

Guardrails to address greenwashing of climate transition finance

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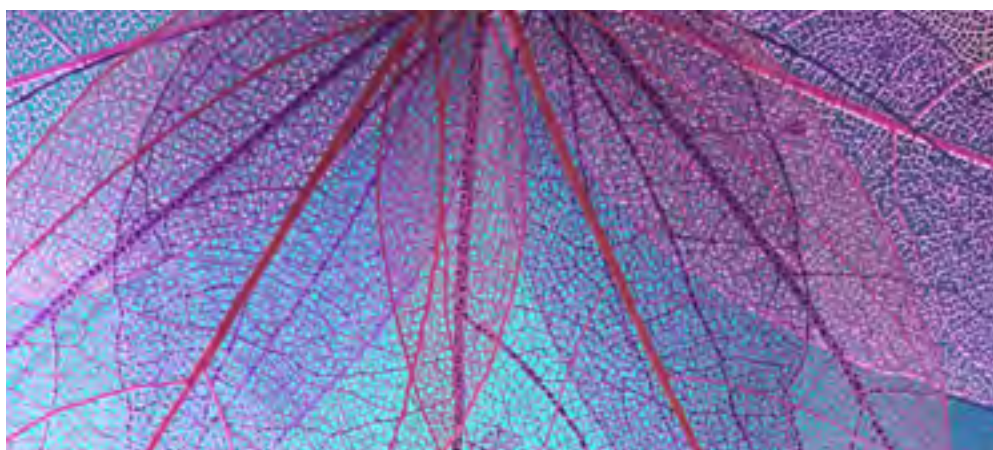
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EXECUTIVE SUMMARY

The world's transition to net zero greenhouse gas emissions is as urgent as ever. Increasingly, climate transition finance is being recognised by policymakers and the private sector as a potentially critical lever for making finance flows consistent with an emissions reduction pathway that aligns with the Paris Agreement temperature goals and mitigates climate transition risks.

This paper is focused on how to raise standards in markets for labelled climate transition finance debt instruments, which have been most closely associated with the transition finance concept to date. The potential of these instruments has been lauded given their inclusivity of carbon-intensive sectors, which have been estimated to make up over 90% of the global economy, and their entity-level focus. If restricted to firms executing a credible Paris-aligned transition strategy, labelled transition finance instruments could prove to be a key cog in facilitating and incentivising the real economy's climate transition and thereby limiting the worst impacts of climate change.

It is therefore imperative that these markets scale up and function with high integrity. However, there is increasing evidence that labelled transition finance in the debt capital markets is stalling due to widespread concerns about greenwashing or, more specifically, transition-washing. Transition-washing occurs where transition finance is provided to entities that are not in fact, or have no meaningful intention to, transition their business to net zero greenhouse gases at the pace required to achieve the Paris Agreement temperature goals. If this issue is not addressed, investor concerns about transition finance markets are likely to deter their continued growth and, more importantly, there is the significant risk of a large-scale misallocation of capital that would delay or obstruct the achievement of the Paris Agreement goals. In response to these concerns, investors and some policymakers are increasingly calling for more robust standards to improve the quality of transition finance instruments.

Based on an analysis of the markets for sustainability-linked bonds and Japanese transition-labelled bonds, this paper makes recommendations as to the critical ingredients of an effective policy response to the issue of transition-washing in labelled transition finance debt markets in the corporate sector, and particularly bond markets. The recommendations may also be useful to policymakers considering how to address transition-washing in other areas of the market – e.g. loan, equity and fund markets. Recognising that no one size can fit all, the recommendations are framed at a deliberately high level, and aim to provide policymakers with a 'helicopter view' of relevant options, precedents and key considerations that they can adapt to local needs and contexts.

The six recommended policy guardrails are set out in the table below and can be segmented into three parts. Guardrails 1 – 3 build on the existing literature as to how **market-supporting tools** can help firms to prepare, and investors to assess, science-based and high integrity transition strategies that mitigate transition-washing risks, including those relating to carbon lock-in. Guardrails 4 – 5 make the case for incorporating such tools into a targeted and proportionate **regulatory framework** aimed at addressing the transition-washing of particular protected transition finance labels. Such regulation would aim to create, within the regulatory perimeter, a high integrity market where genuine climate leaders in carbon-intensive sectors can receive benefits including a cheaper cost of capital. Guardrail 6 contains a recommendation that policymakers also develop supporting **systemic reforms** to scale up effective transition finance as a whole, both labelled and unlabelled, to encourage greater urgency and integrity in corporate transition planning that will of itself mitigate transition-washing risk. It provides illustrative examples of policies recommended to be worthy of consideration in this regard.

Together, these guardrails seek to demonstrate the opportunity to create, and outline the critical ingredients of, policy frameworks that can blend the apparent need for a robust transition finance rulebook with a pragmatism that the complexity and changeable nature of climate transition finance requires. Without these, transition finance is unlikely to play its part in catalysing and accelerating a Paris-aligned net zero transition in the real economy.

Guardrails to address transition-washing and scale up transition finance

Problem Statement	Policy Guardrails
<p>A. There is a shortage of scientifically robust, Paris-aligned transition pathways for carbon-intensive sectors and activities, tailored to particular geographies.</p>	<p>Guardrail 1: prepare national (or regional) Paris-aligned emissions reduction pathways to: (a) lend scientific credence to differences between emissions reduction trajectories of corporates operating in developing versus developed economies; and (b) provide a better foundation for the development of other policy tools for labelled transition finance, including targeted financial regulation.</p>
	<p>Guardrail 2: prepare (or approve) scientifically robust classification standards for carbon-intensive activities and associated technologies, incorporating robust mechanisms to mitigate the risk of carbon lock-in such as detailed, science-based criteria setting out: (a) which carbon-intensive activities / technologies are within the scope of Paris-aligned sectoral transition pathways; and (b) the required emissions reduction trajectory of those activities / technologies.</p>
<p>B. Firms are not required to benchmark transition plans and strategies against any particular Paris-aligned standards or pathways. The majority of such plans and strategies are not aligned with achievement of the Paris temperature goals at present.</p>	<p>Guardrail 3: build capacity in the market for external verification, so that second party opinion providers are capable of navigating uncertainties across evolving national and international transition finance tools, in order to provide investors with a clear view on the Paris-alignment and scientific credibility of a transition finance instrument on a case by case basis.</p>
<p>C. Firms are financially and reputationally incentivised to raise transition finance, even where they are not transitioning their whole business including Scope 3 emissions. Transition finance standards are non-binding and regulatory action to raise market standards has not yet materialised. External verification exercises have not provided meaningful challenge to issuers. Overall, firms are not meaningfully incentivised to issue high quality transition finance debt instruments.</p>	<p>Guardrail 4: implement targeted financial regulation providing mandatory threshold requirements for credible use of protected labels in transition finance bond markets, including alignment of the issuer's groupwide Scope 3 net zero targets, underpinning transition strategy and instrument-level uses of proceeds (where relevant) with science-based pathways aligned with the Paris temperature goals, together with policy incentives to encourage use of the protected labels.</p>
	<p>Guardrail 5: empower financial regulators to penalise transition-washing where mandatory rules contained in generally applicable securities regulations, or targeted transition finance regulation, are being breached, for example through allocation of additional financial resources, boosting technical expertise and/or setting out a framework definition of transition-washing.</p>
<p>D. The prevalence of transition-washing is contributing to misallocations of capital and investor concerns about transition finance generally. This has resulted in lost growth momentum in labelled transition finance in the debt capital markets, which remain very small. To make up the climate finance shortfall needed urgently to achieve the Paris temperature goals, policymakers need to consider more systemic reforms.</p>	<p>Guardrail 6: implement systemic reforms to scale up transition finance, both labelled and unlabelled, such as by mandating the Paris-alignment of the business strategies of large firms or progressively restricting access to public markets to firms with Paris-aligned transition plans and strategies.</p>

INTRODUCTION

The transition to net zero greenhouse gas emissions has been described by prominent financial policymakers as the industrial revolution of our time.¹ The Glasgow Financial Alliance for Net Zero ("**GFANZ**") estimates that US\$100tn of finance is needed to achieve net zero at the global level over the next three decades.² The importance of finance in the struggle to mitigate the worst impacts of climate change is also reflected in Article 2(1)(c) of the Paris Agreement, where the international community agreed to make finance flows consistent with a pathway towards low greenhouse gas emissions.

Climate transition finance ("**transition finance**") has emerged to facilitate and incentivise the emissions reduction pathways of carbon-intensive businesses, sectors and sovereigns. Policymakers are increasingly agreed that the integrity of transition finance is pivotal for the achievement of the Paris Agreement temperature goals. It is therefore vital that policymakers are able to tackle the challenge of greenwashing or, more specifically, **transition-washing**: the provision of transition finance to entities that are not in fact, or have no meaningful intention to, transition their business to net zero greenhouse gases at the pace required to achieve the Paris Agreement temperature goals. Failure to address transition-washing will, at best, threaten to undermine transition finance flows as investors become more wary of their exposure to transition-washing risks and could, at worst, lead to a massive misallocation of capital to non-transitioning entities, activities and/or technologies that lock in economic dependency on carbon-intensive processes. Such a misallocation of capital at scale could, in other words, significantly delay or obstruct the achievement of the Paris Agreement goals.

The precise boundaries of transition finance remain in flux, and one important recent trend has been greater recognition of the distinction between labelled transition finance, financial instruments bearing a specific label to represent that the finance will be used to further the fundraiser's transition strategy, and unlabelled transition finance, meaning any other finance provided for that purpose but not bearing a specific label i.e. 'vanilla' financing. However, since its emergence around 2020,³ the transition finance concept has generally been closely associated with markets for labelled debt instruments, specifically climate-related sustainability-linked loans and bonds and, especially in China and Japan, explicit transition-labelled loans and bonds.

This paper is focused on the issue of transition-washing in labelled transition finance markets, and in particular bond markets. Its purpose is to assist policymakers seeking to address transition-washing in these markets, through the recommendation of policy guardrails, capable of adaptation for different national and regional contexts, that can mitigate transition-washing risks in these markets and so rejuvenate labelled transition finance and its prospects as a potential catalyst for the global climate transition.

The paper is comprised of three parts.

Part A will discuss the parameters of transition finance, the typical characteristics of instruments utilising the "sustainability-linked" and "transition" labels, and the potential of these instruments (whether loans or bonds) and the wider concept to facilitate and incentivise a whole-of-economy net zero transition.

Part B will consider the characteristics and root causes of transition-washing, taking the markets for sustainability-linked and transition-labelled bonds as case studies, the latter with particular reference to Japan's domestic policy framework.

Part C will recommend a non-exhaustive set of policy guardrails that can help to address the root causes of transition-washing in the markets for labelled bond instruments, whilst recommending further systemic reforms to increase transition finance flows of all types, beyond labelled markets.

Ultimately, the paper is intended to highlight opportunities to create transition finance policy frameworks that can help turbocharge the climate transition, including complementary roles for market-supporting tools, targeted and proportionate financial regulation and systemic whole of economy reforms.

PART A: WHAT IS CLIMATE TRANSITION FINANCE AND WHY IS IT IMPORTANT?

THE CASE FOR AN ORDERLY CLIMATE TRANSITION

In Article 2(1)(a) of the Paris Agreement, the international community agreed to hold the increase in global average temperature to well below 2°C above pre-industrial levels whilst pursuing efforts to limit the temperature increase to 1.5°C above pre-industrial levels (the “**Paris Temperature Goals**”).

However, according to the latest reports of the UN’s Intergovernmental Panel on Climate Change (“**IPCC**”), global warming is likely to surpass 1.5°C in the near term⁴ and Earth is on a course for overall warming of approximately 2.8°C by 2100.⁵ This could lead to large parts of the tropics becoming uninhabitable, widespread crop failures, sea level rise measured in metres and a high risk of crossing further climate tipping points (e.g. collapses of icesheets, rainforest ecosystems and ocean circulation systems⁶) that could cause further jumps in temperature rise.⁷ The IPCC has warned policymakers that:



there is a rapidly closing window of opportunity to secure a liveable and sustainable future for all.⁸



To have a greater than 50% chance of limiting warming to 1.5°C with no or limited overshoot, global emissions must peak by 2025 at the latest, and fall by 43% by 2030 and then 84% by 2050 compared to 2019 levels.⁹ To have a greater than 67% chance of limiting warming to 2°C, global emissions must fall by 27% by 2030 and 63% by 2050.¹⁰

Aside from the grave human suffering at hand, many studies have made the compelling economic case for an orderly, Paris-aligned climate transition (in this paper, references to “**Paris-alignment**” mean consistency with the achievement of the Paris Temperature Goals).¹¹ One study finds that, on its present transition trajectory, the world stands to lose close to 10% of economic value by mid-century.¹²

Transition risks resulting from the world’s transition to net zero may also be significant.¹³ The prospect of widespread asset devaluations and stranding resulting from the transition,¹⁴ potentially wiping out trillions of dollars from asset values,¹⁵ could materially damage financial and price stability.¹⁶ In contrast, an orderly transition to net zero greenhouse gases without the requirement for a series of ‘handbrake turns’ by policymakers would serve to mitigate the risk of widespread asset stranding. An orderly wind down of certain economic activities can also support a just transition and help to mitigate related social risks, such as those relating to energy poverty and high levels of unemployment in stranded carbon intensive sectors.

THE UTILITY OF CREDIBLE LABELLED TRANSITION FINANCE

Transition finance is generally understood to mean finance provided to high-emitting economic businesses, sectors and sovereigns for the purposes of their transitions to net zero. It is distinguishable from green finance, which is generally regarded as being for discrete low- or zero-emitting economic activities and projects.¹⁷

Policymakers are increasingly recognising the innate potential of transition finance.¹⁸ For example, Ravi Menon has commented that because low- or zero-emitting activities are estimated to make up less than 8% of the global economy:



green finance alone is not enough. The world needs transition finance – to provide the funding support for businesses and sectors that are not so green, to...become greener over time.¹⁹



As will be discussed, the precise definition of transition finance is still in flux. The International Capital Market Association (“**ICMA**”) has recently identified that there are at least three overlapping definitions of the concept in general use, each of which implies a different scope.²⁰ An increasingly important distinction is that between for purpose, labelled transition finance instruments (the focus of this paper) and ‘vanilla’, unlabelled financing applied towards the transition.²¹

Uncertainty notwithstanding, it is suggested that the core utility of transition finance is its potential to facilitate and incentivise net zero transitions based on the terms and conditions on which such financing is provided. On this basis, many proponents such as ICMA and the Organisation for Economic Co-Operation and Development (“**OECD**”) have sought to restrict the concept to financing for corporates undertaking whole-of-group transitions.²² For firms earnestly undertaking such transitions, labelled transition finance markets should theoretically be capable of reflecting mitigated transition risks in a cheaper cost of capital, supported by continued high investor demand for sustainable financial products.²³ Effective labelled transition finance markets could, in other words, prove vital to facilitating and incentivising the real economy’s climate transition.

WHAT DEBT INSTRUMENTS FALL UNDER THE LABELLED TRANSITION FINANCE UMBRELLA?

The financial instruments recognised as falling under the labelled transition finance umbrella are likely to expand and develop over time. Box A sets out the key characteristics of sustainability-linked and transition-labelled debt instruments, which have been most closely associated with the concept to date.²⁴

SUSTAINABILITY-LINKED FINANCE

- General purpose instruments the characteristics of which change depending on whether the fundraiser achieves pre-defined sustainability performance targets (“**SPTs**”). Includes sustainability-linked bonds (“**SLBs**”) and sustainability-linked loans (“**SLs**”). Specific uses of proceeds are not required.
- Failure to meet any target will typically lead to the fundraiser being penalised, most commonly via an increase in their cost of capital from the point of failure onwards. Meeting any target may alternatively lead to a reward, such as a reduction in the cost of capital.
- Fundraisers will typically obtain a pre-transaction second party opinion (“**SPO**”) regarding the relevance and robustness of key performance indicators (“**KPIs**”) and SPTs. Post-transaction, fundraisers will typically publish at least annual reports of progress against the SPTs, verified by an external reviewer.

TRANSITION-LABELLED FINANCE

- Instruments with specified uses of proceeds tied to particular projects or activities (similarly to green finance). Includes transition-labelled bonds and transition-labelled loans.
- Pre-transaction, fundraisers will typically obtain second party verification of their transition strategies, and alignment of the proposed uses of proceeds with such strategies.
- Post-transaction, fundraisers will typically prepare periodic allocation reports as to the uses of proceeds, verified by an external reviewer. They may also prepare impact reports.

PART B: "TRANSITION-WASHING": THE GREENWASHING OF TRANSITION FINANCE

WHAT IS TRANSITION-WASHING?

Transition-washing is a sub-category of greenwashing. The concept of greenwashing in essence refers to claims, acts or omissions that create an impression that something is more environmentally sustainable or beneficial than it actually is. The term is most commonly used in relation to companies that use false, deceptive or misleading advertising or statements to misrepresent their green credentials to stakeholders. In turn, transition-washing occurs where claims, acts or omissions create an impression that an entity is transitioning its economic or business activities to a state of net zero greenhouse gas emissions to a greater extent or more rapidly than it actually is. This can be distinguished, for example, from greenwashing that may occur in relation to the environmental credentials of a discrete product or project.

In an economic system that relies primarily on decision-making informed by disclosure, greenwashing in the context of the climate transition i.e. transition-washing has been described as the single gravest threat to the achievement of the Paris Temperature Goals.²⁵ This is because it fundamentally undermines the ability of the market to allocate and price capital properly. Companies earnestly incurring the cost of transitioning to net zero are placed at a disadvantage to transition-washing companies that are able simultaneously to avoid such costs and obtain benefits flowing from stakeholder perceptions that they are transitioning e.g. cheaper access to capital driven by climate conscious investors. In short, the corporate playing field becomes uneven and financial markets become distorted. To the extent the challenge of transition-washing exists at scale, it could therefore lead to a huge misallocation of capital including to firms, activities and technologies that contribute to carbon lock-in,²⁶ serving to delay and prevent the achievement of the Paris Temperature Goals.

Given these high stakes, exposure to all types of greenwashing, including transition-washing, poses financial, reputational and legal risks to investors.²⁷ For example, financial businesses unaware of the scope of their exposure to transition-washing firms and their carbon-intensive assets may sustain significant losses following widespread devaluations of such firms and their assets.²⁸ The UN's human rights experts have recently clarified that a financial firm's long-term exposure to companies whose business activities conflict with the achievement of the Paris Temperature Goals, for example engagement in greenwashing, can place that financial firm in breach of international human rights law in certain circumstances.²⁹



This paper will explore transition-washing in markets for labelled transition finance debt instruments, bond instruments in particular, where stakeholder discussion of transition-washing has been most concentrated to date. In these markets, transition-washing can be said to occur where, in contradiction of the labels, such finance is provided to entities that are not in fact, or have no meaningful intention to, transition their business to net zero greenhouse gases at the pace required to achieve the Paris Temperature Goals. Accordingly, the credibility of a firm's transition strategy is central to the question of whether transition-washing has occurred. The lack of credibility of a firm's transition strategy is likely to be clear where:

- A. net zero targets and/or the underpinning implementation strategy (in this paper, "**transition strategy**" incorporates reference to a firm's near-, mid- and long-term net zero targets and its plan for achieving them) do not align with the best available science-based sector specific emissions reduction pathways; and/or
- B. transition finance instruments issued by or provided to the firm:
 - do not, in the case of general purpose instruments (e.g. SLBs or SLLs), materially incentivise a firm's groupwide Scope 3 transition, based on their characteristics; and/or
 - allocate proceeds, in the case of use of proceeds instruments, to corporate activities clearly incompatible with Paris-aligned sectoral transition pathways and/or in ways that can be described as "business as usual" or contributing to carbon lock-in e.g. the development or application of non-credible climate change mitigation technologies.

As the following discussion sets out in more detail, transition finance bond instruments have regularly been regarded as having sacrificed climate integrity for inclusivity³⁰ and have been linked to carbon-lock in concerns³¹ and business as usual.³² Investors are accordingly increasingly wary of their exposure to transition-washing risks.³³

This suggests, as many stakeholders now acknowledge, that transition-washing is impeding the development of transition finance, where growth momentum has been lost.³⁴ Policymakers have found that firms in carbon-intensive sectors still find it difficult to access climate finance to progress their transitions³⁵ and the IPCC's latest report finds that wider finance flows are falling well short of the levels needed to transition to meet climate goals across all sectors and regions.³⁶

Commentators³⁷ and organisations such as the World Bank,³⁸ OECD³⁹ and Climate Bonds Initiative ("**CBI**"),⁴⁰ and various regulators,⁴¹ have recognised that robust standards are required for transition finance markets to develop the integrity needed to become effective at scale. However, if such standards are to be effective, they will need to address the root causes of transition-washing. These are discussed below, by reference to the markets for sustainability-linked bonds and Japanese transition-labelled bonds.

CASE STUDY: SUSTAINABILITY-LINKED BONDS

In recent years, evidence has mounted that the majority of climate-related SLBs (in this paper, references to SLBs mean climate-related SLBs i.e. SLBs where SPTs and KPIs are related to an issuer's net zero transition⁴²) are failing to provide meaningful transition incentives. This appears to be the case for at least three reasons:

- A. SPTs are not ambitious.** In particular, they are generally not linked to strategic decarbonisation milestones such as interim emissions reduction objectives. For example, of the 48 SLBs issued by the 18 biggest borrowers in 2021, a Reuters analysis found that nearly half included a target permitting improvement at a slower rate than prior to issuance, i.e. the SPTs were "*so soft that firms can actually take their foot off the gas.*"⁴³ In 2022, only one-fifth of SLBs issued were linked to all three scopes of emissions.⁴⁴ In addition, some SLBs utilise economic intensity SPTs, which are regarded as being less robust and ambitious than absolute or physical intensity SPTs.⁴⁵
- B. SLB penalty mechanisms are not material.** The majority of SLBs to date have prescribed an increased interest rate in the amount of c.14 – 33 basis points should SPTs fail to be met.⁴⁶ This is likely to be insufficient to incentivise the progress of a firm's transition. In fact, coupon step-ups have often threatened a smaller financial penalty than the greenium (i.e. pricing benefits in the form of lower yields for issuers resulting



from greater investor interest in sustainable finance instruments than non-thematic, 'vanilla' comparators) obtained at issuance.⁴⁷

C. SLBs contain structural loopholes. A World Bank empirical study of the SLB market conducted in late 2022 found that SLBs with larger step-up penalties typically contain late SPT dates (reducing the time window in which the consequences of such penalties can bite before the bond matures), or embedded call options allowing for an acceleration of repayment of SLBs in order to avoid step-up consequences.⁴⁸ Regarding the latter, as at December 2021, this was true for 66% of the SLB market by volume.⁴⁹ In contrast, and illogically, investors are generally not provided with mechanisms allowing them to walk away from the debt in the event of poor issuer performance.

This position is perhaps unsurprising given the wider state of corporate transition planning. The OECD has identified that credible corporate transition plans are fundamental to addressing the growing risk of transition-washing in transition finance and in facilitating a global, whole-of-economy climate transition.⁵⁰ Yet the general quality and integrity of such plans and the targets underpinning them has routinely been found to be "alarmingly low".⁵¹ An assessment of the transition targets, plans and strategies of the 166 focus companies of Climate Action 100+ found that very few had set Paris-aligned short- and medium-term greenhouse gas reduction targets or made a commitment to align capital expenditure with long-term reduction goals.⁵² Analyses of the fine print behind net zero commitments find caveats and disclaimers making it simple for firms to resile from any commitments made.⁵³

Three significant factors contribute greatly to these issues. The first is that there remains a lack of consensus as to the credibility of different transition technologies.⁵⁴ The second is that, as recognised by ICMA,⁵⁵ the UN's Race to Zero Campaign⁵⁶ and the International Monetary Fund,⁵⁷ there is a lack of nationally and sectorally tailored, Paris-aligned sectoral emissions reduction guidelines and pathways which firms can rely upon when preparing and/or assessing transition plans (with the partial exception of Japan, see below). The third is that, although a plethora of transition plan standards are emerging, so far they are not proving sufficient to shift the corporate sector into widespread Paris-alignment. This, it is suggested, is in part due to the following key issues evident from review of a recent mapping exercise conducted by CBI, which found that across the standards:⁵⁸

- A. there is no consistent message that corporate transitions should have as their end goal alignment with the Paris Temperature Goals;⁵⁹ and
- B. firms are generally permitted to choose (as long as they justify) the emissions reduction pathways their transition plans are benchmarked against (irrespective of the scientific credibility of such pathways).⁶⁰

Independent external verification could usefully act as a check on non-Paris-aligned issuances. For example, ICMA's Climate Transition Finance Handbook provides that issuers should obtain a pre-issuance SPO as to the Paris-alignment and scientific credentials of an issuer's transition strategy.⁶¹ However, studies have identified key issues with the approaches taken to SPOs by certain external verifiers, including:

- A. over-reliance on questionable offsetting strategies;⁶²
- B. permitted reliance by corporates on discontinued verification methodologies;⁶³
- C. insufficient scrutiny of Scope 3 climate targets;⁶⁴
- D. non-disclosure of the method and data used for specific certifications;⁶⁵ and
- E. a preference for backward-looking assessments, based on peers' past performance, rather than comparing strategies with a forward-looking, science-based pathway or long-term target specifying where the sector is supposed to be in the future.⁶⁶

Certain investors have stated publicly that because SPOs are not demanding enough, they need to do their own analysis instead.⁶⁷ The OECD has called for more standards and greater oversight of verification providers to ensure they operate with environmental integrity and provide meaningful and credible assessments.⁶⁸

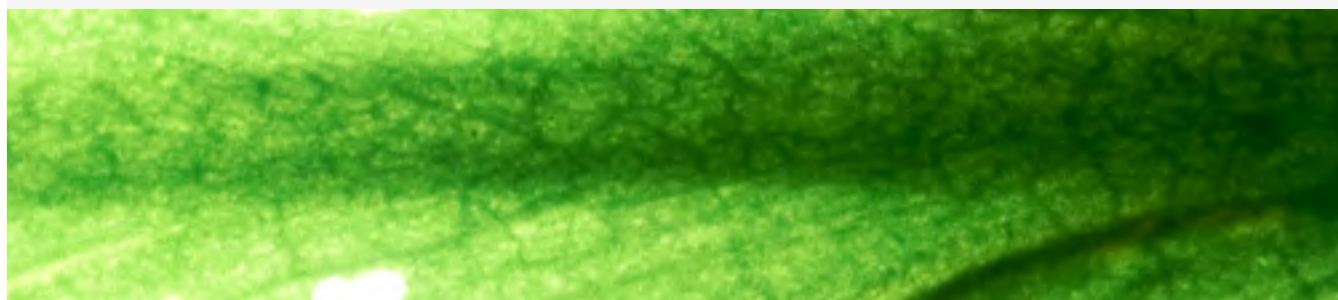
Running through these issues is a further fundamental root problem: voluntarism. Research and market experience has shown that firms will not voluntarily sink the costs and take the risks that the transition demands whilst a significant proportion of investors value short-term financial returns above all else.⁶⁹ However, at the same time, firms are unwilling to miss out on the reputational and financial benefits that flow from impressive sounding (and free) climate and sustainability pledges designed to appeal to the portion of the investment community that is seeking to value climate leaders at a premium.⁷⁰ It is suggested that this dissonance is at the heart of the transition-washing observable in the markets for SLBs.

In the absence of mandatory requirements for businesses to transition in line with the Paris Temperature Goals,⁷¹ binding standards regarding the use of transition finance labels could negate these incentives to transition-wash. However, at present the only standards that exist are voluntary. Coupled with that, regulatory interventions to hold issuers accountable in SLB markets have been virtually non-existent to date, notwithstanding that complaints have been made⁷² and concerns expressed.⁷³

Widespread perceptions of transition-washing in the investment community have chilled the market for SLBs.⁷⁴ As of April 2024, reports suggest that SLB issuance has had its worst start to a year since 2020, as a result of widespread concerns about the quality of such instruments.⁷⁵ Soft demand due to investor scepticism recently caused TotalEnergies to cancel SLB issuances it had been planning for several years.⁷⁶ Morgan Stanley has acknowledged that: *"investors want SLBs to work, but challenges with the structure amidst high greenwashing risk are deterring [companies]."*⁷⁷ In October 2023, ICMA acknowledged that: *"ambition and materiality in the early development of the new sustainability-linked bond market may have been insufficient."*⁷⁸ One investor summed up the mood of the market when it stated:



when we see an SLB come to the market, the first question we ask is: what are these guys hiding?⁷⁹



CASE STUDY: JAPANESE TRANSITION-LABELLED BONDS

Japan has been a frontrunner in the establishment of its domestic transition finance framework and has placed transition-labelled instruments at the heart of that framework. Japanese issuers accounted for over half of all transition-labelled bond issuances in 2022.⁸⁰ The Japanese Government has also begun to issue tranches of sovereign transition-labelled bonds, with a goal of 20 trillion yen in total, based on its Climate Transition Bond Framework.⁸¹ Both public and private sector initiatives are designed to support the Japanese Government's Green Transformation programme ("GX Programme"), an investment roadmap for 150 trillion yen (approximately US\$1 trillion) of public-private financing over the next 10 years to transform 22 industrial sectors in achieving Japan's 2050 carbon neutrality goal.⁸²

However, significant concerns have been expressed regarding the integrity and effectiveness of the Japanese transition finance framework. Many of these concerns have revolved around the scientific credibility of certain uses of proceeds for transition-labelled bonds, including eligible uses of proceeds under the Climate Transition Bond Framework.⁸³ These concerns have focused in particular on the power generation sector, where Japanese policy appears to be misaligned with the Paris Temperature Goals.

An overview of the issues is set out below.

2030 TARGET ENERGY MIX

Japan's Sixth Strategic Energy Plan provides for a 2030 target energy mix comprising, amongst others, 36-38% renewables, 20% LNG and 19% coal.⁸³

In contrast, IPCC pathways suggest that to achieve the Paris Temperature Goals, the share of renewables in the global energy mix should rise to 53.68% whilst the share of coal should fall to 7.28%, both by 2030.⁸⁴

In addition, advocacy in the GX Programme of a coal to gas switch is not aligned with the IPCC's pathways.⁸⁵

RELIANCE UPON HYDROGEN AND AMMONIA CO-FIRING

Japan's longer term energy strategy relies significantly upon the gradual blending of hydrogen and ammonia with gas- and coal-fired thermal power stations respectively. The Japanese government has designated hydrogen and ammonia as low carbon power generation sources, even if produced from unabated fossil fuels.⁸⁶

However, Japan's large-scale reliance on hydrogen and ammonia co-firing is mis-aligned with IPCC science⁸⁷ and the International Energy Agency's ("IEA") global 2050 net zero roadmap for the energy sector ("IEA NZE")⁸⁸ and is otherwise problematic for a number of reasons, including that:

- i. it implies a significant continued role for coal- and gas-fired power until 100% combustion of hydrogen-based fuels is possible closer to 2050;⁸⁹
- ii. in the interim, gradual blending has limited emissions reduction prospects at the point of generation. For example, at a co-firing ratio of below 50%, ammonia/coal power plants will emit as much carbon dioxide as a natural gas power plant;⁹⁰
- iii. even if 100% combustion of these fuels is technically possible and economically viable closer to 2050 (which is not certain), Japan's failure to account for the lifecycle emissions of hydrogen / ammonia in energy sector policy⁹¹ implies a scenario whereby Japan could reach its energy sector targets without any reduction in real world emissions;

- iv. this last is not a remote prospect. In 2022, natural gas without carbon capture and storage (“**CCUS**”) accounted for 62% of global hydrogen production (grey hydrogen), whilst unabated coal was responsible for 21% of global production.⁹² As ammonia is produced by mixing hydrogen and nitrogen, based on the present state of the hydrogen supply chain, over 90% of ammonia is effectively produced from fossil fuels. Such production represents around 1% of global carbon dioxide emissions.⁹³ Accordingly, the IEA has described hydrogen production as more of a climate problem than a climate solution.⁹⁴
- v. due to methane leaks (fugitives) in the natural gas supply chain, hydrogen produced with natural gas and CCUS (blue hydrogen) has been found to have a higher greenhouse gas intensity than simply using natural gas (outright) on a lifecycle basis.⁹⁵ Ammonia co-fired coal plants may also emit greater quantities of nitrous oxide, a greenhouse gas with a global warming potential 273 times larger than that of carbon dioxide over a 100-year timescale;⁹⁶ and
- vi. analyses suggest that decarbonising the present supply chain for grey hydrogen would require 3x the amount of solar and wind electricity that the world produced in 2019.⁹⁷ Accordingly, the IPCC suggests that even hydrogen produced from renewables (green hydrogen) has a “modest” role to play in the transition and only in particular hard-to-abate sectors such as industry (e.g. steel-making) and transport where electrification is not economically feasible.⁹⁸

Transition bonds issued by specific Japanese corporates have reflected these concerns. For example, analyses by CBI⁹⁹ and Anthropocene Fixed Income Institute (“**AFII**”)¹⁰⁰ have critiqued the scientific credibility of transition bonds issued by JERA, Japan’s largest power generating business, and Mitsubishi Heavy Industries (“**MHI**”), a leading Japanese industrial group providing equipment to the power sector. The use of proceeds frameworks for these bonds were dedicated in significant part to the development and demonstration of hydrogen- and ammonia-based technologies for use in the power sector.¹⁰¹

These organisations have also spotlighted the lack of credibility of the transition strategies underpinning these transition bonds. In the case of MHI, AFII highlights that the company’s 2030 and 2040 emissions reduction targets do not cover the entire value chain, but only “*emissions attributed to our customers’ use of our products and services*”.¹⁰² Similarly to wider Japanese policy, the upstream does not appear to have been considered. AFII notes that this restricted definition of Scope 3 could potentially allow MHI to achieve its emission reduction targets without actually achieving real world reductions and whilst potentially prolonging the use of coal plants.¹⁰³ In the case of JERA, CBI’s analysis highlights interim emissions reduction targets to reduce domestic (rather than Scope 3) emissions by 60% by 2035 (against a 2013 baseline) and a strategy to replace inefficient coal-fired plants with ammonia and hydrogen co-firing plants.¹⁰⁴ The CBI observes that these plans are inconsistent with internationally recognised sectoral pathways such as the Transition Pathway Initiative’s (“**TPI**”) 1.5-degree pathway for electric utilities and the IEA NZE. CBI also notes that, in contradiction to its own targets and IEA and TPI science-based scenarios, JERA is continuing to develop and acquire additional coal and gas power stations domestically and overseas.

Japan’s *Basic Guidelines on Transition Finance* are seemingly robust in their (non-binding) recommendation that transition bond issuers should have set and disclosed science-based targets covering Scopes 1-3 and tracking to Paris-aligned emissions reduction pathways.¹⁰⁵ However, the pre-issuance SPOs endorsing the compliance of these JERA and MHI issuances with the *Basic Guidelines* do not discuss the credibility issues raised by AFII and CBI in their analyses. Instead, DNV, which prepared the SPOs in question, relied almost exclusively in its endorsing analysis in each case upon the Japanese Ministry of Economy, Trade and Industry’s (“**METI**”) sectoral roadmaps for the power¹⁰⁶ and gas¹⁰⁷ sectors, which reflect Japan’s wider endorsement of hydrogen-based technologies (see Box B). For DNV, alignment with these roadmaps appears to have equated to compliance with the *Basic Guidelines* and, ultimately, Paris-alignment. Accordingly, both of these bond issuances were listed as transition finance ‘model’ case studies by METI, notwithstanding that, based on AFII’s and CBI’s analyses, they do not appear to comply with Japan’s own *Basic Guidelines*.

Concerns about the credibility of Japan's energy sector transition strategy have also been raised by its G7 partners¹⁰⁸ and the investor community. Investors have expressed concerns that Japanese transition finance is ultimately a vehicle for promoting the international competitiveness of Japan's thermal-powered industries through encouraging the use of thermal power technologies elsewhere in Asia through initiatives such as the Asia Zero Emissions Community.¹⁰⁹ There has been a reluctance in the international markets to use the explicit transition label because of its association with carbon lock-in and emissions-intensive activities.¹¹⁰

These concerns have carried into the investment community's response to Japan's GX Programme. A CBI paper, for example, described the GX Programme's incorporation of support for technologies such as ammonia, hydrogen and CCUS in the power sector as being inconsistent with global models for the achievement of 1.5°C outcomes, undermining of the credibility of the transition label and attractive of greenwashing accusations.¹¹¹ A recent Principles for Responsible Investment ("PRI") briefing, likewise, suggests that GX Programme support for hydrogen co-firing technologies in the power sector creates greenwashing risks and increases the likelihood of carbon lock-in.¹¹²

As a result of these transition-washing concerns expressed in particular by international investors, the Japanese Government created the Climate Transition Bond Framework to govern the issuance of sovereign bonds,¹¹³ and excluded power sector co-firing technologies from its initial auctions for such sovereign bonds held on 14 and 27 February 2024 (though these did not generate more than a modest investor appetite, particularly amongst international investors, and do not appear to be trading with a greenium as against their vanilla Japanese sovereign bond counterparts). While the Climate Transition Bond Framework stipulates exclusionary criteria such as the financing of "Projects involved in mining, refining and transportation of coal" and "Projects involved in transactions that may cause human rights, environmental, or other social issues,"¹¹⁴ the Framework and more detailed sectoral investment strategies¹¹⁵ standing behind the GX Programme bonds preserve space for inclusion of these co-firing as well as CCUS technologies in uses of proceeds in subsequent auctions. In addition, a recent law approved by the Japanese government on 13 February 2024 specifically for the purpose of promoting a hydrogen-based society, including in the power sector, suggests that Japan's wider power sector policy has not changed.¹¹⁶

In Japan, therefore, an energy sector transition pathway that is inconsistent with science-based pathways has created transition-washing risks that will likely undermine the credibility and effectiveness of transition-labelled bond finance. These risks have arisen notwithstanding the significant domestic policy framework that has been created around the concept. Issues that were highlighted in the SLB case study, including poor quality transition strategies and SPOs, unchecked by non-binding standards, are also evident in Japanese transition bond finance.



SUMMARY FOR POLICYMAKERS – PART B

The discussion in Part B has highlighted a number of root causes of transition-washing in transition finance, by reference to the international market for sustainability-linked bonds and to Japanese transition-labelled bond finance. These root causes, and their consequences, inform the recommended policy guardrails set out in Part C and can be summarised in the following problem statement.

- A. There is a shortage of scientifically robust, Paris-aligned transition pathways for carbon-intensive sectors and activities, tailored to particular geographies.
- B. Firms are not required to benchmark transition plans and strategies against any particular Paris-aligned standards or pathways. The majority of such plans and strategies are not aligned with achievement of the Paris Temperature Goals at present.
- C. Firms are financially and reputationally incentivised to raise transition finance, even where they are not transitioning their whole business including Scope 3 emissions. Transition finance standards are non-binding and regulatory action to raise market standards has not yet materialised. External verification exercises have not provided meaningful challenge to issuers. Overall, firms are not meaningfully incentivised to issue high quality transition finance debt instruments.
- D. The prevalence of transition-washing is contributing to misallocations of capital and investor concerns about transition finance generally. This has resulted in lost growth momentum in labelled transition bond finance (which remains a very small corner of sustainable (let alone non-sustainable) finance¹⁷). To make-up the climate finance shortfall needed urgently to achieve the Paris Temperature Goals, policymakers need to consider more systemic reforms.



PART C: GUARDRAILS TO ADDRESS TRANSITION-WASHING AND SCALE UP TRANSITION FINANCE

INTRODUCTION

Building a policy framework to address transition-washing and scale up transition finance, whether labelled or unlabelled, is a complex challenge. Such a framework will have as its core objective the channelling of finance in order to create and support climate leaders in carbon-intensive sectors. Yet investors seeking to identify the right opportunities for that purpose face unique challenges resulting from the need to bridge usual decision-making processes to an understanding of complex, evolving climate science e.g. the depleting global carbon budget, and industry technological innovations.

Such decisions are made all the more challenging by the issue of transition-washing that was explored in Part B. There it was shown that investor concerns about transition-washing have effectively stalled labelled transition finance markets in the corporate sector and led to calls for the imposition of more stringent standards, to help investors sort between high and low quality transition finance instruments. As a result, a coherent policy response addressing transition-washing risk is necessary, if transition finance is to deliver its potential to catalyse the climate transition (see Part A).

Against that background, the recommended policy guardrails in this Part C are intended to contribute to an effective policy response to transition-washing in the corporate, labelled, transition finance debt market, and focus in particular on bond markets. The recommendations may also be useful to policymakers considering how to address transition-washing in other areas e.g. loan, equity and fund markets. Recognising that no one size can fit all, the recommendations are framed at a deliberately high level, and aim to provide policymakers with a 'helicopter view' of relevant options, precedents and key considerations that they can adapt to local needs and contexts.



GUARDRAIL 1: PREPARE NATIONAL (OR REGIONAL) PARIS-ALIGNED EMISSIONS REDUCTION PATHWAYS



Problem statement reference

A. There is a shortage of scientifically robust, Paris-aligned transition pathways for carbon-intensive sectors and activities, tailored to particular geographies.

As the OECD has pointed out, whilst activity-level criteria can, of themselves, help to prevent the greenwashing of green use of proceeds instruments, in transition finance such criteria (discussed in Guardrail 2) must be supplemented with policy tools to aid the development and assessment of entity-wide strategies, such as emissions reduction pathways.¹¹⁸

The majority of existing emissions reduction pathways are global in nature.¹¹⁹ These pathways can, helpfully, set out critical emissions reduction milestones and commensurate restrictions that different economic sectors must meet / recognise to remain aligned with the Paris Temperature Goals. One example of such a milestone is the IEA NZE direction that there is no longer room for new investment in new coal, oil and natural gas.¹²⁰

However, beyond relatively crude differentiations,¹²¹ global pathways inherently struggle to address the fact that states are implementing emissions reduction strategies at their own pace, based on factors such as their state of development, the carbon intensity of their economy, political considerations and capacity for green technology uptake, such as renewables, amongst others.

Such factors detract from the authority and influence of global pathways. Corporates, even those with net zero pledges, pay more attention to their domestic circumstances than global emissions reduction pathways and their milestones.¹²²

The same is true for policymakers. Preliminary discussions regarding the set-up of Japan's transition finance framework did not appear to consider in depth global emissions reduction pathways but focused, amongst others, on the alleged incompatibility of the EU's "deep green" approach to sustainable finance with Japan's and Asia's interest in "economic development"¹²³ and as places where "GHG emissions are increasing".¹²⁴ Part B offered insight into how Japanese issuers of transition bonds, and SPO providers, look to METI's sectoral roadmaps as their key sources of guidance on the transition. Similarly, the ASEAN Taxonomy only considers global pathways in certain of its "Tier 1" criteria contained in its more stringent "plus standard" for climate change mitigation,¹²⁵ one of three tiers of criteria where the bottom tier permits activities in line with national level NDCs where a state does not have a net zero timeline.¹²⁶

National or regional sectoral emissions reduction pathways can play a vital role in the development of transition finance.¹²⁷ Where credible, they can provide a robust foundation for the development of other national or regional policy tools such as a transition taxonomy (see Guardrail 2), sectoral technology roadmaps (as Japan has done, see Part B) or transition plan standards. Corporates can also use such pathways to set ambitious net zero and interim targets and devise strategies appropriate for their geographies of operation.¹²⁸ As ASEAN's Transition Finance Guidance states, national or regional pathways have the potential to lend scientific credence to the fact that emissions reduction trajectories are proceeding at different rates in different parts of the world.¹²⁹ They can therefore support the development of emerging transition finance markets (by providing firms and investors with a clear benchmark against which transition strategies should be set and assessed) and make it easier to reflect socio-economic differences in any transition finance regulation (see Guardrail 4).

Breaking down global pathways into granular pathways by regions and countries is a complex exercise, requiring a delicate balance of considerations related to ambition, technical feasibility, responsibility and fairness. Moreover, the Japan case study in Part B has shown some of the issues that can arise where a national emissions reduction pathway and accompanying strategy contain scientific loopholes that undermine their credibility. This

is not an isolated occurrence: local emissions reduction pathways developed to date by countries or industry bodies often reflect local constraints and feasibility concerns, and often do not align with global science-based emissions reduction pathways or effectively account for global emissions reduction needs.¹³⁰ In Japan's case, such constraints appear to have included a belief that the country's capacity to scale-up renewables is limited.¹³¹ Politicisation is another critical issue. InfluenceMap analysis suggests that the issues discussed relating to Japan's roadmaps are in part attributable to intense lobbying by incumbent heavy industry corporations.¹³²

If, for these or other reasons, policymakers are unwilling or unable to take on the task of preparing national or regional pathways themselves, then one option they might consider is to incentivise one or more of the most respected existing global pathway providers, such as the IEA, to break down their pathways by jurisdiction. Maintaining an arms length relationship during the development of local pathways could help to insulate such providers and their scientific analyses from contradictory political considerations and corporate lobbying. Policymakers would then be well placed to meet the inevitable political and corporate headwinds that fly in the face of national or regional emissions reduction policies, armed with the best available climate science.

There would also appear to be a gap in the transition finance architecture for an international body to oversee and make transparent the credibility of national and regional emissions reduction pathways. New UN initiatives¹³³ could, for this purpose, perhaps broaden their present focus on, amongst others, verifying and showcasing best practice *non-state* entity level transition strategies, to providing objective reference assessments of national and regional level emissions pathways, as these continue to come into sharper focus in developing national and regional transition strategies.



GUARDRAIL 2: PREPARE (OR APPROVE) SCIENTIFICALLY ROBUST CLASSIFICATION STANDARDS FOR CARBON-INTENSIVE ACTIVITIES AND ASSOCIATED TECHNOLOGIES



Problem statement reference

A. There is a shortage of scientifically robust, Paris-aligned transition pathways for carbon-intensive sectors and activities, tailored to particular geographies.

Whilst emissions reduction pathways set the required pace of emissions reductions if the Paris Temperature Goals are to be met, they do not necessarily provide guidance as to the particular economic activities or technologies that firms (or countries/regions) should rely upon in strategies to achieve these reductions.

Complementing emissions reduction pathways and showing the way to their achievement, transition finance is unlikely to be effective without a clear classification, based on the best available climate science, of: (a) which carbon-intensive activities are within the scope of Paris-aligned sectoral transition pathways; and (b) where necessary, the required emissions reduction trajectory of those activities. Classification standards of this kind have been identified by the G20 Sustainable Finance Working Group ("**G20 SFWG**") as an important foundation for scaling up transition finance, mitigating transition-washing risks and protecting market integrity.¹³⁴

Comprehensive guidance now exists as to how taxonomies are increasingly including features relating to carbon-intensive transition technologies.¹³⁵ The OECD summarises how taxonomies have to date typically deployed three mechanisms to mitigate the risk of carbon lock-in in particular:¹³⁶

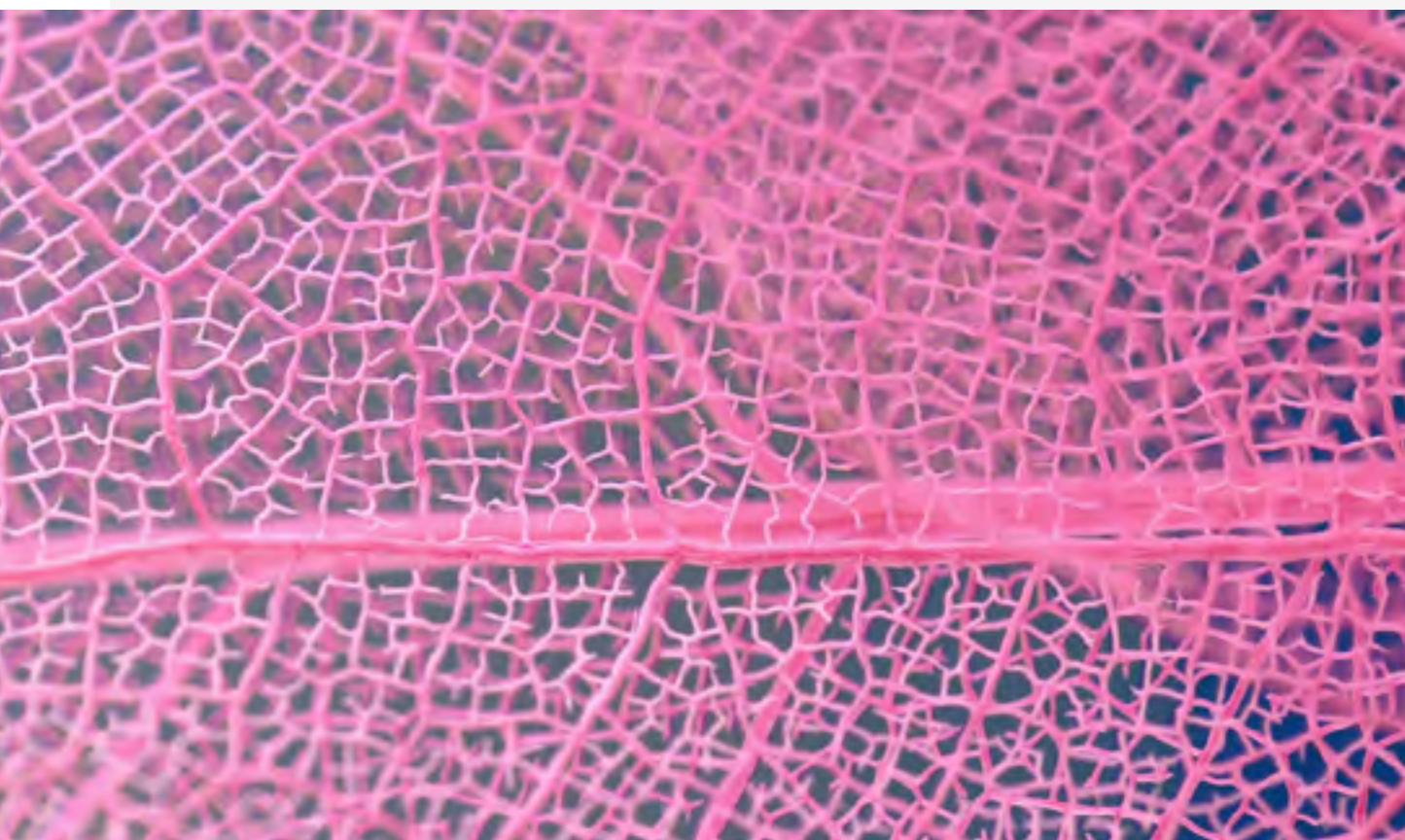
- A. technical screening criteria to delineate taxonomy-aligned activities;
- B. ensuring that carbon-intensive assets can pivot to the use of near- or zero-emitting technologies in future; and
- C. providing sunset clauses for carbon-intensive activities requiring them to comply with more stringent technical criteria by a particular date or else become stranded from a taxonomy-alignment perspective.



As discussed in Part B, Japan has taken a different “principles-based”¹³⁷ approach to classification, providing high-level guidance for the identification of activities and technologies that can help support Japan’s emissions reduction strategy, including as to the use of ammonia and hydrogen co-firing for the purpose of decarbonising the power and gas sectors. By contrast, the EU,¹³⁸ Singaporean¹³⁹ and ASEAN¹⁴⁰ taxonomies include detailed criteria regarding the use of hydrogen-based fuels (including ammonia) for electricity generation. Notably, the EU¹⁴¹ and Singapore¹⁴² taxonomies also contain detailed criteria applicable to the manufacture of hydrogen covering lifecycle emissions.

Given the difficulty and amount of time it typically takes to produce and maintain taxonomies, as well as the complexity of actually using certain taxonomies, such approaches should not be discarded out of hand. However, the Japan case study in Part B has shown how a lack of detailed criteria bounding the use of ammonia and hydrogen co-firing technologies, including on a life-cycle basis, has led to investor and stakeholder concerns and a real risk of carbon lock-in. The absence of technical criteria from METI’s sectoral roadmaps (or included elsewhere in its transition finance framework) has resulted in PRI investor polling where 58% of respondents agreed that Japan should develop a sustainable taxonomy, with 67% of respondents of the view that continued lack of a sustainable taxonomy “*would create risks for investors when trying to align reporting and activities with global market practices*”.¹⁴³

Accordingly, whilst policymaker experimentation as to how best to guide markets should be encouraged, ensuring that the scientific basis for any such guidance is robust will be critical to the effectiveness of any transition finance framework. Moreover, the more specific such guidance can be, the easier it will be to design a robust regulatory framework (see Guardrail 4).¹⁴⁴ Policymakers unwilling to develop a new national or regional taxonomy may wish to consider approving as authoritative all or part of one or more existing classification standards, e.g. taxonomies already prepared by states, regions or private sector providers e.g. CBI. To the extent additional criteria are required covering particular activities or technologies e.g. due to the unique needs of national or regional emissions reduction pathways, then such criteria could then function as an overlay to such approved standards, or serve to amend only specific parts of the same.



GUARDRAIL 3: BUILD CAPACITY IN THE MARKET FOR EXTERNAL VERIFICATION



Problem statement reference

B. Firms are not required to benchmark transition plans and strategies against any particular Paris-aligned standards or pathways. The majority of such plans and strategies are not aligned with achievement of the Paris Temperature Goals at present.

Policymakers and standard setters are dedicating significant time and resource to the development of voluntary transition plan standards, for the purpose of raising the quality of transition plans and related reporting. There are at least 13 notable standards or initiatives in the market at present.¹⁴⁵ These efforts, and ongoing discussions about how to integrate these new standards into wider transition finance policy frameworks, are welcomed. However, given that such standards are generally framed at a high level, adherence to them may not guarantee the credibility of a firm's transition strategy. Nor can such adherence be taken as Paris-alignment given that many transition plan frameworks, such as that produced by the UK's Transition Plan Taskforce ("**TPT**"),¹⁴⁶ require disclosure around the external benchmarks or scenarios used in transition plans. They do not prescribe use of any particular Paris-aligned standards or pathways, instead relying on the market to interrogate plans.¹⁴⁷

This underlines the importance of the role played by SPO providers in labelled transition finance. So too do the inherent difficulties and complexities facing policymakers developing tools to support the market's climate transition, such as emissions reduction pathways and classification standards (see Guardrails 1 and 2). High calibre SPO providers can, theoretically, navigate all of these uncertainties and provide investors with a clear view on the Paris-alignment and scientific credibility of a transition finance instrument on a case by case basis. The OECD, in its work on the mitigation of carbon lock-in risk, has characterised the role of verifiers and SPO providers as being of critical importance necessary to provide transparency to, and secure the growth of, transition finance markets.¹⁴⁸

Yet, as Part B has shown, the level of scrutiny presently being applied by some SPO providers is too weak. This may be due to conflicts of interest: providers are generally paid in accordance with the subscriber-pay models that have attracted such heavy scrutiny (and, belatedly, regulation) in the ESG ratings industry.¹⁴⁹ It may also be the result of a lack of capacity: investors have questioned the general credibility of the SPO industry in the environmental context, due to a lack of capacity and expertise which is likely to take a long time to develop.¹⁵⁰

Policymakers are recommended to prioritise measures to address these issues. Whilst Guardrail 4 will recommend the regulation of SPO providers, in part to address the risks associated with conflicts of interest and set a higher baseline for performance, policymakers are also recommended to consider policies that can accelerate the development of expertise held by SPO providers and support their development generally. Particularly to counterbalance the risks associated with becoming a regulated entity, such policies could include financial incentives to encourage more firms to engage in SPO business e.g. publicly funded rebate or subsidy schemes that lower the cost of SPO certification and may boost business (similarly to schemes already employed by Hong Kong, Singapore and Japan).¹⁵¹

Ultimately however, if policy measures are insufficient to facilitate a robust private-sector SPO market in the near-term, then state- or regional-level governments may need to consider establishing public bodies to perform this vital market function. Putting such assessments on a public footing could have substantial benefits. These include the higher quality of opinions that a larger volume of public funding should imply, and the fact that publication of a body of SPO opinions could, over time, allow fundraisers and other market stakeholders to have access to a detailed, applied and evolving body of guidance as to the hallmarks of a credible, Paris-aligned transition strategy in their particular sector.

GUARDRAIL 4: IMPLEMENT TARGETED FINANCIAL REGULATION PROVIDING MANDATORY THRESHOLD REQUIREMENTS FOR CREDIBLE USE OF PROTECTED LABELS IN TRANSITION FINANCE BOND MARKETS



Problem statement reference

C. Firms are financially and reputationally incentivised to raise transition finance, even where they are not transitioning their whole business including Scope 3 emissions. Transition finance standards are non-binding and regulatory action to raise market standards has not yet materialised. External verification exercises have not provided meaningful challenge to issuers. Overall, firms are not meaningfully incentivised to issue high quality transition finance debt instruments.

This recommendation seeks to address three fundamental questions that policymakers may justifiably ask: (i) why does financial regulation have a role to play in labelled transition bond finance; (ii) what is the right role for regulation in labelled transition bond finance; and (iii) how can policymakers incentivise issuers to use labels protected by regulation?

Why does financial regulation have a role to play in labelled transition bond finance?

Policymakers may be instinctively reluctant to regulate labelled transition bond finance. Regulation may seem heavy handed and inappropriate given the complexity and changeability of the underlying subject matter. Moreover, particularly given the low quality of corporate transition strategies, the costs associated with regulatory compliance may be seen as likely to shut down labelled transition finance altogether, or at least use of the particular labels protected by regulation. Practically speaking, the need for transition finance is urgent (see Part A), yet well considered regulation inevitably takes a long time to prepare and implement. These points notwithstanding, targeted financial regulation is necessary and advisable.

First, and most importantly, Part B has demonstrated that transition-washing is a critical factor holding back markets for impactful labelled transition bond finance, and that transition-washing risk is likely to be hard-wired into these markets unless the balance of investor preferences changes decisively towards a greater valuation



of climate leadership. Some incumbent firms in carbon-intensive or hard-to-abate industries have also shown a tendency to greenwash, in order to delay the transition and protect revenues derived from the present economic system.¹⁵²

Voluntary disclosure standards are unlikely to be sufficient to remedy this issue, because such voluntary standards provide a far less impactful incentive to change behaviour than direct changes to legal and regulatory frameworks.¹⁵³ That is, in essence, because such changes – if supported by robust enforcement mechanisms (see Guardrail 5) – modify corporate behaviour directly without relying on transparency to catalyse sufficient pressure for change from market stakeholders, which may or may not be forthcoming.¹⁵⁴

Second, given its sector-focus, transition finance in effect seeks to service the frontier – the grey areas – of the climate transition, where the risk of carbon lock-in is high (and significantly higher than in green finance).¹⁵⁵ The complexity of conducting a holistic assessment of any corporate's transition strategy (versus a discrete low- or zero-emitting project, the generally accepted function of green finance), and the feasibility of the technologies relied upon, makes assessing the credibility of any labelled transition finance instrument difficult, and this exacerbates investor concerns about transition-washing.¹⁵⁶ This difficulty is a critical reason why labelled transition finance is an area where regulators should have a more active role to play.

Third, well designed financial regulation could have a positive enabling effect on labelled transition finance. Mandatory rules can create a level playing field for climate leaders,¹⁵⁷ by creating a regulatory perimeter around particular protected (voluntary use) transition finance labels, and effectively excluding from their use those firms not making an earnest attempt to meet their net zero commitments. If such perimeter can thereby guarantee integrity and mitigate transition-washing risks, then it could inject vital market confidence into the relevant protected transition finance labels.

If a regulated labelled transition finance market were to take off, for example because issuers meeting the requirements of the regulation benefit from a cheaper cost of capital (see Part A) that offsets the cost of regulatory compliance, it could also have an outsized impact on the wider climate transition. That is because firms implementing credible, science-based transition strategies are likely to push policymakers to enact further policies that level the playing field as against their industry peers.¹⁵⁸ In other words, a regulatory framework for labelled transition finance could help to create a vanguard of corporate climate leaders capable of driving the wider net zero transition across the global economy. This development is sorely needed: legal experts have described 'obstructionism' from incumbent interest groups as a key barrier to effective net-zero regulation.¹⁵⁹

Fourth and finally, implementation of effective regulatory frameworks could demarcate for investors those financial centres where labelled transition bond finance is likely to be impactful and less exposed to transition-washing risks. Labels with particular jurisdictional associations could foreseeably come to command greater confidence in the sustainable investment market than others, bringing concurrent benefits e.g. a "*UK Sustainability-Linked 1.5°C Bond*" could in time offer issuers a cheaper cost of financing than equivalent non-UK instruments, assuming investors considered the theoretical UK transition finance regulatory framework to be more ambitious and credible than national or regional competitors.

What is the right role for regulation in labelled transition bond finance?

Regulating labelled transition finance is likely to be a challenging task. Any regulatory framework will need to be responsive to the fact that each firm's transition strategy will be legitimately unique, based on factors including where they do business (see Guardrail 1), and that the scientific backdrop against which such strategy is set and implemented will be constantly changing as time passes. This calls for a degree of flexibility, informed by tools of the type discussed in Guardrails 1 – 3, yet any regulation must also be sufficiently precise to allow for vitally important enforcement and accountability.

There are at least four areas which regulation can and must address in order to be as effective and helpful as possible: (i) defining the scope of labelled transition finance; (ii) setting the Paris Temperature Goals as the ambition point for labelled transition finance; (iii) providing threshold conditions to protect the integrity of protected (voluntary use) transition finance labels; and (iv) supporting these conditions with adequate regulatory penalties applicable upon breach of the rules.

A. Definition

Legal and regulatory definitions control the meaning and understanding of concepts. Confusion about the purpose of labelled transition finance, and its precise boundaries, contributes to market concerns about transition-washing risk.¹⁶⁰ Regulators can therefore make a contribution to the effectiveness of labelled transition finance simply by resolving some of the critical uncertainties at the heart of the concept, including:

- the **scope** of labelled transition finance, including which types of labels are within such scope (see below), and how it fits within the umbrella transition finance concept;¹⁶¹
- whether labelled transition finance has an **entity-level** focus i.e. whether financial instruments focused on economic activities, without reference or regard to the transition plan/strategy of the relevant underlying firm, can fall within the definitional perimeter of transition finance; and
- the precise boundaries as between green and labelled transition finance.

Policymakers are recommended to adopt a regulatory definition restricting the use of protected transition finance labels to firms engaged in whole-of-business Scope 3 emissions reductions.

This would accord with the majority of prominent definitions of transition finance to date, a selection of which are included at **Appendix 1**, and can be justified for at least three reasons. First, as discussed in Part A, labelled transition finance markets are likely to have the greatest potential to accelerate the climate transition if they can convert widespread demand for sustainable investments into a cheaper cost of capital for issuers implementing a credible, Scope 3, science-based transition strategy across the whole corporate group. Second, if this restriction on the concept is not imposed, firms will be more likely to carve out transition activities – including the raising of transition finance – to particular parts of their business, whilst business-as-usual continues in other areas or entities.¹⁶² This would create transition-washing risks. Third, such an entity-level focus can help to distinguish the purpose of labelled transition finance from labelled green finance, the latter of which has, as already noted, generally been regarded as project-focused to date.

A regulatory definition should also set out clearly which particular label formulations are to be protected in regulation (the **"Protected Labels"**). If the conceptual distinction discussed above is set up, labels and regulatory frameworks should be able to reflect coherently that the boundaries of transition and green finance use of proceeds labels might still overlap. For example, a firm with a Paris-aligned Scope 3 whole of group transition strategy may well seek to issue a green use of proceeds bond to finance a particular low- or zero-emitting project e.g. building a wind farm. Such a firm could be permitted to use the transition label to denote the credibility of its underpinning transition strategy alongside a green label to signal the low or zero- emitting nature of the specific uses of proceeds e.g. "Transition Bond: Green Proceeds". Where the same firm seeks to issue a use of proceeds



bond for a mixture of green uses of proceeds e.g. building a solar farm and transition uses of proceeds e.g. finance to phase-out a coal plant in accordance with relevant criteria,¹⁶³ the label “Transition Bond: Green / Amber Proceeds” could be used. The difference between “Green” and “Amber” proceeds here could be determined based on underlying activity or technology level classification standards (see Guardrail 2), whilst the “Transition” aspect of the label would again denote the credibility of the underlying transition strategy. Finally, where the same firm seeks to issue general purpose transition financing without specific uses for the proceeds, the simple “Transition Bond” or “Sustainability-Linked Bond” labels (or other Protected Label, subject to the definition) could be used.

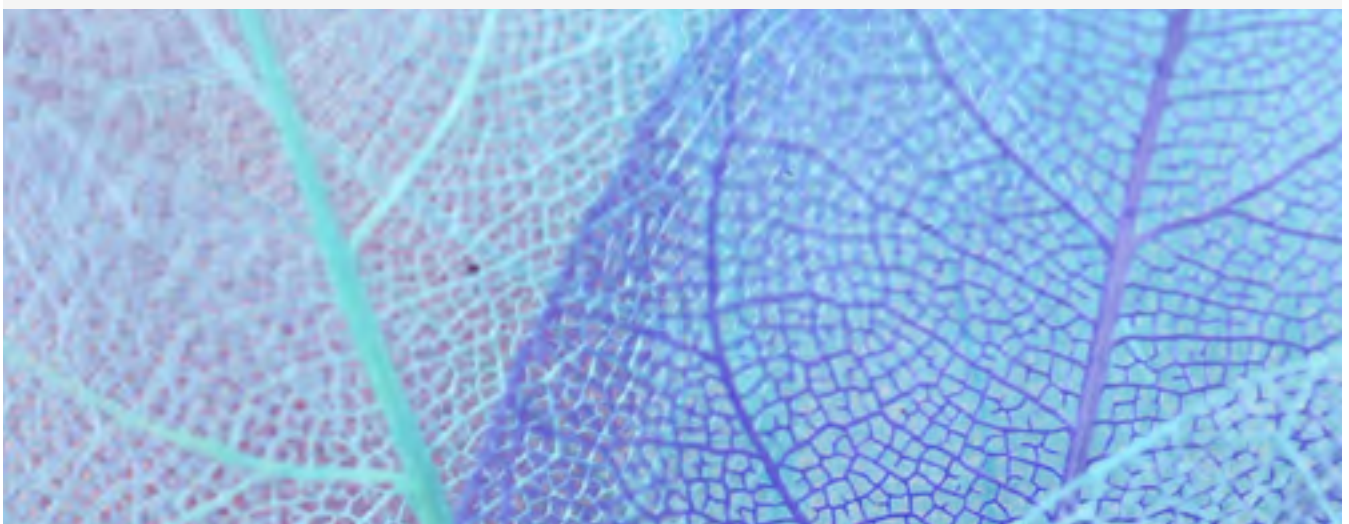
B. Ambition

Even policymakers that can see a valuable role for regulation in labelled transition finance may be concerned that requiring Paris-alignment on a firm-level basis might be too heavy handed, given the dearth of Paris-aligned transition strategies in carbon-intensive sectors at present. Such policymakers may be minded to: (i) omit references to Paris-alignment from regulation; and/or (ii) allow firms to demonstrate Paris-alignment by reference to their contributions to whole-of-economy emissions reduction initiatives. Policymakers are recommended to resist these potential temptations.

First, regarding (i) and as the OECD has pointed out, setting the Paris Temperature Goals as the benchmark for firm-level net-zero targets in transition finance is a critical safeguard for mitigating carbon lock-in risk.¹⁶⁴ Accompanying Paris-aligned corporate transition strategies should be the bedrock of effective labelled transition finance.¹⁶⁵ Without this context, such finance is at risk of being misallocated at scale, for example to firms that are relying upon stranded or defunct technologies / activities or otherwise failing to make an earnest attempt to decarbonise.¹⁶⁶ Market standard-setters have long acknowledged this: ICMA’s Climate Transition Finance Handbook contains clear requirements that issuing firms should have science-based emissions reduction targets aligned with the Paris Temperature Goals.¹⁶⁷ And if the purpose of regulation is, in part, to create a new market for the financing needs of climate leaders (per the discussion above), as the original labels were intended to do,¹⁶⁸ then Paris-alignment is undoubtedly recognised as the benchmark for such leadership, as initiatives such as the UN’s Race to Zero and GFANZ are intended to demonstrate.

Moreover, firms unable to meet Paris-aligned regulatory threshold requirements for labelled transition finance will be able to avail themselves of the entire market for unlabelled transition finance (or markets for non-Protected Labels) in order to move towards qualification for use of Protected Labels. Incentives related to the use of Protected Labels (see below), and more systemic changes to the financial system and wider economy (see Guardrail 6), can also be deployed to accelerate this process.

That said, policymakers may understandably want to incorporate flexibility in favour of climate leaders from developing economies. Here, incorporating the ability to benchmark issuers against different national or regional emissions reduction pathways (to the extent possible, see Guardrail 1) could be critical, to allow for a



less stringent near-term standard of ambition than developed economy issuers. Where issuers operate across multiple jurisdictions, issuer strategies could be benchmarked against national or regional pathways either where the firm is headquartered or earns the highest proportion of its revenues.

Second, regarding (ii), Part B has demonstrated an integrity issue at the heart of the issue of transition-washing that is undermining labelled transition finance. Although a full analysis is outside the scope of this paper, providing issuers with the option to submit contributions to whole of economy emissions reduction initiatives as proof of climate leadership, rather than firm-level emissions reduction strategies, seems likely to exacerbate this issue. This is particularly so given the nascent state of relevant tools and metrics; GFANZ's initial proposed expected emissions reductions (EER) metric has, for example, been heavily criticised for its complexity, opacity and susceptibility to being "gamed" based on subjective assumptions.¹⁶⁹ By analogy, the market's experience with climate offsets, which have generally been found to be of either opaque value or of extremely poor quality, is also a particular cause for scepticism in this regard.¹⁷⁰ And as noted above, the propensity of some incumbent firms to greenwash in an effort to stall the climate transition should be kept in mind.

C. Threshold Conditions

This paper is not the right forum for detailed recommendations as to the contents of regulation for labelled transition finance. That is for policymakers to determine based on what is appropriate and possible in their particular jurisdictions. Nonetheless, any regulation is likely to need certain basic threshold conditions regarding the use of the relevant Protected Labels if these are to become credible and effective. Drawing on leading transition finance guidelines and the evidence examined in Part B, such conditions are recommended to include the following.



Protected Labels are restricted to issuers with credibly Paris-aligned, Scope 3 net zero targets, including long-, mid- and near-term targets, and a high integrity underpinning strategy for achieving those targets applicable across the whole corporate group.

Policymakers wishing to set out detailed parameters for this stipulation now have a wealth of options, ranging from leading transition finance standards such as Japan's *Basic Guidelines on Transition Finance* to the ICMA Climate Transition Finance Handbook, to emerging transition plan standards and related guidelines providing recommendations on the preparation and/or characteristics of a high quality transition plan and/or strategy.¹⁷¹ The TPT's transition plan disclosure framework, for example, sets out such criteria against five elements: foundations, implementation strategy, engagement strategy, metrics and targets and governance.¹⁷² However, for the reasons discussed it is recommended that compliance with ambition neutral transition plan standards should not render a firm eligible, without more, for use of a Protected Label.





SPTs, and related KPIs (see Part A), included in general purpose transition finance instruments bearing a Protected Label should be required to: (a) align with the issuer's underlying transition strategy; and (b) include a material incentives mechanism.

Closing structural loopholes and ensuring a minimum level of rigour in general purpose transition finance instruments bearing a Protected Label would be an important function of transition finance regulation. The OECD has noted, for example, that measures to ensure sustainability-linked (i.e. general purpose) instruments contain KPIs and SPTs that are meaningful, science-based and Paris-aligned can enhance the credibility of transition finance frameworks.¹⁷³ Regulation could achieve this in a variety of ways. For example, stipulations could be made restricting the use of call options and the deployment of target dates within a certain proximity to the repayment date for the bond. Materiality for different types of penalties could also be defined to the extent possible, for example financial penalties for failure to meet SPTs could be required to be set at a certain level above the prevailing central bank base rate. Issuers could also be required to show, in bond offering documentation, how the relevant SPTs and KPIs line up with its wider transition strategy. A further option for policymakers could be to mandate that bond instruments include covenants providing investors with certain rights where SPTs are not met, such as an option for bondholders to accelerate or redeem their bonds.¹⁷⁴



Uses of proceeds, in use of proceeds transition finance instruments bearing a Protected Label, should be allocated in a manner that: (a) aligns with relevant classification standards (see Guardrail 2); and (b) aligns with the finance or capex plan included in the issuer's underlying transition strategy.

Ensuring that the uses of proceeds of bonds bearing a Protected Label are credible: (i) in their own right, based on the latest climate science; and (ii) in the context of the issuer's transition strategy, is another potentially vital function of transition finance regulation. With regards to (i), policymakers again now have a wealth of classification standards, e.g. taxonomies, from which to draw and reference, per the discussion in Guardrail 2.

Policymakers also have the opportunity to mitigate carbon lock-in risks by explicitly excluding from the Protected Label regulatory perimeter activities and technologies, and firms relying upon them, that categorically do not fit into a Paris-aligned transition e.g. upstream oil and gas expansion (per the IEA NZE), investments in new unabated coal power plants,¹⁷⁵ or the use of ammonia co-firing to decarbonise a power business (see Part B).¹⁷⁶ A relevant precedent in this regard is provided in recent European Securities and Markets Authority (ESMA) guidance providing that sustainability-related labels should not be used in fund names where, amongst others, the fund invests in companies that derive: (i) 1% or more of their revenues from exploration, mining, extraction, distribution or refining of hard coal and lignite; (ii) 10% or more of their revenues from the exploration, extraction, distribution or refining of oil fuels; (iii) 50% or more of their revenues from the exploration, extraction, manufacturing or distribution of gaseous fuels; or (iv) 50% or more of their revenues from electricity generation with a greenhouse gas intensity of more than 100 g CO₂ e/kWh.¹⁷⁷

A recently published EU regulation providing, from 21 December 2024,¹⁷⁸ a voluntary-use gold standard for issuers seeking to use the "European green bond" or "EuGB" labels ("**EuGB Regulation**") may also provide policymakers with useful guidance as to how parallel transition finance regulation might be set up,¹⁷⁹ including helpful provisions on "grandfathering" providing directions in circumstances where technical criteria change or economic activities are sunsetted during the life of a bond.





The Paris-alignment of a prospective issuer's transition strategy, and of the specific uses of proceeds of a bond (where relevant), should be verified by an SPO provider before a Protected Label can be used.

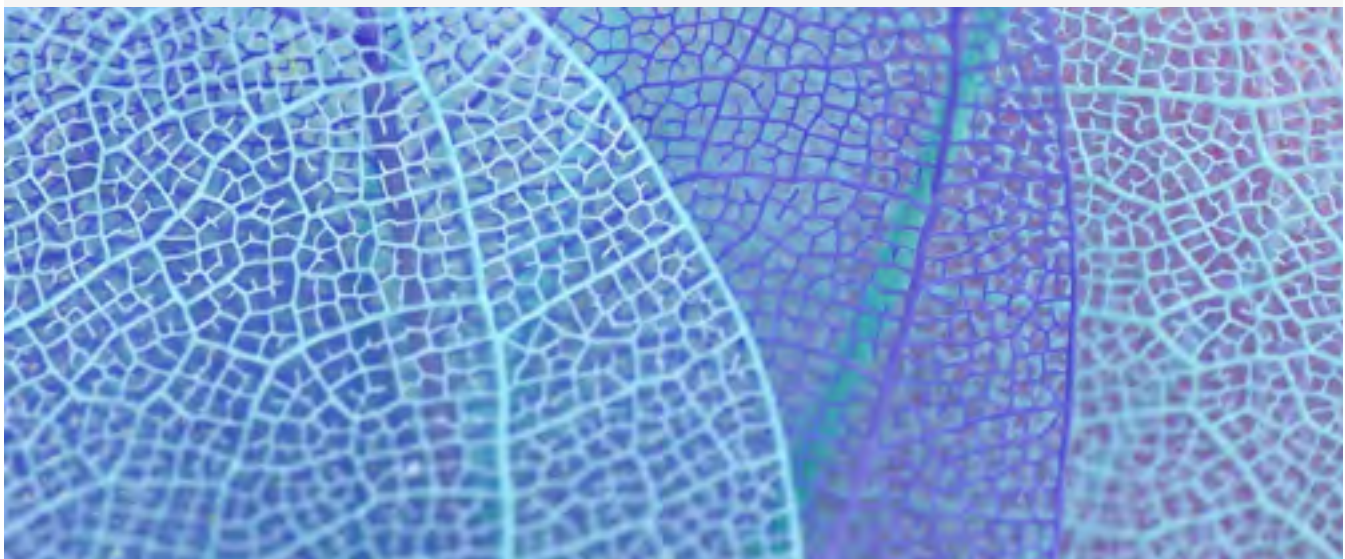
As discussed in Guardrail 3, SPO providers have a critical role to play in assessing whether an issuer's transition strategy is Paris-aligned on an instrument by instrument basis, ideally in the context of relevant national or regional transition pathways (see Guardrail 1), and including whether uses of proceeds (if relevant) are scientifically credible and feasible and support such strategy. This role becomes even more important where policymakers are unable or unwilling to approve or endorse market-supporting tools such as pathways, taxonomies and/or transition plan standards in regulation.

Given their importance, and the issues with the quality of some SPOs provided to date, policymakers are recommended to establish a registration and supervision regime for SPO providers that can raise standards, with oversight being provided by financial regulators (see Guardrail 5). Regulation should seek to ensure that SPOs are provided by personnel with appropriate qualifications/credentials (see Guardrail 3),¹⁸⁰ including, to the extent possible, detailed knowledge of both climate science and relevant industry sectors. This recommended approach is similar to that taken in the EuGB Regulation, but goes beyond Japan's voluntary code of conduct for ESG evaluation and data providers.¹⁸¹

Importantly, such a framework could also potentially provide a mechanism for dialogue between SPO providers and their regulators as to the boundaries between a credible net zero transition plan and transition-washing. Such dialogue could play a key role in calibrating both the tenor of SPOs and also regulatory enforcement practices (see Guardrail 5).

D. Penalties

No regulatory framework can be effective unless it is supported by adequate and proportionate penalties for breach of the rules.¹⁸² Policymakers again have a range of options when considering what these penalties could be. Guidance on the appropriate level for financial penalties can again be derived from the incoming EuGB Regulation, which will provide EU regulators with powers to levy fines of up to EUR500,000 or 0.5% of annual turnover for issuers¹⁸³ and, for third party reviewers, sanctions including fines of up to EUR200,000 or the withdrawal of their right to certify instruments using the EuGB label.¹⁸⁴ Issuers, too, could be censured or excluded from using Protected Labels where they are in breach of regulatory rules. Regarding the latter, it is noteworthy that the Philippine Securities and Exchange Commission has reserved a discretionary power to restrict fundraisers from using the "ASEAN Sustainability-Linked Bond" label in order to allow it to protect the public interest, the interests of investors, to encourage transparency and to ensure the integrity of the Philippine sustainable finance market.¹⁸⁵ Finally, policymakers could again consider penalties that provide options to investors where regulations are breached, for example the option to accelerate or redeem their bonds.¹⁸⁶



How can policymakers incentivise firms to use labels protected by regulation?

The inevitable risks and compliance costs for firms seeking to utilise Protected Labels, and the dearth of transition strategies likely to comply with a regulatory requirement for Paris-alignment at present, heightens the need for policy incentives to encourage firms to develop towards their use. A range of such tools to provide such incentives are available to policymakers, many of which have been helpfully identified by the G20 SFWG.¹⁸⁷

Likely to be of particular importance are policies to ensure that a significantly cheaper cost of financing does in fact materialise for issuers qualifying for and using Protected Labels. This could include guiding (or flexing the mandates of) national public financial institutions to take de-risking / first loss positions on transition finance instruments or use of central bank monetary policy levers.

Regarding the latter, one useful precedent for policymakers to examine is the Bank of Japan's Funds-Supplying Operations to Support Financing for Climate Change Responses.¹⁸⁸ This targeted refinancing scheme allows Japanese private sector financial institutions, provided they make certain prescribed climate disclosures, to obtain 0% loan refinancing for investments or loans to corporates that the financial institution self-determines and self-certifies have complied with recognised green or transition finance guidelines (such as the Japanese government's *Basic Guidelines* or the ICMA Climate Transition Finance Handbook).¹⁸⁹ Over 8 billion yen had been disbursed under the scheme as at January 2024.¹⁹⁰ Whilst a substantive analysis has not been conducted in the preparation of this paper, one potential issue with the scheme is the permission of self-certification by financial institutions. There also does not appear to be any mechanism by which the Bank of Japan checks the quality of the transition finance instruments it refinances and therefore its support may not be well calibrated to supporting the development of a credible, high integrity transition finance ecosystem in Japan.

Finally, an important incentive for firms to use Protected Labels will be confidence in the relevant regulator's grasp of the need for a balance between robust enforcement action and pragmatism, per the discussion in Guardrail 5 below.



GUARDRAIL 5: EMPOWER FINANCIAL REGULATORS TO PENALISE TRANSITION-WASHING



Problem statement reference

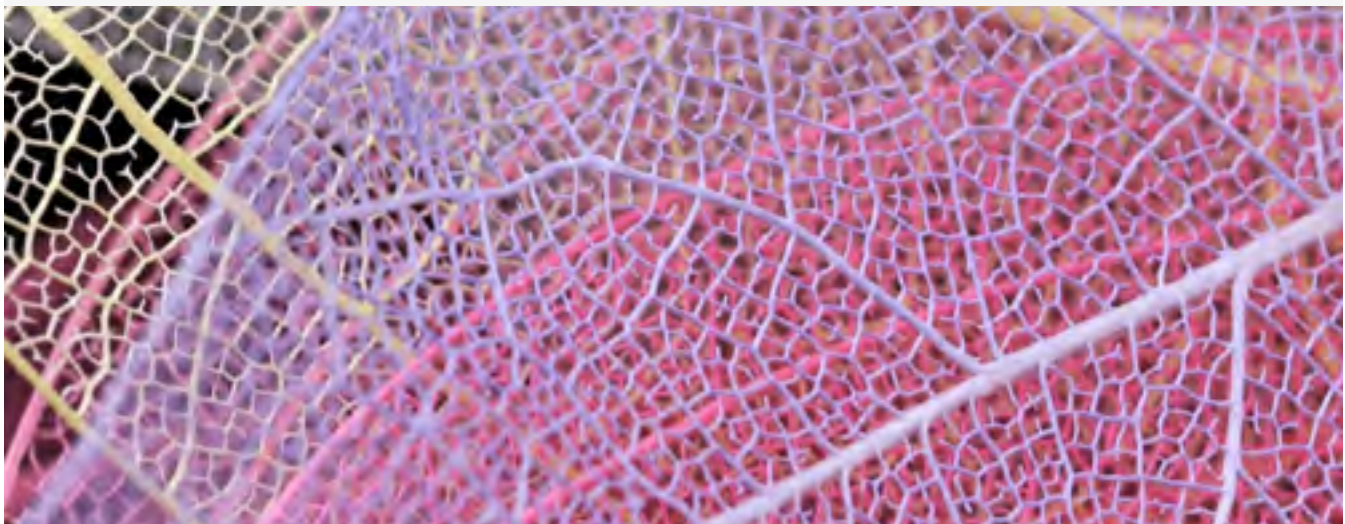
C. Firms are financially and reputationally incentivised to raise transition finance, even where they are not transitioning their whole business including Scope 3 emissions. Transition finance standards are non-binding and regulatory action to raise market standards has not yet materialised. External verification exercises have not provided meaningful challenge to issuers. Overall, firms are not meaningfully incentivised to issue high quality transition finance debt instruments.

Notwithstanding the suggested need for a more developed regulatory framework covering labelled transition finance bond markets (per Guardrail 4), regulators should already be seeking to penalise transition-washing where generally applicable securities regulations are being breached, for example rules which require statements regarding financial products to be fair, clear and not misleading. Only with the threat of meaningful sanction is the practice likely to be effectively deterred – market pressure alone is unlikely to suffice.¹⁹¹

Transition finance presents particular challenges for regulators. They must grapple with the fact that any judgement of the credibility and integrity of the transition credentials of a fundraiser involves future predictions and inherent uncertainties.¹⁹² They must also strike a balance between encouraging the development of transition finance through an attitude of enforcement restraint where such finance is provided in good faith for the execution of credible entity-level transition strategies, whilst being willing and ready to penalise, with meaningful sanctions, transition-washing that falls short of generally applicable, or transition finance-specific, regulation necessary to protect market integrity.

Policymakers, and regulators themselves, can take at least three steps in order to help meet these challenges. First, providing regulators with appropriate funding and resources can have transformative impacts. For example, last year, supported by additional funding from its government, the Australian Securities & Investment Commission (“ASIC”) resorted to legal action against three asset managers deemed to have made misleading climate claims regarding certain of their funds.¹⁹³ In late March, ASIC secured its first greenwashing court outcome when the Australian court agreed with ASIC that Vanguard’s Australian arm made misleading claims about certain ESG exclusionary screens applied to investments in a bond index fund.¹⁹⁴

Second, regulators can improve their capacity to handle the complex technical questions, e.g. regarding the feasibility or scientific credibility of particular technologies, that transition finance and the question of transition-washing inevitably will increasingly raise (and particularly so if regulators are given a mandate to oversee SPO providers, per Guardrail 4). Regulators should, for this purpose, already be looking to hire personnel with expertise in the latest climate science and its permutations for different industrial sectors.



Third and finally, regulation (or at least guidance) applicable to transition finance can set out a definition (and perhaps worked examples) of transition-washing (see Part B and Guardrail 4), in order to signal to the market (and regulatory personnel) the relevant standards and make it easier for the right enforcement balance to be struck.

This would not be unprecedented; regulatory definitions of the broader greenwashing concept are beginning to emerge. The UK's Financial Conduct Authority, for example, has recently introduced an anti-greenwashing rule requiring firms to ensure that any reference to the sustainability characteristics of a product or service is consistent with the sustainability characteristics of the product or service, and is fair, clear and not misleading.¹⁹⁵ Similarly, in order to include a regulatory direction for banks not to channel finance to greenwashing companies, the Bangko Sentral Ng Pilipinas has defined greenwashing as including:



the dissemination of misleading information, whether intentional or not, regarding a company's environmental strategies, goals, motivations, and actions that can induce false positive perception of a company's [environmental and social] performance.¹⁹⁶



Policymakers and regulators are, of course, best placed to determine which specific types of transition-washing behaviours should attract sanction. Implementing, in the design of a labelled transition finance framework, Guardrails 1 – 4 above can also help in this regard, by brightening the lines against which transition-washing can be assessed and thereby also making it easier for the right enforcement balance to be struck.



GUARDRAIL 6: IMPLEMENT SYSTEMIC REFORMS TO SCALE-UP TRANSITION FINANCE, BOTH LABELLED AND UNLABELLED



Problem statement reference

D. The prevalence of transition-washing is contributing to misallocations of capital and investor concerns about transition finance generally. This has resulted in lost growth momentum in transition bond finance, which remains a very small corner of finance. To make-up the climate finance shortfall needed urgently to achieve the Paris Temperature Goals, policymakers need to consider more systemic reforms.

Notwithstanding the steps that policymakers may take to restore integrity and credibility to Protected Labels in transition finance, it is acknowledged that many firms, and their investors, are likely to shy away from their use. This is particularly so given the transition-washing risks that such labels are presently associated with and/or the costs and risks that would attach to compliance with relevant regulatory threshold conditions (see Guardrails 4 and 5). For these reasons, scaling up broader unlabelled transition finance is critical. However, as noted in Part A, there remains a major gap to the scale of climate finance needed to achieve a Paris-aligned transition. This is particularly so in carbon-intensive and hard-to-abate sectors.¹⁹⁷

Accordingly, policymakers are recommended to develop further 'whole of economy', systemic reform proposals that could help to bring all transition finance into Paris-alignment, beyond the labelled instruments which have been the focus of this paper. Communication of this direction of travel to the market could also play a catalytic role, of itself, in the development of labelled transition finance. Crucially, to the extent such reforms compel or incentivise higher integrity Paris-aligned transitions, they are also likely to mitigate transition-washing risks.

Much emphasis has been placed to date upon disclosure rules, relying upon the "invisible hand" of market competition and investor pressure to drive behavioural change through efficient capital allocation to climate leaders and away from climate laggards. Yet, as noted in Guardrail 4, such rules are likely to be necessary but not sufficient.¹⁹⁸ This is especially likely given that climate change is widely acknowledged as the:



greatest and widest-ranging market failure ever seen.¹⁹⁹



Markets (including regulators and policymakers) continue to materially underestimate the seriousness and proximity of climate-related financial risks, including stranded asset risks, posed to firms.²⁰⁰ Even were this not the case, any business which can persuade its investors that the financial opportunities of maintaining the status quo outweigh climate-related financial or reputational risks is unlikely to be proactive when it comes to the climate transition. Ultimately, a dearth of laws and regulations relies upon voluntary action, and as the UN High Level Climate Champions have put it, "*we cannot rely on voluntary action alone to achieve the goals of the Paris Agreement.*"²⁰¹

One option that policymakers could prioritise in this regard is to consider mandating, as the EU is poised to do²⁰² and as GFANZ has previously called for,²⁰³ amongst others, that large businesses publish transition plans for climate change mitigation in line with the Paris Agreement. The EU's Corporate Sustainability Due Diligence Directive ("**CSDDD**") is the first example of lawmaking to mandate a Paris-aligned transition plan, and, if properly enforced, represents arguably the most effective and coherent way for policymakers to accelerate the net zero transition. Applying such an obligation to the financial sector, as the CSDDD is set to do (whilst excluding the financial sector from some of its other key provisions relating to downstream/client due diligence),²⁰⁴ would also

provide a significant incentive for financial institutions to accelerate the decarbonisation of their balance sheets and so encourage the growth of transition finance loan books.

A second option that policymakers could explore, as ClientEarth has written elsewhere in relation to the London Stock Exchange,²⁰⁵ is to progressively restrict access to public markets to firms without Paris-aligned transition strategies. To maximise their leverage with respect to the private sector, regulators could introduce a requirement that firms must prepare, disclose and then implement scientifically credible, externally verified climate transition targets, plans and strategies as a condition of accessing listed markets and then maintaining their listed status, or the listed status of their bond offerings. Companies could also be required to provide a standing undertaking that the proceeds of listings (whether equities or bonds) will not be used to fund activities that are inconsistent with their disclosed transition plan. Not only would such rules provide a powerful incentive for fundraisers to prepare, disclose and implement credible transition strategies, protecting investors in public markets from transition-washing risk, they could also play an important role in mitigating stranded asset risk and related systemic risks (such as green swan risk²⁰⁶).

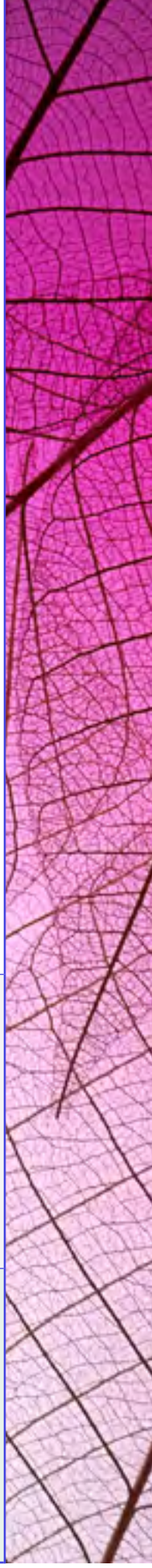
These two non-exhaustive examples are intended only to illustrate the type of reforms that policymakers will (and should) be considering in order to scale-up transition finance (labelled or unlabelled) in order to accelerate the net zero transition in the real economy. The creation of a policy framework for labelled transition finance in accordance with the recommendations contained in Guardrails 1 – 5 can play a symbiotic role in this regard. As Guardrail 4 has noted, to the extent labelled transition finance policy frameworks can help to create a vanguard of corporate climate leaders in carbon-intensive sectors, such firms will themselves become more likely to drive systemic change.





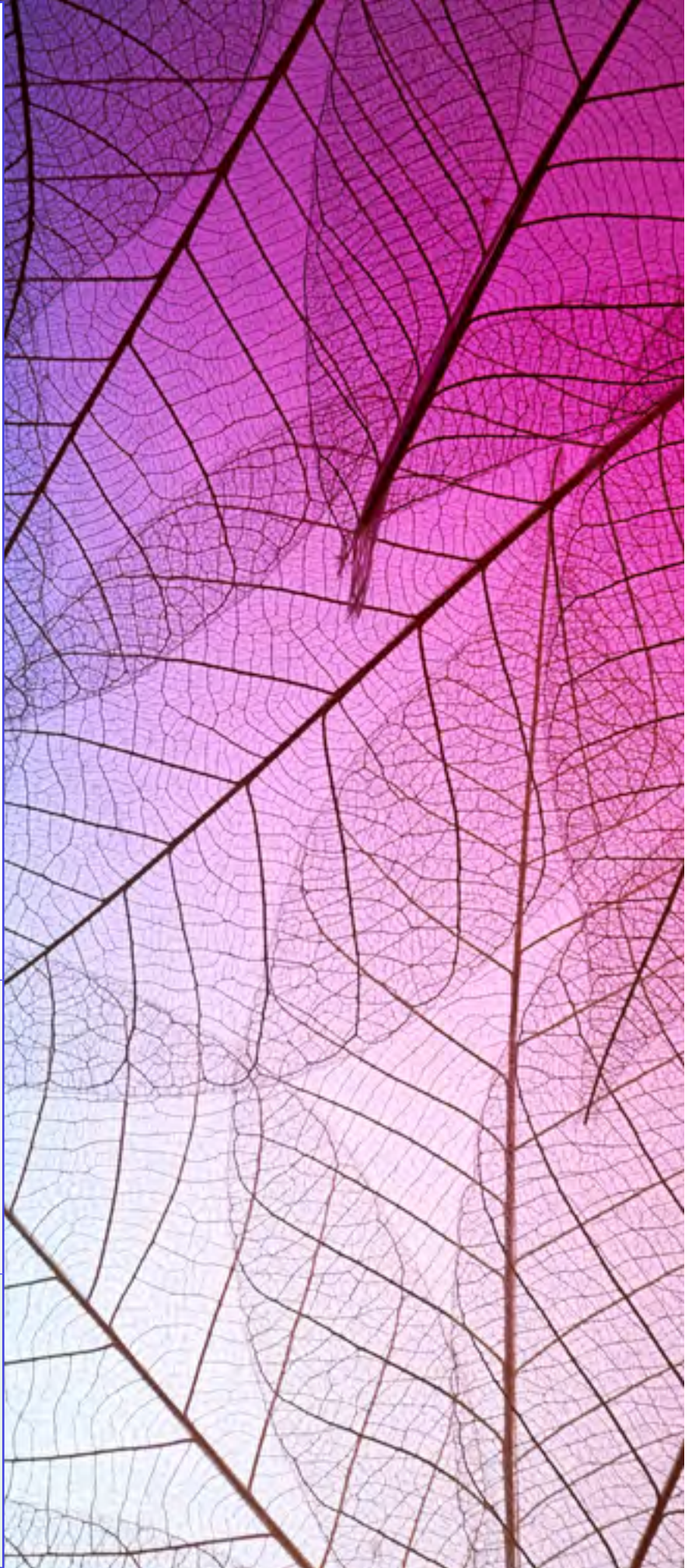
APPENDIX 1: PROMINENT DEFINITIONS OF TRANSITION FINANCE

Organisation	Framework	Definition
ASEAN Capital Markets Forum	ASEAN Transition Finance Guidance, 17 October 2023	"With reference to the Glasgow Financial Alliance for Net Zero (GFANZ), transition finance is defined as the investment, financing, insurance and related products and services that are necessary to support an orderly real-economy transition to net zero..." ²⁰⁷
European Commission	Commission Recommendation (EU) 2023/1425 of 27 June 2023 on facilitating finance for the transition to a sustainable economy	<p>"Transition finance means financing of investments compatible with and contributing to the transition, that avoids lock-ins, including:</p> <ol style="list-style-type: none"> investments in portfolios tracking EU climate transition benchmarks and EU Paris-aligned benchmarks; investments in Taxonomy-aligned activities, including: <ul style="list-style-type: none"> transitional economic activities as defined by Article 10(2) of Regulation (EU) 2020/852 [the EU Taxonomy] for the climate mitigation objective; Taxonomy-eligible economic activities becoming Taxonomy-aligned in accordance with Article 1(2) of Commission Delegated Regulation (EU) 2021/2178 over a period of maximum 5 (exceptionally 10) years; investments in undertakings or economic activities with a credible transition plan at the level of the undertaking or at activity level. investments in undertakings or economic activities with credible science-based targets, where proportionate, that are supported by information ensuring integrity, transparency and accountability."²⁰⁸
G20 Sustainable Finance Working Group	2022 G20 Sustainable Finance Report, October 2022	"Transition finance, as discussed in this report, refers to financial services supporting the whole of economy transition, in the context of the Sustainable Development Goals (SDGs), towards lower and net-zero emissions and climate resilience, in a way aligned with the goals of the Paris Agreement." ²⁰⁹



Organisation	Framework	Definition
GFANZ	Expectations for Real-economy Transition Plans, September 2022	<p>"GFANZ has identified four key financing strategies that define transition finance. These strategies are inclusive of financing, investment, insurance and related products and services, that are critical to delivering real-economy emissions reduction in support of an orderly, net-zero transition of the global economy:</p> <ol style="list-style-type: none"> 1. Climate solutions: Financing or enabling entities and activities that develop and scale climate solutions. This strategy encourages the expansion of low-emitting technologies and services, including nature-based solutions, to replace high-emitting technologies or services, remove greenhouse gases from the atmosphere, or otherwise accelerate the net-zero transition in a just manner. 2. Aligned: Financing or enabling entities that are already aligned to a 1.5 degrees C pathway. This strategy supports climate leaders and signals that the financial sector is seeking transition alignment behavior from the real-economy companies with which it does business. 3. Aligning: Financing or enabling entities committed to transitioning in line with 1.5 degrees C-aligned pathways. This strategy supports both high-emitting and low-emitting firms as they develop robust net-zero transition plans, set targets aligned to sectoral pathways, and implement changes in their business to deliver on their net-zero targets. 4. Managed phaseout: Financing or enabling the accelerated managed phaseout (e.g., via early retirement) of high-emitting physical assets. This strategy facilitates significant emissions reduction by the identification and planned early retirement of assets while managing critical issues of service continuity and community interests. GFANZ believes this activity is essential to reducing global emissions and supporting a smooth and just economic transition."²¹⁰
Financial Services Agency, Ministry of Economy, Trade and Industry and Ministry of the Environment, Japan	Basic Guidelines on Transition Finance, May 2021	<p>"Transition finance refers to a financing means to promote long-term, strategic GHG emissions reduction initiatives that are taken by a company considering to tackle climate change for the achievement of a decarbonized society.</p> <p>In particular, Japan, with the aim to achieve 2050 carbon neutral, defines transition finance as a finance for supporting the fundraiser who have set their target consistent with the Paris Agreement and satisfied the elements set forth in these Guidelines...</p> <p>...transition finance is determined not only by the Use of Proceeds of the funds raised, but also the credibility of the strategies and practices of the fundraiser."²¹¹</p>

Organisation	Framework	Definition
OECD	Guidance on Transition Finance: Ensuring Credibility of Corporate Climate Transition Plans, October 2022	"In the context of this Guidance, transition finance is understood 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." ²¹²
US Department of the Treasury	Principles for Net-Zero Financing & Investment, September 2023	"Transition finance: This practice involves providing financing, investment, or advisory services to clients and portfolio companies that are implementing measures to significantly reduce the emissions from their goods or services. Transition finance can support decarbonization in high-emitting sectors for which decarbonization is particularly difficult due to the current limitations in technological viability and/or price competitiveness of low-emissions alternatives." ²¹³



ENDNOTES

- ¹ [What does it take to get to net zero](#), Ravi Menon, 19 August 2022
- ² [Amount of finance committed to achieving 1.5°C now at scale needed to deliver the transition](#), GFANZ, 3 November 2021
- ³ The International Capital Market Association issued its first [‘Climate Transition Finance Handbook’](#) in December 2020.
- ⁴ See Box SPM.1, pp7-8 in [Climate Change 2022: Impacts, Adaptation and Vulnerability](#), IPCC Working Group II, February 2022
- ⁵ See A.4.3, p11 in [Synthesis Report of the IPCC Sixth Assessment Report \(Summary for Policymakers\)](#), IPCC, March 2023
- ⁶ [Climate tipping points — too risky to bet against](#), Lenton, TM et al, November 2019
- ⁷ See p18 in [Unburnable Carbon: Ten Years On](#), Carbon Tracker, June 2022
- ⁸ [AR6 Synthesis Report: Headline Statements](#), IPCC, March 2023
- ⁹ See C1, C1.1 in [Climate Change 2022: Mitigation of Climate Change \(Summary for Policymakers\)](#), IPCC Working Group III, April 2022
- ¹⁰ Ibid
- ¹¹ For example, see pp29-30 in [NGFS Climate Scenarios for central banks and supervisors](#), Network for Greening the Financial System, June 2020
- ¹² See p1 in [The economics of climate change: no action not an option](#), Swiss Re Institute, April 2021
- ¹³ Resulting, for example, from policy responses to climate change, technological innovations or a changed business environment resulting from evolving stakeholder perceptions and expectations.
- ¹⁴ Generally, a “stranded asset” is one that cannot viably be exploited for the life for which it was expected to be utilised, which negatively impacts on its current value. Stranded asset risks are prevalent in several sectors of the global economy e.g. the energy and power sectors. For more detail, see p19 in [The green swan: central banking and financial stability in the age of climate change](#), Bank for International Settlements, Banque de France, January 2020
- ¹⁵ Ibid
- ¹⁶ [Resolving the climate paradox](#), Mark Carney, September 2016
- ¹⁷ See p13 in [Transition finance: Investigating the state of play: A stocktake of emerging approaches and financial instruments](#), OECD, August 2021; and p4, [2022 G20 Sustainable Finance Report](#), G20 Sustainable Finance Working Group, October 2022
- ¹⁸ See sections 1.1, 1.1.1 in [OECD Guidance on Transition Finance: Ensuring Credibility of Corporate Climate Transition Plans](#), OECD, October 2022; section 2.1 in [Mechanisms to Prevent Carbon Lock-in in Transition Finance](#), OECD, September 2023; and p26 in [2022 G20 Sustainable Finance Report](#), G20 Sustainable Finance Working Group, October 2022
- ¹⁹ See p2 in [Blended finance for the net-zero transition](#), Ravi Menon, October 2022
- ²⁰ See p7 in [Transition Finance in the Debt Capital Market](#), ICMA, February 2024
- ²¹ See p11 in [Transition Finance in the Debt Capital Market](#), ICMA, February 2024
- ²² See, generally, [Transition Finance in the Debt Capital Market](#), ICMA, February 2024; and section 3.1 in [OECD Guidance on Transition Finance: Ensuring Credibility of Corporate Climate Transition Plans](#), OECD, October 2022
- ²³ See p17 in [Green Pills: Making Corporate Climate Commitments Credible](#), Armour, J et al, 1 December 2022; pp11,18 in [Transition finance: Investigating the state of play: A stocktake of emerging approaches and financial instruments](#), OECD, August 2021; and p22 in [2022 G20 Sustainable Finance Report](#), G20 Sustainable Finance Working Group, October 2022. Investors have also noted, in particular, that sustainability-linked bonds could be “*especially strong in their contribution to decarbonization goals, as they tie the issuer’s entire operations to these specific goals...linking them to financial incentives.*” See [Sustainability-linked bonds: The investor perspective](#), Nordea, May 2021
- ²⁴ See section 2 in [OECD Guidance on Transition Finance: Ensuring Credibility of Corporate Climate Transition Plans](#), OECD, October 2022; and see pp50-51 in [Transition finance: Investigating the state of play: A stocktake of emerging approaches and financial instruments](#), OECD, August 2021
- ²⁵ [Keynote Speech: Climate Reporting in ASEAN – State of Corporate Practices](#), Tan Boon Gin, 19 July 2022
- ²⁶ “Carbon lock-in” can arise when transition finance flows to technologies that offer only a marginal emissions reduction improvement, but are overall still emissions-intensive and long-lived e.g. technologies that offer marginal emissions reductions in the context of high-emitting assets that cause a delay in the transformation or decommissioning of those assets. See Box 1.1 in [Mechanisms to Prevent Carbon Lock-in in Transition Finance](#), OECD, September 2023
- ²⁷ [Greenwashing and how to avoid it: an introductory guide for Asia’s finance industry](#), ClientEarth, April 2023
- ²⁸ Estimates of stranded asset risk have ranged from US\$1 – 19 trillion, see p19 in [The green swan: central banking and financial stability in the age of climate change](#), Bank for International Settlements, Banque de France, January 2020
- ²⁹ [UN warns Aramco and its financiers over their role in driving climate-fuelled human rights violations](#), ClientEarth, 25 August 2023
- ³⁰ A risk predicted by the OECD in late 2022, see Executive Summary in [OECD Guidance on Transition Finance: Ensuring Credibility of Corporate Climate Transition Plans](#), OECD, October 2022
- ³¹ For example, see section 1.2 in [Mechanisms to Prevent Carbon Lock-in in Transition Finance](#), OECD, September 2023
- ³² See p5 in [Transition finance for transforming companies](#), Climate Bonds Initiative, 6 September 2022
- ³³ [Transition Finance Gap Remains Amid Uncertainties](#), Sustainable Fitch, 12 July 2023
- ³⁴ For example, transition-labelled bonds grew only 5% in 2022 from a low (US\$3.3bn) base, and SLB issuances declined 32% year on year in 2022. See pp5, 17, 21 in [Sustainable Debt: State of the Market 2022](#), Climate Bonds Initiative, April 2023
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- ³⁹ See section 4.4 in [Mechanisms to Prevent Carbon Lock-in in Transition Finance](#), OECD, September 2023
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- ⁴³ [Insight: How companies can lower the bar in sustainability bond binge](#), Reuters, December 2021
- ⁴⁴ Worse, none of the US\$5.4bn of SLBs issued by oil and gas companies in 2022 included scope 3 emissions reduction targets. See pp19-20 in [Sustainable Debt: State of the Market 2022](#), Climate Bonds Initiative, April 2023
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- ⁴⁶ See p36 in [TRV Risk Monitor: ESMA Report on Trends, Risks and Vulnerabilities](#), ESMA, 9 February 2023
- ⁴⁷ See pp21-22, [Who pays for sustainability? An analysis of sustainability-linked bonds](#), Kölbel & Lambillon, 12 January 2022
- ⁴⁸ [Structural Loopholes in Sustainability-Linked Bonds](#), World Bank, October 2022
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- ⁵⁰ [OECD Guidance on Transition Finance: Ensuring Credibility of Corporate Climate Transition Plans](#), OECD, October 2022; [Mechanisms to Prevent Carbon Lock-in in Transition Finance](#), OECD, September 2023
- ⁵¹ See [Net Zero Company Benchmark Interim assessments](#), Climate Action 100+, October 2022; and p5 in [Corporate Climate Responsibility Monitor 2024](#), New Climate Institute, 9 April 2024
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- ⁵³ See pp3-4 in [Green Pills: Making Corporate Climate Commitments Credible](#), Armour, J et al, 1 December 2022
- ⁵⁴ See pp6, 24 in [Transition Finance in the Debt Capital Market](#), ICMA, February 2024

- ⁵⁵ See p16 in [Transition Finance in the Debt Capital Market](#), ICMA, February 2024
- ⁵⁶ See p21 in [The Pivot Point](#), UN High Level Climate Champions, September 2022
- ⁵⁷ [Achieving Net-Zero Emissions Requires Closing a Data Deficit](#), International Monetary Fund, 23 August 2022
- ⁵⁸ See p37 in [Transition Finance Mapping](#), Climate Bonds Initiative, 30 September 2023
- ⁵⁹ See p27 in [Transition Finance Mapping](#), Climate Bonds Initiative, 30 September 2023
- ⁶⁰ With the exception of certain standard setters e.g. the Science Based Targets initiative has prepared its own pathways, and generally refers corporates to those in its certification standard. See p31 in [Transition Finance Mapping](#), Climate Bonds Initiative, 30 September 2023
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- ⁶³ Ibid
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- ⁷⁰ Ibid
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- ⁷⁴ [Empty ESG Pledges Ensure Bonds Benefit Companies, Not the Planet](#), Bloomberg, 4 October 2022; [Sustainability bond market stumbles as investors get picky](#), Financial Times, 14 February 2023; [Companies face intensifying scrutiny over greenwashing](#), Financial Times, 16 October 2023; and [Market integrity and greenwashing risks in sustainable finance](#), ICMA, October 2023
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- ⁷⁶ [TotalEnergies pauses SLB plans amid weak market development](#), Environmental Finance, 19 April 2024
- ⁷⁷ [Companies face intensifying scrutiny over greenwashing](#), Financial Times, 16 October 2023
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- ⁷⁹ [Our first question when we see an SLB: 'What are these guys hiding?'](#), Environmental Finance, 20 November 2023
- ⁸⁰ See p21 in [Sustainable Debt: State of the Market 2022](#), Climate Bonds Initiative, April 2023
- ⁸¹ [Japan Climate Transition Bond Framework](#), Cabinet Secretariat / Financial Services Agency / Ministry of Finance / Ministry of Economy, Trade and Industry / Ministry of the Environment, November 2023
- ⁸² [What is GX?](#) Climate Integrate, January 2024. See also "Sector-specific Investment Strategies" Compiled as Effort for Specifying Investment Promotion Measures for the Realization of GX, Japan Ministry of Economy Trade and Industry, December 2023
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- ⁸⁴ See pp23-24 in [Japan's \\$1 Tn GX \(Green Transformation\) Policy](#), InfluenceMap, November 2023
- ⁸⁵ See p26 in [Japan's \\$1 Tn GX \(Green Transformation\) Policy](#), InfluenceMap, November 2023
- ⁸⁶ See pp24-26 in [Japan's \\$1 Tn GX \(Green Transformation\) Policy](#), InfluenceMap, November 2023
- ⁸⁷ Which provides that "[a]s a general rule, and across all sectors, it is more efficient to use electricity directly and avoid the progressively larger conversion losses from producing hydrogen, ammonia, or constructed low GHG hydrocarbons". See p45 in [Climate Change 2022: Mitigation of Climate Change \(Technical Summary\)](#), IPCC Working Group III, April 2022
- ⁸⁸ [Net Zero Roadmap: A Global Pathway to Keep the 1.5°C Goal in Reach \(2023 Update\)](#), IEA, September 2023
- ⁸⁹ See pp24-26 in [Japan's \\$1 Tn GX \(Green Transformation\) Policy](#), InfluenceMap, November 2023
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- ¹⁷⁷ See footnote 1 on p2 in [Update on the guidelines on funds' names using ESG or sustainability-related terms](#), ESMA, 14 December 2023; and footnote 5 on p7 in [Final Report: Guidelines on funds' names using ESG or sustainability-related terms](#), ESMA, 14 May 2024
- ¹⁷⁸ See Article 72(2) in [Regulation 2023 / 2631](#), Official Journal of the European Union, 22 November 2023
- ¹⁷⁹ [Regulation 2023 / 2631](#), Official Journal of the European Union, 22 November 2023
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- ²¹¹ See p4 in [Basic Guidelines on Transition Finance](#), Financial Services Agency, METI and Ministry of the Environment, May 2021
- ²¹² See section 1.3.1 in [OECD Guidance on Transition Finance: Ensuring Credibility of Corporate Climate Transition Plans](#), OECD, October 2022
- ²¹³ See p5 in [Principles for Net-Zero Financing & Investment](#), US Department of the Treasury, September 2023



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