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EU Sustainable Finance and Transition Investments

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The European Union continues to promote and to revise its sustainable finance regime, with ongoing work on the review of the Sustainable Finance Disclosure Regulation ("SFDR"). One point of focus, highlighted in recent opinions by the European Securities and Markets Agency ("ESMA") and the joint European Supervisory Agencies ("ESAs"), is how SFDR and the related EU Taxonomy Regulation ("Taxonomy") approach "transition investments", which are investments to transform assets that are not currently environmentally sustainable. Examples include:

- upgrading assets to reduce their carbon emissions, such as by using carbon capture processes;
- putting in place "enabling" technologies to improve the efficiency of a process and reduce its environmental impact;
- the adoption of green sourcing policies, such as to procure renewable energy to replace existing carbon-based supplies;
- "greening" a company's facilities and support functions, such as improving the energy efficiency of its buildings or adopting electric vehicles; and
- financing the decommissioning of facilities, such as coal-powered energy generation, where technology does not exist to improve their environmental performance.

It is important to distinguish the term "transition investments" from the concept of financing the economy's transition to net zero. While transition investing often transforms assets to improve their sustainability by reference to emissions and climate impact, financing the transition to net zero (and the EU's concept of "transitional activities") refers to a broader range of activities that contribute to climate change mitigation, such as through forestation or renewable energy.

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The Glasgow Financial Alliance for Net Zero's ("GFANZ") has defined four strategies to finance the economy's transition to net zero, namely: *(i)* financing the development and scaling of climate solutions; *(ii)* financing assets or companies already aligned to a 1.5 degrees Celsius pathway; *(iii)* financing assets or companies committed to transitioning in line with 1.5 °C-aligned pathways; and *(iv)* financing the accelerated managed phase-out of high-emitting physical assets, with the last two strategies being types of transition investments.

With the EU Commission's Recommendation on facilitating finance for the transition to a sustainable economy, the EU has also provided a definition of both "transition" and "transition finance":

Transition means transition from current climate and environmental performance levels towards a climate-neutral, climate-resilient and environmentally sustainable economy, in a time frame to reach *(a)* the objective of limiting the global temperature increase to 1.5 °C in line with the Paris Agreement and, for undertakings and activities within the Union, the objective of achieving climate neutrality by 2050 and a 55% reduction in greenhouse gas ("GHG") emissions; *(b)* the objective of climate change adaptation; or *(c)* other environmental objectives, namely pollution prevention and control, protection and restoration of biodiversity and ecosystems, sustainable use and protection of marine and fresh-water resources, and the transition to a circular economy.

Transition finance comprises four types of investments:

(A) Investment in portfolios tracking EU climate transition benchmarks and EU Paris-aligned benchmarks.	This is investment in portfolios, generally of listed investments, that are designed to match or exceed the performance of various EU benchmarks that track the performance of a set of companies, based on factors such as their carbon intensity and decarbonisation rate.
(B) Investment in Taxonomy-aligned economic activities, including Taxonomy-eligible economic activities becoming Taxonomy aligned.	This is investment in companies which derive a proportion of their turnover or have made operational or capital expenditures ("opex" or "capex"), in activities which are aligned with the technical-screening criteria in the Taxonomy, or which have made capex in order to convert or expand activities to become aligned with the Taxonomy in the future. The Taxonomy is the EU classification

for activities that make substantial contributions to various environmental objectives, with companies that meet the technical criteria being considered Taxonomy aligned. The Taxonomy includes rules for companies to classify capex as Taxonomy aligned where the capex is based on a plan to expand or upgrade activities to make them Taxonomy aligned, meeting certain conditions, in particular, that the plan aims to expand or upgrade activities within five years, or, with special justification, 10 years. Where the company wishes to raise finances to make its activities Taxonomy aligned for a longer time frame, or where the company wishes to convert or expand activities for an environmental objective in a manner which is not aligned with the Taxonomy, it can do so under the broader category of raising finance with transition plans, described in (c) below.

Where the investment is by way of loan or bonds, the investment is eligible for the "EU Green Bond" designation, covered in a separate In Depth.

(C) Investment in undertakings or economic activities with a credible transition plan at the level of the undertaking or at activity level.

This is investment in companies which have adopted transition plans, either for the whole company or for a specific activity, that sets out climate or environmental targets and the financing, principally capex, needed to reach those targets. The transition plan will include information on milestones, activities, processes and resources.

Companies can use the Taxonomy criteria for contribution and the "do no significant harm" principle as a resource and guide for these plans, albeit that the outcome of the investment is not intended to be a Taxonomy aligned activity.

(D) Investment in undertakings or economic activities with credible science-based targets, where proportionate, that are supported by information ensuring integrity, transparency and accountability.	This is investment in companies which have set climate or environmental targets in line with publicly available and sector-specific environmental improvements, either for decarbonisation in line with the Paris Agreement or, for instance, the reduction of a company's environmental footprint based on the EU Biodiversity Strategy. This is different from category (C) above in that the investment is not linked to a specific transition plan. Instead, the investor is investing in the company generally on the basis of a company's stated climate or environmental targets, with the investor expected to receive ongoing reporting on the company's progress to those targets.

Any transition investment must avoid "lock-ins", namely long-term lock-ins to GHG-intensive or environmentally significant harmful activities or assets, considering the lifetime of those assets.

Current Position of Transition Finance under SFDR

The SFDR is the framework on disclosure of sustainability features for financial products (including funds) marketed or domiciled in the EU, including financial products which invest with climate emission reduction targets. SFDR contains a broad concept of "sustainable investments" with flexibility for sponsors to define their contribution to specific measurable environmental or social objectives. We describe the current position of transition finance under SFDR.

The Article 8 category of SFDR applies to funds that promote environmental or social characteristics. Firms describe their own criteria for promoting environmental or social characteristics under Article 8 of SFDR. A fund may promote under Article 8, as an environmental characteristic, any of the types of transition finance listed above.

Funds that disclose under Article 8 of SFDR will also specify whether or to what extent they make any sustainable investments under SFDR. Taxonomy-aligned activities

automatically qualify as sustainable investments, including those linked to category (B) of the types of transition finance listed above.

In relation to investments in categories (C) (investments with a credible transition plan) and (D) (investments with credible science-based targets) above, the EU confirmed in 2023 that the sustainable investment concept, and specifically the condition that the investment "does no significant harm" to any environmental or social objective, does not currently accommodate investments doing significant harm at the time of the investment, even where a transition plan is in place which aims to achieve that the "whole investment" does not significantly harm any environmental or social objectives. In other words, where the main thesis for the investment is a transition plan, such as "brown to green" real estate development, the investment is not a sustainable investment until the targeted transition is reached. Until that point, the investment falls in the general category under Article 8 of SFDR of an investment that promotes environmental characteristics and cannot be qualified as a sustainable investment. Hence, financing the retrofitting of existing buildings is not a sustainable investment (unless it can be qualified under the Taxonomy for the strict specifications for "Renovation of existing buildings"), whilst financing the construction of new green-certified buildings is a sustainable investment, which may also qualify for Taxonomy alignment if it meets the technical-screening criteria. The question arises as to whether a fund can qualify an investment as Taxonomy aligned (including on the basis of a capex plan) where the investment does not exclusively conduct Taxonomy-related activities—it is a matter of judgement on the fund's part as to what portion of the company's activities is sufficient. Similarly, the EU's confirmation left open companies qualifying as "sustainable investments" where only part of the company's activities is causing (or may cause) harm and where the fund has a transition plan in place to address it, although that is also a question of judgement for the investor.

Any fund categorised under Article 8 or 9 of SFDR which promotes environmental characteristics must specify and report the degree of alignment of its portfolio with the Taxonomy, which may be zero. The Taxonomy technical-screening criteria include many "transitional activities" that contribute to the transition to a climate-neutral economy, such as renewable power generation. However, the only type of investment covered in the technical-screening criteria for climate change mitigation that is a transition investment, covered by a transition plan, is "Renovation of existing buildings"—other transition investments, such as conversion of carbon-based energy infrastructure to green energy infrastructure, are not covered. As described above, a separate regulation that contains the rules for companies to report under the Taxonomy allows companies to classify capex as Taxonomy aligned where the capex is based on a plan to expand or upgrade activities to make them Taxonomy aligned, meeting certain conditions, in particular, that the plan aims to expand or upgrade activities within five years, or, with special justification, 10 years. This allows companies to qualify capex as

Taxonomy aligned if the capex is linked to a plan to make activities Taxonomy aligned in the future. As above, a Taxonomy aligned investment automatically qualifies as a sustainable investment under SFDR. However, where the company only has a certain percentage of Taxonomy-aligned capex, challenges may arise in qualifying the entire company as a sustainable investment under SFDR.

Expansion of the EU Taxonomy

The Taxonomy flags extending the scope of the Taxonomy to "economic activities that significantly harm environmental sustainability", and the EU has published an in-depth report on this topic: the 2022 Platform on Sustainable Finance published its Final Report on Taxonomy Extension Options. Separately, in its recent opinion on the EU sustainable finance framework, ESMA summarises the EU's ambition for the Taxonomy to cover two types of transition investments:

- Activities for which no technological possibility of improving their environmental performance exists and for which urgent action—exit or decommissioning—is required, with measures to address the impact on people and economies dependent on those activities. Examples are thermal coal mining and solid fuel power generation.
- Activities for which there is a technological possibility of improving their environmental performance and which are in need of an urgent transition to avoid significant harm to environmental objectives. These activities can either be decommissioned, or, with investment, can improve their environmental performance, such as by using carbon capture and storage technology or by using alternative energy sources.

When introduced, the Taxonomy for transition investments will include technical-screening criteria to specify improvement targets and timelines, with criteria to ensure the investment does no significant harm to other environmental objectives. According to the EU's 2022 report, the improvements targets may be linked to the "do no significant harm" criteria in the existing Taxonomy, such as the threshold of 270g of carbon (or equivalent) emissions per kWh for electricity generation projects. Qualitative criteria will also apply. Once the Taxonomy for transition investments is in place, it may be that a sponsor will have the choice of qualifying a transitional investment on the basis of a capex plan, under existing rules, or qualifying a transitional investment under the new Taxonomy, although that is unclear given the EU's general direction to capture all types of sustainable investments within the Taxonomy.

The European Supervisory Authorities have expressed their view that, in time, the tests for contribution and "do no significant harm" assessment through principal adverse impact factors, which sponsors must define to qualify an investment as a sustainable investment, with considerable flexibility given to sponsors, will be less relevant and eventually replaced by the expanded and prescriptive Taxonomy, with the Taxonomy becoming the sole reference point for qualifying investments, including transition investments, as sustainable. This will also require the EU to adopt a Taxonomy for social investments. Given the diversity of strategies that sponsors currently use, including for transition investments, to qualify an investment as sustainable, categorising all such investments within the Taxonomy is an ambitious target and will likely lead to fewer sponsors promoting a sustainable strategy.

New Category of "Transition" Funds

As above, SFDR allows Article 8 funds that do not commit to invest in sustainable investments to invest in transition investments, according to criteria developed by the fund sponsor. An Article 8 fund that commits to invest in sustainable investments and an Article 9 fund that invests exclusively in sustainable investments have limited ability to invest in transition investments, because the investments will usually be based on addressing some current harm, such as a high level of carbon emissions —and, as above, that conflicts with the principle that all such investments "do no significant harm" to any environmental or social objective from the outset.

With the SFDR, both ESMA and the European Supervisory Authorities have published their view that there should be a new category of "transition" funds, incorporating a definition of "transition investments" alongside a new category of "sustainable" funds. The "transition" category will likely involve disclosure of transition plans, decarbonisation trajectories and relevant principal adverse impact data, with the updated SFDR potentially setting a minimum level of mitigation. This will be a helpful development, although the EU will need to consider both the position of funds that only want to make a portion of "transition" investments and legacy funds that have to date accommodated transition investments within the broad Article 8 category of funds that promote environmental or social characteristics.

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