Green bonds and beyond: sustainable finance in the capital markets

 David A. Seville

 Janet Holmes

 Michael Murphy

Sustainable finance continues to gain momentum as governments and corporate issuers pay increasing attention to environmental, social and governance (ESG) factors and investors, regulators and other stakeholders encourage more robust ESG practices.

Interest in sustainable finance accelerated in 2020, with the COVID-19 pandemic highlighting the need for funds to help economies, businesses and individuals recover in a responsible manner that addresses environmental and social challenges[1]. The global market for sustainable finance totaled US$732 billion in 2020, up 29% from US$565 billion in 2019[2], with responding to COVID-19 ranking fifth in terms of value for use of proceeds among bonds issued in 2020, behind renewable energy, green buildings, access to essential services and clean transportation[3].

Market offerings in sustainable finance include green bonds, green loans, social bonds, sustainability bonds, sustainability-linked bonds and loans, transition bonds and Sustainable Development Goals-linked bonds (SDG-linked bonds). In this article, we discuss these instruments and relevant examples from the Canadian and global markets.

Green bonds

What they are: The proceeds of green bonds are exclusively applied to finance or re-finance new and/or existing “Green Projects” as defined by the *Green Bond Principles* issued by the International Capital Markets Association (ICMA)[4].

Green Projects should provide clear environmental benefits that can be assessed and, where feasible, quantified by the issuer. The green bond market dates back to the inaugural green bond issuance by the World Bank in November 2008 and is the most well-developed of the sustainable finance markets. These bonds require the issuer to deploy and track the use of proceeds according to a disclosed framework, develop a process for project evaluation and selection, and report on the deployment of proceeds.

In the market: Green bonds constituted just under half of the global sustainable finance market in 2020, with US$296 billion issued (up from US$271 billion in 2019). The COVID-19 pandemic slowed growth of the green bond market in the first half of 2020 as compared to 2019. Market activity strengthened in the second half of the year[5].

According to Climate Bonds Initiative, Canada ranked eighth globally for green bond issuance in 2020 (up from tenth place in 2019), issuing approximately US$9 billion in 2020 (an increase of approximately US$2 billion from 2019). In 2019, non-government issuers surpassed government issuers as the largest issuers of green bonds in Canada.

- In 2017, Torys assisted Manulife Financial Corporation in becoming the first life insurance company to sell a green bond. Manulife returned to the market with green bond issuances in 2018 and 2020.

- In March 2020, Torys represented a syndicate of agents that facilitated RioCan Real Estate Investment Trust's private placement of green bonds, the first green bond issuance by a REIT in Canada.

Climate resilience bonds are a subset of green bonds whose proceeds are used to improve the ability of assets and systems to persist, adapt and/or transform in the face of climate-related stresses and shocks. In 2019, the European Bank for Reconstruction and Development's US$700 million bond issuance was the first dedicated climate resilience bond, with projects to be selected and managed in alignment with Climate Bonds Initiative's *Climate Resilience Principles*[6].

In Climate Bonds Initiative's inaugural *Green Bond Treasurer Survey* published in April 2020, 86 treasurers shared their experiences of issuing green bonds. Respondents indicated that pricing was not the principal benefit[7]. Rather, green bonds were seen as 1) contributing to transition, risk management and future-proofing the business, 2) broadening the investor base and offering new engagement opportunities, 3) enhancing reputation and visibility, 4) strengthening internal integration, 5) encouraging better issuance standards and 6) providing gains in excess of the efforts expended to issue.

In Canada, the past three years have seen non-government issuers surpass government issuers as the largest issuers of sustainable finance instruments.

In its 2020 Fall Economic Statement the Government of Canada announced its intention to issue green bonds in 2021-22 to help finance investments in green infrastructure and other green initiatives. Further information is expected to be presented in the federal Budget 2021. Commentators have observed that federal green bond issuances could help fuel activity in the Canadian green bond market for institutional and other investors, building institutional capacity while setting the best possible benchmark price for Canadian dollar issuances and modelling high performance standards for other Canadian green bond issuers[8].

Green loans

What they are: Green loans are similar to green bonds in that funds are made available exclusively to finance or re-finance new and/or existing eligible "Green Projects" as defined in the *Green Loan Principles*[9] developed by the Loan Market Association. Green Projects are defined the same way under both the Green Bond Principles and the Green Loan Principles, thereby providing issuers with the flexibility to choose between debt financing options for Green Projects.

You can read more about green loans and other sustainable loans in "Trends in ESG loans".

Social bonds

What they are: The proceeds of social bonds are exclusively applied to finance or re-finance new and/or existing "Social Projects" as defined in ICMA's *Social Bond Principles*[10]. Social Projects include providing and/or promoting affordable basic infrastructure, access to essential services, affordable housing and food security.

In the market: In 2018, Canadian Imperial Bank of Commerce issued the first social bond in Canada, with the proceeds used to provide loans to corporations that meet certain criteria, including having a minimum of 30% of board positions and executive positions held by women. And in 2020, the City of Toronto issued $100 million in social bonds to fund housing (including shelter bed) initiatives as part of its Social Debenture Program, the first such program by a government in Canada.

The COVID-19 pandemic has accelerated interest in social bonds. Globally, social bond issuance increased substantially in 2020. Notable social bond issuances intended to address the pandemic include the International Finance Corporation's March 2020 US$1 billion issuance (with proceeds to strengthen public health systems to address COVID-19 in emerging markets), the African Development Bank's March 2020 US$3 billion "Fight COVID-19" social bond to help prepare the African population to address COVID-19 challenges, and Bank of America's US$1 billion social bond issued in May 2020, the first social bond by a U.S. commercial bank entirely focused on the COVID-19 pandemic[11].

Sustainability bonds

What they are: Sustainability bonds are instruments whose proceeds are exclusively applied to finance or re-finance a combination of both Green Projects and Social Projects in accordance with ICMA's Sustainability Bond Guidelines[12].

Sustainability bonds may be an attractive option for issuers that would like the flexibility to allocate proceeds among Green Projects and Social Projects without having to issue separate bonds.

- Torys assisted Sun Life Financial Inc. with the issuance of its $750 million sustainability bond in August 2019, the proceeds of which will be used to finance or re-finance investments in renewable energy, energy efficiency, green buildings, clean transportation, sustainable water management and access to essential services, such as hospitals, childcare and elder care centres and vocational training.

Sustainability-linked bonds and loans

What they are: Sustainability-linked bonds and loans differ from green bonds, green loans, social bonds and sustainability bonds in that the proceeds do not need to be used to finance Green Projects and/or Social Projects. Instead, the borrower's achievement of (or failure to achieve) predetermined sustainability performance objectives (e.g., a reduction in greenhouse gas emissions, or increased use of renewable energy), external ratings and/or equivalent metrics can result in a decrease (or increase) in borrowing costs. These bonds require specified pre-issuance disclosure such as an overall sustainability strategy, identification of the precise targets and performance indicators, and post-issuance verification of performance.

In the market: In June 2020, ICMA released *Sustainability-Linked Bond Principles*, reflecting the growing significance of this segment of the market[13].

For example, in 2020 Brookfield Renewable Partners secured a revolving credit facility structured as a sustainability-linked loan from BNP Paribas US Inc. Under the credit facility, negotiated by Torys as counsel for Brookfield Renewable Partners, Brookfield Renewable Partners' cost of debt decreases as it grows its renewable and clean power production capacity and meets certain avoidance levels for carbon dioxide emissions.

While the green bond market is the most well-developed sustainable finance market in Canada, we expect the other sustainable instruments to become increasingly popular

Borrowers may also incur a higher cost of debt if they fail to achieve certain targets. For example, in July 2019 Spanish telecom company Masmovil took out a sustainability-linked loan with an interest rate tied to an overall ESG evaluation score. If the score improves, the interest rate drops by 15 basis points, but if it deteriorates, the interest rate increases by 15 basis points.

Transition bonds

What they are: Transition bonds are similar to sustainability-linked bonds and loans in that they do not generally require proceeds to be used to finance or re-finance Green Projects. Instead, the proceeds of transition bonds are used to fund a firm's transition towards a reduced environmental impact or to reduce the firm's carbon emissions[14]. Transition bonds may be an attractive option for issuers that are taking meaningful steps to reduce their environmental impact but do not have significant projects that would qualify as Green Projects and therefore would be unable to issue green bonds. These bonds require the publication of a transition framework, disclosure in line with the TCFD recommendations, commitment to the goals of the Paris Agreement or approved targets to achieve zero emissions by 2050, and reporting on transition performance.

SDG-linked bonds

What they are: SDG-linked bonds include covenants based on the United Nations' *Sustainable Development Goals* and the issuer is penalized if it fails to meet these covenants in the agreed timeframe[15].

In the market: One recent example is Italian energy company Enel's issuing of a EUR$1.4 billion SDG-linked bond in 2019 with covenants tied to Goal 7: Affordable Clean Energy. If Enel is unable to produce 55% or more of its energy from renewable sources by 2021, investors will receive a one-time coupon step-up of 25 basis points.

Another example is French multinational company Schneider Electric's issuance in November 2020 of the first sustainability-linked convertible bond. This zero-coupon bond offers investors a premium if the company underperforms on three sustainability objectives relating to CO2 emissions, increasing gender diversity among its new hires, front-line managers and leadership teams, and training underprivileged people in energy management.

A growing market

Initiatives to enhance transparency and liquidity in the sustainable bonds market are continuing to develop to support market participants. These include Nasdaq's Sustainable Bond Network (NSBN), which makes issuer-submitted data on allocation, impact, frameworks, certifications and bonds available on its open network platform for issuers that meet the NSBN's criteria. In Canada, the TSX introduced trading of sustainable bonds on its exchange effective March 1, 2021[16]. Steps are also being taken by a group of international organizations to develop a comprehensive corporate reporting system for ESG that includes frameworks and standards for sustainability disclosure as well as an integrated reporting framework to connect sustainability disclosure to existing disclosure regimes[17]. Enhanced disclosure about ESG matters should facilitate the growth of the sustainable bonds market as increased transparency should promote investor confidence, facilitate monitoring and encourage further product innovation.

We expect the size of the sustainable finance market to continue increasing in the coming years, both in Canada and globally. Drivers of growth include scaled up commitments by governments and companies to tackle climate change, pandemic recovery plans (which may incorporate green transition goals), and rising expectations among investors for companies and other issuers to make credible commitments to make measurable progress toward standardized sustainability targets[18].

In Canada, the past three years have seen non-government issuers surpass government issuers as the largest issuers of sustainable finance instruments. While the green bond market is currently the most well-developed sustainable finance market in Canada, we expect the other sustainable finance instruments mentioned in this article to become increasingly popular, especially as public company boards, shareholders, regulators and other stakeholders increasingly focus on sustainability, diversity and the societal impact of corporate practices. In particular, sustainability-linked bonds and loans, transition bonds and SDG-linked bonds, which do not require that proceeds be used to finance or re-finance Green Projects, may be attractive options for issuers that are unable to issue green bonds but have climate change management and broader social performance objectives in their corporate strategies.

---

[1] See also our January 28, 2020 article "Sustainable finance gaining traction" and our November 26, 2020 article "“Pandemic-proof?”: the resilience of sustainable finance through COVID-19".

[2] Bloomberg NEF, "Sustainable Debt Breaks Annual Record Despite COVID-19 Challenges", January 11, 2021.

[3] Environmental Finance, *Sustainable Bonds Insights 2021*.

[4] Available here.

[5] Ibid.

[6] Available here.

[7] Available here.

[8] G. Hodgson, *The Next Green Bond Wave: Should Ottawa Step in? Commentary 591* (Toronto: C.D. Howe Institute, 2021).

[9] Available here.

[10] https://www.icmagroup.org/green-social-and-sustainability-bonds/social-bond-principles-sbp/

[11] Laurentian Bank Securities, *Canada ESG Thematic Bonds Update – Social and Twin Bonds* (September 18, 2020).

[12] https://www.icmagroup.org/green-social-and-sustainability-bonds/sustainability-bond-guidelines-sbg/

[13] https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/sustainability-linked-bond-principles-slbp

[14] Institute for Sustainable Finance, *Sustainable Finance Primer Series: Transition Bonds*.

[15] https://sustainabledevelopment.un.org/?menu=1300

[16] The Climate Bonds Initiative maintains a list of exchanges that have dedicated green bond or sustainable bond sections at https://www.climatebonds.net/green-bond-segments-stock-exchanges.

[17] In December 2020, the Global Reporting Initiative, the Sustainability Accounting Standards Board, the Climate Disclosure Standards Board, the CDP (formerly the Carbon Disclosure Project), and the International Integrated Reporting Council released a prototype climate-related financial disclosure standard.

[18] ICMA's Climate Transition Finance Handbook, published in December 2020, is one example of the guidance being made available to issuers regarding the practices, actions and disclosures to be made available when raising funds in debt markets for climate transition-related purposes.