

Transition Finance Guidance

(Interim report by Transition Finance Study Group by Academic researchers in
Japan) published on 22 April 2020

Introduction

There is a global need for financial institutions and financial markets to evaluate the impacts of climate change factors and environmental ones and to provide finance for materializing balanced and optimum of resource allocation in order to achieve low-carbon or zero-carbon society, with minimization of environmental pollution, conservation of biodiversity, and circular economy. Under these backgrounds, the market for green bonds and other ESG-related bonds has already expanded, and the scope of such bonds has also expanded from green finance to sustainable finance. However, financing green projects alone is not enough to solve the challenges we have faced. Economic and social management that ensures the sustainability of the entire planet is required by achieving a smooth and reliable transition from the long-standing fossil fuel dependent energy structure to low-carbon or zero carbon energy structure at an optimal cost and consequently realizing a just transition.

For this purpose, additional investment and financing (hereinafter transition finance) is necessary to make projects, assets, and activities with carbon intense or high environmental impact ones (so-called “brown projects”) into one with low-carbon or low-environmental impact projects smoothly and reliably In order to promote and expand the use of this transition finance, it is necessary to assess the appropriateness of the transformation and transition of the targeted projects and to establish common procedures and methods to confirm the results of the transformation and transition. This draft proposal was compiled as a guidance by a team of researchers who are interested in this issue, in order to help consider the standardization of such transition finance.

Scope

Green finance refers to providing finance to the green projects such as low- and zero-CO2 emissions, as is typical in the case of renewable energy projects to combat global warming. For this reason, the evaluation of the "greenness" of the projects that are to be tackled or that are already being tackled will be the key point. On the other hand, in the case of transition finance, it would be focused on the existing projects with high carbon emissions or high environmental impact (brown projects) which should be changed and transformed into the low- or zero carbon or environmentally friendly projects with smoothly and reliable way by providing finance. Therefore, it is significant to consider that transition finance should be accompanied by an assessment of the transition process and confirming whether the "greening" target has been achieved due to the transition finance. Confirmation of the "Transition Process and Results" will ensure that investors are confident of the viability of transition finance and their contribution to sustainable development.

As the evaluation criteria for green bonds and other ESG bonds used in the market are framed by four core components of the Green Bond Principles (GBP) managed by International Capital Markets Association (ICMA). Those are 1. Use of Proceeds 2. Process for Project Evaluation and Selection 3. Management of Proceeds and 4. Reporting. In the case of transition finance, it is desirable to add "Review transition processes and results" as an additional and special component, also taking ICMA's four core components into account.

It should be noted that the transition to a low-carbon and zero-carbon society or circular economy requires not only the transformation and transition of projects, assets and activities by companies, but also the transformation and transition of the business entities themselves that deal with these issues. This guidance does not deny its importance. However, the "Review transition process and results" of all business entities is not easy at present because assessment measurements and methods for transformation and transition of business entities have not yet been established or shared. Currently, measurements and methods such as ESG evaluation of companies are being adopted for stock markets and ESG assets managers. But their tools for evaluating ESG factors are still in the halfway to be standardized. Without consideration of these circumstances, placing transition finance in companies rather than projects, assets and activities might kill the reliability of transition finance. Therefore, we think we should promote the sharing

of finance that contributes to the transformation and transition of individual projects, assets, and activities.

Providing finance to green projects, assets and activities building at greenfield or for the disposal of old projects or facilities and building of new green project at same premise should be regarded as green finance. In case of retail transition loan to individuals and SME, such as package type reform loan for enhancing electricity efficiencies providing by banks, those providers can play a proxy role for retail and SME lenders for confirmation of 5 core components of transition finance.

Definition

Transition finance is defined as financing in which all proceeds will be exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible transition projects (see section 1 Use of Proceeds) and which are aligned with the following five core components of this guidance. It includes all debt instruments for promoting transformation and transition of existing projects, assets and activities, such as transition bond and transition loan. Some of the projects, assets, and activities subject to the transition may also have social benefits such as financing for employment costs that will occur during the transition period. It is important to note that transition finance should not be considered fungible with debt instruments that are not aligned with five components of this guidance.

Principles

1. Use of Proceeds

Transition finance is the utilization of the proceeds of the bond or loan for transition projects, assets and activities, which should be appropriately described in the legal documentation for the relevant debt instruments. All designated transition projects should be provided clear transition benefits, which have been raised from the transition process transforming brown projects, assets and activities to green ones. Those benefits should be assessed and, when feasible, quantified by issuers.

If full or part of the proceeds are or may be used for refinancing of existing eligible projects, it is recommended issuers should provide an estimate of the ratio of initial financing to refinancing and, where appropriate, clarify which projects, assets and activities are eligible for refinancing.

Targeted projects, assets, and activities that will be used for transition financing shall reach their "green" targets through a certain transition period. The targets for transition are net-zero CO2 emission, or certain sustainable level for conservation of natural resources, conservation of biodiversity, and pollution prevention and management. Same as green finance, a list of transition projects categories (brown taxonomy) should be required to make it easier to determine the eligibility of targeted projects, assets, and activities.

Where a phase-in target is established for technical or regional reasons, the target and transition period for each phase should be clarified and disclosed. In doing so, it is feasible to set intermediate phase-in target. However, when setting such target or an interim goal, it should be desirable to indicate the final transition goal at the same time.

Eligible transition projects categories (brown projects categories), listed in no specific order, include but are not limited to:

- 1) coal-fired power generation => fuel conversion from coal to natural gas and biomass, or mixed
- 2) coal-fired power generation =>retrofitting CCS and CCU for existing plants
(In case of converting Critical pressure power generation or Super Critical pressure one to Ultra Super Critical pressure one only resulted in insufficient reduction of CO2 emission and emerges fear of lock-in effect. Therefore, they shall be excluded)
- 3) natural gas power generation =>restoration of pipelines (Reduction of methane leakage)
- 4) natural gas =>fuel conversion from natural gas to biogas and biomethane
- 5) automobile =>shift from gasoline and diesel vehicles to gas and biofuel vehicles and introduction of hybrid vehicles
- 6) ship =>fuel conversion from heavy oil to gas

- 7) ship =>retrofitting solar and wind power generation for driving ships
- 8) aircraft =>fuel conversion from existing jet fuel to biofuel and improvement of operation system
- 9) building and housing=>green renovation (energy conservation and introduction of renewable energy)
- 10) palm oil plantation => reforestation and making mixed forest
- 11)cement =>reduction in clinker ratios
- 12)metals and glass => utilization of recycled resources
- 13)steel and chemicals =>introduction of hydrogen reduction method and hydrogen co-combustion
- 14)restaurant eatery =>conversion of plastic containers to biodegradable containers
- 15)clothing =>conversion to recycled materials
- 16)consumer goods =>introduction recycled and reusable package
- 17)real estate and land use =>remediation and cleaning up contaminated soil
- 18)others

(It should be expected to be classified into transition taxonomy “brown taxonomy” based on these categories)

2.Process for Project Evaluation and Selection

The issuer of transition bond under transition finance should clearly communicate to investors:

- The expected degree of improvement and effects of climate and environmental projects, assets and activities through smooth and reliable transformation and transition.
- Reason for determining that the targeted projects, assets, and activities falls under the categories of eligible projects based on specified in transition taxonomy.
- Criteria on which the eligibility of the project is assessed.

Issuers are encouraged to position this information within the context of the issuer's overarching objectives, strategy, and policy and/or processes related to environmental sustainability. Issuers are also encouraged to disclose any green environmental standards or certifications referenced in project evaluation and selection.

3. Identification for transition process and its results

In transition finance, the most important point is to ensure smoothly and reliable transformation and transition from existing projects, assets, and activities to low- and zero-carbon, or low-environmental impact ones, as assumed by the issuer, after issuing transition bonds and other transition finance products. Prior to issuing a transition bond, it is necessary to specify how many years the transition period will be and where to place the level of targeted low-carbon and zero-carbon, low-environmental impact projects, assets, and activities, including the setting of phased transition targets. In post of issuing, it is necessary to monitor for any deviations from the process during those transitions. In addition, failure to meet the target level could adversely affect investors in terms of return on investment and ESG contribution.

In response to these requirements:

- In the case of bonds, its transition periods should be equal or within its redemption period (loan term in the case of a loan).
- The progress achieved during the transition period shall be periodically disclosed by the issuer (borrowers in the case of loans) and the appropriateness thereof shall be approved by an independent external body. It is desirable, where possible, to add a financial assessment because the transformation or transition of projects, assets, and activities from brown to green would lead to improvements in climate and environment as well as in the asset value of issuers, which might be called as "stranded free assets".
- If the target is not achieved, the initial expectations from investors against the

issuer will not be satisfied and the bond value would be affected. In order to prevent from these situation, it is desirable to ensure the viability of bonds by, for example, introducing "variable coupon system" which has additional coupon increasing in the event of failed transition period, or setting "covenants" clause in a loan agreement with an interest rate increase clause in the case of loans. It is also conceivable to make it mandatory for issuers to disclose information on "non-delivery".

4. Management of Proceedings

All funds raised through transitional finance such as bonds or loans should be credited to a sub-account separately in issuers or borrowers, moved to a sub portfolio or otherwise tracked by the issuer or the borrowers in an appropriate manner. In the case of bonds, the balance of internally controlled funding should be periodically adjusted to match allocations to eligible transition projects, assets and activities for smooth and reliable transformation and transition. If there are unallocated proceeds, the issuer should make known to investors the intended type of temporary placement for the balance of unallocated proceeds. The management of funds raised by the issuer should be complemented by use of an auditor, or other third party.

5. Reporting

Prior to implementing the transition finance, issuers are required to disclose information in the form of pre-implementation reporting on methods such as "Process for Project Evaluation and Selection" in (2) and "Identification for transition process and its results" in (3). In the post-implementation transition period, issuers are also required to disclose information that monitors the progress of the transition, as well as the outlook for achieving the objectives of the transition.

In the case of post reporting in implementing transition, issuers should make and keep readily available up to date information on the use of proceeds to be renewed annually and on a timely basis in case of material developments during transition periods.

In addition, since the transition is expected to improve both climate and environment, as well as the relevant asset value of issuers, it is expected to disclose appropriate evaluations from a financial perspective, if possible. These disclosures should preferably include a list of the projects, assets, and activities to which the funds have been allocated, as well as, if possible, their progress and achievements of transition “from brown to green”. If the number of transition projects is large, overall or portfolio disclosure should be encouraged. In order to ensure the transparency of information, quantitative indicators should be used as much as possible, and qualitative indicators may also be used.

External Review

In order to confirm the alignment of the transition finance in this guidance, issuers or borrowers are required to obtain an assessment by independent external reviewer prior to the execution of the bond/loan to ensure that the issuance and borrowing program complies with the above five core components (Principles). At the same time, it is necessary to obtain another external review to confirm whether the post-implementation transition process is proceeding as expected and whether the targets can be achieved as expected.

In the case of green bonds, the same external reviewer provider is often responsible for both pre-issuance and post-issuance assessment. However, in the case of transition finance, the weight of the external reviewer in charge of assessment should be considered to differ between the stage of product design before issuance and the stage of confirmation of alignment in the transition process after issuance. The former is to check the appropriateness of the product design or planning of financing, and the latter is to measure whether there is a discrepancy between the process and the target that was assumed. In some cases, the external reviewer should be required to ask the issuer to correct the discrepancy in the transition process, or to determine to invoke the covenants when things have not improved by the issuers.

Given these different roles of external assessments, it is expected to appoint different external reviewers for pre-issuance and post-issuance assessment individually. In the latter case, an independent auditing firm for the company concerned transition projects, assets and activities may be in charge of the transition assessment, or a third party with a certain certification qualification

should be in charge of the assessment separately from the pre-issuance reviewer, because financial conformity assessment of the asset may be expected in some cases. These external review procedures are additional costs to the issuer or the borrower additionally, but those costs should be incorporated into the principle and payments of the bond or loan. Because the benefits of the transition finance confirmed by both reviewers would raise investment return and additional ESG return, reducing transition risk in the relevant projects, assets and activities.

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