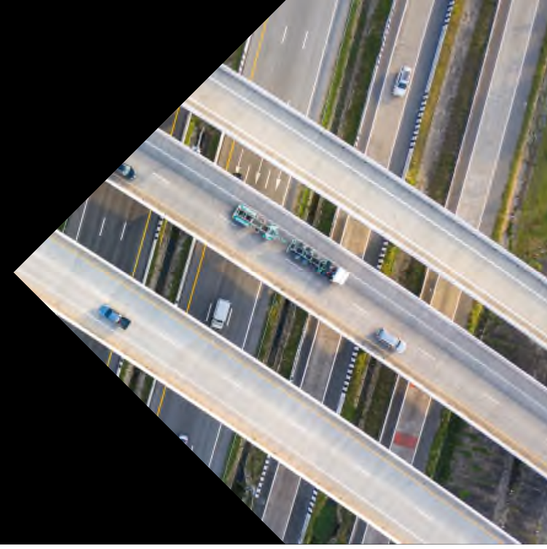
HSBC Asset Management



# Transition Finance –
## Challenges in turning brown into green

**July 2024**

**For professional investors only**

Transition finance is a major topic in the industry when it comes to sustainable finance. The UK Transition Finance Market Review which is due to be published in July for example, is looking at setting out opportunities in how to scale and define the market as well as create innovation in transition finance services. An estimated $3 trillion a year by 2030[1] from public and private sectors is needed in order to support the global transition to a net-zero economy by mid-century. However, current investment deployed is far below the estimated amount required[1].

The critical questions are how can we encourage more capital investments to support the transition and what are the key barriers to investors? This was discussed at 'Tackling transition finance: Next steps for investors' – the first plenary session of Responsible Investor Europe 2024, in which Cathrine de Coninck-Lopez, our Global Head of Responsible Investment was a speaker. In this article, we will explore these questions and give an overview of how HSBC Asset Management (HSBC AM) is embedding climate considerations in our investment strategy.

## Defining transition finance and understanding the challenges for investors

Whilst there is no one widely accepted market or regulatory definition of transition finance, clearer guidelines that are more sector based would encourage investors and 'give them the courage' to go into hard-to-abate sectors.

Hard-to-abate sectors – e.g. steel, heavy industrials, transport - are critical to transitioning the global economy towards net-zero as they contribute to both global greenhouse gases (GHG) emissions and are an essential component for infrastructure and industrial developments. Yet, these sectors can be more challenging to decarbonize as most of the critical technologies are costly to develop and still early in development phase. Regulatory constraints to ensure energy security add to this obstacle. Supporting the transition across these sectors is especially important in emerging markets, and in Asia in particular, which accounted for around half of global GHG emissions in 2023, up from one quarter in 2000[2].

For investors, a key consideration in transition finance is the trade-off between shorter-term portfolio decarbonization versus longer-term real world decarbonization. To illustrate, investing in sectors and industries with a traditionally low level of carbon emissions can make the portfolio appear 'greener' while it may not contribute significantly to the reduction of GHG emissions in the real economy. In order to support the global net zero transition, hard-to-abate sectors should be transformed instead of avoided, with the decabonisation progress of individual companies taken into account. However, without prescriptive regulatory support and guidance, investors can face potential reputational concerns when supporting 'brown to green' investment in their portfolios as it could increase their portfolio's carbon footprint in the near term. This is why transition plans of investee companies can play a critical role in backing this type of investment decision.

1. Energy Transitions Commission - Financing the Transition: how to Make the Money Flow for a Net Zero Economy (March 2023): https://www.energy-transitions.org/wp-content/uploads/2023/08/ETC-Financing-the-Transition-MainReport_update.pdf
2. International Energy Agency – CO2 Emissions in 2023 (February 2024): https://iea.blob.core.windows.net/assets/33e2badc-b839-4c18-84ce-f6387b3c008f/CO2Emissionsin2023.pdf

## Assessing the credibility of transition plans

Should transition plans be imposed on companies if they are an important element of assessment in transition finance as mentioned? This is an ongoing discussion in the industry. Some argue that transition plans should be mandatory, but this could be considered pre-mature given the lack of data and data consistency, in addition to the nuances across markets, sectors and the scale of the company.

It would be fair to say that having a transition plan is already a good place to start, but to make it credible, there should be more than just targets. Companies are expected to develop their own capabilities to enable a just transition and have an execution plan in place which includes projected capital allocation and a concrete timeline. Looking at the transition plans of companies is an important part of HSBC AM's engagement approach under 'climate change', one of our key engagement themes[3]. For example, a scoring methodology has been developed to assess the credibility of such plans specifically for the issuers related to coal investments.

## HSBC AM's approach to implementing net-zero

To be more precise, we have four key levers at HSBC AM which helps to support our net zero commitment as a signatory of the Net Zero Asset Managers Initiative. The first is our alignment classification framework which acts as a forward-looking indicator for our portfolio's progress towards interim and longer-term net zero targets, whilst also projecting the likelihood of decarbonisation at issuer level. The mechanism enables us to combine our assessments of alignment and considerations of climate related risks to inform investment decision making and portfolio construction.

The second lever is active engagement. HSBC AM has developed an engagement strategy for priority issuers (typically the top emitting issuers) based on their contribution and materiality to our financed emissions. For each of the identified issuers, specific and measurable engagement targets are set and progress towards these targets is regularly assessed through maintaining an open dialogue with the company. This approach enables us to support issuers along their transition journey and track improvement in issuers' alignment overtime, with the objective of reducing the emission intensity of portfolios in the long run.

Our third lever is our climate solutions and capital allocation framework. This lever informs how we embed climate considerations into the investment process and create investment solutions to provide opportunities for investors to drive the transition. These investment solutions span across strategies investing in companies with low or decreasing carbon footprints and impact strategies investing in green bonds or climate technology etc. As mentioned, we recognise the importance of looking beyond carbon emissions at portfolio level and driving real world decarbonisation in regions and sectors where it's most needed.

Divestment is our fourth lever. Engagement is a multi-year journey and may not be successful in all cases. Even though engagement is preferred over divestment to keep our influence over the company as an investor, divestment may be considered in portfolios where this is possible, for issuers that do not have an intention to embed transition into their business planning or do not make progress towards our engagement targets after continuous engagement efforts.

3. For more details, please refer to our Stewardship Plan 2024: https://www.assetmanagement.hsbc.co.uk/en/institutional-investor/about-us/responsible-investing/-/media/files/attachments/uk/policies/stewardship-plan-uk.pdf
4. For more details, please refer to our webpage: https://www.netzeroassetmanagers.org/signatories/hsbc-asset-management/

## The gradual phase-out of thermal coal investments

Today, we and many of our customers contribute to greenhouse gas emissions. Step by step, we are developing strategies to reduce our own emissions and to help our customers reduce theirs. In 2022, we committed to phase out existing thermal-coal investments in active holdings and restrict new finance for companies exposed in this field through the introduction of a new, formal thermal-coal policy[5]. Under this policy, companies with more than 10% revenue exposure to thermal coal have to undergo an enhanced climate assessment which includes analysis of their transition plans, CAPEX planning and whether considerations of just transition have been taken into account. In-depth information on the target company's climate ambition and transition trajectory which is gathered through direct engagement feeds into this process. Acknowledging the different starting points of developed and emerging markets, the policy states our ambition to phase out thermal coal exposures in EU or OECD markets by 2030 and the rest of the world by 2040. Having part of the stewardship team based in Asia, where $CO_2$ emissions from coal combustion is still on the rise[6], helps us understand the cultural nuances and facilitates our engagement with some of the world's largest emitters.

## Investment opportunities in transition finance

For many investors, transition finance is still a relatively new domain. Venturing into this would mean changes to their existing investment approach and processes, need of new data and adapting the due diligence procedures, further to the aforementioned challenges. This leaves them with the question 'Is the gain worth the pain?'. In the panel discussion at Responsible Investor Europe 2024, an investment manager expressed that 'if transition finance is done well, there will be opportunities to generate alpha'. There has yet to be supporting market research but more investors see the opportunity to better position themselves in the early phase of one of the biggest transformations of this century - the transition towards a global net zero economy.

5. For more details, please see our coal policy: https://www.assetmanagement.hsbc.pt/-/media/files/attachments/common/coal-policy-en.pdf
6. International Energy Agency – CO2 Emissions in 2023 (February 2024): https://iea.blob.core.windows.net/assets/33e2badc-b839-4c18-84ce-f6387b3c008f/CO2Emissionsin2023.pdf

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