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An Overview of Green Finance.

Earlier this month, we introduced the concept of socially responsible investing ("SRI"), discussing both its genesis and modern-day appeal to investors and financial institutions. As a reminder, SRI usually falls into two categories: use-based, socially responsible investing and the more forward-thinking "environmental, social and governance" incorporated investing ("ESG"). Use-based, socially responsible investing is easy to visualize—just think of the investor who refuses to invest in a company that supports tobacco production. ESG, on the other hand, considers environmental, community, other societal and corporate governance criteria in investment analysis and underwriting decisions. Put another way, ESG looks beyond lending and investment standards by considering both the impact of environmental and social risk on the financial system, as well as the financial system's impact on environmental and social risks.

There is no doubt that our capital markets are going green. While the majority of ESG activity in this space has been on the equities side, debt markets have seen their share of growth in green and sustainable products. Annual reports and marketing materials published by some of the world's largest banks now include talking points about "green finance" and "green lending." Investors, customers, and communities are focusing their discussions on the availability of "green financing" and "green financial products", to the point where green finance now has its own vernacular. "Green bonds", "green loans", and "sustainability-linked loans", among others, have emerged as viable financing tools offered by lenders to companies focused on both the cost of capital and on social impact. "Greening the financial system" is a popular phrase used by professionals in this space.

While it is easy to throw around monikers and acronyms, generally speaking, there is a lack of understanding of green finance and green financing products. Ask someone to explain the difference between a green loan and a sustainability-linked loan and chances are you will get one of two reactions: a blank stare and corresponding lull in the conversation or a race to see whether Siri or Wikipedia provides the best answer in the shortest amount of time. In any case, the likelihood of you receiving a helpful answer from a reliable source is relatively small.

The purpose of this blog post is to clear up some of the more obvious confusion regarding green finance and green financing products. As an added bonus, we will introduce you to some of the more popular products emerging in this space. Thereafter, more detailed blog posts on these products will follow in the coming months.

Keeping in mind that no "green" dictionary currently exists and people often use terms interchangeably, sometimes with slightly different meanings, let us begin our walk through green lexicon:

"Green finance" refers to the financing (or refinancing) of new and existing public and private investments with sustainability objectives, as well as the related institutional and market arrangements that contribute to the achievement of these goals. Examples of sustainability objectives include renewable energy, conservation, and sustainable agriculture. Green finance can take many different forms, including green bonds and green loans which are discussed below. The terms "green lending" and "sustainable finance" are often synonymous with "green finance."

"Green bonds" (also referred to as "climate bonds") are bonds created to fund projects that have positive environmental and/or climate benefits. The majority of green bonds are "use of proceeds" bonds that earmark the proceeds of the bonds for specific projects that are designed to achieve these benefits, but are financially backed by the bond issuer's entire balance sheet. There are several types of green bonds available, including revenue bonds and securitized bonds.

"Green Bond Principles" refer to a voluntary, high-level framework/methodology of market standards and guidelines promulgated by the International Capital Market Association that address the eligibility criteria for green projects and the monitoring and use of financing proceeds. The Green Bond Principles ("GBP") do not require issuers to consider ESG generally or specify what constitutes a "green" project. Rather, the GBP leave the final determination as to what is "green" up to the market. A future blog post will discuss the main components of the GBP, as well as GLP and SLLP (which are discussed below).

"Green loans" are term loans that can be used to fund a range of environmental and sustainability projects, spanning areas including energy efficiency, waste and water management, green transport, sustainable farming and greenhouse gas emission reduction. Green loans may be structured as bilateral loans or syndicated loans. The hallmark of a green loan is that its proceeds are used solely to finance a pre-approved environmental or sustainability project. "Green project finance loans"(which are discussed below) fall within the ambit of green loans.

"Green Loan Principles" build off and refer to the GBP, but focus on bringing consistency to the green loan market (as opposed to the green bond market). Promulgated by the Loan Market Association and the Asia Pacific Loan Market Association, the Green Loan Principles ("GLP") create a high-level framework of market standards and guidelines intended to provide a consistent methodology for originating, servicing and tracking green loans. The goal of the GLP is to preserve the integrity of the green loan market as it develops, while at the same time, allow the Green Loan product to retain its flexibility.

"Sustainability-linked loans" are loans designed to incentivize companies to meet their ESG targets. Unlike green loans, sustainability-linked loans do not require proceeds to be earmarked for specific purposes. In fact, the typical sustainability-linked loan is structured as a revolver for general working capital purposes. The attractiveness of sustainability-linked loans is their linkage between pricing (i.e., interest rate) and a borrower's ESG performance. These loans are structured to offer a pricing discount (up to 5%) when a borrower meets or outperforms its ESG targets.

"Sustainability-Linked Loan Principles" build on and refer to the GBP and GLP. The first set of Sustainability-Linked Loan Principles ("SLLP") was published earlier this year by the Loan Market Association, Loan Syndicated and Trading Association and the Asia Pacific Loan Market Association. The SLLP share the same goals as the GBP and GLP, but focus on the proliferation of sustainability-linked loans rather than green bonds or green loans. As mentioned above, a blog post regarding the SLLP (as well as the GBP and GLP) is forthcoming.

"Green banks" are banks, at both the community and national level, which specialize in financing sustainable or green projects. These banks have committed to promoting and supporting green initiatives by seeking out green projects and offering financial incentives to borrowers, including PACE loans, credit enhancement, co-investment opportunities and on-bill financing.

"Green asset finance" is a subset of asset financing that supports the financing of a variety of green assets through lease purchase, finance and operating leases. Qualifying green assets cover multiple thematic areas, such as energy efficiency, renewable energy, green transport, waste management and sustainable forestry. Green asset finance is more prevalent in Europe and Asia at this time.

“Green financial products” are financial products offered to consumers and businesses that either provide environmental benefits or reduce negative environmental impacts. Examples include green car loans, energy efficiency mortgages, green credit cards, and eco-savings deposits. Green financial products are provided by a variety of institutional lenders, including banks, credit unions and mortgage loan originators. They are available on a worldwide basis.

As you might imagine, the breadth of “green” vernacular is staggering. It would be fairly easy to put together an entire book on how to speak green as it relates to our financial system. Unfortunately, that would take more time and space than a series of blog post. Hopefully, though, this article has provided a sufficient basis for you to begin speaking green insofar as our debt markets are concerned, while at the same time given you a preview of some of the more popular green loan products that we will be highlighting in future posts. Stay tuned…

In case you missed the previous part of this series:
Part 1: An Introduction to Sustainable Lending

by Stacia Wells

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