# Investing without remorse

How Green Bonds frame a sustainable future

Investing sustainably sounds easy. But only if you have to choose between a cardboard recycling factory and a coal power plant. With less risky investment strategies, like in government or corporate bonds, it's far more complicated to hit the right trade-off between sustainability and profitability every single time. For your investments to be successful, your ideal investment strategy needs to be based on some rules and standards. The International Capital Market Association (ICMA) developed such a framework, which consists of an array of rules, standards and codes of conduct that is the basis of sustainable investment activities worldwide. The ICMA framework includes principles and guidelines like the GBP, SBP and SBG. What do these acronyms stand for and what is the difference between Green Bonds and Social Bonds? You'd better pay attention, as these guidelines are here to stay.

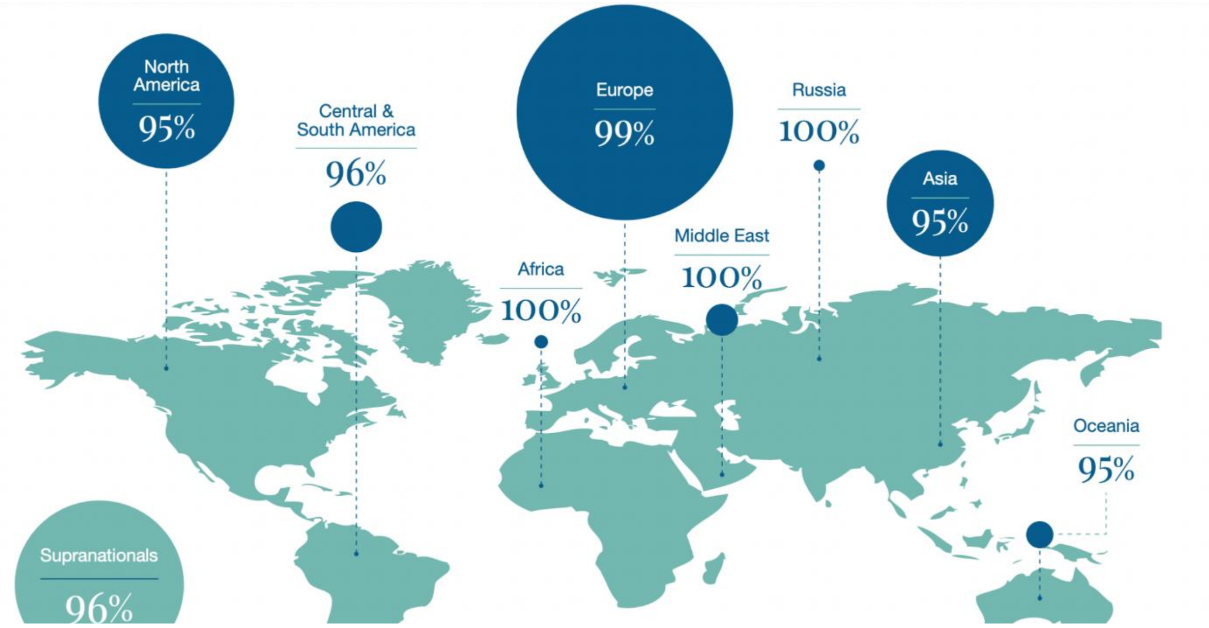


*Figure 1:* Percentage of sustainable bonds by region that were based on GBP, SBP, SBLP (excluding supras) in 2020 (ICMA: https://www.icmagroup.org/assets/documents/Sustainable-finance/GBP-Infographic-040521.pdf)

Since 2007, Green Bonds have been available, whose proceeds are only to fund projects with a positive societal, environmental and climate impact. As they are new to the market there is still some controversy around Green Bonds: They allegedly lack transparency and credibility, and it is still to be determined to which extent green bonds generate revenue for sustainable projects. But despite these issues, they are very popular, with investor demand usually surpassing supply.

To create a universal standard on what investment qualifies as a Green Bond and which doesn't, the ICMA principles provide support in the form of voluntary process guidelines for bond issuers, advising on governance and other areas of investment. They are backed by a global market initiative bringing together all market participants and stakeholders from both private and official sectors. And if you want to invest sustainably there is no way around it, since the framework is the global leader in sustainable bond issuance, as shown in Figure 1.

## The GBP, SBP and SBG principles

The foundation of the ICMA framework is the guiding "Principles": The **Green Bond Principles (GBP)** include projects that operate in the "greening" and creating of sustainable economic activities. While the **Social Bond Principles (SBP)** take care exclusively of social projects, the **Sustainability Bond Guidelines (SBG)** are a combination of the first two, as they are issued for projects that involve both environmental and social projects.

By taking a closer look at four core components that act as a financial guidance instrument, we can see how investments align with these principles:

The Green Bond Principles

The Social Bond Principles

The Sustainability Bond Guidelines

**Use of proceeds**

The first component is the basic **use of proceeds** of the investment. **GBPs** are used with projects typically associated with environmental themes: Renewable and efficient energy, pollution prevention and control, terrestrial and aquatic biodiversity, clean transportation, sustainable water and waste-water management, green buildings, and circular economy. This is set out to benefit issues like climate change mitigation, climate change adaptation, natural resource conservation, biodiversity conservation, pollution prevention and control.

**SBPs** on the other hand, are used with areas of the social sphere like affordable basic infrastructure, access to essential services, affordable housing, employment generation and unemployment alleviation, food security and systems, socioeconomic advancement and empowerment. This should positively impact target groups like people living below the poverty line, marginalized populations, people with disabilities, vulnerable groups, the unemployed and undereducated.

**Process for project evaluation and selection**

To be able to qualify for a bond and to know which kind of bond the activity should be assigned to, issuers should clearly communicate to investors:

> What are the objectives of the environmental sustainability or social impact?
> How do the projects fit within the green or social project categories?
> How does the issuer identify and manage the social and environmental risks of the project?

**Management of proceeds**

How the proceeds are managed should also follow clear and transparent rules: The net proceeds should be traceable and credited to a sub-account or sub-portfolio and can be managed on a per bond or aggregated basis. Proceeds of outstanding bonds are to be periodically adjusted to match allocations to the projects carried out during that period.

**Reporting**

With regards to reporting, **transparency** is of pivotal importance, hence issuers should use the 'Harmonized Framework for Impact Reporting' for guidance. They should provide information on the use of proceeds, important developments, projects financed by the bond, qualitative as well as quantitative performance indicators and disclose the underlying methodology.

**Further Recommendations**

It is recommended for applicants to explain the alignment of their bond with the four components of either GBP, SBP or SBG in a bond framework or in their legal documentation. They should summarize the overarching sustainability and social strategy and make the bond framework or legal documentation readily available and easily accessible. For Green bonds, the '[Climate Transition Finance Handbook]' gives additional guidance.

Applicants are also advised to appoint an external reviewer to assess pre-issuance of the green bonds framework's alignment with four core components. After successful issuance, an external auditor or third-party review can verify internal tracking and allocation of proceeds in addition to issuer's proceeds management. For external reviewers, the '[Guidelines for External Reviews]' can be helpful, as they not only provide guidance on the organization, content and disclosure for their reports, but also on professional and ethical standards.

## Types of bonds and examples

In addition to the three general types of bonds, there are four subtypes of bonds with either Green or Social focus that can be issued with the ICMA framework:

1) The money raised by the **Standard Use of Proceeds Bond** will be spent on funding environmental activities.

Tech giant Apple offers us a real-life example of a **Use of Proceeds Green Bond**: To reduce greenhouse gas emissions across Apple's value chain, where green bond proceeds are intended to support the execution of its 2030 carbon neutrality roadmap. Apple's specialized in-house team leads an annual evaluation and project selection process to identify projects eligible for green bond proceeds, which must meet at least one of these Green Bond criteria: "Low carbon" design and engineering, energy efficiency, renewable energy, carbon mitigation or carbon sequestration.

A prominent example for a **Use of Proceeds Social Bond** is a €300 million bond by the food corporation Danone to increase its positive social impact. By issuing this bond, Danone aims to support its long-term ambition to lead the way in creating and sharing sustainable value. The goal is to attract ESG investors and allocate the proceeds to projects promoting positive social impact on stakeholders in the areas of research and innovation for advanced medical nutrition, social inclusiveness, responsible farming and agriculture, entrepreneurship financing and quality healthcare and parental support.

2) A **Revenue Bond** is a type of municipal bond in which the repayment of the obligation is mainly guaranteed by the operating revenues of an entity. A so-called Net Zero Energy Revenue Bond has been proposed by the local energy supplier BED of Burlington (Vermont, USA) and its mayor. This bond would accelerate the progress toward the city's bold climate goals and aims to save local customers' energy costs. $17.5 million are allocated to support projects that help advance toward the Net Zero Energy goal and $7.8 million are aimed to fund grid upgrades that support reliability and manage new loads from strategic electrification. Further money supports action on renewable energy generation plant maintenance and upgrades, investment in electric vehicle charging and demand response infrastructure and upgrades to technology systems to support new dynamic rates and load control.

3) Instead of borrowing from the bank market to finance large infrastructure-related projects, the funds can come via a **Project Bond**. Goldman Sachs decided to rely on this financial instrument to improve the societal impact of their investments by

only funding renewable energy and other sustainable projects.

4) **Securitization Bonds** can be subdivided in three types of bonds (see AFME and Hogan Lovells papers): The first type requires **Green collateral,** where the ABS is backed by portfolios of green assets (e.g. mortgages to finance energy-efficient homes, electric vehicle loans/leases, solar leases and SME loans to fund environmental projects, etc.), while the second type ‚**Green use of proceeds,** has proceeds of the ABS used for investment in Green Projects. These two are more akin to ordinary green bonds: proceeds & capital are used for green purposes, while the securitized portfolio can be composed of non-green assets. The third **Capital relief / synthetic securitization bond** uses freed-up capital or leverage from a capital relief or synthetic securitization to invest in green projects.

We here at FORRS can accompany you with technical and managerial support for the specification of suitable projects for all the different types of Green and Social Bonds mentioned above. For a successful certification process, you need to get the specifications right. This is why we also support you in the verification process for these bonds.

In the next article we'll take a look at **Sustainability-Linked Bonds**, where the proceeds are primarily aimed at the pursuit of identified KPIs and Sustainability Performance Targets.

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