European Bank
for Reconstruction and Development

GUIDANCE NOTE

Methodology to determine the Paris Agreement alignment of indirectly financed EBRD investments

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1. Context and overview of the EBRD's Paris alignment methodology for indirect finance

Context

1.1. The Paris Agreement is an international treaty with the goal of "holding the increase in the global average temperature to well below 2°C above pre-industrial levels and pursuing efforts to limit the temperature increase to 1.5°C above pre-industrial levels".

1.2. All of the economies in which the European Bank for Reconstruction and Development (EBRD) invests have endorsed the Paris Agreement.[1] It also has the widespread support of the Bank's shareholders.

1.3. At the 2021 Annual Meeting, the EBRD's Board of Governors committed to aligning all of the Bank's activities with the Paris Agreement by the end of 2022. Paris alignment is an integral part of the Bank's work to support the climate action of the economies in which it operates.[2]

1.4. The Paris alignment of the EBRD's financial flows is anchored in Article 2.1(c) of the Paris Agreement, which commits signatories to make "finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development". Its alignment, therefore, refers to both the mitigation and adaptation goals of the Paris Agreement. In this guidance note, low greenhouse gas (GHG) emissions development, or a "low-carbon economy", means to transition towards energy sources that produce low GHG emissions. It is a precursor to the ultimate goal of achieving a "net zero"-carbon economy by around mid-century.[3]

1.5. In June 2021, the EBRD published its methodology to determine whether projects the Bank might finance directly were "aligned" or "non-aligned" with the goals of the Paris Agreement. The scope of that methodology was the EBRD's direct-finance investments, or projects involving the specific use of proceeds (see Annex 1).[4]

1.6. The June 2021 publication noted that an alignment approach for other types of Bank finance would be forthcoming in early 2022. This is to ensure that the EBRD's Paris alignment approach covers all financial instruments and financing types the Bank may use.[5]

1.7. The Bank's Paris alignment methodology will be reviewed at least annually and updated as required. These updates will reflect, among other things, lessons learned by using the methodology for different types of project, the experience of other institutions (including other multilateral development banks, or MDBs) with regard to Paris alignment and the development of external tools and reference works (many of which have been incorporated into this methodology).

[1] Despite formally endorsing the goals of the Paris Agreement, Kosovo is unable to be a signatory to the Paris Agreement due to its status at the United Nations. All other economies in which the EBRD invests have signed and ratified the agreement.

[2] See EBRD (2020; 2021a). In July 2020, the EBRD set out its Green Economy Transition (GET) approach for 2021 to 2025 and committed to "aligning its activities with the principles of international climate agreements, including principally the Paris Agreement".

[3] The Paris Agreement aims to strengthen the global response to the threat of climate change in the context of sustainable development and efforts to eradicate poverty. All of the EBRD's activities seek to make economies more competitive, well-governed, green, inclusive, resilient and integrated. These six transition qualities are aligned with the 2030 Agenda for Sustainable Development, which was adopted by all United Nations member countries in 2015, and its accompanying Sustainable Development Goals (SDGs).

[4] See EBRD (2021b). The methodology was opened to public consultation to encourage public feedback on the Bank's approach. EBRD (2021b) provides an overview of the public consultation responses received.

[5] In mid-2022, the Bank will publish a consolidated Paris alignment approach covering all financing types used by the Bank. This will be based on the direct and indirect finance methodologies for Paris alignment that underwent public consultation.

1.8. The methodology intersects with a number of Bank processes that are related to, but distinct from, Paris alignment. These include the EBRD's assessment and attribution of green financing, Environmental and Social Policy requirements (EBRD, 2019), transition impact and climate-related financial risk appraisal (see Annex 2 for further detail).

Purpose and scope

1.9. This note sets out the EBRD's methodology for determining the Paris alignment of its indirectly financed investments. Specifically, it refers to EBRD finance extended to financial intermediaries that finance a set of sub-transactions to end beneficiaries (through sub-projects or sub-investments). The methodology will be used to determine whether such projects financed indirectly by the Bank are "aligned" or "non-aligned" with the mitigation and adaptation goals of the Paris Agreement.[6]

1.10. The EBRD's engagement with its partner financial intermediaries (PFIs) presents a unique opportunity to facilitate the low GHG emissions and climate-resilient development required to deliver on the goals of the Paris Agreement. PFIs lend to the whole economy, so engage with the full spectrum of economic actors in the countries where they invest. These actors then invest in activities that could generate climate-related risks (through associated GHG emissions and/or exposure to physical climate impacts), but also climate-related opportunities. A PFI's portfolio captures the aggregate climate impact of all its sub-transactions. Consequently, by capitalising on its interactions with PFIs to promote their Paris alignment, the EBRD can impact financial flows that are many times larger than its own lending volumes.

1.11. The long-term outcome of implementing this methodology is to ensure that all of the EBRD's PFIs, in all of the economies in which it operates, align their financial flows to deliver on the goals of the Paris Agreement. By applying its methodology, the EBRD will ensure that PFI lending, in time, reorients PFI portfolios towards Paris-aligned activities and curtails the financing of non-aligned activities, thus transforming the financial sector and, in turn, accelerating the low-carbon and climate-resilient transformation of the real economy. Overall, the methodology supports the impact the EBRD seeks in the financial sector, namely, one that is resilient to shocks and provides the financing needed to deliver climate action.

1.12. At present, the majority of PFIs in the EBRD regions are not subject to climate-related regulatory signals and see limited climate finance demand from borrowers, who often lack incentives or knowledge to access related opportunities. Therefore, the EBRD will support its PFIs in integrating climate considerations into their operations, including through the development of institutional transition plans. These plans will, among other things, set a route for the transformation of their lending portfolios, establish underlying business practices to deliver on their ambitions and work towards public disclosure. The Bank will rely on the insights and advice from leading climate-related financial-sector initiatives to understand how to bring about the change it seeks. As market and regulatory experience develops, the EBRD will step up its ambition and its expectations from PFIs. By supporting PFIs in building institutional practices, the Bank will reduce the risk that EBRD projects with PFIs will support activities that are non-aligned with the goals of the Paris Agreement.

1.13. From 1 January 2023, all EBRD transactions signed with PFIs will require a determination of Paris alignment using this methodology. The methodology for indirect finance will apply to new EBRD investments only.

[6] See EBRD (2021c). This includes debt, trade finance, bank equity, private equity and other instruments. A specific product methodology will be developed for private equity (namely, investment funds), drawing on the core methodology set out in this note. A specific methodology will be developed, too, for corporate equity (equity stakes in companies), which contains aspects of both direct and indirect finance, which will also draw on both the direct and indirect finance methodologies.

1.14. While not covered in detail here, the methodology is complemented by the EBRD's work with leading initiatives and organisations on financial-sector policy, regulation and best practice for climate action. This includes, among other things, the Bank's active engagement with the European Union (EU) and the Network for Greening the Financial System (NGFS). The methodology will also inform the Bank's policy engagement with financial regulators and central banks in the economies where it operates, which will also form a crucial part of the work underpinning the methodology.

1.15. The EBRD's internal governance ensures that compliance with the Bank's Paris alignment methodology is verified in a robust way. While teams from the EBRD's Client Services Group are responsible for its implementation (the Financial Institutions and Green Economy and Climate Action Departments), its application is independently verified by the Bank's "second line of defence" under the purview of the Chief Risk Officer.

Methodology overview

1.16. The EBRD's approach to determining the alignment of its projects with the Paris Agreement is grounded in the joint MDB alignment framework.[7] This high-level framework guides MDBs in elaborating their Paris alignment methodologies, giving them the flexibility to reflect their mandates and business models. It also recognises that, for MDBs, Paris alignment covers a full range of activities at investment, policy and corporate level.[8]

1.17. At the United Nations Conference on Climate Change (COP26) in November 2021, the MDBs presented the joint MDB principles for Paris alignment of intermediated finance.[9] The principles recognise the opportunity for MDBs to partner with financial intermediaries to deliver on the goals of the Paris Agreement, but also some of the challenges inherent in doing so. The MDB principles acknowledge that:

a. the MDB financial flow ("transaction based") *and* the broader activities of PFIs ("counterparty based") can be used as the basis for determining alignment

b. the counterparty-based alignment of a PFI's corporate activities should be based on the development of a "credible alignment pathway" at institutional level, recognising that PFIs may need support to reach the end goal of Paris-aligned corporate practices

c. MDBs will work together to pool their leverage and coordinate engagement with clients

d. there is a need to work together to improve climate-related financial regulation and practices through international initiatives and targeted policy work at regional and national level.

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[7] See EBRD (2018a).

[8] The joint MDB approach to alignment with the objectives of the Paris Agreement was presented at the United Nations Climate Change Conference (COP24) in 2018 (EBRD, 2018a). The approach has six "building blocks" for Paris alignment: (BB1) alignment with mitigation goals; (BB2) adaptation and climate-resilient operations; (BB3) accelerated contribution to the transition through climate finance (in the EBRD's case, GET finance); (BB4) strategy, engagement and policy development; (BB5) reporting; and (BB6) alignment of internal activities (for example, administration, procurement and treasury). Therefore, Paris alignment has a project-screening element ("BB1" and "BB2"), a climate finance and policy element ("BB3" and "BB4") and a corporate element ("BB5" and "BB6"). Complementing the MDB approach for climate change, MDBs are also working together on enhancing the way that broader environmental considerations are built into decision-making (see MDBs (2021a), for example, for the *MDB Joint Nature Statement*).

[9] See MDBs (2021b). The MDBs are the African Development Bank, the Asian Development Bank, the Asian Infrastructure Investment Bank, the EBRD, the European Investment Bank, the Inter-American Development Bank Group, the Islamic Development Bank, the New Development Bank, and the World Bank Group (International Finance Corporation, the Multilateral Investment Guarantee Agency and the World Bank).

1.18. Informed by the joint MDB principles, the EBRD's approach to determining Paris alignment for indirectly financed projects comprises four pillars.[10]

Pillar 1: Counterparty commitment to the Paris Agreement. All EBRD PFIs must be committed to working towards Paris alignment in their own institutions.

Pillar 2: Sub-transactions filter. The vast majority of EBRD financial instruments with PFIs can be structured in such a way as to provide confidence in the Paris alignment of sub-transactions financed by EBRD proceeds. In a minority of cases, where a sub-transactional approach is not possible (for example, equity or general-purpose liquidity), pillars 3 and 4 will be prioritised and form the basis of alignment determination.

Pillar 3: Counterparty assessment to understand baseline practices. PFIs will be assessed on their current approach to climate action relative to leading market and regulatory practices.

Pillar 4: Paris transition plan. PFIs will be required to make progress on alignment with advanced climate-related business practices to ensure they are credibly supporting the goals of the Paris Agreement. Progress will be assessed against time-bound milestones.

1.19. Three of these pillars (1, 3 and 4) target the transformation of the Bank's PFI counterparties at institutional level, ensuring the progressive alignment of their entire activities with the goals of the Paris Agreement. Pillar 2 targets sub-transactions financed indirectly by the EBRD and serves as a prioritisation filter for pillars 3 and 4. Where sub-transactions are aligned, the focus on institutional transformation will be phased in; where sub-transaction alignment is less clear or not possible, the focus on institutional transformation will be introduced immediately.

1.20. From 1 January 2023, all EBRD project signings involving financial intermediaries will be required to make a commitment to the Paris Agreement (pillar 1) and be subject either to requirements related to sub-transactions linked to EBRD financing (pillar 2) or to an assessment leading to a Paris transition plan (pillars 3 and 4) as the basis for a Paris alignment determination.[11] The phased requirements for pillars 3 and 4 will be implemented gradually, in tandem with EBRD transactions. The Bank expects the vast majority of its PFIs to be addressed under pillars 3 and 4, in parallel with new transactions, within four years. This phasing is illustrated in Figure 1.

1.21. The phasing of pillars 3 and 4 gives the Bank time to adjust its approach as it scales up. It will facilitate client understanding after initial engagement with a smaller number of PFIs. As more and more EBRD investments are phased in over time, the Bank's expectations of its PFIs will take into account ongoing external developments in policy and regulation to (a) support financial intermediaries in increasing finance to achieve the mitigation and adaptation goals of the Paris Agreement; (b) develop effective risk management systems to account for transition and physical climate risks; and (c) publicly disclose climate-related financial information.

1.22. Each PFI will require a bespoke approach. This is particularly the case for pillar 4 – setting a Paris transition plan – which will be designed to reflect the PFI's specific circumstances. EBRD expectations of a PFI at any given time will depend on a variety of factors, such as: regulatory expectations in a given location, the size and complexity of the PFI, its current corporate practices on climate, the EBRD's influence (which may, for example, be higher in PFIs in which the Bank holds equity) and the availability of support from the EBRD and other actors, including other MDBs. In addition, because of the wide variations among PFIs, a proportionate approach is required, which prioritises engagement in areas with the greatest impact. In all cases, however, the transition plan adopted by the PFI in question will include credible milestones to

[10] The remainder of this guidance note focuses on its application to financial intermediaries. There are other indirectly financed investment types (such as the financing of corporate equity), for which a specific product methodology will be developed.

[11] EBRD (forthcoming). The EBRD's draft Financial Sector Strategy 2021-25 makes clear the ambition to evolve from a "use of proceeds" model to a comprehensive institutional capacity-building model to scale up green financing, reduce climate risks and accelerate the low-carbon transition.

reassure the EBRD that it is on a trajectory that will ensure its financial flows become consistent with the Paris goals in a timeframe that aligns with those goals.

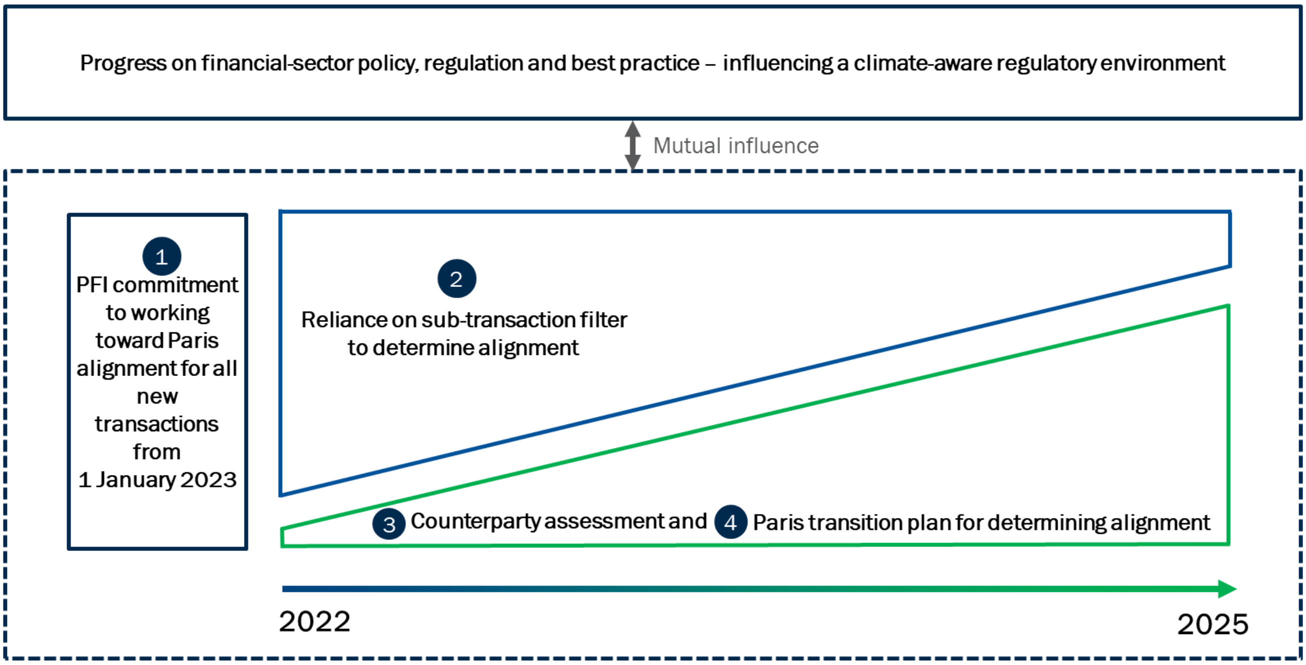
1.23. The EBRD's methodology, particularly for implementing pillars 3 and 4, draws from the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD). The TCFD framework – focused on recommended disclosures in four thematic areas: governance, strategy, metrics and targets, and risk management – is an effective tool for managing, assessing and disclosing PFI progress on Paris alignment. The framework also allows the Bank to employ a degree of consistency and objectivity in working with its PFIs in the context of rapidly evolving regulatory and market practices. In their bespoke transition plans, PFIs will work to implement business practices consistent with TCFD recommendations. The EBRD will pay particular attention to the areas of (i) metrics and targets and (ii) strategy to make sure that PFIs are setting ever more specific and time-bound institutional targets consistent with the goals of the Paris Agreement and have a clear route to implementing them.[12]

1.24. It is important to distinguish between the alignment of the EBRD's activities and the Bank's ambition to promote the accelerated transformation of its PFIs. EBRD Paris alignment for indirect finance will be ensured by applying all four pillars over time. The speed at which PFIs progress their transition plans and align themselves with the Paris Agreement, and the ambition with which the EBRD promotes this transformation, will depend on a number of factors, including those set out in paragraph 1.22.

1.25. The four pillars apply to all EBRD transactions with financial intermediaries, regardless of their size or location. Taken together, they aim to facilitate systemic change in the PFIs with which the EBRD works. This approach builds on the EBRD's existing climate financing to PFIs, which focuses on providing funds earmarked for climate finance to sub-transactions.

1.26. The remainder of this note describes the methodology in further detail. Context and other relevant information can be found in the annexes.

Figure 1: Illustration of the methodological application to EBRD PFIs, 2022-25



[12] Regulatory and market practices linked to climate change are evolving, so the frontier of what constitutes best practice will also evolve. In this respect, the Paris alignment of PFIs is not about achieving static end goals but a "voyage of discovery", with the EBRD's expectations of its PFIs changing over time. The EBRD will review new industry standards as they become available and incorporate them into its Paris alignment methodological framework.

2. Methodology for determining the Paris alignment of the EBRD's indirectly financed investments

Considerations in determining the alignment of indirect finance

2.1. The nature of intermediated financing requires a dual focus to determine alignment – on any eventual sub-transaction linked to EBRD finance as well as the wider activities of a PFI. This is because:

a. While most financial instruments used by the EBRD have defined sub-transaction types, a PFI will undertake other financing activities not linked to EBRD financing.

b. Where the financial instrument used by the EBRD is not linked to individual sub-transactions, the financial flow is linked to the PFI's general asset pool, comprising sub-transactions from any financing activities of the PFI.

2.2. The focus on "what" and "who" are being financed mirrors emerging regulatory approaches and climate-related initiatives for financial intermediaries.[13] While there is no single, consistent global standard for the Paris alignment of financial intermediaries, the TCFD is emerging as a leading framework at institutional level. As of October 2021, it had been adopted by more than 2,600 financial and non-financial companies in around 90 countries. Established by the Financial Stability Board in 2015 with the goal of developing consistent climate-related disclosure standards for the private sector, emerging financial-sector regulation is increasingly allied to the TCFD framework.[14]

2.3. PFIs in the EBRD regions face an evolving regulatory landscape when it comes to requirements on climate change. In general, climate-related financial regulation is either not present or at a nascent stage. The exception is in the EU, where regulatory signals are emerging. There are growing expectations and requirements for large financial intermediaries to disclose their climate-related risks (for example, linked to the European Central Bank's guide to climate-related and environmental risks) and to steer finance to climate-related opportunities (for example, aided by the EU taxonomy for sustainable activities and the definition of a European green bond standard).[15]

2.4. Regulators appreciate that a lack of standardisation and tools may hinder the process for PFIs to build adequate internal capacity to assess, manage and disclose climate-related risks and opportunities. The NGFS has emerged as a leading voluntary initiative of central banks and financial regulators to support the development of regulatory approaches worldwide and exchange implementation experience. It aims to enhance the role of the financial system in

[13] PCAF (2021) provides a non-exhaustive mapping of initiatives, methodologies and tools for the financial sector (both banks and investors) linked to climate change. Such initiatives span a range of areas, from high-level commitments (Net Zero Banking Alliance, Climate Action in Financial Institutions) and the measurement of GHG emissions (Partnership for Carbon Accounting Financials) to target setting (Science-Based Targets initiative), scenario analysis and strategy development (Transition Pathway Initiative), investor action (Climate Action 100+) and the disclosure of climate-related information (Carbon Disclosure Project).

[14] See TCFD (2021a). In the EU, the Corporate Sustainability Reporting Directive (CSRD) and the Sustainable Finance Disclosure Regulation (SFDR) are broadly consistent with TCFD recommendations, though they are broader than climate change in scope, incorporating other aspects of sustainability.

[15] See European Commission (2020; 2021). Various regulatory requirements relevant to financial intermediaries have been proposed at EU level. The ECB, for example, will undertake a climate risk stress test, as set out in ECB (2021).

managing risks, to mobilise sustainable finance and to provide insights relevant to determining the alignment of financial intermediaries.[16]

2.5. PFIs in the EBRD regions will typically require support to integrate climate considerations into their operations and to align their corporate practices with the Paris Agreement. This need for support – and the importance of regulatory signals to act – was confirmed by an EBRD survey of PFIs across the regions in which the Bank operates. The poll sought to understand PFIs' progress on incorporating climate risk approaches into their operations, to determine the obstacles they faced in doing so and how to overcome these in the evolving regulatory environment.[17]

2.6. The considerations set out above imply that, in developing an EBRD approach for the Paris alignment of intermediated financing:

a. EBRD financial flows *and* the broader activities of PFIs should be used as the basis for determining alignment.
b. Any approach to alignment used by the EBRD should build on and be guided by external market frameworks and best practices linked to Paris alignment.
c. As PFIs need support and time to reach the end goal of Paris-aligned corporate practices, the EBRD should provide this support where needed and increase its expectations of its PFIs over time.
d. To complement engagement with PFIs, parallel work is required to improve climate-related financial regulation and practices to support and accelerate action at PFI level.

Assessment approach

2.7. The EBRD's approach to determining the Paris alignment of indirectly financed projects comprises four pillars:

Pillar 1: Counterparty commitment to the Paris Agreement. All EBRD PFIs must be committed to working towards Paris alignment in their own institutions.

Pillar 2: **Sub-transactions filter.** The vast majority of EBRD financial instruments with PFIs can be structured in such a way as to provide confidence in the Paris alignment of sub-transactions financed by the proceeds of EBRD financing. In a minority of cases, where a sub-transactional approach is not possible (for example, equity or general-purpose liquidity), pillars 3 and 4 will be prioritised to form the basis of alignment determination.

Pillar 3: Counterparty assessment to understand baseline practices. PFIs will be assessed on their current approach to climate action relative to leading market and regulatory practices.

Pillar 4: Paris transition plan. PFIs will be required to make progress on alignment with advanced climate-related business practices to ensure they are credibly supporting the goals of the Paris Agreement. Progress will be assessed against time-bound milestones.

2.8. Initially, determining the alignment of most transactions will rely on pillar 2, which focuses on the use of EBRD proceeds. From the outset, some transactions, notably those for which there is no defined use of proceeds, will rely on pillars 3 and 4. However, over time, as markets and regulation continue to shift to low GHG emissions and a climate-resilient development model,

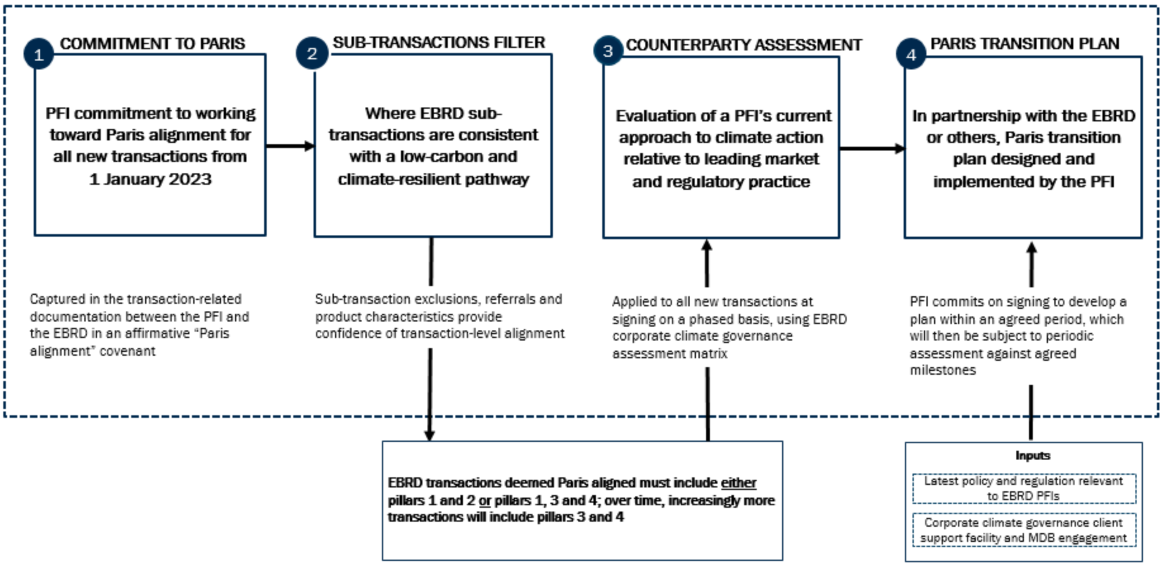
[16] PFI alignment is also a function of the general stringency of climate policy, not just that related to the financial sector. Most financial intermediaries are exposed to the economic activities of the countries in which they operate, with demand for financing from firms and individuals that make financial decisions depending on policy signals to support climate action. These differ from country to country. Enhanced policy signals on climate change, therefore, will shift demand for PFI financing towards Paris aligned activities.

[17] EBRD (2021d). ECB (2020) also shows that ECB-supervised Banks need to make significant efforts to improve their disclosure of relevant climate-related financial information.

more and more transactions will rely on pillars 3 and 4, thus unlocking the systemic impact of this approach, delivering on climate ambition and ensuring alignment (see Figure 1).

2.9. The EBRD's Paris alignment methodology for indirectly financed EBRD investments is illustrated in Figure 2. Each of the four pillars is explained in detail below.

Figure 2: Methodology to determine the Paris alignment of indirectly financed EBRD investments



Note: Exact phasing of pillars 3 and 4 is subject to the availability of technical cooperation funding and staffing resources.

Pillar 1: Counterparty commitment to the Paris Agreement

2.10. All of the PFIs with which the EBRD works will be required to commit to supporting the goals of the Paris Agreement. In most cases, this commitment will be in the form of an affirmative covenant in transaction-related or other formal documentation that sets out the basis of engagement between the EBRD and the PFI. The PFI may also express such commitment in other forms (for example, its annual report, business strategy or on a corporate webpage).[18]

2.11. In making this commitment, the EBRD acknowledges that PFIs may not, at present, be subject to any regulatory requirements on climate or be implementing business practices in line with leading market conduct. However, it is a commitment, in the context of the EBRD methodological application, to move towards business practices that are consistent with the goals of the Paris Agreement and to work with the EBRD, partner MDBs, a development institution or an impact investor to implement that commitment.

2.12. When it comes to PFI commitment and subsequent engagement, the counterparty must be defined. This is not always straightforward, as many PFIs with which the EBRD works are subsidiaries of a larger parent financial intermediary. Where this distinction is a relevant consideration, the EBRD will focus, in applying its methodology, on the subsidiary level with which the EBRD has a financial relationship. However, it will in some instances need to coordinate with the parent company, particularly if engagement on climate-related issues is coordinated at that level.

[18] In most cases, this will be included in the legal documentation between the EBRD and the PFI. However, for some financing types (such as capital market transactions), where such a form of commitment is not possible, equivalent approaches will be used to ensure a clear shared commitment to the long-term goal of Paris-aligned financial flows.

Pillar 2: Sub-transaction filter

2.13. The EBRD uses a variety of financial instruments with PFIs. These fall into two categories:

a. Those where the eventual nature of sub-transactions is known, even if the specific sub-transaction cannot be defined. These can include, for example, credit lines earmarked for loans to SMEs, Green Economy Financing Facilities (GEFFs) focused on financing investments with environmental benefits, or short-term financing to a PFI under the EBRD's Trade Facilitation Programme.

b. Those where the eventual nature of sub-transactions is not known. In such cases, the EBRD may be providing financing that is general in nature and which can be used for any purpose, for example, equity investments (new or a capital increase) or general-purpose liquidity.

2.14. All EBRD intermediated financing, regardless of financial instrument, is subject to relevant Bank policies on fossil-fuel exclusion. The EBRD will not knowingly finance, directly or indirectly through financial intermediaries, projects where EBRD proceeds are used for activities relating to thermal coal mining, coal-fired electricity generation or upstream oil and gas.[19]

2.15. The exclusions remove the types of PFI sub-transaction with the highest risk of non-alignment with the mitigation goal of the Paris Agreement. In addition, (i) the absolute monetary size of individual sub-transactions with PFIs is typically small, so portfolios are granular and diversified, (ii) sub-transactions permitted under policy statements between the EBRD and its PFIs would typically be determined Paris aligned under the EBRD's Paris alignment methodology for directly financed investments.[20] Furthermore, the eventual implementation of pillars 3 and 4 will strengthen the PFI's climate-related institutional practices and support the achievement of the mitigation goals of the Paris Agreement.

2.16. An assessment of sub-transactions with respect to the Paris Agreement's adaptation goals requires detailed locational and sectoral information that is typically not available at the time of EBRD financing, in keeping with the delegation principle for the financing of financial intermediaries. Therefore, ensuring alignment depends primarily on the PFI's operational processes with regard to adaptation, climate resilience and physical climate risk management. Consequently, where a PFI could be exposed to material physical climate risks in their operations, they will be prioritised for a full counterparty assessment by the time of signing (pillar 3) and a Paris transition plan (pillar 4).[21]

2.17. Where the eventual nature of sub-transactions is not known, a PFI is at greater risk of financing non-aligned projects using EBRD finance. This is particularly the case in jurisdictions not subject to regulatory requirements on climate and/or where the PFI is not assessing the transitional and physical climate risks of sub-transactions. Accordingly, from 1 January 2023, all PFI signings involving financial instruments with unknown sub-transactions will require a counterparty assessment by the time of signing and a commitment to developing a Paris transition plan within an agreed timeframe (which, subject to assessment of the PFI and its operating environment, the EBRD will typically expect within two years).

[19] See EBRD (2019). In addition, the EBRD Environmental and Social Policy (ESP) sets out expectations for all projects with financial intermediaries under Performance Requirement 9 (EBRD, 2019). This includes organisational capacity requirements to manage environmental and social risk, stakeholder engagement and reporting to the EBRD. It also includes a list of sub-transaction types that would require escalation to the EBRD, some of which are associated with climate change considerations. The EBRD ensures compliance with the ESP as part of the due diligence undertaken as part of its investment appraisal and post-signing through its annual monitoring process with each PFI.

[20] See EBRD (2021a).

[21] This PFI prioritisation will be based on information collected as part of the EBRD's own process for climate risk management in its investments. It will be based on available information relevant to the PFI (such as a PFI portfolio and associated country- and sector-specific physical climate risk profile).

Pillar 3: Counterparty assessment to understand baseline practices

2.18. To progress from considerations of EBRD financial flows to an assessment of the counterparty more broadly, the Bank needs to understand the business practices of the counterparty in relation to climate change. Here, the question is whether the counterparty is aligning with the goals of the Paris Agreement. To answer this question, the EBRD needs a reference point.

2.19. While there is no objective Paris alignment standard for financial intermediaries, practice is evolving to guide the financial sector in understanding its role in supporting the achievement of Paris Agreement goals. The framework of the TCFD and its underlying recommendations provide a useful starting point for assessing the current practices of EBRD PFIs.[22] The TCFD is focused on the climate-related financial disclosures recommended for inclusion in public financial filings. The framework, through its detailed sub-recommendations, suggests how PFIs can effectively incorporate climate change considerations into their operations. In this respect, it is relevant for all PFIs, regardless of whether their fiduciary duties mandate public disclosure of financial information.

2.20. Using a dedicated “corporate climate governance matrix” developed for financial intermediaries and grounded in the detailed recommendations of the TCFD and other leading market initiatives, the EBRD will assess PFIs on their institutional readiness for Paris alignment. The baseline assessment will ask a series of questions structured around the thematic areas of the TCFD, designed to reflect the way that organisations operate. They are:

a. **governance** – the organisation’s governance of climate-related risks and opportunities, including the role of the PFI’s board and management in determining and managing climate issues

b. **strategy** – the actual and potential impacts of climate-related risks and opportunities on the organisation’s business, strategy and financial planning

c. **risk management** – the processes used by the organisation to identify, assess and manage material climate-related risks

d. **metrics and targets** – the metrics and targets used to assess and manage relevant climate-related risks and opportunities, including those that can be used to support the long-term goals of the Paris Agreement.[23]

2.21. The EBRD’s assessment matrix is structured around a series of questions on each of the four TCFD areas. The questions are binary (“yes” or “no”) and the assessment is to be completed in collaboration with the PFI as part of the Bank’s wider due diligence process. Depending on the assessment, for each TCFD core element and for the PFI overall, one of the following “transition stages” will be assigned:

- **Early stage.** The PFI has incorporated climate change into its operations in a limited way or not at all and does not publicly disclose climate-related information.
- **Developing practice.** The PFI is undertaking some practices that incorporate climate change considerations into its operations, but some significant gaps remain.
- **Advanced practice.** The PFI has fully incorporated climate change considerations into its operations and implemented public disclosure where appropriate. While some gaps may remain, these are not significant.

2.22. The purpose of the assessment is to determine a PFI’s stage of development on climate-related matters and to identify support needs and priority actions for improvement. The assessment is based on the extent to which the PFI has implemented the recommendations of the TCFD and,

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[22] See TCFD (2021b). This framework has undergone extensive consultation, is widely used, offers guidance specific to the financial sector and can flexibly incorporate differing regulatory requirements and emerging best practices from other climate-related initiatives. The EBRD will also review other relevant evidence (such as emerging industry standards or regulatory requirements) in the assessment of its PFIs under pillar 3.

[23] In this context, all PFIs will work towards providing the EBRD with a portfolio sector breakdown in line with industry reporting standards (consistent, for example, with recognised approaches such as the Global Industrial Classification Standards (GICS) or Nomenclature of Economic Activities (NACE)).

in implementing these recommendations, can be shown to be credibly supporting the goals of the Paris Agreement. The assessment and the metrics used to assess PFIs will not be static and will evolve to reflect market-leading and regulatory experience as it emerges. It will also be adapted to reflect the EBRD's early implementation experience.

Pillar 4: Paris transition plan

2.23. Two actions can result from the counterparty assessment undertaken in pillar 3:

a. The PFI is determined to be at an "advanced practice" stage, in which case, the EBRD will not request any further action from it. The EBRD considers a PFI that has implemented such business practices to be consistent with its commitment to the Paris Agreement made in pillar 1. The PFI, through its financing, is thus in a position to effectively support the climate action required by the Paris Agreement.[24]

b. The PFI is determined to be "early stage" or "developing practice", in which case a "Paris transition plan" will be agreed by the EBRD and the PFI in question. This transition plan will be prepared within an agreed period of project signing. The plan will set out how the PFI will improve its business practices in relation to climate change, leading to Paris-aligned financial flows. The focus will be on identifying practical and implementable short- and medium-term steps, in open dialogue with the PFI, to improve existing practice. These steps will be set out as clear, time-bound milestones for the PFI, with accompanying reporting to the EBRD as part of standard EBRD PFI project monitoring.

2.24. Progress on the transition plan will be monitored on at least a bi-annual basis and will compare current practices, the PFI's baseline and the milestones set out in the transition plan. The PFI's practices are expected to improve over time. The outcome of these reassessments will result in one of three outcomes:

a. a determination of continued alignment with the EBRD Paris alignment methodology (in other words, progress milestones are being met and the PFI is aligning practices with the goals of the Paris Agreement)

b. a revised set of actions to further improve practices (a revised transition plan)

c. a determination of non-alignment (progress milestones are not being met in a satisfactory way and a PFI does not demonstrate the commitment or willingness to work with the EBRD to achieve them). In such an eventuality, the Bank will explore potential steps up to and including disengagement with the PFI.

2.25. When developing the transition plan, requirements must be tailored to the context. In general, PFIs will work towards business practices consistent with TCFD recommendations. The EBRD will pay particular attention to the "metrics and targets" and "strategy" thematic areas, ensuring PFIs are establishing ever more specific and time-bound institutional targets consistent with the goals of the Paris Agreement and have a clear route to implementing them.[25]

2.26. While the actions required of PFIs will vary, the outline of what constitutes a credible transition plan are beginning to emerge. The precise requirements of transition plans over time will be developed based on the latest TCFD guidance (see Box 1), other emerging industry standards, market experience, the regulatory context and any requirements of the PFI in question. It will also be informed by the PFI's readiness and ambition. Thus, the milestones agreed by the EBRD

[24] In some cases, demonstrable performance against regulatory standards that facilitate "advanced practice" will mean no action is required by a PFI.

[25] For example, TCFD (2021c) sets out detailed guidance on how to implement the metrics and targets area of the TCFD framework and how this can be incorporated into an overall "transition plan". This reflects early experience of TCFD framework implementation and emerging best practices. For example, it highlights the importance of using recognised and transparent methodologies and setting specific dates by which targets must be reached. Work by the United Nations Environment Programme Finance Initiative (UNEP FI, 2021) and the Science Based Targets initiative (SBTi, 2021) also set out advice on how the financial sector can set targets to support robust climate action by FIs.

and the PFI will be specific to that PFI; all intermediaries will not be expected to advance at the same pace.[26]

2.27. In some instances, the PFI will require dedicated support to develop and implement the milestones in its transition plan. The EBRD will be able to provide support through its Corporate Climate Governance Client Advisory Facility, which supports EBRD clients in improving their practices in the areas of governance, strategy, risk management, metrics and targets. The EBRD will structure any support in consultation with other MDBs and development finance institutions and seek to pool its leverage with clients and provide mutual recognition of client engagement to support Paris alignment.[27]

[26] Emerging industry standards and their implications for the design of transition plans will be reviewed at least annually in the context of the methodology's normal review cycle. The Glasgow Financial Alliance for Net Zero recently produced a reference work that gives guidance on the design of transition plans (GFANZ, 2021). It says that the principles of credible net zero transition plans for the financial sector are (i) supporting the real economy; (ii) setting emission reduction targets; (iii) taking tangible steps to deliver on targets; and (iv) committing to regular disclosure. The study is based on a stocktake of 12 leading financial-sector climate initiatives, including the TCFD.

[27] If a PFI cooperates with another MDB, development finance institution or impact investor and has agreed a similar transition plan, this will be evaluated. In the absence of material shortcomings in the plan or substantial delays in its implementation, the EBRD will regard such a plan as fulfilling its requirements on Paris alignment.

Box 1. Transition plan – key elements

TCFD (2021c) sets out guidance on the potential elements of an organisation's transition plan. While illustrative and designed to apply to all types of organisation, the high-level guidance set out in Table E1 of the document (page 42), mapped to the core elements of the TCFD, is a core reference point in EBRD engagement with PFIs on their tailored plans. Elements of Table E1 are set out here:

Governance

Approval: The board or appropriate committee of the board approves the transition plan and climate-related targets.
Oversight: The board or appropriate committee of the board oversees execution of the transition plan.
Accountability: Senior management is responsible for the execution of the transition plan and the responsible parties have adequate authority and access to resources to ensure effective execution.
Incentives: Remuneration and other incentives are aligned with the organisation's climate goals, as described in the transition plan.
Reporting: The board or appropriate committee of the board and senior management receive regular status reports.
Review: The organisation periodically reviews and updates its plans, activities, metrics and targets.
Transparency: The organisation reports on its transition planning goals and performance to external stakeholders, including financial aspects, performance against targets and impacts on the organisation's business.
Assurance: The organisation's reporting is subject to independent review or third-party assurance.

Strategy

Alignment with strategy: The organisation aligns its transition plan with its overall strategy, and the transition plan describes the following:

- activities – how the organisation will achieve targets in defined time horizons
- temperature goal – alignment with a global temperature goal (such as 1.5°C), relevant regulatory mandates and/or sectoral decarbonisation strategies.

Plan assumptions: The transition plan describes the organisation's assumptions, particularly in relation to transition pathway uncertainties and implementation challenges. The assumptions should be consistent with those used by the organisation in its financial accounts, capital expenditures and investment decisions.
Prioritised opportunities: The transition plan describes how the organisation intends to maximise its prioritised climate opportunities as the world transitions to a low-carbon economy.
Action plans: The transition plan outlines short-term and medium-term tactical and operational plans and describes how related actions address material sources of GHG emissions. The plan includes current and planned initiatives to reduce climate-related risks and increase climate-related opportunities.
Financial plans: The transition plan describes the supporting financial plans, budgets and related financial targets (for example, the amount of capital and other expenditures supporting decarbonisation strategy).
Scenario analysis: The organisation tests the achievability of the transition plan and associated targets using multiple climate-related scenarios.

Risk management

Description of risks: The transition plan describes the risks the organisation faces from a transition to a low-carbon economy.
Plan challenges and uncertainties: The transition plan describes the assumptions, uncertainties and challenges the organisation faces in successfully executing its transition plan.

Metrics and targets

Metrics: The transition plan describes metrics the organisation will monitor to track progress against plans and targets, including related operational and financial performance metrics, metrics aligned with the cross-industry, climate-related metric categories and industry- or organisation-specific metrics.
Targets: The transition plan includes quantitative and qualitative targets based on sound climate science. For GHG emissions targets, the plan indicates the type and scope of GHG emissions included, as well as the extent of GHG emissions across territories, timeframes or activities.*
Methodology: Metrics and targets in a transition plan are based on widely recognised and transparent methodologies.
Dates: The transition plan specifies the dates when targets are intended to be reached and includes targets during the plan's time horizon (for example, a timetable for the plan's roadmap).
GHG emissions reductions: The transition plan addresses the relative contribution of reductions, removals and offsets.

*Organisations may find it useful to disclose medium or long-term targets for 2030 and 2050, which have become key target dates following the publication of IPCC (2018).

Source: TCFD (2021c).

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Annex 1. Overview of the methodology to determine the Paris Agreement alignment of directly financed EBRD investments

A1.1. The scope of the EBRD guidance note, *Methodology to determine the Paris Agreement alignment of directly financed EBRD investments*, is directly financed EBRD investments for specific capital expenditure.[28] Figure A1 summarises the EBRD's Paris alignment methodology for directly financed EBRD investments.

A1.2. The Bank's approach to Paris alignment for climate change mitigation entails demonstrating that each project meets the following two conditions:

a. consistency with long-term low-carbon development, to give assurance that it is part of a transition to a future consistent with the Paris Agreement mitigation goals

b. a low likelihood of carbon lock-in, to give assurance that the project does not enable an emissions-intensive asset to continue operating when economically preferable, lower-carbon options could replace it.

A1.3. The Bank's approach to Paris alignment for climate change adaptation entails demonstrating that each project meets the following two conditions:

a. that physical climate risks have been identified and addressed

b. that its activities do not undermine climate resilience in the context in which the project operates.

A1.4. A project must meet each of these four conditions to be deemed Paris aligned. For some projects, this will be straightforward (for example, projects with a limited carbon footprint), while for others (particularly those that entail significant GHG emissions or are exposed to material physical climate risks), this will require detailed analysis, drawing on complementary analytical tools and evidence. This approach recognises that projects have different levels of non-alignment risk with the goals of the Paris Agreement.

A1.5. For alignment with the mitigation goals of the Paris Agreement, the Bank will use a two-step filtering process that takes into account the degree of uncertainty surrounding the alignment of a specific project.

a. The first filter is a general screening that identifies project types for which there is low uncertainty as to Paris alignment. The general screening will use the "aligned" and "non-aligned" lists of project types agreed by the MDBs (see EBRD (2021a), Annex 2). Any investment that meets the EU taxonomy criterion of a "substantial contribution" to climate change mitigation will be deemed aligned.[29] Projects on either list will be assigned the corresponding determination and no further action will be required.

b. The second filter is a "specific assessment" using the following analytical tools: a review against nationally determined contributions (NDCs), including the long-term strategies (LTSs) and other policy plans underpinning them; a review against low-carbon pathways

[28] See EBRD (2021a).

[29] See European Commission (2020).

(LCPs), including benchmarks and criteria derived from them; the application of carbon lock-in tests; and, for projects with significant GHG emissions, an economic viability test based on an economic assessment using a shadow carbon price. The evidence provided by these tools will be combined to determine Paris alignment.

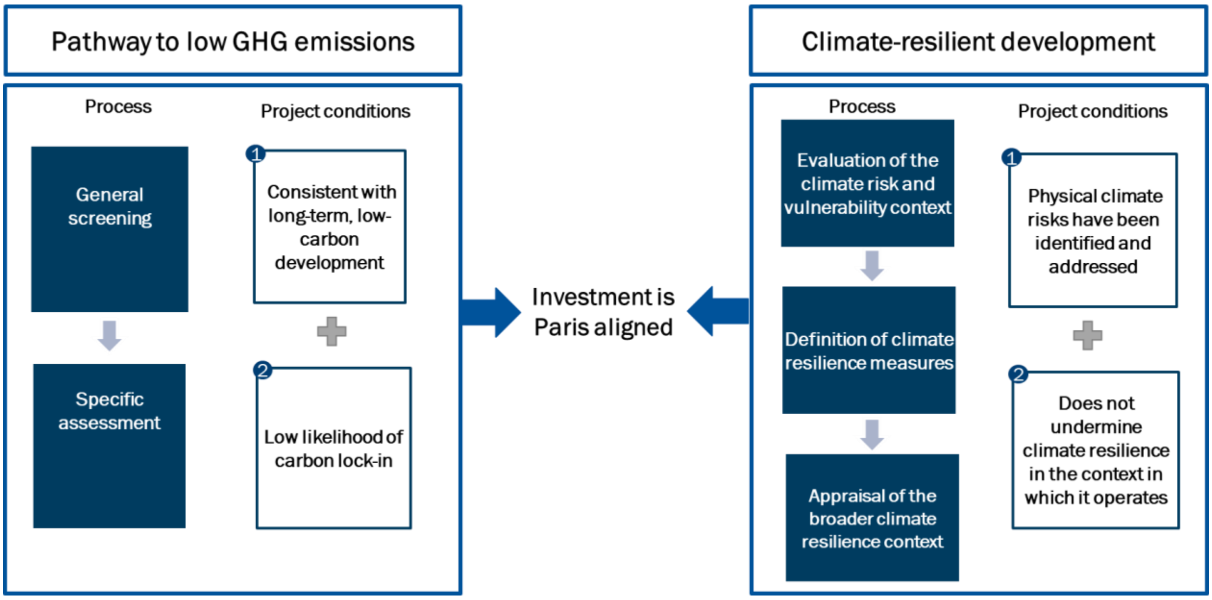
A1.6. For alignment with the adaptation goals of the Paris Agreement, the Bank will use a three-step process:

a. establishment of the climate risk and vulnerability context of a project to identify materially relevant physical climate risks

b. where physical climate risks are material, definition of climate resilience investments and other measures to incorporate into project design

c. appraisal of the broader climate resilience context of the project to ensure that it does not contravene national policies for adaptation or the climate resilience of the wider system (for example, exacerbate climate risks for communities or businesses in its vicinity or for broader supply chains).

Figure A1: Methodology to determine the Paris Agreement alignment of EBRD investments



Annex 2. Links between the EBRD's Paris alignment methodology and other processes

A2.1. The determination of a project's Paris alignment is linked to several other Bank processes, as explained below.

a. **Climate data management**. The determination of a project's Paris alignment will be supported by the Bank's central IT system (Monarch). Work in this regard will be completed in 2021-22. The full integration of the Paris alignment determination methodology into Monarch will enable the Bank to track the most relevant climate indicators over the project cycle. These data will be available for different purposes, including GET assessments, risk assessments and internal and external reporting.

b. **Climate-related financial risk**. Determining a project's Paris alignment is distinct from the concept of climate-related financial risk. Climate-related financial risk encompasses potential risks from climate change – be they from low-carbon transition ("transition risks") or climate impacts ("physical risks") – that could affect the commercial viability of financial institutions and impact broader financial stability. While likely to draw on the same source information for individual projects, this perspective is captured through the EBRD's approach to risk management and disclosure in line with the TCFD.[30]

c. **Environmental and Social Policy***.* The Bank's Environmental and Social Policy guides project-level due-diligence, management, monitoring and reporting.[31] The environmental and social assessment of a project provides important environmental information relevant to Paris alignment (such as the environmental management systems of the financial intermediary client or the level of GHG emissions from the investment and from client operations). The environmental and social requirements of financial intermediaries are captured in Performance Requirement 9.

d. **GET finance attribution***.* This is the EBRD's measure of "green" finance. Projects or project components that qualify for GET must have measurable environmental benefits. The three main categories of environmental benefit are: (1) climate change mitigation (reduction of GHG emissions); (2) climate change adaptation (enhancement of climate change resilience); and (3) other environmental benefits (including improved resource efficiency, reduced local pollution, greater resilience and the restoration of ecosystems). The aggregate volume of GET finance is reported annually as a share of annual banking investment. An EBRD project with a PFI must be determined Paris aligned to be eligible for GET finance attribution; they will use common datasets and evidence. A project that is Paris aligned may not necessarily involve GET finance, however.

[30] See EBRD (2021e) for the EBRD's own disclosure in line with TCFD recommendations, focusing on the Bank's portfolio position as of 31 December 2020.

[31] See EBRD (2019).

e. **Green transition impact.** “Green” is one of the EBRD’s six transition qualities. To have a green transition impact, a project must have a GET finance attribution. Projects are awarded a higher transition impact rating if they have enhanced systemic impact, such as large, positive environmental outcomes, complementary policy dialogue or innovation (major demonstration impact, for example). A project’s green transition impact can also be supported by the Bank’s other transition qualities, for example, corporate climate governance (well-governed); green capital market development (resilience); policy engagement to decommission state-owned fossil-fuel infrastructure (competitive); development of plans for electric-vehicle charging infrastructure networks (integrated); and consideration of just transition (inclusive).

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