New ICMA Principles Guidance for Sustainable Bonds

ICMA issues guidance on Green Enabling Projects and creates the new Sustainability-Linked Loans Financing Bonds label.

European Union - Legal flash

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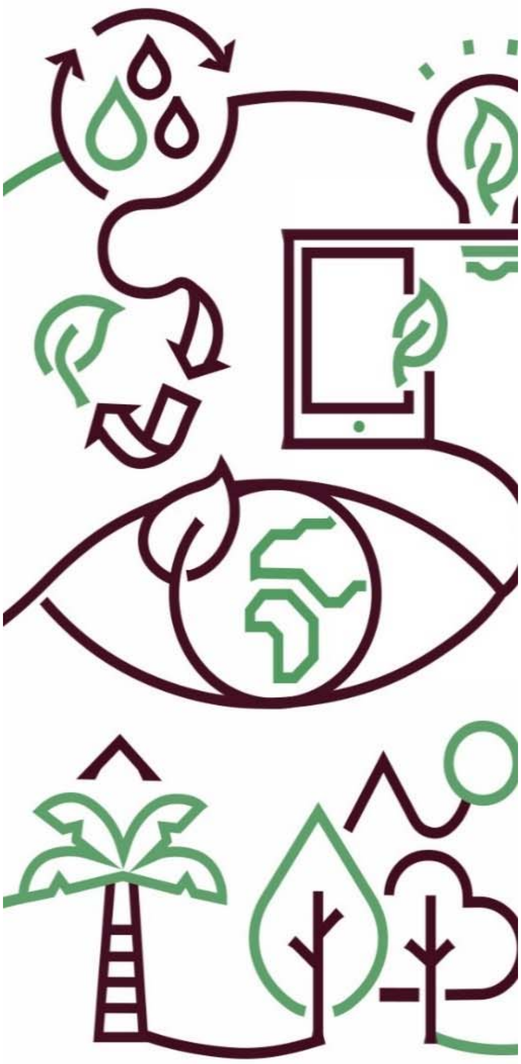

Key aspects

- The Principles introduce a new category - Sustainability-Linked Loan Financing Bonds - for bonds whose proceeds are allocated to finance sustainability-linked loans adhering to the Loan Market Association's sustainability-linked loan principles.
- The four fundamental components of Sustainability-Linked Loan Financing Bonds align with the Green Bond Principles and are the use of proceeds, the selection process and evaluation of sustainability-linked loan portfolios, the management of proceeds, and reporting.
- Additionally, the Principles offer guidance to elucidate the criteria that 'green enabling' projects must meet to be financed by funds procured through the issuance of green bonds.
- 'Green enabling' projects, while not overtly green, are essential for the value chain of green projects that yield a distinct environmental advantage.

On June 25, 2024, the International Capital Market Association ("**ICMA**") in occasion of its conference celebrating the 10th anniversary of the Green Bond Principles ("**GBP**"), the Social Bond Principles ("**SBP**"), and the Sustainability Bond Guidelines ("**SBG**") (together, the "**Principles**"), published new guidance for green enabling projects ("**Green Enabling Projects Guidance**") and for Sustainability-Linked Loan financing Bonds ("**SLLB**" and the "**SLLBs Guidelines**") alongside other important updates.

These initiatives aim to support the transition to a net zero economy and to expand the scope and diversity of the sustainable bond market.

SLLBs are bonds that finance or refinance a portfolio of Sustainability-Linked Loans ("**SLLs**") aligned to the Sustainability-Linked Loan Principles ("**SLLPs**") published by the Loan Syndications and Trading Association (LSTA), Asia Pacific Loan Market Association (APLMA), and Loan Market Association (LMA). The financing of SLLs through bonds will hopefully stimulate sustainable finance by enabling lender banks to access increased capital for lending, thereby escalating the use of SLLs by borrowers in the real economy and fostering greater transparency in the SLL market.

Sustainability-linked Loans are loans with economic characteristics that vary based on the borrower's achievement of predetermined sustainability performance objectives, usually an adjustment of the margin which decreases or increases according to whether the predefined sustainable objectives have been reached or not.

Green enabling projects are projects that are not explicitly green but are necessary for the value chain of green projects. The definition of green enabling projects broadens the spectrum of defined eligible activities for green bonds and paves the way for a more inclusive, transparent, and sustainable financial landscape stimulating transition.

Both guidance will hopefully support the transition to a net zero economy and the achievement of the Paris Agreement and European Climate Law objectives.

Paris Agreement: The Paris Agreement's central aim is to strengthen the global response to the threat of climate change by keeping a global temperature rise this century well below 2 degrees Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5 degrees Celsius.

European Climate Law: The European Climate Law writes into law the goal set out in the European Green Deal for Europe's economy and society to become climate-neutral by 2050. The law also sets the intermediate target of reducing net greenhouse gas emissions by at least 55% by 2030, compared to 1990 levels.

Sustainability-Linked Loan Financing Bonds

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The SLLBs Guidelines create a new sustainable finance product, keeping in mind the important role that bank´s play in the transition to a net zero economy. The SLLBs Guidelines provide voluntary guidance for issuers who wish to create a new sustainability labeled bond that finances or refinances a portfolio of SLLs.

The SLLBs Guidelines are adapted from the GBP and the SBP and require issuers to align their SLLBs with four core components:

(a) **Use of proceeds:** proceeds need to be allocated to the financing or refinancing of a portfolio of eligible SLLs that comply with the SLLPs. Issuers are encouraged to disclose their SLLB Frameworks, which should describe the eligibility criteria for selecting SLLs based on the SLLPs.
The SLLBs Guidelines suggest two possible approaches for achieving transparency on the SLL portfolio:

- Approach 1: where the issuer provides detailed information on the evaluation process, criteria, and thresholds for assessing the relevance and materiality of the selected key performance indicators ("**KPIs**") and sustainable performance targets ("**SPTs**") at the SLLB Framework level, but not at the individual SLL level; and

- Approach 2, where the issuer seeks an independent external review for each eligible SLL in the portfolio, together with a high-level description of the borrowers' sectors, the selected KPIs and their intended sustainability objectives. The guidelines acknowledge that Approach 2 may not be practicable for some issuers, especially those with larger numbers of smaller loans.

The SLLBs Guidelines recommend that issuers appoint external review providers to assess the alignment of their SLLB with their four core components in a pre-issuance review. Where the issuer adopts Approach 1, the external reviewer reviews the SLLB Framework of the Issuer against the SLLB Guidelines but will not assess the alignment of each SLL to the SLLP. On the other hand, if the issuer adopts Approach 2 the external reviewer reviews the SLLB Framework of the issuer against the SLLB Guidelines and opines on each SLL.

(b) **Process for SLL Evaluation and Selection**: issuers need to disclose their eligibility criteria, evaluation process, and governance structure for selecting and monitoring SLLs, as well as any sectorial exclusion criteria or ESG risk management policies.

(c) **Management of proceeds**: issuers need to track and adjust the net proceeds of the SLLB and link them to their lending and investment operations for eligible SLLs and inform investors about the types of temporary placement for unallocated net proceeds. The SLLBs Guidelines recommend that issuers seek external verification of their management of proceeds.

(d) **Reporting**: issuers should maintain and annually update information on the eligible portfolio of SLLs.

Green Enabling Projects Guidance

Green enabling projects are projects that are not explicitly green but are necessary for the value chain of green projects. For example, a project that provides materials or equipment for a renewable energy plant or a low-carbon transport system. The Green Enabling Projects Guidance recognizes that some activities that indirectly contribute to greening the economy may not fit the existing eligible green project categories listed in the GBPs and it seeks to provide transparency by defining which projects are green enabling based on specific criteria and transparency end-use, with the objective of including these in projects that can be funded through the issue of green bonds.

Specific criteria

- **Necessary for an enabled Green Project's value chain**: The green enabling project must be necessary for an enabled green project's value chain to be developed and/or implemented in net-zero scenarios and medium to long-term transition plans, it needs to be taken into consideration that these may change over time.

- **No carbon lock-in:** The green enabling project must not lead to locking-in high greenhouse gases emitting activities relative to other technologically feasible and/or commercially viable solutions, including at the level of an enabled green project.

- **Clear, quantifiable and attributable environmental benefit:** The green enabling project must provide a clear, quantifiable, and attributable environmental benefit, either based on actual impacts or estimates of the potential outcome of enabled green project(s) and assessed based on a life cycle analysis type approach. The environmental benefit should be demonstrated using quantitative and qualitative performance indicators, such as avoided emissions, and disclosing the key underlying methodology and/or assumptions used in the quantitative determination, including the attribution factors. The green enabling project should be mapped to one or more eligible green project categories as listed in the GBPs.

- **Mitigated adverse social or environmental impacts**: The green enabling project must demonstrate that it is appropriately managing identified environmental and social impacts and risks.

Transparency on end-use

The transparency on end-use requires that the issuer demonstrates how the green enabling project is currently used or how it can lead to a ramp up in developing enabled green projects over time with clear reference to timelines. The issuer may decide to count the green enabling project in full towards a green bond, or to use a pro-rata approach dependent on end-use (either known or estimated). In any case, the chosen approach must be clearly outlined to investors.

Additional Guidance

Section III of the Green Enabling Projects Guidance provides some additional guidance for issuers of green bonds incorporating green enabling projects, as follows:

- Issuers should align with the GBPs and in particular, with section 2 on disclosure of the Process for Project Evaluation and Selection within the context of their environmental sustainability objectives, strategy, policy and/or processes.

- Issuers should consider the indicative, non-exhaustive list of sectors that typically apply to green enabling projects when necessary for an enabled green project's value chain, such as mining and metals, building and construction supplies and equipment, chemicals and specialty chemicals, ICT and telecommunication networks, and manufacturing of industrial parts and components.

- Issuers should avoid double counting of impact when reporting on their green enabling projects and refer to the Guidance Handbook of the Principles for general guidance on this issue.

How do the SLLBs Guidelines and the Green Enabling Projects Guidance contribute to the transition to a net zero economy?

Transitioning to a net-zero economy and achieving the targets set by European Law and the Paris Agreement necessitates economic transformation and significant capital investment. However, investors seeking to finance this transition face challenges, such as the absence of quality, comparable data and reliable labelled products that can inform their investments without extensive sustainability due diligence. Meanwhile, issuers and borrowers, understanding the need to transition to net-zero, struggle to identify mature green assets and projects while they are still in the transition phase.

The Green Enabling Projects Guidance offers a solution, opening a new avenue in transition finance. While 'green enabling' activities have always been eligible for inclusion in sustainable bonds, issuers often hesitated to finance these activities due to the lack of clear criteria and the fear of greenwashing allegations. This guidance supports issuers who may not have explicitly green projects or assets, enabling them to access sustainable finance confidently, knowing they can demonstrate their actions are not greenwashing. It recognizes that even projects not intrinsically green can contribute significantly to the transition towards a net-zero economy.

The guidance also encourages banks to finance in the capital markets, raising funds for lending in the real economy via SLLs. This approach could potentially attract a larger investor pool, enabling cheaper borrowing. It incentivizes borrowers to opt for SLLs, promoting the establishment of sustainability strategies and targets, which, if unmet, can affect borrowing costs. Banks are encouraged to develop harmonized, transparent, and well-defined lending criteria, enhancing market transparency and improving data quality and comparability at both the bank and borrower levels.

This shift in focus from solely green projects to a broader spectrum of activities is crucial in leveraging capital as a catalyst for economic transformation and achieving the goals of the Paris Agreement and the European Climate Law. By broadening the scope of sustainable finance and introducing definitions in transition finance, the guidance incentivizes projects that indirectly contribute to the greening of the economy, a critical step in our collective journey towards sustainability.

The (ICMA) Principles Guidance

- *Green Bond Principles (GBP)*
- *Social Bond Principles (SBP)*
- *Sustainability Bond Guidelines (SBG)*
- *Sustainability-Linked Bond Principles (SLBP)*
- *Climate Transition Finance Handbook*
- *Guidance Handbook and Q&A*
- *Green Enabling Projects Guidance*
- *Guidelines for Sustainability-Linked Loans financing Bonds (SLLB)*

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For further information, please contact our *Knowledge and Innovation Group* lawyers or your regular contact person at Cuatrecasas.