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Investing for a
world of change

SMI AO/AM Transition Finance Working Group:

A Framework to Define a Transition Category for
Investors

July 2022





Where we invest matters.

Asset Managers and Asset Owners have a critical role in the transition.

The SMI AM/AO Taskforce have drafted a 'Transition Investment Category' framework for investors to identify high emitting assets with high transition potential

By the SMI Asset Manager/Asset Owner Taskforce members:



This document is in draft format and is for discussion purposes only



Executive summary

SMI Transition Categorisation for Investors

1. **90% of the world's economy is committed to the net zero transition** predicted to cost upward of \$4trillion p.a. to 2050, front-loaded to accelerate the decarbonisation of high-emitters while scaling low-carbon solutions
2. **Most of the finance needed to reach net zero will be in high-carbon sectors and emerging markets:** 4 sectors – power, mobility, industry, buildings – are responsible for 85% of global emissions, with emerging markets on track to produce 90% of new emissions by 2030
3. **Investing in transition means investing in carbon-intensive companies that have credible transition plans or that supply materials/products that enable the transition to net zero** e.g., copper and lithium producers which are carbon-intensive industries generating core materials needed for low-carbon solutions such as batteries, solar PV and semi-conductors
4. **However, financial institutions are under pressure to align portfolios with environmental thresholds**, encouraging the redirection of capital toward low-carbon assets and regions via carbon budgets and portfolio alignment metrics – driving capital away from where the carbon is and potentially squeezing out emerging market economies
5. **The transition to net zero needs to be orderly to avoid unintended economic consequences:** if carbon-intensive production declines at a faster rate than lower-carbon alternatives are phased in, there is a risk of supply shortages and price hikes that could drive economic disorder while widening the gap between developed and emerging market countries
6. **Excluding carbon-intensive exposures could be destructive for three reasons:** 1) adequate funding is not made available to fully decarbonise the economy and we don't achieve global goals, 2) portfolios are less able to weather supply shocks causing economic disruption as a consequence, 3) already vulnerable regions set to lose from an unjust transition

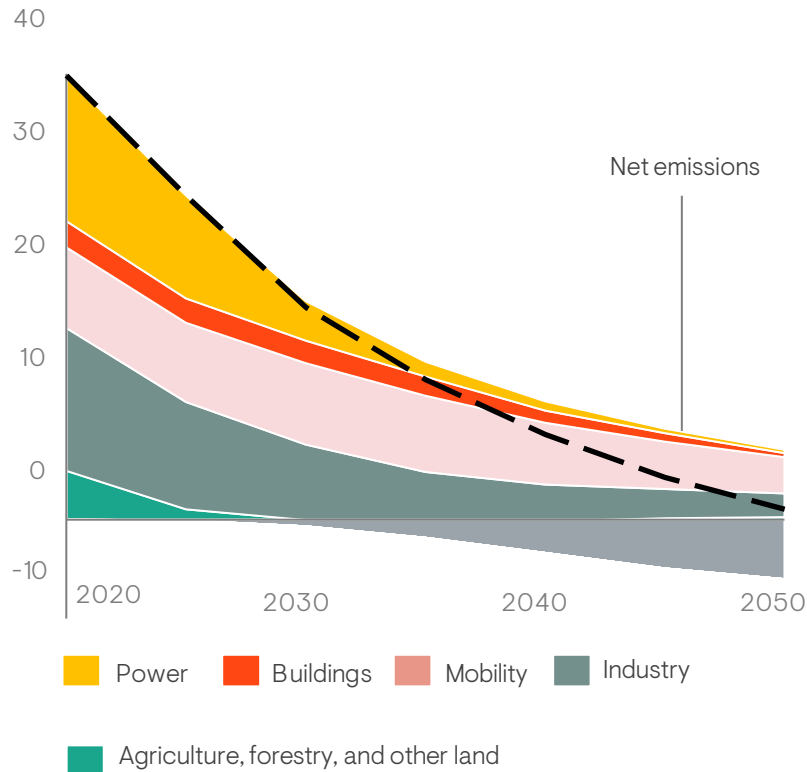
The SMI Transition Categorisation enables continuing investment into sectors and regions that are critical to the net zero transition. The aim is to avoid indiscriminate funding, ensuring the transition is *orderly* and remains *just*, while increasing the *resilience* of investor portfolios to the shocks experienced in ever-fluctuating markets



Decarbonisation of high emitting sectors is a net zero priority

Majority of emissions come from high growth sectors that require significant finance to decarbonise

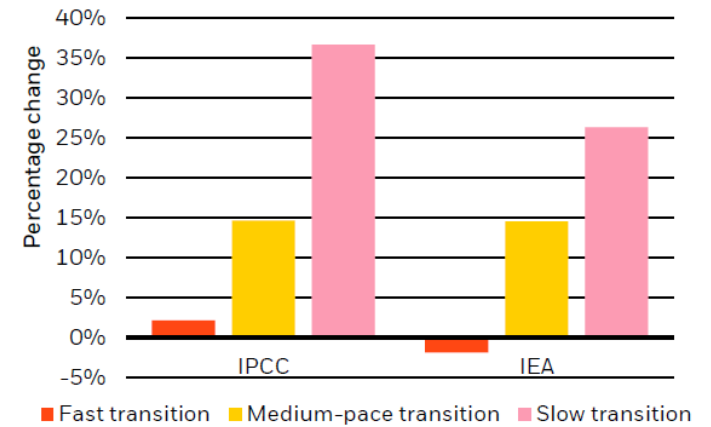
85% of CO2 emissions are generated by 4 sectors that are reliant on the production and burning of fossil fuels



Energy demands increasing as high investment needs to decarbonise are realised

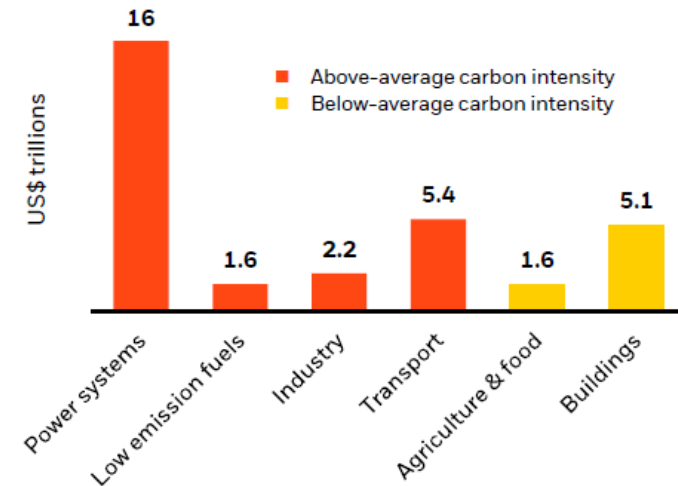
Global energy demand still growing

Change in energy consumption, 2020-2050



Investment needed in high-carbon sectors

Capex needs by 2030 and carbon intensity, by sector

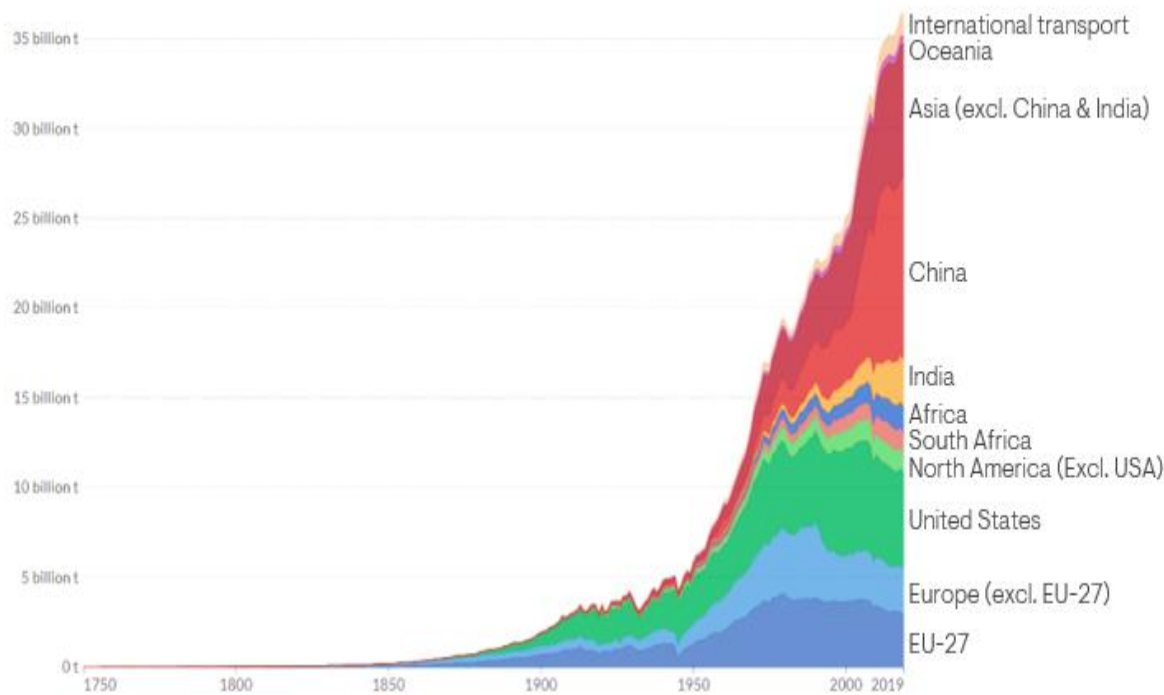




The world cannot decarbonise unless emerging markets do: more finance is needed

Emerging markets are expected to account for 90% of emissions growth

The transition in EMS is expected to cost \$1 trillion p.a. of which only 15% has been deployed to date



Annual total CO2 emissions, by world region





Financial allocators need to finance real world decarbonisation

- Divestment does not lead to real-world decarbonisation, it leads to cleaner investment portfolios.
 - To drive down global emissions, we need be able to go to where the carbon is and to invest in companies and countries that have high transition potential
 - A globally accepted, scientifically backed framework is required to guide investors to aligned transition investment opportunities



SMI Methodology to define transition assets

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Is the asset in 1 of 4 heavy emitting sectors?

Decision tree



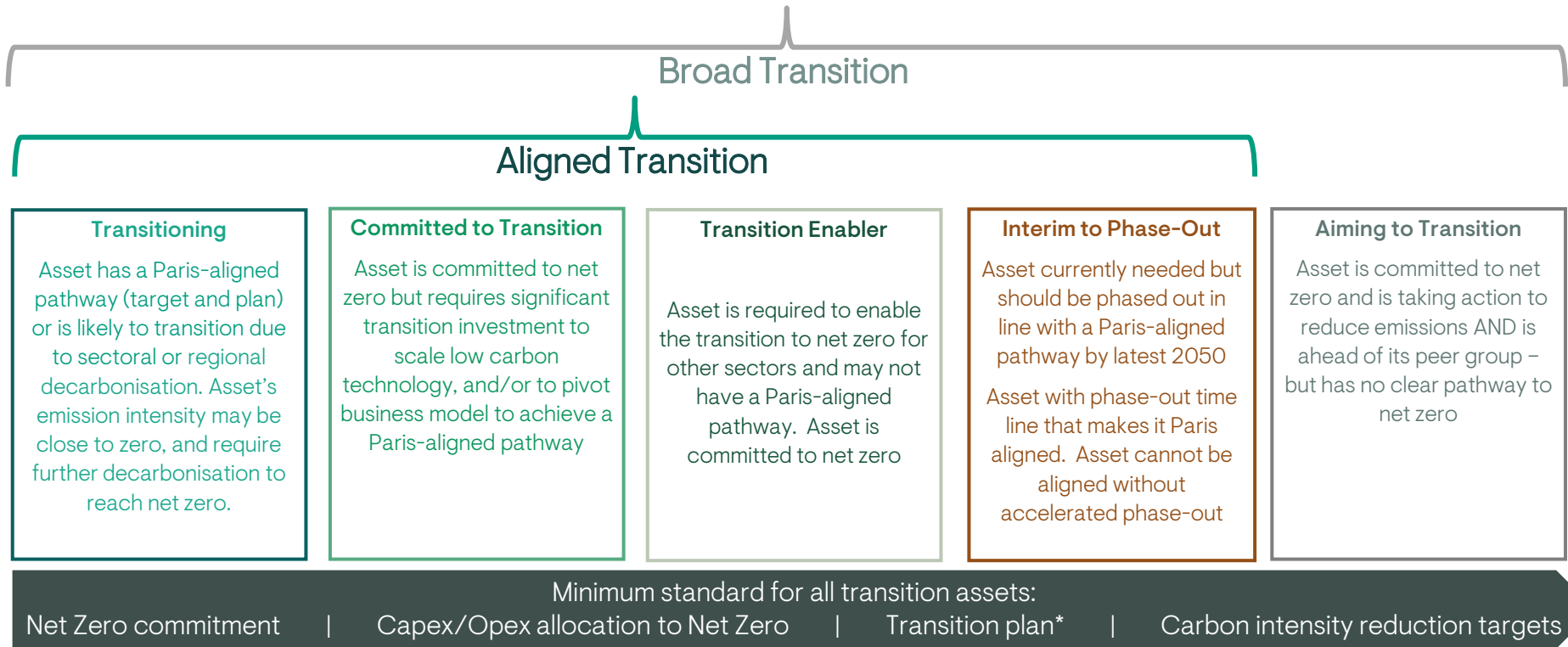
Transition asset buckets





Proposed classification and minimum standards of transition investments in the 4 high emitting sectors

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Suggested criteria for Transition asset boundaries

- SBTi approved ~1.5C Paris-aligned pathway as it exists
- ~95% revenue generated from green revenue, in line with EU Taxonomy (exl. gas)
- SBTi approved Net Zero target
- Robust transition plan for a 1.5C pathway
- Transition technology is commercially viable
- Strategy requires significant financing
- Output or product required for net zero economy (no alternative exists)
- Carbon intensity of production target to reduce annually by [X]%
- [50]% CAPEX allocated to transition by 2030
- >[30]% revenue generated by low carbon by 2030
- For interim: Asset reduces GHGs relative to alternatives with phase out by 2050
- For phase out: phase out within a defined science-aligned time horizon
- Incorporate GFANZ Managed Phaseout Criteria
- IIGCC oil and gas standard
- Consistent progress on Transition Plan metrics*
- Incorporate SMI Energy Transition framework
- Company leading peers on transition metrics

* Transition plan metrics to be identified by industry experts

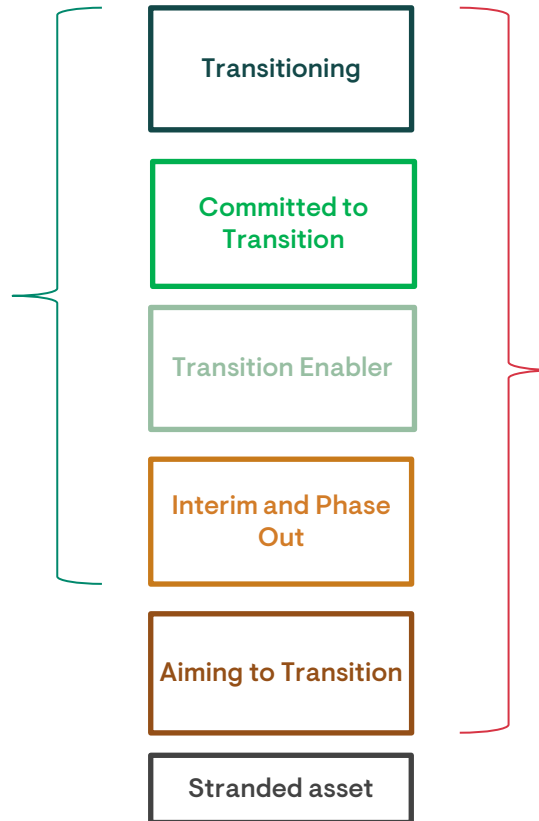
Transition can take different forms

Aligned Transition

Investment scales assets that have the potential to be 1.5C aligned either through pivoting, technology investment or accelerated phase-out AND/OR assets in sectors that are required to enable the net zero economy beyond 2050.

Examples:

- Transitioning; semiconductors and EVs
- Enablers: lithium and copper mines as critical inputs for solar PV, EVs and semi-conductors; transmission and grid infrastructure essential to connect new clean energy to users
- Interim and phase out: baseload gas plants becoming peaking energy beyond 2050



Broad Transition

Aligned transition with the addition of companies that do not have a pathway as they exist but are committed to transition

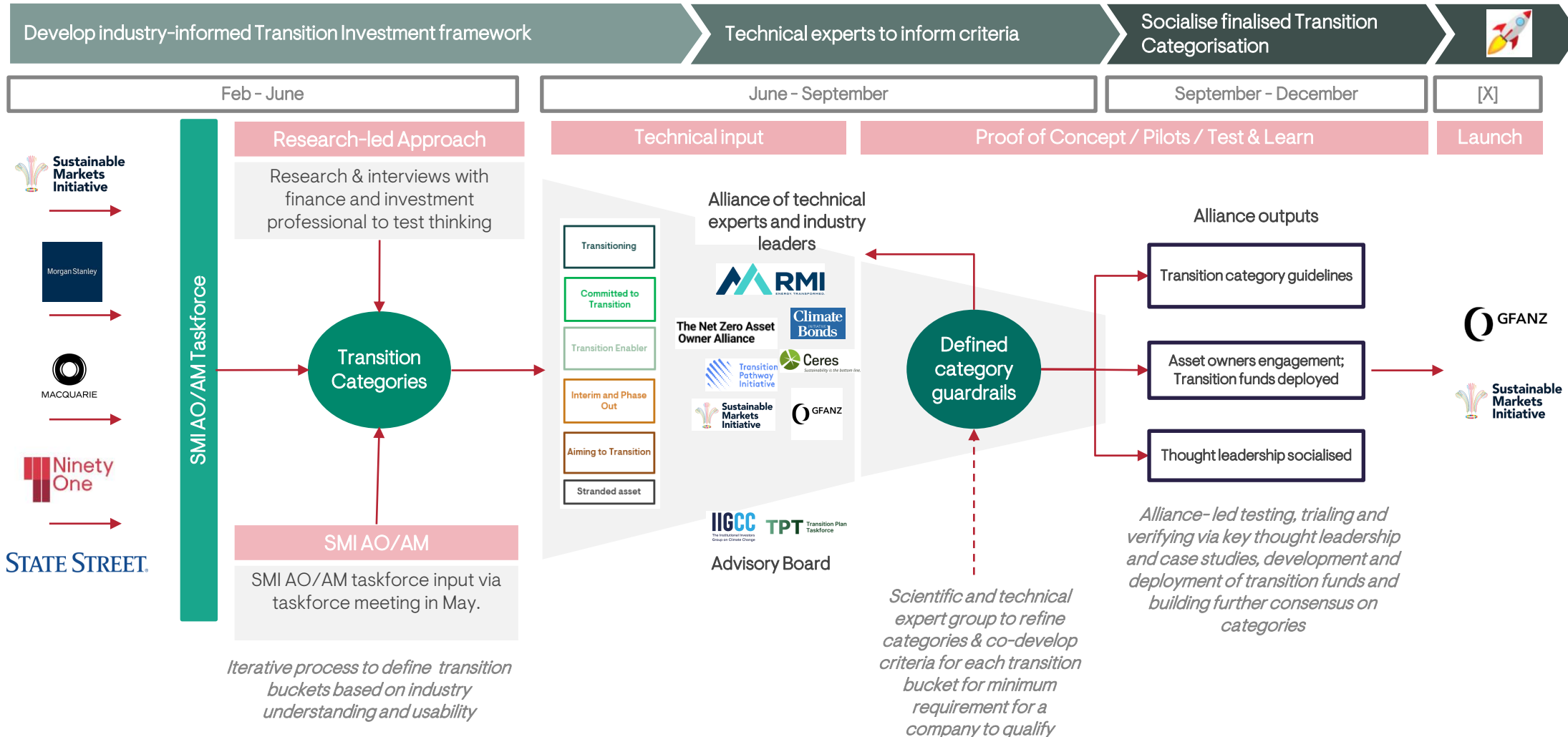
Examples:

- Aiming to Transition: oil major committed to transition with revenue stream being hydrocarbons but with plans to diversify into low-carbon and green



Proposed next steps

Critical transition criteria for categories to be created by technical experts and launched by existing platforms





This work has been developed with input from thought leaders and industry experts and is for discussion purposes

With thanks to SMI Transition Finance working group for input:



The work has been informed by thought leadership and informal consultation with transition-finance leaders:



Appendix

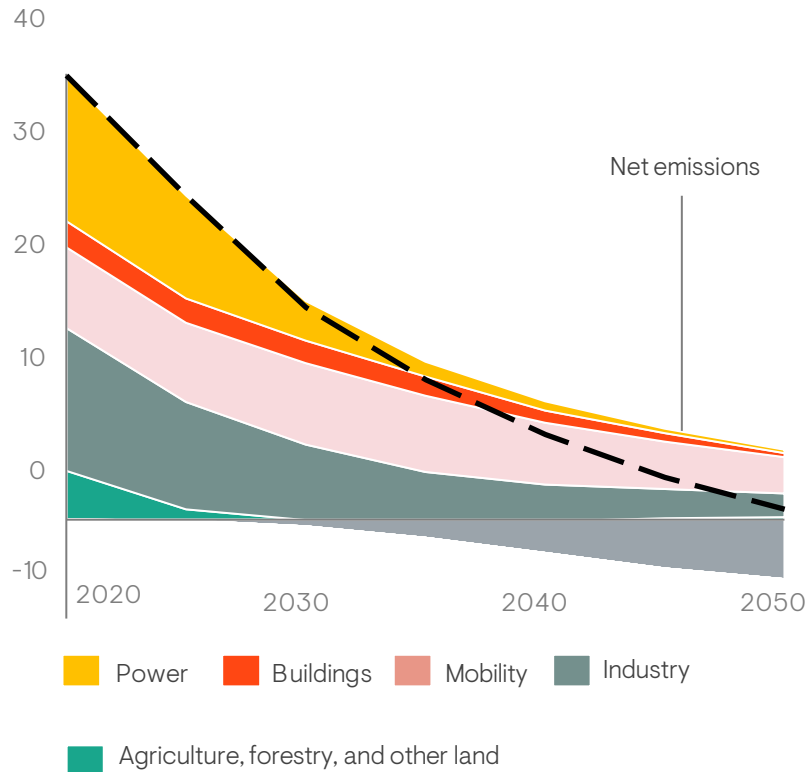




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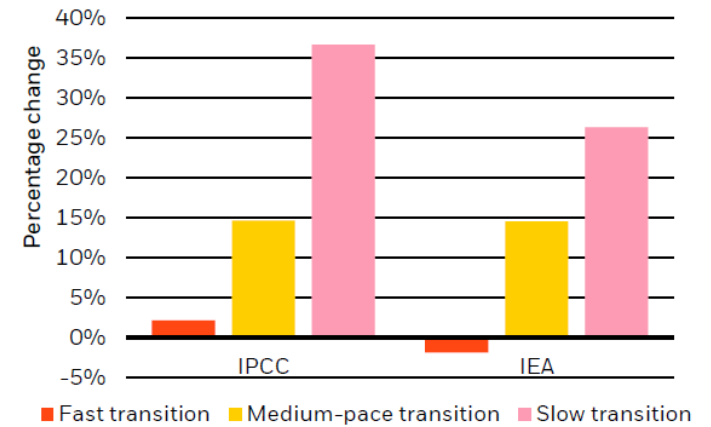
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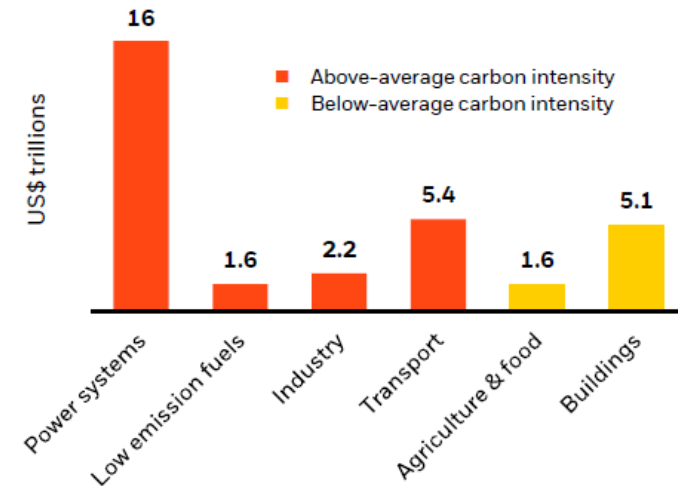
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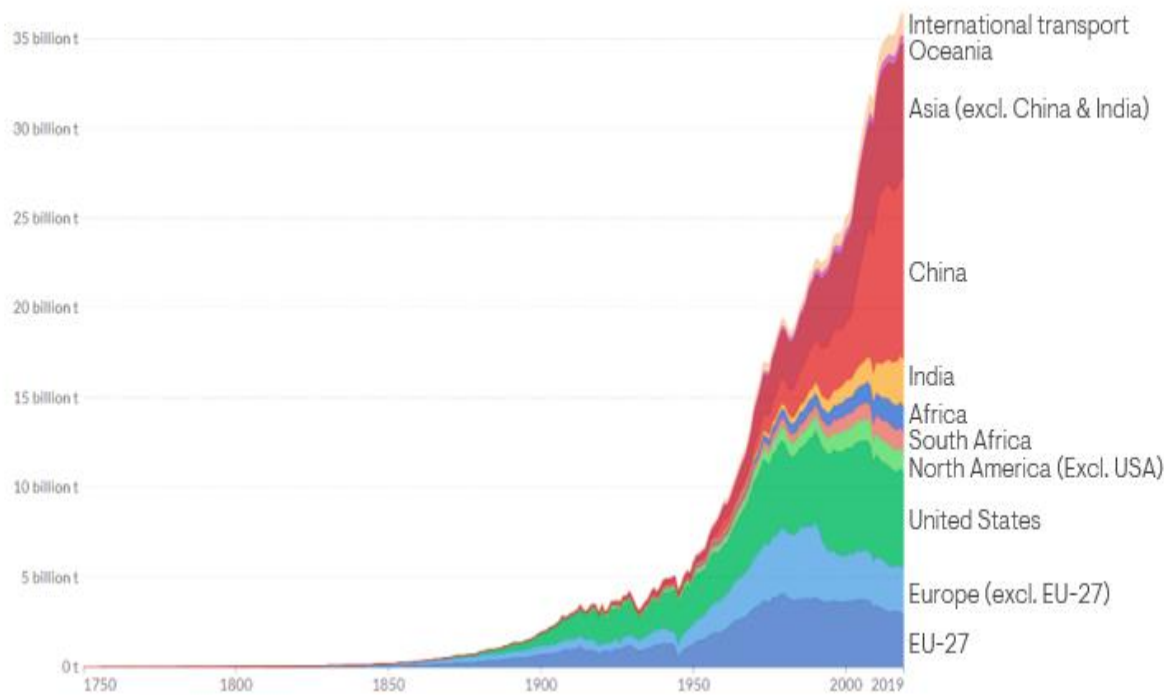




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Annual total CO2 emissions, by world region





Industry-developed toolkits are helping to guide investment into transition

SMI and GFANZ outputs on Transition Finance are complementary, solving for different needs within the financial system but that work to deliver a common goal



A shared approach and spirit

- ✓ Convening committed financial institutions to drive net zero
- ✓ Collaboration and collective-action at the centre of the approach
- ✓ Coordinating input on key levers for change
- ✓ Consultative process with users and technical experts
- ✓ Developing tools to guide financial sector to invest for a better tomorrow



Unique but complementary outputs

- Asset Owner/Asset Manager Transition Finance working group developing a Transition Categorisation for institutional investors
- Build consensus on categorisation of transition assets
- Develop guardrails to ensure categorisations are robust
- Allow investors to make judgements on transition investing based on appetite and own view of transition

- Financial Institution Net-Zero Transition Plans workstream develop recommendations and guidance to deliver on net zero for financial institutions
- Four key approaches identified for financial institutions to support real economy reductions
- Allows financial institutions to evaluate the credibility of other institutions transition plans

A common goal

To mobilize finance to accelerate a responsible transition to a net zero, sustainable real economy



GFANZ definition of asset categories



Source: GFANZ, June 2022 [paper](#)

Climate solutions: Technologies directly contributing to the **elimination of real-economy GHG emissions**, and services supporting the **expansion of these technologies**, that financial institutions can support in order to enable the global transition to net zero. These solutions include **scaling up zero-carbon alternatives** to high-emitting activities — a prerequisite to phasing out high-emitting assets

Aligned assets: Financing or enabling **companies that are already aligned to a 1.5 degrees C pathway**. This approach supports climate leaders and signals that the finance sector is seeking transition alignment behaviour from the real-economy companies with which it does business.

Transition assets: Technologies or services that **may reduce GHG emissions relative to prevalent alternatives**, and thus play a role in the transition, but that ultimately do not enable the elimination of GHG emissions. This may include **fuels like natural gas** as an alternative to coal in some jurisdictions. Financial institutions' support of these assets should be clearly defined in order to ensure that short-term emissions reductions do not prevent the development of climate solutions that enable the economy-wide transition to net zero. **Transition assets may be replaced with cleaner options as the net-zero transition advances.**

Managed phaseout projects: Targeted efforts to reduce GHG emissions through **accelerated retirement of high-emitting physical assets** (shortening their operating life). Financial institutions can finance or enable strategies for managed phaseout of these assets **within a defined science-aligned time horizon**, thereby limiting the likelihood that these assets will be stranded in a low-carbon future. These projects require appropriate scrutiny and governance to ensure that emissions reductions occur as planned.



How the SMI Transition Category framework aligns with GFANZ Transition approach

GFANZ "Four approaches to net zero"		SMI Transition Categorisation				
		Transitioning Ready	Committed to Transition	Transition Enabler	Interim to Phase Out	Aiming to Transition
Climate solutions	Financing or enabling the development and scaling of climate solutions to replace high-emitting technologies or services.	✓				
Aligned assets	Financing or enabling companies that are already aligned to a 1.5 degrees C pathway.	✓				
Transition assets	Financing or enabling the transition of real-economy firms according to transparent and robust net-zero transition plan		✓		✓	
Managed Phaseout	Financing or enabling the accelerated managed phaseout (e.g., via early retirement) of high-emitting physical assets				✓	
Framework alignment		Aligned	Aligned	Additional	Aligned	Additional



How do the various SMI frameworks work together?

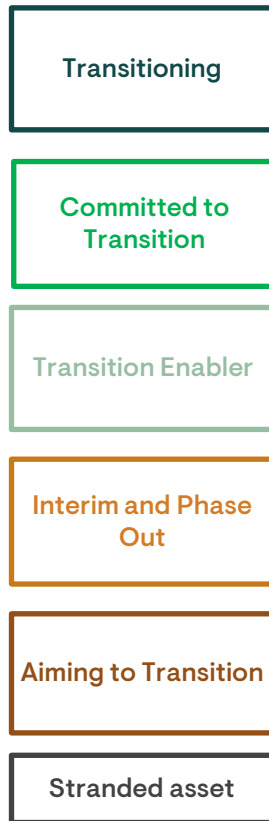
Two of the frameworks being developed complement each other well and can be used to further inform the integrity of a high emitting companies ability to transition

Step 1. SMI Transition Categorisation

Identify transition asset category using the decision tree methodology and suggested guardrails

Is the asset committed to reduce emissions, but has no clear pathway to net zero?

Yes



Step 2. SMI Energy Transition Taskforce tool

The “Aiming to Transition” assets (mostly oil and gas majors) to use the Energy Transition Taskforce assessment tool to identify leaders and laggards at company level within this category to establish the integrity of the company's transition

