unimc
UNIVERSITÀ DI MACERATA
l'umanesimo che innova

Co-funded by the Erasmus+ project of the European Union

BLEUSE CATTEDRA JEAN MONNET
BUSINESS LAW IN THE EUROPEAN UNION AND SUSTAINABLE ECONOMY

Introduction and definitions

Sustainable finance, Green bonds, Sustainable and Sustainability-Linked Bonds

Alessio Bartolacelli

University of Macerata - Italy

Sustainability

Difficult definition, blurred concept

The currently most convincing idea: "securing **social foundations** within **planetary boundaries**" (Sjåfjell & Bruner, 2020)

Dimensions:

- **E**nvironmental (planetary boundaries)
  - pollution
  - climate change
  - biodiversity preservation
  - waste of water
  - ocean acidification
  - …

Sustainability

- **S**ocial (social foundations)
  - gender equality
  - social equality
  - peace and justice
  - healthcare
  - food, housing
  - energy
  - education, work, transportation
  - ...

[- **G**overnance (*how?*)]
  - both private (corporate), and public

ESG ▶ **SDGs** (UN Agenda 2030)

It usually implies…

… a **long-term approach**, as the consequences only can be appreciated in the long run

- let's consider this from the firm's point of view

Long-term also deals with **replicability** by future generations

- impact on the environment (not only)
  - possibility for future development (social)

Firms and enterprises are **encouraged** (not bound, or at least not necessarily) to act sustainably by

- **reputation**
- **public policies** (awarding regulation)
- specific shareholders/investors **beliefs**

How to deal with sustainability?

A holistic approach is needed: the EU roadmap

- Substantive rules at national level
- European rules for the development of a sustainable single market
  - Definitions: taxonomy
  - Companies: activities, capital and debt
  - Finance
  - Disclosure
  - Due diligence in the value chain?

Sustainable finance

As it is finance, it deals with…

…**Equity**

- shares
  - depends on **all the activities** carried out by the company

…**Debt financing**

- mainly **bonds** (not just bonds, however: bank loans and so on…)
  - depends on the **use of the proceeds**, consistent with ESG goals

Sustainable finance

But it's also "**sustainable**":

Integration of sustainability into the global financial system **in order to promote *sustainable development***

- Sustainable Development Goals (UN Agenda 2030 as a driver)

Key issue: ***integration***, **not replacement**. Sustainable finance is intended to **balance** financial returns with public interest goals, not just promote the latter

- financial sustainability matters, as well
- balance is left to the issuer (and assessment to the market)
- in general, and popular terms: "doing well, by doing good"

The key problems

Define

- when green is green?
- when social is social?

Easier with environmental issues, more difficult for social ones

- objective and material data, more than personal beliefs

Measure

- basically: **impact**
- a well-known European definition used to call them "non-financial"; actually, they have a huge financial impact…
- …in fact, the latest amendment (December 2022) changes the name of reporting in **"corporate sustainability"**

Why? Avoiding big risks

Greenwashing…
…and **social-washing**

Impact and **reporting** are fundamental

But also: reports addressed to… **whom**?
- **investors**
  - not just directly: also, **credit agencies**
- **general public** ▶ reputation

Fallouts on technical profiles in the drafting (e.g., machine readability improves also international investments)

SRI

Socially Responsible Investment

- Social recognition (**reputation**)
- Balance between profit and public benefit with different strategies
  - **Passive**: exclusion of certain activities
  - **Active**: **selection** (rating) and **engagement**
    - Stronger with equity…
    - …but possible also with debt
- In any case, necessity to **measure** the impact (credibility)

In this framework debt is crucial

And **bonds** are the key debt asset

- **Green** Bonds
- **Social** Bonds
- **Sustainability-Linked** Bonds

Each addresses a different main target, but they have a basically similar structure

Green bonds

Green Bonds are any type of bond instrument where the **proceeds** or an **equivalent amount** will be **exclusively applied** to **finance** or **re-finance**, in part or in full, new and/or existing **eligible Green Projects** and which are **aligned** with the **four core components of the GBP**

Similar alternative: Blue bonds for marine environment

Types of GB, according to ICMA, 2018

- **Standard green use bonds** (recourse to the issuer) [bestseller: around 59%]
- **Green revenue bonds** (non-recourse to the issuer: use of proceeds go to related or unrelated Green Project) [riskier, usually issuer is a public organization]
- **Green project bonds** (investor has direct exposure to the risk of a green project – with or without recourse to the issuer)
- **Green securitized bonds** (collateral green projects as guarantees)

Social Bonds

Social Bonds are any type of bond instrument where the **proceeds**, or an **equivalent amount**, will be **exclusively applied** to **finance or re-finance** in part or in full new and/or existing **eligible Social Projects** and which are **aligned with the four core components** of the SBP

Primarily social purpose; if they include also sustainable one, they become **Sustainability Bonds** (combination Social + Green)

Types: **likewise Green Bonds** (Standard social use, Social revenue, Social project, Social securitized and covered)

Sustainability-Linked Bonds

Sustainability-Linked Bonds are any type of bond instrument for which the **financial and/or structural characteristics can vary** depending on **whether the issuer achieves predefined Sustainability/ ESG objectives**.

In that sense, **issuers** are thereby **committing explicitly** (including in the bond documentation) to **future improvements in sustainability outcome(s) within a predefined timeline**. SLBs are a forward-looking performance-based instrument.

Different structure from GB and SB: here the use of proceeds is not that relevant, while there is the necessity to **measure the objectives to be achieved** (Key Performance Indicators and Sustainability Performance Targets)

Much **more demanding** and **goal oriented**. But **riskier**, too.

Common features

ICMA (International Capital Market Association) issued principles (latest editions: Green Bonds 2021 [Appendix 2022]; Social Bonds: 2021 [Appendix 2022]; Sustainability-Linked: 2020)

Four core components:

1. Use of Proceeds
2. Process for Project Evaluation and Selection
3. Management of Proceeds
4. Reporting

Plus, two key recommendations:

i. **Establishment of a framework**
ii. **External reviews**

The Principles

The Green Bond Principles

The Social Bond Principles

The Sustainability Bond Guidelines

The Sustainability-Linked Bond Principles

Use of Proceeds*

Green, Social, Sustainability Bonds ("GSS" or "UoP")

Core Components:

1. Use of Proceeds
2. Process for Project Evaluation and Selection
3. Management of Proceeds
4. Reporting

Key Recommendations:

1. Bond Frameworks
2. External Reviews

General Purposes*

Sustainability-Linked Bonds ("SLBs")

Core Components:

1. Selection of Key Performance Indicators (KPIs)
2. Calibration of Sustainability Performance Targets (SPTs)
3. Bond characteristics
4. Reporting
5. Verification

Financial Instrument Guidance

Climate Transition Finance

Climate Transition Finance Handbook (CTFH)
(Guidance may be applied to GSS/UoP Bonds or SLBs)

Thematic Guidance

More specifically on Green Bonds

Issued in 30+ Countries

Largest markets: US, Canada, France, UK, China

Sectors:

- Climate mitigation
- Climate adaptation
- Transport
- Energy
- Recycling
- Building
- Water treatment

Green Bond regulation

Public: rather limited

- Public official guidelines in China and India (2016)
- In other cases, incentives and certification (Singapore, USA, France, EU)

Private: much more widespread

- Green Bond Principles IMCA
- Climate Bonds Initiative (certification + label)
- Green Bonds Indexes in major Stock Exchanges (e.g.: FTSE4Good, plus others)
- Second opinion agencies, to review frameworks and regulations used by the issuer

Key features of Green Bonds

- Issued by
  - **Public organisations** (States, Regions, Municipalities)
  - **Companies** to promote its own "greenness"
  - **Financial institutions** to finance companies' "greenness" by loaning money

- Compliance with the four core principles in order to get a label "Green Bond"
- Who releases the **label**? Different releasers, but the key point is **trust** (and reputation)

Compliance with the principles

1. Use of proceeds

Describing in the legal documentation ***how* the proceeds will be used** in eligible Green Projects (environmental benefits must be clear)

Financing or re-financing: in the latter: state-of-the-art update

Categories for green projects: they depend on the standards (see also EU Taxonomy). *Inter alia* (IMCA):

- Renewable energy
- Energy efficiency
- Pollution prevention and control
- Management of living natural resources and land use
- Biodiversity preservation
- Sustainable transportation
- Water protection (waste and management)
- Climate change adaptation
- Circular economy
- Green buildings
- Promotion of zero-emission strategy

Compliance with the principles

2. Project selection and evaluation

Communication to the investors of:

- Environmental sustainability objectives
- Process used by the issuer to select the green project categories
- All the remaining complementary information on how the issuer identifies and manages risks related to the projects

The communication should provide the market with information on the **issuer's long-term objectives and policy**, and on the **consistency** with taxonomies and other criteria (exclusion criteria, too).

Mitigation of adverse fallouts, with trade-off explanation.

Compliance with the principles

3. Management of proceeds

- Accounting segregation, or specific tracking
- Both bond-by-bond approach and aggregated basis (portfolio approach) are allowed, in general, insofar they provide for clear evidences
- Recommended **external auditor or third party** to verify internal tracking and allocation of funds

Compliance with the principles

4. Reporting

Annual information on the use of proceeds, until fully allocated

Description of projects

Amount allocated

Expected/achieved **impact** (qualitative and quantitative performance indicators)

Recommendations (optional)

Framework

- Document to explain **how** the Green Bonds **meet the requirements** of the Principles
- Must state **issuer's general policy towards sustainability** and reference to the main environmental objectives (for the EU, see the six included in the EU taxonomy)

External reviews

- **Pre-issuance** assessment on the alignment on the principles
- **Post-issuance** assessment of internal tracking and allocation of funds

The proposal for an EU GB standard (EUGBS)

Usability guide issued in 2020 by Technical Expert Group

Based on two key assumptions:

1. Expansion of IMCA Principles, enhanced
2. Closely linked with the EU Taxonomy

Differences in the EU GBS:

- Use of proceeds aligned with the **EU Taxonomy**
- Framework is always **required**, not just recommended
- Reporting ex ante (allocation) and ex post (impact)
- External verification by an approved verifier (mandatory at least for allocation report)

More details in Mr Fougner's presentation, later today

The EU Taxonomy

The backbone of European sustainability strategy

The only instrument of **hard law** we have been discussing so far

- Implementing the principles of the Action Plan, and of the EU Green Deal
- But also **serving as guiding principles** for the delegated acts

Basically, it's the answer to the question: **"How green green should be in order to be considered green?"**

Green projects must contribute to **at least one** of its six environmental objectives

Regulation (EU) 2020/852

Aims at establishing "a framework to facilitate sustainable investment", besides amending a further EU Regulation (2019/2088)

The key purpose

Art. 1.1

"This **Regulation establishes the criteria** for determining whether an economic activity qualifies as environmentally sustainable for the purposes of establishing the degree to which an investment is environmentally sustainable"

The **criteria only**: the actual determination is made under the **delegated acts** for the relevant areas of interest (see below)

And is applicable to

- **The MSs and the EU** itself
- **Financial markets participants** that make available financial products
- **Enterprises that are obliged to publish non-financial statements** pursuant to the Directive 2013/34/EU

And applicable for:

- **Bonds**, of course
- **Other financial products** (which ones?) (art. 4)
- ***Reasonably, not shares…***

The definitions (art. 2)…

…show very clearly the *acquis communautaire* in the field of environment, due to the many cross references

- e.g.: 'greenhouse gas', 'waste hierarchy', 'pollution', 'good environmental status'…
- Note worth: ***'Circular economy'*** *means an economic system whereby the value of products, materials and other resources in the economy is maintained for as long as possible, enhancing their efficient use in production and consumption, thereby reducing the environmental impact of their use, minimising waste and the release of hazardous substances at all stages of their life cycle, including through the application of the waste hierarchy*

Environmentally sustainable economic activities

Criteria: the sustainable economic activity

(a) **contributes substantially to one or more of the environmental objectives** set out by the regulation;

(b) **does not significantly harm** any of the environmental objectives set out in Article 9;

(c) is **carried out in compliance with the minimum safeguards** laid down in Article 18;

(d) complies with **technical screening criteria** that have been established by the Commission

N.B.: all the four criteria must be met **jointly**…

Specific disclosure duties

Pre-contractual and **periodic** reports

Basically: **prospectus**

The key idea is to have a disclosure of the

- **Environmental objectives** the financial products contributes to; and
- 'a **description of how and to what extent** the investments underlying the financial product **are in economic activities that qualify as environmentally sustainable**', with a specific reference to the ***proportion*** *of environmentally sustainable economic activities as a* ***percentage*** *of all investments selected for the financial product*

N.B.: just **each financial product**, *not* the issuer as a whole

A couple of principles and six objectives

Principle 1:

"**Do no significant harm**" [Reg. (EU) 2019/2088, whereas 17 and art. 2 (17)]:

'To ensure the coherent and consistent application of this Regulation, it is necessary to lay down a **harmonised definition of 'sustainable investment'** which provides that the investee companies follow good governance practices and the precautionary principle of 'do no significant harm' is ensured, so that neither the environmental nor the social objective is significantly harmed.'

Minimum safeguards (OECD and ILO principles)

Principle 2:

No significant harm to environmental objectives: it is not possible promoting one, while damaging others. That activity is not deemed to be sustainable

- Also considering not just the activity but its products' lifecycle

A couple of principles and six objectives

The objectives (to be achieved by means of economic activities):

(a) climate change mitigation;

(b) climate change adaptation;

(c) the sustainable **use and protection of water** and marine resources;

(d) the transition to a **circular economy**;

(e) pollution prevention and control;

(f) the protection and restoration of **biodiversity** and **ecosystems**.

Each of them is carefully described an arts 10 to 15. Here just a few examples

Contribution to climate change mitigation

- Substantial contribution…
- Stabilisation of **greenhouse gas concentrations** in the atmosphere by, i.a.,
  - Improving **energy efficiency**
  - Increasing climate-neutral mobility
  - Producing clean and efficient fuels
  - …

Contribution to climate change adaptation

- Substantially, again…
- The economic activity:
  - '(a) includes **adaptation solutions that either *substantially reduce the risk of the adverse impact of the current climate and the expected future climate* on that economic activity** *or* ***substantially reduce that adverse impact***, *without increasing the risk of an adverse impact on people, nature or assets*; or
  - (b) provides adaptation solutions that, in addition to satisfying the conditions set out in Article 16, contribute substantially to preventing or reducing the risk of the adverse impact of the current climate and the expected future climate on people, nature or assets, without increasing the risk of an adverse impact on other people, nature or assets.'

Substantial contribution to the sustainable use and protection of water and marine resources

The activity contributes to achieving the good status of bodies of water, by, i.a.:

- Protecting the environment from **wastewater discharges**
- Protecting human health from the adverse impact of **contaminations of water**
- Improving water management and efficiency
- …

Substantial contribution to the transition to a circular economy

The activity contributes to the **transition to a circular economy**, by, i.a.:

- Increasing the **efficiency in the use of natural resources**, also reducing the use of primary raw materials or increasing the use of by-products and secondary raw materials
- Increasing **durability, reparability, upgradability**… of products
- Increasing **recyclability of products and materials**
- Developing high-quality recycling of waste
- Reducing waste generation…

Substantial contribution to pollution prevention and control

The activity contributes to achieving the pollution prevention and control, by, i.a.:

- **Reducing pollutant emissions** into air
- **Preventing or minimising any adverse impact** on human health and the environment of the production, use or disposal of chemicals
- Cleaning up litter and other pollution
- …

Substantial contribution to the protection and restoration of biodiversity and ecosystems

The activity contributes to the protection, the conservation or the restoration of the **biodiversity** or to the achievement of a **good condition of the ecosystems**, by means of, i.a.:

- Sustainable **agricultural** practices,
- Sustainable **land use** and management
- Sustainable **forest management**…

And, in addition…

- **All the enabling activities**, leading to the abovementioned objectives, are to be considered sustainable if they contribute substantially to one or more among those objectives
- Provided that they **do not undermine long-term environmental goals**, and have a positive environmental impact

How to achieve the objectives?

- The Taxonomy considers the **big picture**, but does not provide for detailed specifications
- The **specific technical screening** criteria for determining whether an activity promotes sustainability in the aforementioned meaning, or on the contrary harms the environment are included in **delegated acts** to be issued by the Commission, after consulting the Platform on Sustainable Finance
- The **requirements for technical screening** criteria to be included in the delegated acts are set down in Art. 19
  - **Extremely detailed** (delegated acts released so far exceed 600 pages…)
  - Principle of **quantitative measurability**, as far as possible
  - Conclusive scientific evidence, considering life-cycle
  - As a general criterion: **use of fossil fuels for power generation prevents the qualification of the activity in terms of sustainability**

The Green Bond Framework

Released by the **issuer** and published on its website, to be made available throughout the entire GB's lifecycle

Confirms the **commitment** and the **alignment** of the bonds with the EU GBS, including, in particular, the use of proceeds.

It must include:

- **Environmental objectives** of the GB or the GB programme and **issuer's strategy** on GBs
- Details of the **process of selection and verification** (alignment with EU Taxonomy)
- Description of **projects to be financed**. In particular: details for near zero carbon emissions
- How the **lending** is related with the GB (financial institutions)
- Description of the **reporting**

Reporting

Allocation reporting (upon full allocation – **mandatorily verified**)

- Statement of alignment with EU GBS
- Allocated amounts **divided per sectors**
- Geographical distribution

+

Impact reporting (at the end of the project – encouraged verification)

- Description of the project
- Objectives pursued
- Description of allocation of (re-)financing
- **Information on metrics and methodology for impact**

The market

Once on the market, the bonds, as any financial product, are **rated**

Rating agencies specialised in GB are present, too.

- Often controlled by big enterprises or other rating agencies (e.g.: Moody's)

Examples:

- VIGEO-EIRIS
- MSCI
- Thomson Refinitiv
- ISS-Oekom
- Sustaynalitics

Different methods, but they are all **based on materiality**

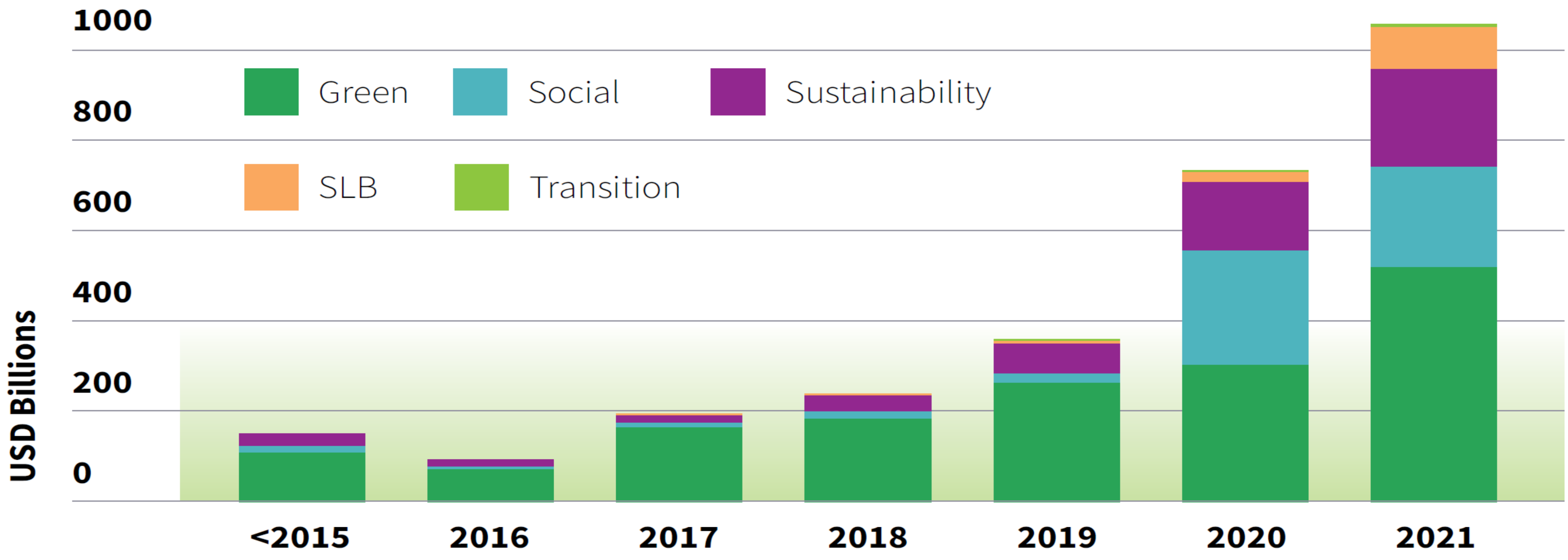
Practical fallout of the impact

Global state of the market (source: CBI)

Total size of thematic markets as of 31/12/2021

	Green	Sustainability*	Social*	SLB	Transition
Total size of market	USD1.6tn	USD520.5bn	USD538.8bn	USD135.0bn	USD9.6bn
Number of issuers	2045	425	861	225	15
Number of instruments	9886	2323	3471	317	32
Number of countries	80	51	44	37	12
Number of currencies	47	38	33	16	7

GSS+ debt volume surpassed USD1tn in 2021



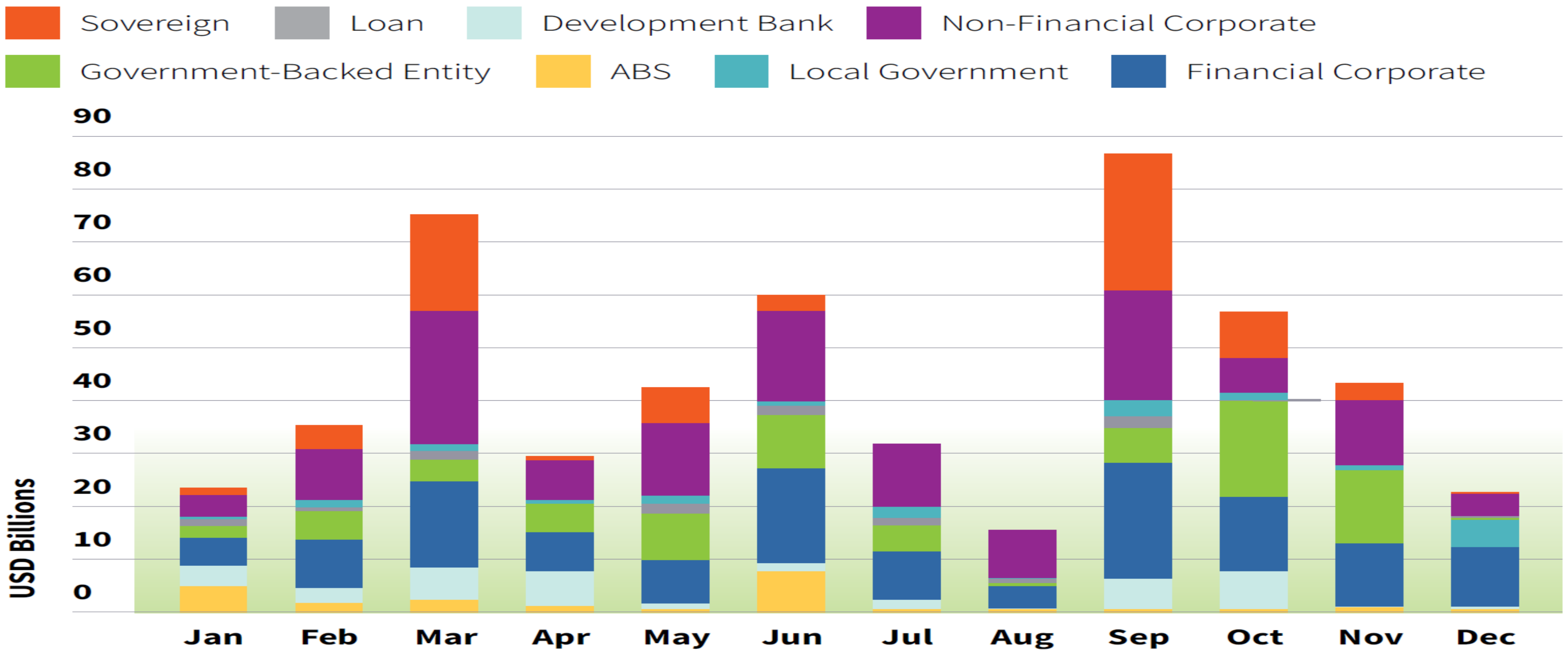
Source: Climate Bonds Initiative

unIMC
UNIVERSITÀ DI MACERATA
l'umanesimo che innova

Cofinanziato dal programma Erasmus+ dell'Unione europea

BL..SE CATTEDRA JEAN MONNET
BUSINESS LAW IN THE EUROPEAN UNION AND SUSTAINABLE ECONOMY

September was the busiest month on record for green bonds



Source: Climate Bonds Initiative

80% of green UoP went to Energy, Transport, and Buildings