Beyond green: Sustainable finance vs. green loans - part 1

By Natasha Pather

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A holistic approach to ESG-linked funding can unlock additional funding benefits for businesses. Understanding the various elements in the ESG umbrella and the interplay between them, coupled with determining the right funding instrument and type of funding arrangement, appropriate metrics, reporting obligations and intervals is key to this and can require specialist insight from a number of advisors. Businesses should partner with experienced advisors to achieve these objectives.

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ESG-linked financing is a hot topic in the finance arena. What does it mean for you?

To begin, let's define ‘ESG’. ESG is an umbrella term encompassing three broad spheres – environmental aspects, social causes and governance issues. These three spheres are often considered mutually exclusive, but this is frequently not the case, and they can each be much broader than they first appear.

A great practical example of the interlinked nature of ESG is a renewable energy project. There are obvious potential environmental benefits to the construction and operation of a renewable energy project. When you look closer, however, it is easy to see how the implementation of that project can have far-reaching social implications for the immediate local community and broader society – job creation, contributing to relieving the energy crisis, and income generation, to name a few – while the manner of implementation, quantifying and reporting on performance, as well as ensuring compliance with the relevant regulatory regimes falls firmly within the "governance" sphere.

Businesses tend to focus on the environmental aspects, as these are easiest to identify and quantify, but the social and governance aspects can be equally important levers when negotiating your funding arrangements. The interplay between these aspects is key to unlocking value in funding arrangements.

Forms of funding in the South African market

In the South African market, we generally see two types of ESG-linked funding made available to corporate borrowers – sustainable financing and use of proceeds financing (also sometimes known as green loans or social loans). Here are a few high-level risks and benefits of each and when they might be suitable for your business:

Sustainable financing

Sustainable financing is a type of funding that allows borrowers to measure their performance against a set of predetermined key performance indicators (KPIs). Depending on the level of performance achieved against those KPIs, the borrower can obtain a financial benefit, such as a margin reduction or access to additional funding for which that borrower may otherwise not be eligible.

A failure to perform against one or more KPIs can sometimes also result in a margin ratchet, which was not the case in the early days of sustainable financing. Depending on the number of KPIs and level of performance with individual KPIs and as a whole, the margin ratchet or reduction may be structured on a tiered basis.

Naturally, this arrangement requires detailed and accurate information to be delivered timeously to, and verified by the funders. Suitable KPIs are usually determined with reference to the nature and extent of the business of the borrower or its group, its operational requirements and what is achievable and sustainable, without compromising on the business's product.

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Limitations

This type of funding typically takes the form of a loan instrument, rather than a bond, commercial paper or other securities, as the number of funders is generally limited (and thus the borrower is more easily able to manage these information requirements with a smaller pool of funders). Depending on the nature of the business of the borrower, its creditworthiness and various other factors, other financial institutions may also not be able to participate in the instrument, which would limit uptake in the broader market.

Sustainable financing is typically a better fit for larger corporates who already have their own corporate social responsibility programmes geared towards one or more ESG objectives and have the relevant information and verification systems and relationships in place, as well as the requisite financial resources to implement these.

Targets

Funders may be willing to accept pre-existing KPIs determined by the borrower where it can be shown that adequate consideration and objective assessment has gone into determining these KPIs; however, they may wish to set their own KPI targets or verify that the proposed targets are sufficiently ambitious.

In the UK and European markets, there appears to be an emerging trend of requiring more aggressive KPI targets, both upfront and year-on-year, to avoid allegations of greenwashing. The basis for these allegations within the funding space specifically seems to be that the funders' intervention has not caused the "good behaviour" for which both these corporates and funders are being rewarded through financial incentives.

We may see a similar trend for more aggressive KPI targets in future in the South African market and perhaps more punitive margin ratchets and structuring.

The benefits of a sustainable financing arrangement are that a borrower can:

- save on its interest costs (and often in circumstances where it is already complying or aligning with its own internal objectives); and
- potentially access additional funding that it may otherwise not be eligible to access.

The risks are that:

- failure to comply could result in an increased interest cost; and
- if the KPI targets are not set at appropriate levels, one could potentially face allegations of greenwashing.

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Use of proceeds financing

Use of proceeds financing focuses on the purpose against which the proceeds are applied. This funding arrangement can be either a loan (or similar instrument) or a security, such as bonds, notes or other commercial paper. Listed bonds and notes tend to largely be limited to the use of proceeds financing due to many of the factors mentioned above.

This type of funding is appropriate where it is possible to link the purpose to which the funding will be applied to an ESG-linked cause. This purpose could take various forms, such as a once-off expenditure such as the installation of a solar-powered system, a multi-stage project, such as the construction of a greenfields development; or a brownfields expansion, or even a longer-term, ongoing initiative such as a housing or education development programme.

We initially saw a number of "green bonds" or "green loans" (also known as sustainability-linked funding instruments) where the proceeds were used to fund an environmentally friendly or climate-based initiative. There has been a recent rise in the number of social funding instruments (targeting, for example, housing or employment initiatives), "blue" funding instruments (targeting ocean-based initiatives) and sustainability funding instruments (which combine characteristics of green and social instruments).

Benefits and risks

A benefit of this type of funding is that it can be more accessible for a broader range of borrowers or issuers, ranging from governments, project companies and big corporates to smaller enterprises looking to fund an ESG-linked purpose. There are even products available now to individuals who are looking to fund alternative energy sources for their homes. In addition, access to the listed and unlisted bond market may provide additional funding opportunities for a range of borrowers.

It is a key requirement for the borrower or issuer to disclose how the proceeds are applied for this type of funding. This may include a report on initial expenditure and subsequent reporting on the actual and anticipated impact of the funded initiative.

There are similar risks and benefits for this type of funding – namely, a potential margin ratchet for non-compliance, on the one hand, and a margin reduction and/or access to additional funding on the other. Greenwashing also remains a risk if, for example, the purpose to which the loan proceeds are applied does not actually benefit, or even indirectly support an initiative that actively harms the relevant cause.

Additional bond market considerations may also apply if the funding instrument is a debt security. These include, on the one hand, access to a different, potentially broader pool of funders (each with their own internal investment criteria) and the ability to determine the pricing of the instruments up front. On the other hand, the listed bond space is also subject to additional regulatory requirements, which may impose further reporting obligations and pose other regulatory pitfalls.

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