Institute for Sustainable Finance

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This series explores the foundations of sustainable finance, one of the most important emerging fields of our time. Sustainable finance aligns financial systems and services to promote long-term environmental sustainability and economic prosperity.

SUSTAINABLE FINANCE PRIMER SERIES:

Transition Bonds

WHAT ARE TRANSITION BONDS?

Transition bonds are a new class of bonds, the proceeds of which are used to fund a firm's transition towards a reduced environmental impact or to reduce their carbon emissions. The proceeds can be used exclusively to finance new and/or existing eligible transition projects. These bonds require the issuer to commit to shifting to more sustainable business practices. Transition bonds do not require the project or the issuer to be classified as "green" but the issuer is required to use the proceeds for climate transition-related activities. For example, a coal-mining firm may issue a transition bond to finance efforts to capture and store carbon. Advocates of transition bonds suggest that it is better for companies aspiring to become "greener" to finance their assets using transition bonds rather than be excluded from the green bond market without an alternative source of funding to support transition projects.

WHAT ARE THE GUIDELINES AND CRITERIA?

To date, few requirements exist for transition bonds. However, AXA Investment Managers put forward their Transition Bond Guidelines, which advise issuers to provide similar disclosures as Green Bond Principles:

- **Use of proceeds:** Direct proceeds to finance projects within pre-defined climate transition-related activities.
- **Project evaluation and selection process:** Explain why these projects are important to finance from the perspective of commercial transformation and climate transition. AXA encourages details on the projects' environmental objectives, alongside expected outcomes and impacts.
- **Management of proceeds:** The net proceeds of a transition bond should be tracked in a formal internal process once the transition bond is outstanding, with the method verified by a third-party audit.
- **Reporting:** Regular and comparable reporting on the environmental performances and outcomes of the financed projects is important.

These guidelines are not universally accepted, they are in-flux and are intended to start a conversation across stakeholders. Additionally, the Corporate Knights and Council for Clean Capitalism in Canada have released their draft Clean Transition Bonds Guidelines. The proposal includes a taxonomy and classification of different projects and issuers that would be aligned with the transition towards a low-carbon economy.

WHY ARE TRANSITION BONDS IMPORTANT?

Transition bonds offer the potential to enable firms that would not qualify to issue green bonds to obtain sustainable-related financing. They also have the potential to help to fulfill increasing demand for sustainable investment opportunities that risk being unmet due to the limited supply of green bonds. The Intergovernmental Panel on Climate Change (IPCC) reported that an average of $3.5 trillion CAD in investments is required each year between 2016 and 2050 to support the necessary clean energy infrastructure to limit global warming. Green bonds only offer a fraction of this amount with cumulative green bond issuance between 2007 and 2018 reaching only $691 billion CAD. Transition bonds offer a vehicle for helping to fulfill this investment gap.

HOW ARE THEY DIFFERENT FROM A GREEN BOND?

Unlike green bonds, where the focus is on the direct use of the debt proceeds for environmentally friendly projects or the profile of the issuer, transition bonds focus on an issuer's commitment to becoming greener. A focus on behavior is an approach that has recently gained significant momentum in the loan market, particularly through products such as sustainability-linked loans.

When considering investment products as being green, investors and banks are increasingly taking into account a firm's overall profile and commitment to reducing their carbon footprint. In 2017, the precedent for transition bonds was set when a major oil company, Spanish firm Repsol SA, stirred debate in the industry by issuing a green bond. Many investors doubted the sustainable nature of the bond due to Repsol SA's industry, and it was not included in major green bond indexes. This catalyzed the push for transition bonds.

WHAT ARE THE CHALLENGES?

There is lingering skepticism about green bonds, particularly as no universally accepted standards have been adopted. Garnering public trust in transition bonds as a solution for climate change, rather than as vehicle for firms to make themselves appear more environmentally friendly (often referred to as "greenwashing"), is difficult. To avoid greenwashing and distrust, there needs to be well-defined and widely accepted criteria for eligible transition bond projects and transparent reporting requirements. Recently, the European Union published proposals for a code that may potentially supersede the Green Bond Principles.

WHAT'S HAPPENING IN CANADA?

Transition bonds are particularly important for industries that are not currently viewed as green, as is the case for most Canadian mining, materials, and oil and gas firms. Transition bonds offer Canadian firms an opportunity to access funding markets at reduced rates for projects designed to reduce their negative environmental impact. This will allow Canadian firms an opportunity to transition from high-carbon to low-carbon while reducing the negative economic impacts associated with an immediate exclusion from low-cost funding markets. In fact, one of the recommendations from the Expert Panel on Sustainable Finance is to work with financial sector leaders to accelerate Canada's supply of liquid green and transition-linked fixed income products.

WHAT'S THE FUTURE OF TRANSITION BONDS?

Still in its early stages, regulations are not yet in place for the commitments required by companies to be eligible for transition bonds. However, firms will likely be required to commit to specific targets and broader sustainability goals. If the number of firms seeking financing for environmental projects continues to increase and institutional investment grows, transition bonds may experience growth like that of sustainability-linked loans.

Explore other primers in the sustainable finance series here.

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