Sustainability Toolkit

Green Bonds and Sustainability-Linked Loans

Green Bonds and Sustainability-Linked Loans (SLLs) are two important financing tools for companies interested in pursuing sustainability initiatives or leveraging favorable sustainability performance.

Here are some key questions and issues you need to consider:

- What are Green Bonds?
- What are the primary uses for Green Bonds?
- What are the Green Bond Principles (GBP)?
- What are the different types of Green Bonds?
- What is the future of Green Bonds?
- What are Sustainability-Linked Loans (SLLs)?
- How do SLLs work?
- What are the Sustainability-Linked Loan Principles (SLLP)?
- What is the future for SLLs?

COVINGTON

What are Green Bonds?

Green bonds are corporate debt instruments the proceeds of which are used to fund new or existing projects that are intended to have positive environmental or climate effects.

- Green bonds were introduced as a way to combat climate change and a way for a variety of issuers to finance environmentally friendly projects.
- The first green bond was issued in 2008, and in 2019 green bond issuances totaled **$257.5 billion**.
- The defining attribute of a green bond is the use of its proceeds. The proceeds of a green bond must be used for “green projects,” and the specifics of the utilization should be described in the security’s legal documents. Green bonds should provide clear environmental benefits that are quantified by the issuer and reported with transparency.
- Green Bonds are increasingly important, as investors’ appetites for sustainable investment options grow.

What are the primary uses for Green Bonds?

The proceeds of a green bond must be used for "green projects."

- Green projects may have green objectives or fall in green project categories.

Typical green project objectives:

- Climate change mitigation
- Climate change adaptation
- Natural resource conservation
- Biodiversity conservation
- Pollution prevention and control

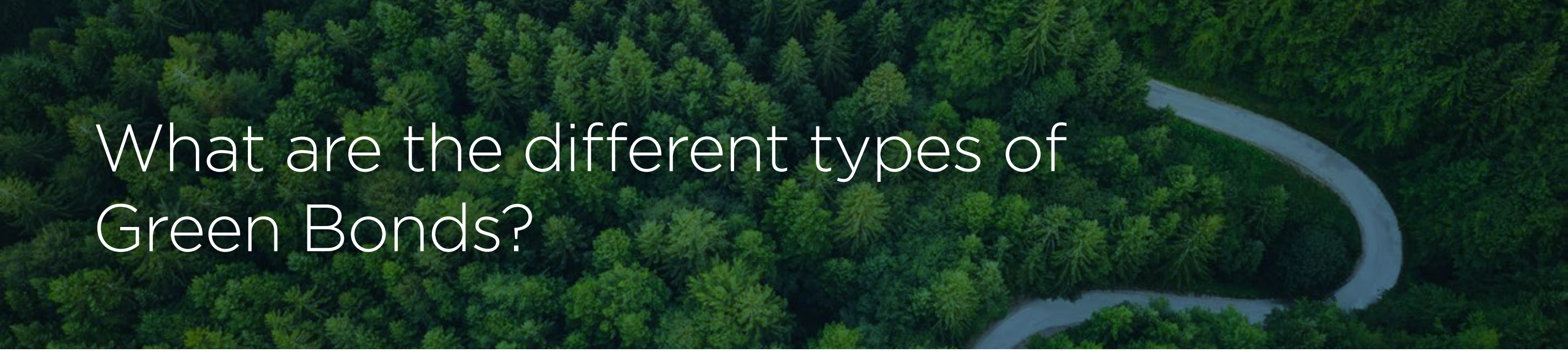
Typical green project categories:

- Renewable energy
- Energy efficiency
- Pollution prevention and control
- Environmentally sustainable management of living and natural resources
- Terrestrial and aquatic biodiversity conservation
- Clean transportation
- Sustainable water and wastewater management
- Climate change adaptation
- Eco-efficient and/or circular economy adapted products
- Production technologies and processes
- Green buildings

What are the Green Bond Principles (GBP)?

- The International **Capital Market Association** established the Green Bond Principles (GBP), which are a set of voluntary process guidelines that promote transparency and integrity and disclosure in the green bond market by clarifying the approach for issuance of a Green Bond.
  - The International Capital Market Association established the GBP, which were last updated in June 2018.
- The GBP have four core components:

1. **Use of proceeds**
   - Green Bond proceeds must be used for Green Projects.
2. **Process for project evaluation and selection**
   - Issuers of Green Bonds should communicate their sustainability objectives and the process by which the issuer determines how projects fit within the eligible Green Project categories.
3. **Management of proceeds**
   - Issuers must track in an appropriate and transparent manner the use of net proceeds of the Green Bond.
4. **Reporting**
   - Issuers should make and keep up to date information regarding the use of proceeds to be renewed annually until proceeds are fully allocated to Green Projects.



What are the different types of Green Bonds?

There are four different types of green bonds in the market today:

- **Standard green "use of proceeds" bonds**
  - Standard recourse-to-the-issuer debt obligations
  - Proceeds are dedicated to funding a range of green projects
  - Aligned with GBP
- **Green revenue bonds**
  - Non-recourse-to-the-issuer debt obligations
  - Credit exposure is limited to the revenue stream, fees, and taxes of the income-producing green project
  - Aligned with the GBP
- **Green project bonds**
  - Debt obligations financing one or more green projects
  - Investor has direct exposure to the risk of the project with or without recourse to the issuer
  - Aligned with the GBP
- **Green securitized bonds**
  - Bonds collateralized by one or more specific green projects
  - Includes covered bonds, asset-backed securities, mortgage-backed securities, and other structured products
  - The source of repayment is often the cash flows generated by the pool of underlying assets
  - Aligned with the GBP

Other Sustainability-Focused Bond Types:

- **Social bonds** fund projects that directly aim to address or mitigate a specific social issue and/or seek to achieve positive social outcomes, especially for a target population. Such bonds typically feature performance metrics that must be achieved for payouts.
  - Social bonds can pivot as urgent financing needs change and are currently being used to help flatten the curve of the COVID-19 pandemic.

- **Sustainability bonds**, which are a mix of social and green use of proceeds bonds.
  - The sustainability bond market grew from **$18 billion** in 2018 to **$40 billion** in 2019.
  - Sustainability bonds finance both social and environmental resilience.

- **SDG-themed bonds** do not comport with the GBP, but are issued by organizations that are mainly or entirely involved in sustainable business activities.
  - Borrowers attest that the use of SDG-themed bond proceeds will help achieve one or more SDGs.

What is the future of Green Bonds?

In 2019 green bond issuances totaled $257.5 billion, and this market was expected to grow to $350 billion in 2020, according to the Climate Bonds Initiative pre-pandemic.

COVID-19 is having a rebalancing effect on the sustainable bond market. While in 2019 Green Bonds accounted for about 80% of the sustainable bond market, that percentage dropped to about 50% by April 2020.

Experts predict that investment in Green Bonds will resume their positive growth once markets stabilize. Many investors see the COVID-19 pandemic as a dress rehearsal for the next climate-related crisis.

COVINGTON

What are Sustainability-Linked Loans (SLLs)?

SLLs are ESG-friendly debt facilities that incentivize borrowers' commitment to sustainability and that support environmentally and socially sustainable economic activity and growth.

SLLs highlight a company's commitment to its ESG goals by linking improved sustainability performance to lower-cost financing.

The loan proceeds from SLLs can be used for general corporate purposes.

SLLs help banks and lenders diversify their lending portfolios to include sustainable investments.

In 2018, SLLs represented a $36.4 billion market. That number rose to $122 billion in 2019 , with the most momentum gaining in Europe and the Asia Pacific regions.

COVINGTON

How do SLLs work?

Lenders and borrowers work together to set customized sustainability performance targets (SPTs) for the loan, and loan terms are tied to the borrower's sustainability performance.

- In these arrangements, if the ESG rating or other SPT improves, the interest rate goes down.

- SLLs are not pure green financings, but they serve an important role in helping companies transition to more sustainable business models. SLLs highlight a company's commitment to its ESG goals by linking improved sustainability performance to lower-cost financing.
  - In addition to loans, SLLs may also include contingent facilities, bond lines, guarantee lines, or letters of credit that incentivize improvement in a borrower's sustainability profile.

The first syndicated SLL

In 2017, Philips and ING led the first syndicated SLL.
A consortium of sixteen banks agreed on a $1 billion revolving credit facility.

The interest rate was tied to Philips' year-over-year sustainability performance improvement as measured by the ESG rating agency Sustainalytics.

What are the Sustainability-Linked Loan Principles (SLLP)?

The Sustainability-Linked Loan Principles are voluntary global guidelines establishing clear standards and definitions for the SLL market.

- The Loan Market Authority (LMA), the U.S. Loan Syndications and Trading Association, and the Asia Pacific Loan Market Association (APLMA) developed these principles together in March 2019.
  - These voluntary global guidelines capture the fundamental characteristics of SLLs.
- Core components of the SLLP framework

1. Analyzing the relationship of the Sustainability Performance Targets (SPTs) to the borrower's overall corporate social responsibility (CSR) strategy
   - Borrower should clearly communicate to its lenders its sustainability objectives and strategy.
2. Target-setting
   - SPTs should be negotiated and set between the borrower and the lender for each transaction.
3. Reporting the borrowers performance with respect to the relevant SPTs
   - Borrowers should keep SPTs and any external ESG ratings readily available.
4. The need for external review, which is negotiated separately for each deal

These guidelines capture the fundamental characteristics of SLLs and provide clarity as issuers and borrowers navigate this rapidly evolving market.

What is the future for SLLs?

- The COVID-19 pandemic has resulted in a surge of debt market activity. Corporate issuers are actively accessing the debt markets for sources of additional liquidity in light of market volatility and macroeconomic uncertainty.
- In the interest of time and ease of execution, corporate borrowers are focused on traditional, investment-grade loan products rather than SLLs or green loans. Data from Refinitiv shows that **$13 billion** in sustainability-linked loans were issued in the second quarter of 2020 as compared to **$59 billion** in the fourth quarter of 2019.
- The impact of COVID-19 on the SLL borrowers' SPTs is an ongoing concern.
  - At least one sustainability linked loan exceeding **€1 billion** was issued in 2019 which included a mechanism for SPTs to be recalibrated following the occurrence of pre-determined events. If such events impact SPTs or the ESG environment by more than a certain margin, the SPTs will be readjusted.
  - Issuers and lenders should consider including such a readjustment provision in SLLs to avoid protracted amendment and waiver negotiations between parties.

Sustainability Toolkit

Explore the topics	Defining Sustainability	Public Policy: Climate Change	Public Policy: COVID-19	Public Policy: Environmental Justice	Public Policy: UN Sustainable Development Goals
Engaging and Advising BODs	Investor Expectations	Corporate Disclosure: The Basics	Corporate Disclosure: Standards and Initiatives	Setting Corporate Goals	M&A and JV Transactions
Green Bonds and SLLs	Carbon Markets	Marketing Claims	Crisis Management	Insurance Implications	Sustainability NGOs