

Types of financing

SUSTAINABLE FINANCE

Sustainable finance has become very important in last few years and is considered one of the most important tools to tackle climate change. Various types of sustainable finance includes green bonds, social bonds, sustainability linked bonds and sustainability linked loans.



Main Types of Sustainable Debt Financing

Green Bonds

To qualify as a “green bond” the proceeds must be used to fund projects with positive environmental outcomes. Examples include climate bonds, blue bonds, clean transportation, and waste water management.

Social Bonds

To qualify as a “social bond”, proceeds must be used to achieve positive social and economic outcomes for an identified target population. Examples include social bonds to fund affordable housing, food security, and access to essential services. These bonds may also be aligned with the UN Sustainable Development Goals (SDG).

Green and Social Loans

Loans are similar to bonds, but differ in how the funding is raised. With bonds, funds come from the investor market, while funds for loans come from a bank. Like bonds, loans can be classified under the green, social or sustainability label.

Green loans: The funds are committed to environmental or climate projects, such as green retrofits for office buildings.

Social loans: The funds are committed to social impact projects, such as training people with disabilities to improve employability.

Sustainability loans: The funds are committed to a mix of green and social impact projects.

A consortium of international financial associations developed the **Green Loan Principles** and the **Social Loan Principles**, which provide a consistent methodology for use across the green and social loan markets.

Sustainability-linked Bonds

Sustainability-linked bonds provide funds for a particular project or initiative that is committed to advancing sustainability and the coupon is tied to the corporation's achievement of pre-defined sustainability-focused KPIs. These projects may also be aligned with the UN Sustainable Development Goals (SDG).

Sustainability-linked Loans

Sustainability-linked loans provide funds for corporate level work (instead of project level) with interest rates that are linked to the borrower's ability to hit defined performance targets.

Features of Sustainability-Linked Loans and Sustainability-Linked Bonds

A key component of sustainability-linked loan (SLL) and sustainability-linked bond (SLB) agreements is the linking of the finance terms to the achievement of predetermined sustainability performance targets. The targets should be both ambitious and relevant to the issuer or borrower's operations and sustainability strategy.

The targets, and the key performance indicators on which they are based, should also be benchmarked either internally to the company's past performance and/or externally to science-based targets or other independent assessments such as an ESG score.

Unlike labeled bonds or loans, the proceeds from an SLL or an SLB can be used for general corporate purposes. The flexibility of the sustainability-linked structure enables companies from industries not traditionally considered green (or those without a portfolio of eligible green or social assets or projects) to access the sustainable finance market and a more diverse pool of investors.

SLL and SLB Structure

For SLLs, the interest rate of the loan may increase if the borrower fails to achieve the agreed-upon sustainability performance target, and vice versa. Revolving credit facilities can also be included in this category because while the funds are only drawn when needed, the same agreement – interest rate paid is based on achieving sustainability target – can be made.

In an SLB agreement, the bond's coupon rate will increase, or the issuer may pay a penalty when the bond matures, if it fails to achieve the sustainability or ESG objectives.

Forward-looking issuers are also linking the terms of their use of proceed green, social, or sustainability bonds to the achievement of sustainability performance targets. This combination “sustainability-linked labeled bond” has added credibility and appeals to both issuers and investors. The issuer demonstrates its commitments to sustainability by tying the coupon rate to sustainability targets, and the investor can be assured that the funds raised will be allocated to projects with a positive benefit, while also incentivizing corporate sustainability improvements within the issuer organization.

The International Capital Market Association (ICMA) has issued the Sustainability-Linked Bond Principles and the Sustainability-Linked Loan Principles which provide guidelines and recommendations around structuring features, disclosure and reporting.