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Why Sustainable Finance Is On The Rise

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The corporate world continues its embrace of environmental, social and governance, or ESG, factors in 2020 like never before. As part of this ongoing trend, ESG criteria are appearing with increasing prevalence in the bond and loan markets, and new opportunities within sustainable finance are opening up as a result of major financial institutions making their own commitments with respect to ESG criteria.

Green bonds, green loans and performance-specific sustainability-linked debt instruments are just some of the instruments falling under the umbrella of sustainable finance. According to the latest in-depth sector analysis from Moody's Corp., global issuance of green, social and sustainability bonds — collectively referred to as "sustainable bonds" — totaled $99.9 billion in the second quarter of 2020, a quarterly record and 65% higher than in the first quarter of the year.

While these levels are a relatively small portion of overall global debt issuance at 4%, Moody's predicts that the pandemic and heightened focus on ESG factors will support the continued growth of sustainable bonds. In their most basic forms, sustainable bonds — or their corollary in the loan market, sustainable loans — are any type of financial instrument where the proceeds will be exclusively applied to eligible environmental and/or social projects.

In contrast to sustainable bonds and loans, the proceeds of "sustainability-linked" bonds and loans are intended for general corporate purposes, but incentivize the issuer's achievement of material, quantitative, predetermined, ambitious, regularly monitored and externally verified sustainability objectives through sustainability performance targets, or SPTs.

Recent examples of green financings include JPMorgan Chase & Co.'s $1 billion green bond, issued in September and earmarked for a range of projects from green buildings to renewable energy, and National Grid North America Inc.'s $743 million green loan, entered into in June and intended to fund new subsea electricity cable.

Recent examples of sustainability-linked financings include Tereos Sugar & Energy Brazil's $105 million sustainability-linked loan, entered into in June, with SPTs related to reducing its carbon emissions and improving its ESG score, and Enel SpA's $1.5 billion issuance in 2019 with an SPT tied to increasing its renewable generation — the debut of sustainability-linked instrument in the bond market.

Analysts are anticipating $350 billion of sustainable bond issuances for 2020, and some believe the overall market size of the green bond market alone could grow to $1 trillion by the end of 2021. These debt instruments present benefits for companies, investors and lenders — including impact on pricing, relational and reputational benefits and investment in environmental and social change.

These instruments, and their benefits, are increasingly available to all sorts of corporate issuers across an expanding universe of industries, and may take the form of bonds, term loans, revolving loans and other working capital facilities. This article focuses first on sustainable bonds and will then address sustainability-linked instruments.

Guiding Principles

The Green Bond Principles, or GBP, the Social Bond Principles, or SBP, and the Sustainability Bond Guidelines have become the leading frameworks globally for issuance of green, social and sustainability bonds. The International Capital Market Association, or ICMA, serves as secretariat, assuming administrative duties, and providing guidance for the governance of these frameworks. As the frameworks are designed to be industrywide, bond issuers and investors as well as banks are invited to participate.

Following the annual general meeting of the GBP and SBP in early June, the ICMA announced the publication of new and updated documents that represent an important additional step toward the gradual harmonization and expansion of the global sustainable finance markets. These documents include the new Sustainability-Linked Bond Principles, a 2020 update of the Social Bond Principles, a collection of social and sustainability bond case studies, and updates to a variety of other publications.

With these updated documents, the ICMA seeks to respond to the evolution of sustainable financing instruments and acknowledge the need for greater clarity on how these instruments are being deployed.

In the loan market, the guiding principles for green loans and sustainability-linked loans are in line with those adopted by the ICMA, with the key distinctions deriving from the nature of the loan debt instrument and the nature of the loan investor. Specifically, the Loan Market Association, the Asia Pacific Loan Market Association and the Loan Syndications & Trading Association have promulgated the Green Loan Principles and the Sustainability-Linked Loan Principles, to provide guidance for issuances of green loans and sustainability-linked loans, respectively.

Green Bonds

Green bonds are typically issued to raise funds that are applied to finance green projects or issuers with defined environmental benefits, goals or key performance indicators.

While originally formulated as a debt instrument for governments, the first corporate green bond was issued by Vasakronan, a Swedish property company, in November 2013, to fund energy-efficient new buildings, retrofit existing buildings and develop renewable energy projects, among other things. Since then, many large corporate issuers have tapped the green bond, including Apple Inc., Bank of America Corp., Citigroup Inc., the Goldman Sachs Group Inc., PepsiCo Inc., Visa Inc., Verizon Communications Inc., Volkswagen AG and Toyota Motor Corp.

Determining whether a bond is "green" depends on the eligibility of the project to which it relates, and not the eligibility of an issuer. Even companies in industries that may not be universally considered to be green, including those with high greenhouse gas emissions, can tap into the green bond market if the project to be financed meets certain eligibility criteria.

Green bonds can be structured as a typical corporate bond with recourse to the issuer and its group, or as project bonds, revenue bonds or asset-backed bonds — but in any case, should satisfy the four key components outlined by the GBP regarding (1) use of proceeds, (2) process for project evaluation and selection, (3) management of proceeds and (4) reporting.

Use of Proceeds

Use of proceeds is the key component of the GBP. The eligible green project financed or refinanced by an issuance should be clearly identified, and, if possible, quantified, in the use of proceeds section of the offering document.

The financing will need to be clear and with specific disclosure around the intended uses, including around particular projects, and their continued or expected environmental benefit. Note that it is possible to fund only a portion of the total cost of a project with green bonds if other parts of the project would otherwise be ineligible, provided that green bonds are only used to fund the eligible portion.

A nonexclusive list of eligible green categories that can be selected for the use of proceeds includes:

- Renewable energy;
- Energy efficiency;
- Pollution prevention and control;
- Management of living natural resources and land use;
- Terrestrial and aquatic biodiversity conservation;
- Clean transportation;
- Sustainable water and wastewater management;
- Climate change adaptation;
- Eco-efficient and/or circular economy adapted products;
- Green production technologies and processes; and
- Green buildings.

Some examples of eligible green projects undertaken by green bond issuers include Apple's transition to 100% recycled aluminum alloy, Bank of America's investment in numerous solar and wind farms, PepsiCo's purchase of more sustainable plastics and packaging, Verizon's conversion to using all light-emitting diodes in its facilities and Volkswagen's contributions to e-charging infrastructure.

Process for Project Evaluation and Selection

Companies issuing green bonds are expected to provide clear communication to investors about the objectives of any environmentally beneficial projects, the protocols used in determining the project's adherence to the green projects list above and other eligibility criteria.

Management of Proceeds

The GBP encourage issuers to ring-fence the net proceeds of an issuance in an external or internal account, attested to by a formal allocation process. The company will typically need to inform investors about the types of temporary investments any unallocated funds are being held in, and auditors are often tasked with independently evaluating the allocation of funds.

Reporting

Under the GBP, companies are expected to prepare and make readily available annual disclosures on the use of proceeds until the proceeds of the bond sale have been fully allocated. Companies will also report new material developments.

The annual report will include a list of the projects to which green bond proceeds have been allocated, as well as a brief description of the projects and the amounts allocated, along with their expected impact. Impact reporting should provide quantitative and qualitative information. The GBP also recommend core indicators for two sectors, energy efficiency and renewable energy, and reference reporting templates that issuers could adapt to their own circumstances.

Green Loans

The corollary to green bonds in the loan market are green loans, which, like green bonds, are a use-of-proceeds or project-specific instrument used to finance or refinance an eligible green project. As mentioned above, the Green Loan Principles and GBP are closely aligned, and center around the same four key components.

As is the case with green bonds, identifying a loan as "green" turns on the eligibility of the project to which it relates, and not the eligibility of an issuer. So projects associated with industries that are traditionally associated with negative environmental impact, such as the production of fossil fuels, can be eligible — so long as the core components for eligibility are met (e.g., projects to improve the efficiency of fossil fuel production).

Social Bonds and Sustainable Bonds

While the use of proceeds for green bonds is applied exclusively to eligible green projects, social bonds focus on other ESG-related concerns, and raise funds for new and existing projects with positive social outcomes. The SBP, promulgated by the ICMA, provides guidelines for social bond issuers, and contains the same four core criteria found in the GBP: use of proceeds, process for project evaluation and selection, management of proceeds, and reporting.

If an issuer intends to apply proceeds to both eligible green and social projects, it may issue a sustainability bond, a category of bond with proceeds applied to finance or refinance a combination of both green and social projects. The Sustainability Bond Guidelines have been published to reiterate the relevance of the GBP and the SBP in the context of sustainability bonds.

Sustainability-Linked Instruments

Sustainability-linked debt instruments, both bonds and loans, provide an opportunity for the benefits of sustainable finance to extend beyond the four-corners of a specific project and into a company's working capital structure irrespective of industry. Sustainability-linked instruments are not use-of-proceeds or project-specific, but look instead to improve a company's overall ESG performance through identifying key performance indicators that are complementary of a company's core ESG strategies.

From the key performance indicators, a company and its investors agree upon one or more SPTs, which the company will either be rewarded for meeting or penalized for missing (or both). The carrot and/or the stick, so to speak, in these sustainability-linked instruments usually takes the form of an interest rate or coupon toggle — but may also affect other economics of the debt instrument and/or covenants, as may be agreed.

In addition to establishing the relevant key performance indicators, SPT and impact on the debt instrument, both the Sustainability-Linked Bond Principles and the Sustainability-Linked Loan Principles emphasize reporting and review/verification as core components to a sustainability-linked instrument. Reporting is recommended to be undertaken on at least an annual basis, with disclosure of methodology and calculations used by an issuer in determining SPT performance and external review is promoted as the gold standard of verification.

While key performance indicators and the related SPTs often tie to environmental concerns, they may also tie to ESG scores (more common in European deals), diversity metrics or other ESG concerns. For example, Lanxess AG's €1 billion ($1.175 billion) loan entered into in December 2019 included an SPT tied to the number of women in the top three levels of management, in addition to an SPT based on reduced greenhouse gas emissions.

External Review

Common across the board for the guiding principles is the importance of transparency and measurement around the ESG impact of a green bond, green loan or sustainability-linked debt. All guidance recommends the benefits of external sources and their involvement in nearly all stages of the process.

For example, external evaluation of an eligible green project, or external auditing of compliance with SPTs, second-party opinions and third-party verification are now standard in green bond issuances. New services have developed to facilitate the sustainable finance market, providing for certifications and opinions on green credentials, external auditing and ESG scores.

These include Sustainalytics, the Centre of International Climate and Environmental Research Oslo, Vigeo, Leadership in Energy and Environmental Design and the Climate Bond Initiative.

Conclusion

Although the sustainable finance market is still a relatively small part of the overall debt markets, issuances of sustainable bonds and loans as well as sustainability-linked debt instruments look set to continue their upward trajectory, as ESG factors increase in importance for both companies and investors.

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