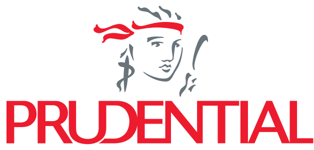


Prudential's Financing the Transition framework

A just and inclusive approach with regards to emerging markets

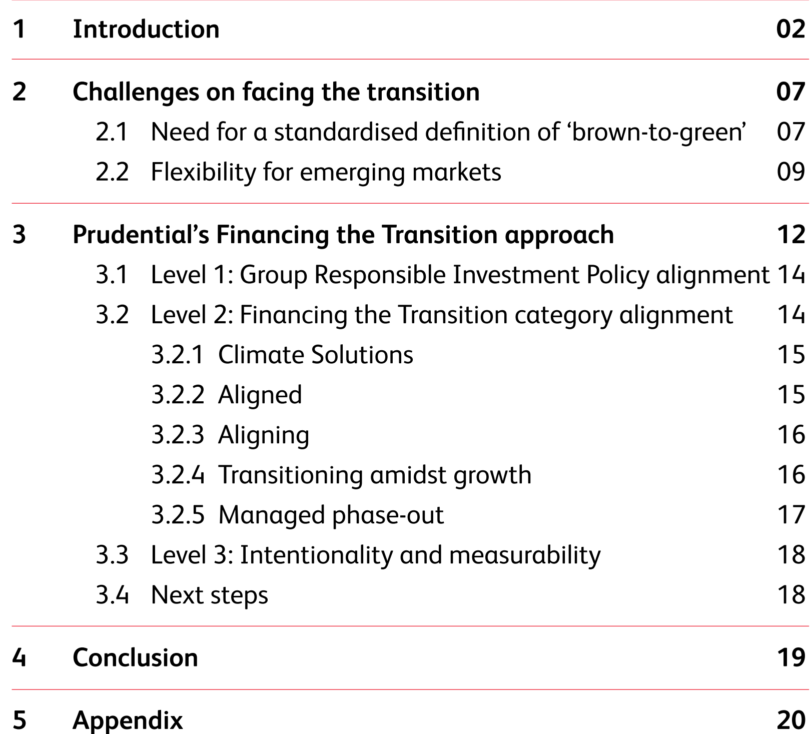
Climate bonds Initiative is an international organisation working to mobilise global capital for climate action.
This framework, along with Climate Bonds Initiative's endorsement, is not specific to bond investments only.

Endorsed by the Climate Bonds Initiative

Climate Bonds INITIATIVE

September 2024

Contents



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Endorsement by Climate Bonds Initiative

Climate Bonds Initiative confirms that the transition category alignment and composite transition screen developed by Eastspring and Prudential were guided by the core principles of Climate Bonds Initiative to ensure credibility of transition finance and endorses them on that basis.

1 Introduction

As a life and health insurer and long-term investor in 24 markets across Asia and Africa, our sustainability strategy is guided by our purpose: 'For Every Life, For Every Future'. We want to positively impact the future and wellbeing of our planet and our societies. As a company owned by independent shareholders, this means creating value and ensuring it is underpinned by good governance and responsible business practices.

Our sustainability strategy centres on three pillars:

1. **Simple and accessible health and financial protection,**
2. **Responsible investment, and**
3. **Sustainable business.**

We are committed to responsible investment, with a particular focus on climate change and emerging markets, because many of the markets in which we operate are emerging markets. We have pledged to decarbonise our investment portfolio and become a net zero asset owner by 2050. We are also committed to playing a role in Financing the Transition and leveraging our influence to mainstream responsible investments in emerging markets.

This document is intended to be a technical paper and should be read by audiences with requisite understanding of finance, investment and Environmental, Social and Governance (ESG) knowledge, including (but not limited to) knowledge on Climate Change and Climate Transition.

Prudential's Financing the Transition framework has been assessed against market standards and is in line with applicable taxonomies on the date of publication. This paper and the framework will continue to evolve in line with evolving and transitioning taxonomies, regulation, market standards and practices.

Prudential plc is an international company incorporaated in the United Kingdom. Prudential plc is not affiliated in any manner with Prudential Financial, Inc., a company whose principal place of business is in the United States of America or with the Prudential Assurance Company, a subsidiary of M&G plc, a company incorporated in the United Kingdom.

What does a Just and Inclusive Transition mean to Prudential?

The International Labour Organization defines a just and inclusive transition as 'greening the economy in a way that is as fair and inclusive as possible to everyone concerned, creating decent work opportunities and leaving no one behind'[1]. This was echoed by the high-level ministerial roundtable on just transition at the 28th Conference of the Parties (COP 28), reinforcing the need for achieving the goals of Paris Agreement in a way that is just and equitable for all[2]. Prudential's perspective on 'leaving no one behind when we green the economy' is relevant on two levels:

- **Global level:** All countries need to transition to a greener economy, and no country, especially the most vulnerable ones, should be left behind; and
- **National level:** Within countries, workers' rights and livelihoods within impacted region should not be adversely impacted by the transition.

Prudential's Just & Inclusive transition white paper outlines the case for a just and inclusive transition in emerging markets (the global level).

This approach is a core part of our sustainability strategy and underpins our climate change initiatives. We aim to place the considerations for emerging markets at the forefront of our Responsible Investment activities.

Emerging markets are incredibly diverse with different needs. While this paper groups all emerging and developing countries together as 'emerging markets'[3], we recognise the need for further differentiation based on regions, predominant economic industries and sectors and other factors and ideally adopt a country-approach. We feel that differentiation between developed and emerging markets within Responsible Investment frameworks and standards is a good first step.

The implementation of a Just & Inclusive transition strategy within our investments focuses on two key aspects of Responsible Investment:

- **Engagement:** Using our influence as an asset owner to influence investee companies, asset managers, and regulators and policy makers on climate change and other sustainability topics and the importance of a just and inclusive transition. Our approach to engagement can be found here and describes our activities with respect to corporate engagement, asset manager engagement and policy engagement. Prudential has a target on engagement with respect to climate change: we engage with companies responsible for 65% of our financed emissions. Our engagement approach includes an escalation process which contains divestment as a last resort.

- **Financing the Transition:** We aim to be an active investor in financing a just and inclusive climate transition to net zero. We define Financing the Transition as directing investment into enablers[4], industry leaders, or high-impact sectors with the explicit goal of enabling and accelerating the net-zero transition.

1 Climate change and financing a just transition | International Labour Organization (ilo.org)

2 COP28 Agreement Signals "Beginning of the End" of the Fossil Fuel Era | UNFCCC

3 Prudential aligns its definition of emerging markets to MSCI

4 Enablers are assets and entities that indirectly contribute to, but are necessary for, emissions reductions by facilitating the deployment and scaling of Solutions or supporting the decarbonization of other actors' operations. Examples may include the development of new or smart grid infrastructure

This paper focuses on **Financing the Transition.** Prudential aims to invest more in the climate transition and this paper shares the approach we have developed. Our approach defines different categories of investments which can contribute towards Financing the Transition. Our approach is principles-based for the time being, and includes requirements which investments have to meet in order to be qualified as Financing the Transition. **This framework therefore applies only to those investments made in the context of financing the transition, and – for the time being – will not apply to the entire portfolio.**

This paper is intended for our direct stakeholders (peers, investors, policymakers, etc.) and we aim to influence the debate on transition finance for emerging markets.

Creating more growth opportunities in our markets

Prudential is uniquely positioned as both a global and a local asset owner, influencing our engagement approach and collaboration with asset managers. As a local asset owner in many emerging markets in Asia and Africa, we invest a significant portion of our assets in the countries where we operate. In addition, regulatory requirements for local investments necessitate a more selective approach to investment opportunities.

By matching local insurance liabilities with local currency assets, we often become significant buyers of securities traded in local markets, frequently issued by government or state-controlled entities. We believe that this investment positively contributes to local society and to the development of local securities markets. This should lower the overall cost of investment funding in emerging markets, channel individual savings to long-term investments, create more opportunities for economic growth, higher employment and incomes, and, in line with our engagement strategy, support a just transition.

Importance of emerging markets and transition finance

Emerging markets are crucial for global climate transition due to their unique challenges and significant potential for impactful change.

Prudential has pledged to become a net zero asset owner by 2050. Our efforts and commitment to achieving portfolio net zero by 2050 are aligned with goals of **the Paris Agreement**. However, operating in diverse markets with a particular exposure to Asia and Africa requires a considered and dynamic approach to the low-carbon transition.

The climate-related risks and opportunities in developed markets with diversified and mature economies differ significantly from those in emerging markets. Emerging markets:

- Have historically contributed less to the cumulative greenhouse gas (GHG) emissions present in our atmosphere today[5];
- Are generally more vulnerable to the physical impacts of climate change[6];
- Are considered to be more dependent on fossil fuels to meet their development needs[7];
- Have fewer resources to fund the transition to a lower-carbon economy and to manage the physical impacts of climate change[8]; and
- Face significant unfinanced development needs as highlighted by the Sustainable Development Goals of the United Nations.

This results in a large divergence among countries, regions and industries in their efforts and ability to reduce their carbon footprint and combat climate change.

Prudential has a global investment footprint spanning both developed and emerging markets. As we operate in many emerging markets, we act as a local asset owner. Taking a differentiated approach to transition is one element of enabling a just and inclusive transition to net zero which we consider to be crucial for these countries and core to Prudential's responsible investment approach. In addition to financing 'green' activities, we believe that financing the transition from 'brown-to-green' will be crucial for the global climate transition, especially in emerging markets.

Effective impact cannot be achieved by ignoring or excluding the harder-to-decarbonise assets from investment portfolios. While it may be tempting to write off hard-to-abate businesses as unfeasible to decarbonise, the climate goals will not be met without them being part of the solution and decarbonising their operations. Active engagement can help transition firms from 'underperforming' to 'average' creating real-world impact. Engagement is therefore a crucial element of the Financing the Transition strategy. While Prudential generally does not directly engage with investee companies, we require our asset managers to engage the companies on their transition planning on our behalf. As the asset owner, we assess and monitor whether the engagement process is in line with our requirements. We require engagement from the asset managers we work with, but most importantly Eastspring. Prudential and Eastspring, as affiliated companies with the Prudential plc group, are aligned in our approach to engagement.

This approach will mean that the emissions related to our investment portfolio might increase in the short term. While this may challenge our decarbonisation progress in the near term, we will accept this short-term impact, and highlight this to our own stakeholders, as we believe financing 'brown-to-green' will be essential. A non-linear reduction path is aligned to the reduction pathways of many emerging markets: carbon emissions for these markets often need to peak first before they decrease, as recognized in the Paris Agreement (article 4.1). This means that carbon reduction targets of many emerging market countries are intensity-based at first, reflecting that their absolute emissions might need to peak first before they decrease to allow their development.

5 Cumulative CO_2 emissions by world region (ourworldindata.org)
6 Country Index // Notre Dame Global Adaptation Initiative // University of Notre Dame
7 Many countries have decoupled economic growth from CO2 emissions, even if we take offshored production into account - Our World in Data
8 Chapter 3. Financial Sector Policies to Unlock Private Climate Finance in Emerging Market and Developing Economies in: Global Financial Stability Report, October 2023 (imf.org)

How is the Just & Inclusive Transition approach aligned to Paris?

Prudential's Just & Inclusive Transition approach places the considerations of emerging markets at the forefront of the discussion. For Prudential's Financing the Transition framework this means that we allow some flexibility with regards to emerging markets (i.e. we do not apply the same thresholds for developed and emerging markets). This is aligned to the Paris Agreement. The Paris Agreement aims to 'hold the increase in the global average temperature to well below 2°C above pre-industrial levels' and pursue efforts 'to limit the temperature increase to 1.5°C above pre-industrial levels'[9]. Achieving this requires 'making financial flows consistent with a pathway to low-greenhouse gas and climate resilient development' (Article 2.i.c).

Article 2.i.c stresses that the goal of the Paris Agreement and the climate transition is not just for finance to support net zero and resilience but to do so 'in the context of sustainable development and efforts to eradicate poverty'. Additionally, the Paris agreement includes the principle of 'common but differentiated responsibilities'. This means that while all countries must take climate action, the specific actions will depend on their national circumstances.

Additionally, article 4.1 states that 'countries aim to reach global peaking of greenhouse gas emissions as soon as possible, recognising that peaking will take longer for developing countries' and that carbon reduction should be achieved 'on the basis of equity, and in the context of sustainable development and efforts to eradicate poverty'.

Prudential's Just & Inclusive Transition approach considers these differing regional, national, and sectorial circumstances and allows for flexibility with regards to emerging markets.

9 Source: The Paris Agreement

2 Challenges on Financing the Transition

Prudential aims to tackle two main challenges in Financing the Transition:

1. **Lack of a standardised definition for 'brown-to-green':** There is no universally accepted definition of what constitutes financing the shift from 'brown' (high carbon) to 'green' (low carbon) projects.
2. **The need for flexibility with regards to emerging markets:** Emerging markets need flexibility in line with the 'common but differentiated responsibilities' principles of the Paris Agreement

Prudential's Financing the Transition framework is designed to address these challenges. Whilst it encourages international coordination in defining standards and taxonomies, Prudential acknowledges the differences in political, legal, and individual views on the topic of climate change.

2.1 Need for a standardised definition of 'brown-to-green'

According to the OECD, in 2023 only 7.9% of total global assets under management (AUM) are invested in 'green' assets by investment funds[10]. Prudential believes that merely investing in 'green' activities won't be enough to achieve net zero. It is essential to actively invest in carbon-intensive economies to help them decarbonise.

International discussions on emission reduction have shifted from excluding high emission sectors that are not immediately 'green', to recognising that transitioning to a net zero Pathway involves making credible and measurable efforts in trying to decarbonise brown companies by investing in and engaging with them. International forums like the COP, which were traditionally heavily focused on emissions reduction increasingly recognise the importance of transition as a contributing factor to emission reduction. For example, the 2023 COP28 in Dubai included discussions on coal phaseout strategies, the role of transition fuels, and the concept of a just transition for impacted communities[11]. MAS also states that 'the world needs transition finance – to provide the funding support for businesses and sectors that are not so green, to adopt cleaner technologies, increase energy efficiency, and become greener over time'[12].

Achieving transition requires financing significant decarbonisation across all economic sectors, especially among energy-intensive and hard-to-abate sectors. The increased prominence of transition finance in climate discussions among regulators and industry standard setters have led to the development of frameworks to guide the market on how to practically finance the clean energy transition, which the International Energy Agency (IEA) estimates will need up USD 2 trillion per annum by 2030[13].

10 Towards Orderly Green Transition - Investment Requirements and Managing Risks to Capital Flows (oecd-ilibrary.org)

11 United Nations Framework Convention on Climate Change. 13 Dec 2023. Matters relating to the global stocktake under the Paris Agreement

12 Ravi Menon: Getting transition finance right (bis.org)

13 Executive Summary, Scaling Up Private Finance for Clean Energy in Emerging and Developing Economies – International Energy Agency, June 2023

From a financing perspective, the lack of a standardised definition of 'brown-to-green' leads to ongoing debates about what constitutes transition finance. This contrasts with the definition of 'green', which many countries[14] define largely in alignment with the definition of 'green' as part of the EU taxonomy.

Further Eastspring-Prudential research: Financing the Transition in capital markets

In collaboration with Eastspring, the asset management business of Prudential plc, we published a whitepaper on the climate transition: 'Framework for investing in climate transition in the capital markets'. This paper includes an overview of the available 'brown-to-green' frameworks. The paper argues that many existing transition solutions, such as sustainable finance taxonomies and industry frameworks, focus on activity-level. This focus makes them less useful for measuring alignment at the *company* level. Consequently, there is a need for data-based solutions to identify companies that are already aligned or making credible progress in aligning their business activities. These company-level data solutions are essential for Financing the Transition, especially in capital markets. The paper proposes a data-driven approach to address this issue which aligns to Prudential's framework. Other methodologies and approaches will be considered too as there is not just one solution to this challenge.

This solution is useful for capital markets. The potential impact of capital markets on the climate transition is immense due to their size. Global equity markets are valued at nearly USD 106 trillion, and bond markets add another USD 128 trillion globally[15]. Mainstreaming transition finance through these markets can make a significant impact and help close the financing gap for the climate transition, particularly in emerging markets.

In addition to the lack of a standardised definition of transition finance, data is another challenge. Especially for asset owners, company data is crucial to determine whether companies are credibly transitioning. Initiatives by the International Sustainability Standards Board, the Transition Plan Taskforce, and the European Union's Corporate Sustainability Reporting Directive and Corporate Sustainability Due Diligence Directive aim to address this challenge. However, we expect the lack of data to remain a challenge for the near term, especially for emerging markets.

The need for managed phaseout in emerging markets

To achieve climate goals, it is essential to not only transition away from carbon-based industries but also to manage the phase-out of carbon-intensive assets. One of the most urgent activity need for this is in coal-based energy production, which is the largest source of greenhouse gas emissions globally, particularly in emerging markets. Since 2000, there has been a surge in coal-fired power capacity, with emerging markets accounting for three-fourths of the world's 9,000 coal-fired power plants.

Additionally, power plants are relatively young in emerging markets, averaging less than 15 years in the Asia Pacific region compared to about 40 years in the United States. This implies significant costs for decommissioning, retirement, and social adjustments. When coal-fired power plants are retired before their expected lifespan, their net financial value is lost because capital expenditures cannot be recovered. However, phasing out coal early could lead to considerable net economic and social benefits, especially with the availability of increasingly affordable renewable energy alternatives[16]. In Asia, multiple initiatives are being tested to finance early phase out of coal plants, such as the Energy Transition Mechanism of the Asian Development Bank[17] and the initiative of the Monetary Authority of Singapore focusing on the use of transition credits to manage phaseout of coal plants[18].

Emerging markets account for **75%** the world's **9,000** coal-fired power plants

Power plants in emerging markets are relatively young, averaging **<15** years in Asia-Pacific **≈40** years in United States

The retirement of coal-fired power plants before their expected lifespan has a **net financial loss**, which consequentially have economic and social impact

14 For example, ASEAN taxonomy, Singapore, Thailand and South Africa

15 Impact Taskforce, 2021, Mobilising institutional capital towards the SDGs and a Just Transition

16 Chapter 3. Financial Sector Policies to Unlock Private Climate Finance in Emerging Market and Developing Economies in: Global Financial Stability Report, October 2023 (imf.org)

17 Energy Transition Mechanism (ETM) I Asian Development Bank (adb.org)

18 Transition credits (mas.gov.sg)

2.2 Flexibility for emerging markets

The Paris Agreement recognises the need for a holistic approach to sustainable development when decarbonising emerging markets. While recognising the necessity of transitioning to more sustainable energy sources, it is crucial that this transition remains affordable for emerging markets. These regions often face unique economic challenges and higher levels of energy poverty. If the transition leads to a significant increase in energy prices, it could adversely impact the livelihoods of millions of people who rely on affordable energy for their daily needs. Therefore, we need a holistic approach that consider the equity of the transition, providing support and resources to emerging markets to help them adapt without compromising their economic stability and social well-being; while recognising and respecting that countries themselves determine the various economic policies and financial regulation suited to their circumstances and requirements. Some of these effects go hand in hand. For example, addressing emissions will also significantly improve air quality: 15 of the 25 most polluted cities in the world are in emerging markets (with an additional nine in China), and air pollution is a major cause of premature death[19].

Why are emerging markets crucial to the energy transition?

The global climate transition depends on emerging markets. In 2022[20] emerging markets, including China, were responsible for 72% of global greenhouse gas emissions. Without sufficient action to transform their energy systems, these regions will be the largest source of emissions growth in the coming decades. Between 2020-2030, 90% of middle-class growth is expected to come from the Asia Pacific region, while 98% of population growth will occur in Asia, Africa and Latin America. This growth will drive increased energy use and carbon emissions[21].

Within emerging markets, Southeast Asia will play a crucial role. This region includes 660 million people across the 10 members of the Association of Southeast Asian Nations (ASEAN), representing almost 10% of the world's population and collectively forming the fifth-largest global economy by GDP. Currently, coal and natural gas supply almost 75% of the region's electricity. Additionally, 45 million residents in Southeast Asia lack access to electricity, and many businesses face significant disruption due to unreliable energy sources. Energy demand in the region has grown by more than 80% between 2000 and 2019[22].

Emerging markets underrepresented in climate strategies

To ensure emerging markets are not left behind in the climate transition, they must be able to develop economically and meet their societal needs while also decarbonising, which might lead to an increase in emissions before they decrease. There are countries that have managed to decouple economic growth from carbon emissions adjusted for trade, or in other words carbon emissions consumed within the country (see below graphs from Our World in Data). Most of these countries are developed countries. 'Our World in Data' suggests that there are two key reasons why emissions have fallen in these countries:

1. Some countries have managed to decouple energy use and economic growth[23]. There GDP has increased while total energy use has remained flat, or even decreased.

2. More importantly: countries are replacing fossil fuels with low-carbon energy sources. This allows them to produce more energy, without the emissions that used to come with it[24].

19 Financing Clean Energy Transitions in Emerging and Developing Economies (iea.blob.core.windows.net)

20 EDGAR Community GHG Database (a collaboration between the European Commission, JRC and IEA), 2023

21 Financing Clean Energy Transitions in Emerging and Developing Economies (iea.blob.core.windows.net)

22 Clean Energy Finance in ASEAN: Promising Potential or False Dawn? | Teneo

Decoupling: Countries that achieved economic growth while reducing CO_2 emissions, 2005-20

Emissions are adjusted for trade. This means that CO_2 emissions caused in the production of imported goods are added to its domestic emissions – and for goods that are exported the emissions are subtracted.
Average incomes are measured by GDP per capita (except for Ireland, for which it is measured by GNI per capita).

Data sources: Global Carbon Project & World Bank.
There are more countries that achieved the same, but only those countries for which data is available and for which each change exceeded 5% are shown.
OurWorldInData.org – Research and data to make progress against the world's largest problems. Licensed under CC-BY by the author Max Roser

Source: Many countries have decoupled economic growth from CO2 emissions, even if we take offshore production into account - Our World in Data

However, this shift requires financing, and the financing gap for the climate transition in emerging markets is substantial. Currently, emerging markets clean energy investment represents only 14% of the global total[25]. Annual investment needs to triple from USD 770 billion in 2022 to USD 2.2-2.8 trillion by early 2030s (excluding the financing needed for the early retirement of coal-fired power plants).

This financing cannot come solely from public resources, as this would require allocating well over 10% of aggregate tax and non-tax revenue to clean energy investment. According to the International Energy Agency (IEA) and International Finance Corporation (IFC), the private sector will need to contribute 60% of the clean energy financing in emerging markets.

This more than tripling in clean energy investment will require not only reallocating existing investments from fossil fuels to clean technologies but also attracting new sources of funding[26].

23 How much energy do countries consume when we take offshoring into account? - Our World in Data
24 Energy Data Explorer - Our World in Data
25 Mobilizing Capital in and to Emerging Markets | Full Report | BloombergNEF (bnef.com)
26 Scaling Up Private Finance for Clean Energy in Emerging and Developing Economies – Analysis - IEA

Unfortunately, emerging markets are often underrepresented in climate-related investment strategies, increasing the already large financing gap. For example, the IMF states that the share of assets in emerging markets Asia in global non-ESG investment funds is around 10%. However, these markets are underweighted in ESG funds as their share in those funds is only 2%. If their share of global ESG funds were to rise to match its share of overall funds (i.e. rise from 2% to about 10%), this would generate approximately USD 500 billion per year in inflows to the region[27].

Underinvestment in regions where transition financing is most needed hampers not only the global climate transition but also long-term sustainable social and economic growth in these regions. On the other hand, emerging markets offer the largest opportunity in terms of impact: every dollar invested in clean energy in emerging markets results in 12 tonnes of emission reductions by 2035, which is 30% more than in developed markets[28].

Underinvestment in emerging markets hinders global cliamte goals and sustainable growth, despite these regions offering the highest impact per dollar invested in clean energy.

Taking stage of economic development into account

At Prudential we believe that economic growth and decarbonisation can happen simultaneously. However, it's important to recognise the varying stages of economic development across different countries. This different stage of economic development leads to different considerations. Whereas most developed markets are more concerned about energy security; energy affordability and energy access are more concerning topics for emerging markets. The IEA projected that despite that energy cost for households in emerging markets under a net zero emissions by 2050 scenario can be improved compared to their Stated Policy Scenario, energy cost will still increase[29]. The climate transition cannot in our view be just and inclusive on a global level if we do not recognise the importance of energy access and affordability for emerging markets.

However, many benchmarks and thresholds for decarbonisation follow a single global, sector-specific pathway[30] and therefore do not take the different stage in economic development into account. Companies in emerging markets may struggle to meet the high decarbonisation thresholds set by developed markets. Additionally, engagement initiatives often require alignment with this global pathway. In practice, this means that society expects the same rate of decarbonisation for both German and Indonesian utility companies, without considering their different levels of economic development, expected economic growth and population growth (which impact growth in electricity demand), and differences in the cost of capital. These factors significantly impact the decarbonisation rate of companies and countries.

There are increasing efforts to distinguish between developed and emerging markets. For example, IEA Net Zero 2050 scenario differentiates between developed and emerging economies for the utility sector. This differentiation is also adopted by the Transition Pathway Initiative[31]. Additionally, the NGFS argues that expectations on transition planning by companies need to be tailored to emerging markets: 'while effective transition planning can contribute to risk management and climate finance, there is also a risk of unintended consequences, such as undermining access to finance and creating entrenchment effects in emerging markets' transition funding if not done effectively'[32]. These different expectations should be reflected in the definition of transition finance as well. The ASEAN taxonomy also aims to capture the different stages of economic development in a taxonomy. These differentiation efforts are very much needed. However, they are not yet systematically integrated into investment frameworks.

27 International Monetary Fund (IMF), 2024, Unlocking Climate Finance in Asia-Pacific: Transitioning to a Sustainable Future

28 Scaling Up Private Finance for Clean Energy in Emerging and Developing Economies – Analysis - IEA

29 Prices and affordability – World Energy Outlook 2021 – Analysis - IEA

30 Example of this is the Science Based Targets initiative

31 How can climate assessment tools support investment in emerging markets? - Transition Pathway Initiative

32 Tailoring Transition Plans: Considerations for EMDEs (ngfs.net)

3 Prudential's Financing the Transition approach

In developing our Financing the Transition framework, we have reviewed over 20 transition frameworks and taxonomies from global and regional institutions[33]. This comprehensive review helped us understand the variations and commonalities among these frameworks and appreciate the effort that is being made on the transition front. Despite the increasing number of frameworks which include 'brown-to-green', there is not a broadly accepted definition of this concept and the definitions for 'brown-to-green' vary significantly across frameworks. Additionally, none explicitly addresses the need for flexibility in emerging markets for asset owners.

Prudential decided to focus on developing a framework to help address that gap and align it with global market developments such as GFANZ. We aim to consider the unique characteristics of emerging markets, aligned to initiatives such as ASEAN taxonomies. This approach allows us to balance local market contexts with global best practices.

Considerations for 'financing the transition' from an asset owner perspective

The term 'transition' captures a large spectrum of companies on different journeys and with different maturities. We aim to classify companies based on where they are on their journey to net zero. We think it is essential we invest in companies at various stages of decarbonisation with the appropriate guardrails in place to ensure the companies are willing, capable, and demonstrating that they are transitioning. The spectrum captures anything from 'brown-to-green' to 'green' (with each having different subcategories), with the aim of moving the 'brown-to-green' companies to 'green'.

As an asset owner, our activities result in providing finance to companies, particularly through investments in capital markets. It is therefore important we assess the transition characteristics at a company-level, and not just focus on certain activities the companies employ. Within Prudential's Financing the Transition Framework, we therefore allow classification of companies into one of the five transition categories (see section 4.2). This in contrast to, for example, focusing on use-of-proceeds bonds that focus on certain activities. The Eastspring and Prudential whitepaper: 'Framework for investing in climate transition in capital markets' dives deeper into assessing companies on their transition characteristics.

Financing the Transition target

We have set an internal target for transition finance investments to actively support the world's shift to a lower carbon future which demonstrates our genuine commitment to net zero as both an asset owner and asset manager. This target is linked to our executive remuneration.

Transition investments that include flexibility with regards to emerging markets remain limited. Hence, we aim to catalyse quality investment opportunities by establishing a clear framework and committing to an investments target. This also aims to promote awareness about the critical need for these investment opportunities.

33 See Appendix for full overview

Our framework is currently principles-based and the following principles apply:

- **Prioritisation of real-world impact:** The objective of this framework is to finance the transition in a just and inclusive way. Creating real-world impact is the most important consideration. In addition to financing 'green' companies, Prudential will also invest in carbon-intensive companies with credible efforts to accelerate their decarbonisation process. We allow flexibility in this framework for 'brown-to-green' and emerging markets, not to maintain the status quo but because we believe this is the practical and just and inclusive way forward. Where possible, Prudential aims to influence the industry through policy engagement, participation in industry collaborations and investing in scalable solutions.
- **Approach aligned to the Paris Agreement:** Our expectations on decarbonisation are time-bound and aligned with the Paris Agreement. Prudential is inclusive of a range of science-based pathways, including but not limited to the Intergovernmental Panel on Climate Change (IPCC), International Energy Agency (IEA), Network for Greening the Financial System (NGFS), and One Earth Climate Model (OECM). We understand these pathways may need to be adapted to regional contexts, considering the varying emission baselines and nationally determined contributions.
- **'Brown-to-green' investments are needed:** Prudential believes that 'brown-to-green' investments are crucial to deliver on the Paris Agreement. The 'brown-to-green' category is intended for hard-to-abate sectors but will not exist indefinitely. While emerging markets may require transitional solutions or energy sources, the focus should remain on transitioning away from carbon-intensive activities to achieve Paris-alignment. Forward-looking data will be crucial to assessing the transition potential of companies.
- **Alignment to market standards:** Where possible, we aim to align with Paris-aligned market standards and taxonomies. However, we take an adapted and inclusive approach if we believe certain challenges remain unaddressed by market standards, such as the needed flexibility with regards to emerging markets.
- **Differentiated approach with regards to emerging markets:** Prudential believes emerging markets need more flexibility due to their different stages of economic development. Our approach differentiates between developed and emerging markets and introduces a 'transitioning amidst growth' investment category (see paragraph 3.2.4). This aligns with the 'common but differentiated responsibilities' principle of the Paris Agreement and the ASEAN taxonomy, which aims to 'be inclusive and cater to the different development stages of ASEAN Member States'[34]. This category, like the 'brown-to-green' categories, will not exist indefinitely as eventually companies need to align to a net-zero pathway.
- **Compatibility with other environmental and social objectives:** Prudential's approach integrates globally the principle of 'Do No Significant Harm' (DNSH). For us, activities benefiting the transition should be compatible with other environmental and social objectives. This includes assessment of human rights, labor rights, deforestation, among other key topics, ensuring a just transition within countries. Through the required ESG-integration, environmental and social risk factors are expected to be systematically assessed and managed by our asset managers across our investments.
- **Inclusions of all asset classes:** The approach covers all asset classes, reflecting that all aspects of the financial system need to contribute to the transition, but each has a different role to play. Private markets are needed to finance emerging technologies that provide the necessary climate solutions. Meanwhile, Financing the Transition investments need to become mainstream and available to public markets to achieve a systematic transition.
- **The framework will evolve over time:** Due to a lack of sufficient data required to assess a large number of companies on alignment within this framework, a principles-based approach will be taken to assess both fund investments and individual investments. A data-driven approach is preferable but currently not feasible due to data limitations. Prudential will assess investments on a case-by-case basis and apply lessons learned.
- **Compatibility with different asset managers:** The principles-based approach allows us to accommodate different approaches to Financing the Transition from various asset managers which we use. Recognising the lack of standardisation in the market and data challenges, different asset managers will inevitably have different approaches to determine which companies align with the framework. The different approaches will be reviewed during the due diligence process and monitored over time to ensure they continue to align to Prudential's framework. We will engage with the asset manager where any deviation is discovered, and escalate the matter where deviations exist.

As an insurance company, we act in the best interest of our clients. Therefore, all our investments, including those aimed at Financing the Transition, must meet our fiduciary duty, and legal, regulatory and other obligations. Some of these Financing the Transition investments might be inherently risky and this investment risk will be managed in our regular investment process. In addition to the standard investment governance process, qualifying 'Financing the Transition' investments undergo the following three steps:

34 ASEAN Taxonomy for Sustainable Finance (Version 3)

Level I: Group Responsible Investment policy alignment
First, eligible investments must comply with requirements in Prudential's Group Responsible Investment policy, which is accessible on the linked website.

Level II: Financing the Transition category alignment
Next, the investments are evaluated for alignment with the Financing the Transition categories as defined by Prudential and integration of DNSH consideration.

Level III: Intentionality and measurability
Finally, we assess intentionality and measurability of the investments.

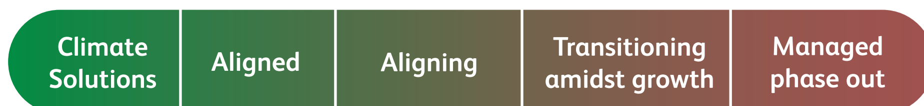
3.1 Level I: Group Responsible Investment Policy alignment

Prudential's Financing the Transition investments should align with Prudential's Group Responsible Investment policy, most importantly focusing on exclusions[35], stewardship and ESG-integration (incorporating financially material ESG considerations into the investment process).

Stewardship, i.e. our engagement with investee companies but also asset managers, is crucial for this approach. Effective engagement enhances investors' understanding of a company, adding rigour to the due diligence process and ensuring that investee companies are genuinely transitioning. Asset managers should also use engagement to ensure that the social aspects of the transition are adequately considered by portfolio companies. Exercising voting rights in line with net zero goals may also be required, if applicable.

3.2 Level II: Financing the Transition category alignment

Prudential has defined five categories for Financing the Transition investments[36], which includes both 'green' and 'brown-to-green'. The 'transitioning amidst growth' category provides the necessary flexibility for emerging markets. The framework is summarised below.



The framework captures five distinct opportunity sets, as we recognise that no single category can deliver the transition at the required speed and scale. The operational feasibility and commercial viability of the above categories can vary. For example, solar and wind energy sources are mature and readily available, while the managed phaseout has a longer timeline and in general aligns with policy decisions of a specific jurisdiction.

Recognising these challenges, we believe that combining categories covering both 'green' and ≈ creates a reinforcing mechanism that supports a just and inclusive transition. In addition, while applicable to all categories, stewardship may play an outsized role in 'brown-to-green' to ensure the decarbonisation progress are accountable and credible. Details of Prudential's stewardship approach is outlined in this paper, which also outlines our engagement approaches with investees, policymakers, and asset managers.

The following sections provide a dive deeper into each category.

35 Managed phaseout would not be subject to coal exclusion, given the nature of such investment is to decommission coal fired power plants earlier than their economic lifecycle. (See section 3.2.5 for the definition of managed phase-out.)

36 Note that this framework took inspiration from other frameworks and taxonomies, including GFANZ. However, the exact definitions might differ from other frameworks.

3.2.1 Climate solutions

Description: Companies, projects, or business units dedicated to producing climate solutions that significantly contribute to climate mitigation, climate adaptation, and climate resilience[37].

Rationale: The decarbonisation progress depends on climate solution providers offering technologies, services and tools (e.g. renewable energy, hydrogen, etc). Investing in this category has the potential to accelerate economy-wide emission reductions and create business opportunities resulting in financial growth.

Investment scenarios

- *Early-stage disruptors: Due to the early development stage of disruptive climate solutions, investment opportunities are typically found in the private equity/credit space. At the **asset level**, these can be early-stage private companies focused on providing breakthrough renewable energy solutions. At the **fund level**, there are a growing number of thematic funds targeting climate mitigation, or impact funds aligned to Sustainable Development Goals (SDG) #13 on climate action.*
- *Established companies: Companies with a significant impact on the industry (e.g., large market share) attributed to climate solutions that are investable through listed equity and fixed income funds.*
- *Other debt instruments available are use-of-proceeds instruments, e.g., green bonds or green loans.*

3.2.2 Aligned

Description: Companies/projects already aligned with a 1.5-degree or below-2-degree pathway.

Rationale: This category acknowledges climate leaders across various sectors whose transition pathways align with the Paris Agreement. Eligible assets are included in the investment universe because they have demonstrated scientifically informed decarbonisation rigour, positioning them for a more sustainable and resilient long-term business model.

Investment scenarios

- *Portfolio companies in this category typically have lower emission intensity. They possess robust transition plans validated by accredited third parties and aligned with a science-informed 1.5-degree or below 2-degree pathway.*
- *Opportunities are seen across both aligned 'pureplay' firms with significant green business activities and climate leaders in their respective general industries.*
- *Companies with smaller emissions baseline and resources, are planning to become carbon negative by 2030[38].*

37 This category is also inclusive of nature-based solutions that store or reduce carbon. Definition: captures the key sectors involved in climate transition, including renewable energy, transport, buildings, and energy efficiency. Green funds are then classified as holding a certain share of such companies in their portfolio.

38 The rise of carbon negative companies & the carbon negative office

3.2.3 Aligning

Description: Companies/projects *committed* to align with a 1.5-degree or below 2-degrees pathway.

Rationale: This category aims to address the challenges of financing hard-to-abate[39] but essential sectors with higher emissions baselines. Effective transitions in these sectors can lead to significant emissions reduction. While these companies may not be fully on a 1.5 or below-2 pathway as yet due to the unavailability of breakthrough technologies, they have made official commitments to achieve such alignment. Investing in this category allows us to support these companies in implementing their net-zero targets.

Investment scenario

A steel producer currently has a relatively high emissions intensity but has recently announced its commitment to align with the Paris Agreement. These commitments may not be verified by a third-party such as the Science Based Targets initiative (SBTi), and although the company's business-as-usual (BAU) emissions trajectory may not meet the 1.5-degree or below 2-degree targets, it has activities and programmes that demonstrate its dedication to achieving its announced goals. For example, the company has issued a sustainability-linked bond tied to short-, mid- and long-term emissions targets, using an SBTi-based methodology for alignment.

3.2.4 Transitioning amidst growth

Description: Companies in carbon-intensive sectors in emerging markets that are significantly reducing emissions intensity.

Rationale: This reflects Prudential's internal view on the need for additional flexibility within the Financing the Transition strategy, recognising the socio-economic conditions of emerging markets. Although the GFANZ framework does not explicitly identify this classification, the Singapore-Asia Taxonomy for Sustainable Finance (Singapore-Asia Taxonomy[40]) launched by the Monetary Authority of Singapore (MAS), recognises these types of companies in the regional context and Prudential's framework aligns on a high level to this framework[41]. Specifically, the Singapore-Asia Taxonomy classifies qualifying companies under the 'amber' category of its traffic light system if they are 'not presently on 1.5°C pathway but are either: moving towards a green transition pathway within a defined time frame ("aligning" per Prudential's definition[42]); or facilitating significant emissions reductions in the short term with a prescribed sunset date ("transitioning amidst growth" per Prudential's definition).' Investment in this category should be coupled with effective engagement and monitoring of progress.

Compared to the 'aligning' category, the 'transitioning amidst growth' category recognises two key differences:

1. Companies may not be aligned to a 2050 or earlier net zero target:

- Companies may not align with a 2050 net zero target, as their countries align to different net zero timelines. (e.g., India commits to net zero by 2070).

39 Executive summary – Achieving Net Zero Heavy Industry Sectors in G7 Members – Analysis - IEA

40 Singapore-Asia Taxonomy for Sustainable Finance | 2023 Edition

41 The Singapore-Asia taxonomy defines activities, while the Prudential's framework aims to categorize investments (fund or direct). Prudential's framework is influenced by concepts used by the Singapore-Asia and ASEAN taxonomies.

42 It further states that this amber category is relevant only for transition of existing infrastructure and activities and it does not apply to new projects.

While these companies can still represent meaningful decarbonisation efforts and lead the transition, they may not be picked up by data providers as the public commitment is not aligned to net zero by 2050.

- In cases where Paris alignment is absent, evaluating investment opportunities involves considering transition plans and/or activities. Key criteria include long-term net zero targets backed by interim targets and near-term commitments, leadership governance, and accountability.

2. Applicability to emerging markets only:

- The 'transitioning amidst growth' category specifically applies to emerging markets, whose regional context may not be well captured under a global decarbonisation pathway.
- While Prudential maintains an inclusive approach, we acknowledge that all economies must transition to net zero, regardless of regional specificities.
- However, this category is not expected to exist indefinitely, as our goal is to support these companies towards the 'aligning' and 'aligned' categories through our capital and stewardship.

The below textbox aims to contextualise through a hypothetical investment scenario.

Investment scenario

An Indian telecommunication service provider has significant power consumption. While it has not yet committed to a 1.5-degree pathway, it has transitioned 90% of its rural sites to hybrid-solar power. The company has also committed to reducing its greenhouse gas emissions by 40% by 2030 and reaching net zero by 2060, which is 10 years ahead of India's Nationally Determined Contributions (NDC).

3.2.5 Managed phase-out

Description: Carbon-intensive assets that need to be phased out before the end of their economic lives to converge to an 'aligned' or 'aligning' pathway. Accelerating emissions reduction would require not only renewable technologies, but also the early phase-out of carbon-intensive ones[43]. Given the high carbon intensity of these assets, the phase-out would significantly reduce carbon emissions in the real economy. Additionally, it promotes an orderly transition by reducing the risk of sudden value destruction from stranding assets[44]. GFANZ highlighted the essential role of Managed Phaseout in supporting and accelerating the transition towards a net-zero economy.

Investment scenario

Managed Phaseout can be financed through either equity or debt. While conceptually robust, opportunities are generally less mature as the concept is very new and mainly reliant on alternative vehicles such as project financing or blended finance mechanisms. Prudential is a partner in Vietnam's Just Energy Transition Partnership (JETP), a financing initiative involving public and privates sector financiers. This programme aims to unlock funding to support Vietnam in accelerating its shift towards cleaner energy sources in a just manner.

43 This may involve fossil fuel assets, with an explicit intention of accelerating their decommission or conversion.

44 GFANZ-Managed-Phaseout-of-High-emitting-Assets_June2022.pdf (bbhub.io)

3.3 Level III: Intentionality and measurability

When assessing new investment funds and strategies, the following considerations are crucial:

- **Intentional:** Funds should clearly demonstrate their intentional allocation into 'green' and 'brown-to-green' assets. This can be shown through criteria that explicitly prioritise 'green' and 'brown-to-green' assets, regular and transparent reporting on milestones and/or outcome, and disclosure of engagement outcomes.
- **Measurable:** Despite challenges in quantifying Financing the Transition attributes, funds should have clearly defined data points to measure the baseline and ongoing improvement of the underlying assets while recognizing the current limitations on data. Where possible, quantitative indicators are prioritised over qualitative indicators.

In addition to requiring asset managers to monitor performance on transition criteria, Prudential, as asset owner, will monitor relevant data points of the Financing the Transition investments over time. Additionally, the methodologies and frameworks of asset managers will be regularly assessed to ensure they continue to align to Prudential's framework.

3.4 Next Steps

With this document being our inaugural Financing the Transition framework, we recognize the need for continuously improving the rigour and methodology as market development evolves. Areas we look to further explore may include:

Carbon lock-in

Some may be concerned that the investment into high-emitting entities may delay the shift to low-carbon alternative solutions. While the risk is recognised, we advocate for the imminent transition of existing assets. This needs to happen in tandem with low-carbon solutions becoming commercially viable on a larger scale and with lower risk. Over time, as data quality on carbon lock-in improves, we plan to phase in increasingly rigorous assessments.

Sunset date

Categories such as the 'aligning' and 'transitioning amidst growth' are not meant to be permanent. Our objective is to expedite these assets' decarbonisation or phase-out process. As guidance on setting sunset dates for assets at a regional or industrial level emerges, we will keep abreast of these developments to integrate corresponding expectations.

Scope 3

In assessing emission reduction performance, our focus aims to extend to include Scope 3 emissions when they are material. At this moment, this is not feasible due to lack of reported data, challenges on comparability of reported data, and therefore the current reliance on modelled data. However, the consideration for scope 3 has been incorporated into the due diligence process we apply when choosing the asset managers with which we collaborate. Furthermore, we anticipate enhancing our scrutiny of Scope 3 emissions over time.

4 Conclusion

We believe a just and inclusive transition is essential to transition to a low-carbon world. Countries will face specific challenges and may not decarbonise at the same pace or through the same methods, consistent with the principles of the Paris Agreement.

At Prudential, we focus on supporting an accelerated climate transition through engagement and opportunities for financing the transition, rather than divestment, wherever possible. We have committed to being a net zero asset owner by 2050. By setting intermediate targets and taking concrete action, we are confident we can reach our net zero target and support a just and inclusive transition.

With the Financing the Transition approach presented in this paper, Prudential aims to address two key challenges:

- **Lack of a standardised definition of financing 'brown-to-green'**
- **Needed flexibility for emerging markets in line with the 'common but differentiated responsibilities' principles of the Paris Agreement**

We will continue to evolve our framework as the market evolves to stay aligned with global framework development. We aim to align to market standards and taxonomies as much as possible, as they continue to evolve. As set out in this paper, we take a more inclusive approach if we believe certain challenges remain unaddressed by market standards. This approach allows us to strike a balance between acknowledging local market contexts, aligning with global best practices, while still driving tangible real world progress in the race to net zero. We welcome feedback, comments and engagement on this framework.

5 Appendix

Given Prudential's diverse geographic exposure, the following global and regional resources have been reviewed and referenced to enable interoperability and applicability:

1. ASEAN Taxonomy
2. ASEAN Transition Finance Guidelines
3. Carbon Action Tracker
4. Climate Bonds Initiative Financing Credible Transitions
5. Climate Bonds Initiative Transition Principles and Certifications
6. Climate Bonds Initiative Navigating Corporate Transitions: A tool for financial institutions to assess and categorise corporates by their transition credibility and maturity
7. Climate Change and Principles-based Taxonomy (Malaysia)
8. Climate Transition Finance Handbook (ICMA)
9. EU sustainable finance taxonomy
10. GFANZ Managed Phaseout of High Emitting Assets
11. GFANZ Defining Transition Finance and Considerations for Decarbonisation Methodologies – consultative document

12. Just Transition Criteria – How to align investments with a just transition
13. MDB Just Transition High-Level Principles
14. NZAOA - ASCOR Fair Share methodology (Sovereigns)
15. PSP Green Asset Taxonomy
16. Rocky Mountain Institute Methodology and Metrics
17. SBTi
18. Singapore-Asia Taxonomy for Sustainable Finance
19. Sustainable Finance Disclosure Regulation
20. Sustainable Markets Initiative Asset Manager and Asset Owner Transition Categorisation Framework
21. TPI national pledges scenarios*
22. Transition and the enabling role of taxonomies and frameworks

* While not directly applied due to data limitations, Prudential references the sectoral decarbonisation pathways of the Transition Pathway Initiative.

Prudential plc

Prudential's Financing the Transition framework — A just and inclusive approach with regards to emerging markets (September 2024)

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