Sustainable Markets Initiative

ACCELERATING VIABLE TRANSITION FINANCE STRUCTURES

RECOMMENDED ACTIONS

ASSET MANAGER & ASSET OWNER TASK FORCE

January 2022

ABOUT THE ASSET MANAGER & ASSET OWNER TASK FORCE

The Sustainable Markets Initiative (SMI) was formed at the invitation of His Royal Highness the Prince of Wales, at the World Economic Forum (WEF) Annual Meeting 2020, with the goal of creating a coalition of parties who share his view that progress towards a sustainable future must be accelerated. The Asset Manager & Asset Owner Task Force is a sub-group of the SMI formed of a group of CEO-level executives from a number of the world's largest asset manager and asset owners. It brings together senior leaders to develop and enable solutions to help accelerate the transition to sustainable markets and support the rapid decarbonisation required across the real economy using the two most powerful levers at their disposal: capital already invested in companies and fresh capital investments directed at climate mitigation and adaptation projects.

Members of the Asset Manager & Asset Owner Task Force Include:

AP2
Bank of America Merrill Lynch Asset Management
Brookfield Asset Management
CalPERS
CalSTRS
Capital Group
CDPQ
Fidelity International
Gulf Capital
HSBC Asset Management
JPMorgan Asset Management
Kuwait Investment Authority
Legal & General Investment Management
Macquarie
Morgan Stanley
National Employment Savings Trust
New Zealand Superannuation Fund
Ninety One
PensionDanmark
People's Pension
PIMCO
PKA
Rockefeller Capital Management
Schroders
TIAA/Nuveen
Vanguard
Washington State Investment Board
Wells Fargo Asset Management

THIS DOCUMENT IS THE PRODUCT OF THE TRANSITION FINANCE WORKING GROUP OF THE SMI ASSET MANAGER & ASSET OWNER TASKFORCE

Chaired by

Morgan Stanley

CONTENTS

EXECUTIVE SUMMARY

Despite the growing supply of capital for sustainable investing globally, persistent barriers remain to financing projects, technologies and companies that are critical to achieving a full and responsible transition to a net-zero and nature-positive future. Convened under the Sustainable Markets Initiative Asset Manager & Asset Owner taskforce, the Transition Finance Working Group has codified a set of findings and recommendations to accelerate the flow of capital, at scale, toward viable transition finance structures. In summary:

- Financial capital is needed to **support a range of industries, economic activities and companies across the "transition readiness spectrum"**. Market actors should prioritize evaluation of transition pathways or readiness over absolute, point-in-time metrics such as carbon intensity, in order to finance an effective and inclusive transition.

- Ambitious action and coordination are needed across asset managers, asset owners and allocators, Multilateral Development Banks (MDBs), Development Finance Institutions (DFIs) and policymakers in order to **accelerate the speed-to-market, private capital participation and scale of transition funds**.

- Asset managers have increasing opportunity to **attract a broad spectrum of capital into credible and scalable transition finance products**, informed by existing market structures across varied risk-return profiles and by areas of common ground among private investors and MDBs/DFIs.

- Asset owners should **clearly define and document commitments to deploy capital toward transition finance**, in order to establish internal alignment and provide clear market signals.

- MDBs and DFIs can increase the flow of transition projects while lowering perceived and real risk for investors through greater use of instruments such as **guarantees and long-term FX hedging, and publicizing data on historical investments**.

- Policymakers should focus on **clarifying the regulatory environment for transition finance**, including the use of mechanisms such as subsidies or tax schemes with predictable longevity and glidepath that can support long-term investment and decision making.

INTRODUCTION

As long-term and global investors, we recognize the imperative for responsible transition pathways to decarbonize and achieve net-zero greenhouse gas (GHG) emissions in addition to creating a nature-positive future with a focus on biodiversity regeneration. Achieving this transition will require ambitious action and coordination across the public and private sectors. In particular, sustainable investment and industry action will be required—at scale—to simultaneously reduce emissions and support critical new solutions across the 10 Transition Coalitions identified by the Sustainable Markets Initiative: Energy, Natural Capital, Road Transport, Fashion & Textiles, Health Systems, Technology, Waste, Plastics & Chemicals, Aviation and Shipping.

Despite the growing global supply of capital for sustainable investment, we recognize several barriers that have historically slowed or prevented the flow of capital to critical transition projects, sectors and geographies.[1] Addressing these barriers will require concerted action on behalf of stakeholders across the global capital markets, including asset managers, sponsors and underwriters; asset owners and allocators; Multilateral Development Banks (MDBs) and Development Finance Institutions (DFIs); and policymakers. **This document aims to codify actionable recommendations for market participants to accelerate the scale and speed of capital toward viable and credible transition finance structures.**

These recommendations were informed by a review of transition finance structures across sectors, technologies, geographies, and degrees of success. Despite the wide range of viable transition finance structures, we believe the hallmarks for achieving scale and impact include a credible and inclusive transition definition, a supportive enabling and policy environment, and appropriate levels of blended finance and investment de-risking.

[1] For a fuller discussion of barriers, see SMI's June 2021 commissioned report, "Scaling Private Sector Investment in Sustainable Projects"

SCOPE AND AIMS OF TRANSITION FINANCE

Financial capital is needed to support a range of industries and economic activities in their transition to a net-zero emissions and nature-positive future. Individual companies and projects may fall along a spectrum of "transition readiness", broadly defined as the capacity to reduce emissions and, over time, protect and restore nature. This spectrum may be categorized as follows:

- **Credible Transition Pathway:** Companies with a clear pathway to net zero emissions and/or nature-positivity by 2050 or sooner
- **Interim Transition:** High-emitting companies actively working to reduce emissions, but who may be lacking viable transition plans
- **Transition Amidst Growth:** Companies that are significantly reducing emissions intensity (per unit of output) but whose overall emissions are still rising as a result of operating in high-growth sectors or economies

By financing and working with companies across this transition readiness spectrum, we believe that investors can support an inclusive transition while reducing real-world emissions and environmental impacts.

However, to accelerate the speed-to-market, private capital participation, and scale of transition funds, we believe a number of actions are needed by the four relevant key stakeholder groups—asset managers, sponsors and underwriters; asset owners and allocators; Multilateral Development Banks (MDBs) and Development Finance Institutions (DFIs); and policymakers. The key aims that should guide the actions of each stakeholder group are outlined in the table that follows.

Key aims that should guide the actions of each stakeholder group

STAKEHOLDER GROUP	TRANSITION FINANCE AIMS
Asset managers, sponsors, underwriters	**1.** Develop and launch credible and scalable transition finance products **2.** Attract capital into credible transition finance products
Asset owners and allocators	**3.** Commit capital to transition finance **4.** Commit to supporting industry best practices for transition finance, and communicating progress with stakeholders
Multilateral Development Banks (MDBs) and Development Finance Institutions (DFIs)	**5.** Strengthen enabling environment for transition activities **6.** Invest in activities that can increase speed-to-market of scalable transition finance funds
Policymakers	**7.** Clarify the regulatory environment for transition finance **8.** Expand active measures to fund transition activities

RECOMMENDED ACTIONS FOR MARKET PARTICIPANTS

The following sections include a comprehensive list of recommended actions we believe can accelerate the scale and speed of public and private capital toward viable and credible transition finance structures.

Among these actions, the following stand out as **near-term priorities**.

ALL STAKEHOLDERS

PRIORITIZE MEASURES OF TRANSITION OVER ABSOLUTE EMISSIONS

When setting policy, structuring funds or allocating capital, stakeholders should prioritize an understanding of *transition pathways* (e.g., transition metrics & transition readiness assessments) over absolute, point-in-time metrics such as carbon intensity, in order to fund an effective and inclusive transition.

ASSET OWNERS

DOCUMENT COMMITMENTS TO DEPLOY CAPITAL TO TRANSITION FINANCE

Asset owners should look to document the business case for transition finance investment, as well as clear objectives for impact and returns, within the institution's investment beliefs and/or policy statement in order to create internal alignment across leadership and investment staff, and embed the commitment to fund transitions.

MDBs AND DFIs

INCREASE FLOW OF TRANSITION PROJECTS WHILE LOWERING PERCEIVED AND REAL RISK FOR INVESTORS

Multilateral Development Banks (MDBs) and Development Finance Institutions (DFIs) can play an active role in catalyzing private sector capital into transition projects in emerging markets. Key areas of focus should be increasing & coordinating project preparation grants, increasing incentives to deploy risk mitigating instruments such as guarantees and long-term FX hedging to alleviate commercial and currency risk, and publicizing data on historical investments, including default rates by market sector & participants. Together, these measures could help increase the flow of projects and induce private institutional capital into vehicles that fund credible emerging markets transition projects by reducing both real and perceived risk.

DETAILED RECOMMENDATIONS FOR ASSET MANAGERS, SPONSORS AND UNDERWRITERS

ASSET MANAGERS ASSET OWNERS MDBs AND DFIs POLICYMAKERS ALL STAKEHOLDERS

AIM 1: Develop and launch credible and scalable transition finance products

RECOMMENDED ACTIONS	COMMON BARRIERS	KEY PARTNERS
• Seek to replicate and scale transition finance structures that have worked.	• Extended fundraising and capital deployment cycles associated with bespoke or first-time structures	MDBs AND DFIs ASSET OWNERS
• When evaluating investments, prioritize an understanding of transition pathways (e.g., transition metrics & transition readiness assessments) over absolute, point-in-time metrics such as carbon intensity, in order to fund an effective and inclusive transition.	• Common accounting practices focused on emissions and intensity metrics; relatively early progress on codifying transition metrics/ assessments	ALL STAKEHOLDERS
• Focus on areas of "common ground" between DFIs/MDBs and private investors in order to deploy the most capital toward high impact transition sectors, regions, technologies and deal types. • Acknowledge that blended finance structures may not be appropriate in all scenarios. Where using blended finance, design a clear rationale for addressing specific sector or geographic risks. Also consider ways to leverage sources philanthropic or public sector capital outside of a fund structure—e.g., technical assistance or grant funding for project preparation and accelerating technology deployment in hard-to-reach geographies.	• Limited precedent for public-private partnerships or blended finance structuring at private sector asset managers	MDBs AND DFIs ASSET OWNERS

AIM 2: Attract capital into credible transition finance products

RECOMMENDED ACTIONS	COMMON BARRIERS	KEY PARTNERS
• Articulate a clear thesis and glidepath to commerciality of underlying investments–i.e., a built-in endpoint for blended finance or de-risking mechanisms.	• Limited precedent or disparate experience with transition-focused investments; unclear or volatile policy environment	MDBs AND DFIs POLICYMAKERS
• Ensure and illustrate varied risk-return profiles to attract a full-spectrum of investors–i.e., between low-yielding debt to high-risk equity.	• Perception that transition finance is niche and limited to narrow or "impact-first" investor base	MDBs AND DFIs
• Seek to attract multiple sources of capital–institutional private capital, local private capital, local governments, and MDBs/DFIs–in order to achieve both scale and credibility. • When raising private capital, target at least some institutions that are well positioned to repeat for follow-on funds.	• Lack of programmatic allocation to transition finance, underpinned by strategic relationships and connectivity with sources of public and private capital	MDBs AND DFIs ASSET OWNERS

DETAILED RECOMMENDATIONS FOR ASSET OWNERS AND ALLOCATORS

ASSET MANAGERS · ASSET OWNERS · MDBs AND DFIs · POLICYMAKERS · ALL STAKEHOLDERS

AIM 3: Commit capital to transition finance

RECOMMENDED ACTIONS	COMMON BARRIERS	KEY PARTNERS
• Document the business case for transition finance investment, as well as clear objectives for impact and returns, within the institution's investment beliefs and/or policy statement in order to create internal alignment across leadership and investment staff. • Embed transition finance considerations within strategic asset allocation decisions. • Clearly communicate expectations with managers for participating in follow-on funds to ensure timely repeatability and scalability of successful transition finance structures.	• Lack of strategic direction on transition finance from senior leadership	ALL STAKEHOLDERS
• Seek to support investment managers working with high-emitting companies to transition, while limiting the use of divestment purely to reduce current portfolio emissions.	• Divergence of transition finance structures and approaches; stakeholder pressure on divestment or achieving explicit emissions/intensity targets	ASSET MANAGERS POLICYMAKERS

AIM 4: Commit to supporting industry best practices for transition finance, and communicating progress with stakeholders

RECOMMENDED ACTIONS	COMMON BARRIERS	KEY PARTNERS
• Actively participate in industry working groups and open consultations to help codify common, usable and accessible categories and standards for transition finance. • Where resourcing permits, commit to openly sharing transition finance approaches and best practices in order to serve as a model for other institutions just beginning to consider transition finance commitments. • Use common industry frameworks and definitions (e.g., UN Sustainable Development Goals, EU Taxonomy, Impact Management Project) wherever possible to prioritize and facilitate collective action over individual/ in-house impact criteria.	• Time and resource constraints • Lack of strategic direction or commitment on transition finance from senior leadership	ALL STAKEHOLDERS
• When evaluating investments/managers, prioritize an understanding of transition pathways (e.g., transition metrics & transition readiness assessments) over absolute, point-in-time metrics such as carbon intensity, in order to fund an effective and inclusive transition.	• Common accounting practices focused on emissions and intensity metrics; relatively early progress on codifying transition metrics/ assessments	ALL STAKEHOLDERS

DETAILED RECOMMENDATIONS FOR MDBs AND DFIs

ASSET MANAGERS · ASSET OWNERS · MDBs AND DFIs · POLICYMAKERS · ALL STAKEHOLDERS

AIM 5: Strengthen enabling environment for transition activities

RECOMMENDED ACTIONS	COMMON BARRIERS	KEY PARTNERS
• Increase availability of project preparation grants and facilities, including coordinating efforts among agencies to ease the regulatory approval process. • Publicize data on historical finance allocations (e.g., default rates by market, sector, and participants).	• Insufficient coordination across agencies and national regulators	POLICYMAKERS
• Modernize institutional mandates by adding incentives to deploy risk-mitigating instruments such as guarantees and long-term FX hedging to alleviate commercial and currency risk, which would induce private capital into transition finance structures by reducing both real and perceived risks. • Increase allocations to diverse and emerging fund managers, particularly those that are representative of global populations impacted by climate and economic transition.	• Time, resource and expertise constraints; lack of strategic alignment on transition finance needs within emerging market & developing countries (EMDCs)	ALL STAKEHOLDERS ASSET MANAGERS

ASSET MANAGERS ASSET OWNERS MDBs AND DFIs POLICYMAKERS ALL STAKEHOLDERS

AIM 6: Invest in activities that can increase speed-to-market of scalable transition finance funds

RECOMMENDED ACTIONS	COMMON BARRIERS	KEY PARTNERS
• Create mechanisms to aggregate transition deal sourcing and coordinate diligence expertise across emerging markets, in order to support capital allocation at scale. • Publicize data on historical finance allocations (e.g., default rates by market, sector, and participants).	• Lack of national platforms for financial institutions	POLICYMAKERS
• Streamline internal approval processes–i.e., from a project-by-project basis to a programmatic approach–while prioritizing an understanding of transition pathways (e.g., transition metrics & transition readiness assessments) over absolute, point-in-time metrics such as carbon intensity, in order to fund an effective and inclusive transition. • Create a common DDQ covering primary requirements for transition finance managers. • Invest in strategic relationship management function in order to deepen understanding of asset manager and allocator priorities and facilitate more rapid transition finance partnerships.	• Time and resource constraints; lack of strategic alignment or communication on transition finance priorities	ASSET MANAGERS ASSET OWNERS

DETAILED RECOMMENDATIONS FOR POLICYMAKERS

ASSET MANAGERS · ASSET OWNERS · MDBs AND DFIs · POLICYMAKERS · ALL STAKEHOLDERS

AIM 7: Clarify the regulatory environment for transition finance

RECOMMENDED ACTIONS	COMMON BARRIERS	KEY PARTNERS
• Establish clear support and funding for transition sectors and technologies, but do so through mechanisms such as subsidies or tax schemes with predictable longevity and glidepath, in order to support long-term decision making by private investors who can deploy capital at scale.	• Political volatility tied to common support mechanisms such as subsidies or tax schemes	ALL STAKEHOLDERS
• Develop, codify and endorse capital markets mechanisms to support scalable and credible transition finance in the public markets, especially in emerging markets. • Support harmonization of transition finance categories/taxonomies—with a focus on understanding transition pathways over absolute, point-in-time metrics—to enable clearer alignment of capital sources while reducing the proliferation of costly data systems.	• Lack of regulatory focus or expertise	ALL STAKEHOLDERS
• Modernize risk management frameworks at local commercial banks (e.g., use of customer payment history to facilitate receivables financing).	• Lack of regulatory capacity in project host countries	ALL STAKEHOLDERS

AIM 8: Expand active measures to fund transition activities

RECOMMENDED ACTIONS	COMMON BARRIERS	KEY PARTNERS
• Expand the use of Green Banks to fund capital-intensive transition technologies with blended public/private capital—with a plan for ultimate private sector ownership. • Develop or identify mechanisms to cover outsized set-up and operating costs of innovative transition finance structures, including credible data and measurement tools. • Better prepare project developers with access to information about risk-mitigation tools available—e.g., offtake and other insurance mechanisms, TA, grants.	• Lack of regulatory capacity in project host countries	ALL STAKEHOLDERS

CONCLUSION

The recommended actions presented in this document are necessary but insufficient to achieving the greater aims set forth by the Sustainable Markets Initiative and its collaborators. We recognize that an inclusive transition to a net-zero and nature-positive economy will require collective effort across multiple industry sectors and solutions represented by the Sustainable Markets Initiative's 10 Transition Coalitions: Energy, Natural Capital, Road Transport, Fashion & Textiles, Health Systems, Technology, Waste, Plastics & Chemicals, Aviation and Shipping. However, we believe the role of capital markets participants—including asset managers, asset owners and allocators, DFIs and MDBs, and policymakers—is critical to providing the financing, at scale, necessary to achieve this credible and inclusive transition.

Special thanks to Courtney Thompson and Haley Hattendorf for their work on this report.

CONTACTS

For more information about the SMI, visit

www.sustainable-markets.org

For enquiries, contact

info@sustainable-markets.org

Sustainable Markets Initiative