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G7 FINANCIAL MINISTERIAL: THE CRITICAL ROLE OF TRANSITION PLANS AND THE NEED FOR A SYSTEMIC APPROACH TO FINANCE

POLICY BRIEFING
MAY 2024

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STRATEGIC CONTEXT IN VIEW OF G7 MINISTERIAL MEETING

Given the imperative to mobilize private investment at the scale required to address climate change, the effective deployment of funding, policies, and frameworks becomes paramount (COP28). The potential for significant growth in private climate finance, compared to public finance, reflects the abundant private capital available globally, juxtaposed against the limited public funds. To truly lead on the international stage and translate its ambitious climate agenda into tangible actions, **the European Union has the opportunity at the upcoming G7 meetings to champion its ambitious vision for the global decarbonization,** aiming to prioritize a collaborative approach to the effective deployment of funding, policies, and frameworks that support the transition to a low- carbon economy.

Echoing Enrico Letta's recent report on the European Single Market, the transition to a low-carbon economy presents a compelling case for collective action. While the costs associated with this shift are systemic, with impacts beyond EU borders, the benefits are extensive, reaching citizens, businesses, and workers. This is not just an environmental necessity, but it needs to be seen as an economic opportunity in the context of an increasingly sustainability-focused global landscape.

Placing Transition Plans (TPs) at the heart of the G7 finance agenda represents a great opportunity for the European Union as well as G7 countries to boost their competitiveness. A coherent approach on requirements across G7 countries to TPs (for States, Corporates and Financial Institutions) can **re-orient align financial flows towards resilient and sustainable economic systems, whilst securing competitiveness in the process.**

In July 2023, the EU Commission published a communication on transition finance, providing an initial and non-binding definition of what transition plan means. The EU is now at the forefront of transition finance legislation. **To drive global progress and coherence, the EU's ambitious approach to TPs should be replicated at G7 level,** bringing forward a coherent vision that can inspire a unified approach on transition plans.

Moreover, transition plans are increasingly being recognised as an essential and strategic tool within and outside the EU. By using TPs, public and private entities can decarbonise and strengthen the resilience of their operations, whilst attracting more investments. If correctly implemented and appropriately integrated in regulatory frameworks, **TPs become key instruments in guiding public and private capital flows.** They enable all economic market players – from governments to companies and financial institutions – to align their strategies with clear objectives and meet their low-carbon commitments. This alignment not only contributes to emissions reduction, but also to the effective and orderly management of climate-related risks.[1] TPs are also a driver of innovation and competitiveness: they translate targets into concrete plans which then shape the size of new markets and enable investable projects to surface.

The context in which G7 operates requires to look beyond national borders and adopt coordinated approaches on a global scale. **While the G20 remains the chief forum for global economic coordination, the G7 plays a critical role in influencing the international debate through setting ambition.** Therefore, G7 should higher the ambition on transition plans and, at the same time, bringing relevant support for strong G20 outcomes.

This is even more relevant in 2024, considering the G20 Task Force on a Global Mobilization against Climate Change (TF-CLIMA) set up by Brazil and the well-established SFWG. The TF-CLIMA puts national transition plans and financial frameworks aligned with the Paris Agreement at the heart of the G20 finance, climate and Sherpa tracks. Supporting Brazil's G20 presidency serves the G7's geopolitical and geoeconomic interests. The TF-CLIMA fosters a new collaboration within the G20, aimed at unlocking agreements and driving the substantial shift in national investment and financial reforms needed to reach Paris Agreement commitments.

To make the most of this new setting, G7 finance and climate tracks should align their strategy, find a common position and support a systemic approach to defining and financing national transition plans. Such a systemic approach developed by G7 is critical to give confidence, build trust and inform next set of finance and climate decisions at COP29 and COP30 on the New Collective Quantified Goal on Climate Finance (NCQG) and the Nationally Determined Contributions (NDCs).

STRENGTHENING THE 2024 COMMUNIQUÉ: FOUR KEY OUTCOMES

The G7 forum provides an opportunity to advance reforms of the international financial architecture, which would not be possible without addressing the crucial role of transition finance in aligning investments with climate goals. **Europe can and should take a leadership role in ensuring that this transition is inclusive, reflecting the specificities of diverse global markets and building upon previous work, particularly the G20 Sustainable Finance Working Group** (Indonesia, India).

[1] "The disorderly transition and hot house world long-term stress scenarios produce risk estimates that are between 20% and 30% higher than those under the orderly transition scenario" European Central Bank, Results of the 2022 climate risk stress test of the Eurosystem balance sheet.

Coordinating efforts within the G7 finance and climate tracks is vital for shaping G20 outcomes. In 2024 the G7 should therefore aim to achieve four outcomes:

1. **Acknowledge Transition Plans as the primary strategic tool for market actors to address climate risks.**
2. **Explicitly recognize the responsible entities for crafting and implementing Paris-aligned Transition Plans (States, Corporates, and Financial Institutions) and ensure tight and strategic interconnections, emphasizing a systemic approach.**
3. **Mandate to develop a common Paris-Aligned TP framework, applicable to all G7 members, that is specific to each entity of the economic system.**
4. **Make Transition Plans mandatory in each G7 member.**

The past two Japanese ministerial declarations of 2023 (Finance Ministers, Climate, Energy and Environment Ministers and Finance Track) already identified transition finance as fundamentally important for all countries, emphasizing the need to consider the specific circumstances of each region. These four objectives are crucial to keep momentum in the transition finance realm and to ensure continuity with the work of the Japanese G7. Developing shared international approaches, in line with past G7, G20 and COP commitments, is crucial for aligning and mobilizing financial flows for sustainable and climate-resilient development. Notably, these four objectives would create a competitive and level playing field where G7 countries would manage to drive the transition globally.

1. MITIGATING CLIMATE-RELATED RISKS: INTEGRATION OF LONG-TERM RISK MANAGEMENT INTO TRANSITION PLANS

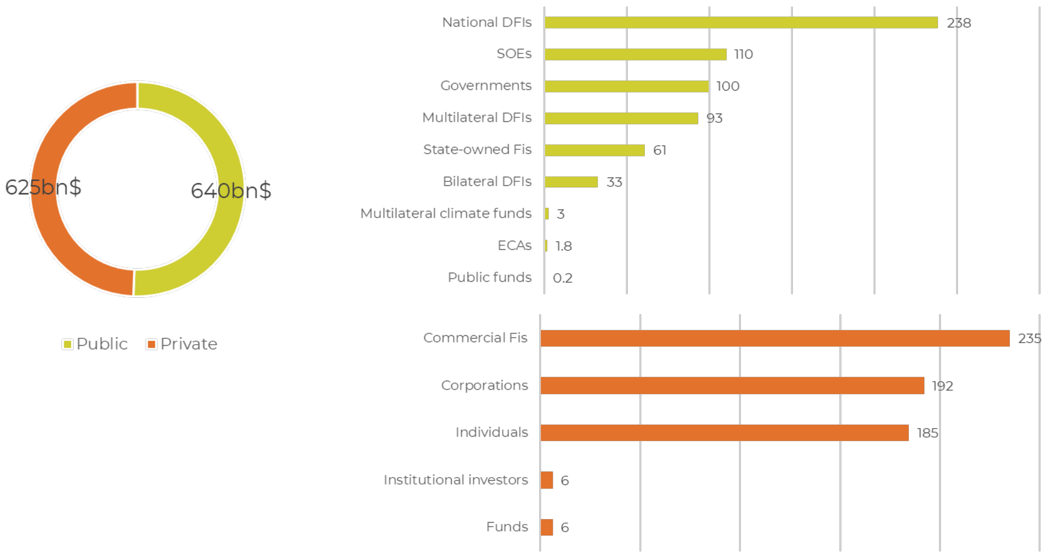
According to the European Central Bank, there is a growing consensus among policymakers and supervisors that climate change poses real financial risks. The 2023 Global Risk Report of the World Economic Forum shows that climate and environmental risks are at the forefront of global risk perceptions for the next decade, however indicating a clear lack of readiness and progress on climate action. In this context, and with **Europe being the fastest warming continent in the world, its leaders can make resilience against climate risks a strategic EU priority.**

One of the effective policy actions to reduce climate risks is investing in a consolidated and coherent transition finance framework: **transition plans are emerging as the most appropriate tool to be adopted by all economic actors not only for defining a mitigation strategy, but also for a risk-based approach**. Achieving greater consistency between the target setting component and the risk management one of transition planning is crucial. The EU has recently made progress in the legislative steps for establishing a regulatory framework for transition finance, but it requires consolidating various EU laws. CSRD and CSDDD focus mostly on mitigation strategy (with a risk management component). On the other side, CRD6 and Solvency2, through which EBA and EIOPA will develop implementing guidelines for banks and insurers' plans, focus on the risk management component of the plans. The prevailing tendency to treat climate risks as short-term issues should be overcome, and EU is already doing steps toward this direction, to start assessing and managing long-lasting impacts. Climate change is indeed not only amplifying existing systemic risks, but is also emerging as a systemic risk on its own. For this reason, for TPs to be effective, they should define, beyond climate targets, also robust risk assessments strategies considering short-, medium- and long-term scenarios, for physical and transitional climate-related risks. Integrating a granular analysis of climate risks into current Risk Management Systems is crucial to identify the economic repercussions of climate change on market actors across different time horizons.

Given the wealth of scientific research underscoring the economic and social consequences of climate change, it becomes critical that national and supranational policies recognise the economic and security relevance of transition plans. **The G7 has a pivotal role in acknowledging transition plans as the primary strategic tool for market actors in addressing all climate-related risks.** If constructed with a clear focus on building resilience to an increasing uncertain world, they would go beyond mere communication tools for carbon footprints or signalling reduction targets. Instead, they would also become concrete action – indeed transformation – plans to manage the economic and security interests of nations, companies, and financial institutions.

2. THE IMPORTANCE OF A SYSTEMIC APPROACH

Adopting a systemic approach means requiring all agents of the economy to develop transition plans to achieve climate goals, and mobilise the investment needed. The graph below indicates a relatively even distribution in 2021/2022 of global climate financing between public and private entities, with private actors contributing to 49% of the total financial flows.



Source: Climate Policy Initiative 2023

It is therefore crucial that the **G7 explicitly recognise that public and private actors should be responsible for crafting and implementing Transition Plans, whilst ensuring that these plans are tightly and strategically interconnected.** These actors are:

- **States** through Nationally Determined Contributions (NDCs) and, in the case of EU Member States, National Energy and Climate Plans (NECPs). National transition plans work as a pivotal tool in steering the country's decarbonization pathway and the transition away from fossil fuels agreed at COP28 in Dubai. They are key to providing guidance and support for private actors and regulators in developing their own Transition Plans, underpinned by sectoral pathways and supportive policies. In the EU context, sectoral roadmaps are required under Article 10 of the EU Climate Law. The governance of national plans, policies, and incentives plays a crucial role in interpreting the mandates and the work undertaken by the national financial and economic architecture, national promotional banks included.
- **Corporates:** Empowered and guided by the strategies of their respective Governments, every company must craft its own transition plan with clear targets and risk management strategies. These plans should be tailored to the specific technical features of each sector, designed for the specificities of each company, setting out how that company is going to support the delivery of NDCs by aligning to generally accepted sectoral pathways through the decarbonisation of its products or services.
- **Financial institutions:** It is essential for every type of financial entity to implement transition plans for its entire value chain, encompassing activities from upstream to downstream (such as investments and exposures), to articulate how they are going to support the real economy transition and meet green finance

commitments. Beyond banks, insurance, investment funds and asset managers, regulatory bodies and central banks must consider the impacts of climate change on the entire economic system, which is crucial to ensure financial and monetary stability, as well as long term economic growth and systemic risk management.

3. HARMONIZING TRANSITION PLANS FOR GLOBAL COMPETITIVENESS

The increasing recognition of the strategic significance of Transition Plans has led to a proliferation of reporting frameworks across various institutions and nations in recent years. A most prominent example are the European Sustainability Reporting Standards (ESRS1) on Climate Change, developed for companies within the European Corporate Sustainability Reporting Directive (CSRD) scope. It offers guidance on reporting and encompasses processes for identifying and assessing material climate-related impacts, risks, opportunities, and targets related to both mitigation and adaptation. Another equally crucial framework is the Transition Plan Taskforce (TPT), initiated by the UK HM Treasury in April 2022, which is now recognized as the golden standard for private sector climate transition plans. Another key tool, the Task Force on Climate-related Financial Disclosure (TCFD) Framework, provides comprehensive guidelines for reporting information on climate risks, opportunities, and the associated strategies and governance. Internationally, the Science-Based Targets initiative (SBTi) standard is widely used to set science-based targets aligned with the objectives of the Paris Agreement.

Likewise, **supervisory bodies, Central Banks, regulators and Governments face significant challenges in identifying and addressing the risks associated with climate change due to the lack of available and comparable data.** Without comprehensive information provided through TPs, the ability of these entities to effectively manage the consequences of climate inaction is severely hindered. There exists a crucial link between the technical work of data collection and the development of a robust policy framework that encourages, supports, or mandates the disclosure of TPs. This connection is vital for ensuring that decision-makers have access to accurate and reliable information to formulate effective policies and regulations. Without such data-driven insights, regulatory and governmental efforts will fail on their mandate to protect the public interest, leaving financial systems and economies vulnerable to the impacts of climate change. **Fostering collaboration between technical experts, policymakers, and financial market participants is essential to bridge the gap between data collection and policy development, ultimately enhancing the resilience of financial systems. Integrating TPs into the supervisory and regulatory toolkit requires adherence to the proportionality principle and the tailoring of**

approaches to the size, relevance and exposure of financial institutions to transition risks.

4. MAKING PARIS-ALIGNED TRANSITION PLANS MANDATORY

Despite one-third of major public and private corporations have committed to net-zero pledges, less than 10% are currently making substantial progress toward achieving these goals. While 565 financial institutions, as members of the Glasgow Financial Alliance for Net Zero, have announced some form of net-zero targets for their financing activities and portfolios, fewer than half have established well-developed goals with specific targets and timelines, resulting in a situation where substantial capital remains unutilized (CPI, 2023).

If Governments are serious about addressing climate change in time according to science and want to ensure that all economic actors play their fair share, the G7 must forge a consensus – starting from themselves – for the adoption of mandatory transition plans globally.

Many countries are already going in this direction: the **EU** Corporate Sustainability Due Diligence Directive (CSDDD) indicates a growing commitment to mandating the implementation of climate transition plans for companies and financial institutions. The **UK** Companies Act is already asking for a TCFD-aligned report and is expected to align its disclosure rules with the International Sustainability Standards Board's (ISSB) standards, integrating the disclosure requirements with several provisions relevant to transition planning, and the UK Financial Conduct Authority is expected to adopt ISSB and TPT outputs for its listing rules. In March 2023, the **US** Securities and Exchange Commission (SEC) finalized a rule on climate-related financial disclosures which can help investors to understand the risks to companies from climate change, and how companies will seek to address them, by requiring that this information is included in mainstream filings. Other major economies like **Japan, Nigeria, and Singapore** are also set to adopt ISSB's S1 and S2 disclosure standards, encompassing requirements related to transition plans. **Australia** is actively consulting on the disclosure and implementation of standardized, internationally aligned requirements for disclosing climate-related financial risks and opportunities, emphasizing the global shift towards mandatory transition plans:

- At the national level, mandatory TPs would serve as a catalyst for comprehensive climate action, aligning governments with the global commitment to combat climate change.
- For companies, the obligation to adopt and implement TPs ensures that they proactively assess, disclose, and address their climate-related risks and

opportunities. This would also foster transparency, allowing stakeholders to make informed decisions and promoting responsible business practices.

- For financial institutions, a mandatory TP provides a standardized methodology for assessing climate risks, enabling them to make informed investment decisions aligned with sustainable practices. This harmonization also facilitates comparability across different institutions, contributing to the stability of financial markets.

Mandating TPs at the G7 level goes beyond a mere regulatory requirement: it can foster fair competition and collaboration to achieve collective climate goals. By establishing a standardized and compulsory framework for nations, corporates and financial institutions, the G7 would ensure that all actors across borders are held accountable to the same standards. Such standardization would create a level playing field, thus preventing actors in jurisdictions with lower standards to gain unfair competitive advantage.

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Publication date:
22 May 2024