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ESG Series – International Capital Market Association: Principles on Sustainable Finance Instruments

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Green, social and sustainability-linked bonds listed on the Hong Kong Stock Exchange adopt principles formulated by the International Capital Market Association (ICMA). This article introduces the core elements in those principles.

Green and social bonds are commonly known as bonds for funding green and social projects. As a contrast, a sustainability-linked bond provides general-purpose finance (i.e. not for specific projects) to the issuer but the issuers commits to achieve certain environmental, social and/or governance (ESG) targets and its financing cost will increase if such targets cannot be achieved.

ICMA[1]

ICMA is a not-for-profit association (Verein) under the Swiss Civil Code. Its mission is to promote resilient well-functioning international and globally coherent cross-border debt securities markets.

ICMA currently has around 600 members engaging in international debt capital markets. The wide variety of members include banks, securities dealers and brokers, asset and fund managers, insurance companies, central banks, stock exchanges, clearing houses, trading facilities and systems, credit rating agencies and professional firms. Members come from 64 jurisdictions globally, including Mainland China and Hong Kong.

In pursuit of its objectives, ICMA and its members work together to promote the development of international capital and securities markets by pioneering rules, principles and recommendations. One of its priorities is sustainable finance.

ICMA guidance

The Green Bond Principles, the Social Bond Principles, the Sustainability Bond Guidelines

[1] https://www.icmagroup.org/About-ICMA/

and the Sustainability-Linked Bond Principles are a collection of voluntary frameworks and outline best practices when issuing bonds serving green, social and/or environmental purposes. They emphasize transparency, accuracy and integrity of the information to be disclosed and reported by issuers to stakeholders (which should not be limited to the investors, but also include governmental bodies, issuers' employees, business partners and customers, as well as the public).

Green Bond Principles[2]

Green bond is defined as any type of bond instrument where the proceeds or an equivalent amount will be exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible green projects and which are aligned with the four core components of the Green Bond Principles which are:

1. Use of proceeds

   All designated eligible green projects should provide clear environmental benefits, which will be assessed and, where feasible, quantified by the issuer.

   The Green Bond Principles explicitly recognise the following broad categories of eligibility projects which are the most commonly used types of projects supported, or expected to be supported, by the green bond market:

   - Renewable energy, e.g. production, transmission, appliances and products
   - Energy efficiency, e.g. new and refurbished buildings, energy storage, district heating, smart grids, appliances and products
   - Pollution prevention and control, e.g. reduction of air emissions, greenhouse gas control, soil remediation, waste prevention, waste reduction, waste recycling and energy/emission-efficient waste to energy
   - Environmentally sustainable management of living natural resources and land use, e.g. environmentally sustainable agriculture; environmentally sustainable animal husbandry; climate smart farm inputs such as biological crop protection or drip-irrigation; environmentally sustainable fishery and aquaculture; environmentally sustainable forestry, including afforestation or reforestation, and preservation or restoration of natural landscapes
   - Terrestrial and aquatic biodiversity conservation, e.g. protection of coastal, marine and watershed environments
   - Clean transportation, e.g. electric, hybrid, public, rail, non-motorised, multi-modal transportation, infrastructure for clean energy vehicles and reduction of harmful emissions
   - Sustainable water and wastewater management, e.g. sustainable

[2] https://www.icmagroup.org/assets/documents/Sustainable-finance/2021-updates/Green-Bond-Principles-June-2021-140621.pdf

infrastructure for clean and/or drinking water, wastewater treatment, sustainable urban drainage systems and river training and other forms of flooding mitigation

- Climate change adaptation, e.g. efforts to make infrastructure more resilient to impacts of climate change, as well as information support systems, such as climate observation and early warning systems
- Circular economy adapted products, production technologies and processes, e.g. the design and introduction of reusable, recyclable and refurbished materials, components and products; circular tools and services; and/or certified eco-efficient products
- Green buildings that meet regional, national or internationally recognised standards or certifications for environmental performance

The term "projects" includes assets, investments and related or supporting expenditures such as research and development.

2. Process for project evaluation and selection

The issuer should communicate clearly to investors (a) the environmental sustainability objectives of the eligible green projects, (b) its process in determining how the projects fit within eligible categories, and (c) complementary information on processes by which the issuer identifies and manages perceived social and environmental risks associated with the relevant projects.

3. Management of proceeds

The net proceeds of the green bond should be credited to a sub-account, moved to a sub-portfolio or otherwise tracked by the issuer, and attested to in a formal internal process.

The tracked net proceeds should be applied to eligible green projects. The issuer should disclose to investors the intended types of temporary placement for the balance of unallocated net proceeds.

The Principles recommend that the use of an external auditor, or other third party, to verify the internal tracking method and the allocation of funds from the proceeds.

4. Reporting

Issuers should make, and keep, readily available up to date information on the use of proceeds to be renewed annually until full allocation, and on a timely basis in case of material developments. The annual report should include a list of the projects to which proceeds have been allocated, as well as a brief description of the projects, the amounts allocated, and their expected impact.

The Green Bond Principles recommend the use of qualitative performance indicators and, where feasible, quantitative performance measures and disclosure of the key underlying methodology and/or assumptions used in the quantitative determination. Issuers should refer to and adopt, where possible, the guidance and impact reporting templates provided in the "Handbook on Harmonised Framework for Impact Reporting"[3] developed by ICMA.

Issuer should explain the alignment of its green bond or green bond programme with the four core components of the Green Bond Principles in a "green bond framework" or in the bond legal documentation that is readily accessible to investors.

Social Bond Principles[4]

Social Bond is defined as any type of bond instrument where the proceeds, or an equivalent amount, will be exclusively applied to finance or re-finance in part or in full new and/or existing eligible social projects and which are aligned with the four core components of the Social Bond Principles, such components being:

1. Use of proceeds

   All designated eligible social projects should provide clear social benefits, which will be assessed and, where feasible, quantified by the issuer. They should directly aim to address or mitigate a specific social issue and/or seek to achieve positive social outcomes especially but not exclusively for a target population. A social issue is an issue that threatens, hinders, or damages the well-being of society or a specific target population.

The Social Bond Principles give the following illustrative examples of social project categories which are the most common projects supported, or expected to be supported, by the social bond market:

- Affordable basic infrastructure, e.g. clean drinking water, sewers, sanitation, transport, energy

- Access to essential services, e.g. health, education and vocational training, healthcare, financing and financial services

- Affordable housing

- Employment generation, and programs designed to prevent and/or alleviate unemployment stemming from socioeconomic crises, including through the potential effect of Small and medium-sized enterprises financing and microfinance

- Food security and sustainable food systems, e.g. physical, social, and economic access to safe, nutritious, and sufficient food that meets dietary needs and requirements; resilient agricultural practices; reduction of food loss and waste; and improved productivity of small-scale producers

- Socioeconomic advancement and empowerment, e.g. equitable access to and control over assets, services, resources, and opportunities;

[3] https://www.icmagroup.org/assets/documents/Sustainable-finance/2021-updates/Handbook-Harmonised-Framework-for-Impact-Reporting-June-2021-100621.pdf

[4] https://www.icmagroup.org/assets/documents/Sustainable-finance/2021-updates/Social-Bond-Principles-June-2021-140621.pdf

equitable participation and integration into the market and society, including reduction of income inequality

Examples of target populations include:

- Living below the poverty line
- Excluded and / or marginalised populations and / or communities
- People with disabilities
- Migrants and/or displaced persons
- Undereducated
- Underserved, owing to a lack of quality access to essential goods and services
- Unemployed
- Women and/or sexual and gender minorities
- Aging populations and vulnerable youth
- Other vulnerable groups, including as a result of natural disasters

2. Process for project evaluation and selection
3. Management of proceeds
4. Reporting

   The guidance and recommendations in the Green Bond Principles apply to these three components of the Social Bond Principles.

Issuer should explain the alignment of its social bond or social bond programme with the four core components of the Social Bond Principles in a "social bond framework" or in the bond legal documentation that is readily accessible to investors.

Sustainability Bond Guidelines[5]

Sustainability Bonds are any type of bond instrument where the proceeds or an equivalent amount will be exclusively applied to finance or re-finance a combination of both green and social projects. Sustainability bonds are aligned with the four core components of both the Green Bond Principles and the Social Bond Principles.

Certain social projects may also have environmental co-benefits, and certain green projects may have social co-benefits. The classification of a use of proceeds bond as a green bond, social bond, or sustainability bond should be determined by the issuer based on its primary objectives for the underlying projects.

Sustainability-Linked Bond Principles[6]

Sustainability-linked bonds are any type of bond instrument for which the financial and/or structural characteristics can vary depending on whether the issuer achieves predefined sustainability or ESG objectives. In that sense, issuers are thereby committing

[5] https://www.icmagroup.org/assets/documents/Sustainable-finance/2021-updates/Sustainability-Bond-Guidelines-June-2021-140621.pdf

[6] https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/June-2020/Sustainability-Linked-Bond-Principles-June-2020-171120.pdf

explicitly (including in the bond documentation) to future improvements in sustainability outcome within a predefined timeline. A sustainability-linked bond is a forward-looking performance-based instrument.

The Sustainability-Linked Bond Principles recommend a clear process and transparent commitments for issuers, which investors, banks, underwriters, placement agents and others may use to understand the financial and/or structural characteristics of a sustainability-linked bond. The Principles have five core components:

1. Selection of key performance indicators (KPIs)

   The issuer's sustainability performance is measured using sustainability KPIs that can be external or internal. The KPIs should be:

   - material to the issuer's core sustainability and business strategy and address relevant ESG challenges of the industry sector
   - under management's control
   - relevant, core and material to the issuer's overall business, and of high strategic significance to the issuer's current and/or future operations
   - measurable or quantifiable on a consistent methodological basis
   - externally verifiable
   - able to be benchmarked, i.e. as much as possible using an external reference or definitions to facilitate the assessment of the SPT's level of ambition

   Issuers should publicly communicate:

   - their rationale for the selection of their KPIs (i.e. relevance, materiality)
   - a clear definition of each KPI and the applicable scope or perimeter, e.g. percentage of the issuer's total emissions to which the target is applicable
   - calculation methodology, e.g. definition of the denominator of intensity-based KPI, definition of a baseline, where feasible, science-based or benchmarked against an industry standard
   - motivation for the SPTs (i.e. ambition level, consistency with overall strategic planning and benchmarking approach)
   - trigger events leading to a change/variation of bond financial and/or structural characteristics
   - nature of such a change/variation

2. Calibration of sustainability performance targets (SPTs)

   A sustainability-linked bond is the issuer's expression of its ambition level with respect of the KPI. SPTs must be set in good faith and should represent a material improvement in the respective KPIs, i.e. should be beyond a "business as usual" trajectory. Where possible, they can be compared to a benchmark or an external reference. They should be consistent with the issuers' overall strategic sustainability / ESG strategy, and be determined on a predefined timeline, set before (or concurrently with) the issuance of the bond.

The target setting exercise should be based on a combination of the following benchmarking approaches:

- the issuer's own performance over time for which a minimum of 3 years, where feasible, of measurement track record on the selected KPI(s) is recommended and, when possible, forward-looking guidance on the KPI
- the issuers' peers, i.e. the SPT's relative positioning versus its peers' where available (average performance, best-in-class performance) and comparable, or versus current industry or sector standards
- reference to the science, i.e., systematic reference to science-based scenarios, or absolute levels (e.g. carbon budgets), or to official country/regional/international targets (Paris Agreement on Climate Change and net zero goals, Sustainable Development Goals, etc.) or to recognised best-available-technologies or other proxies to determine relevant targets across environmental and social themes

3. Bond characteristics

The cornerstone of a sustainability-linked bond is that the bond's financial and/or structural characteristics can vary depending on whether the selected KPIs reach the predefined SPTs, i.e. the bond will need to include a financial and/or structural impact involving trigger event(s).

The potential variation of the coupon is the most common example, but it is also possible to consider the variation of other financial and/or structural characteristics of the bond. The variation should be commensurate and meaningful relative to the issuer ' s original bond financial characteristics.

Any fallback mechanisms in case the SPTs cannot be calculated or observed in a satisfactory manner should be explained. Issuers may also consider including disclosure in the bond documentation potential exceptional events (e.g. as significant change in perimeters through material merger/acquisition activities) or extreme events, including drastic changes in the regulatory environment that could substantially impact the calculation of the KPI, the restatement of the SPT, and/or pro-forma adjustments of baselines or KPI scope.

4. Reporting

Issuers should publish, and keep readily available and easily accessible:

- up-to-date information on the performance of the selected KPI(s), including baselines where relevant
- verification assurance report relative to the SPT outlining the performance against the SPTs and the related impact, and timing of such impact, on the bond's financial and/or structural characteristics

- any information enabling investors to monitor the level of ambition of the SPTs, e.g. any update in the sustainability strategy or on the related KPI/ESG governance, any information relevant to the analysis of the KPIs and SPTs

This reporting should be published regularly, at least annually, and in any case for any date/period relevant for assessing the SPT performance leading to a potential adjustment of the SLB's financial and/or structural characteristics.

5. Verification

Issuers should seek independent and external verification (e.g. limited or reasonable assurance) of their performance level against each SPT for each KPI by a qualified external reviewer with relevant expertise, e.g. an auditor or an environmental consultant, at least once a year, and in any case for any date/period relevant for assessing the SPT performance leading to a potential adjustment of the SLB financial and/or structural characteristics, until after the last SPT trigger event of the bond has been reached.

The verification of the performance against the SPTs should be made publicly available.

As opposed to the pre-issuance external review which is recommended, post issuance verification is a necessary element of The Sustainability-Linked Bond Principles.

Market development

In structuring sustainability and ESG related bonds, the market practitioners should keep themselves abreast of the development in international guidance and standards, technological advancements, regulatory environment changes and, last but not least, the public expectations.

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