GREEN FINANCE: WHAT DO WE MEAN WHEN WE SAY "GREEN"?

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GREEN FINANCE VS SUSTAINABLE FINANCE

GREEN FINANCE AND SUSTAINABLE FINANCE (ALSO KNOWN AS SUSTAINABLY LINKED FINANCE) SHOULD NOT BE CONFUSED. BOTH SUPPORT THE COMMON GOAL OF RE-DIRECTING CAPITAL TOWARD PROJECTS AND ENTERPRISES THAT POSITIVELY CONTRIBUTE TO GLOBAL GOALS TO REDUCE CARBON EMISSIONS, PROTECT BIO-DIVERSITY AND TILT THE WORLD TO A MORE SUSTAINABLE FOOTING. BUT THEY ARE DIFFERENT.

SUSTAINABLE LOANS

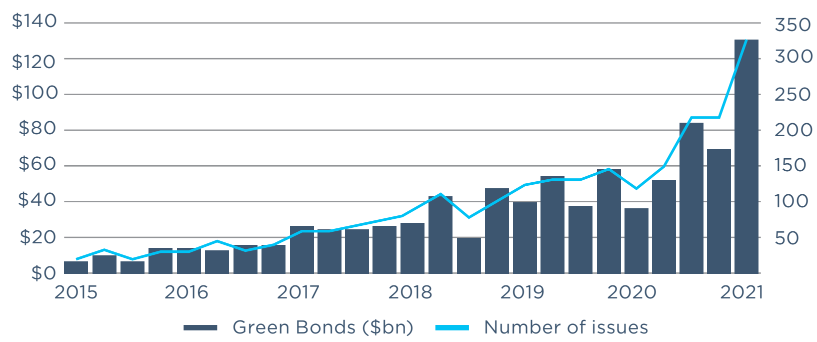
Sustainability linked loans incentivise sustainable borrower behaviour by tracking the borrower's performance against sustainability criteria and ratchet up, or down, the loan interest-rate according to that performance. Loan proceeds do not need to be used for a specific purpose and the borrower does not need to be operating within any specific sector. This model of financing appeals to a wider range of borrowers who are interested in operating in a more sustainable way.

GREEN LOANS

Green loans are loans where the proceeds must be applied towards 'green' projects. They do not incentivise performance and are accessible to a smaller pool of borrowers (i.e. those looking to fund demonstrably green projects). Green bonds function in a similar way and are increasing rapidly.

This is primarily driven by sovereigns and banks attempting to provide relief from the pandemic and galvanise recovery efforts. It also shows their appeal within the market and the pace at which the climate-emergency is climbing the investor agenda.

GLOBAL GREEN BONDS



DEFINING 'GREEN': THE GREEN BOND PRINCIPLES AND GREEN LOAN PRINCIPLES

A GREEN LOAN OR GREEN BOND NEEDS A DEFINITION OF 'GREEN'. VOLUNTARY STANDARDS HAVE EMERGED.

GREEN BOND PRINCIPLES

In the green bond market these include the International Capital Market Association's Green Bond Principles and the Climate Bond Initiative's Climate Bond Standards. These standards provide detailed, science-led environmental criteria to assess projects against.

The early green loans were accredited against the Green Bond Principles – an example being a 2017 power transmission project in Uruguay financed by the Inter-American Development Bank and BBVA, which claims to be the first limited recourse project financing based on 'green loans'.

[1] Refinitiv – Sustainable Finance Review Report 2021 Q1 (23 April 2021), page 5: https://thesource.refinitiv.com/thesource/getfile/index/f5e0218a-a2de-4fe2-a864-438b0231b5d2

GREEN LOAN PRINCIPLES

There is now a set of Green Loan Principles (GLP) created by the Loan Market Association and Asia Pacific Loan Market Association to establish a framework for green loan financing. The proceeds of the loan must be used to finance or refinance (in whole or in part) 'Green Projects'. The GLP set out a non-exhaustive list of 'Green Projects' which include, amongst other things, renewable energy, energy efficiency, climate change adaptation, and clean transportation.

The borrower is responsible for complying with the GLP. In particular, borrowers are encouraged to:

- Establish a process to determine how projects fall within the eligible categories for Green Projects and communicate this to the lenders.
- Establish – and communicate to the lenders – processes for assessing the environmental benefits and impacts of projects.
- Disclose any green standards or certifications which they intend their projects to comply with.
- Credit the proceeds of green loans to ring-fenced accounts or otherwise establish processes to track the proceeds to ensure they are applied for the correct purpose.
- Report to lenders on the use of proceeds using qualitative indicators and, where feasible, quantitative performance indicators.
- Obtain an external review, where appropriate, to verify or certify the borrower's compliance with the GLP.

Borrowers may self-certify their compliance with the GLP if they have adequate internal expertise and experience to certify.

[1] Refinitiv – Sustainable Finance Review Report 2021 Q1 (23 April 2021), page 5: https://thesource.refinitiv.com/thesource/getfile/index/f5e0218a-a2de-4fe2-a864-438b0231b5d2

EU TAXONOMY

POLICY MAKERS ARE NOW CATCHING UP – THE EU HAS INTRODUCED THE TAXONOMY REGULATION[2] TO CREATE CLASSIFICATION CRITERIA FOR SUSTAINABLE INVESTMENTS, TO ENCOURAGE THE MOVEMENT OF CAPITAL TOWARDS SUCH INVESTMENTS. THIS IS WITH THE ULTIMATE AIM OF ACHIEVING CARBON NEUTRALITY BY 2050, IN LINE WITH THE PARIS CLIMATE AGREEMENT.
THE TAXONOMY REGULATION HELPS TO AVOID 'GREENWASHING' – FOR EXAMPLE, WHERE A LENDER OR BORROWER CLAIMS THAT A LOAN IS GREEN OR SUSTAINABILITY LINKED, BUT THE LOAN ACTUALLY IS NOT – BY HELPING TO IDENTIFY WHAT IS OR IS NOT SUSTAINABLE OR GREEN. ALTHOUGH THE INITIAL FOCUS HAS BEEN ON DEFINING WHAT IS SUSTAINABLE IN CLIMATE TERMS, THE INTENTION IS TO DEVELOP RULES ON OTHER ENVIRONMENTAL SUSTAINABILITY OBJECTIVES IN TIME, AND TO EXTEND THE TAXONOMY REGULATION TO SOCIAL OBJECTIVES AT A LATER STAGE.

[2] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L:2020:198:FULL&from=EN

ENVIRONMENTALLY SUSTAINABLE INVESTMENTS

The Taxonomy Regulation specifies that for an economic activity to qualify as environmentally sustainable, it must satisfy the following four limbs:

1. it must contribute substantially to at least one of the six environmental objectives:

    i. climate change mitigation;

    ii. climate change adaptation;

    iii. sustainable use and protection of water and marine resources;

    iv. the transition to a circular economy, waste prevention and recycling;

    v. pollution prevention and control; and

    vi. the protection of healthy ecosystems.;

2. it must “do no significant harm” to any of the other environmental objectives;

3. it must be carried out in compliance with minimum social and governance safeguards (i.e. the eight fundamental International Labour Organisation conventions); and

4. it must comply with technical screening criteria (TSC) to be adopted under the Taxonomy Regulation – such TSCs will be adopted through delegated acts using the available scientific evidence. The practical definition of what it means to ‘substantially contribute’ and do no significant harm to an environmental objective would then be possible to establish.

APPLICATION AND REPORTING

The Taxonomy Regulation applies to financial market participants offering financial products as environmentally sustainable investments (e.g. asset managers and pension funds) and will be supplemented by other regulations in due course. It is also being used to develop new benchmarking and green bond standards.

[2] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L:2020:198:FULL&from=EN

UK REGULATION

EU TAXONOMY REGULATION AND BREXIT

The UK formally left the EU on 31 January 2020 and entered into a transition period which ended at 11pm on 31 December 2020, after which EU law ceased to directly apply in the UK. Although the Taxonomy Regulation entered into force on 12 July 2020, the key operative requirements (including the disclosure obligations) only apply after 31 December 2021. They therefore do not form part of retained EU law in the UK, as things stand.

Nonetheless, many UK funds will be required to adhere to the Taxonomy Regulation in respect of their European operations and activities, and so will still need a full understanding and appreciation of the obligations and requirements of the Taxonomy Regulation. The UK government has publicly endorsed the objectives of the EU Sustainable Action Plan[3] (which promoted the very idea of an EU classification system for sustainable activities, and therefore the Taxonomy Regulation itself), but has not yet commented on the extent to which the UK will align with the EU on the Taxonomy Regulation.

GREEN FINANCE STRATEGY

The Government published its Green Finance Strategy in July 2019,[4] highlighting the intention to mobilise investment in green projects. The Strategy is broken down into three pillars, these being:

1. **Greening Finance** – integrating climate and environmental risks into mainstream financial decision-making

2. **Financing Green** – mobilising and accelerating flows of private finance into key clean growth and environmental sectors in the UK (and internationally)

3. **Capturing the Opportunity** – ensuring that the UK continues to capture the commercial opportunities arising from green finance, building on the experience of developing green innovations including green bonds, green loans and ESG exchange-traded funds.

The aim of the Strategy is to stimulate investment in the types of activities and developments that will protect the UK economy from climate-related risk, and to establish the UK as being at the forefront of all forms of environmental innovations. The three pillars are designed to incentivise financial institutions to move towards a more resilient form of economic growth, reducing their exposure to climate-related risks and future-proofing the economy by placing the UK at the centre of the 'green economy'.

For more information see our article **Green Finance Strategy.**

Of significance, the Government has set out its expectation that all listed companies and large asset owners are to disclose their exposure to climate-related risk in line with the Task Force on Climate-related Financial Disclosures (TCFD) recommendations[5] by 2022. Furthermore, the responsibilities of the Prudential Regulation Authority, the Financial Conduct Authority and the Financial Policy Committee are to be 'clarified' so that they have regard to the Paris Climate Agreement when carrying out their duties.[6]

[3] Following the Economic Secretary to HM Treasury's letter to the Chair of the European Scrutiny Committee (28 May 2020): https://lpscdn.linklaters.com/-/media/files/document-store/pdfns/2020/august/john_glen_letter_to_house_of_commons.ashx?rev=d2dcdea4-7c62-454d-9823-fd598aaca75c&extension=pdf&hash=725497947D20C57788658961BA4A070F
[4] Green Finance Strategy policy paper (2 July 2019): https://www.gov.uk/government/publications/green-finance-strategy
[5] https://assets.bbhub.io/company/sites/60/2020/10/FINAL-2017-TCFD-Report-11052018.pdf (15 June 2017)
[6] Green Finance Strategy (2 July 2019), page 8

BUILD BACK BETTER

As part of the March 2021 Budget announcements, the Chancellor's 'Build Back Better' publication[7] (outlining the Government's plans to support economic growth through investment in infrastructure, skills and innovation) states an intention to "fully implement a 'Green Taxonomy' to provide a common standard for measuring firms' environmental impact".[8] This would require firms to disclose the climate risks they face in line with the recommendations of the TCFD – which itself bears similarities with the Taxonomy Regulation. It also states that the Government has joined the International Platform on Sustainable Finance to ensure standards can operate internationally, further indicating that the proposed 'Green Taxonomy' is to be somewhat aligned with the Taxonomy Regulation.

The development of legislation and guidance in this area is creating a state of flux within the green and sustainable finance sphere on an international scale. The next few years have the potential to be momentous for the long-term prevalence of such financial lending and borrowing models, and will help to address the climate-emergency also.

[7] HM Treasury's 'Build Back Better: our plan for growth' policy paper (3 March 2021): https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/968403/PfG_Final_Web_Accessible_Version.pdf
[8] ibid., page 87

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