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Sustainable Finance: Helping Corporations Integrate ESG Principles into Daily Business and Investment Practices

Sustainable financial products help companies integrate ESG principles into their business and investment decisions. In this article, Vega takes a look at some of the key instruments available including green bonds and loans.

Green Loans

Green loans are loans made exclusively for financing or re-financing all or part of new and/or existing eligible Green Projects. The Loan Market Association (LMA), Loan Syndications and Trading Association (LSTA), and Asia Pacific Loan Market Association (APLMA) have all recognized green loans as instruments companies can use to achieve ESG goals. The LSTA has created a framework for these loans, known as the Green Loan Principles (GLP),[1] to develop responsible loans that can help companies support environmentally sustainable practices. The LSTA has issued further guidance known as the Guidance on Green Loan Principles (GLP or GLP Guidance).[2]

Green Projects address environmental concerns like climate change, conservation of natural resources, renewable energy, loss of biodiversity, and pollution, among others. Green loans must provide clear environmental benefits and must align with the GLP core components.[3] Some of the key features of these include using loan proceeds to target environmental benefits; selecting projects that fit within eligible categories and meet overall environmental sustainability objectives; identifying and managing risks; segregating or otherwise tracking loan proceeds to maintain transparency and promote loan integrity; and maintaining up-to-date records on the use of proceeds throughout the draw-down of the loan.

Green loan goals include positive environmental impacts and climate change mitigation or adaptation; positive impact on corporate reputation and credibility and stronger relationships with stakeholders; corporate access to new markets, greater resilience to climate change-based market disruptions, and lower risk; access to the growing diverse body of investors seeking to

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[1] "Green Loan Principles." *LSTA.* https://www.lsta.org/content/green-loan-principles/ (accessed September 22, 2022).
[2] "Guidance on Green Loan Principles." *LSTA.* https://www.lsta.org/content/guidance-on-green-loan-principles-glp/ (accessed September 22, 2022).
[3] See "Green Loan Principles," Core Components. *LSTA.* https://www.lsta.org/content/guidance-on-green-loan-principles-glp/ (accessed September 22, 2022).

invest in ESG-focused companies; capability of meeting regulatory and policy targets and commitments; and greater ability to attract employees for whom ESG principles are important.[4]

Sustainability-Linked Loans

Sustainability-linked loans incentivize borrowers to achieve ambitious, predetermined sustainability performance objectives. The Sustainability Linked Loan Principles (SLLP)[5] and Guidance on Sustainability Linked Loan Principles (SLLP Guidance)[6] provide important guidance for these loans.

Sustainability-linked loans are typically used for general corporate needs but borrowers can use them to improve their sustainability profile by aligning loan terms to sustainability performance targets (SPTs). For example, a company could set a goal of reducing its carbon emissions by forty percent by 2035, using 2019 emissions data as the baseline. If the company misses the targeted goal, the loan interest rate could rise although, to date, such penalties tend to be mild.

Sustainability-Linked Loans prescribe several core components that borrowers are expected to satisfy. Borrowers should select key performance indicators (KPIs) that are central to its core sustainability and business strategy and are strategically important to current and future operations. KPIs, which cover the entire range of environmental, social, and governance areas, should be benchmarked appropriately and be quantifiable using a consistent methodology.

Sustainability performance targets (SPTs) should target goals above and beyond current business trajectories. These targets should be benchmarked and timeline-based. The loan should link economic parameters to achieving the SPTs. Borrowers are expected to provide updates, at least annually, so lenders can assess whether the company its targets. An external independent auditor, environmental consultant, or independent ratings agency must verify annually the borrower's performance level against SPTs and KPIs so lenders can assess the borrower's performance.[7]

Green Bonds

Green bonds are financial instruments used for new or existing projects targeting climate change, natural resources, renewable energy and energy efficiency, water management, biodiversity, pollution mitigation or adaptation, and similar projects. The International Capital Market Association (ICMA) has developed the Green Bond Principles (GBP) to help global debt capital markets finance these projects.[8]

[4] "Guidance on Green Loan Principles," Fundamentals. *LSTA.* https://www.lsta.org/content/guidance-on-green-loan-principles-glp/ (accessed September 22, 2022).
[5] "Sustainability-Linked Loan Principles." *LSTA.* https://www.lsta.org/content/sustainability-linked-loan-principles-sllp/ (accessed September 22, 2022).
[6] "Guidance on Sustainability-Linked Loan Principles." *LSTA.* https://www.lsta.org/content/guidance-on-sustainability-linked-loan-principles-sllp/ (accessed September 22, 2022).
[7] For more specific guidelines, see "Sustainability-Linked Loan Principles." *LSTA.* https://www.lsta.org/content/sustainability-linked-loan-principles-sllp/ (accessed September 22, 2022).
[8] See "Green Bond Principles." *ICMA*. https://www.icmagroup.org/assets/documents/Sustainable-finance/2022-updates/Green-Bond-Principles_June-2022-280622.pdf (accessed September 22, 2022). There are four types of green bonds. These can be found in Appendix 1.

The GBP focus on four core components: use of proceeds, the process for project evaluation and selection, management of proceeds, and reporting. An issuer is expected to provide to investors information on its project's environmental sustainability objectives, the process used to determine how a particular project fit within the eligible categories, and information on the processes by which it identifies and manages certain perceived risks. A formal transparent internal tracking system and independent third-party verification ensure integrity.

Reporting not only tracks the use of the proceeds but attempts to improve insight into their impact. To encourage transparency, the GBP recommend the use of Green Bond Frameworks or legal documentation to explain how an issuer's green bonds align with the core components. This documentation, which should be made available to investors, should summarize the relevant information and how it fits the issuer's sustainability strategy.[9]

Social Bonds

Social bonds are financial instruments that support projects designed to achieve sustainable social benefits. These bonds can be used to finance or re-finance eligible new or existing social projects in part or in full.

The International Capital Market Association (ICMA) has developed the Social Bond Principles (SBP)[10] to assist global debt capital markets finance projects on basic infrastructure, affordable housing, healthcare and other essential services, job development, food security, and socioeconomic advancement and empowerment. The goal is to benefit certain populations such as the poor, historically excluded and marginalized populations, people with disabilities, migrants, those with lower levels of education, women and gender minorities, older persons, vulnerable younger persons, and others at risk.

The four core principles of the SBP are the same as those applicable to Green Bonds: use of proceeds, the process for project evaluation and selection, management of proceeds, and reporting. Social issues are in a state of flux and the Social Bond Principles cover broad categories of projects. Participants are expected to use suggested criteria to develop their own frameworks within these broad categories to create their own practices. But the projects should be targeted so that the proceeds ultimately lead to clear social benefits.

Transparency is key and issuers are expected to track and correlate the funds used for these projects while improving insight into the impacts these projects have. To this end, the issuers should assess and, where feasible, quantify the results so the impacts are transparent.[11]

Sustainability Bonds

Sustainability Bonds are financial instruments used for a combination of social and green projects. The ICMA has issued the Sustainability Bond Guidelines (SBG) which track the same core components found with Green and Social Bonds. There is often overlap in benefits with social and

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[9] *Id.*

[10] See "Social Bond Principles." *ICMA*. https://www.icmagroup.org/assets/documents/Sustainable-finance/2022-updates/Social-Bond-Principles_June-2022v3-020822.pdf (accessed September 23, 2022). There are four types of social bonds. These can be found in Appendix 1.

[11] *Id.*

green projects. The SBG leave it up to the issuer to classify a project in accordance with its based primary objectives.[12]

Sustainability Bonds used for combined green and social projects can take the same forms as those listed in Appendices of both the Green Bond Principles and the Social Bond Principles.[13] The ICMA encourages organizations focusing solely on sustainable activities to use the Green Bond, Social Bond, and Sustainability Bond best practices where their Sustainable Development Goals (SDGs) might differ from ICMA guidelines. A 'mapping' of the Green Bond and Social Bond principles to the SDGs is now available so issuers, investors, and others can compare these financing objectives.[14]

Sustainability-Linked Bonds

Sustainability-Linked Bonds take Sustainability Bonds a step further, potentially covering not only environmental and social projects but those directed at governance as well. Issuers of these bonds commit to predefined sustainability/ESG outcomes within a specific time period.

The ICMA created the Sustainability-Linked Bond Principles (SLBP)[15] to guide issuers on key aspects of SLBs, provide investors with the information to evaluate their SLB investments, and help underwriters by nudging the market toward predictable structuring and disclosures.

The SLBP have five core components: selection of key performance indicators (KPIs), calibration of sustainability performance targets (SPTs), bond characteristics, reporting, and verification. Proceeds of these bonds are used for general purposes so 'use of proceeds' is not a core component of this type of bond.

The KPIs should be credible, material, and strategically significant to the issuer's current and/or future operations. They should be consistently measurable and verifiable externally. And they should be benchmarked so it is clear how ambitious the SPTs actually are. Issuers should provide information so investors can understand how the KPIs were chosen and how they fit into the overall sustainability strategy.

The SPTs should, among other things, be realistic but ambitious, focusing on material achievements above and beyond 'business as usual.' They should fit the overall sustainability/ ESG strategy and progress should be benchmarked or otherwise measurable on a predefined timeline.

The bond characteristics are key to this type of instrument. The bond should include in the papers some kind of financial or structural impact, such as a meaningful increase in the coupon rate or

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[12] See "The Sustainability Bond Guidelines." *ICMA.* https://www.icmagroup.org/assets/documents/Sustainable-finance/2021-updates/Sustainability-Bond-Guidelines-June-2021-140621.pdf (accessed September 22, 2022).
[13] *Id.,* Note 1.
[14] "Mapping to the Sustainable Development Goals." *ICMA.* https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/mapping-to-the-sustainable-development-goals/ (accessed September 22, 2022).
[15] See "Sustainability-Linked Bond Principles." *ICMA.* https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/June-2020/Sustainability-Linked-Bond-Principles-June-2020-171120.pdf (accessed September 23, 2022).

payment of a penalty, if the issuer does not achieve the predefined level of sustainability or ESG objectives.

Issuers should publish, at least annually, up-to-date information that allows investors to evaluate the performance of the KPIs against the SPTs and the impact on the financial and/or structural characteristics of the bond. Annual publication of independent and external verification of the issuer's performance should continue until the bond's last SPT trigger event is reached.