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Working Paper Regarding Practical Approach to Transition Finance in Asia

Introduction

Mobilizing funds for Asia's climate transition is crucial to achieving global net zero. This enormous demand for transition finance also provides huge investment opportunities in this region.

However, transition finance flows in this region have yet to adequately scale to meet the significant demand. One of the reasons highlighted for this is the absence of a common understanding among stakeholders on a practical approach to transition finance in Asia. To accelerate the flows toward the region, foster investment opportunities, drive the transition of hard-to-abate-sectors, and contribute to global climate efforts, it is essential to develop a practical and common approach to transition finance in Asia while gaining understanding from the entire world, including emerging markets.

Therefore, the Asia Green Transformation (GX) Consortium aims to facilitate discussions among stakeholders active in Asia, especially public and private players in the finance community, on a practical and common approach to promoting transition finance in the region, considering the diverse conditions surrounding the transition in the Asian context through case studies and other methods.

The approach to be formed in the Consortium can be used to facilitate the flow of transition finance, especially to emerging and developing markets in the ASEAN region, and to expand projects at the corporate and transaction levels accordingly. This approach is expected to provide valuable insights not only for investors and financial institutions offering transition finance but also for companies receiving it and for financial authorities involved in creating policies and frameworks to promote transition finance.

Discussions in the Asia GX Consortium will focus on transition finance practices and implementations in Asia, with reference to finance cases and efforts in the region, the ASEAN Taxonomy for Sustainable Finance, the ASEAN Transition Finance Guidance, Japan's approach to transition finance, the four key transition financing strategies by Glasgow Financial Alliance for Net Zero (GFANZ), the Asia Transition Finance Guidelines by the Asia Transition Finance Study Group (ATF SG), and other relevant frameworks and guides.

This Working Paper has been prepared by the Financial Services Agency of Japan, which serves as the secretariat, summarizing discussions from the technical meetings held prior to the official launch of the Asia GX Consortium on 2nd October 2024.

This paper has been consulted with participants of the technical meetings and provides a starting point for further discussion in the Consortium aimed at forming the approach to promote transition finance. This Paper has been endorsed by all the original Consortium members.

Technical meetings in the run-up to the official launch highlighted the importance of mobilizing funds for Asia's climate transition, the role of blended finance, their implementation in the regional context of Asia and facilitating discussion among diverse stakeholders. We have obtained the following observations.[1]

1. Important Perspectives for Transition Finance

The following general observations were made regarding the promotion of transition finance:

- Mobilizing funds for Asia's climate transition is crucial to achieving global net zero. This enormous demand for transition finance also provides huge investment opportunities in this region.
- Transition finance flows in this region have yet to adequately scale to meet the significant demand. The Asia GX Consortium should facilitate the transition finance flows and project developments and should continue to monitor the flows and the status of projects in the ASEAN region.
- In developing a practical and common approach to promote transition finance, it is crucial to bring as many countries and regions on board as possible by taking into account the specific characteristics and circumstances of each. This is essential for ensuring a just and orderly transition. In some countries, capacity building for relevant entities, such as companies, financial institutions and the public sector, may be important as a prerequisite for structuring transition finance projects and creating demand. Regional cooperation is critical to push forward these transition finance agendas.
- To accelerate climate transition, what matters most is the transition/mitigation impact that one's actions create. Such impact should be further enhanced and a label provides a useful tool to recognize and scale the impact. At the same time, it is worth noting that many projects in the region without the label are also creating meaningful transition/mitigation impact.
- Investors and financial institutions providing transition finance need to be mindful of the interrelationships between individual projects, companies, sectors, countries, and enabling policy frameworks and actions. For example, in some cases, the transition in one sector or between companies and supply chains may depend on the transition in another. Understanding these interdependencies is important when prioritizing transition finance recipients and realizing a whole economy transition.

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[1] The original members of the Consortium are as follows: the Financial Services Agency of Japan, the ASEAN Capital Markets Forum (ACMF) and ASEAN Working Committee on Capital Market Development (WC-CMD), the Asia Development Bank (ADB), the Glasgow Financial Alliance for Net Zero (GFANZ), Mizuho Financial Group, Mitsubishi UFJ Financial Group, Sumitomo Mitsui Financial Group, the Development Bank of Japan Inc. (DBJ), the Japan Bank for International Cooperation (JBIC) and the Japan International Cooperation Agency (JICA). Some observers and guest presenters were invited and joined the technical meetings. Moving forward, other public and private players in the finance community (including, but not limited to, ASEAN financial institutions) could be invited to join the Consortium to ensure that the perspectives and needs of the region's context are adequately represented and integrated within the Consortium's works.

- Transition finance related initiatives including the Asia GX Consortium, which bring together participants with diverse backgrounds, provide valuable platforms for fostering regional cooperation and a shared understanding of transition finance agenda.

2. Importance of and Effective Approaches for Mobilizing Funds for "Aligning"

The following points were raised regarding the approach to advancing the transition in Asia.

- The Asia region is experiencing high growth with diverse industrial bases under various economic and geographical conditions. Hence, it is crucial to focus on companies that are not yet fully aligned with net zero but are moving towards it, rather than only on those that are already well on track or have fully addressed net zero.
- The four transition finance strategies outlined by GFANZ for financing a whole economy transition to net zero—"Climate Solutions," "Aligned," "Aligning," and "Managed Phaseout"—provides useful perspectives to consider transition finance and each of them is crucial to achieving climate mitigation. Among these, given the aforementioned context in Asia, one of the most urgent and critical tasks in this region is the mobilization of funds towards entities that are "Aligning."[2]
- Related to the Aligning strategies, "Transitional Activity," which, while not achieving net zero, replaces higher-emission activities with lower-emission ones, was discussed as an important concept at the technical meetings. In this regard, GFANZ[3] suggested the points for consideration for avoiding lock-in effects while taking into account regional contexts.
- The ASEAN Transition Finance Guidance synthesizes the critical elements of the commonly referenced international guidelines, including the aforementioned GFANZ framework and strategies. This guidance provides room for the broader recognition of transition efforts[4] by establishing three tiers "Aligned and Aligning 1.5°C," "Aligned and Aligning Well below 2°C" and "Progressing." This is to take a more inclusive approach in order to balance the resolution of various economic and social issues in Asia with the whole-of-economy transition, and this guidance also indicates the importance of a just transition and the potential use of intensity indicators, which provides useful suggestions in light of the geographical and regional context of Asia.

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[2] The GFANZ four transition financing strategies: "Climate Solutions," "Aligned," "Aligning," and "Managed Phaseout" represent a voluntary framework rather than a set of standards. However, many financial institutions reference this framework, and the discussion in the technical meetings of this Consortium referred to it as a starting point for discussion on transition finance.

[3] See "Box 4. Additional attributes for the use of "transitional" activities" on page 36 of GFANZ report Scaling Transition Finance and Real-economy Decarbonization (December 2023). The GFANZ Japan Chapter contributed to the development of this Box. In this Box, the following points are suggested: 1) the lack of no/low carbon alternatives, 2) demonstrating significant emissions reductions, 3) aligning with and contributing to the achievement of the pathway, and 4) specifying when the transitional activities will be phased out within the net-zero transition plan.

[4] "Aligned and aligning - 1.5°C," and "Aligned and aligning – Well Below 2°C" refer to entities that demonstrate sufficient climate ambition that is already aligned or aligning with a science-based 1.5°C or 2°C trajectory respectively and meet all other criteria of transition credibility. The "Progressing" category includes companies which demonstrate most but not all elements of ability to deliver and/or a climate ambition that is material but not yet aligned or aligning to well below 2°C, and have committed to addressing any material omissions in the next two years.

3. Approach to Evaluating Transition Finance Cases

The following points were raised regarding the evaluation of transition finance cases.

- Investors and financial institutions that provide transition finance should distinguish between the corporate level and transaction level in their evaluation approach.
- At the corporate level, it is crucial to securing a credible transition plan. If a company has such a credible transition plan, it can be eligible for financing regardless of its sector, size, or whether it is in an emerging market.
- When evaluating the credibility of a transition plan, its emissions reduction pathway and target are analyzed in reference to benchmarks. A significant challenge is that many of the benchmark pathways available in the market do not necessarily reflect the geographical and regional characteristics of Asia. While Japan's Sector-Specific Roadmaps provide insight into addressing this challenge, it is essential to enhance the availability of regional benchmarks, including the expansion of the technology list provided in the "Technology List and Perspectives for Transition Finance in Asia (TLP)" by the Economic Research Institute for ASEAN and East Asia (ERIA) and the development of more regionally contextualized sectoral decarbonization pathways.
- Even if the credibility of a transition plan is not yet fully secured, in order to ensure that transition efforts are not delayed and also avoid greenwashing concerns, it is important to utilize some guardrail measures. In this regard, the governance, ongoing monitoring,[5] disclosure of ongoing processes, risk assessment, and independent verification presented in the ASEAN Transition Finance Guidance can serve as valuable guardrail measures.

- At the transaction level, it is essential to ensure the credibility of the use of funds and to confirm that the transaction is financially viable or bankable. Taxonomies with transition category, such as the ASEAN Taxonomy for Sustainable Finance, and sector-specific roadmaps, such as the one developed by Japan and the one by ERIA are useful tools for evaluating the use of funds. Both of these approaches aim to capture dynamic and forward-looking aspects of climate transition and thus are not mutually exclusive, allowing for mutual learning on real-world implementation.
- To make these evaluations and related guardrail measures effective, it is necessary to enhance the quality and quantity of data. In Asia, where each country has different systems and many SMEs have limited resources, it is particularly important to consider the further utilization of digital technologies, which have recently been the focus of various initiatives, to improve data quality and quantity and reduce the burden of collecting data while involving relevant stakeholders.

[5] In the ASEAN Transition Finance Guidance, ongoing monitoring means developing organisation- and activity-level processes to track ongoing progress against transition targets and adapt strategies accordingly.

The following points were made regarding the role of financial institutions in ensuring the credibility of transition plan:

- GFANZ suggests five themes for financial institutions' transition plans. All five of the themes are important, but the engagement strategy is particularly important. Corporate transition plans can be used as a starting point for financial institutions to engage with companies to identify transition opportunities. Through engagement with companies, financial institutions can make transition opportunities clearer and identify capital expenditure and other financing opportunities.[6]
- As financial institutions and the companies in the real economy have a supply-demand relationship in terms of funds, the transition plans of financial institutions are interrelated with those of the companies in the real economy. Financial institutions, through providing funds in response to financing needs, make the companies' climate transition possible. At the same time, through engagement with companies, they can play the role of proactively guiding the transition of the real economy. Therefore, engagement by financial institutions can contribute to increasing the credibility of the real economy's transition plans. While some of the corporations in Asia are yet to have a transition plan, financial institutions can support them in formulating one.
- The mobilization of transition money takes the form of not only indirect financing from banks but also direct financing, such as from asset owners and asset managers. While engagement methods and approaches for indirect and direct financing are different in nature,[7] both are required to make proactive contributions to the provision of funds and knowledge at both the corporate and transaction levels.

4. <u>Approach to Ensuring Bankability</u>

The following points were raised:

- Bankability is analyzed through a combination of a financial lens (e.g., the cashflow a certain project generates) and a non-financial lens (e.g., the technology the project utilizes and other relevant factors). Technology itself is one of the factors considered in this analysis and does not categorically preclude transition financing.
- To achieve a whole-of-economy transition, it is essential to finance a wide range of projects, from those aimed at converting high-emission activities into lower-emission transitional activities to high-risk projects that utilize emerging technologies. This type of financing is particularly crucial in the Asian region, which is characterized by diverse industrial bases and high growth under various economic and geographical conditions. However, financing for emerging technologies projects

[6] In the technical meetings, the following order was presented as one of the typical examples of engagement process: (1) dialogue with the company, (2) understanding the transition plan, (3) identification of transition finance opportunities, (4) due diligence/investment decision, and (5) follow-up. In some cases, financial institutions may receive requests for proposals from the company before starting to consider transition finance.

[7] In terms of SMEs, although engagement methods and approaches differ from country to country, it is generally considered that banks are better positioned for deeper engagement with them.

currently faces challenges due to limited track records and investors relatively high perceived risk sentiments, making it difficult to achieve bankability.[8] To make such projects bankable, it is important to pursue risk-sharing mechanisms, such as blended finance, or cash-generating arrangements such as carbon credits.[9]

- Blended finance allows the public sector and/or philanthropies to improve the risk-return profile of investment opportunities and broaden the range of private investors. Blended finance shares risks among them, thereby contributing to the bankability of projects and catalyzing further private sector funds (jumpstarting demonstration projects and pump-priming of private sector funds). Specifically, there are various blended finance methods or risk-sharing mechanisms, such as funding through subordinated debt financing, guarantees, grants, and insurance.
- In addition to the financial risk-sharing function of blended finance, it is also important to recognize that the participation of the Multinational Development Banks (MDBs) or the Development Financial Institutions (DFIs) themselves can contribute to reducing reputational risk. In relation to this, there are cases in which reputational risk hinders financing by private financial institutions in projects to transform high-emission activities into low-emission transitional activities. It is desirable to further examine mechanisms to reduce such reputational risk.
- Carbon credits have the ability to incentivize emissions reduction by recognizing the economic value of the effect and contribute to improving cash-flows of transition projects. The market for carbon credits is still in its early stages, with relevant infrastructures varying from jurisdiction to jurisdiction and voluntary credits being diverse and fragmented. Further study is needed on how to utilize carbon credits in transition finance projects while ensuring the integrity of the credits and surrounding infrastructures.[10]
- Private financial institutions and MDBs/DFIs need to cooperate through various opportunities to share their views on the existence and utilization of these mechanisms. It is also important to facilitate discussions to clarify which kinds of entities can and would like to take on which risks within blended finance and to identify the types of projects that can be realized through blended finance. The Asia GX Consortium will play a key role in this effort as a hub of this coordination.

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[8] In the technical meeting of the Consortium, the ATF SG shared their key findings obtained through their discussion regarding transition finance, which includes the following: bankability and associated risks of projects utilizing transition technology, potential roles public sectors can play, transition roadmap/pathway and the importance of interoperability.
[9] Some pointed out that even tested and scaled transition technologies are sometimes facing bankability issues to address especially in Asia, since replacing cost itself could be high enough to make a local project financially infeasible.
[10] There is an ongoing pilot project by the Monetary Authority of Singapore to leverage transition credits to close the economic gap for the early retirement of coal-fired power plants.

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Future Direction of the Consortium

This Working Paper summarizes the points raised in the discussions from the past three technical meetings on selected topics. We have just officially launched the Asia GX Consortium and we will engage in more comprehensive and actionable discussions. Our aim is to build consensus among stakeholders and to further refine the approach discussed into a more concrete and practical one moving forward.

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