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Quoted

Sustainable Financing – shifting towards the transition

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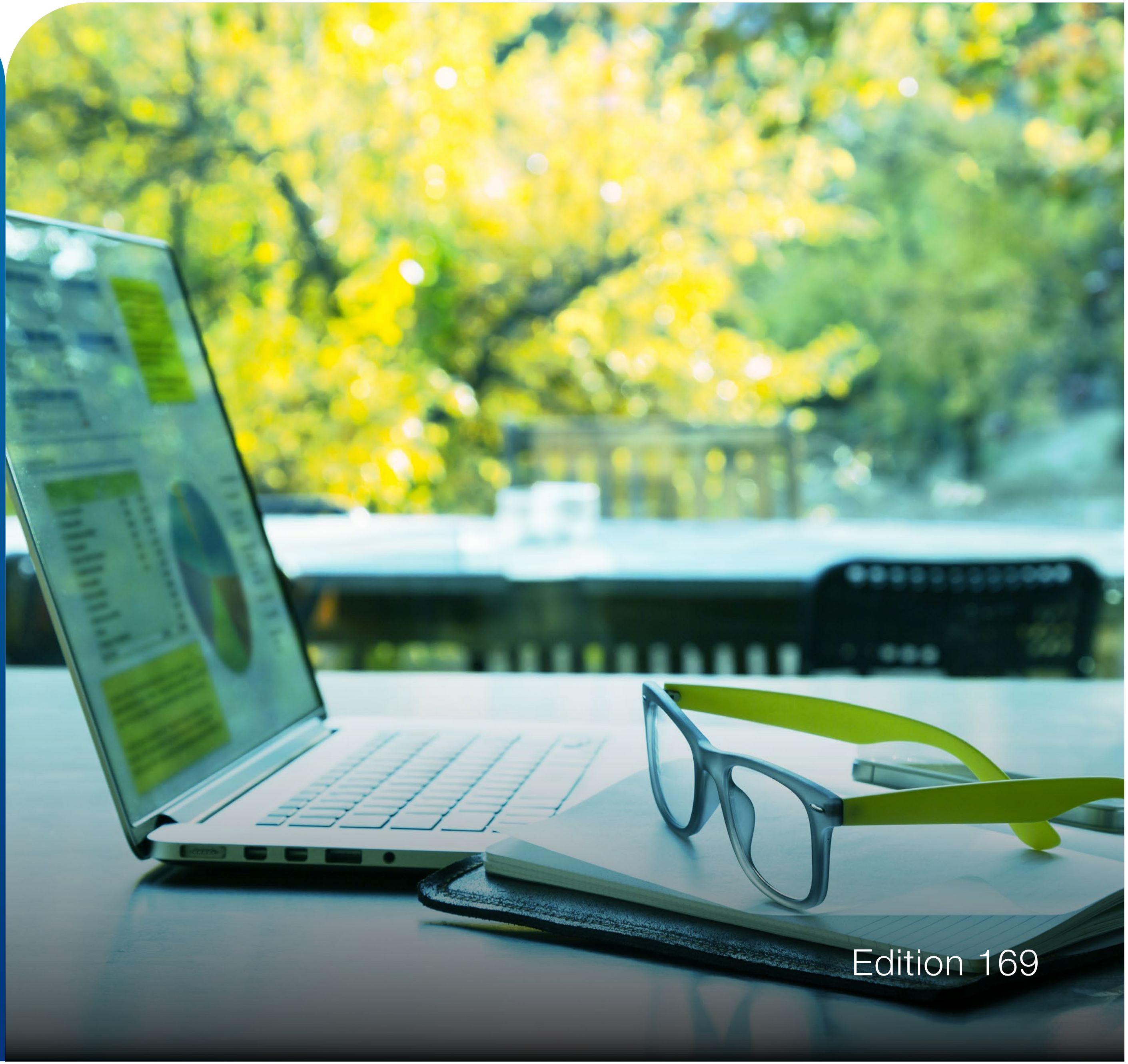

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In this edition

Sustainable Financing - shifting towards the transition

1. Introduction

In the European Union's (EU) policy context, sustainable finance is understood as finance to support economic growth while reducing pressures on the environment to help reach the climate and environmental objectives of the European Green Deal,[1] taking into account social and governance aspects.[2] Sustainable finance is about financing both what is already environment-friendly today (green or sustainability-linked finance) and what is transitioning to environment-friendly performance levels over time (Transition Finance). Transition Finance is any form of financial support that helps decarbonise high-emitting activities or enables the decarbonisation of other economic activities.[3] Standards have been developed for green and sustainability-linked finance for European financial markets (para. 3). No such standards have been developed for Transition Finance yet, which is seen by COP28[4] as lagging behind.[5] However, the Loan Market Association (LMA)[6] published the Guide to Transition Loans by the end of 2025.[7] This guide builds upon existing LMA documentation for green and sustainable lending.

In this Quoted we advocate for the importance of Transition Finance in addition to green and sustainability-linked finance. The main question addressed in this Quoted is how Europe should accommodate Transition Finance (see conclusion in para. 6). We will answer this question based on the following topics:

a. A high-level overview of the relevant EU regulatory framework for sustainable finance: Sustainable Finance Disclosure Regulation (SFDR),[8] Corporate Sustainability Reporting Directive (CSRD),[9] EU Taxonomy regulation (EU Taxonomy),[10] Directive on Corporate

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1 'A European Green Deal – Striving to be the First Climate-Neutral Continent', available at: The European Green Deal – European Commission.

2 https://finance.ec.europa.eu/sustainable-finance/overview-sustainable-finance_en.

3 W. Mak and A. Vinelli, 'Navigating Transition Finance: An Action List', CFA Institute 2024, available at: https://www.cfainstitute.org/sites/default/files/-/media/documents/article/industry-research/transition-finance.pdf. Also see: Overview of sustainable finance – European Commission.

4 COP28 stands for *The 2023 United Nations Climate Change Conference*.

5 K. Leung, 'Beyond COP28: Financial Institutions Should Adopt Nuanced Transition Finance Frameworks to Support Net Zero', Institute for Energy Economics and Financial Analysis (13 February 2024), and para. 9 of: https://www.cop28.com/en/climate_finance_framework.

6 See www.lma.eu.com.

7 Loan Market Association, Guide to Transition Loans, 16 October 2025, http://www.lma.com/documents.

8 Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, *Official Journal of the European Union*.

9 Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting, *Official Journal of the European Union*.

10 Regulation (Eu) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment and amending Regulation (EU) 2019/2088, *Official Journal of the European Union*.

Sustainability Due Diligence (CSDDD)[11] and the Omnibus Simplification Package[12] (para. 2)

b. Types of sustainable finance and, to the extent applicable, LMA principles:[13] green loans, sustainability-linked loans (SLLs) and transition loans (para. 3)
c. Reasons for Europe to focus on Transition Finance (para. 4)
d. Suitability of the current regulatory framework for Transition Finance and suggestions on how to shift towards Transition Finance (para. 5).

2. EU Regulatory Framework

General

The EU's sustainable finance agenda is underpinned by a suite of interrelated regulations: SFDR, CSRD, EU Taxonomy and CSDDD. Together, they are designed to reorient capital flows towards sustainability objectives. These instruments work by enhancing transparency; standardising environmental, social or governance (ESG) data; and reshaping how lenders and investors allocate capital.

The SFDR and CSRD establish a mandatory disclosure framework. While the CSRD ensures that companies disclose ESG data, the SFDR ensures that financial market participants (FMPs) and financial advisers (FAs) use those data to make informed decisions about sustainable investments. Disclosures pursuant to the CSRD provide sustainability data that FMPs and FAs need to meet their obligations under the SFDR. Both frameworks rely on the EU Taxonomy to define what qualifies as a sustainable economic activity.

The EU Taxonomy provides a unified classification system for environmentally sustainable economic activities. The CSDDD introduces binding due diligence obligations, compelling in-scope companies (large companies and their value chains) to proactively manage human rights and environmental risks, with the objective of improving businesses' resilience and attractiveness to sustainability-focused investors. Further, the CSDDD provides the substantive obligations that companies must report on under the CSRD and ensures that companies implement the due diligence processes that SFDR disclosures are meant to reflect. Finally, the Omnibus Simplification Package targets to make sustainability reporting and due diligence frameworks more efficient, pragmatic and proportionate.

Together, the aforementioned regulatory instruments, by mandating ESG disclosures (SFDR and CSRD), defining sustainable activities (EU Taxonomy), mandating corporate due diligence (CSDDD) and streamlining implementation (Omnibus Simplification Package), create a framework that (in theory) enhances transparency, aligns capital with sustainability goals and embeds ESG considerations into lending and investment decisions, in the hope that this will accelerate the EU's broader transition towards a net-zero economy.

SFDR

The SFDR lays down harmonised disclosure and transparency rules for FMPs and FAs on sustainability risks and on how to integrate ESG factors into their investment decisions, financial advice and overall product-related sustainability ambitions.[14] The objective of the SFDR is to limit the risk of greenwashing, where financial products are marketed as

11 Directive (Eu) 2024/1760 of the European Parliament and of the Council of 13 June 2024 on corporate sustainability due diligence and amending Directive (EU) 2019/1937 and Regulation (EU) 2023/2859, *Official Journal of the European Union*.

12 Proposal for a Directive of the European Parliament and of the Council amending Directives 2006/43/EC, 2013/34/EU, (EU) 2022/2464 and (EU) 2024/1760 as regards certain corporate sustainability reporting and due diligence requirements.

13 International Capital Market Association (ICMA), 'Green and Sustainability Bond Principles', available at: Green-Bond-Principles-GBP-June-2025.pdf, and Sustainability-Linked-Bond-Principles-June-2024.pdf.

14 Recital 17 of the Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability- related disclosures in the financial services sector, *Official Journal of the European Union*.

sustainable or climate friendly, or where FMPs make sustainability-related claims that are not supported in practice.[15]

Under the SFDR, FMPs[16] must publish sustainability information about their products and services. The SFDR, therefore, applies to a wide range of products with an investment component. Also, under the SFDR, FAs are obliged to fulfil certain transparency obligations regarding sustainability characteristics when advising on such products. FMPs must disclose sustainability information on their website, in pre-contractual documents and in periodic reports. This information is required at both entity level (e.g. policies on integrating sustainability risks and considerations of adverse impacts) and product level (e.g. how a financial product addresses ESG objectives). Pursuant to Article 2 of the SFDR, at entity level the FMP must make transparent how it deals with sustainability in a generic sense (known as 'complying or explaining'). Products and the required disclosure level are often classified on whether they promote ESG characteristics or pursue a sustainability objective.

The SFDR was originally designed as a disclosure regime to improve transparency on how sustainability risks are integrated into investment decisions. In practice, it has been widely used as a product-labelling system. Pursuant to the SFDR at product level, every provider must clearly state the sustainability characteristics of the product.[17] This is where the product in practice gets the label 'dark green',[18] 'light green'[19] or 'grey'.[20] This labelling results in inconsistent application and greenwashing concerns.[21] Therefore, the SFDR was revised. On 20 November 2025, the European Commission published its legislative proposal for the amendment of the SFDR ('SFDR 2.0').[22] The key revisions are follows:

a. Introduction of defined product categories instead of previous disclosure-based approach: (i) transition category (new Article 7) – at least 70% of investments must meet a measurable transition objective, (ii) ESG-basics category (new Article 8) – at least 70% of investments must integrate sustainability factors and (iii) Sustainable category (new Article 9) – at least 70% of investments must meet a clear and measurable sustainability objective. Each category has specific requirements and exclusions, particularly regarding fossil fuels, tobacco and controversial weapons;

15 Summary of the Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability- related disclosures in the financial services sector, Summaries of EU Legislation.

16 FMP stands for Financial Market Participant, as defined in Regulation 2019/2088 (SFDR). FMPs include fund managers, investment firms, insurers, pension funds and banks that offer asset management services (Art. 2(1) SFDR).

17 Art. 6-10 Regulation SFDR.

18 Art. 9 SFDR. A 'dark green' has the following key requirements: (i) the product must aim to make sustainable investments, as defined in Art. 2(17) SFDR (Investments in economic activities that contribute to an environmental or social objective, provided they do not significantly harm any other objectives and follow good governance practices); (ii) the product must demonstrate that its investments do not significantly harm other environmental or social objectives (Art. 2(17) SFDR); (iii) in pre-contractual documents, on the website and in periodic reports, providers of the product must comply with the disclosure requirements (Art. 6(1) and (3) SFDR); (iv) if a product claims to be a dark green product, the provider must describe the likely impacts of sustainability risks on the returns of the financial products (Art. 6(1) sub b SFDR); and (v) if product intends to make environmentally sustainable investments, it must disclose the extent to which these investments are aligned with the EU Taxonomy.

19 Art. 8(1) SFDR. A 'light green' has the following characteristics: (i) the product promotes environmental and/or social characteristics, and that the investee companies have good governance practices in place (Art. 8(1) SFDR)); (ii) in pre-contractual documents, on the website and in periodic reports, providers of the product must be transparent on how ESG characteristics are achieved (Art. 8(1) 11 and 13 SFDR); (iii) light green products may include investments that qualify as sustainable investments (Art. 8(1) and 2(17) SFDR), but this is not mandatory; and (iv) if the product includes environmentally sustainable investments, it must state to what extent those investments are aligned with the Taxonomy.

20 Art. 6 SFDR. A 'grey' product does not promote environmental or social characteristics (light green) and does not have a sustainable investment objective (dark green). It has the following characteristics: (i) the product is neutral with respect to sustainability and (ii) even if the product does not have an ESG focus, pre-contractual documentation must include basic disclosures about how sustainability risks are integrated into investment decisions, or if they are not considered relevant, an explanation why not (comply or explain).

21 'The EU Sustainable Finance Disclosure Regulation 2.0 – 10 Questions', February 2025, available at: esg-briefing--sfdr-20-february-2025.pdf.

22 'Commission simplifies transparency rules for sustainable financial products, 20 November 2025, available at: Commission simplifies transparency rules for sustainable financial products - Finance.

b. Deletion of definition of “sustainable investments” and instead the focus is on whether products meet the criteria for one of the three new categories, using sustainability-related indicators and thresholds;
c, Reduction of the burden for FMPs by deleting principal adverse impacts (PAI) disclosure requirements: (i) entity-level disclosures under previous Article 4 (PAI) and Article 5 (remuneration policies) have been deleted, (ii) financial advisors and portfolio managers are now excluded from the scope of SFDR 2.0 and (iii) product-level PAI disclosures remain for product in the transition and sustainable categories but entity level reporting is longer required; and
d. Certain grandfathering and transition provisions are included – closed-ended products established before its application date may choose not to apply the new rules. Other existing products must comply with the new categories, website and reporting provisions within 12 months from SFDR 2.0’s application date.[23]

CSRD

The CSRD substantially expanded the reporting obligation for ‘large’ public interest entities (PIEs) under the Non-Financial Reporting Directive (NFRD) to large non-listed companies and small and medium-sized (SMEs) listed companies.[24] The CSRD requires these companies to include certain non-financial information in their annual reports with the goal of ensuring adequate, publicly available information about a company’s risks and opportunities arising from social and environmental issues and on the impact of their activities on people and the environment (the so-called double-materiality principle). These non-financial reports must be prepared in accordance with the European Sustainability Reporting Standards (ESRS).[25]

In addition to broadening the scope of the NFRD, the CSRD introduces more detailed and standardised reporting requirements. Companies subject to this directive must report on various sustainability topics, including ESG topics, as well as the company’s business model and impact on both people and the planet.[26]

Furthermore, the reporting must contain strategic and financial plans, such as investment decisions and implementation measures that demonstrate how the company’s business model aligns with the transition to a sustainable economy. These plans must be in accordance with the Paris Agreement and the EU’s climate neutrality target for 2050.[27]

As a result, investors and lenders will have access to key sustainability disclosures from in-scope companies, including published transition plans.[28] The CSRD’s reporting

23 The application date of SFDR 2.0 is not fixed yet. According to the official proposal, once SFDR 2.0 is formally adopted through the EU legislative process, it will apply 18 months after its entry into force.

24 To be in scope of the CSRD, companies need to meet at least two of the following criteria on two consecutive balance sheet dates: (i) more than 250 employees, (ii) net turnover exceeding EUR 50 million and (iii) total assets exceeding EUR 25 million. This applies to both EU companies and EU subsidiaries of non-EU parent companies. The CSRD takes a phased-in application timeline (Art. 2(1) and (2) CSRD): 2024 (reporting year 2025): companies subject to the NFRD; 2025 (reporting year 2026): all large undertakings and large parent undertakings (meeting the aforementioned criteria), 2026 (reporting year 2027): listed SMEs, small and non-complex credit institutions and captive insurance undertakings (with opt-out until 2028) and 2028 (reporting year 2029): non-EU companies with net turnover of more than EUR 150 million in the EU and at least one EU subsidiary or branch.

25 Delegated Regulation (EU) 2023/2772 of the European Commission of 31 July 2023 on supplementing Directive 2013/34/EU of the European Parliament and of the Council as regards sustainability reporting standards, *Official Journal of the European Union*. Also see Art. 29b(1) Directive (EU) 2022/2464 (CSRD).

26 Art. 19a(2), Directive 2013/34/EU as amended by CSRD.

27 Ibid.

28 Companies must disclose whether they have adopted a climate transition plan. If they have, they must describe how their business model and strategy are aligned with (i) transitioning to a sustainable economy, (ii) limiting global warming to 1.5ºC and (iii) achieving climate neutrality by 2050. If a company does not have a transition plan, it must provide a clear explanation for its absence. See: ‘Transition plans as a supervisory tool. Evolving regulatory expectations’, July 2023, Transition plans as a supervisory tool and ‘Climate transition plans under the CSRD’, June 2025, Climate transition plans under the CSRD – Sweep.

requirements, therefore, enable the integration of ESG risks and opportunities into financial analysis and credit assessments.

EU Taxonomy

The EU Taxonomy introduced a harmonised classification system for identifying environmentally sustainable economic activities.[29] It is important to know that the EU Taxonomy does not oblige investors to invest in Taxonomy-compliant activities, nor does it require any party to adapt their economic activities to meet Taxonomy-standards. However, the aforementioned disclosure requirements introduce obligations for both FMPs and PIEs to disclose information on the extent to which their products are Taxonomy aligned.[30]

When determining whether an economic activity qualifies as an environmentally sustainable economic activity, the economic activity must contribute substantially to one or more of the following environmental objectives:[31] (i) climate change mitigation, (ii) climate change adaption, (iii) sustainable use and protection of water and marine resources, (iv) transition to a circular economy, (v) pollution prevention and control and (vi) protection and restoration of biodiversity and ecosystems.[32]

The EU Taxonomy is a helpful tool for lenders providing Transition Finance products to companies. Article 10(2) EU Taxonomy introduces the concept of transitional activities, which are economic activities that do not yet have a technologically and economically feasible low-carbon alternative but still contribute to climate change mitigation. To qualify as a transitional activity under Article 10(2) EU Taxonomy, the activity must meet three strict criteria:

a. It must have Green House Gas (GHG) emission levels that are among the lowest in its specific sector (*best-in class*).
b. It must not hinder the development and deployment of low-carbon alternatives (*no obstruction*).
c. It must not lead to long-term reliance on carbon-intensive infrastructure (*no lock-in*).

In addition to contributing substantially to one or more EU Taxonomy environmental objectives, the economic activity may not do significant harm to any of the environmental objectives.[33] Thirdly, the economic activity should be carried out in compliance with the minimum social safeguards laid out in the EU Taxonomy,[34] and finally, the economic activity should meet certain technical screening criteria that are laid out in the delegated acts adopted by the European Commission.[35]

CSDDD

The CSDDD requires in-scope companies to promote sustainable and responsible corporate behaviour. Unlike the SFDR, CSRD and EU Taxonomy – which are primarily disclosure and transparency rules – the CSDDD focuses on corporate conduct and accountability. It establishes a duty for large companies to identify (via due diligence),

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29 Recital 16 of the Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment and amending Regulation (EU) 2019/2088, *Official Journal of the European Union*.
30 Consolidated questions and answers (Q&A) on the SFDR (Regulation (EU) 2019/2088) and the SFDR Delegated Regulation (Commission Delegated Regulation (EU) 2022/1288), available at: de2ef448-5638-4b07-b493-259e109e35c2_en.
31 Art. 3 sub a EU Taxonomy.
32 Art. 9 EU Taxonomy.
33 Art. 3 sub b jo. 9 EU Taxonomy.
34 Art. 3 sub c jo. 18 EU Taxonomy.
35 Art. 3 sub d jo. 10(3), 11(3), 12(2), 13(2), 14(2) or 15(2) EU Taxonomy.

prevent, mitigate and account for actual or potential adverse human rights and environmental impacts in their own operations, their subsidiaries and their value chains. The due diligence required by the CSDDD is not limited to direct suppliers but also includes indirect relationships, where relevant.

The main objective of the CSDDD is to promote sustainable and responsible corporate behaviour by including human rights and environmental considerations into companies' operations and value chains.[36] The CSDDD applies to both EU and non-EU companies that exceed specific thresholds regarding the number of employees and net turnover.[37] We note that financial institutions are in scope of the CSDDD, but with a more limited application compared with other large corporates. Under the CSDDD, regulated financial undertakings (including investment firms, insurance companies, credit institutions and fund managers) are required to conduct due diligence on their own operations, their subsidiaries and their upstream[38] value chain (so their suppliers and service providers). In addition to new rules on due diligence, the CSDDD notably introduces a requirement for the largest companies to adopt a climate transition plan to align their business strategy with the Paris Agreement.[39]

Failure to comply with the CSDDD can lead to reputational damages, administrative penalties[40] and civil liability[41] for harms that could have been prevented with proper due diligence. Governance is a key focus of the CSDDD, and as part of this, directors are responsible for oversight and implementation of due diligence actions, as well as implementing concerns for human rights, climate and environmental consequences into the company's corporate strategy.[42] Although the CSDDD does not encode a new EU-level directors' duty, it requires Member States to treat failure to consider sustainability impact as a breach of directors' existing duty of care under their national laws. Although it has to be seen how Member States will transpose this requirement, this could open the door to civil and personal liability of directors by effectively extending the interpretation of existing director duties to include damages resulting from their failure to take into account serious environmental or human rights risks. In addition, the CSDDD empowers national authorities to enforce compliance by levying fines up to 5% of a company's worldwide turnover.[43]

Omnibus Simplification Package

The Omnibus Simplification Package, comprising two legislative bundles introduced by the European Commission in February 2025, includes amendments to the CSRD, the CSDDD and a draft Taxonomy Delegated Act with the goal to reduce reporting burdens by narrowing the scope. Only companies with more than 1,000 employees and either a turnover above €50 million or a balance sheet total above €25 million will remain subject to the set-out rules.[44]

36 Art. 1(1) sub a CSDDD.

37 Art. 2 CSDDD.

38 So downstream due diligence is not required under the CSDDD. See: 'The EU's Corporate Sustainability Due Diligence Directive – Obligations for Companies', 2024, The EU's Corporate Sustainability Due Diligence Directive – Obligations for Companies.

39 Art. 15 CSDDD.

40 Art. 27 CSDDD.

41 Art. 29 CSDDD.

42 Art. 26 CSDDD.

43 Art. 27 CSDDD.

44 Commission Staff working document on the proposal for a Directive of the European Parliament and of the Council amending Directives 2006/43/EC, 2013/34/EU, (EU) 2022/2464 and (EU) 2024/1760 as regards certain corporate sustainability reporting and due diligence requirements, p. 9.

The Omnibus Simplification Package will ensure that sustainability reporting requirements for large companies do not place excessive demands on smaller companies and their supply chains.[45] To this end, the Commission will adopt a voluntary reporting standard. These standards are based on advice from European Financial Reporting Advisory Group (EFRAG)[46] and ensure that larger CSRD-reporting entities and financial firms may only request limited sustainability data from companies employing under 1,000 staff.

Furthermore, it will also amend and simplify the existing ESRS. The remaining companies that stay within the scope will (via this amendment and simplification) also feel the effect of the Omnibus Simplification Package. The obligation for the Commission to establish sector-specific standards is deleted, and the security requirement remains at the level of 'limited' assurance, without any future transition to the more stringent level of 'reasonable' assurance.[47]

The Omnibus Simplification Package in sum entails the following:

a. For CSRD: limits in-scope companies, postpones reporting obligations for second wave of in-scope companies with two years, introduces voluntary SME standards shielding them from excessive data requests by larger companies and drops the reasonable assurance standard
b. For EU Taxonomy: limits companies[48] that need to report on Taxonomy key performance indicators (KPIs),[49] promotes usability through tools such as the Taxonomy Compass and Calculator and introduces the concept of a 'safe harbour'[50]
c. For SFDR: encourages better alignment with the Taxonomy interlink. As mentioned, the SFDR 2.0 has been published by the European Commission
d. For CSDDD: postpones the transposition deadline by one year (from 2026 to 2027) and clarifies its scope to only direct business partners, reducing due diligence burden on SMEs

3. Types of Financings and to the Extent Applicable ICMA[51] and LMA Principles

With the right tools and shared understanding, loan markets can serve as a powerful engine for financing real-world decarbonisation. In driving the change to net zero, the EU has principally focused on reorienting capital flows towards sustainable investments by a combination of incentives ('carrots') and disincentives ('sticks'). The 'carrots' encourage

45 Commission Staff working document on the proposal for a Directive of the European Parliament and of the Council amending Directives 2006/43/EC, 2013/34/EU, (EU) 2022/2464 and (EU) 2024/1760 as regards certain corporate sustainability reporting and due diligence requirements, p. 23.

46 EFRAG is the technical adviser to the European Commission responsible for developing the draft European Sustainability Reporting Standards (**ESRS**) for CSRD compliance.

47 The difference between limited assurance and reasonable assurance under the CSRD lies in the depth of the auditor's work and the level of confidence provided in the sustainability information disclosed by a company.

48 Only companies with at least 1,000 employees and €450 million turnover.

49 KPI stands for Key Performance Indicators.

50 The concept of a "safe harbour" in the EU Taxonomy is most commonly discussed in relation to disclosure obligations: where companies or financial market participants may be given temporary relief or simplified requirements when full compliance is not yet feasible (for example, due to data gaps or the phased introduction of technical screening criteria). In the context of alignment with other regulations: the European Commission and European Supervisory Authorities have discussed a "safe harbour" for investments that are already Taxonomy-aligned, so that these investments are automatically deemed to meet certain sustainability disclosure requirements under the SFDR, without needing to undergo a second, duplicative assessment.

51 ICMA stands for the International Capital Market Association. ICMA is the leading global trade association for participants in the cross-border bond markets, including banks, issuers, asset managers, and market infrastructure providers. In the context of ESG, ICMA is known for developing and maintaining the Green Bond Principles, Social Bond Principles, Sustainability Bond Guidelines, and Sustainability-Linked Bond Principles, which are the global voluntary standards for sustainable bonds.

market participants to make sustainable business choices by making these (financially) attractive. 'Sticks', on the other hand, impose requirements or costs to ensure compliance with the net-zero targets set by the EU. While there are numerous examples of both 'carrots' and 'sticks', we focus on the EU sustainable regulatory framework.

Since the adoption of the EU Sustainable Finance Action Plan, principally via the assortment of regulations (as outlined in para. 2) that make up the EU's sustainable regulatory framework, wide-ranging obligations have been imposed on EU businesses and certain non-EU businesses investing in the EU to manage financial risks associated with climate change. EU businesses are required to collect and report on large quantities of ESG data. The regulatory framework emphasises increased transparency and long-term planning around the transition. However, market surveys show that market participants are confused and burdened by administrative, assurance and regulatory compliance as well as by the associated costs.[52] This is complicated further by the different timelines of adoption, parallel compliance processes and multiple layers of (inconsistent) sustainability reporting. As described in para. 2, non-compliance in certain cases can lead to reputational damages, administrative penalties and civil liability for breaches of the EU sustainable regulatory framework. The administrative burden and overlapping requirements could even lead to disengagement or minimal compliance rather than proactive sustainability efforts.

This is not to say, however, that the EU sustainable regulatory framework is without 'carrots'. These regulations have provided the necessary (policy and political) signals to investors and lenders to channel capital to sustainable outcomes. While the EU sustainable regulatory framework is still new and its impact on business practices will take time to materialise, there are early signs that the goal of reorienting capital flows is being achieved. This framework has driven financial innovation through the creation of new and successful financial products, namely, green loans and bonds, SLLs and bonds and transition loans and bonds. These innovations have been driven predominately by private market participants and their industry associations such as the LMA. These financial products aim to encourage, on the one hand, greater use of ESG-linked financing products and, on the other hand, greater adoption of sustainable business practices through economic and reputational rewards (hence 'carrots'). In this section, we will go into more detail on the different types of ESG-linked financing products and how these can be used.

Green and Sustainability-linked Loans

The LMA, in collaboration with the Asia Pacific Loan Market Association and the Loan Syndications and Trading Association, has developed (and revised, most recently on 26 March 2025) principles and guidance for two commonly used types of sustainable finance products: (i) green loans (Green Loan) and (ii) sustainability-linked loans (SLLs) and published the Guide on Transition Loans in October 2025. The LMA has further published model form provisions providing a framework for the implementation of Green Loan Principles (GLPs) and Sustainability-Linked Loan Principles (SLLPs) into the LMA recommended form for leveraged acquisition finance transactions which can be used by lenders and borrowers on a transaction-by-transaction basis. We will briefly summarise both the GLPs and SLLPs and the model form provisions, all as published by the LMA. It is worth noting that these LMA publications are a form of self-regulation, intended only as recommendations, leaving it to parties to freely choose whether and to what extent to adopt these recommendations. We will not elaborate on the Guide on Transition Loans as practical experience with the use of this guide in Transition Finance is lacking due to its very recent publication.

Green Loans

Green Loans are any type of loan instruments where the proceeds shall be exclusively applied to (re-) finance new and/or existing eligible green projects. The 'use of proceeds' is the fundamental determinant of whether a Green Loan qualifies as 'green' or not.

52 LMA Position Paper, 'Sustainability Omnibus Simplification Package (the Omnibus)', available at: https://www.lma.eu.com/application/files/2517/3987/9943/LMA_Omnibus_Position_Paper_-_18.02.25.pdf.

Examples of 'eligible green projects' are numerous, and the LMA has included several illustrations in a non-exhaustive list attached to the GLPs. Some of these categories may include renewable energy, clean transportation, green technologies or sustainable water and wastewater management. While the GLPs' purpose is not to take a position on which green standards are optimal for qualifying projects as 'green', several international initiatives, such as the EU Taxonomy Regulation, provide useful guidance to Green Loan borrowers as to what may be considered eligible for a Green Loan.

Other core components of a Green Loan that both borrowers and lenders should take into consideration are the following:

a. Process for selecting and evaluating eligible green projects: a borrower must clearly communicate to its lender (i) what its environmental and sustainability goals are, (ii) the process by which it has determined whether the project is green (iii) the selection (or exception) criteria it has used to determine whether the project is green and (iv) the process by which it has identified and will manage potential environmental and social risks of the green project.
b. Management of proceeds: given that the fundamental determinant of a Green Loan is its use of proceeds, the management of the said proceeds is an important component of a Green Loan. The proceeds of a Green Loan must be made available by deposit into a designated bank account or otherwise properly monitored in order to maintain transparency, thereby ensuring the integrity of the Green Loan product and avoiding greenwashing.
c. Reporting: borrowers should keep up-to-date information on the use of proceeds and make this readily available to institutions participating in the loan. Furthermore, borrowers should make this information public where feasible. The borrower should draw up, on at least an annual basis until the loan is fully drawn (and in the event of any material development), a report including a list of green projects to which the proceeds have been allocated, a brief description of the projects and, where possible, achieved impact. Both qualitative performance indicators and quantitative performance indicators should be measured and reported, including the underlying methodology and/or assumptions used. Borrowers and lenders may agree that reporting should take place more regularly, including during the lifetime of the loan, even after it has been fully drawn.

With the publication of its draft model provisions for Green Loans on 7 November 2024, the LMA has offered borrowers and lenders a framework for inserting Green Loan provisions into the LMA's recommended form facilities agreements. The draft includes guidance on how to identify and describe eligible green projects, how to monitor and report on the use of proceeds and how to structure borrower reporting obligations. This typically involves the delivery of periodic updates in the form of a green compliance certificate, project-specific reporting and, if agreed, independent verification. Importantly, the provision also clarifies that failure to meet certain green criteria may result in the loan losing its Green Loan designation, without automatically triggering an event of default under the facility agreement. Borrowers are further expected to give representations affirming the reliability and completeness of the information they provide in connection with the green aspects of the loan.

SLL

SLLs are any type of loan instruments that incentivise the borrower's achievement of ambitious, predetermined, regularly monitored and externally verified sustainability performance targets (SPTs). A borrower's sustainability performance is measured using predefined KPIs that measure improvements in the borrower's sustainability profile. With an SLL, the focus is on incentivising borrowers to achieve future improvements in their sustainability profile by aligning financial or structural terms, often the margin, to the borrower's performance within a predefined timeline. Hence, unlike a Green Loan, use of proceeds is not a key determinant in the qualification of an SLL, and in most instances, SLLs are used for general corporate purposes.

Pursuant to the SLLPs, the fundamental characteristics of an SLL are as follows:

a. Selection of KPIs: KPIs must be (i) relevant, core and material to a borrower's overall current and future business; (ii) consistent with the borrower's overall sustainability strategy; (iii) measurable or quantifiable on a consistent methodological basis; (iv) where feasible, externally verifiable; and (v) able to be benchmarked using an external reference to facilitate the assessment of the SPT's level of ambition. Poorly selected KPIs can be ineffective in incentivising a borrower to improve its sustainability profile in ways that are relevant and material to its business, and the credibility of the SLL product depends on the selection of KPI(s) that are robust.
b. Calibration of SPTs: the process of selecting the SPTs per KPI is key to an SLL as it will determine and be an expression of the level of ambition of the borrower. SPTs must be relevant throughout the life of the loan, and therefore, annual SPTs are set per KPI for each year of the loan term (unless there is a strong rationale as to why this frequency is not appropriate). SPTs set too low or deemed unambitious can lead to accusations of greenwashing. To avoid this, SPTs must (i) represent a material improvement in the respective KPIs and be beyond a 'Business as Usual' trajectory; (ii) be comparable to a benchmark or an external reference, taking into account the regional and national context of the borrower (e.g. the borrower's own performance, the borrower's peers or a science-based scenario); (iii) be consistent with the borrower's overall sustainability strategy and, where applicable, business strategy; and (iv) be determined on a predefined timeline for the target's achievement, set before or concurrently with the origination of the loan. SPTs should also make clear reference to the baseline or reference point selected for improvement of KPIs, in what situations recalculations or adjustment to baselines are permitted and how the borrower will achieve the SPTs.
c. Loan characteristics: a key characteristic of an SLL is that the loan's financial and/or structural characteristics can vary depending on whether the selected KPI(s) reach (or not) the predetermined SPTs. For example, the variation of margin under an SLL may be reduced (or increased) where the borrower satisfies (or fails) a predetermined SPT as measured by the predetermined KPIs.
d. Reporting: for an SLL, a borrower must, where possible and at least annually, provide the lenders participating in the loan with up-to-date information sufficient to allow monitoring of the performance of the selected KPI's. More generally, as transparency on sustainability performance is increasingly important in the market, borrowers should also be encouraged to make this information publicly available.
e. Verification: borrowers are recommended to have an external party verify their performance level against each SPT, for each KPI, at least once per annum. As opposed to a pre-signing external review, verification occurs after signing the credit agreement and is performed by an independent external party, such as a qualified expert, an auditor and/or an independent rating agency.

The LMA's published model provisions for SLLs, offering borrowers and lenders a framework for drafting SLL provisions. The framework consists of a mechanism for margin adjustments by which borrowers have a commercial incentive to achieve the SPTs; a mechanism for amending KPIs, SPTs, calculation methodology or related terms during the life of the loan (i.e. a rendezvous clause); a consequence for a breach of SLL provisions (ultimately) resulting in the loan being disqualified as an SLL rather than an event of default; a reporting mechanism by which a borrower provides regular sustainability information updates through a dedicated compliance certificate; a sustainability report and a verification report addressed to the lender(s); and a (repeating) representation attesting to the truthfulness, accuracy and completeness of the sustainability information provided to the lender(s).

Transition Finance

As mentioned, climate transition focuses on the credibility of a borrower's GHG emissions reduction strategy, commitments and practices. Transition Finance is any form of financial support that helps decarbonise high-emitting activities[53] or enables the decarbonisation of other economic activities.[54] Current practice for Transition Finance is focused on the Climate Transition Finance Handbook (CTFH).[55] The LMA recently published its own Guide to Transition Loans to facilitate financing flows to climate-related transition activities that investors under the existing frameworks (i.e. the Green and SLLPs) find challenging to finance.

The CTFH sets out that Transition Finance instruments may consist of 'use of proceeds' provisions (similar to Green Loans) or may stipulate that proceeds are for 'general corporate purposes' (similar to sustainability-linked instruments). The CTFH seeks to provide clear guidance and common expectations on the practices, actions and disclosures to be made available by borrowers when attracting funds for their climate transition strategy. Transition Finance, as understood within the meaning of the CTFH, is not a distinct type of debt instrument (as an SLL or Green Loan) but rather a complementary or supplementary framework utilised in both sustainability-linked and green financing that have climate adaption or climate mitigation as their investment objective. In other words, Transition Finance may be applied to both use-of-proceeds and performance-based instruments. In the case of use-of-proceeds instruments, this can include green projects that will make a direct contribution to a borrower's own GHG emissions trajectory. In the case of sustainability-linked instruments, this can include one or more KPIs that monitor reductions in GHG emissions, either directly (i.e. absolute GHG emission metrics) or indirectly (i.e. metrics that support or incentivise reductions in GHG emissions). Transition Finance today overlaps both instruments. A sustainability-linked instrument can be used to set targets that progress a borrower's overarching transition strategy, while a use of proceeds instruments can be used to finance specific capex investments to achieve transition milestones. The ICMA does not propose that 'transition' become a separate market segment, but rather that any distinct 'transition' label applied to a use of proceeds or performance-based debt instrument serve to communicate the implementation of a borrower's corporate strategy to addressing climate-related risks and alignment with the goals of the Paris Agreement.

A key component to any transition financing is the 'transition plan' as it aims to transform a borrower's business model and operations towards a net-zero pathway. Therefore, providers should be able to assess the economic and environmental integrity of the borrower's entire business strategy. Transition plans are emerging as the standard, forward-looking tool to convey this sort of information. It is essentially the roadmap for a company's climate and environmental strategy. In the absence of such transition plans, providers of transition financing face significant challenges in assessing and comparing the extent to which a potential investment is credible from a financial, business and environmental perspective. While no single definition or form has been recognised as an international standard, transition plans are generally understood to include time-bound targets (for emissions reduction and other environmental improvements), interim milestones, proposed actions to achieve them and resource allocation.[56] A credible transition plan is aligned with the goals of the Paris Agreement and avoids long-term lock-

53 High-emitting sectors include aluminium, steel, iron and other metals and mining, cement, chemicals, aviation and shipping, energy, power and utilities, and pulp and paper. Transition finance may be utilised by borrowers in sectors across the economy, but is more likely to be utilised by high-emitting sectors.

54 W. Mak and A. Vinelli 2024, 'Navigating Transition Finance: An Action List', CFA Institute Research & Policy Center, available at: https://www.cfainstitute.org/sites/default/files/-/media/documents/article/industry-research/transition-finance.pdf. Also see: Overview of sustainable finance – European Commission.

55 ICMA, 'Climate Transition Finance Handbook (Guidance for Issuers)', June 2023, available at: https://www.icmagroup.org/assets/documents/Sustainable-finance/2023-updates/Climate-Transition-Finance-Handbook-CTFH-June-2023-220623v2.pdf.

56 Climate Policy Initiative, 'What Makes a Transition Plan Credible? Considerations for financial institutions', March 2022, available at: https://www.climatepolicyinitiative.org/wp-content/uploads/2022/03/Credible-Transition-Plans.pdf.

in of unsustainable practices.[57] Under the CSRD, many companies will need to disclose such transition plans or at least disclose whether their strategies are Paris aligned.

To credibly apply a use-of-proceeds or sustainability-linked instrument in Transition Finance, the CTFH recommends including four key elements. For each element, borrowers must disclose the specific practices or actions they undertake, supported by independent reviews, assurances and verifications. Preferably these disclosures should be made available through publicly accessible channels such as annual reports, sustainability reports, climate transition strategies, statutory filings or other non-financial disclosures.

a. Borrower's climate transition strategy and governance: the green or sustainability-linked financing should support the borrower's GHG emissions reduction strategy, aligned with the objectives of the Paris Agreement. Borrowers should provide a comprehensive transition plan, detailing capital expenditure allocations, relevant technological considerations, carbon pricing assumptions and applicable regulatory drivers.
b. Business model environmental materiality: a borrower's transition strategy should address the environmentally material aspects of its business model, considering future scenarios that may affect present materiality assessments. The CTFH recommends disclosing this through a materiality matrix, either publicly or within annual reports, highlighting the impact of climate-related projects and KPIs on the borrower's overall emissions profile.
c. Science-based climate transition strategy and targets: the CTFH recommends that borrowers disclose science-based targets across short-, medium- and long-term horizons, consistent with Paris-aligned pathways. Borrowers are encouraged to disclose historical absolute emissions data across Scopes 1, 2 and 3,[58] clearly identifying the baseline year, scenario and methodology applied. Given the evolving nature of Scope 3 measurement in some sectors, reasonable estimates may be used on a best-efforts basis.
d. Implementation transparency: borrowers offering green or sustainability-linked financing should ensure transparent communication, where practicable, regarding the underlying investment programme, including both capital and operational expenditures. The CTFH recommends disclosing a capital spending rollout plan aligned with the transition plan, along with a phaseout strategy for emissions-intensive activities incompatible with science-based targets. Disclosures should also quantify the share of assets, revenues, expenditures and divestments associated with the transition strategy.

To illustrate the aforementioned principles, we can consider the case study of JFE Holdings, Inc., one of Japan's two largest iron and steel groups.[59] In 2022, the JFE Group raised thirty billion yen through a use-of-proceeds bond instrument, the proceeds of which were to be applied to eligible projects tied to its transition plan and associated investment plan. The iron and steel industry, as mentioned, is a hard-to-abate sector, given that producing steel with today's technologies is emission intensive. While several low-carbon technologies (e.g. hydrogen-based steel or electric arc furnaces with high recycled content) are in development, these technologies are yet to be proven as technically and economically feasible. In the interim, iron and steel manufacturers can invest in heavily cutting their emissions through efficiency gains and (partial) replacement of coal – a clear use case for Transition Finance.

57 Lock-in is a significant factor contributing to the risks of greenwashing in transition finance. It occurs when fossil fuel assets, whether existing or new, delay or prevent the transition to net-zero alternatives. This risk is heightened when investors or financial institutions have a stake in these assets, as they are incentivised to continue the asset's operation until the end of its useful life.

58 Scope 1 = direct emissions, Scope 2 = indirect emissions from energy and Scope 3 = indirect emissions across the value chain.

59 In order to promote transition finance, the Ministry of Economy, Trade and Industry of Japan published select model cases that are deemed to have model qualities for transition finance. The JFE Holdings, Inc. model case and others can be sourced at: https://www.meti.go.jp/english/policy/energy_environment/transition_finance/index.html.

To qualify as a Transition Finance instrument, the JFE Group firstly formulated its 'Environmental Vision for 2050' in May 2021 and announced the goal of achieving carbon neutrality by 2025 through both the development and implementation of available and technically feasible energy-saving and efficient initiatives (e.g. expansion of scrap metal use, renovation of existing coke ovens, introduction of new electric arc furnaces) in the iron and steel industry, as well as future super- innovative technologies (e.g. development of a carbon-recycling blast furnace with carbon capture and utilisation, development of hydrogen-based iron and steelmaking) (Element 1 CTFH). To successfully implement this vision, the JFE Group established new governance structures through a company-wide project team under the direct control of the president, whose goal it was to promote the development and commercialisation of super-innovative technologies to realise carbon neutrality in 2050 (Element 1 of CTFH). The JFE Group deems the reduction of its own carbon emissions, as well as those of its customers and across society, as a material issue of its business (Element 2 of CTFH). Hence, its transition plan also established targets to manufacture new eco-friendly products as well as deploy renewable energy sources and carbon-capture and storage technologies. In addition to achieving carbon neutrality by 2050, the JFE Group established medium-term targets that can be achieved with the maximum introduction of current and innovative technologies, aligned with the sectoral and technology roadmap developed by the Ministry of Economy, Trade and Industry of Japan for the iron and steel sector (Element 3 of CTFH). Finally, the investment plan for achieving its transition plan and carbon neutrality goal for 2050 was published (Element 4 of CTFH).

4. Why Should Europe Focus on Transition Finance?

Financial market players have and continue to benefit from making use of SLL and Green Loan products in meeting their sustainability objectives. Total sustainable debt issuance reached US$1,740 bn in 2024, representing a 12% increase compared with volumes seen in 2023 and 2022 and just short of 2021s record total of US$1,883 bn.[60] These products have allowed both borrowers and lenders to align their sources of funding with their sustainability commitments, enhance their reputation and credibility in the market, engage with internal and external stakeholders in the implementation of sustainability strategies and objectives and comply with evolving regulatory trends and disclosure requirements. The emergence of these products has undoubtedly been a positive development in the financial sector and in the realisation of the much-desired goal of channelling private capital flows towards green and sustainable investments. The speed at which markets grow and mature depends on many variables, including policy and regulatory factors. Certainly, the growth witnessed in the SLL and Green Loan product markets is partly policy driven as the EU sustainability regulatory framework has encouraged market participants to make use of these products with more confidence, helping to scale up volumes. However, a critical question is whether this surge in SLLs and Green Loans is translating into actually greening the economy (i.e. lowering emissions).

Due to stringent reporting, eligibility and verification requirements, green and sustainability-linked financing has primarily been adopted by borrowers with established transition strategies and robust sustainability reporting practices. These borrowers typically operate in sectors with well-defined technological and economic pathways to net zero. In contrast, sectors with less clear decarbonisation trajectories, such as oil and gas, cement, steel, plastics, chemicals, aviation and shipping, tend to underutilise these instruments. This is often due to heightened greenwashing concerns with hard-to-abate sectors[61] and because

60 W. Sharpe, 'Sustainable Debt in Focus: 2024 Summary and 2025 Outlook', Loan Market Association 2025, available at: https://horizons.lma.eu.com/q1-march2025/market-outlook.

61 S. Shirai, 'An Overview of Approaches to Transition Finance for Hard-to-Abate Sectors', December 2023, Asian Development Bank Institute, available at: www.adb.org.

lenders are reluctant to increase their financed emissions without clear guidance or pathways to reducing these emissions.[62] The result is a nearly thirty trillion dollar funding gap in the hard-to-abate sectors to meet net-zero emissions by 2050.[63] Nevertheless, in spite of the concerns, there is a growing consensus on the need to increase financing for companies operating in hard-to-abate sectors to support their transition efforts towards net zero given that these sectors make up approximately 40% of global GHG emissions.[64] In other words, if we do not find means to fund this gap, it shall be at least very challenging or even impossible to become net zero in 2050.

Transition Finance has emerged as a means to bridge this funding gap by supporting the decarbonisation efforts of the hard-to-abate sectors. Transition Finance generally targets companies or economic activities that are (1) emission intensive, (2) may not currently have economically viable or credible low- or zero-emissions alternatives and (3) play a crucial role in future socio-economic development.[65] To enhance the credibility and transparency of such financing, various principles and standards have been developed, most notably the CTFH, which (as mentioned in paras. 3.9 and 3.10) currently serves as the primary reference for market participants.

5. Suitability of Current Regulatory Framework for Transition Finance and Suggestions on How to Shift Towards Transition Finance

As mentioned in para. 3, the EU uses a carrot and stick approach and combines incentives and penalties to encourage and enforce sustainable practices. The question, therefore, is whether the current EU sustainable finance framework ensures that funds are well spent and reach the needed scale. As seen in para. 4, it is evident that the EU has crowded in significant private investment into green and/or Taxonomy-aligned activities. However, critics say that these investments are aimed at a small portion of the EU economy[66] while neglecting the much larger and arguably more significant transition sector. There is a strong desire to engage in sustainable practices, yet there is uncertainty on how to proceed, especially with respect to how to finance the greening of the economy (in other words, the transition of the economy) and not only the green economy. The existing regulatory framework does not provide sufficient clarity around what the EU considers to be credible investment in transition activities. To drive capital flows to support the decarbonisation of the EU, it is important that regulatory frameworks provide clear signals to the market and to support investment decisions, much in the same way that it promotes the so called “green” economy.

Before exploring potential recommendations, we will discuss the EU’s current guidance on Transition Finance to frame our understanding of the regulatory landscape. Although the

62 Japan Public and Private Working Group on Financed Emissions to Promote Transition Finance, ‘Addressing the Challenges of Financed Emissions’, October 2023, available at: https://www.meti.go.jp/policy/energy_environment/global_warming/transition/addressing_the_challenges_of_financed_emissions_eng.pdf.

63 R. Bocca, ‘How to Raise the $30 trillion Investment Needed for “hard-to-abate” Sectors to Reach Net Zero’, 18 December 2024, World Economic Forum, available at: https://www.weforum.org/stories/2024/12/net-zero-transition-requires-a-30-trillion-investment-for-hard-to-abate-sectors/.

64 Ibid.

65 Organization for Economic Co-operation and Development (OECD), ‘OECD Guidance on Transition Finance’, 3 October 2022, available at: https://www.oecd.org/environment/oecd-guidance-on-transition-finance-7c68a1ee-en.htm.

66 The EU Commission claims that the EU Taxonomy covers economic activities that make up 80% of carbon emissions; however, various sources place the actual economic footprint of the EU Taxonomy to between 20% and 40% of all EU-based economic activities.

EU sustainable finance framework does not explicitly cover the concept of Transition Finance (despite market participants advocating for the introduction of such a concept), the EU Commission has issued recommendations[67] on facilitating finance for the transition to a sustainable economy. This non-binding guidance, offering practical suggestions to market participants on how to apply the EU sustainable finance framework to Transition Finance, demonstrates that the EU Commission is aware of the importance of this type of financing towards funding the investment gap in economic activities that are transitioning to net zero. The key recommendation made by the EU Commission is to utilise the EU Taxonomy as a planning tool: companies can use the EU Taxonomy criteria as targets or benchmarks for improvement by either

a. formulating a capital expenditure plan for Taxonomy-eligible activities[68] or
b. setting intermediate targets using the EU Taxonomy.[69]

However, the challenge for the EU sustainable finance framework is its overreliance on the EU Taxonomy's binary system of 'green or not green' classification. This binary system is too simplistic to be applied to Transition Finance and leaves out a large middle ground unrecognised. The EU Taxonomy targets economic activities and thresholds that are, by design, very demanding in order to define 'what is green'. Investments are labelled 'Taxonomy aligned' when they are directed towards economic activities that already make a substantial contribution to one of the six environmental objectives. This stringency is followed to avoid greenwashing. However, as a consequence, it leaves as 'non-aligned' a vast majority of economic activities, which is problematic in several ways. Firstly, this creates the perception that any economic activity that is not 'Taxonomy aligned' is by default 'unsustainable' or 'brown', leading to a high risk of misrepresentation and misunderstanding of investments that are aimed at greening the economy. In other words, a company making steady emissions reductions or with a credible business strategy to adapt its business model over a long-term horizon is still categorised the same as a highly polluting one, as 'not green'. As a result, investors may shun any and all activities outright that are not Taxonomy aligned, starving transition efforts of necessary funding and missing out on potentially the most effective (in terms of impact) means of carbon emission reduction. The EU Commission's recommendations do not fully resolve this issue as it uses the high and burdensome targets set by the EU Taxonomy to benchmark a successful transition strategy as being Taxonomy aligned (i.e. green) versus everything else.

To improve the use of Transition Finance, it is crucial to address several key aspects. The current EU sustainable finance framework treats a company steadily cutting its carbon output the same as one doing nothing – as mentioned, 'not green'. In a recent position paper, the LMA has argued that the EU framework should provide explicit support for Transition Finance. It suggests that two steps be prioritised: (i) developing sectorial decarbonisation pathways and (ii) creating a labelling system, including a transition category in regulations.[70] More broadly, we firmly believe that the EU should provide a more explicit regulatory signal that Transition Finance is a recognised and integral element of the sustainable finance framework. The EU could take several steps to integrate Transition Finance into the current regulatory framework. Firstly, it should broaden the EU Taxonomy and guidelines towards a classification scheme that recognises improvements to sustainability performance and clarifies if and how certain transition efforts qualify as

67 Commission Recommendation (EU) 2023/1425 of 27 June 2023 on facilitating finance for the transition to a sustainable economy, available at: https://eur-lex.europa.eu/eli/reco/2023/1425/oj/eng.

68 If a company has an activity that is Taxonomy eligible but not currently aligned, it can create a CapEx plan to meet the EU Taxonomy TSC within a set period (up to 5 years and 10 years, in exceptional cases). Under existing rules, capital expenditures outlined in a transition plan to achieve Taxonomy alignment in the near future are considered Taxonomy aligned immediately in disclosures.

69 If full alignment is too far or not immediately feasible, the Taxonomy criteria can be used as interim targets. For example, a company might first aim to improve its activities to meet all the EU Taxonomy's DNSH requirements for climate and later strive for a 'substantial contribution' level. Such steps should be documented in an 'activity-level transition plan'. Even if these interim improvements do not qualify as Taxonomy aligned, the EU Commission view is that this could attract transition finance nonetheless.

70 Sustainability Regulation – Horizons01 Publication.

green or greening. Several recommendations on expanding the EU Taxonomy have been proposed, most notably by the Platform on Sustainable Finance, which recommended expanding the EU Taxonomy with a 'traffic-light' system and 'Amber' categories of economic activities that are not green but on a credible path to greening.[71] In addition, regulators and supervisors can also improve prudential and disclosure frameworks. The European Central Bank has warned that banks not taking action to align with the Paris goals face material risks,[72] although it would be helpful if it also clarified that financing credible transition projects (even if not Taxonomy aligned) is part of a prudent risk management, helping alleviate banks' concerns of being penalised for increasing their financed emissions in the short term.

High-level, economy-wide targets are essential, although they are insufficient in determining how different industries are expected to cut emissions over time. Climate targets have yet to be translated into clear, quantified emission or carbon budgets or technology roadmaps for each sector. This lack of sectoral pathways is a key barrier to Transition Finance. If it is unclear what trajectory a cement plant or an airline should follow to align with the Paris goals, lenders and investors will struggle to evaluate transition plans in those industries. Having sector-specific decarbonisation pathways means that there is a reference point for measuring a company's trajectory for emissions reductions and technology adoption consistent with climate goals. At the same time, it avoids funding transition projects that are incompatible with long-term climate goals and result in a potential lock-in of emissions.

A credible Transition Finance label or standard should serve as a market-based tool to enhance financing the decarbonisation of high-emitting sectors. The growth of the sustainability-linked and Green Loan market over the past decade is evidence that clear standards like the LMA principles are crucial for investors' confidence and transparency in the market. Lacking such labels and standards, the Transition Finance market has lagged. A credible Transition Finance label would broaden the sustainable investment universe, offer reputational benefits and lower financing costs for borrowers and improve market integrity by helping avoid greenwashing. To be credible, such a label must be underpinned by science-based targets, robust transition plans and clear reporting obligations. As mentioned, the LMA is working on Transition Loan guidance which may contribute to the development of a transition label. A new EU transition bond standard, modelled on the EU Green Bond Standard, would also be welcome, provided that it is aligned with international standards and best practices (such as those published by the ICMA and the LMA).

6. Conclusion

How should Europe accommodate Transition Finance? The current EU Taxonomy uses a binary 'green' or 'not green' classification that seems too simplistic to cover the funding gap for the finance needed for the so-called hard-to-abate sectors and, therefore, to meet the Paris goals. A dichotomous approach (only 'green' or 'not green') may result in market fragmentation and could deter investments in transition activities. We recommend expanding the scope of the Taxonomy to cover a transition category (e.g. a traffic-light system with amber for credible transition activities). This would recognise and support activities that are not yet fully green but are on a credible path to decarbonisation. In addition, sectoral decarbonisation pathways should be developed as the lack of clear, quantified emissions or carbon budgets and technology roadmaps for each sector is a barrier to Transition Finance. Such pathways could guide companies and financiers. Companies should use the Taxonomy criteria as targets or benchmarks for improvement, either by formulating a capital expenditure plan for Taxonomy-eligible activities or by

71 EU: Platform on Sustainable Finance publishes final recommendations on a 'traffic-light' Taxonomy, Sara Feijao, Vanessa Havard-Williams, Rachel Barrett, Raza Naeem, David Ballegeer, Silke Bernard Platform on Sustainable Finance's report on environmental transition Taxonomy.

72 https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.bankingsectoralignmentreport202401~49c6513e71.en.pdf.

setting intermediate targets. Even if activities are not immediately Taxonomy aligned (although they should be if there is a transition category), credible transition efforts should attract Transition Finance. Transition Finance should be recognised as an integral part of the sustainable finance framework, not as a separate or fragmented market segment. Lastly, the prudential and disclosure frameworks should be improved to make sure that transition projects are part of prudent risk management. That should help financiers and investors to alleviate concerns about short-term increases in financed emissions.

We advocate for a more nuanced, inclusive and supportive regulatory framework that recognises and facilitates Transition Finance, especially for sectors that are not yet 'green' but are making credible progress towards decarbonisation. This approach is essential for Europe to bridge the funding gap and achieve its net-zero goals.

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