

## Financing for the Future: Surging Sustainable Finance Market Presents Challenges, Opportunities

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The sustainable finance market is experiencing rapid growth, driven by many factors including an increasing number of capital providers seeking to meet their own environmental, social and governance ("ESG") investment and operational goals. There is a sense we are now at an inflection point, with climate mitigation and other ESG issues becoming core to investment and business strategies for issuers, borrowers and investors.

Since the issuance of the first green bond by the European Investment Bank in 2007, which was used to fund renewable energy and energy efficiency projects, the sustainable finance market has matured and expanded to include a range of other products that have become available to a much larger base of companies. The use of such products worldwide has been steadily increasing and accelerated dramatically in 2019 and 2020, with the COVID-19 pandemic increasing focus on social infrastructure and investor social responsibility. According to BloombergNEF, sustainable debt issuances worldwide totaled \$732.1 billion in 2020, the greatest volume of issuances ever in a single year.<sup>1</sup>

### Sustainable Debt Instruments

Sustainable finance products are designed to support certain identified environmental and social projects or goals. In some cases, driven by strong market demand for ESG investments, they allow borrowers and issuers to take advantage of "greenium" pricing in the form of lower financing costs.<sup>2</sup>

Sustainable finance products include:

- **Green bonds** – Bonds used to fund climate adaptation and mitigation and other environmental projects.
- **Social bonds** – Bonds used to fund projects with positive social outcomes, such as improved employment, public health or education outcomes. Social bond issuances increased in 2020, as many investors sought products that addressed or mitigated issues related to the social impacts of the COVID-19 pandemic, and many companies sought capital for their responses (such as helping people access essential healthcare services).
- **Sustainability bonds** – Bonds used to fund a combination of green and social projects.
- **Transition bonds** – Bonds designed to provide financing to transition high greenhouse gas-emitting activities to lower carbon alternatives.
- **Sustainability-linked bonds and loans** – Bonds and loans in which a company agrees to a pricing adjustment conditioned on its achievement of pre-determined ESG performance metrics, with diversity and greenhouse gas reduction targets being particularly common, or the achievement of a specific third-party ESG score.

## Potential Benefits to Pursuing Sustainable Finance Strategies

In addition to the potential for “greenium” pricing, there are numerous benefits to pursuing a sustainable finance strategy. In particular, sustainable finance products can be used to raise funds for a company’s ESG initiatives and/or create financial incentives for ESG performance. Sustainable financing may also provide an opportunity to broadcast an ESG commitment to investors, lenders, customers and other stakeholders, providing tangible credibility for ESG initiatives that could give a company an edge over industry competitors that have not developed clear ESG strategies.

Importantly, these products can help diversify a company's investor and lender base as ESG financing commitments continue to rise. Sustainable finance products often attract investors who have their own ESG requirements or allocated capital for ESG-friendly investments. In recent years, the majority of global banks have committed to expanding their financing sustainability products. For example, in April 2021, Bank of America increased to \$1 trillion its goal of financing activities that accelerate the transition to a low-carbon economy by 2030. JP Morgan pledged to facilitate \$2.5 trillion in climate-friendly investments, while Citigroup and Morgan Stanley each

pledged \$1 trillion to finance activities that advance the UN Sustainable Development Goals.

Finally, the launch of a sustainable finance product can facilitate internal collaboration between in-house sustainability leads and the core business and finance leads, encouraging collaboration and elevating the importance of ESG initiatives and projects as business-critical issues.

## Notable Recent Financings and Expectations for Market Growth

A number of notable sustainable financings launched in 2021. For example:

- Whirlpool Corporation and Kellogg Company each issued inaugural sustainability bonds. Whirlpool's \$300 million, 10-year bond has an interest coupon of 2.4% per annum, and Kellogg's €300 million eight-year bond has an interest coupon of 0.50% per annum.
- Italian oil supermajor Eni raised €1 billion from a seven-year sustainability-linked bond with an interest coupon of 0.375%. The first oil and gas firm to issue a sustainability-linked bond, Eni stated it intended to issue bonds only in sustainability-linked formats in the future.
- Newmont Corporation, a leading gold company and metal producer, signed a \$3 billion sustainability-linked revolving credit facility in March 2021, pursuant to which Newmont will receive pricing adjustments on its drawn balances, based on its sustainability performance as assessed by certain third-party ESG ratings. Newmont is one of the first companies in the mining industry to add a sustainability-linked pricing component to its revolving credit facility.

The growth of the sustainable finance market is showing no signs of slowing movement into the second half of 2021, with Moody's predicting \$650 billion in green, social and sustainability bond issuance in 2021, a 32% increase over the \$491 billion issued in 2020, and S&P expecting global issuance of sustainability-linked debt instruments to surpass \$200 billion by the end of 2021.<sup>3</sup>

## Challenges and Opportunities

There are a number of challenges and opportunities for companies seeking to pursue sustainable finance strategies, including:

- 1. Evolving Voluntary and Regulatory Guidelines:** Over the past decade, a number of voluntary guidelines have emerged to guide the development of sustainable finance products, but there is no firm consensus on what constitutes a sustainable project or how to measure success or milestones. The most widely accepted standards in the U.S. are the Green Bond Principles, Social Bond Principles, and Sustainability Bond Guidelines issued by the International Capital Markets Association (for bonds) and the Green Loan Principles and Social Loan Principles issued by the Loan Market Association, Loan Syndications and Trading Association, and Asia Pacific Loan Market Association (for loans). Regulation by authorities, particularly in the EU, appears likely to increase in the near future, but its form remains unclear. The EU's Taxonomy Regulation, which aims to provide a unified classification system for "environmentally sustainable economic activities," will likely influence the market as it comes into force beginning in 2022, and the European Commission has proposed a regulation to create a voluntary European Green Bond Standard that would require full alignment of funded projects with the EU Taxonomy, as well as second party review by an entity supervised by the European Securities Markets Authority. Regulation impacting the sustainable market is also possible in the U.S., given the Biden administration's focus on ESG and climate change and the SEC's focus on combating "greenwashing."
- 2. Metrics, Measurement and Assurance:** Because there is no standard definition of what constitutes a "green project," "social project" or "sustainable" business activity, issuers and borrowers have broad latitude in selecting impact and reporting metrics. Particularly for sustainability-linked instruments, it is important to ensure any impact metrics and targets are objective, measurable and can be independently verified, as well as to set meaningful goals. For use of proceeds instruments, third-party reviews and consultations are typically conducted to evaluate the issuer's process for project evaluation and selection, and third parties, often independent auditors, are also often engaged to independently verify the allocation of funds. As regulation continues to evolve and market practice becomes more consistent, it should be easier to compare and contrast the quality of projects and measurements of success. In the meantime, it is critical to carefully evaluate what metrics, measurement and assurance mechanisms are being used in connection with a sustainable finance product.
- 3. Legal Risks and Mitigation:** Any issuer of securities should be aware of the legal risk inherent in connection with issuing green, social, and sustainability bonds,

which could implicate Rule 10b-5 of the Securities Exchange Act of 1934. For example, if an investor purchases a green bond in reliance on intentionally or recklessly misleading disclosure related to the sustainability credentials of the issuer and the planned use of proceeds, and the investor then loses money because the revelation of such misleading disclosure leads to a drop in the resale value of the bond, then that investor could potentially make a claim under Rule 10b-5. Establishing disclosure controls and procedures is advised for purposes of internal and external reporting. Additionally, confusing or misleading disclosures can also give rise to reputational harm even if they fall short of the Rule 10b-5 threshold. For green, social and sustainability loans, the primary risk is breaching the loan documents, and for sustainability-linked products, the primary risk is an increase in the interest rate or coupon. Both of those scenarios can give rise to reputational risk. It is therefore crucial to ensure that legal counsel is involved in the careful review of offering/loan and related documents in addition to internal procedures to ensure they are consistent, accurate and unlikely to be misleading. Many borrowers and issuers will also obtain Second-Party Opinions ("SPO") regarding alignment of their financing frameworks with applicable guidelines and regulatory standards and the sustainability credentials of the borrower or issuer. Finally, it is important to note that for "use of proceeds" instruments (versus project or securitization bonds or "sustainability-linked instruments), transparent annual reporting on management and use of proceeds, coupled with review by a third-party auditor, as well as (where feasible) impacts of projects, decreases investor and issuer risk even further. Similarly, for sustainability-linked products, third-party auditor review of metrics and targets is advisable even when not required.

- 4. Reputational Considerations:** As noted above, the failure to adhere to a specified use of proceeds or to achieve ESG goals, or the setting of goals that are not ambitious enough, could cause reputational damage to the issuer or borrower, including claims of "greenwashing." For example, issuers of sustainability bonds who make statements about positive social impacts could later face scrutiny if third-party assessments find them lacking, such as a poor score on a third-party corporate benchmarking human rights assessment. In certain cases, investors are refusing to invest in certain companies or projects that they deem not "green" enough. Comprehensive ESG due diligence and periodic third-party audits are therefore key to confirm disclosures are factually accurate and supported by underlying data, as the credibility of a company's ESG statements is critical to manage risks and optimize opportunities.

Kirkland's fully integrated ESG & Impact, Capital Markets and Debt Finance practices are helping borrowers and issuers navigate these and other risks and opportunities presented by the surging sustainable finance market. We will continue to monitor

market and regulatory trends and intend to cover any significant new developments in future *Alerts*.

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1. BloombergNEF, "Sustainable debt issuance exceeds \$730 billion in 2020," *Bloomberg* (February 25, 2021).↔

2. Environmental Finance, Climate Bonds Initiative, Amundi Asset Management SA, "Why Going Green Saves Bond Borrowers Money," *WSJ* (December 17, 2020).↔

3. Moody's Investors Service, "Moody's - Sustainable bond issuance to hit a record \$650 billion in 2021," *Moody's* (February 4, 2021).↔

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## Related Services

### Practices

- Capital Markets
- ESG & Impact
- Debt Finance
- Transactional

## Suggested Reading

- 28 September 2021 - 29 September 2021 Sponsored Event The Renewable Energy Finance Forum
- 22 September 2021 - 23 September 2021 Sponsored Event Private Debt Investor New York Forum Virtual Experience
- 16 August 2021 Press Release Kirkland Represents Azentio Software on Acquisition of Software Assets from Path Solutions

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