance has grown among businesses and other organizations due to the need to rapidly scale the move towards sustainable practices. However, there has been much confusion about the nature and relationship of transition finance to other forms of sustainable finance such as green finance. In this article, I will discuss how to best understand transition finance and to discuss its relationship with green finance from a policy perspective. By illustrating the commonalities and distinctions between both approaches to sustainable finance, it is hoped that policymakers can implement ways to increase the rapid adoption and credibility of environmental and socially sustainable practices both at the firm and economy-wide level.

There are three major takeaways from this article. First, a policy-relevant definition of transition finance is one that incorporates the addressing of both environmental and social issues simultaneously and within a specified time frame. Second, while green finance and transition finance are concerned with accounting for environmental factors in the providing of funding, transition finance is distinguished by its inclusion of social issues as an area of concern. Third, policymakers need to focus their efforts on ensuring that transition finance activities and products credibly deliver what they promise. Policymakers should focus their efforts on validating transition finance activities and products through standard setting and developing methods and metrics to assess sustainable performance.

KEY MESSAGES

- **Both green and transition finance aim to promote improvements to environmental outcomes of organizations**
- **Transition finance is best defined as financial activities that are conditional on entities achieving contextually relevant environmental and socially sustainable criteria within a limited time frame**
- **In contrast to green finance, transition finance recognizes the importance of addressing social issues along with environmental issues**
- **Policymakers should focus on making greenwashing within transition finance and green finance more costly**
- **As societies begin to seriously speed green transition plans, the role of transition finance will continue to grow**

DEFINING TRANSITION FINANCE

Much of the confusion between transition finance and green finance arises from a lack of clarity on how the former is defined. This is not a unique problem; many areas of sustainable finance are criticized for lacking a clear definition. This has had the unfortunate effect of making it hard to understand what distinguishes various groupings of sustainable finance activities both among policymakers and the public. To allow for a focused discussion of the relationship between green and transition finance, I will identify the definition of transition finance for this article after reflecting on how it has been defined in the past.

Initial definitions of transition finance were varied and typically reflected the unique context in which the funding provided was deemed to assist "sustainable transition." International organizations would tend to define transition finance with a focus on promoting the achievement of the Sustainable Development Goals (SDGs). For example, the OECD (2019) defines transition finance as the optimization of the access to finance for sustainable development and to avoid major financing gaps or socio-economic setbacks. In contrast, organizations and financial firms have traditionally stressed a definition of transition finance that focuses on organizational shifts to adopt environmental and sustainable projects that address climate-related risks (e.g., Klier et al. 2020 and ICMA 2020). An example of a definition that is illustrative of this approach would be the defining of transition finance as a form of risk mitigation; it is a type of funding that improves the underlying performance of the organization through a reduction in its transition risk exposure (Tandon 2021). Thus, to achieve a successful "transition," an organization is to identify ways to address and/or mitigate transition risk exposure. With respect to finance, transition risk could be addressed using financial markets and instruments

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to hedge transition risk and/or incentivize risk management through contractional terms specifying a commitment to decarbonization.

Further developments to the definition of transition finance sought to explicitly stress the conditional linkage between environmental and social sustainability performance and any funds provided from transition finance activities. Linking the achievement of environmental and socially sustainable criteria also has the effect of connecting transition finance explicitly to the SDGs and the core aspects of sustainable finance broadly. Such linkages have been theorized to incentivize transition adoption – should the financial instrument be designed appropriately – to reduce the cost of capital when sustainability criteria are achieved (e.g., Caldecott 2022). This approach, however, has been criticized as resulting in transition finance to be no more than a variant of traditional finance. It is argued that financial instruments can be identified as "transition finance" so long as contractual terms within the financial product in question refer to environmental and social sustainability criteria (Tandon 2021).

More recent definitions of transition finance have begun to include a temporal component that is related to major environmental sustainability objectives. An example of this shift is the most recent OECD definition of transition finance (OECD 2022). This work defines transition finance as "… finance deployed or raised by corporates to implement their net zero transition, in line with the temperature goal of the Paris Agreement and based on credible corporate climate transition plans".

While the reference to achieving net zero transition indicates a linkage between the providing of funds and the attainment of environmental and socially sustainable objectives, it is implied that there is an endpoint to the provision of this kind of finance. When organizations realize a net zero transition, transition finance would no longer be needed. This can be contrasted with financing that seeks to maintain longer term sustainable practices of organizations such as green bonds that can be issued and renewed for longer time horizons.

An important takeaway for policymakers from this discussion is that there is an emerging consensus around a general view of what transition finance is. I would like to propose a definition of transition finance for the remainder of this brief that realizes this development. Transition finance is best defined as financial activities that are conditional on entities achieving contextually relevant environmental and socially sustainable criteria within a limited time frame. Such a definition provides important flexibility in allowing policymakers to determine what may or may not be environmentally or socially sustainable for certain entities while simultaneously stressing the need to achieve transition commitments within a short period of time.

THE RELATIONSHIP BETWEEN GREEN FINANCE & TRANSITION FINANCE

The previous discussion of what transition finance is allows for a more detailed discussion about its relationship with green finance. It is common for both green and transition finance to be used interchangeably to describe various financial activities and products. Despite this common usage, it is important for policymakers to recognize that while both share some common attributes, there are important distinctions between both subsets of sustainable finance. The failure to recognize these distinctions has important policy implications when trying to ensure integrity and credibility of green and transition finance markets and products, respectively.

The main reason why it is common to view green and transition finance as one and the same is because both are a form of sustainable finance. Sustainable finance is defined as looking at how finance interacts with economic, social, and environmental issues (Schoenmaker and Schramade 2019). Economic issues relate to investing impacts on economic conditions at local, national, and global levels. Social issues relate to rights, well-being, and interests of people and communities. Environmental issues are those which are related to the quality and functioning of the natural environment (UNEP 2016).

Both green and transition finance are best understood as subset approaches to finance within the broader sustainable finance ecosystem. Both green and transition finance are related through the mutual incorporation of environmental factors in finance and financial activities. Green finance has been framed as any structured financial activity that has been created to ensure a better environmental outcome in a broader sense beyond simply climate change (World Economic Forum 2020 and UNEP 2016). Like green finance, transition finance concerns itself with all aspects of environmental issues involved in the transition to sustainable economic systems and practices. For example, green bonds as a financial instrument could prima facia be viewed as either a type of green finance or a type of transition finance. This is because this financial instrument is focused on promoting better environmental outcomes for issuers.

However, transition finance is distinguished from green finance by virtue of its incorporation of social issues. An example of this inclusion is shown in the notion of a Just Transition; the equitable distribution of the costs and benefits among stakeholders affected by the transition to sustainable economic practices (EBRD 2022 and International Labour Organization 2015). Within this framework, it is widely recognized that funds provided to organizations must also account for the likely social impacts of the transition and account for them in a fair and equitable manner. These types of social considerations are not usually considered within green finance because their scope

tends to be limited to producing sustainable environmental outcomes, such as reduction in CO_2 emissions. Returning to the green bond example, the bond in question could be considered a form of transition finance should there be covenants within the bond that require firms to meet social sustainability metrics in addition to environmental ones. Should these not be included, the green bond should be viewed as a type of green finance instead.

It is important for policymakers to understand that while green finance and transition finance share a focus on environmental issues, they are not the same type of sustainable finance activity. This distinction is of increasing importance as policymakers shift towards hardening benchmarks for decarbonization. Conditioning funding on targeted environmental outcomes such as greenhouse gas (GHG) emissions does not necessarily mean that firms are also meeting socially sustainable metrics.

A good way to emphasize this distinction is by way of an example. Suppose funds were raised to allow an energy company to retire coal power plants earlier than expected. While such retirement would produce reductions in greenhouse gas emissions, such early retirement may result in the redundancy of many workers and may affect the wider society that supports such a large industry. Transition finance would attempt to address the social implications of decarbonization activities along with the environmental impacts. In this example, transition finance would seek to allocate funds to ensure that workers and regions are compensated for the loss of an important industry. In contrast, green finance would not be concerned with this social element and would instead focus on raising funds to allow for the rapid retirement of the powerplant regardless of the social effects.

CREDIBILITY OF TRANSITION FINANCE

Another way that green finance and transition finance are often related to one another is through the common issue of credibility. At present, it is very difficult for policymakers and the public to credibly determine what green or transition finance activities are legitimate activities from those that are not. This phenomenon is known as "greenwashing": the active misleading of consumers, the public, and policymakers of the environmental performance and/or benefits of a product or service (Delmas and Burbano 2011).

Greenwashing is a natural result of the explosion of the green finance market. In 2021, the global sustainable finance market passed over 1 trillion USD in total size representing a 20-fold rise since 2015. Sustainable debt markets issuance rose to over 1 trillion USD in 2021 alone and was driven by sharp increases in green bond issuances (Toole 2022). Sustainable equity capital markets have witnessed similar increases with the amounts raised in 2021 totaling a record of 48 billion USD. The sustainable finance market has slightly cooled in 2022 with sustainable debt and equity returning to immediate post COVID 2021 levels (Jones 2022).

The growing size and amount of sustainable finance markets and instruments provides an incentive for greenwashing to occur. There is a clear underlying incentive for firms to misrepresent their sustainability metrics and transition paths for the sake of witnessing larger increases in firm value through reduced cost of capital without providing any fundamental changes to the sustainability of the business.

Further exacerbating the greenwashing problem in both green and transition finance are several unique barriers to providing credible products to the market. At present there is a lack of clarity and coordination on the guidelines, standards, and definitions of activities that are considered transition finance. Moreover, there are unique difficulties in measuring sustainable performance and relevant key performance indicators that demonstrate when organizations have achieved sustainability criteria (OECD 2022). Not only is it difficult to identify what a sustainable financial product is, but it is also difficult to verify whether an organization has met their commitments.

Both green and transition finance are susceptible to greenwashing. However, unlike green finance, the effects of greenwashing actions in transition finance may be more severe. By its very nature, transition finance provides funding to assist existing organizations that may be engaged in activities that are currently deemed environmentally or socially unsustainable. Given the underlying incentive to cheat, already unsustainable businesses may be able to lower their funding costs through greenwashing actions. Not only have the funds provided failed to transition the business towards more sustainable practices, but it may have the effect of further lengthening their use of unsustainable practices through reduced cost of capital. This ultimately presents a serious threat to the achievement of decarbonization pathways should all firms follow similar actions with transition finance funds.

In light of these main issues, there are a number of avenues through which policymakers can improve the integrity and credibility of both green and transition finance products and activities. Policymakers can focus on the further development of standards and guidelines to identify what the transition finance products and activities are that are nationally and internationally accepted. An example of standard development is the EU taxonomy for sustainable finance activities. This taxonomy provides companies, investors, and policymakers with appropriate definitions for economic activities that can be considered environmentally sustainable (European Union 2022). The European Commission (2022) has already recommended extending this taxonomy to include transition finance activities as well. It is generally rec-

ommended that this work continue to be extended in other jurisdictions.

Policymakers can also make a concerted effort to further establish key performance indicators that can both accurately measure and assess whether organizations have truly met their stated environmental and socially sustainable commitments. Accounting organizations have taken the lead in this regard. For example, the International Financial Reporting Standards (IFRS) have recently launched the International Sustainability Standards Board (ISSB) to deliver a comprehensive global baseline of sustainability-related disclosure standards to provide investors and other capital market participants with information about companies' sustainability-related risks and opportunities (IFRS 2022). Similar standards are being introduced by central bank authorities through the Network for Greening the Financial System (NGFS) (NGFS 2022). National level policymakers and regulators should also coordinate to develop similar standards within their jurisdictions and contribute their experiences with others to identify best practices for sustainability disclosures over time.

Finally, policymakers should develop ways to incentivize credible transition plan adoption by improving the benefits organizations can witness by adopting credible transition plans while increasing the costs to firms engaged in greenwashing activities. An illustration as to how policymakers can increase the benefits for adopting credible transition plans is the recently launched transition plan disclosure framework by the Transition Plan Taskforce. This guide provides clear recommendations as to how firms can formulate, implement, and monitor an effective transition plan (Transition Plan Taskforce 2022). As a form of best practices, this should reduce the cost to implement a transition plan, thereby maximizing any potential "greenium" i.e., a lower cost of capital, organizations may witness from adopting transition finance products and activities. Simultaneously, policymakers should introduce more severe penalties for greenwashing as well as adopt a more active role to monitor green finance markets for such misrepresentation.

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