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Sustainable Finance Update

New Loan Standards, Proposed EU Green Bond Standard and Other Recent Developments

SUMMARY

Sustainable finance is a fast-growing and diversifying market which is becoming increasingly relevant to investors, investment funds, companies, banks, insurers, regulators and their advisors. Beyond achieving positive environmental and/or social outcomes, sustainable finance can also yield commercial and reputational benefits for market participants. Issuing a green bond or entering into a green or sustainability-linked loan can be a high-profile means of showcasing corporate sustainability efforts. Greater levels of disclosure and operational efforts to address sustainability can lead to deeper, positive stakeholder engagement, including with investors, employees, customers and local communities. Conversely, sustainability commitments may impose operational costs and pose reputational risks in the event of non-compliance. There are also modest, incremental administrative costs associated with green/sustainable products which have thus far not been demonstrably offset by pricing advantages.

This update covers several recent developments in the market following our last update from December 2018.[1] Two new voluntary loan standards were published: the Sustainability Linked Loan Principles and the Poseidon Principles. In addition, new guidance was released on the Green Bond Principles (GBPs) and the Social Bond Principles (SBPs), although no changes were made to the principles themselves. However, the European Union (EU) Technical Expert Group released the proposed voluntary EU Green Bond Standard as part of the European Commission's comprehensive sustainable finance initiative. Several other proposals were recently published in connection with this initiative. In sum, the new developments generally continue the trend of non-binding, industry-led standards which rely on commercial and reputational incentives to ensure compliance. However, various components of the EU sustainable finance initiative would entail greater levels of regulatory oversight. This should be considered

and monitored by market participants both in Europe and beyond, as it is likely to influence sustainable finance policy and practice in other jurisdictions in the future.

BACKGROUND

"Sustainable finance" refers to the practices and instruments of the financial services industry aimed at promoting desirable environmental and/or social outcomes. These include green bonds, green loans, social bonds, sustainable bonds and sustainability-linked loans. The growth and diversification of these markets has accelerated since the 2015 Paris Agreement on climate change, which included a commitment to making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development.[2]

The global development of sustainable finance has been driven largely by voluntary market standards rather than through mandatory regulatory frameworks. For example, the GBPs,[3] updated periodically since 2015 by the International Capital Market Association (ICMA), have developed into the global baseline standard for green bond issuers. We have previously outlined the key legal considerations associated with issuing a green bond.[4] The GBPs have now been complemented by similar guidelines for issuers of social bonds[5] and sustainability bonds,[6] as well as for borrowers and lenders of green loans.[7]

One notable exception to the purely voluntary nature of sustainable finance is the ongoing EU sustainable finance initiative. As we summarized previously,[8] in March 2018 the European Commission published an Action Plan for integrating sustainability considerations into its financial policy framework to better support

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1 "Recent Developments in Sustainable Finance", *Project Finance International* (Craig Jones and Samuel Saunders, December 12 2018): https://www.sullcrom.com/publications-craig-jones-samuel-saunders-publish-article-project-finance-international-2018.

2 Article 2.1(c) of the Paris Agreement, adopted on 12 December 2015 by the 21st Conference of the Parties (COP 21) to the United Nations Framework Convention on Climate Change (UNFCCC) (hereafter, the "Paris Agreement").

3 The GBPs can be accessed at: https://www.icmagroup.org/green-social-and-sustainability-bonds/green-bond-principles-gbp/.

4 *See* Czerniecki and Saunders (2016) "Green Bonds: An Introduction and Legal Considerations", 48 SRLR 275, available at https://www.sullcrom.com/publications-czerniecki-saunders-author-bloomberg-bna-article-green-bonds-2016.

5 The SBPs can be accessed at: https://www.icmagroup.org/green-social-and-sustainability-bonds/social-bond-principles-sbp/.

6 The SBGs can be accessed at: https://www.icmagroup.org/green-social-and-sustainability-bonds/sustainability-bond-guidelines-sbg/.

7 The GLPs can be accessed at: https://www.lma.eu.com/application/files/9115/4452/5458/741_LM_Green_Loan_Principles_Booklet_V8.pdf.

8 "Recent Developments in Sustainable Finance", *Project Finance International* (Craig Jones and Samuel Saunders, December 12, 2018): https://www.sullcrom.com/publications-craig-jones-samuel-saunders-publish-article-project-finance-international-2018.

the EU's climate and sustainable development agenda. The Action Plan contains 10 comprehensive action points outlining the Commission's proposals. The EU also set up a Technical Expert Group (TEG) on sustainable finance to assist in its development of the sustainable finance package. In May 2018, the Commission released the first proposed legislative package under the Action Plan, and further political agreements were announced earlier this year.[9] However, the timing of implementation of the various steps remains uncertain, and proposals have progressed at varying speeds.

RECENT DEVELOPMENTS

A. NEW LOAN STANDARDS

i. Sustainability-Linked Loan Principles

Following on from the Green Loan Principles[10] (published in 2018), on March 20, 2019 the Loan Market Association (LMA), Loan Syndications and Trading Association (LSTA) and Asia Pacific Loan Market Association (APLMA) published the Sustainability-Linked Loan Principles (SLLPs). The SLLPs establish a voluntary framework for the design and negotiation of sustainability-linked loans (SLLs). SLLs are loans that have certain terms such as pricing tied to sustainability performance targets of the borrower (such as a reduction in greenhouse gas (GHG) emissions, improvements in energy efficiency rating of buildings owned or leased by the borrower, or increases in the use of verified sustainable raw materials). Borrowers are incentivized with margin reductions (or increases) depending on their ability to achieve certain pre-set environmental or social performance targets. Typically, the margin step-ups are quite modest.

The proceeds of SLLs can be used for general corporate purposes, unless the borrower also is seeking to have the SLL qualify as a green loan, in which case the proceeds must be used for green projects in accordance with the Green Loan Principles.

ii. Poseidon Principles

On June 18, 2019, a group of international banks, including Citi, DNB and Société Générale, published a voluntary framework, the "Poseidon Principles", committing to assessing and disclosing the climate alignment of their ship finance portfolios. In this context, "climate alignment" refers to the extent to which GHG emissions associated with a financial institution's portfolio are in line with the climate targets set by the International Maritime Organization (IMO).[11] In order to complete the annual assessment and reporting, the signatories have committed to include a covenant in new loan agreements requiring the

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9 *See*, for example: "Capital Markets Union: Commission welcomes agreement on sustainable investment disclosure rules" (*European Commission Press Release*, 7 March 2019) http://europa.eu/rapid/press-release_IP-19-1571_en.htm; and "Sustainable Finance: Commission welcomes agreement on a new generation of low-carbon benchmarks" (*European Commission Press Release*, 25 February 2019) http://europa.eu/rapid/press-release_IP-19-1418_en.htm.

10 The GLPs can be accessed at: https://www.lma.eu.com/application/files/9115/4452/5458/741_LM_Green_Loan_Principles_Booklet_V8.pdf.

11 The Poseidon Principles can be accessed at: https://www.poseidonprinciples.org/principles/

borrower to provide the necessary data on carbon emissions of its vessels. A model covenant clause was published along with the principles.

The Poseidon Principles are currently applicable to signatory lenders, lessors and financial guarantors and will be applied to all credit products and finance leases secured by title or mortgages over IMO-covered shipping vessels. Climate alignment is currently the only environmental factor considered. The scope of the principles may grow over time, and it is likely that additional banks and export credit agencies active in shipping finance will become signatories.

B. PROPOSED EU GREEN BOND STANDARD

On June 18, 2019, the EU TEG published its report on a proposed voluntary EU Green Bond Standard (EU-GBS).[12] The objectives of the EU-GBS are to enhance transparency, integrity, consistency and comparability of green bonds, with an overarching goal of increasing financing into green and sustainable projects. The EU-GBS would not apply to social bonds.

i. Key differences between the EU-GBS and GBPs

The EU-GBS generally aligns with the GBPs published by ICMA (a private sector trade association) and existing market practice. A few points of interest are:

1. The EU-GBS would require the funded green projects to contribute substantially to at least one of the Environmental Objectives[13] defined in the EU Taxonomy Regulation (when implemented, as discussed below) while not significantly harming any of the other objectives, as well as comply with minimum social safeguards represented by the principles and rights set out in the eight fundamental conventions identified in the International Labour Organisation's declaration on Fundamental Rights and Principles at Work.[14] In practice, most existing green bonds should meet these criteria.

2. The EU-GBS has some welcome guidance on which projects bond proceeds can be applied against, which can include:

    a. Green assets, including physical assets and financial assets such as loans. Green assets can be tangible or intangible, and they can include the share of

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[12] The EU GBS Report can be accessed at: https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190618-sustainable-finance-teg-report-green-bond-standard_en.pdf.

[13] Namely (i) climate change mitigation, (ii) climate change adaptation, (iii) sustainable use and protection of water and marine resources, (iv) transition to a circular economy, waste prevention and recycling; (v) pollution prevention and control and (vi) protection of healthy ecosystems.

[14] These conventions cover freedom of association and the effective recognition of the right to collective bargaining, the elimination of forced or compulsory labor, the abolition of child labor and the elimination of discrimination in respect of employment and occupation.

working capital that can reasonably be attributed to their operation. It also makes clear that green loans/bonds can refinance other green loans/bonds.

b. Green expenditures, including any capital expenditure and selected operating expenditures, such as maintenance costs related to green assets, that either increase the lifetime or the value of the assets, as well as research and development costs. Operating expenditures such as purchasing costs and leasing costs would not normally be eligible.

c. In addition, it is specified that green assets qualify without a specific look-back period provided that at the time of issuance they follow the eligibility criteria listed above, while eligible green operating expenditures qualify for refinancing with a maximum three-year look-back period before the issuance year of the bond. The GBPs do not have a maximum look-back period.

3. Reporting requirements are expanded under the EU-GBS and would entail:

   a. Allocation reporting at least annually until full allocation of the bond proceeds (and thereafter, in case of any material change). A final allocation report would be required showing a breakdown of allocated amounts by geography and sector/type, which would need to be verified by an external party.

   b. An impact report at least once during the lifetime of the bond, although this would not need to be verified externally. The impact report would include a breakdown of green projects by the nature of what is being financed (assets, capital expenditures, operating expenditures, etc.) and the split of proceeds used for new financing versus "refinancing" (up-front allocation of proceeds against past expenditures), as well as information and, when possible metrics, on the projects' environmental impacts.

4. The EU-GBS includes a proposed centralized scheme of accreditation for external green bond verifiers, overseen by the European Securities and Markets Authority (ESMA). External verification is recommended under the GBPs but not required.

5. A green bond framework outlining what projects are eligible for the use of proceeds, is required under the EU-GBS, which most issuers already publish.

Issuers would be given the option to align their existing bonds with the EU-GBS once it is in effect.

ii. Proposed Incentives / Benefits of the EU-GBS

The EU-GBS would be voluntary, but the TEG report contains recommendations to incentivize compliance, including:

1. Requiring disclosure of EU-GBS compliant holdings by European institutional investors in conjunction with the contemplated sustainability-related disclosures regulation;[15]

[15] Sustainable finance: Presidency and Parliament reach political agreement on transparency rules, updated 26 March 2019: https://www.consilium.europa.eu/en/press/press-releases/2019/03/07/sustainable-finance-presidency-and-parliament-reach-political-agreement-on-transparency-rules.

2. Encouraging central banks to preferentially purchase EU-GBS bonds when purchasing green bonds;

3. Providing financial incentives to support EU-GBS compliant issuers, such as grants to offset the additional costs of external verification; and

4. Tax incentives and preferential prudential treatment of EU-GBS bonds on the balance sheets of regulated financial institutions, ideas which the report notes require further analysis.

The timing of the implementation of the EU-GBS is currently uncertain. The Commission has indicated that it will now study the report, while the TEG works further on the design of a proposed temporary, voluntary registration system of approved verifiers.

C. OTHER RECENT EU DEVELOPMENTS

In addition to the EU-GBS, the EU sustainable finance initiative continues to generate new reports and guidelines. In brief, these include:

1. ***EU Sustainable Investment Taxonomy Regulation.*** A "political agreement" was announced in March 2019 by the European Parliament and the European Commission on a proposal for a new EU regulation on the establishment of a sustainable investment framework (a "Taxonomy"). The exact drafting of the regulation remains under discussion. The Taxonomy regulation would provide companies with consistent and easily comparable sustainability credentials. On June 18, 2019, the TEG published a lengthy technical report[16] containing final recommendations for the Taxonomy. It sets out technical screening criteria for 67 economic activities to qualify as "environmentally-sustainable economic activity" and thus be Taxonomy-eligible.

2. ***EU Sustainable Benchmark Regulation.*** A "political agreement" was also announced in February 2019 on a proposal for the amendment of the Benchmark Regulation 2016/2011[17] to create two climate benchmarks: the EU Climate Transition Benchmark and the EU Paris-aligned Benchmark, and to define ESG disclosure requirements applicable to all investment benchmarks. Further to this proposal, the

[16] The Taxonomy Technical Report can be accessed at: https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190618-sustainable-finance-teg-report-taxonomy_en.pdf.

[17] Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016.

TEG published on June 18, 2019 an interim report[18] providing technical advice on minimum disclosure requirements to improve transparency and comparability of information across benchmarks regarding both climate-related information and other ESG indicators.

3. ***European Commission Guidelines on Reporting Climate-Related Information.*** On June 17, 2019, the European Commission published guidelines[19] on reporting climate-related information pursuant to Directive 2014/95/EU,[20] which sets out rules on the disclosure of non-financial information. The recently published guidelines supplement the Non-Binding Guidelines on Non-Financial Reporting published by the Commission in June 2017[21] and seek to facilitate the disclosure of non-financial, sustainability-related information by companies in a consistent and comparable manner.

D. UPDATED GREEN BOND AND SOCIAL BOND PRINCIPLES MATERIALS

The ICMA announced on June 13, 2019 that there would be no updates to the GBPs, SBPs or SBGs for 2019. However, the ICMA did publish several guides on the interpretation and application of these standards, including publications on harmonizing frameworks for impact reporting for green bonds[22] and social bonds.[23] These frameworks outline key principles and recommendations for impact reporting and include suggested core indicators and reporting templates for various types of green and social projects. Of note, the recommendations contemplate funding investments or projects which are only partially eligible as Green or Social Projects, provided that: (i) the issuer is transparent about whether and to what extent it accepts partial eligibility; and (ii) the green bond proceeds are allocated only to the eligible portion of the project.

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18 The TEG Interim Report on Climate Benchmarks and Benchmarks' ESG Disclosures can be accessed at: https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190618-sustainable-finance-teg-report-climate-benchmarks-and-disclosures_en.pdf.

19 The Guidelines on Reporting Climate-Related Information can be accessed at: http://ec.europa.eu/finance/docs/policy/190618-climate-related-information-reporting-guidelines_en.pdf.

20 Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups.

21 The Guidelines on non-financial reporting can be accessed at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52017XC0705(01).

22 The Handbook can be accessed at: https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/June-2019/Handbook-Harmonized-Framework-for-Impact-Reporting-WEB-100619.pdf.

23 This publication can be accessed at: https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/June-2019/Framework-for-Social-Bond-Reporting-Final-06-2019-100619.pdf

In addition to the reporting frameworks, a "green project mapping" was published[24] for those investors with specific environmental objectives, such as climate change mitigation or biodiversity, to clarify the extent to which certain green project categories under the GBPs contribute to those objectives. Another publication, the "High-Level Mapping to the Sustainable Development Goals"[25] maps the UN-sponsored Sustainable Development Goals (SDGs) against GBP Project categories in order to assist issuers and investors in aligning their green bond frameworks and investments with the SDGs, which is an increasingly common objective.

IMPLICATIONS

For investors, funds, corporates, banks and others considering how to be more active in the sustainable finance market, these recent developments present a broader range of options for increasingly sophisticated, bespoke solutions to meet desired objectives. Significantly, newer products such as sustainability-linked loans, add direct commercial incentives by way of decreased interest costs, in contrast to traditional sustainable bonds/loans, which thus far have not delivered clear pricing incentives.

What qualifies as "green", "social" or "sustainable" remains a key consideration, along with ensuring transparency and compliance with relevant sustainability commitments. While most market standards remain voluntary, issuers and borrowers need to consider the reputational risks of non-compliance. In addition, a regulatory framework for sustainable finance in the EU is gradually developing, driven by a desire to ensure the integrity of the asset class and limit "greenwashing". This is reflected by the focus on robust disclosure, harmonization of standards and verification, and quantification (and comparison) of impacts. As sustainable finance continues to develop and diversify at a rapid pace, it is important for all market participants to monitor the evolution of market regulations, standards, practices and perceptions.

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[24] Green Project Mapping can be accessed at: https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/June-2019/Green-Projects-Mapping-Document-100619.pdf

[25] The High-Level Mapping to the Sustainable Development Goals can be accessed at: https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/June-2019/Mapping-SDGs-to-Green-Social-and-Sustainability-Bonds06-2019-100619.pdf.

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