



Finance ADVISORY ■

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Green Bonds, Sustainability-Linked Bonds, and the New European ESG Disclosure Requirements

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In case you missed it, [Part 1 in our ESG series](#) introduced environmental, social, and governance (ESG) finance, considered its impact on the structured finance markets, and considered the implications of the COVID-19 pandemic on ESG. [Part 2 in our ESG series](#) considered green loans, the 'Green Loan Principles', and the relevance of green loans to businesses. [Part 3 in our ESG series](#) considered sustainability-linked loans, the 'Sustainability Linked Loan Principles', and how businesses could attract and qualify for a sustainability-linked loan.

According to Moody's, the heavy issuance of bonds aimed at tackling the effect of the COVID-19 pandemic may push the size of the sustainable debt market to a new record this year. Companies are taking advantage of historically low interest rates to shore up cash and taking advantage of new types of debt to demonstrate their social-consciousness credentials as they weather the pandemic. The rating agency has forecast that the volume of newly issued debt based on ESG principles could reach \$375 billion (an increase of \$50 billion over last year), with the market moving away from green bonds to other types of social and sustainability-linked bonds.

GREEN BONDS

What Are Green Bonds?

Green bonds are bond issuances in which the proceeds must be exclusively applied to finance or refinance, in part or in full, new or existing eligible projects that promote progress on environmentally sustainable activities.

Originally issued by multilateral and supranational lenders such as the World Bank, corporates have over the last few years begun to issue green bonds in order to appeal to ever-more environmentally aware investors. According to Dealogic, green bond issuance has increased by about eightfold over the past five years, to \$77.4 billion. On the other hand, investment-grade companies issued \$2.3 trillion in traditional bonds through 1 October 2020, a 9% increase compared with the whole year of 2019.

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The Green Bond Principles

The [Green Bond Principles](#) (GBP) are voluntary guidelines set out by the International Capital Markets Association (ICMA), first introduced in June 2018. They recommend and encourage transparency and disclosure in, and promote integrity to facilitate the development of, the green bond market. They are designed to provide issuers with guidance on the key components involved in the issuance of green bonds. Any business looking to issue a green bond should follow this guidance to secure investors in any green bond issuance.

The GBP do not seek to define with any certainty what a green bond is, or even what types of projects may justify a green bond issuance; rather, they aim to aid investors by promoting availability of information to evaluate the impact of investing in a business's green bond whilst assisting issuers and underwriters by moving the market towards industry-standard disclosures. The GBP emphasise transparency, accuracy, and integrity of information to be disclosed and reported by issuers to investors.

How Does a Business Qualify for a Green Bond? The GBP's "Four Core Components"

In order to qualify for a green bond, businesses should comply with the "four components" of the GBP.

Use of proceeds

A business will need to declare which of the eligible 'green project' categories the project falls into. The GBP recognises several broad categories of eligibility for green projects (climate change mitigation, climate change adaptation, natural resource conservation, biodiversity conservation, and pollution prevention and control) and also provides a nonexhaustive list of the most commonly used types of projects supported or expected to be supported by the green bond market, including renewable energy, pollution prevention and control, environmentally sustainable management of living natural resources, clean transportation, sustainable water and wastewater management, and green buildings.

A business will further need to declare which of these categories (including types of investments made indirectly through financial intermediaries) the green bond will fund in the disclosures section of the legal documentation. The GBP recommend that clear environmental benefits be described and, where at all possible, quantified.

Process for evaluation and selection

An issuer will need to determine and communicate to investors:

- 'The environmental sustainability objectives'.
- The process for determining how the project fits within the eligible green projects categories.
- 'The related eligibility criteria, including, if applicable, exclusion criteria or any other process applied to identify and manage potentially material environmental and social risks associated with the projects'.

Management of proceeds

The net proceeds of the bond issuance will need to be credited to a sub-account or moved to a sub-portfolio (or otherwise track in a similar manner) and attest to this through an internal process that will be linked to lending and investment operations for green projects. So long as the green bond remains outstanding, the balance of these tracked proceeds should be periodically adjusted to match allocations to eligible green projects made during that period. Any unallocated net proceeds should be made known to investors.

The GBP encourage a high level of transparency and recommend that an auditor or other third party verifies this internal tracking method.

Reporting

The use of proceeds should be reported at least annually to investors via electronic channels and promptly updated with any material developments. It appears, however, to be becoming the market norm for issuers to report quarterly. This should include filed financial reports on the specific investments made from the green bond proceeds, detailing (unless confidentiality or competitive considerations prevent it) the specific projects and amounts invested along with their expected environmental impact. When confidentiality prevents this from being disclosed, as much detail as possible should be included in generic terms or on an aggregated portfolio basis.

The GBP recommend the use of qualitative performance indicators and, where feasible, quantitative performance measures and disclosure of the key underlying methodology and assumptions used in the quantitative measures.

Green Bonds – External Review

The GBP recommend that issuers use external assurance (via an auditor or other third party) to confirm the alignment to the four core components). This may include:

- **Second-party opinions** – An institution with recognised expertise in environmental oversight might be able to provide assurance or a second-party opinion. This institution should be independent from the issuer or its advisors and could help to review or assess the selection or evaluation of the selected green project in line with stated objectives. For example, the Big Four accounting firms have just launched a joint initiative to unveil a reporting framework for ESG standards.
- **Verification** – Issuers could obtain independent verification, or audits, on the business processes, environmental criteria, or allocation of funds, in line with the internal or external standards made in the offering documentation.
- **Certification** – The green bond could be certified against a recognised external green standard or label (for example the Carbon Trust assurance or certification under the Climate Bonds Standard).
- **Green Bond Rating** – It is now commonplace for credit rating agencies to provide scoring or rating methodologies for rating ESG products, which could be applied to the green bond. We discussed the [rating of ESG products further in Part 1 of our ESG series](#).

SUSTAINABILITY-LINKED BONDS

What Are Sustainability-Linked Bonds?

As opposed to green bonds, sustainability-linked bonds (SLBs) are bonds whose proceeds are not ring-fenced to be applied towards green or sustainable purposes. Instead, SLBs will have financial or structural characteristics that will vary depending on whether the issuer meets certain pre-defined key performance indicators (KPIs), which are assessed against certain sustainability performance targets (SPTs).

SLBs may be used for application in a general corporate setting or for other purposes; therefore, the use of proceeds is not a determinant in its categorisation as an SLB. If an SLB is issued, the issuer will be committing to improvements in the sustainability outcomes of its business within a pre-agreed timeline. SLBs are forward-looking, performance-based instruments. SLBs appeal to companies that want to offer ESG bonds with fewer financial restrictions. Companies

issuing SLBs tend to experience lower staffing and administrative costs compared with green bonds. Similarly, companies have more control over the financial benefits of SLBs because the financial benefits of SLBs are in the hands of the issuer.

The growth of SLBs throughout the course of 2020 is enabling more issuers to access the sustainable finance market. Whereas green bonds tend to be issued by issuers with heavy expenditure in the green area (e.g., renewable energy, utilities providers, sustainable construction), corporate issuers that do not rely on green expenditures use the proceeds of an SLB without using such proceeds to fund a green project. Investors are able to get more clarity on their ESG commitments through such an SLB sale, and extra resources will not need to be expended to isolate ESG projects. As an issuer of an SLB, what will be of significant importance to investors will be the sustainability/ESG strategy and whether or not pre-agreed targets are met through the term of the SLB. This could explain the reason SLB issuance has grown so sharply during the course of the COVID-19 pandemic. According to Moody's in Q2 2020, a record \$19 billion SLBs were issued, compared with \$48 billion in the whole of 2019. It seems COVID-19 has heightened awareness of social and sustainability issues.

In September 2020, the European Central Bank (ECB) announced it would start to accept SLBs as collateral from 1 January 2021 and that it could start buying them under its asset purchase programmes provided they comply with programme-specific eligibility criteria. Although green bonds have featured in the ECB's asset purchase programmes for years, SLBs had not been eligible for them because the ECB considered coupon increases or decreases triggered by an issuer's sustainability performance as a margin. This has now changed, and the ECB has said the coupons on SLBs must be linked to a performance target referring to one or more of the environmental objectives set out in the EU Taxonomy Regulation and one or more of the United Nations' Sustainable Development Goals relating to climate change or environmental degradation.

The Sustainability-Linked Bond Principles

In June 2020, the ICMA published the [Sustainability-Linked Bond Principles](#) (SLBPs). Whilst these are voluntary guidelines, they do represent best practices to promote market integrity and transparency, and market participants and investors would encourage an SLB to comply as much as possible.

How Does a Business Qualify for an SLB? The SLBP's 'Five Core Components'

In order to qualify for a sustainability-linked bond, a business should comply with the 'five core components' of the SLBP.

Selection of KPIs

The success of the SLB will depend on the selection of sustainability KPIs. These must be credible and they must be material to a core sustainability and business strategy but can be internal or external. The SLBPs state that any selected KPIs should be:

- Relevant, core, and material to the overall business, and of high strategic significance to current and future operations.
- Measurable or quantifiable on a consistent methodological basis.
- Externally verifiable.
- Able to be benchmarked (as much as possible using an external reference/definition to benchmark the level of the SPT ambition).

A business will be encouraged to select any KPIs that have previously been included in any annual reports or sustainability reports to allow investors to evaluate the historical performance of the business in this area. If this information is not available, historical externally verified values should be provided covering at least the last three years.

Businesses are also encouraged to communicate to investors the rationale in selecting the KPIs, to provide clear definitions, and to provide relevant baseline or historical data.

Calibration of SPTs

The process of calibrating the SPTs for each KPI is important because this sets the level of ambition issuers are willing to commit to when issuing an SLB. The SPTs should be set in good faith and should clearly be realistic. They should also be ambitious and:

- Represent a material improvement in the KPIs and be beyond a 'business as usual' trajectory.
- Where possible, be compared to a benchmark or an external reference.
- Be consistent with an overall strategic sustainability/ESG strategy.
- Be determined on a pre-defined timeline set before (or concurrently with) the issuance of the SLB.

The target-setting exercise should also be based on a combination of benchmarking approaches:

- Historical performance (preferably a minimum of three years).
- Peer-to-peer comparison.
- By reference to science or official country/regional/international targets or to recognised best available technologies or other proxies.

The SLBPs encourage external reviewers, for example third-party auditors, to be appointed to assess the relevance, robustness, and reliability of the selected KPIs, the rationale and the level of ambition of the proposed SPTs, and the credibility of the strategy. If there were any material change to the perimeter or KPI methodology or SPT calibration, external reviewers should be encouraged to assess these changes.

Bond characteristics

The key element of an SLB is that its financial and structural characteristics may vary depending on whether the KPIs agreed at issuance achieve their targets during the term of the SLB. When such targets are not achieved, it is recommended that the financial and structural characteristics are 'commensurate and meaningful' in order to place significance on issuers to achieve their targets.

Potential variation of characteristics may include the step-up/step-down of coupon or the change in maturity date of the SLB. There is, however, no set mechanic outlined in the SLBT.

Reporting

Reporting should be published and remain easily available and accessible:

- Up-to-date information of the performance of the selected KPIs, including baselines where relevant.
- A verification assurance report relative to the SPTs outlining performance against it.
- Any information enabling investors to monitor the level of ambition of the SPTs (e.g., any update in sustainability strategy or information relevant to the analysis of the KPIs and SPTs).

This should be published at least annually and in any case for a period relevant to assessing SPT performance leading to a potential adjustment of the SLB's financial and structural characteristics.

Verification

Independent and external verification (e.g., from an independent auditor) should be sought to assess the KPI performance against the pre-agreed SPTs by a qualified external reviewer with experience in this sector. This should occur at least once a year and whenever relevant when a potential adjustment of the SLB's financial or structural characteristics may occur.

THE NEW EUROPEAN ESG DISCLOSURE REGIME

The Sustainable Finance Disclosure Regulation, (EU) 2019/20885, published in December 2019, and the Taxonomy Regulation, (EU) 2018/0178, published in June 2020, both form part of a new European ESG disclosure regime.

The Sustainable Finance Disclosure Regulation

Overview

The Sustainable Finance Disclosure Regulation (SFDR) requires certain firms to make strategic, business, and policy decisions about their approach to ESG.

Such firms will be required to provide investors with (1) pre-contractual disclosures; (2) disclosures in periodic reports; and (3) disclosures on their websites about their ESG processes and monitoring, as well as how ESG is integrated into their risk processes.

There are 50 sustainability measures to consider, of which 30 will be mandatory. Firms in scope will need to comply by implementing a due diligence policy that sets out how sustainability factors into their investment decisions. The explanation should include information on whether and when the firm does intend to consider such impacts.

Although the focus of the SFDR is to assist in the disclosure of ESG information to market participants, especially investors, it is clear that many firms will need to allocate more resources to ESG monitoring going forward. Most of the obligations will not come into force until 10 March 2021, but issuers and other market participants should start considering how they will comply with the SFDR now.

Scope

The SFDR applies at both the firm and product levels for all financial products, rather than just those with an ESG focus (though clearly SLBs and green bonds will be particularly relevant). This includes:

- **Financial market participants** – AIFMs, UCITS management companies, MiFID investment firms, managers of qualifying VC funds or qualifying social entrepreneurship funds, pan-European personal pension product providers, manufacturers of pension products, and institutions for occupational retirement provision.
- **Financial advisors** – AIFMs, UCITS management companies, investment firms, insurance intermediaries relating to IBIPs, insurance undertakings relating to IBIPs, and credit institutions if those firms provide investment advice.
- **Financial products** – AIFs, UCITS, portfolios managed under MiFID, IBIPs, pension products, and PEPPs.

New concepts

The SFDR has also introduced a number of new concepts that will need to be considered by firms when disclosing their approach to ESG:

- ***Sustainable investment*** – An investment in an economic activity:
 - That contributes to an environmental or social objective or an investment in human capital or economically or socially disadvantaged communities.
 - That does not significantly harm those objectives.
 - Whose investing company follows good governance practices.
- ***Sustainability risk*** – An ESG event or condition that, if it occurs, could cause an actual or potential material negative impact on the value of an investment.
- ***Sustainability factors*** – Environmental, social, and employee matters, respect for human rights, anti-corruption, and anti-bribery matters.

The Taxonomy Regulation

A further development in the journey of ESG is the Taxonomy Regulation, which provides an EU-wide framework for classifying economic activities that can be identified as ‘environmentally sustainable’.

The majority of its provisions will apply from 31 December 2021.

The Taxonomy Regulation sets out six environmental objectives that should be considered:

1. *Climate change mitigation.*
2. *Climate change adaptation.*
3. *Sustainable use and protection of water and marine resources.*
4. *Transition to a circular economy.*
5. *Pollution prevention and control.*
6. *Protection and restoration of biodiversity and ecosystems.*

There are four requirements that economic activities must comply with in order to qualify as environmentally sustainable:

1. *They provide a substantial contribution to at least one of the six environmental objectives.*
2. *‘No significant harm’ is caused to any of the other environmental objectives.*
3. *Compliance with robust and science-based technical screening criteria.*
4. *Compliance with minimum social and governance safeguards.*

A key focus of the new regime is to prevent issuers from ‘greenwashing’ or ‘sustainability washing’ their products, concepts we have previously discussed at length in this series, when issuers aim to paint their products as more green or sustainable on the face of it than they actually are.

CLOSING REMARKS

The investment landscape is changing. Whether this is a result of the COVID-19 pandemic or not is up for debate. Nonetheless, ESG is becoming an increasingly more important investment decision for companies to consider.

At some point, all investments will have an ESG component, and it is those businesses and those investments that have strong ESG metrics that are more likely to prosper over those that disregard ESG principles. As more and more examples of good and bad social or governance strategies emerge from the COVID-19 pandemic, investors may increasingly demand, and managers to increasingly become mandated to invest in, ESG products such as green bonds and SLBs. Investor demand for ESG-related investments such as these will increase as demographics, public opinion on social and justice issues, and the aftermath of the COVID-19 pandemic and climate change continue to evolve.

Alston & Bird is one of the first firms to activate a multidisciplinary [ESG Advisory Group](#) made up of lawyers across several practice groups to assist boards of directors and managers of public companies in understanding the evolving ESG landscape.

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