

Transition Finance Q & A

Q: What is the basic difference between green finance and transition finance?

A: Green finance, such as green bonds, is providing any type of debt instruments where the proceeds will be exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible green projects assets and activities under the green taxonomy.

The transition finance is also providing debt instruments where the proceeds will be exclusively applied to finance or re-finance, in part or in full, to change and transform the projects assets and activities with high CO2 emissions at present into lower emissions. The target is so-called "brown project" that should be classified in the transition taxonomy, but this "brown project" will be "greened (reducing CO2 emissions or approaching net zero emissions) "through transition finance process.

Q: The EU Sustainable Finance taxonomy (which is under the final phase) includes both green finance and transition finance in the same guidance. But in your case, you are setting separate standards for transition finance from green finance. What are the reasons for that?

A: The EU proposal for Sustainable Finance taxonomy includes transition projects in green finance with conditions for greening (thresholds).

As we think transition finance is significantly different from green finance in terms of taxonomy of the target projects assets and activities, confirmation of alignment for transition period, monitoring, evaluating the results of transition and so on. Therefore, we propose a separate guidance.

Q: This guidance for transition finance covers projects, assets, and activities, not companies that actually work on transition financing. Some point out that a company itself needs "greening". What is the reason for limiting the scope of transition finance to projects, assets, and activities, not companies?

A: We do not ignore the importance of greening, transformation and transition of companies themselves. That seems to be the most desirable. However, regarding the "confirmation of the transition process and results" for the entire company, its standardized evaluation methods have not been established at this time in the market. The ESG evaluation methods which are currently applied to equity investments are still at developing stage as different evaluation entities provide different evaluation methods. Besides, they are not suitable for complete quantification. Therefore, at present, we think it should be focused on projects, assets and activities that we can assess the goals and

results of the transition in investment and financing.

Q: What is the target goal or figure for transition finance?

A: Ideally, in case of climate transition finance, a net zero CO₂ emission is desirable. However, depending on the transition process of greening the brown project, some cases may need intermediate goals. Alternatively, even if it is difficult to achieve zero emissions due to the technical characteristics of the type of projects or installation, as the goal of the transition is to reduce emissions as much as possible, phase-in approach should be accepted. If setting phase-in approach, it is expected for the company or financing entity that owns the project to explain how and when the intermediate goals lead to the final goal.

Q: What is the difference between green finance and transition finance when it comes to reducing CO₂ emissions from existing coal-fired power plants?

A: The financing for dismantling and removing existing coal-fired power plants and constructing new renewable energy power plants on their premises will be green financing. The financing for reducing CO₂ emissions by retrofitting additional installations or changing materials such as CCS or CCU and fuel conversion while maintaining the existing power plant is transition finance.

Q: This guidance requires that its business/projects should be evaluated/or assessed by different external reviewers before and after financing. What is the reason for this requirement?

A: In the case of green finance, in many cases, the same external reviewer providers assess both pre- and post-evaluations. In the case of transition finance, the pre-assess is mainly the evaluation of a business plan for moving an existing brown projects, assets and activities to green one. Therefore, after executing transition finance, monitoring during the transition process and post-evaluation are required. If the expected result of the transition is not realized, there is a possibility that the covenants clause may put into effect, such as implementing improvement action to the projects or raising coupon rate in case of transition bond. In such case, as the validity of the pre-evaluation may also be included as the scope of the evaluation, it is preferable that another external reviewer will be involved. In addition, post-reviewer may evaluate to what extent be changed of the targeted projects, assets and activities from the threat of strandedness.

Q: If the pre-evaluation and post-evaluation are performed by different reviewers, the external reviewing cost of transition finance is likely to be higher than green finance. Who is bearing the cost?

A: Basically, we believe that it is desirable to incorporate the external reviewing cost into the use of the funds for transition finance as part of the cost to promote the greening of the target projects, assets and activities. Therefore, the reviewing costs should be borne by the recipient. In the case of investment products, the reviewing costs should be transferred and borne by investors.

There are some cases which reviewing cost were covered by public subsidies as a separate funding. However, public subsidies for specific financial products are not considered appropriate from the perspective of sound financial markets. We think that institutional investors who prefer to invest in “green” and “transition” are willing to bear the cost of the reviewing. Because they could get lowering transition risk during their long-term investing to transition debt instruments.