

How Sustainable Finance Can Support ESG Goals

Compliance and Ethics

Financial Services



Cheat Sheet

***Evolving*.** The EU Taxonomy Regulation, which helps delineate green economic activities, is one recent development in the ESG space.

Instruments. Sustainability-linked bonds and transition bonds are two innovative finance instruments available to investors.

***Khaki*.** As the economy transitions from “brown” to “green,” it is OK for the ESG needle to only move to ‘khaki” in the short term.

***Ingenuity*.** Ultimately, more flexibility and ingenuity, including in the finance space, is needed to combat climate change.

Environmental, social, governance (ESG) has become a focal point for businesses. First, there has been a rise in public concern for the environment and social equity, which has been reflected in an increasing demand for ethical investments (especially in relation to pension funds), as well as a corresponding move by many financial institutions away from investments in industries that are perceived to be too “brown” in that they have heavy carbon footprints.

Second, financial institutions have come to better understand the risks to investments associated with ESG issues. These may be direct risks, such as climate-related flooding impacting property investments or tightening regulations and reporting obligations. On the other hand, the risks may be indirect, such as changing consumer preferences that affect demand for products or services.

Third, ESG considerations may open opportunities for innovation and the creation of new products, thus giving businesses a competitive advantage and leading to financial outperformance over time, rendering them more attractive to investors.

Sustainability means more than “green”

Sustainable finance generally refers to taking due account of ESG considerations when making investment decisions. Sustainability in this context means much more than reducing the carbon footprint.

There are 17 different Sustainable Development Goals (SDGs) within the United Nations 2030 Agenda, covering areas from climate action to poverty and hunger reduction, gender equality, and education.



The increasing focus on sustainable finance has not been without controversy. Skeptics point to a lack of common criteria for determining and assessing a “sustainable” investment. Others highlight the prevalence of “greenwashing” tactics adopted by both investors and companies to overstate their ESG credentials. These uncertainties have led to calls for broadly applicable policy frameworks that can be used to govern the disclosure, reporting, and assessment of sustainable investments.

ESG regulatory frameworks are evolving

Fortunately, there has been significant convergence among global regulators and multilateral institutions in their efforts to address these shortcomings. One of the most significant recent developments in sustainable finance is the introduction of the EU Taxonomy Regulation which entered into force in July 2020. The regulation creates a classification system for green and sustainable economic activities, known as the “Taxonomy,” which is intended to be used by market participants in the European Union and beyond to navigate the transition to a low-carbon, resilient, and resource-efficient economy.

The Taxonomy defines six key environmental objectives: climate change mitigation, climate change adaptation, the sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control, and the protection and restoration of biodiversity and ecosystems. Under the Taxonomy, in order for an economic activity to be classified as “green,” it must:

- Substantially contribute to one of the six environmental objectives;
- Do no significant harm to the other five objectives;
- Comply with certain governance safeguards like OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights; and
- Comply with science-based performance thresholds (or “technical screening criteria”).

The Taxonomy is structured as a roadmap to change the trajectory of economic activities on an industry-by-industry basis and align those activities with the goals and targets of the Paris Agreement. The Taxonomy is intended to provide greater certainty as to what is “green,” thereby helping to avoid issues of greenwashing.

There are signs of increasing cross-border convergence. During recent talks with US climate envoy John Kerry, French Finance Minister Bruno Le Maire called for Europe and the United States to agree on common rules to determine how “green” a financial investment is. In March 2021, the US Securities and Exchange Commission (SEC) announced the creation of a Climate and ESG Task Force in the Division of Enforcement that is consistent with increasing investor focus and reliance on climate and ESG-related disclosure and investment. The SEC sees climate risks and sustainability as “critical issues for the investing public and US capital markets” — which may indicate movement towards sustainable finance regulation.

In Asia, the heterogeneity of the legal regimes within the region (from developed, emerging, and the least developed economies) magnify the challenges towards achieving a consistent regulatory regime for sustainability-linked investments. This is not to say that governments within Asia are not supportive of promoting sustainable finance, and we have seen various encouraging examples of policies and guidelines being put forward.

For instance, a Green Finance Action Plan was launched by the Monetary Authority of Singapore in 2019 with four key goals: strengthen the financial sector’s resilience to environmental risks; develop green financial sector and solutions for a sustainable economy; harness technology to enable trusted and efficient sustainable finance flows; and build knowledge and capabilities in sustainable finance. On a similar note, China launched a Green Bond Endorsed Project Catalogue in June 2020. The initiative contains People’s Bank of China-led policies promoting sustainable finance, standards for China’s green bond market, and evaluation of banks’ performance in the green finance sector.

In November 2020, the Australian Sustainable Finance Initiative (bringing together leaders spanning Australia’s major banks, superannuation funds, insurance companies, financial sector peak bodies and academia) published a Sustainable Finance Roadmap envisioning the adoption of green taxonomy and calling for financial system participants to embed sustainability into their organisation’s purpose, strategy and leadership.

These developments highlight the mounting need for a coherent regulatory framework for sustainable finance. In the meantime, investors must look towards sustainability reporting standards and frameworks to navigate the growing range of investment opportunities claiming to be tied to ESG-principles. As the frameworks continue to evolve, however, additional questions have arisen around what exactly should fall within the scope of a green investment. Should the “sustainable financing” tag only be available to issuers and instruments that already meet the agreed sustainability criteria? Or is there scope to extend the existing framework to also cover issuers that, while not immediately associated with sustainability, are nonetheless seeking to finance sustainable objectives?

Sustainable finance instruments

The greater the variety of sustainable finance instruments available to investors, the more investors will be able to find attractive investments in the sustainable finance space. Issuers facing the most pressing sustainability challenges may look to green bonds or innovative alternatives in the form of sustainability-linked bonds (SLB) and transition bonds (TB).

Sustainability-linked bonds

The SLB market has seen rapid growth since the publication of the International Capital Market Association's Sustainability-Linked Bond Principles in June 2020. Companies are seeking to take advantage of the availability of significant green liquidity in financial markets to finance their sustainability strategy. They are prepared to link their cost of capital to their sustainability performance. Freed from the constraint of identifying sufficient eligible green expenditures, issuers are using this flexibility to apply proceeds at their discretion in order to best progress their transition. Many recent issuances have come from sectors associated with high carbon emissions, including oil and gas, power generation, and the production of clothing and packaging.

Transition bonds

TBs are the subject of the 2019 AXA Transition Bond Guidelines (TB Guidelines) and the Climate Bond Initiative's 2020 white paper "Financing credible transitions" (White Paper). Both acknowledge that the "transition" label may be particularly appropriate for companies from high-emitting sectors that may be unable to identify sufficient green expenditures, but nevertheless want to transition in a meaningful manner towards sustainability. The TB Guidelines expect a TB to be aligned with an issuer's broader transition strategy, which should be both material to its sustainability profile and set by reference to short- and long-term measurable targets and objectives. The White Paper recommends that the relevant transition strategy should be aligned with the Paris Agreement. The TB market is likely to develop as the focus on transitioning carbon-intensive sectors increases. Given this, various stakeholders' expectations around transitioning activities are likely to coalesce.

Green bonds are well suited to bank issuers but do not prove as useful for non-investment grade companies or those seeking to invest in higher-yielding bonds. Non-investment grade companies are far less likely to be able to issue sufficiently large bonds purely for environmental purposes because these companies are often smaller and more leveraged. One further innovation that could help open the green bond market to more companies is green striping, when an issuer commits to using a stated fraction of the total principal amount of a series of bonds for environmental purposes. This has not been used in practice to date but may be an exciting development for the future.

The transition from "brown" to "dark green"

While proponents of the Taxonomy note that the severity and urgency of climate change do not allow for partial or half measures, critics assert that the standards set by the Taxonomy (which are intended to be incorporated in the new EU Green Bond Standard and set an example framework for other jurisdictions) threaten to exclude large parts of the global economy from the sustainable finance market at exactly the time when economic actors should be encouraged to finance critical steps towards improving sustainability. Facilitating access to sustainable finance even for companies with the heaviest carbon footprint could offer the greatest opportunity to achieve aggregate improvements in sustainability.

One of the authors of this article, Aquila Capital's General Counsel, Asia Pacific Maree Myerscough,

believes in such an open-arms approach towards companies looking to embrace ESG-focused policies to attract investors, even if it only moves their ESG needle towards “khaki” in the short term.

> Committing to “sustainability” and the vast array of factors that it now concerns is an overwhelming task for a company that has traditionally operated outside this space. We must help such companies adopt more sustainable business practices by facilitating their path and providing greater access to investor capital when they do so. It’s a journey similar to the energy transition, whereby renewable energy technologies have increasingly been embraced by fossil-fuel players because it makes business sense to be “green” — such that the pathway towards a zero-carbon future is now in sight.
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> - Maree Myerscough

Arguably, pure green financing may not address all financing needs, and a greater focus is required on facilitating the transition from “brown” to “dark green.” The importance of this transition has received support and acknowledgement from many in the market, including the Climate Bond Initiative and AXA. In a speech in the fall of 2019, Mark Carney, former Governor of the Bank of England, called for flexibility and ingenuity to combat climate change, noting that “we need 50 shades of green.” More recently he reinforced this sentiment, pointing out that it would be deeply damaging if the Taxonomy is too rigid and not workable for the companies engaged in complex transition.

Next steps

Ultimately more effort is needed to educate investors on the substance of the factors beyond the green banners of ESG so they can understand the totality of their investment decisions in sustainability-linked instruments and then have the ability to transparently monitor their performance against the agreed criteria.

For more information on this topic please refer to the additional resources authored by Latham & Watkins:

- ESG in 2021: 10 Things to Look Out For (January 2021)
- Green Bond Impact Reporting Under Securities Law (Bloomberg Law, June 2020)
- Green Bond Second Party Opinions: Legal and Practice Considerations (Bloomberg Law, June 2020)
- Key Risks for Green Bond Issues When Plans Change (Law360, April 2020)
- 50 Shades of Green Finance (PE Views (Latham), December 2019)
- Sustainability-Linked Bonds Complement and Bolster the Sustainable Finance Market (Environmental Finance, November 2018)
- Transition Bonds Guidelines May Expand Sustainable Finance (Latham Client Alert, June 2019)
- First Telco Green Bonds Set path for Connectivity Industry (Latham Client Alert, February 2019)
- Blue Bond, Out of the Blue (IFLR, February 2019)

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