Transition bonds – a pioneering concept to finance low-carbon transition efforts

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Green or climate bonds are a relatively new type of financial instrument intended to fund projects with climate or environmental added value. Interest in such bonds has soared recently, with the market now worth more than USD 1 trillion, as companies and investors become increasingly engaged in building diverse portfolios with positive environmental impacts. The issuers of green bonds, however, are often sovereigns, utilities or financial companies with high investment grades. Hence, there is a need for new instruments to support carbon intensive players that are actively decarbonizing but have not yet reached the grading or "greenness" that makes their efforts eligible for green bonds. Even if the world adopts a steep low-carbon trajectory, it will not be enough to meet the global energy demand in the short to medium term. It is therefore essential, that the generation and use of carbon intensive energy is replaced with low-carbon business activities, and financing for these activities is made available. To help tackle these issues, AXA developed a new concept and launched, in November 2019, the first of its kind "transition bond" in partnership with Crédit Agricole CIB.

Whereas green bonds have strict eligibility criteria to determine what can be classified as a "green project", transition bonds fill the gap between "already green" projects that are eligible for green bond funding, and those that are not, but would nevertheless make huge strides towards lowering their carbon footprint. The main difference with green bonds is that the use of proceeds will be directed to industrial companies from "brown industries" with the aim to decarbonize their business activities. This includes the transition from e.g. carbon intensive coal- or oil-based power to gas for companies that cannot yet change their business model to solely rely on renewable energy.

Use of proceeds

In these transactions, the use of proceeds from the transition bond can for example be used in the following ways:

- electricity production: loans made to an electric utility company in an emerging economy currently dependent on coal and oil for power generation. These loans finance the development of gas fired power stations. Current Combined Cycle Gas Turbine technologies have an average carbon intensity of 353 tCO_2/kWh, which is 60% lower than the average coal production unit;
- marine transport: loans made to shipping companies to switch from heavy marine diesel oil to liquid natural gas propulsion (25% emissions reductions), which is the most efficient improvement currently available at scale to reduce emissions for large scale commercial shipping. Shipping is currently one of the few activities where transition technologies can be implemented on a large-scale;
- industrial resource efficiency: loans made to a South American industrial company implementing energy efficiency and waste-water treatment with expected reduction in energy intensity by 44% between now and 2040.

Transparency

Just as for green bonds, we believe that issuers of transition bonds must provide a means of mapping the invested funds to be able to clearly demonstrate that they are used for green projects (use of proceeds). Transparency is critical in this regard: investors must be regularly informed about how money is being used and what environmental outcomes are being achieved. AXA encourages transition bond issuers to use indicators, like those developed in the Green Bond Principles, to demonstrate the environmental impact of the transition bond funded projects or the strategic shift to a low carbon business model. In addition, transition bond issuers should clearly communicate what climate transition means in the context of their current business model and their future strategic direction, including a commitment to align their business with meeting the Paris Agreement goal of limiting the global temperature increase to below 2°C by the end of this century. It is important to have transparent and accepted "Transition Bonds Principles", which is why AXA worked through AXA IM together with peers and policymakers within the International Capital Markets Association (ICMA) to launch the Climate Transition Finance Handbook.

At AXA, we believe that transition bonds have the potential to provide carbon-intensive companies with a much-needed new source of financing to "green" their business activities. We view transition bonds as a new and attractive asset class for investors – and ultimately as an important instrument to accelerate the fight against climate change.