Inside the U.K.'s *Transition Finance Market Review*

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We were proud to provide market-leading expertise and legal support to the secretariat of the Transition Market Finance Review. The review explores how the U.K. can become a leading market for transition finance domestically and internationally and play a critical role in delivering net zero.

WHY IS TRANSITION FINANCE IMPORTANT?

Decarbonising the global economy by 2050 is a monumental task, and a USD200 trillion investment opportunity.[1 2] Without a properly functioning transition finance market, U.K. and global emissions of greenhouse gases will continue to rise.

Transition finance is the financing of the transition of the whole economy to net zero. It involves the sourcing of money from both the public and private sector, through various channels and in various forms, to fund "activities" that support the transition and to fund "entities" that are transitioning to net zero.

The report of the Transition Finance Market Review[3] (the "**TFMR**" and "**review**") proposes a blueprint for a transition finance market and a roadmap for achieving it. More specifically, the review explores and proposes a model for, and the necessary ingredients of, a successful transition finance market in the U.K. Such a market would both serve the U.K. and position it as a leading global hub for transition finance, in particular supporting emerging markets and developing economies ("**EMDEs**") as they transition to net zero.

A&O Shearman provided market-leading expertise and legal support to the secretariat of the TFMR. Here we summarise the core findings of the TFMR and its key recommendations.

The TFMR blueprint is, unsurprisingly given the commonality of challenges, adaptable for other areas of the U.K. economy and its industrial strategies (such as technology/ AI strategy).

A critical recommendation of the review is coordination between departments, regulators, industrial sectors and market participants within the climate space. The same logic necessitates coordination between the different U.K. industrial strategies, given that funding, capacity and time is not infinite and policy choices and prioritisation will be required. It is not just about what money is spent, but about which sectors it is spent on, where in the country it is spent, and what trade-offs are required.

The urgency with which we need to address a suite of challenges dictates that these questions must be answered in the next six to nine months. A&O Shearman is committed to playing an active role in this endeavour.

[1] 'Delivering Net Zero by 2050: the $200 trillion opportunity' (https://www.aoshearman.com/en/insights/how-big-is-the-net-zero-financing-gap/delivering-net-zero-by-2050-the-200-trillion-opportunity).

[2] For a more detailed look at the scale of investment required to achieve net zero by 2050 across a range of sectors and regions, please refer to the landmark study undertaken by Climate Policy Initiative in partnership with A&O Shearman available at https://www.aoshearman.com/en/insights/how-big-is-the-net-zero-financing-gap.

[3] The report (available at https://www.theglobalcity.uk/insights/scaling-transition-finance) was issued by the TFMR. The TFMR is an independent market review commissioned by the U.K. Government to explore how the U.K. can support the scaling of a high-integrity transition finance market in support of global net zero ambition.

What does a definition of transition finance need to address?

To create a successful transition finance market, we first need a commonly understood definition of transition finance.

Whilst the key is not to be overly prescriptive, a clear definition and guidance as to what amounts to transition finance are necessary to provide sufficient certainty that: (i) the finance is being spent on decarbonising activities and entities; and (ii) the providers of such finance are not exposed to litigation and reputational risks, in particular those that arise from allegations of greenwashing (or transition-washing).

To encourage economy-wide decarbonisation, the definition of transition finance should be sufficiently broad to cover all sectors and all forms of financing, including instruments that mitigate commercial risk (for example, government grants or forms of guarantees). It also needs to be dynamic, as our understanding of the effort required to effect the transition and of the technologies and activities required to support it will continue to evolve.

Embedded within the definition of transition finance is the question "to what outcome are we transitioning?". To that question we ought to add "how do we get there?", "over what period?" and "from what starting point?".

How does the review define transition finance?

The TFMR adopted a broad definition of transition finance, noting that *"Transition finance, in the broadest sense, incorporates the financial flows, products and services that facilitate an economy-wide transition to net zero consistent with the Paris Agreement."*

The TFMR's view finds support in other similarly broad understandings of transition finance put forth by, for example, the European Commission, the Glasgow Financial Alliance for Net Zero ("**GFANZ**") and the G20 Sustainable Finance Working Group. Those definitions (or understandings) do not limit transition finance to a particular sector or industry but generally encompass the financing, in whatever form, of what is necessary to credibly transition towards net zero. That said, it is expected that high-emitting sectors will receive the most focus in the near term given the significant emissions reductions required and the significant investments needed.

How does the review propose to facilitate the practical application of the definition?

When interpreting and applying the TFMR's broad definition of transition finance, finance providers need to exercise judgement as to which activities or entities may fall within scope, in addition to whether to provide finance. Getting this assessment wrong can have costly implications (not least reputationally) and jeopardise the push to decarbonise.

The transition varies by entity, sector and country, as well as over time. It is therefore unsurprising that the market has yet to coalesce around a common framework for assessing when financing an activity/entity credibly amounts to transition finance.

In the absence of a common framework to guide their assessment, individual financiers have started to design and deploy their own bespoke frameworks which vary in approach and robustness. However, this status quo is not satisfactory because it contributes to market fragmentation and leaves room for transition-washing.

THE REVIEW SETS OUT TWO PROPOSED TOOLS TO FOSTER GREATER CONSISTENCY IN APPLYING THE DEFINITION ON A CASE-BY-CASE BASIS:

A transition finance classification system (the "TFCS")[4]

The TFCS is intended to assist in identifying, through classification, activities and entities that qualify for receipt of transition finance. Noting that GFANZ has already identified four key financing strategies that define transition finance, the TFCS considers the four strategies at an "activity-level" and at an "entity-level".[5] It also includes non-exhaustive examples of eligible activities and entities.

The financing of qualifying activities (defined as "**transition activities**") includes climate solutions activities (such as the generation and storage of renewable energy and low carbon fuels), activities that enable climate solutions (such as the transmission and distribution of such energy), activities that support an entity in aligning to a credible decarbonisation pathway (such as the electrification of processes), and activities which lead to the early retirement of high-emitting assets.

The financing of qualifying entities (defined as "**transitioning entities**") includes entities that derive a high percentage of revenues from climate solutions and enablers, and entities that are aligning or aligned with a credible transition strategy (which may involve funding specific activities carried out by an entity or general-purpose funding).

A set of voluntary Guidelines for Credible Transition Finance[6]

The Guidelines for Credible Transition Finance are intended to help credit institutions[7] establish or refine their own transition finance frameworks to assess whether finance is transition finance, which in turn will contribute to promoting a shared and more sophisticated understanding of transition finance.

The guidelines are principles-based and are designed to be used in tandem with existing sustainability frameworks, pathways and tools (such as taxonomies), reflecting the varied and dynamic nature of transition finance. They allow finance providers to retain discretion over which frameworks, pathways and tools to utilise, and to leverage current knowledge and data,[8] when assessing transition finance opportunities. This thereby reduces the burden of applying the guidelines.

The review recognised the importance of taking non-emissions factors into account when assessing transition finance opportunities, such as nature, climate adaptation and just transition considerations. However, it considered that, in the near term, a whole-of-economy approach to emissions reduction remains the primary objective of transition finance. Financiers can bear this in mind when applying the guidelines, which recommend "appropriate consideration" of non-emissions factors.

The guidelines seek to provide some standardisation (which, it is hoped, will assist with mitigating risks associated with transition finance) but also to retain flexibility to cope with the evolving landscape of decarbonisation technologies, science, policy priorities and demand signals.

Financiers seeking to incorporate the guidelines within their own assessment methodologies continue to have discretion over whether to apply or disapply individual factors under the guidelines.

The guidelines provide a good basis for widening stakeholder engagement (including with trade associations, industry groups, government and regulators) to further develop, refine and update the guidelines. For example, further consideration may be given to:

- clarifying where the Activity Factors and Entity/Strategy Factors do or should overlap (or diverge);
- supplementing the guidelines with a shortlist of selected frameworks, pathways, taxonomies and other tools that are deemed to be credible; and
- indicating how the guidelines map across to relevant frameworks, such as the U.K. Transition Plan Taskforce disclosure framework.

[4] This is developed from the categorisation of transition finance produced by GFANZ. To avoid market fragmentation, the review sensibly seeks to borrow and benefit from existing practices, guidance and consensus. Amongst other benefits, this will help to ensure international acceptance and interoperability.

[5] Entities includes not only corporates, but also governments, public institutions and other bodies.

[6] This is a set of voluntary guidelines for assessing whether proposed finance credibly amounts to transition finance.

[7] These guidelines were developed, in the time available, primarily for use by credit institutions but with the intention for them to be further consulted upon, developed and used more broadly by other financial institutions.

[8] This is particularly when the data necessary to demonstrate compliance with the principles overlaps with the data that is also required under existing frameworks.

What blueprint for a transition finance market does the review propose?

The TFMR's blueprint describes the key elements that together would constitute a functioning transition finance market in the U.K.

01

An overarching policy framework for achieving net zero within the U.K.

The review proposes that the government and industry work together to consider the most appropriate structure of the U.K.'s net zero policy framework, and that the government issues its findings by **Q1 2025**. Any structural change should ideally provide greater clarity as to how the government intends to achieve forthcoming carbon budgets.

02

A whole-of-economy national transition plan

There are already efforts by the UNFCCC and G20 to encourage a focus on whole-of-government transition planning to support the realisation of National Determined Contributions under the Paris Agreement.

In that context, the review recommends that the government be a first mover in developing a national transition plan **in the medium term**, including through engaging with the emerging globally applicable national transition planning framework. A national transition plan would, among other things, specify clear roles, responsibilities and mechanisms for delivering emissions reductions, and be consistent with sectoral pathways.

03

Sectoral decarbonisation pathways that set out a sector-focused plan for delivering net zero

The review proposes that the government collaborates with industry to develop clearer pathways for sectors and sub-sectors, which detail the practical steps that will need to be taken and their cost, funding, systematic sequencing and dependencies.

The review recommends that the government reinstates a form of the **Net Zero Council** before the end of **2024** to serve as an engagement route between policymakers, industry and financial services firms, including to assess efficient sector/sub-sector splits, test out policies, etc.

04

Financing for transition activities and transitioning entities

This is explored in the next few pages.

05

The translation of sectoral pathways into action at individual entity level, supported by clear frameworks and standards

The review stresses that action at entity level is essential, financed by activity-level and entity-level financing, and supported by the disclosure and reporting of activities and by the appropriate verification, assurance, rating, monitoring and stewardship of such activities.

Elements 1, 2 and 3 set out the need for national and sectoral plans on how to achieve net zero. The plans need to be costed and to address all the key components practically required to deliver their objectives, including policy-, fiscal-, regulatory-, financial- and infrastructure-related considerations.

The plans need to be coordinated across impacted government departments and between relevant regulators, and their development needs to have input from and be accepted by real economy and financial services stakeholders. It was recognised by the review that *"a strong feedback loop needs to be established between the companies, financial institutions, and policymakers engaged in transition planning at all levels, acknowledging the significant interdependencies".*

This highlights an important point – that to generate transition finance, there needs to be underlying, credible policies and pathways for different sectors, unified in a detailed national-level plan for decarbonising the real economy. If the intended financiers do not have confidence in the efficacy and execution of the national transition plan and sectoral pathways, or do not believe that it is in their economic self-interest to finance such plans, then the money will not be forthcoming – period.

That dovetails into **elements 4 and 5**, which deal with how, within the national and sectoral contexts, financing can be provided to credible activities and entities in a manner which sufficiently mitigates risk (including financial, transition-washing and reputational risks). To evaluate whether transition financing for activities and entities will be credible, the review considers that the factors in the Guidelines for Credible Transition Finance should be taken into consideration.

Another dimension that the review touches on is the supply of domestic capital and the competition for international capital. As extensively discussed elsewhere, the government is exploring the possibility of U.K. savings (in particular, pensions) being used to fund growth and innovation within the U.K. The review notes that such savings could be invested in, and profit from the successes of, transition solutions. Any policy in the U.K. to attract international finance (and, indeed, U.K. finance) will be competing for such finance against similar financing opportunities in other countries.

What is the main challenge with activity-level funding? How does the review propose addressing it?

The TFCS splits financing into (i) the financing of activities (specific purpose funding, such as to fund the development or use of renewable energy or to fund the retirement of carbon-intensive equipment), and (ii) the financing of entities (such as general purpose financing for entities that are aligning to a credible decarbonisation pathway).

Commercial viability was identified by the review as the main barrier to financing transition activities that are not commercially viable under usual market mechanisms. This may be due to the uncertainties surrounding new technologies or processes, the amount of upfront investment required, the lack of clarity regarding future demand for an activity's output or other risks that private providers of finance are unable to cost or are unwilling or unable to bear.

The review proposes that the solution to solving commercial viability issues is through a combination of supply- and demand-side levers, the use of public and private de-risking mechanisms, as well the development of an enabling policy and regulatory environment. There is no silver bullet; a series of interventions will be required. **The review's recommendations in this regard are set out in the column on the right.**

The review points to the fact that most current transition funding is at an activity-level, which is easier to identify and verify and reflective of the current sophistication of the market. However, to effect an economy-wide transition, funding will, over-time, need to extend to entity-level funding.

What is the main pre-requisite for entity-level financing?

Widespread, credible and consistent transition planning is central to achieving an economy-wide transition. This is because transition plans can provide a valuable source of information about corporate strategy, including concrete steps being taken or planned to ensure timely, meaningful progress towards net zero. The review has noted that, over time, there is an ambition for transition finance to be *"finance which facilitates the delivery of a credible transition plan at both the country and company level"* but, at this stage, *"a credible transition plan cannot always be a pre-requisite for access to transition finance".*[10]

Mandatory requirements in relation to disclosure or adoption of transition plans have already started to emerge. Notably, IFRS S2,[11] the EU Corporate Sustainability Reporting Directive and rules in the U.S. and U.K. require entities to disclose transition plans if they have one. The EU Corporate Sustainability Due Diligence Directive goes a big step further by mandating entities to *"adopt and put into effect"* transition plans, and it remains to be seen whether the U.K. will also go down this path. The review recommends that the U.K. moves forward with mandating transition plans.

With more than 20 jurisdictions representing more than half of global GDP having already decided to use (or started taking steps to introduce) the IFRS sustainability disclosure standards in their legal frameworks, transition planning and related disclosures will rapidly become the norm. Notably, IFRS has assumed responsibility for the U.K. Transition Plan Taskforce ("**TPT**") disclosure-specific materials to support global harmonisation and greater comparability in best practice transition plans.[12]

THE REVIEW RECOMMENDS:

1. **Using public funding** to de-risk relevant activities (in particular, emerging transition solutions for high-emitting sectors) such that they become commercially viable under usual market mechanisms, and repurposing the U.K.'s **private finance institutions**, in a coordinated and coherent manner, to provide such targeted public funding.

2. **Crowding in private capital** through the use of such public funding (the combination being referred to in the review as **blended finance**[9]). Blended finance could take many forms on the "public side", including concessional and/or subordinated debt, grants, guarantees, targeted subsidies and tax incentives, and revenue-supporting mechanisms (such as contracts for difference). The government's ongoing work on a new National Wealth Fund signals its commitment to blended finance as a lever for unlocking private investment in transition technologies and new industries of the future. To facilitate the provision of blended finance, the review also recommends:
   - a single-point, user-friendly gateway through which the private sector can engage;
   - a knowledge bank of replicable transition finance solutions; and
   - a private sector-driven, and government supported, accelerator (the "**Transition Finance Lab**"), based within the Green Finance Institute, to design and test transition finance solutions.

3. **Creating demand signals** to further de-risk transition financing and bolster market confidence in investing in emerging decarbonisation solutions. This could be by ensuring demand for the resultant products and other outputs, including via a more comprehensive and structured approach to demand aggregation (for example, akin to the First Movers Coalition) or public procurement (e.g., a commitment to purchase electricity from renewable sources).

4. **Deploying insurance solutions** to de-risk and support the bankability of financing solutions. Involving insurance firms at an early stage in the development of new technologies and financing solutions has the potential to leverage their skills in understanding and mitigating risk, facilitate the design of insurance products to better address technology and market risks, and aid in the development of risk management standards that can be used alongside the deployment of new products and technologies.

5. **Communicating publicly** the business case for, and benefits of, transition financing to reduce the hesitancy towards, and perceived risks associated with, providing such financing.

6. **Creating the skills needed** to support the widespread provision of transition financing.

[9] Blended finance is the combination of public and private funding with the aim of lowering the risk for and attracting private investment. Blended finance unlocks private investment and enables projects that would not be feasible under purely commercial terms.

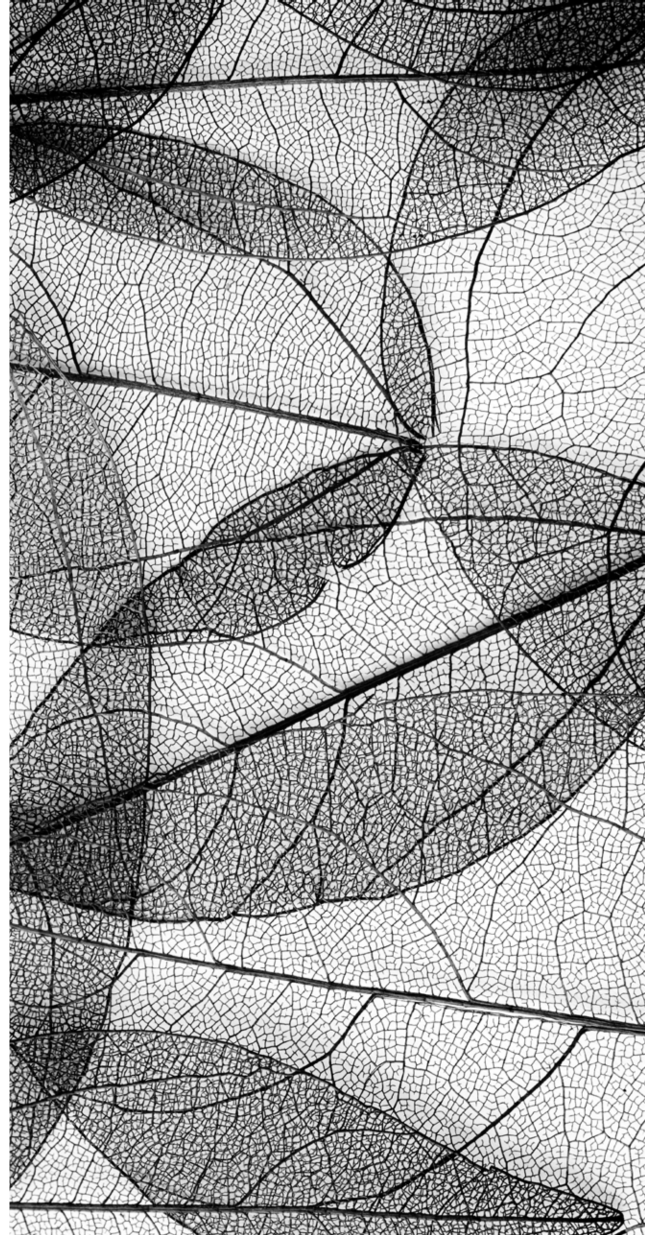
[10] Standards and frameworks for transition planning are at an early stage of development and adoption, and entities need time to familiarise with, design, implement and operationalise transition plans. Entities in emerging markets and developing economies, as well as small and medium enterprises, may also struggle to achieve transition planning without proportionality adjustments.

[11] This refers to the International Financial Reporting Standards ("**IFRS**") sustainability disclosure standard for climate-related disclosures.

[12] Several other governments and regulators have also issued (or consulted on) guidelines in respect of transition planning. It is hoped that the IFRS's endorsement of the TPT's materials can contribute to reducing fragmentation in transition planning approaches.

THE REVIEW ASSESSES SEVERAL CONDITIONS THAT WOULD BOOST THE ADOPTION OF CREDIBLE TRANSITION PLANS, INCLUDING:

- More widespread use of the U.K. TPT disclosure framework on a voluntary basis, while mandatory requirements are not yet present.[13]
- Incentivising the disclosure of good quality forward-looking data in transition plans. This may involve borrowing from the FCA's proposed concept of "*protected forward-looking statements*", as well as improving the market's understanding of liabilities that could arise from omissions or misstatements in transition plan disclosures.
- The creation of granular, sector-specific decarbonisation pathways (as mentioned above) which can inform the development of credible transition plans.
- Developing and strengthening assurance and verification standards in respect of key climate-related data points and processes, and in respect of a transition plan's quality, ambition and viability.
- Ensuring that the ICMA Voluntary Code of Conduct for ESG Ratings and Data Products Providers applies to transition focused, forward-looking scores, opinions, assessments and ratings, to enable greater comparability in the assessment of transition plan strategies and their successes.
- Effective stewardship.
- Communication, education and skills training.



For greater credibility in the transition finance market, entity transition plans must be set within the context of sector transition pathways, which in turn must be set within the context of a national transition plan and a net zero policy, all of which need to have credible funding plans.

Delivery of the policy and plans at each level of the stack is necessary for the continued credibility and success of the other levels in the stack; there is a continuous feedback and reinforcing loop. For the levels to work together, there needs to be clear communication, messaging and information flows between all participants.

[13] Please refer to our client publication *'Roadmap to climate resilience: a legal steer on transition planning'* (June 2024) at https://www.aoshearman.com/en/insights/roadmap-to-climate-resilience-a-legal-steer-on-transition-planning.

Where are the opportunities for industry to get involved?

KEY OPPORTUNITIES TO GET INVOLVED IN THE BURGEONING TRANSITION FINANCE LANDSCAPE INCLUDE:

- Making use of the TFCS and the Guidelines for Credible Transition Finance when evaluating transition finance opportunities – feedback on these tools will likely be welcomed via the **Transition Finance Council**.
- Engaging with upcoming efforts to develop and improve decarbonisation pathways at sector and sub-sector levels (including providing feedback on existing policies and sectoral decarbonisation needs) – engagement will likely be via the **Net Zero Council.**
- Engaging with upcoming efforts to design, develop and test finance structures and solutions (e.g., insurance solutions) to accelerate sector-specific transition pathways – engagement will likely be via the **Transition Finance Lab**, which is expected to be private sector led.
- Engaging with the U.K. TPT disclosure framework and sectoral guidance (where relevant), in anticipation of hardening regulatory requirements on **transition planning** and **sustainability reporting**.
- Engaging with other market-led initiatives to scale transition finance (e.g., the Loan Market Association's consideration of a 'transition' use-of-proceeds loan label).
- Engaging with regulatory initiatives to scale transition finance (e.g., the FCA's Sustainability Improvers label[14]).
- Championing an increasingly sophisticated understanding of transition finance.

WATCHING OUT FOR UPCOMING POLICY MOVEMENTS IN AREAS RIPE FOR CONSULTATION, SUCH AS:

– new sustainability reporting standards aligned with the International Sustainability Standards Board's global baseline reporting standards;

– transition planning and transition plan disclosures;

– U.K. green taxonomy;

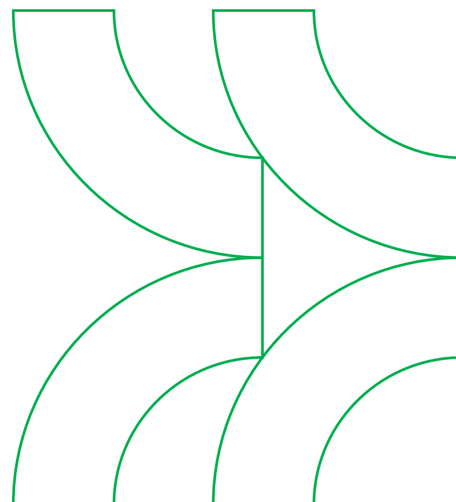
– scaling a high-integrity voluntary carbon market;

– U.K. carbon border adjustment mechanism; and

– demand aggregation for emerging transition activities.

[14] This refers to refers to a label in the U.K.'s sustainability disclosure requirements and investment labels regime. The label may apply to financial products that aim to improve or pursue positive environmental and/or social outcomes indirectly through investing in assets with sustainability characteristics that have the potential to meet a robust, evidence-based standard of sustainability. (Source: FCA Policy Statement 23/16 Annex 2).

What does the review propose with respect to emerging markets?



Supporting transition finance in EMDEs will be critical to achieving the world's collective climate goals. The review looks at the main opportunities and challenges to mobilising transition finance in EMDEs as well as practical and actionable recommendations for the U.K. government to support.

This includes the provision of technical assistance and knowledge-sharing, a rewiring of EMDE grants from the U.K. to support transition activities, and ensuring that the U.K. market and regulatory frameworks accommodate the provision of U.K.-origin financing for decarbonisation in EMDEs.

Opportunities *ahead*

The opportunity described by the TFMR is immense. The U.K. economy needs to transition, and the review proposes a blueprint for financing that transition. Other countries are considering their own transition needs and the associated financing. The U.K. has a rich financial ecosystem and is a world-leading centre of legal excellence, which give it a distinct advantage. Should the U.K. choose to do so, it ought to be able to leverage that expertise and lead the way in transition finance.

AUTHORS

Should you wish to discuss the matters discussed above, please get in touch with the authors or your usual contact at A&O Shearman.

Matthew Townsend
Partner, Global Co-Head, Environment, Climate and Regulatory Law Group, London
Tel +44 20 3088 3174
matthew.townsend@aoshearman.com

James Roe
Partner, Equity Capital Markets, London
Tel +44 20 3088 4637
james.roe@aoshearman.com

Ying-Peng Chin
Senior Knowledge Lawyer, Environment, Climate and Regulatory Law Group, London
Tel +44 20 3088 3708
ying-peng.chin@aoshearman.com

Fleur Clegg
Global Head – ENRI Knowledge, Energy, Natural Resources and Infrastructure, London
Tel +44 203 088 4794
fleur.clegg@aoshearman.com

We were delighted to provide market-leading expertise and legal support to the TFMR secretariat. More than 20 of our experts across multiple specialisms contributed to the TFMR's work. The team was led by partners Matthew Townsend and James Roe and Senior Knowledge Lawyer Ying-Peng Chin (member of the TFMR secretariat).

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