



ESG financing for corporates

Interest in Environmental, Social and Governance (ESG) financing, including green bonds and sustainability-linked financing facilities, is growing significantly. The green bond market is estimated to be around \$1trn¹ with growth fuelled not just by business need but also by political will for a “green recovery”.

There’s still much confusion among stakeholders: What are the different types of ESG financing? How can corporates raise ESG financing? Are there specific requirements related to ESG financing?

What are green bonds?

Green bonds function the same way as any other bonds, i.e. they are a fixed income debt issuance financial products. However, unlike traditional bonds, **green bond proceeds** (i.e. the cash received by issuer, from the investor in the bond) are intended to be allocated to financing new or existing projects **with specified climate and environment-related objectives**.

What is sustainability-linked financing?

Sustainability-linked financing is any form of funding arrangement, for instance a bond or loan, which incorporates specific features related to a set of **ESG Key Performance Indicators** (KPIs). For example, a sustainability-linked bond would have many of the typical features of a conventional bond, but the coupon payable by the issuer could vary depending on whether the issuer achieves predefined ESG objectives agreed at pre-issuance, such as reducing greenhouse gas emissions or achieving diversity targets on board committees.

Why is the market growing?

ESG financing can provide specific funding to support a firm’s strategic ESG objectives. Both issuers and investors have recognised the importance that green bonds and sustainability-linked financing play in reaching these objectives.

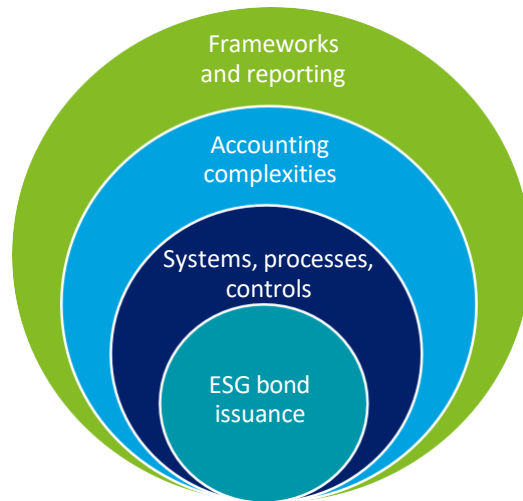
Commercially, **ESG financing can also attract improved financing terms**, a pricing premium or “greenium” in comparison to conventional financing.

Do issuers need to do anything differently?

Yes. While many of the features of ESG financing are similar to those used on conventional bonds, the ESG related element of ESG financing introduces specific requirements on the issuer.

¹ Forbes ‘Green Bond Market Will Reach \$1 Trillion With German New Issuance’ ([link](#)).

In particular, there is an increased focus on **external reporting**, as issuers will be required to demonstrate how funds have been used or whether ESG related KPIs have been met. In addition, the issuer may need to adapt or establish a new **suite of internal controls** relating to ESG financing, as well as considering the **accounting complexities** and new financial reporting **disclosure requirements**.



Key Considerations for Corporates

Key considerations for corporates and ESG financing

ESG Financing can affect a wide range of business activities. It is important that corporates give careful consideration to the far-reaching implications, both pre- and post-issuance, to ensure success.



Can any firm use ESG financing?

The broad nature of the ESG financing market means that a wide range of firms can access it, regardless of the size and nature of the underlying business, firms have sought to use ESG financing as a tool to support their progress towards

meeting ESG objectives.

How does an issuer define their approach to ESG financing?





Issuers often publish an ESG financing framework. **The framework tends to describe the nature of the issuer’s ESG financing strategy and how that relates to their corporate sustainability goals.** In sustainability-linked financing, the framework may describe the ESG metrics that will determine the coupon level and the system, processes and controls that have been established to govern performance. Many issuers also publish an annual statement covering the use of proceeds and key ESG metrics associated with their financing.

Are there specific accounting considerations, including hedge accounting?

Yes. The nature of ESG financing can result in accounting complexities. Sustainability-linked financing **can cause variability in the cash flows** of issued debt and the financial statements, for example it may change the interest rate profile depending on whether the issuer meets ESG related targets. Issuers need to assess whether such features represent **embedded derivatives** that have to be separated from the debt host contract and accounted for as standalone derivatives.

In addition, the impact of features such as **step-up coupons** need to be taken into consideration when developing an appropriate **hedging strategy**. Should an issuer wish to hedge its debt, for example for interest rate risk or foreign currency risk, step-up features present in the bond may not be present in the hedging instrument, **which may lead to hedge ineffectiveness and financial statement volatility**. As such, careful designation of the hedged risk is required.

The lifecycle of a green bond

 Market exploration	 Pre-issuance	 Issuance	 Post-issuance
<ul style="list-style-type: none"> The green bond market is emerging rapidly and before entering, issuers should make sure they understand the market, undertake appropriate research and preparation and consider how green bonds will fit with their business profile and wider strategy. Consideration as to whether the issuance of a green bond would be appropriate is important before undertaking any work on a specific programme. If a green bond is considered a strategically and commercially attractive route to market, then preparation will be key to ensuring issuance is effective. 	<ul style="list-style-type: none"> There are a number of green bond standards/principles already in place in the market. Issuers may want to consider aligning their green bonds with those standards. Those most commonly used include the International Capital Market Association (ICMA) Green Bond Principles, the Climate Bond Initiative (CBI) or the emerging EU Green Bond Standards. Green bond frameworks are an essential step in that process, setting out a clear plan for engagement in how the firm will approach its issuance of green bonds, the use of proceeds and reporting. 	<ul style="list-style-type: none"> The issuance process for a green bond is similar to that for a conventional bond, but will incorporate a number of elements specific to the bond being considered as green, for example – the publication of a green framework. In addition to the regular assurance applicable to a bond issuance, to support the green credentials of a bond the associated green bond framework can require third party assurance (provided against a set of criteria), or second party opinions (an independent view on the green credentials). 	<ul style="list-style-type: none"> The issuance of green bonds requires ongoing management by the issuer to ensure the green objectives are realised though the allocation and monitoring of bond proceeds. Issuers often commit to periodic reporting of use-of-proceeds and environmental-KPIs associated with green bonds. Preparations for reporting should include the scope of data requirements, reporting format and assurance options.

Latest Development in South Africa

On 1 April 2022, South Africa's first Green Finance Taxonomy was published by the Taxonomy Working Group chaired by National Treasury, as part of South Africa's Sustainable Finance Initiative.

What is the Green Finance Taxonomy?

The Sustainable Finance Initiative² defines the SA Green Taxonomy as: "an official classification or catalogue that defines a minimum set of assets, projects, and sectors that are eligible to be defined as "green" or environmentally friendly. It supports emerging national policy and voluntary private sector initiatives toward sustainable finance by reducing costs and uncertainty in classifying a core set of green activities."

The Green Finance Taxonomy can also provide a uniform framework against which to assess assets and activities. It is based on 3 key principles:

- Principle 1: Substantially contribute to at least one of the six objectives of the taxonomy
- Principle 2: Do no significant harm to any of the other objectives
- Principle 3: Comply with minimum social safeguards

The Taxonomy sets out 6 key objectives (as defined under Section 2.4 of the taxonomy), and the 1st edition focuses on the 2 key objectives namely:

- Climate Change Mitigation
- Climate Change Adaptation

These objectives are further categorised according to macro-sector and economic activity. The classification of activities as well as the abovementioned principles are used to assess the alignment of different activities to the taxonomy.

Let's talk ...



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² <https://sustainablefinanceinitiative.org.za/wp-content/downloads/SA-Green-Finance-Taxonomy-1st-Edition-Final-01-04-2022.pdf>