MARKET INSIGHT

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SUSTAINABLE BONDS AND LOANS: CAN WE ACHIEVE MORE?

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The transition to a sustainable global economy requires real and immediate efforts regarding the financing of investments that provide environmental and social benefits.

Bond markets are playing a key part through the emergence of new instruments such as green, social and sustainability bonds whilst the loan market, through banks and professional associations, is also playing an essential role in attracting capital to finance these global needs.

The targets that we need to reach in terms of sustainability are far better understood than ever before, with sustainable finance now growing at a fast pace.

The rules imposed on issuers or borrowers have not received much attention, yet with adequate incentives to drive the emergence of a sustainable economy forward, its development would be significantly boosted.

LOOKING BACK

The Sustainable Development Goals[1] (SDGs) were born at the United Nations Conference on Sustainable Development in Rio de Janeiro in 2012, and are a universal call to action by the UN Development Program (UNDP) to end poverty, protect the planet and ensure that all people enjoy peace and prosperity. The objective was to produce a set of goals that meet the urgent environmental, political and economic challenges our world is facing.

The SDGs were built on the Millennium Development Goals issued in 2000, and have expanded to include additional critical matters such as gender equality, life underwater and on land, peace, justice and strong institutions.

Meeting the SDGs target is going to be costly, and will require the involvement of the public, but also of the private sector. The UN Conference on Trade and Development (UNCTAD) says achieving the SDGs will require no less than five to seven trillion US dollars in annual investments[2].

ESG IN ASSET MANAGEMENT

The investment community has become increasingly active and vocal on sustainable issues that consider environmental, social and governance factors in portfolio management, predominantly in the equity space. The fixed income market via the green bond market and, more recently, social and sustainability bonds and green and sustainable loans have gained strong momentum.

On these particular segments, less attention is paid by investors to the monitoring of how debt issuers and borrowers comply with their undertakings under green social and sustainability bonds or loans.

Green, social and sustainability bonds as well as green or sustainable loans, are any type of debt instrument where the proceeds will be exclusively applied to environmental and/or social projects. These products do not differ from standard instruments and the regulations applying to them are the same as for other fixed income instruments.

However they are attractive for different reasons. Bonds have historically been the remit of the asset management community and institutional investors, who in particular are starting to realise the high-risk posed by climate change to social and financial stability. Green and sustainability loans are traditionally made by banks, and may stand to benefit from regulatory capital relief to further incentivise financial institutions to grant them in the future.

In order to be eligible for their target investors, issuers and borrowers must follow certain rules, aiming at uniting the green, social and sustainability market.

The purpose of the below is to advocate for additional efforts and stricter rules to be applied towards issuers and borrowers to ensure that these instruments really meet their goals.

THE EMERGENCE OF SOCIAL AND SUSTAINABILITY BONDS ALONGSIDE GREEN BONDS

The purpose of a green bond is to dedicate the proceeds towards green projects. These projects are described in the prospectus governing the relevant bond and all designated green projects should, according to the Green Bonds Principles[3] released by the International Capital Market Association (ICMA), provide clear environmental benefits. Social bonds are less well known than green bonds, but at least equally inspiring. They operate on a similar principle and are intended for specific target populations. This includes those who are living below the poverty line, excluded, marginalised populations, communities, unemployed persons, vulnerable groups, people with disabilities, migrants and/or displaced people, undereducated or in need of access to essential goods and services.

There are currently several types of social bonds, ranging from plain vanilla social bonds, which contain standard recourse provisions against the issuer and the proceeds of which are used in social projects, to securitised and covered bonds that are collateralised by one or more specific social projects. This latter category includes covered bonds, asset backed notes, mortgage backed securities and other structures, in which the first source of repayment is generally the cash flows and/or the assets of a given social project[4].

Projects eligible for social bond treatment can be affordable basic infrastructure, access to essential services, affordable housing, employment generation, microfinance, food security, socioeconomic advancement and empowerment.

Lastly, the proceeds of sustainability bonds, which are arguably the least well-known of all, are exclusively applied to finance, or re-finance, a combination of both green and social projects.

Sustainability bonds are aligned with the core components of both green and social bonds. The purpose of creating a hybrid category is because certain social projects also have environmental co-benefits, and certain green projects may have social co-benefits.

A FRAMEWORK FOR GREEN AND SUSTAINABLE LOANS

It is worth noting that a new set of principles has emerged in 2018, the green loans principles, under which the Loan Market Association (the leading professional association of banks) released the green loan principles. These principles aim at creating a framework for the green loan market, particularly by establishing the conditions in which a loan can be labelled green[5]. They were followed in March 2019 by the sustainability loan standards.

The green loan principles set out a list of examples of green projects that include, for example: renewable energy projects, biodiversity conservation and wastewater management. Although these principles leave aside certain aspects of social and sustainability projects, compared to the green, social and sustainability bonds, they unite the criteria to be used by banking institutions and are a great way to incentivise them to be more active in green and sustainable finance.

These criteria and the duties of the borrower thereunder, closely track the green, social and sustainability bonds principles, as detailed below.

THE RESPONSIBILITY OF THE ISSUER

Regarding disclosures, issuers of green, social and sustainability bonds are required under the various sets of principles to communicate to investors the sustainability objectives, the process by which they determine how the underlying projects fit within the eligible categories, the related eligibility criteria and the process applied to identify and manage potential environmental and social risks associated with the relevant project[6].

The Green, Social and Sustainable Bonds Principles also encourage issuers to position the information they provide to investors within the context of their general objectives, strategy, policy and processes relating to sustainability, and to disclose any green standards or certifications referenced in the project in which they deploy the capital they raise[7].

Regarding management of proceeds, the Green, social and Sustainability Principles provide that the net proceeds of the relevant issuance should be credited to a sub-account, moved to a sub-portfolio or otherwise tracked by the issuer in an appropriate manner, as well as attested by the issuer in a formal internal process linked to its operations for sustainable projects[8].

In terms of reporting, issuers are required to provide up to date information on the use of proceeds to be renewed annually until full allocation, and on a timely basis in case of material developments[9].

Transparency is of particular value in communicating the expected impact of green, social or sustainable projects[10]. For example, the Green Bonds Principles recommend the use of key performance indicators and, where feasible, quantitative measures such as energy capacity, electricity generation, greenhouse gas emissions reduced/avoided, number of people provided with access to clean power, decrease in water use, reduction in the number of cars required etc.

Regarding green and sustainable loans, according to the Green Loans Principles the relevant borrower should clearly communicate to its lenders

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its environmental and sustainability objectives and the process by which the relevant project fits these criteria. Similarly to green, social or sustainability bonds, proceeds of the loan should be credited to a dedicated account and appropriately tracked.

Borrowers are also encouraged under such principles to develop internal governance structures for tracking allocation of funds and should always maintain an appropriate level of information on the use of proceeds, including the expected or achieved impacts of the loan. Key performance indicators, measures and disclosure of underlying methodology are recommended.

As one can see, the above-described principles are certainly great steps forward, however, they still fail to be coercive.

GREAT PRINCIPLES. BUT WHAT IF?

There is a risk that funds raised under a green, social or sustainability bond or loan are not applied consistently, or that a given organisation represents its activities or policies as producing positive environmental outcomes when this is not the case. This practice is known as "green washing" and it is one of the main hurdles faced by the green and sustainable finance market.

The green bond principles make it clear that investors in green bonds are not responsible if issuers do not comply with their commitments or the use of the resulting net proceeds and that these bonds will not default if green bond recommendations are not followed.

The same is also true of for green loans, where no event of default is triggered by the failure to track use of funds or to observe any of the duties described above.

A breach of covenants related to use of proceeds, or meeting specified key performance indicators is generally also not considered as an event of default or even a circumstance that would cause the early repayment of the loan.

Many market participants are encouraging preferred capital treatment for banks that are more active than others in providing green or sustainable loans. This would be a great way to promote them.

However these instruments need to be clearly definable and must contain strict requirements to be efficient in reaching their objectives. If we want them to be attractive, appropriate incentives must be in place for both issuers (or borrowers) and underwriters.

If a default is still a step too far, failure to report or justify that the proceeds of a given bond or loan are used in accordance with the legal documentation, could justify an increase in the spread of the relevant instrument, or additional financial (or other) covenants or undertakings. The purpose of which, would be to compensate the fact that the relevant investment or instrument is no longer eligible for green, social or sustainable treatment.

This should be the price to pay for an issuer or a borrower to benefit from a privileged status, and the way for finance to contribute more than it presently does to the efficiency of green and sustainable development

[1] For a full description of the SDGs: https://sustainabledevelopment.un.org
[2] https://stats.unctad.org/
[3] https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/June-2018/Green-Bond-Principles---June-2018-140618-WEB.pdf
[4] https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/June-2018/Social-Bond-Principles---June-2018-140618-WEB.pdf
[5] https://www.lma.eu.com/application/files/9115/4452/5458/741_LM_Green_Loan_Principles_Booklet_V8.pdf
[6] https://www.icmagroup.org/green-social-and-sustainability-bonds/green-bond-principles-gbp/
[7] https://www.icmagroup.org/green-social-and-sustainability-bonds/green-bond-principles-gbp/
[8] https://www.icmagroup.org/green-social-and-sustainability-bonds/green-bond-principles-gbp/
[9] https://www.icmagroup.org/green-social-and-sustainability-bonds/green-bond-principles-gbp/
[10] https://www.icmagroup.org/green-social-and-sustainability-bonds/green-bond-principles-gbp/

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