ESG financing for corporates

Interest in Environmental, Social and Governance (ESG) financing, including green bonds and sustainability-linked financing facilities, is growing significantly. It is estimated that the green bond market will grow to $1trn in 2021 with growth fuelled not just by business need but also by political will for a “green recovery”.

But there’s still much confusion amongst 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.

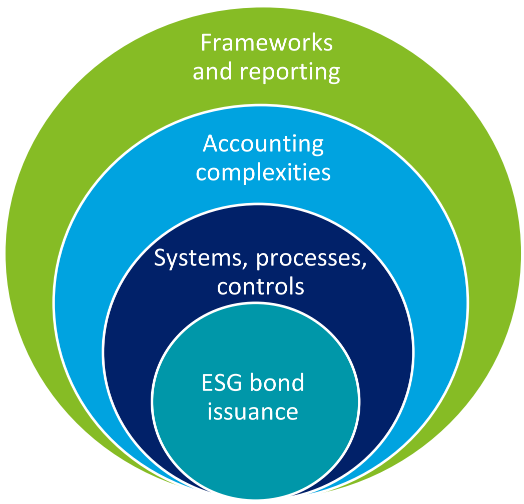
Why is the market growing?

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 have plays 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. Whilst 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.

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**.



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

Key Considerations for Corporates

Key considerations for corporates and ESG financing

ESG Financing can affect a wide range of business activities, it is important 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, as regardless of size and nature of underlying business, firms have sought to use ESG financing 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** needs 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

- 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.

Pre-issuance

- 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.

Issuance

- 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).

Post-issuance

- 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.

How Deloitte can help …

Strategic and product diagnostic: Analysis of the context, use of potential frameworks and market opportunity.	**Key performance indicators:** Identification of the KPIs, asset class and specific bond issuance.	**Transaction AUPs:** Deloitte have considerable experience issuing AUP transactions in relation to bond issuance.	**Verification:** Certain frameworks can require verification of a bond against a framework or set of criteria.
Frameworks and principles: A framework used to set out an overall approach.	**Independent Debt Advice:** Professional, independent advice fully aligned with the borrower's debt financing objectives.	**Third party assurance:** ISAE 3000 in relation to green bond issuance.	**Use of proceeds assurance:** Relating to the application of funds received from a bond issuance into eligible projects and periodic reporting
	Competitive Financing Processes: Efficient execution of competitive debt financing processes designed to meet the client's strategic timetable objectives.	**Second party opinions:** To support credibility of a green bond issuance, an independent second party opinion can be obtained.	**Impact assessments:** Used to determine the influence a green bond issuance has had on the intended ESG factors, which can require assurance.

Let's talk …

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