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# Investor Impact in Transition Finance: Learning from Ecolabels

AN OVERVIEW REPORT BY CLIMATE & COMPANY

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## EXECUTIVE SUMMARY

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Reaching net zero targets by 2050 requires massive investments from the private and public sector, as well as a supporting financing framework. While there has been a surge in interest in investments that are currently sustainable (such as renewable energy investments), there is a need for stronger financial incentives in current emissions-intensive sectors to help them decarbonise (such as manufacturing or agriculture). Creating better financing conditions for economic activities *becoming green* lies at the heart of the frequently discussed term “**transition finance**”.

Over the past years, a **packed transition finance landscape** has emerged: a growing number of companies are setting science-based targets, developing transition plans, or making green investments. Investors collaborate to collectively shift investment volumes into the transition. Both the financial sector and the real economy are encompassed by an emerging policy framework and private sector initiatives, both of which foster transparency and give guidance.

In general, there are **two direct channels** through which investors can contribute to the transition of the real economy: **capital allocation and engagement**. The allocation of capital to companies with a credible transition path can be guided by forward-looking information about portfolio companies. This information could be, for example, the existence of a corporate emissions reduction target or the level of investment in sustainable technologies. Both can be a predictor of lower corporate emissions. This can be complemented by an active engagement process, i.e., through voting rights and dialogue. Our literature review provides robust evidence that engagement can lead to changes in real-world parameters. However, the success rate depends on a few determinants such as collaboration among investors or focusing on financially material issues, among others.

Professional investors have signalled a broad willingness to invest in transitioning “brown” industries – *if* trust is established by clear performance indicators and thresholds. For retail investors, incorporating sustainability preferences into investment decisions comes with high information costs and the access to suitable financial products remains limited. **Increasing transition finance access and enhancing transparency** for both investor groups is therefore crucial.

**Ecolabels for financial products are an existing illustration of how both mechanisms – capital allocation and engagement – intertwine and can be applied to financial products.** This report reviews eight Ecolabels for financial products and how they address the transition. To date, most labels are dominated by backward-looking criteria and current sustainability performance which might exclude companies that can contribute to the transition. We find that the EU Ecolabel and the Nordic Swan Ecolabel are frontrunners regarding the integration of forward-looking elements. We highlight four principles to (better) include transition characteristics in Ecolabels, namely:

- Alignment with the Paris Agreement and other environmental targets.
- Reduce the investable universe by excluding companies without willingness to transform their business model.
- Define clear KPIs and science-based thresholds for the qualifying criteria.
- Specify the criteria for the engagement process.

# 1. INTRODUCTION

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To limit the temperature increase compared to pre-industrial times to well below 2°C, preferably 1.5°C (UNFCCC, 2015), **public and private finance needs to be enhanced across all sectors and regions towards investments into the green transition** (IPCC, 2018). As described in the Paris Agreement article 2.1c, financial flows need to be made consistent with the trajectory towards lower greenhouse gas (GHG) emissions. However, in this “decade of delivery” (OECD, 2021), there are still significant investment gaps. Responding to the Paris Agreement, the EU’s Green Deal defined the target of climate neutrality by 2050. This goal has been enshrined into the European Climate Law – with an intermediate target of reducing GHG emissions by at least 55% by 2030 compared to 1990 levels (European Commission, 2020). This requires extraordinary investments with estimates revolving around EUR 300 bn per year (Claeys and Tagliapietra, 2020).

Furthermore, most financing efforts have so far focused on “dark green” economic activities, (CBI, 2020), such as energy from wind and solar or low-emission transport solutions. But there is also the urgent need to **finance the transition pathways of current GHG intensive sectors**. There are a range of sectors (including “hard-to-abate sectors” such as the steel, cement, and aluminium sector) with a significant GHG reduction potential (to date, manufacturing or agriculture account for 26% and 16% of the EU’s GHG emissions respectively)<sup>1</sup>. If the EU is serious about reaching climate neutrality by 2050, financing solutions as well as a better understanding on measuring and incentivising the climate transition are needed.

Transition finance has been high on the agenda of working groups from multinational and private initiatives (such as the G20 Sustainable Finance working group, a working group of the International Platform on Sustainable Finance, and the independent EU Platform on Sustainable Finance, among others. See Annex 3 for an overview). All of them have published different reports to outline the evolving transition finance landscape and to provide recommendations to jurisdictions, corporates, or financial institutions. Regardless of these efforts, there is no dominating framework yet (E3G, 2022), and the definitions of transition finance vary despite its growing importance (WWF, 2021).

## **What is the scope and structure of this report?**

The remainder of this report is structured as follows. Chapter 2 describes the existing transition finance framework with a focus on two key players: non-financial corporates and investors. Chapter 3 discusses data indicators that are currently used by financial markets to select companies in transition (i.e., the mechanism of capital allocation), discusses the channel of shareholder engagement, and presents scientific evidence. Chapter 4 describes how both mechanisms intertwine in the example of Ecolabels for financial products, and how those currently incentivise retail investments into economic activities to transition. Chapter 5 concludes and extracts recommendations for financial institutions, label providers, and policy makers.

This report builds on research originating from the ClimLabels project funded by the German Federal Ministry of Education and Research<sup>2</sup>. While labels are only one specific example to combine transition metrics in financial products, and mostly have a focus on the secondary equity markets, we believe that the learnings are also relevant to other dimensions.

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<sup>1</sup> Eurostat, 2019 data; online data code: env\_ac\_ainah\_r2

<sup>2</sup> More information available online: [Link](#)

## 2. WHAT CONSTITUTES THE TRANSITION FINANCE LANDSCAPE?

“Transition finance” intends to allocate capital to companies and economic activities that are “becoming green” instead of allocating capital to companies that are already sustainable at this point in time (OECD, 2021). In other words, transition finance lies at the interface of transition activities and sustainable finance (WWF, 2021).

Over the past years, a packed transition finance landscape has emerged, ranging from voluntary sustainability labels to mandatory disclosure frameworks, targeting both companies and financial institutions. Figure 1<sup>3</sup> below attempts to summarise these relationships in a simplified way: **Non-financial corporates** are in a phase of sustainability transition and publish forward-looking information about their progress. **Financial institutions** – or more broadly, “investor activity” including retail investors – can access the disclosed information and can support transitioning activities by the two main channels of investor impact, i.e., capital allocation and engagement. Both the financial sector and the real economy are encompassed by the policy framework and private sector initiatives supporting the interplay between financial sector and real economy. We therefore identify three main building blocks of the transition finance

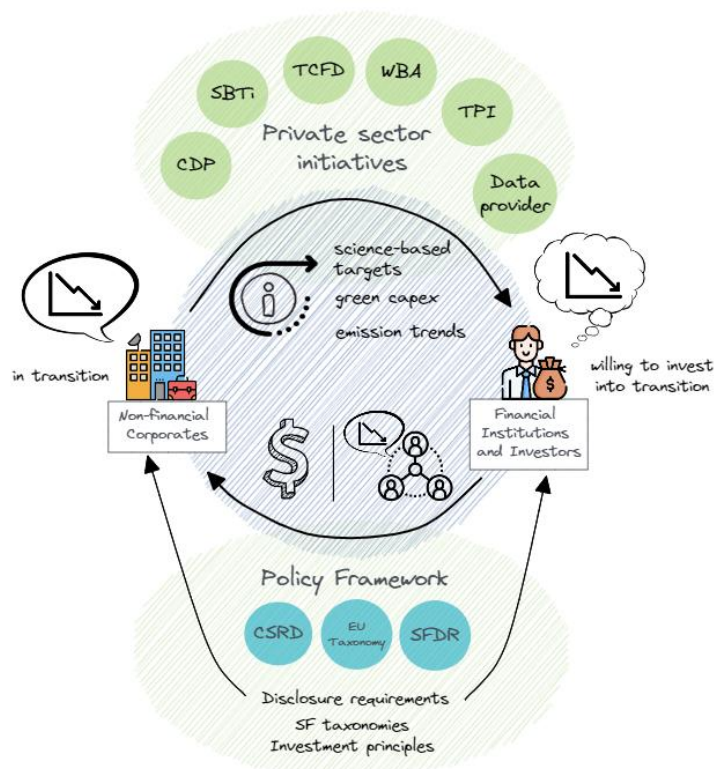


Figure 1 - Transition finance landscape

<sup>3</sup> All acronyms will be introduced and further explained in the remainder of this report (SBTi: Science Based Target Initiative; TCFD: Taskforce for Climate-Related Financial Disclosures; WBA: World Balancing Alliance; TPI: Transition Pathway Initiative; CapEx: capital expenditures; SFDR: Sustainable Finance Disclosure Regulation; CSRD: Corporate Sustainability Reporting Directive)

landscape: corporates, investor activity, and the (evolving) policy and disclosure framework, all supported by private sector initiatives.

### Building Block I – Non- financial Corporates: How to set up a target and a transition pathway?

The number of companies making commitments and announcing targets to reach carbon neutrality by 2050 is steadily growing. In 2022, 3,152 listed firms of the MSCI ACWI Investable Market index, comprising around 9,000 companies, had some decarbonisation commitment, but only 41 of these commitments were credible net-zero targets<sup>4</sup> (MSCI, 2022). Additionally, the target setting process is often opaque, and first actions following an emission pathway and a financing plan are often missing. With the aim of bringing more structure, ambition and clarity into this, several public and private organisations (e.g., IPSF, ISO, ICMA, or the five “Hallmarks” of CBI; also see Annex 3) have developed guidance and recommendations for companies willing to transform their business model to a more sustainable one. Steps to develop credible transition pathways include: (1) to set Paris-aligned targets for scope 1, 2, and 3 emissions with a realistic and credible baseline considering the most appropriate level (e.g., entity, portfolio, or asset level), (2) to create a mitigation plan based on accounting standards<sup>5</sup>, (3) to monitor and measure all implemented actions, and (4) to internally and externally report the progress according to sustainability reporting standards and have it verified by a third-party (CBI, 2021; ISO, 2022b).

The go-to source for companies to manage their climate transition is the **Science-based Target Initiative (SBTi)**. The private initiative provides companies with a clearly-defined pathway to reduce GHG emissions in line with the Paris Agreement and offers methodologies for target setting and validation. At the time of writing this report, more than 4,500 companies around the world are working with SBTi (SBTi, 2022). Building on the momentum of the SBTi, the Science-Based Target Network (SBTN) equips companies and cities to set science-based targets for climate and nature aspects (SBTN, 2022).

### Building Block II – Investor activity and their contribution to the transition

There are two main mechanisms of investor impact: capital allocation and shareholder engagement (e.g., Fama and French, 2007; Brest and Born, 2013, Koelbel et al, 2020; see also Figure 1)<sup>6</sup>.

- **Capital allocation** may affect corporate activity by changing its costs of capital, thereby creating incentives to change the quality or quantity of its activity (Koelbel et al., 2020). For this mechanism to work, one needs to assume that investors can influence the asset prices, and therefore costs of capital, by a change in demand (think about a sufficient number of investors investing proportionally more into “Paris-aligned” companies).
- **Investor engagement and stewardship.** Investors can influence the strategic development of their portfolio companies by using their voting rights or engaging in a direct dialogue. More capital from retail investors can increase their influence.

Investors have already joined forces to collectively change investment patterns. Initiatives such as Climate Action 100+, for example, are engaging companies to improve climate-related financial disclosures and reducing GHG emissions. However, investors can currently not unleash their full potential. If transition aspects were accurately priced in, companies without any decarbonisation strategy would be exposed to transition risks (e.g., have higher costs of capital) which would incentivise firms to follow a transition plan to improve their access to capital (OECD, 2021). However, transition risks are not well (enough) reflected yet since data availability on forward-looking aspects is often seen as limited (Bocquet et al., 2021) which makes

<sup>4</sup> Credible in terms of SBTi approved.

<sup>5</sup> Examples are the [GHG Protocol Corporate Accounting and Reporting Standard, ISO 14064-1:2018](#), or [standards from the International Sustainability Standards Board \(ISSB\)](#).

<sup>6</sup> In this report, we disregard other potential channels and indirect impacts. Other channels include indirect impacts defined as impact mechanisms where investor activities influence a third party, which in turn affects company activities (Koelbel et al, 2020). Another channel refers to “Impact investing” where investors allocate capital based on a stated theory of change. The investment strategy is chosen to achieve a positive impact. The addressed markets are often underserved or are characterised by market failure. This has, for example, been highlighted as a third channel of investor impact in the draft UK label criteria (FCA, 2022).

it difficult to differentiate between entities with and without a credible transition pathway<sup>7</sup>. Transparency thus plays a crucial role.

### **Building Block III – Policy and Disclosure regulations: Transparency as the foundation**

Disclosure regulations play an important role by enhancing transparency for financial markets and by raising corporate awareness for the required transition, among others. However, many disclosure requirements focus on backward-looking data, barely including transition aspects (IPSF, 2021). This is slowly changing with an increasing number of jurisdictions addressing the disclosure of transition plans, investments into sustainable activities, etc. The EU's Corporate Sustainability Disclosure Regulation (CSRD), for example, targets around 50,000 companies in the EU. The disclosure requirements go beyond existing frameworks and also ask for transition plans (see Annex 3 for an overview on transition aspects in disclosure frameworks).

Going beyond disclosure, investors need to identify investments that contribute to the sustainability transformation. More and more jurisdictions are introducing **sustainable finance taxonomies**, which are classification systems, i.e., a “common language”, to facilitate the identification of sustainable economic activities. As of today, 29 government-led sustainable finance taxonomies have already been adopted or are currently in a developing or initiating phase (WWF, 2022). Some taxonomies also aim to classify transitional activities and consider the transition dimension, for instance through a traffic light approach. Besides these governmental efforts to balance risks and facilitate investments into the transition, non-governmental and private sector initiatives have also been working on these issues. For instance, the Transition Pathway Initiative (TPI) provides sectoral decarbonisation pathways to facilitate the sustainability assessment of investors (TPI, 2022), and the World Benchmarking Alliance (WBA) offers a tool to measure corporate progress against the climate targets (WBA, 2022).

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<sup>7</sup> If a company has, for example, a validated target by the Science-Based Target Network (SBTN), the transition plan is already more credible as the target is aligned with science and best practices. Getting a target validated by the SBTN also requires a certain time commitment. At the other extreme are companies that declare a goal of, for example, carbon neutrality by 2050 without any interim steps or detailed planning. More information on target setting can be found in Chapter 2.

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## 3. INCREASING INVESTOR IMPACT: CAPITAL ALLOCATION & ENGAGEMENT

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### 3.1. Capital allocation: Evidence of forward-looking metrics

When it comes to concrete metrics to “measure” company-level transition towards net zero, different types of data have been used. The data can have different time dimensions: **past** data such as past levels of emissions can be used for future predictions, **present** data can provide an outlook, for example by analysing current investments, and **future** data can be targets or commitments (FoSDA, 2021). Because all this information should give insights on future developments, we call it **forward-looking information** here. It can be qualitative, such as a transition plan, or quantitative, such as expected emissions or the volume of investments into sustainable technologies. The issuer of this forward-looking information can be either the company itself, or an independent third party, for example a data provider, who might also further process the publicly disclosed data, or use modelling to provide additional information.

Forward-looking information is already advanced regarding “traditional” financial disclosures, including the strategic direction, future risks and opportunities, and financial prospects of the firm (PwC, 2016). Forward-looking metrics, such as earnings forecasts, are further standardised and are an important part of the investment decision (McClure, 2022).

Going beyond “traditional” financial disclosure, forward-looking sustainability information can facilitate the identification of companies that are likely to meet future sustainability targets, even if they have the same static performance as their competitors today (FoSDA, 2021). However, forward-looking information also comes with **challenges**. The data availability or coverage is often limited – there are already large gaps in historic GHG emissions data. Since reporting is still mostly voluntary, self-reported data can be exposed to a self-selection bias (see Kalesnik et al, 2022). Furthermore, there is a lack of standardisation and transparency of the applied methodology for processed data, such as emission scores published by data providers (Bocquet et al., 2021). Extrapolated or estimated data bears the risk of not being accurate and difficult to compare to metrics using an alternative methodology. The uncertain policy environment also makes it difficult to come up with assumptions over future regulations or carbon price developments (FoSDA, 2021). Considering all this, no single indicator can show the whole picture of the transition progress of an entity (Bocquet et al., 2021). This is why an isolated view should be avoided in the assessment.

A better understanding of forward-looking metrics, their integration into transition finance products and labels, combined with a better understanding of how investors, traders and fund managers make their relevant investment decisions, is therefore of great importance. It would help investors to develop financial products, help sustainability rating agencies develop appropriate scores and rating methodologies, and make it easier for policymakers to design (and adapt existing) policy instruments. All of these would incentivise investments into the transition by financial and non-financial entities.

Table 11 gives a comprehensive, but non-exhaustive, overview of forward-looking metrics, differentiated by past, present and future data and including references to existing frameworks (such as CSRD). Nevertheless, the explanatory power of these metrics remains of key importance. Below, (scientific) evidence is provided for some selected indicators.



## What is already known about the explanatory power of forward-looking data?

### “Green” investments

There is evolving (scientific) evidence on the characteristics of credible metrics, and if there is a link to an improving firm-level environmental performance. For instance, research shows that higher **green research & development (R&D)** expenses are associated with lower corporate GHG emissions (Alam et al., 2019; Lee and Min, 2015). Moreover, firm-level analyses destrate the positive link between green innovations, measured as the number of **green patents**, and the environmental performance in China (Yan and Zhang, 2021; Chen et al., 2022). Higher **capital expenditures (CapEx)** outside low-carbon scenarios leads to higher stranded asset risk (Carbon Tracker, 2020), the positive link between green investments and greenhouse gas emissions can also be confirmed by country-level evidence (Lyeonov et al., 2019; Hordofa et al., 2023). Nevertheless, these three metrics cannot provide a direct link to the climate or other environmental targets, and it remains unclear if a company follows a Paris-aligned emissions pathway.

### Carbon Management Scores

Because it is hard to gather and process large volumes of sustainability information from companies, data providers, such as **Refinitiv** or **Bloomberg**, provide entity-level information on companies’ progress towards the transition, for example with low-carbon scores or carbon management scores<sup>8</sup>. However, the providers do not need to follow certain requirements leading to differences in methodologies (EUROSIF, 2021). It is thus not uncommon that the same company receives a different rating from different data providers (Berg et al., 2019 or Dumrose et al., 2022). Nevertheless, most institutional investors rely on these platforms (Hirai et al., 2021)<sup>9</sup>.

Different carbon management scores are associated with a reduction in CO<sub>2</sub> emissions, mostly because good carbon governance is positively linked to a high quantity of green innovations, which is a driver for superior environmental performance (Albitar et al., 2022; Haque and Ntim, 2022).

### Science-based targets

Science-based targets (SBTs) link corporate carbon reduction goals to climate science and outline steps to align them with a 1.5°C or 2°C global warming scenario. Targets can be long-term or mid-term (e.g., 2050 or 2030), considering all greenhouse gas emissions or just carbon emissions, direct and/or indirect emissions, or (no) offsets. The SBTi recommends a sectoral decarbonisation approach (SDA) to divide the aggregate carbon budget among companies. Under the SDA, firms must reduce their CO<sub>2</sub> emissions according to their sector’s carbon reduction potential.<sup>10</sup>

Another literature strand finds that large firms with internal targets are more likely to set an external (science-based) target (Yin et al., 2017; Freiberg et al., 2021; Bolton and Kacperczyk, 2022). However, whereas Freiberg et al. (2021) argue that carbon-intensive firms are more probable to set a target, Bolton and Kacperczyk (2022) find that firms with low absolute baseline emissions are more likely to set one. On the one hand, firms with high emissions may perceive a higher risk regarding regulatory and physical impacts of climate change and engagement pressure, while on the other hand, they may still consider voluntary commitments to be more costly than the benefits of reducing such risks.

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<sup>8</sup> Scores that represent the quality of the corporate management of the climate risk, the risk itself, carbon exposure, or other factors, usually range from 0 to 10 or 0 to 100 and are published by several data providers, such as MSCI, Refinitiv, or Bloomberg.

<sup>9</sup> Financial institutions need to not only identify specific investments in line with the transition towards a net zero economy but also identify a more general investment strategy for their whole portfolio. Mentioned instruments in this paper (e.g., taxonomies) can also support in this matter. However, this is not part of this overview here. For example, financial institutions can also use tools like PACTA ([link](#)) to measure the alignment of their portfolio with the Paris Agreement. The EU Benchmark Regulation also prevents greenwashing in this context by defining requirements for benchmarks.

<sup>10</sup> Another common approach is the absolute contraction approach (ACA) under which each firm must linearly reduce its emissions at the same percentage rate (Walenta, 2019). There is no consensus on the most adequate method, but the allocation principle will matter for the target completion (Faria and Labutong, 2020; Bjørn et al., 2021).

Regarding the effectiveness of SBTs in terms of emissions reductions, most existing studies focus on scope 1 and 2 emissions, thus neglecting scope 3 emissions<sup>11</sup>, mainly due to a lack of data availability. One main finding is that the more ambitious the target is, the higher the probability is to achieve significant emissions reductions (Ioannou et al., 2016; Dahlmann et al., 2019). Appropriately, 75% of companies with a science-based target for scope 1 and 2 emissions only are on track to meet their target with an average absolute emissions reduction of 29% between 2015 and 2020 (Giesekam et al., 2021; SBTi, 2022). In contrast, just 52% of targets including scope 3 emissions are on track (Giesekam et al., 2021). Moreover, there is still a lack of evidence for an overall economy-wide reduction in emissions, i.e., including firms without a target, potentially due to the short time span since the introduction of SBTs and the limited number of participating firms, but also partially due to firms with low emissions being more probable to commit, the use of relative instead of absolute emissions reduction targets or a hesitancy of firms with high scope 3 emissions to commit (Bolton and Kacperczyk, 2022)<sup>12</sup>.

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<sup>11</sup> Scope 1 emissions refer to direct greenhouse gas emissions from sources that are owned or controlled by a company; scope 2 emissions refer to indirect emissions from purchased electricity; scope 3 emissions are all other indirect emissions that occur in a company's value chain ([GHG Protocol](#)).

<sup>12</sup> Relative targets are often set relative to business performance indicators, such as revenues. If revenues grow faster than emissions, emission intensity will decrease while absolute emissions might still increase.

Table 1 - Overview of forward-looking metrics

Metric	More details	Source or references in existing frameworks etc.
Based on past data		
<b>GHG emission trends</b> (Quantitative)	Shows the development of GHG emissions over a particular time.	GHG emissions covered in several (planned) disclosure requirements (e.g., <a href="#">CSRD</a> , <a href="#">SEC proposal</a> ) and voluntary recommendations or initiatives (e.g., <a href="#">TCFD</a> ). Several data provider also offer GHG emission data (e.g., <a href="#">MSCI</a> , <a href="#">Refinitiv</a> )
<b>Expected future emissions</b> (Quantitative)	Based on past data, modelling under specific assumptions.	e.g., included in low-carbon scores of data providers, such as <a href="#">MSCI</a> .
<b>Implied temperature rise</b> (Quantitative)	Requires modelling and can for example be based on a carbon budget approach.	Provided by data providers, such as <a href="#">ISS ESG</a> (temperature score), <a href="#">CDP</a> , <a href="#">ESG Book</a>
Present data that give an outlook into the future		
<b>Share of entity-level investments into sustainable economic activities (capital expenditures, CapEx)</b> (Quantitative)	Investments into sustainable activities. Shows efforts the entity is taking to lower its GHG emissions	Referenced by <a href="#">ICMA</a> , <a href="#">EU Taxonomy Regulation</a>
<b>Number of green patents</b> (Quantitative)	Patents for green or sustainable technologies	Data provider <a href="#">MSCI</a>
<b>Climate-related transition and physical risk exposure</b> (Qualitative or quantitative)	Exposure to at-risk business activities and resources. Can be described on a qualitative basis or quantified in a score or metric, such as value at risk.	<a href="#">Entelligent (E-score)</a> , <a href="#">ISS ESG</a> (physical risk solution), <a href="#">MSCI</a> (climate value-at-risk)
<b>Climate risk management quality</b> (Qualitative or quantitative)	Helps to assess how strategically the company considers climate risks and opportunities. Can be expressed in aggregated (carbon management) scores.	<a href="#">C4E</a> , <a href="#">MSCI</a> , <a href="#">FTSE</a> , part of <a href="#">TCFD</a> recommendations
Data on targets or commitments for the future		
<b>(Science-based) emission target</b> (Qualitative or quantitative)	There are several ways how to define an emission target, usually it consists of a target date and a measuring unit. Targets are science-based if they are in line with the latest climate science assessment on how to reach the Paris Agreement goals (SBTi, 2020).	<a href="#">SBTi</a> , <a href="#">SBTN</a> , <a href="#">TCFD</a> , <a href="#">CDP</a> ; disclosure under <a href="#">SEC proposal</a> , <a href="#">CSRD</a>
<b>Voluntary Commitments</b> (Qualitative)	Signatories commit to a certain action in future.	e.g., <a href="#">Glasgow Declaration on Forests and Land use</a> , <a href="#">The Climate Pledge</a> , <a href="#">SME Climate Commitment</a>

### 3.2. Engagement: Evidence and best practices

Next to capital allocation, financial institutions can have an impact on the real economy by following an active engagement approach. Engagement commonly refers to shareholder activities intended to influence companies' ESG (environment, social, governance) practices, also referred to as "voice" (Hirschman, 1970). These include private and public engagement practices. "Private" engagement practices refer to informal meetings, phone calls, or letters, with the portfolio company's management, or threats to divest (see for example, McCahery et al., 2016). "Public" engagement refers mostly to voting rights, exercised by shareholders themselves or via proxy voting agencies. The motivation for shareholder activism can differ. "Traditional" and hedge fund activism, for example, mostly relates to financial return instead of ESG issues (e.g., Dimson et al., 2015).

In general, it is well documented that ESG engagement can change real-world parameters by affecting the quality or quantity of corporate sustainability activity (e.g., Naarayanan et al., 2021; Akey and Apel, 2020; Chu and Zhao, 2019). Naaraayanan et al. (2021) examine the engagement efforts of three major US pension funds (with significant investor influence), finding that targeted firms reduce their toxic releases and GHG emissions, predominantly through abatement initiatives (instead of increased capital expenditures). Akey and Apel (2020) explore hedge fund activism and find a particularly large reduction of air pollution and an associated decrease in ground and water emissions but link these findings to a drop in production rather than an increase in abatement initiatives. Using a similar sample, Chu and Zhao (2019) link green hedge fund activism to reduced toxic chemical emissions, driven by targeted firms closing heavy polluting plants and investing in pollution-reduction technologies. Bauer et al. (2022) analyse private shareholder engagement and find that financially material engagements are more likely to succeed than financially immaterial engagements. Relative to peer firms, successful engagements are associated with a 3.8% increase in MSCI's ESG score and environmental engagements with a 12.4% decrease in CO<sub>2</sub>e intensity.

Hoepner et al. (2022) complement the evidence on real effects through emission reduction by showing that activism is also in the (financial) interest of shareholders, as engagement over ESG topics reduces downside financial risks (value at risk and the lower partial moment). The risk-reduction effect stems from successful engagements on environmental topics (and climate change in particular).

However, the success rate of shareholder activism is not guaranteed and depends on characteristics of the engagement requests, the engaged portfolio company and the engaging investor (Koelbel et al, 2020). Summarising five major studies, Koelbel et al. (2020) find the success rate of engagement requests to be in a range from 18% to 60%. There are three major determinants that drive the success rate: the cost of the requested reform (i.e., environmental requests tend to have a lower success rate than governance requests); the investor influence (i.e., the larger the holdings, the larger the influence, plus cultural and linguistic elements); and the company's level of ESG experience (i.e., previous compliance with engagement requests or higher ex ante ESG ratings).

The evidence bears important findings for investors willing to support the transition:

- There is strong evidence that engagement **can change real-world parameters**. Focusing solely on the asset allocation of funds, without incorporating an engagement process, misses a large part of supporting the transition (Zink, 2022).
- To increase investor influence, collaboration between asset managers, for example through investor initiatives, is recommended (Koelbel et al., 2020; Dimson et al, 2015).
- Investors should focus on engaging on issues that are material to the target company (Bauer et al., 2022). While environmental engagement can be more costly compared to governance issues, reducing the success rate (Koelbel et al., 2020), it has also been shown that environmental engagement is the most effective at reducing financial downside risk (Hoepner et al., 2022).
- Targeting companies with prior ESG experience is more promising than targeting companies with no prior experience (or no willingness to change) (Barko et al., 2015; Dimson et al., 2015).

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## 4. TRANSITION METRICS IN PRACTICE – LEARNING FROM ECOLABELS

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**Ecolabels for financial products** are an existing illustration of how both mechanisms – capital allocation and engagement – intertwine, and thus provide insights to conceptualise the thinking in the transition finance domain. There are already a range of existing Ecolabels that award financial products for their environmental credentials. The label designs vary and include mandatory and optional elements<sup>13</sup> – or contain a scoring system whereby a minimum score must be achieved. This chapter sheds light on Ecolabels and how to construct financial transition products. Despite growing interest in financial products marketed as “green” or “sustainable”, transition finance products are still a niche, given a lack of standardisation (see Box 1).

For **professional investors**, surveys have signalled broad willingness to invest in transitioning “brown” industries, given that trust is established by clear KPIs, thresholds, or reference to scenarios (CBI, 2020; Natixis, 2021). **Retail investors**<sup>14</sup> are also willing to invest in sustainable funds to reflect their social preferences even if this implies forgoing financial performance (Riedl and Smeets, 2017). However, incorporating ESG preferences into investment decisions in general increases information costs. It thus remains challenging to invest into the transition (WWF, 2021). Nevertheless, addressing retail investors is important since some equity markets are dominated by non-professional financial market participants (e.g., almost 60% of the US equity market is owned by households; SEC, 2021). Labels can help to reduce information asymmetries and identify investments with specific characteristics (EEB, 2020) such as transition aspects. Furthermore, Ecolabels have already been shown to increase demand for sustainable investments (see, e.g., Ceccarelli et al., 2023).

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<sup>13</sup> Such as: ESG (environment, social, governance) integration, best in class approach, over/underweighting according to ESG criteria, impact investing strategies, engagement policies etc.

<sup>14</sup> Retail investors are, in contrast to institutional investors, individual and non-professional investors usually investing in securities.

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### Box 1: Transition focus in financial products

Financial products labelled as green or sustainable are **booming**: Only in the first quarter 2021, almost USD 500 bn were issued as Green, Social and Sustainability (GSS) bonds and Sustainability Linked Bonds (SLBs) (CBI, 2021). Slowly, the topic of transition is also increasingly reaching the spotlight – 18 transition bonds had been issued until 2021 (CBI, 2021). Existing financial products with a transition focus mainly differentiate between use of proceeds (UoP) and general-purpose instruments (WWF, 2021). However, many financial institutions still lack specific transition financial products (WWF, 2021) and there has been criticism regarding the limited transparency of transition products. In many cases, the information provided about the transition pathway, actions to achieve the target or other eligibility criteria are insufficient (OECD, 2021). To enhance transparency, the first steps have already been taken by developing guidelines for financial products with transition characteristics. For example, AXA has drafted Guidelines for Transition Bonds (AXA Investment Managers, 2019), the European Bank for Reconstruction and Development (EBRD) has come up with a framework for green transition bonds (EBRD, 2019) or the DBS Bank published a Sustainable & Transition Finance Framework & Taxonomy (DBS, 2022).

Besides individual transition bonds, which are usually not purchased by retail investors, first financial products for non-professionals focusing on the transition have entered the market. An example is the Exchange Traded Fund (ETF) Engine No. 1 Transform 500 ETF which uses its voting rights to promote the environmental transition and invests in companies with activists' campaigns.

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## 4.1. State of play: Transition characteristics in Ecolabels

There are already several sustainability labels on the market that intend to award environmental excellence to equity funds (i.e., the Austrian Ecolabel, the EU Ecolabel, the German FNG label, the French Greenfin label, the Luxflag Labels, Nordic Swan, the Belgian Towards Sustainability Label, or the proposed UK Sustainability Labels). To date, most labels are dominated by backward-looking criteria and current sustainability performance which might exclude companies that can contribute to the transition (Georgieva and Mehrotra, 2022). To facilitate the discussion on forward-looking design criteria, we compare the extent to which existing eco-labels incorporate the transition perspective and seek to drive change in the real economy. We focus on the following indicators (see Chapter 3):

- **Investor engagement** (a major part of supporting the transition)
- **(Science-based) Targets** (to indicate whether “brown” firms are willing to change)
- **Green Revenue**: (to indicate whether a firm started to generate ‘green’ revenues at all; there are EU Taxonomy criteria for transition activities that can be used as a monitoring tool)
- **Green CapEx**: (as a reliable validation whether a company walks the talk – think about a fossil fuel company investing 80% of its capex into renewable energy sources)
- **GHG emissions trends** (to indicate if environmental performance has already improved)

Table 2 below summarises the comparison for selected Ecolabels (see Annex 2 for a more extensive overview). While all analysed Ecolabels address transition elements to some extent, there are significant differences.

With regard to the indicators, the following observations have been made:

- **Engagement** is incentivised by most of the Ecolabels under scope. However, there are vast differences between the “quantity and quality” of the required engagement process. This is due to the design of the label and the fact that some providers take a principles-based rather than a prescriptive approach. The prescriptive approaches describe the required engagement process clearly (e.g., indicating which companies should be prioritised, indicating the minimum number of

engaged companies, or clear guidelines on voting behaviour). Others are rather vague and evaluate whether the engagement is “clear and structured” (see Austrian Ecolabel).

- Including portfolio companies with **science-based targets** is directly addressed by only 1 out of 9 existing Ecolabels. Applicants can earn additional scores for including more companies with SBTs (Nordic Swan). Through a rather indirect application, “brown” companies can be exempted from the exclusion list (EU Ecolabel).
- **Green revenue or CapEx thresholds** are surprisingly scarce as the principles-based approaches usually do not include specific key performance indicators (KPIs). The Greenfin label uses green revenue thresholds to ensure a sufficient “green share” in the portfolio. The Nordic Swan and the draft EU Ecolabel combine green revenue and green CapEx in one formula to ensure “portfolio greenness”.
- **GHG emissions** are at least indirectly part of most Ecolabels. Companies in high-emitting sectors, for example, must be among the top 15% of GHG intensity in their sector (Nordic Swan Ecolabel).

Looking at the different label providers, there are fundamental differences in the balance between principles and prescriptions. We prefer a predominant prescriptive share in the label criteria building on the vast disclosure literature which makes the case for mandatory regulation (i.e., more prescription than principles). Imprecise regulation is one of the main drivers for greenwashing (Delmas and Bourbano, 2011), and unspecific disclosure requirements provide the opportunity to cherry-pick what is disclosed (Bingler et al., 2022; Christensen et al., 2019). This does not mean that other providers are “worse” *per se*, but the rather principles-based structure makes a comparison difficult.

- The **draft EU Ecolabel** and the **Nordic Swan Ecolabel** are frontrunners regarding the consideration of forward-looking aspects (see Annex 2 for more details):
  - **The Draft EU Ecolabel** restricts the investable universe by a formula building on green revenue and green CapEx, which therefore extends the investable universe beyond the green niche. “Green” is defined by the EU Taxonomy which also addresses environmental dimensions beyond climate. Also, the engagement process is clearly defined, with clear guidelines on the dialogue with companies and the exercise of voting rights. Fossil fuel companies can also be exempted from the inclusion list if they have a 1.5 C SBT and zero CapEx on the expansion of fossil fuel activities, among others.
  - **The Nordic Swan Label** design consists of obligatory criteria and a scoring system across various themes where a minimum score must be achieved. The applicant can receive up to 2 points if a certain share of portfolio companies has a validated, credible SBT. High-emitting companies can be considered if investments are in alignment with the EU Taxonomy. Additional points are awarded for the alignment with a benchmark in accordance with the EU Paris-Aligned Benchmark Regulation.
- Noteworthy is also the **UK draft “Sustainable Improvers” label** with a specific focus on financing the transition over time and a clear description of investor impact. However, the criteria are still relatively vague and miss more specific/quantitative criteria (see also [our input](#) to the public consultation 22/20 – Sustainability Disclosure Requirements and Investment Labels).

Table 2 - Ecolabels & transition

	“Transition” criterion part of selection criteria?				
	 Engagement	 (Science-based) targets	 Green Revenue	 Green CapEx	 GHG emissions trends
<a href="#">Draft EU Ecolabel</a>	Yes	(Yes)	Yes	Yes	(Yes)
<a href="#">Nordic Swan Label</a>	Yes	Yes	Yes	Yes	Yes
<a href="#">FNG Label</a>	Yes	(Yes)	(Yes)	(Yes)	(Yes)
<a href="#">Greenfin</a>	N/A	N/A	Yes	N/A	(Yes)
<a href="#">Austrian Ecolabel</a>	Yes	(Yes)	N/A	N/A	(Yes)
<a href="#">Luxflag Climate Finance</a>	N/A	N/A	Yes	N/A	N/A
<a href="#">Luxflag ESG Finance</a>	Yes	N/A	N/A	N/A	N/A
<a href="#">Towards Sustainability Label (Belgium)</a>	Yes	(Yes)	(Yes)	(Yes)	(Yes)
<a href="#">UK Sustainable Investment Label “Sustainable Improvers”</a>	(Yes)	N/A	N/A	N/A	N/A

Legend: Yes = part of the selection criteria; (Yes) = partially / indirectly integrated; N/A = no incentive

## 4.2. How to (better) integrate transition characteristics into Ecolabels

Although first steps have been taken, there is still a lot of room for improvement to better integrate transition characteristics into Ecolabels for financial products. Many of the currently available Ecolabels are not sufficient to support (retail) investors to invest into the sustainability transition.

### Alignment with the Paris Agreement and other environmental targets

To ensure a sufficient level of ambition and to prevent greenwashing, the label criteria should provide a clear reference to the Paris Agreement or other (national) environmental targets. According to a recent study, investment funds categorised as sustainable fail to reduce their carbon footprint compared to conventional funds (Abourabab et al., 2022). There is no room for financing economic activities that are far ahead from a Paris-aligned pathway. However, some of the existing Ecolabel criteria remain unspecific and do not acknowledge the required level of ambition. A credible way to demonstrate Paris-alignment is



through validated **science-based targets** of the companies the fund is investing in. As outlined above, evidence shows that targets are more likely to be fulfilled if they are externally verified. Moreover, **references to existing policy files** in line with the environmental targets strengthen the coherence of the policy framework and realise a sufficient level of ambition. For example, the [EU Benchmark Regulation](#) is directly referenced by the Nordic Swan Ecolabel.

### **Reduce the investable universe by excluding companies without willingness to transform their business model**

To enhance the effectiveness of investor engagement activities, the investable universe should be restricted. Scientific evidence shows that, on the one hand, the proportion of successful engagement requests only lies between 18% and 60%. On the other hand, the success rate is higher if the company has been engaged into ESG topics before (Koelbel et al., 2021). To improve the likelihood of an effective intervention, companies without externally verified ambition or willingness to transform their business model, should not be part of the selected assets. Following this approach, the proposed EU Ecolabel and the Nordic Swan Ecolabel exclude companies from certain high-impact sectors without proper climate change mitigation activities in place.

### **Define clear KPIs and science-based thresholds for the qualifying criteria**

Existing label criteria often remain qualitative and rather principles-based. Clear and quantitative metrics, such as the proportion of assets with science-based targets, provide more accurate information (Popescu et al., 2021). To prevent greenwashing and avoid “cheap talk and cherry picking”, the selection of meaningful KPIs and a required mandatory disclosure of them is crucial (Bingler et al., 2022). Examples of clear KPIs are part of the proposed EU Ecolabel, the Nordic Swan Ecolabel, or the [Illustrative KPI registry](#) of the International Capital Market Association (ICMA).

### **Specify the criteria for the engagement process**

Engagement is, next to capital allocation, the main impact channel for investors. Research shows there is a widespread lack of investor initiatives promising a broad engagement for stronger climate governance, a reduction of greenhouse gas emissions, etc. (Zink, 2022). Since success rates of engagement requests vary, we suggest including specific requirements such as to:

- **Distinguish**, in the qualifying criteria, between the two primary engagement channels – dialogue and voting. Investors can exercise their power by 1) engaging in a dialogue with portfolio companies (for example at management level); and 2) by exercising their voting rights (for example at the AGM, Annual General Meeting).
- Define a **scope for the dialogue with investee companies**. Obviously, it is not feasible for fund managers to engage with 100% of their portfolio companies (which would increase fees and would therefore also lower the attractiveness for retail investors due to lower net-of-fee fund performance). However, there could be an ambitious but feasible minimum level. The Nordic Swan Label, for example, provides incentives to engage with at least 10% of the portfolio companies (in numbers).
- Define the **scope for exercising voting rights**: Similar to the above, including a minimum threshold for exercising voting rights (and a higher threshold when a proxy voting service is used) is making the engagement process concrete; the fund manager should make use of voting rights for at least X% of portfolio companies; and for >X% when a proxy voting service is used.
- Include **clear guidelines for the engagement process**. Existing label providers have included guidance and minimum criteria for the engagement process. The Nordic Swan Label, for example, asks fund managers to A) demonstrate a systematic method for selecting portfolio companies and topics for engagement; B) set time-bound goals for each topic; C) conduct regular assessment of the achievement; and D) describe the resources and tools used. The draft EU Ecolabel asks for a clear objective (based on the six environmental objectives of the EU Taxonomy regulation), a strategy (e.g., how fund managers plan to increase the portfolio companies’ green turnover), to disclose their method and monitor the process.

## 5. CONCLUSION

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Financing the transition to a more sustainable economy, i.e., financing activities “becoming green”, has received increasing attention. Several (international) fora and working groups, such as the International Platform on Sustainable Finance, the G20 Sustainable Finance Working Group, or the German Sustainable Finance Advisory Committee of the Federal Government took up this issue. Furthermore, regulation and private initiatives have been introduced to facilitate investments contributing to a low-carbon future – acknowledging that finance is also needed for economic activities in transition (instead of those that are already green).






To successfully finance the transition, investment opportunities for institutional and retail investors need to be available. These need to ensure that the financing credibly supports the transition and is in line with the emission pathway of the Paris Agreement. Transparency thereby has a crucial role since suitable investments need to be identified. A promising way to channel more retail investments into the transition are **Ecolabels**. However, the award criteria of ecolabels for equity funds often focus on the current sustainability performance – however, the first steps have been taken to integrate the transition dimension to a similar extent. Our analysis shows that investor engagement towards a more sustainable corporate performance is the most present criteria to consider transition aspects. The proposed EU Ecolabel and the Nordic Swan Ecolabel both go beyond this and represent frontrunners to incentivise more retail investments considering forward-looking information. Nevertheless, we highlight four principles to (better) include transition characteristics in ecolabels, namely:

- Alignment with the Paris Agreement and other environmental targets.
- Reduce the investable universe by excluding companies without willingness to transform their business model.
- Define clear KPIs and science-based thresholds for the qualifying criteria.
- Specify the criteria for the engagement process.

We believe that climate and other sustainability targets can only be reached if the backward-looking perspective is complemented by a forward-looking approach. The financial industry, real economy, as well as researchers and policy makers should elaborate on how to put this into practice.

# ANNEX 1 : TRANSITION CHARACTERISTICS IN EXISTING ECOLABELS

Table A1.1 – Detailed overview of Ecolabels & Transition

	Award criteria (Description)	Engagement	(Science-based) targets	Green Revenue Thresholds	Green Capex Thresholds	GHG emission metric	Other (e.g., Paris-aligned benchmarks, PAB)
							
<b>Draft EU Ecolabel</b> <i>(public initiative; European Commission)</i>	Seven different criteria: 1) clear green revenue & green capex thresholds; 2) Exclusions; 3) Social and governance aspects; 4) Engagement; 5) Measures taken to enhance investor impacts; 6) & 7) linked to disclosure.	Engagement Policy (with indications on objective & strategy), Voting rights (with specifications which companies should be approached), clear dialogue policies.	Companies from the fossil fuel sector that meet various transition criteria (targets being one of them) can be removed from the exclusion list.	$G = \sum_{n=1}^0 PC_i \times \frac{GT_i + GC_i}{T_i}$ <p>With PC = portfolio contribution of each company. GT and GC = green turnover and green capex (defined via the EU Taxonomy). T is the total turnover per firm. G (the “portfolio greenness”) must be at least 50.</p>	Not explicitly addressed. However, “green” revenue or capex is measured by the EU Taxonomy and GHG emissions are an essential part of the technical screening criteria on Climate Change Mitigation (Objective I).	A list of “Measures that can be taken to enhance the investor impact of the product” (Criterion 5).	
<b>Nordic Swan Label</b> <i>(public initiative; Nordic Council of Ministries; i.e., Denmark, Finland, Iceland, Norway and Sweden)</i>	Obligatory requirements + a scoring system of which 6 out of 14 possible points need to be reached.	Engagement with at least 5%/10% of the fund’s holdings: 1-2 points 1 point for reporting on engagement  + Regular voting (3 points)	If >= 25% of companies have a validated science-based target (→1 point). If >= 50% of companies have a validated science-based target (→2 points).	Included in formula above which contains green revenue and green capex (defined by EU taxonomy). 1 point for G >= 0.05; 2 points for G >= 0.10; 3 points for G >= 0.20; 4 points for G >= 0.30; 5 points for G >= 0.4; 6 points for G >= 0.5.	Explicitly mentioned as part of the obligatory requirements (O13 – Reductions of GHG emissions in critical sectors).	Other categories under “Enhanced analysis and inclusion” (P2), such as PAB	

<b>FNG Label</b> <i>(private initiative, Qualitätssicherungsgesellschaft Nachhaltiger Geldanlagen)</i>	For the most basic label a range of minimum standards need to be fulfilled. Up to three “stars” can be collected to signal environmental excellence. This is based on: institutional credibility (10%), product standard (20%), selection strategy (35%), engagement strategy (25%) and sustainability KPIs (10%).	The exercise of voting rights and the application of an engagement strategy is incentivized. To go beyond the minimum standard, applicants can score up to 25% on voting and engagement if they want to reach the next award level.	No explicit reference to SBTs. However, the applicant can “promote the transformation effect of the titles” by “using methods” to increase the sustainability contribution of lower-rated firms. (See p. 22 f.)	There are no clear green revenue, green capex or GHG intensity thresholds. However, they could all be evaluated as part of 2.3.4.1 (positive criteria) or 2.3.4.3 (sustainability KPIs).			
<b>Greenfin</b> <i>(public initiative, French Ministry of Ecological and Solidarity Transition)</i>	Different criteria exist. For example, on the “green” share (criterion 1.2), exclusion criteria (1.3), or that the fund manager should measure “the actual contribution of its investments to the energy and ecological transition” (3.1).	No reference at all to an active engagement process or voting rights. This leaves out an important impact channel.	No reference at all to SBTs or forward-looking targets at company level.  The only (minor) link: the investable universe is clearly defined and builds on a taxonomy by CBI. Low-carbon buildings must have an action plan for overall reduction of energy consumption & GHG emissions (see Appendix 1).	Green revenue thresholds exist.: depending on financial product, different threshold applies regarding share of type I / “Greenfin” companies (>50% of turnover from eco-activities mentioned in CBI-based taxonomy)	No reference to CapEx or green investments as a specific metric.	Funds should report on climate change KPIs (or water or biodiversity or natural resources). And should measure the environmental impact. Since the sector focus is on climate-related sectors, this will be about GHG emissions.	
<b>Austrian Ecolabel</b> <i>(public initiative, Austrian Federal Ministry of Environment)</i>	The points awarded for the fields’ selection criteria (point 2.3.1), implementation of selection criteria (point 2.3.2), requirement level (point 2.3.3) and bonus (point 2.3.4) must amount to at least to 70 % of the maximum number of points that can be obtained for the respective product category.	Exercising voting rights / applying an engagement strategy is incentivized: Bonus points can be earned for exercising voting rights; or a “clear and structured” engagement approach (see chapter 2.3.4.1, 2.3.4.2)	Awarded only in combination with engagement: measurement of carbon footprint + reduction path reaching at least four years into the future. Only bonus points.	n/a	No reference to CapEx or green investments as a specific metric.	For climate change mitigation, one must screen and evaluate companies – but there are no strict evaluation criteria. GHG reduction is partially incentivized by engagement and a reduction path (see column on targets).	Bonus points for institutional credibility
<b>Luxflag Climate Finance</b> <i>(private initiative;)</i>	Investment products with a clear and direct link, to mitigation and/or adaptation of climate change or cross-cutting activities.	No reference at all to an active engagement process or voting rights. This leaves out an important impact channel.	No reference at all to SBTs or forward-looking targets at company level.	“Investments in listed and non-listed entities must have at least 50% of their turnover generated from Climate Finance activities”	No reference to CapEx or green investments as a specific metric.	“Expected tonnes of carbon dioxide equivalent (t CO2 eq.) to be reduced or avoided” are mentioned as one of many “indicative measurement factors”.	

<b>Luxflag ESG Finance</b> <i>(see above)</i>	Investment products are 100% screened by at least three out of five ESG strategies (Best-in class, Exclusions, Engagement, ESG integration, Impact Investing).	At least three out of five ESG strategies must be applied. Engagement can be one of them (but does not have to be). An active engagement approach is therefore incentivized.	n/a	n/a	n/a	No clear link to GHG emissions. At best, they could be part of the applicant's ESG strategy (for example impact investing or best in class) – but there are no incentives to do that.	
<b>Towards Sustainability Label (Belgium)</b> <i>(private initiative; Central Labelling Agency; not-for-profit association)</i>	A “sustainable financial product shall make use of the following strategies: ESG integration, normative screening, Exclusion and at least 1 additional strategy (best in class, sustainability themed investing, impact investing, over/underweighting, ....)	Mandatory for the fossil fuel sector – and “encouraged for other sectors with elevated risks for principal adverse impacts”. Chapter 1.7 contains guidelines.	SBTs are only part of the label criteria for “harmful activities”. Companies involved in Coal, Oil & Gas and Power Generation must fulfil one of the following criteria: SBTI target; <5% of revenue from harmful activities; capex thresholds to limit “brown” expansion and increase the “green” share.	“Sustainability themed investing” is one optional ESG strategy with clear revenue thresholds (see Chapter 1.5).	CapEx is only part of the label criteria for “harmful activities”. Companies involved in Coal, Oil & Gas and Power Generation must fulfil one of the following criteria: SBTI target; <5% of revenue from harmful activities; capex thresholds to limit “brown” expansion and increase the “green” share.	GHG emissions must be reported. Other than that, there is no specific reference. GHG emissions could arguably be part of the optional ESG strategies “best-in-class” or “Impact Investing” – but there is no indication towards a benchmark or reduction.	
<b>Sustainable Investment Label “Sustainable Improvers”</b> <i>(public initiative, UK FCA, Financial Conduct Authority)</i>	Three labels for the following categories are proposed: Sustainable Focus, Sustainable Improvers (i.e., transition label), Sustainable Impact. The proposed qualifying criteria are (1) sustainability objective, (2) investment policy and strategy, (3) KPIs, (4) resources and governance and (5) investor stewardship. Cross-cutting and category-specific considerations for the 5 criteria apply.	Investor stewardship is identified as the main channel for the sustainability outcome. Stewardship activities should be in alignment with the sustainability objective (should be shown with to be selected KPIs). However, there are no specific requirements.	n/a	No specific KPIs are required. Only reference to frameworks that could be used for the KPI selection, e.g., the International Capital Market Association’s (ICMA) registry of illustrative KPIs ( <a href="#">link</a> ).			

# ANNEX 2 : DEEP DIVE – EU ECOLABEL & NORDIC SWAN ECOLABEL

## EU Ecolabel for financial products



**Brief description:** The EU Ecolabel for Financial Products emerged from the EU’s Action Plan on Sustainable Finance<sup>15</sup> published in 2018 where action point #2 stipulated the extension of the existing EU Ecolabel for consumer products, ranging from shampoo to printing paper, to financial products. This has triggered an extensive stakeholder process including existing data providers, asset managers, label providers and civil society groups. In 2021, the Joint Research Centre of the European Commission published the fourth (and final) version of draft criteria encompassing a broad spectrum of qualifying criteria (ranging from clear green revenue and CapEx thresholds over exclusion criteria to clear engagement prescriptions). There are seven different criteria that must be fulfilled: 1) clear green revenue & green capex thresholds; 2) Exclusion criteria; 3) Social and governance aspects; 4) Engagement; 5) Measures taken to enhance investor impacts; plus, two criteria (6 & 7) that are linked to disclosure and transparency.

**Focus on transition:** While there is no stand-alone EU “transition label”, the transition aspect is an inherent part of the EU Ecolabel Draft Criteria (see below).

### Do the evaluation criteria incentivise investing in companies in transition?

Table A2.1 - EU Ecolabel criteria and its focus on transition (Source: EU Ecolabel criteria v4<sup>16</sup>)

#### Engagement



#### To qualify for the EU Ecolabel UCITS funds and retail AIFs need to comply with Criterion 4 (Engagement).

**Documenting the Engagement Policy** by describing A) the objective (i.e., how engagement with portfolio companies will be based on the environmental objectives of the EU Taxonomy Regulation - see Regulation 2020/852: climate change mitigation, climate change adaptation, water, circular economy, pollution, biodiversity; B) the strategy (e.g., how the investor plans to engage with portfolio companies to increase their green turnover); C) methods (e.g., how to use their influence); and D) monitoring.

#### Prescriptions how to exercise voting rights:

- **Prioritisation:** It is clearly defined which companies should be prioritised (e.g., companies with green turnover < 10%). Fund managers should try to orientate those companies, for example, to align investment strategies to grow green turnover and phasing out activities not complying with EU taxonomy criteria.
- **Disclosure:** Number of resolutions raised; how votes have been casted; the instances in which cases were adopted; among others.

<sup>15</sup> The Action Plan ([link](#)) was adopted in March 2018 and had three objectives: (1) To reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth; (2) To manage financial risks stemming from climate change, environmental degradation, and social issues; and (3) To foster transparency and long-termism in financial and economic activity.

<sup>16</sup> European Commission ([link](#))

### Prescriptions on dialogue with investee companies:

- **Requirements:** Fund managers shall regularly engage at management level with at least 10% of their portfolio companies. It is clearly defined which companies shall be prioritised.
- **Process:** The process shall be monitored and include, among others, the goals and targets discussed (for example expanding EU Taxonomy aligned activities or closing non-aligned activities); intermediate steps or milestones; frequency and means of communication.



#### Green Revenue

Criterion 1 defines the investable universe. Financial products must contain a certain share of environmentally sustainable economic activities. This “portfolio greenness” is (for UCITS funds) defined by the following formula and must be  $\geq 0.5$  with PC = portfolio contribution of each company, GT = green turnover, GC = green capex, and T = the absolute turnover of the individual portfolio company.

$$G = \sum_{n=1}^0 PC_i \times \frac{GT_i + GC_i}{T_i}$$

The “green” share of turnover and capex is here defined by the EU Taxonomy and therefore relates to existing and forthcoming criteria linked to climate change mitigation and adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, and the protection and restoration of biodiversity and ecosystems.



#### Green Capex

Green CapEx is an inherent part of the formula in Criterion 1 (see above). The “portfolio greenness” of 50% could (hypothetically) be reached by companies with 100% green capex and 0% green turnover, which expands the investable universe.



#### Setting (science-based) Targets

Forward-looking (science-based) targets are not explicitly part of the criteria. However, Criterion 2 describes a detailed exclusion list. Companies deriving more than 5% of their turnover from the “supply and use of solid, liquid and gaseous fossil fuels for fuel, energy generation in the form of electricity and/or heat, heating and cooling” are excluded unless they fulfil the following criteria, demonstrating their willingness to walk the talk:

- A turnover of excluded activities of  $< 30\%$ ;
- A *strategic plan* to reduce GHG emissions to a 1.5 C aligned level including carbon neutrality by 2050. The plan shall also include the phase-out of excluded activities over the next 10 years.
- Zero Capex (and zero OpEx in maintenance costs) for excluded activities.
- Scope 1 GHG emissions decrease annually by at least 7%.



#### Track record of GHG emissions

GHG emissions are not explicitly included. However, GHG emissions are an integral part of the EU Taxonomy criteria for climate change and therefore implicitly included.

## Nordic Swan Ecolabel



**Brief description:** Implemented by the Nordic ministries as a consumer label, the label has also been applied to financial products since 2017 currently awarding 75 financial products for environmental excellence. To receive the Nordic Swan Ecolabel, there are a range of obligatory requirements plus a scoring system of which 6 out of 14 possible points need to be reached.

**Focus on transition:** While there is no stand-alone Nordic Swan “transition label”, the transition aspect is an inherent part of the criteria (see below).

## Do the evaluation criteria incentivise investing in companies in transition?

Table A3.2 - Nordic Swan criteria and its focus on transition (Source: Nordic Swan Ecolabel – Investment Funds – Criteria version 2.1)<sup>17</sup>

## Engagement



### Obligatory Criteria (O16): Engagement with non-confirming holdings

O16 describes the process if an “unacceptable” risk occurs (i.e., not complying with international norms, conventions, and sanctions) or if the portfolio company is in breach with the obligatory exclusion criteria. The fund manager must remove the holdings in question from the portfolio or (if there is doubt regarding the non-conformity) start an engagement process.

Further points can be collected for “Systematic and targeted engagement” (max 3 points) and “Regular Voting” (max 3 points).

#### “Systematic and targeted engagement” (max 3 points)

**General Guidelines:** A fund manager shall demonstrate A) a systematic method for selecting portfolio companies and topics for engagement; B) time-bound goals for each topic; C) regular assessment of the achievement; D) description of resources and tools used.

**Scope of engagement:** 1 point (2 points) if engagement with at least 5% (10%) of the portfolio companies (in numbers). At least 5 (10) holdings are required.

**Transparency:** An additional point can be earned if the reporting contains an accurate description of goals and status for the company engagements.

#### “Regular Voting” (max 3 points)

**Regular Voting:** The fund manager must have a clearly written voting policy. 1 point (2 points) can be earned if fund manager votes at AGMs/EGMs for at least 25% (50%) of portfolio companies. Alternatively, the fund can use a proxy voting service (1 point for 70%, 2 points for 90%).

**Voting transparency:** An additional point can be earned if the voting records (incl. company-specific voting) are disclosed.

**Plus biodiversity critical sectors:** (agriculture, construction and infrastructure, extractive industries, fishery and aquaculture, food and beverage, forestry and logging, and shipping) can only be included if the fund engages according to P3.



## Green Revenue

### “EU Taxonomy alignment” (max 6 points)

Green revenues are an integral part of the scoring system (applicants must collect at least 6 points on top of obligatory requirements). Points are awarded according to the share of the portfolio that is fully aligned with the EU Taxonomy. The same formula as from the EU Ecolabel draft criteria is used (see description above) and the following points are awarded:

$$G = \sum_{n=1}^0 PC_i \times \frac{GT_i + GC_i}{T_i}$$

	1p	2p	3p	4p	5p	6p
<b>Taxonomy</b>	≥ 5%	≥ 10%	≥ 20%	≥ 30%	≥ 40%	≥ 50%



## Green CapEx

Green CapEx is an integral part of the scoring system (see formula above).

### Exemptions from exclusion criteria

Furthermore, green CapEx might exempt companies from the exclusion list related to extracting and refining of fossil fuels; and power generation. The following conditions must be fulfilled: (see *criterion O4 on exclusion criteria*)

- At least 90% of the company’s energy sector CapEx goes towards renewables; AND
- Revenue generated from renewable energy is >50%, among others; AND
- No revenue generated from fracking activities, mining of oil shales, extraction in Arctic region, among others.

<sup>17</sup> Criteria document - version 2.1 ([link](#))





**Setting (science-based) Targets**

**Enhanced Analysis and inclusion (max 2p)**

Including more holdings with a validated 1.5C Net Zero Science Based Target (or other environmental areas) is incentivised via the scoring system. Fund managers can collect 1 point (2 points) if  $\geq 25\%$  (50%) of portfolio companies have a validated target.

Furthermore: SBTs can help to include companies from high-emitting sectors into the portfolio (see below).



**Track record of GHG emissions**

**Reductions of GHG emissions in critical sectors (obligatory requirement)**

Portfolio companies operating in high-emitting sectors (i.e., aluminium, aviation, automobiles, cement, mining, pulp and paper, shipping, and steel) must fulfil one of the following requirements:

- At least  $>0.3$  according to the formula above;
- At least 75% of CapEx is aligned with EU Taxonomy;
- Company has a validated SBT (or similar accepted framework for transition)
- Company is among the best 15% in GHG intensity (in a global comparison of its sector)

(Alternatively, one of the following criteria are met at fund level: 50% alignment of revenues for the part that is eligible to the EU's climate taxonomy; fund has a legally binding commitment to follow the EU PAB)

**Enhanced Analysis and inclusion (max 2p)**

Furthermore, the fund manager can collect one point in the scoring system if the fund has a legally binding commitment to follow an EU Paris-Aligned Benchmark (which is linked to GHG reduction targets).

## ANNEX 3 : TRANSITION CHARACTERISTICS IN INITIATIVES, TAXONOMIES OR DISCLOSURE FRAMEWORKS

Table A3.1 4 - Overview of transnational and national initiatives

Organisation/ Initiative	Accomplishments/ work plan
Transnational initiatives	
G20 Sustainable Finance Working Group ( <a href="#">SFWG</a> )	Transition finance as important topic across all the four Working Group’s focus areas and actions. The OECD supports the SFWG with input, see OECD (2021) and OECD (2022). In October 2022, the SFWG published a framework for transition finance including five high-level principles for jurisdictions supporting transition finance (SFWG, 2022).
International Platform on Sustainable Finance ( <a href="#">IPSF</a> ): Transition Working Group	The IPSF founded its transition finance working group in February 2022. In a recently published publication (IPSF, 2022), they analyse how existing sustainable finance frameworks consider the concept of transition and develop principles at activity-, entity- and portfolio-level for a credible transition.
ISO 32210: Sustainable finance – Guidance on the application of sustainability principles for organizations in the financial sector ( <a href="#">link</a> )	This International Organization for Standardization (ISO) standard published in October 2022 sets out principles and practices to support financial organisations, e.g., regarding transition activities towards contributing to long-term sustainability goals. The standard can be applied at asset, project, and service level (ISO, 2022a).
IWA 42: Net zero guidelines ( <a href="#">ISO</a> )	This international workshop agreement (IWA) presents guidelines for organisations on how to commit to and implement net zero goals (ISO, 2022b).
UN High-Level Expert Group on the Net Zero Emissions Commitments of Non-State Entities ( <a href="#">link</a> )	Established by United Nations Secretary-General Antonio Guterres in March 2022. In November 2022, the UN HLEG (2022) provided detailed recommendations on strong and clear standards for net zero commitments. Crucial elements are the entity-wide transformation, the principle to be science-based, setting interim targets, the consideration of supply chain aspects, and the link to land use activities. They also propose a new taskforce for net zero regulation.

Initiatives from individual jurisdictions	
EU Platform on Sustainable Finance ( <a href="#">EU PSF</a> ): Subgroup 3 – Extended Environmental Taxonomy	<p>The EU Platform on Sustainable Finance consists of experts from academia, industry or civil society to advise on the further development of the EU Taxonomy. Subgroup 3 worked on how to integrate transitional activities, among others, and published a report on it in March 2022. In 2023, the composition of the Platform will be renewed. However, the subgroup working on monitoring capital flows will also take up the issue of transition finance.</p> <p>Several other jurisdictions integrate transition considerations in their taxonomies, see Chapter 2.</p>
Sustainable Finance Committee of the German Government: Subgroup Transition Finance ( <a href="#">link</a> )	<p>The Sustainable Finance Committee of the current German government, recently set up, consists of six subgroups – one of these focuses on transition finance. The goal is to present concrete proposals for different stakeholders to enhance financing the transition. As first step, the group works on a stock-take of existing financing instruments.</p>
UK Transition Plan Taskforce ( <a href="#">TPT</a> )	<p>Launched in April 2022 and having a mandate for two years, the taskforce should develop standards for transition plans for the private sector. Until February 2023, there is an open <a href="#">consultation</a> on the TPT Disclosure Framework and Implementation Guideline.</p>
Japan Taskforce on Preparation of Environment for Transition Finance ( <a href="#">link</a> )	<p>Initiated by the Ministry of Economy, Trade and Industry (METI), jointly with the Financial Services Agency (FSA) and the Ministry of the Environment (MOE), the taskforce formulated Japan’s basic guidelines for transition finance and supports other projects enhancing transition finance.</p>

Table A3.2 - Transition characteristics in sustainable investment frameworks

Framework	Transition characteristics
EU Taxonomy ( <a href="#">link</a> )	<p>It includes few transition activities, e.g., the manufacturing of iron and steel or energy efficiency improvements of buildings. These must perform significantly better than the industry average in terms of CO<sub>2</sub> emissions, possess a credible path towards climate neutrality and must not impede low-carbon investments. It must further not cause significant harm to any other environmental objective. So far, the EU taxonomy only has two categories (aligned vs. non-aligned), but there is the proposal of the independent Platform on Sustainable Finance to further enhance the framework and introduce an “amber” category (PSF, 2022).</p>
Singapore Taxonomy ( <a href="#">link</a> )	<p>The Green Finance Industry Taskforce (GFIT) is currently developing a three-category “traffic light” taxonomy (GFIT, 2022). The amber category should represent transitional activities on a clearly identifiable pathway to net zero and overall must not harm other environmental objectives. It primarily includes the real estate, transport, and energy sectors.</p>

Malaysian Taxonomy ( <a href="#">link</a> )	This taxonomy intends to have three categories: climate supporting, transitioning, and watchlist. Entities with transition activities shall be committed to contribute to the decarbonisation process. They should also set mid-term targets, identify pathways to meet climate objectives and establish implementation plans to meet the target over a defined period of time. Transition activities do not have to comply with the principle of “do no significant harm” to other environmental objectives (Bank Negara Malaysia, 2021).
ASEAN Taxonomy ( <a href="#">link</a> )	Non-focus sector activities are classified into green, amber, and red in without using activity-level thresholds. Activities in six focus transition sectors (agriculture, energy, manufacturing, transportation, water & waste, real estate) are classified under the same traffic-light system using activity-level thresholds. These should follow a transition pathway or make efforts to reduce emissions to reach this pathway, e.g., through “bridge technologies”. All activities are further divided into an “entry”, “intermediate”, and “advanced” pathway to capture different starting points (“stacked approach”). Transition activities may cause harm to other environmental objectives, but they must make efforts to remediate (ASEAN, 2021).
Bank for International Settlements Taxonomy Principles ( <a href="#">link</a> )	Based on current taxonomy developments, these principles suggest using expected future emissions as a metric, including at least one medium category between taxonomy-aligned and non-aligned for transition activities, focusing on the entity rather than the activity level, and considering direct and indirect emissions (Ehlers et al., 2021).
Japanese Basic Guidelines for Transition Finance (not a taxonomy but investment guidelines) ( <a href="#">link</a> )	These guidelines by the Taskforce on Preparation of the Environment for Effective Transition Finance should help firms to generate funds in labelled bonds or loans and propose disclosure requirements to show credibility of the transitional activities (METI, 2021)

Table A3.3 - Transition characteristics in sustainable finance disclosure frameworks

Disclosure Framework	Transition Characteristics
Public	
EU Corporate Sustainability Reporting Directive (CSRD) ( <a href="#">link</a> )	Large firms are required to disclose information about their sustainability targets and progress towards them, the compatibility of the entity with the transition to a sustainable economy, and their alignment with the 1.5°C goal of the Paris Agreement. Exact metrics have already been proposed by the European Financial Advisory Board (EFRAG) and are currently under revision (EFRAG, 2022). Based on the EU taxonomy, firms further need to disclose information on the taxonomy alignment of their CapEx, OpEx, and revenues (European Union, 2020)

Proposed UK standard for transition plans ( <a href="#">link</a> )	The Transition Plan Taskforce (TPT) is developing a mandatory reporting standard (on a “comply or explain” basis) of transition plans for listed companies, asset managers, and regulated asset owners (TPT, 2022).
Swiss climate-related financial disclosures ( <a href="#">link</a> )	Mandatory disclosure of emissions targets and transition plans following recommendations of the Task Force of Climate-related Financial Disclosures (TCDF), starting in 2024 (Federal Council, 2022)
Proposed US rules for climate-related disclosures ( <a href="#">link</a> )	Proposed requirements by Securities and Exchange Commission (SEC) currently under public consultation include climate-related targets and transition plans for entities without a target. This information should be updated each year, complemented by the actions which were taken (SEC, 2022).
Private	
International Capital Market Association (ICMA) disclosure guidelines for green bonds, sustainability bonds or sustainability-linked bonds ( <a href="#">link</a> )	Generate transition credibility on issuer level by showing entity-wide and project-focused transitional activities, e.g., through science-based long-term and interim targets of a climate transition strategy, the business model environmental materiality, and implementation transparency (ICMA, 2020)
Taskforce on Climate-related Financial Disclosures (TCFD) framework ( <a href="#">link</a> )	Framework especially for large companies to disclose climate-based risks and opportunities, e.g., emissions targets and other forward-looking data (TCFD, 2022)
Taskforce on Nature-related Financial Disclosures (TNFD) framework ( <a href="#">link</a> )	Similar to the TCFD framework but with a larger scope than climate change (TNFD, 2022)
International Sustainability Standards Board (ISSB) disclosure ( <a href="#">link</a> )	Climate-related disclosure, including transition plans (ISSB, 2022).
CDP disclosure support ( <a href="#">link</a> )	CDP supports thousands of companies to measure, manage and disclose their risks and opportunities on climate change and other environmental challenges. The questionnaire, which is filled out by each participating entity, also includes some forward-looking metrics, such as emission targets (CDP, 2022).
Climate Bonds Initiative (CBI) transition framework ( <a href="#">link</a> )	As part of the transition framework, CBI developed five hallmarks of a credibly transitioning company: (1) Paris-aligned targets, (2) robust plans, (3) implementation action, (4) internal monitoring, (5) external reporting (CBI, 2021)

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