Shades of Green in Financing: A Discussion on Green Bonds and Green Loans

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Green financing is to play a crucial role in addressing the risks which climate change can bring about to businesses and to allow businesses to transition towards a low carbon economy. One of the commitments from the Paris Agreement is to "making finance flows consistent with a pathway towards low greenhouse gas emissions and climate resilient developments". There are other initiatives, led by investors and the financial sector, that promote green finance and influence policymaking surrounding green finance in order to make this sector a significant driver to achieving the aims of the Paris Agreement.

Green Financing: What would constitute "Green"?

As to what constitutes "green" has been a much-debated question and there is no universally accepted market standard or definition on what would make a financing transaction "green". This is due to the fact that the scope of the potential environmental or social impact of green financing is vast.

The various areas which would be impacted by green financing are also very disparate. Also, as technology and information flow improves and the disclosure standards become more regulated the methods to evaluate whether a transaction is fulfilling its "green" credentials can become more numerous.

Green Bonds

Green finance was first implemented by way of green bonds. The Green Bond Principles (GBP) are a set of voluntary guidelines set out by the International Capital Markets Association (ICMA). The latest version of the GBP was published in June 2017 following consultations with the ICMA members and other observers.

The GBP are intended for broad use by the market:

- They provide issuers with guidance on the key components involved in launching a green bond
- They aid investors by promoting availability of information necessary to evaluate the environmental impact of their green bond investments
- They assist underwriters by moving the market towards a disclosure standard that will facilitate green bond issuances

The GBP recommends a clear process and disclosure for issuers, which investors, underwriters, placement agents and others may use to understand the characteristics of any given green bond. The GBP aims to set a benchmark for green bonds for the required transparency, accuracy and integrity of information that will be disclosed and reported by issuers to investors and other stakeholders.

The GBP consists of four components:

- Use of proceeds
- Process for project evaluation and selection
- Management of proceeds
- Reporting

Use of proceeds

The planned use of the issue proceeds should be sufficiently disclosed. The GBP require that the issuer should disclose the projects which would fit within the eligible green projects categories. The GBP explicitly recognise several broad categories of eligibility for green projects. A green project may relate to more than one category.

The GBP recognise green project categories as including:

- Renewable energy
- Energy efficiency
- Pollution prevention and control
- Environmentally sustainable management of living natural resources and land use
- Terrestrial and aquatic biodiversity conservation
- Clean transportation
- Sustainable water and waste water management
- Climate change adaptation
- Eco-efficient and/or circular economy adapted products, production technologies and processes
- Green buildings which meet regional, national or internationally recognised standards or certifications

Process for project evaluation and selection

The issuer of a green bond should clearly communicate to investors:

- The environmental and sustainability objectives
- The process by which the issuer determines how the projects fit within the eligible green projects categories identified
- 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 green projects

Issuers are encouraged to provide this information within the context of the issuer's overarching objectives, strategy, policy and/or processes relating to environmental sustainability. Issuers are also encouraged to disclose any green standards or certifications referenced in project selection.

The GBP recommend that an issuer's process for project evaluation and selection be supplemented by a review by a third party.

Management of proceeds

The net proceeds of the green bond, or an amount equal to the net proceeds, should be credited to a sub-account, moved to a sub-portfolio or otherwise tracked by the issuer in an appropriate manner, and confirmed to by the issuer in a formal internal process linked to the issuer's lending and investment operations for green projects.

Reporting

Issuers should make and keep readily available up-to-date information on the use of proceeds to be renewed annually until full allocation, and as necessary thereafter in the event of material developments.

Investors are increasingly focused on impact reporting as an important mechanism not only for issuers to be accountable on the achieved environmentally sustainable impact, but also as a metric to measure their own investment performance from a sustainability perspective. The market is looking towards having a harmonised framework for impact reporting to facilitate issuers in the reporting process and also for investors to understand

and compare the impact reports easily. ICMA has developed a harmonised framework for impact reporting for the renewable energy and energy efficiency sectors.

External Review

It is recommended that issuers use an external third party review to confirm the alignment of their green bonds with the key features of the GBP as described above. Some of the ways in which such a review can be conducted are:

- **Consultant Review:** An issuer can seek advice from consultants and/or institutions with recognised expertise in environmental sustainability or other aspects of the issuance of a green bond, such as the establishment/review of an issuer's green bond framework
- **Verification:** An issuer can have its green bond, associated green bond framework, or underlying assets independently verified by qualified parties, such as auditors
- **Certification:** An issuer can have its green bond or associated green bond framework or use of proceeds certified against an external green assessment standard. An assessment standard defines criteria for green bonds, and alignment with such criteria is tested by qualified third parties/certifiers
- **Rating:** An issuer can have its green bond or associated green bond framework rated by qualified third parties, such as specialised research providers or rating agencies

Some Legal Considerations In Relation To Green Bonds

Greenwashing risk

This is the risk of a bond which is marketed as a green bond and by which the funds raised are then not applied to low carbon or other appropriate projects. This is a significant potential reputational risk to the underwriters and the green bond issuers if the issuance does not achieve the desired outcome. Greenwashing can affect the credibility of the green bond markets and also that of the issuer. Given the lack of a specific universally accepted definition of what would constitute a green bond and, the varying views of both the investor and the stock exchanges of what would be a green bond, an issuance is always subject to the risk of being labelled as not being sufficiently "green".

A full and exhaustive disclosure regarding the green project in addition to some of the external reviews described above would assist in mitigating the green washing risk of a green bond.

The ability to call a default and other covenants

Green bonds have generally not been able to obtain a significant pricing advantage due to them being green. Issuers have therefore been able to restrict matters such as the ability to call an event of default to simply the standard bond provisions. The application of the bond proceeds towards green projects is generally not a contractual obligation and therefore investors are limited in their options if the issuance is not achieving its declared investment objective. Issuers will want to ensure that disclosures in relation to the green projects are as complete as possible to highlight to investors that the issuances may not always sufficiently meet the investment criteria of the investors.

GBP

The GBP make it clear that underwriters of green bonds are not responsible if issuers do not comply with their commitments to green bonds and the use of the resulting net proceeds and that the green bonds will not default if they do not follow the GBP recommendations.

The EU Retail and Insurance-based Investment Products Regulation (PRIIPs Regulation)

The PRIIPs Regulation does make reference to environmental disclosure. The PRIIPs Regulation requires that the key disclosure documents, prepared to contain the key terms of a financial product being sold to retail investors, includes, where applicable, details of the “specific environmental or social objectives targeted by the product”

In July 2017, the European Supervisory Authorities concluded that the identified objectives must be sufficiently specific, the strategy for pursuing those objectives must be well established, and investors must be given enough detail to assess the PRIIPs in light of their own environmental or social objectives. Investors need to make their decisions in light of their own green investment considerations.

Green Loans

On 21 March 2018, the Loan Market Association and the Asia Pacific Loan Market Association issued the Green Loan Principles (GLP). The GLP is to serve as a benchmark to the loan market and comprises of voluntary recommended guidelines, to be applied by market participants on a deal-by-deal basis by clarifying the instances in which a loan maybe categorised as “green”.

Green lending has become more mainstream over the years and the GLP is the result of the industry participants recognising the need for a separate mechanism for the green lending market with its own set of characteristics and features. The GLP which was developed with the assistance of ICMA follows or takes on a lot of principles contained in the GBP. The GLP defines green loans as “any type of loan instrument made available exclusively to finance or refinance, in whole or in part, new and/or existing eligible green projects”. Green projects are the same indicative list of green projects as issued by ICMA in the GBP. The GLP also contain the same four components as in the GBP which are:

- Use of Proceeds
- Process for Project Evaluation and Selection
- Management of Proceeds
- Reporting

Green Loan Vs Green Bond

Availing of a loan or issuance of a bond are very much dependent upon the credit profile and the other circumstances of a borrower or an issuer.

Liability

Since loan agreements can often be bilateral there is the ability to contractually bind the borrower as to its green loan obligations. If a green loan fails to use the proceeds for green purposes, this can cause an event of default or trigger in-built penalties until the borrower cures it. In other market examples, if the quantitative sustainability targets set in a facility agreement are not met, a higher interest rate can be charged on a green loan. The consequences for failing to apply proceeds for the stated green purposes in green bonds do not have such penalties or mechanisms; instead bondholders rely on the tort of misrepresentation and other sanctions applicable to mainstream bonds.

The bilateral or small lending group nature of loans means that their performance and penalties can be tailored to the circumstance and can be monitored for breach, which is not possible in widely held bonds.

Incentives for borrowers

Loans can be structured to allow for the margins under the loans to be linked to the borrower company’s adherence to its environmental and sustainability targets. Therefore, unlike green bonds, the returns on investments in a green loan may be directly dependent on the borrower’s ability to benefit the environment.

Green Loans: Looking into the Future

Small Medium Enterprise (SME)financing

The flexibility of size and scale of green loans makes them inherently more accessible to SMEs than green bonds as a method of finance. Many SME projects and financing needs are better suited to green loans than green bonds. Numerous banks worldwide are now offering green loan facilities for SMEs, and if prudential regulation becomes more favourable towards SMEs as envisaged by the European Commission, these offerings may exponentially increase.

SMEs can also take advantage of various schemes incentivising investment in green technology. Some governments are also offering tax relief on certain green plant and machinery. These incentives make green loans more attractive.

Infrastructure financing

Financing sustainable infrastructure will be a key factor for many nations trying to meet their nationally determined targets under the Paris Agreement to decrease carbon dioxide emissions. Bank finance is an important instrument in helping a green infrastructure project to move from planning to implementation phase.

Conclusion

There are very compelling reasons why green finance should grow in the coming years. The need to achieve the aims of the Paris Agreement and work towards a low carbon environment has never been greater. With nearly US $150bn of green bonds issued in 2017, it is clear that green bonds and to a lesser extent, green loans will be a driver for growth in green financing in the coming years. Given the lack of universally accepted definition of "green" financing, we also expect a greater level of activity from regulators and governments aimed at giving green finance the certainty it requires to succeed and flourish. Increased standardisation, improved disclosure standards, classification and information flows will be integral to the success of green finance.

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