COMMISSION RECOMMENDATION

of XXX

on facilitating finance for the transition to a sustainable economy

This draft has been approved in principle by the European Commission on 13 June 2023 and its formal adoption in all the official languages of the European Union will take place later on, as soon as the language versions are available.
COMMISSION RECOMMENDATION

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THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 292 thereof,

Whereas:

(1) The transition to a sustainable economy by 2050 is challenging but also offers opportunities for the Union economy. Investing in the green transition will help make Europe the first climate-neutral continent with a sustainable economy.

(2) Urgent action is needed in this decade to reduce greenhouse gas emissions by 55% and reach our environmental objectives, particularly those related to the nature and water crises, by 2030. The Union will need to invest about EUR 700 billion more each year from 2021 to 2030 than it did from 2011 to 2020 to decarbonise its economy, achieve its environmental objectives¹ and those of the proposed Net Zero Industry Act².

(3) Finance for the transition to a climate-neutral and sustainable economy is needed today for those undertakings that want to become sustainable but cannot shift in one step to a fully environment-friendly, climate-neutral performance model. Transition finance will be necessary over the coming years to ensure a timely and orderly transition of the real economy towards sustainability while ensuring the competitiveness of the EU economy. Not all technologies are yet available for a sustainable economy and economic actors can reach these objectives at different pace.

(4) Sustainable finance is about financing both what is already environment-friendly and what is transitioning to such performance levels over time. The level of sustainable investments is set to increase over time, as the transition progresses.

(5) Although the Union’s legal framework does not define the concept of transition finance, transition finance should be understood as the financing of climate- and environmental performance improvements to transition towards a sustainable economy, at a pace that is compatible with the climate and environmental objectives of the EU.

¹ The Union will need to invest EUR 477 billion more per year in 2021–2030 than it did in 2011–2020 to meet its emissions-reduction targets in the energy and transport sectors. It will need to invest an additional EUR 110 billion per year to achieve its environmental objectives. For details, see the Commission Staff Working Document on ‘Investment needs assessment and funding availabilities to strengthen the EU’s Net-Zero technology manufacturing capacity (SWD (2023) 68 final), and the Communication from the Commission on ‘the EU economy after COVID-19: implications for economic governance’, COM (2021) 662 final.


Financing the transition to a climate-neutral and sustainable economy is at the core of the Commission’s Communication of 2021 on a Strategy for Financing the Transition to a Sustainable Economy, which outlines the need for an inclusive approach to sustainable finance regardless of sectors, geographies, actors and the different starting points in the transition.

This Recommendation clarifies the concept of transition finance, acknowledging the significant role that market participants can play by voluntarily using tools from the Union sustainable finance framework, as needed, for transition finance.

Undertakings, financial intermediaries and investors, Member States and supervisory authorities could raise, provide or approach transition finance through the voluntary use of sustainable finance tools as set out in this Recommendation.

This Recommendation aims to support transition finance in a trusted environment for investors through encouraging the voluntary use of sustainable finance tools and disclosures in ways that can ensure the credibility of transition investment opportunities.

This Recommendation builds on the Union sustainable finance framework and on elements from leading international initiatives for transition finance such as the OECD Guidance on Transition Finance, the G20 Framework for Transition Finance, the Report on Transition Finance of the International Platform on Sustainable Finance and the Report of the United Nations High-Level Expert Group on the Net Zero

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7 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of Regions on Strategy for Financing the Transition to a Sustainable Economy, COM (2021) 390 final.


Emissions Commitments of Non-State Entities\textsuperscript{11}. Therefore, international investors following this Recommendation should be able to match the main aspects of their transition targets and financing needs with international market practice.

(12) The transition to reach the objectives of the European Green Deal\textsuperscript{12} includes the transition to climate neutrality by 2050, with the aim of limiting climate change to 1.5 °C global warming in line with the Paris Agreement adopted under the United Nations Framework Convention on Climate Change\textsuperscript{13}, the transition to a climate-resilient economy, and the transition towards an environmentally sustainable economy, namely a circular, zero pollution, nature-positive economy and sustainable use of water and marine resources.

(13) Market participants can apply this Recommendation to both the climate and environmental transition.

(14) Undertakings (including both non-financial and financial undertakings) might have different starting points in the transition to sustainability, depending on various factors, such as the sectors and geographies in which they are active. Undertakings also have different possibilities and capabilities to transition, depending on their size, financial and physical resources available or the availability of infrastructure and technologies. As a result, undertakings will have different financing needs.

(15) The use of transition finance is voluntary. Not all undertakings, and not all economic sectors, have significant climate- or environmental transition finance needs. But where impacts can be reduced and are being reduced, that improvement should be recognised and financing for it should be facilitated.

(16) Small and medium-sized enterprises (SMEs) might need to finance their transition, and where this is the case, they could benefit from obtaining transition finance by providing key sustainability information. However, due to their size and more limited resources, this can be difficult and costly. SMEs might need the support of their financing partners, suppliers and customers in their value chain when considering their transition finance needs and accessing transition finance in practice. Large corporate and financial intermediaries are encouraged to apply the principle of proportionality when engaging with SMEs and to exercise restraint when requesting information from SME value chain partners, suppliers and customers.

(17) Transition finance can also help finance the transition of undertakings that operate in sectors that are the most affected by the transition to a sustainable economy. For example, new investments and related capital expenditure of such undertakings can be compatible with the transition to meet Union climate and environmental objectives.

(18) Needs for transition finance can be determined by planning ahead and setting transition targets. This can be done, for instance, by setting out the company’s short-, medium- and long-term targets and actions in line with the transition to a climate-


\textsuperscript{12} Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions: The European Green Deal, COM (2019) 640 final.

\textsuperscript{13} Approved by the Union on 5 October 2016; Council Decision (EU) 2016/1841 of 5 October 2016 on the conclusion, on behalf of the European Union, of the Paris Agreement adopted under the United Nations Framework Convention on Climate Change (OJ L 282, 19.10.2016, p. 1).
neutral and sustainable economy, and investment and action plans that indicate the resources that have been allocated and the resources that are still needed, to ensure that the targets are reached and actions are planned and implemented in a transparent, credible and consistent way. This can be done at both company level and activity level, depending on where the need for transition finance arises.

(19) Transition planning, which is the process by which undertakings translate their environmental and climate ambitions into actions, can help undertakings minimise the strategic and financial risks associated with the transition, identify business opportunities, and provide clarity on their business strategy which can attract new investors and business partners.

(20) But undertakings can also use sustainable finance tools of the Union, such as the Taxonomy, not only to disclose Taxonomy-aligned activities and capital expenditures, but also as a forward-looking tool for their transition process, using the criteria of the Taxonomy as reference points for setting targets. The Taxonomy is increasingly being used for transition finance purposes, with many undertakings reporting Taxonomy aligned capital expenditure that is materially higher than aligned revenue, especially in high-impact sectors.

(21) Investments to reach Taxonomy alignment in 5 (exceptionally 10) years are recognised as capital expenditure that is fully aligned with the Taxonomy if it is accompanied by a capital expenditure plan, which is a type of activity-level transition plan. Additionally, investments in transitional activities, as defined by Regulation (EU) 2020/852, are investments in the best available technologies, and are therefore also recognised as Taxonomy-aligned, provided they do not result in long term carbon intensive lock-ins or prevent the development of greener technologies. These are economic activities where no alternative technology currently exists and where the performance is on a transition path to climate neutrality in the future. To ensure continuous improvement throughout the transition, Regulation (EU) 2020/852 provides for a review of the technical screening criteria for transitional activities every three years, to take account of new technologies and scientific evidence as they become available.

(22) The Taxonomy can also be a useful guide, complementing climate or environmental targets or transition plans, for economic activities that cannot reach substantial contribution to one of the environmental objectives set out in Regulation (EU) 2020/852 but where significant improvements in environmental performance are still possible. Its criteria and principles can be used to set interim or minimum targets, for which transition finance could be raised, if the investments are compatible with the EU climate and environmental objectives. This should be ensured through a transition plan for the specific activity (an activity-based transition plan).

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15 Expenditures for activity-based transition plans cannot be considered Taxonomy aligned if they do not fully meet the respective Taxonomy criteria, but they can nevertheless be a meaningful step towards improved levels of sustainability performance and attract transition finance.
Data shows that the Taxonomy is working as intended, with companies in the STOXX Europe 600 index that reported non-zero Taxonomy alignment so far\(^{16}\), on average reporting Taxonomy alignment of around 23\% for capital expenditure, 24\% for operational expenditure and 17\% for revenues\(^{17}\).

The EU climate transition benchmarks and EU Paris-aligned benchmarks are appropriate tools to design portfolios with decarbonisation objectives. Investment funds that track those benchmarks have grown considerably and are currently valued at EUR 116 billion. The use of market based ESG benchmarks with environmental sustainability features is increasing too.

Transition plans are a useful tool to translate climate or environmental targets at the levels of both undertakings and economic activities into actions and an investment plan when communicating with financial intermediaries and investors. Financial intermediaries and investors might also take into account information from transition plans and the integrity, transparency and accountability of the targets included in the plans when assessing the transition and physical sustainability risks associated with an investment.

Transition plans are currently not mandatory, but they are emerging as one of the key forward-looking tools that undertakings can use to set out and articulate their targets and the financing needed to reach those targets, and include information on milestones, activities, processes and resources. Transition plans can be set out by relying on Directive (EU) 2022/2464 and reporting standards under this Directive, where transition plans are part of the overall business strategy of an undertaking aiming to align itself with the goal of the Paris Agreement to limit the global temperature increase to 1.5\°C.

Undertakings that fall within the scope of the reporting obligations of Directive (EU) 2022/2464 will have to communicate any time-bound targets on sustainability matters they might have, as well as any plans they might have to ensure that their business model and strategy are compatible with the transition to a sustainable economy and to limiting global warming to 1.5\°C.

The Commission put forward a proposal for a Directive on Corporate Sustainability Due Diligence\(^{18}\) in February 2022 in order to ensure that companies active in the internal market deliver on the sustainability transition of our economies. It proposes that companies falling under its scope of application adopt a plan to ensure that the business models and strategy of the company are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 \°C in line with the Paris Agreement.

A transition plan, which is an aspect of the overall strategy of the undertaking, can also cover the transition to environmental objectives. The credibility of a transition plan might be strengthened through its adoption by the management of the company, through including a structured set of short-, medium- and long-term targets and

\(^{16}\) As of 17 May 2023, 63\% of the STOXX Europe 600 undertakings have already disclosed their Taxonomy eligibility and alignment for financial year 2022; source: Bloomberg.

\(^{17}\) Nearly two in three companies that disclosed Taxonomy-eligible capital expenditure reported a non-zero alignment figure and one in two companies that disclosed eligible revenue reported a non-zero degree of aligned revenue; Source: Bloomberg.

actions, including allocated and needed resources to ensure that the targets and actions are implemented in a credible and consistent way, including consideration and avoidance of long-term lock-in to GHG-intensive or environmentally significantly harmful activities or assets, considering the lifetime of those assets.

(30) Financial intermediaries have a key role to play in supporting the real economy’s transition to sustainability. Providing transition finance to the real economy therefore enables the financial sector to fulfil its financing function during the transition, reduces transition risk over time, and enables the sector to make its own orderly transition. Transition finance and related investments can reduce financial transition risk in the future even if they are not automatically subject to less financial risk than other investments.

(31) Bank lending and investments are both important for the financing of the real economy, and both are expected to provide a significant amount of transition finance to undertakings. Banks and other institutional investors are in a particularly good position to provide transition finance to their clients, since they can draw on their close client relationships. In this context, banks may consider this Recommendation in conjunction with the provisions on transition and physical risks in Directive 2013/36/EU of the European Parliament and of the Council19 and Regulation (EU) 575/2013 of the European Parliament and of the Council20, which are currently being revised.

(32) The forthcoming advice of the European Banking Authority on green loans21, as well as the work of the Platform on Sustainable Finance22, will consider different aspects of transition finance and will provide relevant input for future considerations on this topic.

(33) Sustainability disclosures help streamline the exchange of information between financial intermediaries and undertakings in transition. For instance, forward-looking information on climate or environmental targets or transition plans, where they exist, might provide useful information for investors and financial intermediaries that are themselves committed to transitioning. The information will help financial intermediaries and investors decide on what to include or not include in investment products as well as assess the implications of different investment time-horizons and the risks of stranded assets.

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Financial intermediaries and investors can also contribute to the transition by offering specific transition-related financing solutions that are linked to climate or environmental targets set by undertakings.

Member States are invited to continue raising awareness on approaches to seeking or providing transition finance. They are also invited to continue to provide training and technical assistance that can help increase the uptake of transition finance and provide specific transition-related financing solutions for undertakings willing to engage in the transition.

The European Supervisory Authorities (ESAs) and National Competent Authorities in the Union should continue raising awareness of relevant approaches to transition finance. This will help instil confidence in market participants on how to use Union sustainable finance tools effectively and encourage the uptake of transition finance and reducing the risk of greenwashing.

This Recommendation does not provide recommendations on all aspects of financing the transition to a climate-neutral and sustainable economy. It aims to clarify the basic concepts of transition finance and the use of tools that can encourage an increase in the uptake of private transition finance.

This Recommendation is not exhaustive as market participants can find other ways to promote or raise transition finance that aligns with the transition to a sustainable economy. It should be considered together with any future market or legislative developments. The Platform on Sustainable Finance will help identify relevant market practices related to transition finance, and market participants can provide feedback to further refine the elements of the sustainable finance framework and its use for transition finance through the Platform or through outreach events organised by the Commission, such as workshops and stakeholder dialogues. The Commission will also scale-up its engagement with international partners, e.g. through the International Platform on Sustainable Finance and the upcoming Sustainable Finance Advisory Hub in the context of the Global Gateway, to promote the uptake and international interoperability of transition finance globally.

HAS ADOPTED THIS RECOMMENDATION:

1. PURPOSE AND SCOPE

1.1. This Recommendation follows up on the Commission Communication on a ‘Strategy for Financing the Transition to a Sustainable Economy’.

1.2. This Recommendation aims to support market participants that wish to obtain or provide transition finance by offering practical suggestions on how to approach transition finance.

1.3. This Recommendation is addressed to undertakings that want to contribute to the transition to climate neutrality and environmental sustainability, while enhancing their competitiveness and are seeking finance for investments for this purpose. It aims to explain the use of sustainable finance tools for this purpose. Transition

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Communication from the Commission on a 'Strategy for Financing the Transition to a Sustainable Economy', COM/2021/390 final.
financing and green financing\textsuperscript{24} can be distinguished from general financing, which does not have sustainability objectives.

1.4. This Recommendation is generally not intended to apply to micro enterprises\textsuperscript{25}, given their size and administrative capacity.

1.5. This Recommendation is also addressed to

(a) financial intermediaries and investors that are willing to provide transition finance to undertakings,

(b) Member States and financial supervisory authorities, to raise awareness of the topic and provide technical assistance, to encourage the uptake and provision of transition finance to the real economy.

1.6. This Recommendation is without prejudice to Union legislation that sets out legal obligations.

1.7. Non-Union actors are welcome to also use this Recommendation but may have specific needs that are not reflected in this Recommendation.

2. DEFINITIONS

For the purposes of this Recommendation, the following definitions apply:

2.1. Transition means a transition from current climate and environmental performance levels towards a climate-neutral, climate-resilient and environmentally sustainable economy in a timeframe that allows reaching:

(a) the objective of limiting the global temperature increase to 1.5 °C in line with the Paris Agreement and, for undertakings and activities within the Union, the objective of achieving climate neutrality by 2050 and a 55% reduction in greenhouse gas emissions by 2030 as established in Regulation (EU) 2021/1119 of the European Parliament and of the Council\textsuperscript{26},

(b) the objective of climate change adaptation\textsuperscript{27}, and

(c) other environmental objectives of the Union, as specified in Regulation (EU) 2020/852 as pollution prevention and control, protection and restoration of biodiversity and ecosystems, sustainable use and protection of marine and fresh-water resources, and the transition to a circular economy.

2.2. Transition finance means financing of investments compatible with and contributing to the transition, that avoids lock-ins, including:

(a) investments in portfolios tracking EU climate transition benchmarks and EU Paris-aligned benchmarks (‘EU climate benchmarks’);

\textsuperscript{24} The distinction and overlaps between transition financing and green financing, as well as how this evolves over time is illustrated in Section 1. of the Annex.

\textsuperscript{25} Commission Recommendation 2003/361/EC of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises (OJ L 124, 20.05.2003, p.1) defines microenterprise as an enterprise which employs fewer than 10 persons and the annual turnover and/or annual balance sheet total of which does not exceed EUR 2 million.


\textsuperscript{27} As defined in Regulation (EU) 2020/852.
(b) investments in Taxonomy-aligned economic activities, including:
   – transitional economic activities as defined by Article 10 (2) of Regulation (EU) 2020/852 for the climate mitigation objective;
   – Taxonomy-eligible economic activities becoming Taxonomy-aligned in accordance with Article 1(2) of Commission Delegated Regulation (EU) 2021/2178 over a period of maximum 5 (exceptionally 10) years 28;
(c) investments in undertakings or economic activities with a credible transition plan at the level of the undertaking or at activity level.
(d) investments in undertakings or economic activities with credible science-based targets, where proportionate, that are supported by information ensuring integrity, transparency and accountability.

2.3. **Transition plan** means an aspect of the undertaking’s overall strategy that lays out the entity’s targets and actions for its transition towards a climate-neutral or sustainable economy, including actions, such as reducing its GHG emissions in line with the objective of limiting climate change to 1.5°C.

**RECOMMENDATION TO UNDERTAKINGS SEEKING TRANSITION FINANCE**

3. Sustainable finance tools to determine and articulate transition finance needs

3.1. Undertakings can consider their transition finance needs based on their sustainability impacts, risks and opportunities. These can be identified through a materiality assessment.

3.2. To determine their transition finance needs, undertakings could start by setting transition targets and defining individual transition pathways based on science-based scenarios and pathways 29.

3.3. Sustainable finance tools, in particular the Taxonomy or the EU climate benchmarks as well as credible transition plans can be used to support the definition of transition targets and articulate specific transition finance needs at the level of the undertaking and at the level of economic activities 30.

3.4. By clearly integrating transition targets and related transition finance needs in a credible transition plan, financial intermediaries and investors can more easily understand, compare and benchmark transition finance opportunities.

3.5. Transition finance needs can be specified as planned capital expenditure and, when appropriate, operating expenditure relating to achieving climate and environmental targets as well as current or targeted revenue related to the transition.

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29 Section 2. of the Annex illustrates how the different characteristics of an undertaking’s transition targets can be reflected in transition financing needs with different time horizons. Figure 2 in the Annex displays various options to articulate transition finance needs.

30 Section 3. of the Annex gives an overview of tools that might be used to determine transition finance needs and options to raise transition finance.
3.6. Where relevant, undertakings could discuss with financial intermediaries and investors their specific transition finance needs and the most suitable financing solutions.

4. Use of credible transition pathways to set science-based targets

4.1. Undertakings can use publicly available cross-sectoral or sector-specific decarbonisation scenarios and pathways, and where they exist environmental improvement scenarios, as references to set science-based targets and determine their transition finance needs.

4.2. When using scenarios or pathways, it is recommended to use those that are science-based, and in the case of decarbonisation pathways, those that are in line with the Paris Agreement, such as the 1.5°C scenarios of the International Energy Agency or the International Panel on Climate Change with no or limited overshoot.31

4.3. It is recommended to adjust the pathways for the individual undertaking in line with Union climate and environmental objectives and based on the locations where it operates and the starting point of the undertaking. To support this, it is also recommended to consult the European Commission’s qualitative EU Transition Pathways per industrial ecosystem32 when evaluating the climate transition challenges and the available best-in-class technologies, and the broader green, digital and resilience challenges in a given sector.

4.4. Science-based transition targets could be used to raise transition finance without a transition plan, where this is proportionate to the complexity, size and impacts of the undertaking, and where they are supported by information that ensures the integrity and transparency of those targets and accountability for implementing actions to reach those.

5. Use of EU climate benchmarks

5.1. Undertakings can use, where appropriate, methodologies used for EU climate benchmarks to complement science-based scenarios or pathways. They can support the definition of individual pathways at either undertaking or project level or to set transition targets and to help determine their transition finance needs.

5.2. The same methodologies can also be used to avoid that new investments become potentially stranded assets, and could make it possible to include issuances of the undertaking, or the capital raised for a relevant transition project, in an investment or lending portfolio that tracks an EU climate benchmark.33

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31 A possible source for such scenarios might be the scenarios published by the Network for Greening the Financial System.


33 Section 4. of the Annex explains in more detail the EU climate benchmark methodologies and how these can be used for articulating transition finance needs.
6. Use of the EU Taxonomy

6.1. Undertakings can determine their transition finance needs by voluntarily using the Taxonomy, alongside other science-based reference points, when setting transition targets for specific economic activities in economic sectors covered by the delegated acts adopted under Regulation (EU) 2020/852\textsuperscript{34}.

6.2. Undertakings are encouraged to use the Taxonomy to plan investments for meeting Taxonomy criteria for a given economic activity in 5 (exceptionally 10) years, as such investments are already recognised as fully Taxonomy-aligned.

6.3. Undertakings can use the Taxonomy to set milestones and intermediate targets for transitioning economic activities, to further improve environmental performance or to ultimately align with the Taxonomy over a longer timeframe that is still short enough to be compatible with the transition. For example, where necessary, undertakings can use the Taxonomy criteria to plan stepwise alignment with the Taxonomy: as a first time-bound target, to transition beyond performance levels defined by the do-no-significant-harm criteria, and as a second time-bound target to align with substantial contribution criteria, explained in an activity-based transition plan.\textsuperscript{35}

6.4. To operationalise the use of the Taxonomy to raise transition finance, undertakings could specify their transition finance needs in terms of the capital expenditure of the undertaking. When appropriate, they could also specify these needs in terms of their current and targeted operating expenditure or revenue, which is either:

(a) Taxonomy-aligned,

(b) will be Taxonomy-aligned in the future, or

(c) displays continuous performance improvements as part of a credible transition plan that is in line with the transition.

7. Use of a credible transition plan

7.1. Without prejudice to legal requirements, undertakings, especially those with activities that involve material impacts or complex transition pathways, can develop transition plans at either undertaking or activity level, or both, to articulate transition targets, milestones, actions and resource needs in a structured and consistent way.

7.2. Reporting standards under Directive (EU) 2022/2464 provide a template for developing credible transition and action plans, which undertakings could use with the aim to ensure the integrity, transparency, and accountability of such plans.

7.3. The Taxonomy and the EU climate benchmarks can be used together with science-based scenarios pathways to determine the targets or financing needs included in such plans at the levels of both undertakings and economic activities.

\textsuperscript{34} Such as the Climate Delegated Act and any future delegated acts specifying technical screening criteria.

\textsuperscript{35} Section 5. of the Annex further illustrates how the Taxonomy can be used for this purpose.
7.4. Plans towards environmental sustainability can also use the EU strategic environmental Action Plans for Circular Economy\textsuperscript{36}, Biodiversity\textsuperscript{37} and Zero Pollution\textsuperscript{38}.

8. Financing instruments to raise transition finance

8.1. Undertakings are encouraged to use one, or a combination of several, transition-related financing instruments to raise transition finance, such as specific loan types or capital market issuances with specific features\textsuperscript{39}.

\textit{Green or other sustainability loans}

8.2. If an undertaking has transition finance needs, it can seek specific types of loans such as sustainability-linked loans, green loans or other specific purpose loans.

8.3. Financial intermediaries are beginning to offer such loans and might offer competitive interest rates when the envisaged environmental performance underlying the loans helps to reduce transition risks or allows for lower refinancing rates for the financial intermediary.

8.4. Investments to achieve a specific transition goal, such as upgrading assets or making new investments that will enable production with low climate and environmental impact, could be financed through a special purpose loan with proceeds exclusively used for this purpose (also called ‘use-of-proceeds financing’). Articulating the purpose through transition targets related to the criteria of the Taxonomy could encourage the take-up of loans dedicated to the transition.

8.5. Investments in performance improvements at the level of undertakings could be financed through a sustainability-linked loan with science-based, time-bound climate or environmental performance targets serving as safeguards, and where interest rates are linked to achieving the planned sustainability performance targets, avoiding lock-in effects.

\textit{Green or other sustainability bonds}

8.6. Undertakings can also issue capital market instruments or specific bond types, such as a green bond or other sustainability bonds, to finance their transition. Bonds can be used to raise capital at both undertaking and economic-activity level.

8.7. To raise transition finance for a specific purpose, issuers could consider issuing bonds that demonstrate the use of proceeds for transition purposes. While international green bond standards exist and could be used to raise transition finance, undertakings could also consider using the European Green Bond Standard for

\textsuperscript{36} Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on A new Circular Economy Action Plan: For a cleaner and more competitive Europe. COM/2020/98 final.

\textsuperscript{37} Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, EU Biodiversity Strategy for 2030: Bringing nature back into our lives. COM/2020/380 final.

\textsuperscript{38} Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Pathway to a Healthy Planet for All EU Action Plan: 'Towards Zero Pollution for Air, Water and Soil'. COM/2021/400 final.

\textsuperscript{39} Section 6. of the Annex provides examples of the financing instruments described below.
issuing green bonds to finance economic activities that will become Taxonomy-aligned in 5 (exceptionally 10) years.

8.8. Sustainability-linked bonds can be used to raise capital for the undertaking’s sustainability performance improvements both at undertaking and activity level. They should be linked to sound sustainability performance targets – for instance Taxonomy key performance indicators – and a timeframe that is aligned with the transition, as the coupons are usually issued subject to achieving and incentivising the envisaged performance.

8.9. The sustainable finance tools mentioned in points 3 to 7 can be used as performance targets and to further strengthen the credibility of sustainability-linked bonds.

*Equity financing and specialised lending*

8.10. Undertakings can also issue equity instruments or consider specialised lending solutions that are linked to sustainability performance targets at the level of the undertaking, project level or economic activity level. Similar approaches to those described above for setting such performance targets can be employed.

**RECOMMENDATION TO FINANCIAL INTERMEDIARIES AND INVESTORS WILLING TO PROVIDE TRANSITION FINANCE**

9. Tools for setting transition finance targets and for identifying projects or undertakings

9.1. Financial intermediaries can contribute to the financing of the transition by reflecting transition financing objectives in their lending or investment strategy.

9.2. When setting transition targets and designing transition finance approaches for portfolios and investment or lending strategies, financial intermediaries can:

(a) consider the recommendations to undertakings on determining transition finance needs and target setting\(^{40}\);

(b) make sure that the transition finance approach helps the transition and decarbonisation of the real economy, takes into account the different starting points of undertakings, applies the principle of proportionality (in particular to SMEs), and includes relevant climate and environmental safeguards, in line with the definition of transition finance in this Recommendation;

(c) translate the transition finance approach into specific targets related to climate or environmental objectives, for all asset classes, and covering all types of finance and all economic sectors that are relevant for the transition;

(d) consider advice and engagement as important parts of the transition finance strategy.

9.3. Investors and asset owners can develop similar approaches for their own assets.

\(^{40}\) Considering also Section 2. of the Annex.
9.4. To operationalise investment strategies with transition finance approaches and identify undertakings and projects that meet the transition targets, financial intermediaries and investors can:\(^\text{41}\):

(a) use information provided by undertakings to determine transition targets and transition finance needs, including transition plans and corporate reporting;

(b) use the decarbonisation methodologies required under the EU climate benchmarks such as clear decarbonisation targets by undertakings and restricting new investments in potentially stranded assets;

(c) use the Taxonomy framework and criteria to identify investments that are eligible and could become Taxonomy-aligned, where necessary through interim steps according to a timetable that is compatible with the transition. For example, where necessary, consider as a first step to finance transition steps beyond performance levels defined by the do-no-significant-harm criteria and a second step to align with substantial contribution criteria, clarified in an activity-based transition plan;

(d) use disclosures and prospectuses that accompany the issuance of green-, transition- and sustainability-linked bonds or equity;

10. Engagement with undertakings in need of transition finance

10.1. Financial intermediaries are encouraged to engage with clients and investee undertakings in transition, especially where there is a significant need for transition finance.

10.2. The engagement policy could include outlining relevant lending or investment strategies that could be suited to the relevant transition finance needs, and the eligibility conditions for financing under these strategies.

10.3. When engaging with clients and investee undertakings, the following aspects could be discussed:

(a) material sustainability impacts, risks and opportunities, and how climate and environmental impacts and risks are addressed;

(b) how the contribution to a climate or environmental objective is determined and what the time horizons for the lending or investments are;

(c) the underlying transition pathways, to ensure that the lending or investment strategy is compatible with the transition;

(d) whether or how the principle of ‘do no significant harm’ as defined in Article 17 of Regulation (EU) 2020/852 is applied and how adverse impacts are dealt with;

(e) how sustainability performance and the transition targets and plans of undertakings will be taken into account, including in assessing the risk of stranded assets, and transition risks and physical risks more broadly.

11. Transition-specific financing solutions

\(^{41}\) Section 7 of the Annex provides further suggestions on such tools.
11.1. Aside from general lending and financing solutions, financial intermediaries can offer transition-specific financing solutions to undertakings or projects with significant transition finance needs.

11.2. This includes, for example, offering loans or financing products that can help finance transition investments on the ground, such as those based on:

(a) investments in alignment with Regulation (EU) 2020/852 that help increase the share of Taxonomy-aligned activities carried out by an undertaking in a meaningful way;

(b) the EU climate benchmarks where they complement science-based scenarios or pathways;

(c) credible entity or activity-level transition plans implementing science-based targets;

(d) credible science-based targets, where proportionate, that are supported by information ensuring integrity, transparency and accountability;

(e) the reduction of environmental footprints based on and aligned with EU strategic environmental Action Plans for Circular Economy\(^ {42}\), Biodiversity\(^ {43}\) and Zero Pollution\(^ {44}\).

(f) a combination of the above, e.g. where transition plans integrate transition finance needs determined through the Taxonomy or the EU climate benchmarks.

11.3. Financial intermediaries can consider setting incentives to encourage a strong performance against the undertaking’s transition targets, for instance rewarding progress towards transition targets or Taxonomy criteria through attractive interest rates, for example based on reduced transition risk or improved funding costs.

12. Transition and physical risks

12.1. Financial intermediaries and investors are encouraged to assess how their transition targets and transition finance objectives align with and contribute to their risk management strategies, to address financial risks arising from misalignment with the transition.

12.2. In particular, financial intermediaries and investors are encouraged to:

(a) take into account in risk management and engagement frameworks forward-looking information from counterparties, such as transition targets and plans, including information on their credibility and annual reporting on progress;

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\(^{42}\) Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on A new Circular Economy Action Plan: For a cleaner and more competitive Europe. COM/2020/98 final.

\(^{43}\) Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, EU Biodiversity Strategy for 2030: Bringing nature back into our lives. COM/2020/380 final.

\(^{44}\) Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Pathway to a Healthy Planet for All EU Action Plan: 'Towards Zero Pollution for Air, Water and Soil'. COM/2021/400 final.
(b) consider financing transition projects that have the potential to reduce negative impacts on sustainability factors and future transition risks and physical risks, e.g. by following the guidance of the climate adaptation Taxonomy.

RECOMMENDATION RELATED TO SMALL AND MEDIUM-SIZED ENTERPRISES

13. Small and medium-sized enterprises seeking transition finance

13.1. If SMEs are interested in raising transition finance, they will need proportionate arrangements, given their size, administrative capacity and resources, and are therefore encouraged to engage with financial intermediaries and investors to explore what financing options and support services are available.

13.2. SMEs that are interested in contributing to the transition could consider raising transition finance for their transition-related investments, which could be immediate investments or investments in the future, for example for the following:

(a) new green technologies;
(b) upgrading existing economic activities or assets;
(c) investing in enabling technologies;
(d) green sourcing policies (e.g. renewable energy);
(e) activities greening their support functions, such as those that increase the energy efficiency of their buildings, or leasing or acquiring electric vehicles, decarbonising their transport use, greening their food supply, etc.

13.3. Listed SMEs fall within the scope of Directive (EU) 2022/2464 and will disclose sustainability information under simplified reporting standards in the future. SMEs that do not fall within the scope of that Directive, but are interested in communicating their key sustainability information, might consider using these simplified reporting standards, or other voluntary reporting standards that are tailored to SMEs for this purpose.\(^45\)

13.4. Large undertakings are strongly encouraged to support in a proportionate manner the SMEs in their value chain that are interested in transition financing, in assessing transition finance needs and, where relevant, obtaining key sustainability information, whether or not they fall within the scope of mandatory sustainability reporting.

13.5. Where relevant, larger undertakings could also cooperate with financing institutions to offer favourable financing conditions and/or purchasing conditions to their value

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\(^45\) Under Directive (EU) 2022/2464, reporting for listed SMEs (except micro businesses) will begin in 2027, based on the 2026 financial year. Listed SMEs will be able to report according to separate, proportionate standards developed by the EFRAG.
chain partners in need of transition finance, in particular SMEs in sectors that are relevant for the transition.\textsuperscript{46}

14. Financing solutions for small and medium-sized enterprises

14.1. SMEs have a limited capacity to provide detailed information, therefore financial intermediaries and investors are encouraged to apply the principle of proportionality in dealings with SME clients. They should not ask for more information than necessary and exercise restraint when requesting information from SME value chain partners.

14.2. Financial intermediaries are encouraged to offer education and awareness programmes, advisory services or web-based tools to help SMEs that are interested in transition finance to increase their awareness of transition risks and opportunities.

14.3. As part of this, support could be given to interested SMEs to assess their transition finance needs in a simple way.

14.4. Green-specific and transition-specific financing solutions that are proportionate and suitable for use by SMEs and which incentivise their uptake, could be offered to SMEs, taking into account that unlisted SMEs are not subject to reporting obligations under Directive (EU) 2022/2464 and Regulation (EU) 2020/852.

RECOMMENDATION TO MEMBER STATES

15. Member States are invited to consider the following recommendations to encourage transition financing:

15.1. Member States are encouraged to raise awareness among market participants of the need to finance investments in the green transition and of the existing standards, principles and safeguards that can ensure the credibility and environmental integrity of such investments. They could explain the benefits of using EU sustainable finance tools for this purpose.

15.2. Member States could encourage market participants to use reference scenarios that are science-based, reflect the decarbonisation pathways in line with the Paris Agreement, such as the 1.5°C scenarios of the International Energy Agency (IEA) or the International Panel on Climate Change (IPCC) with no or limited overshoot, or EU, national or sectoral pathways referencing these IEA or IPCC scenarios.

15.3. Member States could encourage cooperation, within the framework of EU and national competition rules, between market participants to share lessons learned and best practices in providing or seeking transition finance and addressing common challenges. Capitalise on the role industry associations and other reputational bodies can play in this regard.

\textsuperscript{46} For instance, companies can support SMEs, whether or not they fall within the scope of mandatory sustainability reporting, to voluntarily use Union sustainable finance tools or other science-based tools to communicate their transition projects, transition targets or transition plans to address transition risks to banks in a transparent and substantive way.
15.4. Member States could encourage capacity-building in transition finance tools and policies, including the training of civil servants, regulators and financial sector professionals to support the design of transition-related financing solutions and policies that reflect geographical dependencies.

15.5. Member States could encourage and promote innovative sustainable finance products and services tailored to SMEs, taking into account the principle of proportionality.

15.6. Member States could support SMEs in voluntarily reporting key sustainability and transition finance information to stakeholders and financial intermediaries and investors, which could increase the variety of financing options offered to SMEs.

15.7. Member States could encourage multilateral development banks and national promotional banks to support these efforts by offering technical assistance.

15.8. Member States could encourage initiatives between local banks and SMEs to develop and implement sustainable finance strategies and credible transition targets or, where relevant, transition plans for SMEs.

RECOMMENDATION TO THE EUROPEAN SUPERVISORY AUTHORITIES AND NATIONAL COMPETENT AUTHORITIES

16. The European supervisory authorities and the national competent authorities are encouraged to:

16.1. Consider this Recommendation when monitoring and supervising transition-related greenwashing risks.

16.2. Take into account relevant forward-looking information included in transition targets, credible transition plans or Taxonomy disclosures when assessing supervised entities’ financial risks associated with the transition.

16.3. Raise awareness among supervised entities about how the regulatory framework allows forward-looking information from counterparties or investee undertakings to be used to assess, manage and monitor transition risks and physical risks.

16.4. Build capacity with National Competent Authorities on transition finance and encourage a trusted environment for transition finance across the EU.