Sustainable finance for a world in transition

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Foreword

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Hard-to-abate sectors account for a significant portion of greenhouse gas emissions and transition finance is playing an increasingly critical role for heavy emitters as they strive to participate in the global effort to bring on decarbonisation.

For many businesses across the world, emissions reduction poses significant challenges and this is where transition finance kicks in.

Transition bonds, sustainability-linked bonds and sustainability-linked loans are the instruments used by the global sustainable finance community to drive down emissions and hold companies to account.

Each provides a different means of working towards net zero targets and the goals of the Paris Agreement – and with now greatly improved clarity around green credentials, the number of issuers is growing, along with investor enthusiasm.

In this second report in our series with Bloomberg that looks across the globe at the truly dynamic area of sustainable finance, we consider the recent developments in transition finance and how the market is maturing.

It's a topic of particularly strong relevance for many Australian businesses for whom transition finance may be the vital enabler of their net zero by 2050 goals or aspirations. At Westpac, it's a pressing line of enquiry from our customers and we welcome the opportunity to help them discover what's possible.

Our thanks to Nicholas Pfaff, Senior Director, Market Practice and Regulatory Policy International Capital Market Association, Yo Takatsuki, Head of Investment Stewardship, EMEA, at J.P. Morgan Asset Management, and Marayka Flaherty, Senior Credit & ESG Manager at QIC, for their insights and foresight on the evolution of transition finance.

Sustainable finance for a world in transition

While the need to decarbonise the global economy is clear, the low carbon transition will not happen overnight. It is a complex process that will play out in phases. Yet, traditional forms of sustainable finance often don't cover the interim steps. To facilitate their transition to cleaner technologies, carbon-intensive companies are tapping a new source of funding: transition finance.

Born from the need to engage heavy emitters on climate goals, transition finance brings funding to activities that help companies progress toward decarbonisation. Structures including transition bonds, sustainability-linked bonds (SLBs) and sustainability-linked loans (SLLs) promise to fill a crucial funding gap for hard-to-abate industries.

"Transition finance brings it back to what we really need to achieve in the next 20 to 30 years," says Nicholas Pfaff, Senior Director, Market Practice and Regulatory Policy International Capital Market Association (ICMA). "Sustainability is a much broader and more complex agenda. Transition is a narrower set of vital objectives. The goal is to create a pathway for the hard-to-abate sectors to access finance from the sustainable finance community in a manner that is transparent, credible, and honest."

The steel, chemicals, and cement industries, for instance, account for nearly 20 per cent of global carbon emissions. Decarbonising these industries is difficult with many promising technologies still in early stages of development. With global demand for raw materials on course for rapid growth, intermediary technologies such as carbon capture will play an indispensable role in cleaning up carbon-intensive production processes. Transition finance will help fund those interim steps.

"The concept of climate transition is so powerful because it really tackles the heart of the largest industrialised nations," says Yo Takatsuki, Head of Investment Stewardship, EMEA, at J.P. Morgan Asset Management and co-chair of the Climate Transition Finance Working Group of the ICMA Green and Social Bond Principles. "If you look at the challenges faced by countries including the U.S., Canada, Japan, China and Australia, the concept of climate transition could not be more relevant. In some cases, the concept of 'green' is still far away."

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Bomen Solar Farm near Wagga Wagga, NSW

Varieties of sustainability-themed debt

Behaviour based

Issuers use the funds to achieve sustainable targets such as reductions in emissions intensity, eliminating waste from operations, improving workforce diversity, and labour safety.

Activity based

Issuers use the funds on sustainable projects such as a wind farm, an energy efficiency retrofit, or emissions reductions, or social projects such as pandemic healthcare and relief efforts.

Sustainability-linked bond

- General purpose debt; issuer commits to green and/or social targets

Sustainability-linked loan

- General purpose debt; issuer commits to green and/or social targets

Transition bond

- Proceeds used to fund projects that support the issuer's decarbonisation or transition strategy

Green bond

- 100% of proceeds used for eligible environmental activities

Green loan

- 100% of proceeds used for eligible environmental activities

Sustainability bond

- 100% of proceeds used for activities with environmental and social co-benefits

Sustainability loan

- 100% of proceeds used for activities with environmental and social co-benefits

Social bond

- 100% of proceeds used for eligible social activities

Social loan

- 100% of proceeds used for eligible social activities

Different shades of green

Transition bonds are a young and relatively niche asset class that aims to tackle those challenges. Despite the huge addressable market, investors often question the "greenness" of projects that seek funding under the transition banner. Without a clear framework for defining transition activities or projects, it is hard to discern exactly how green a project is.

The ICMA's Climate Transition Finance Handbook brings a different perspective by identifying transition as an overarching objective to be financed rather than defining a new product such as a transition bond. Published in December 2020, the handbook clarifies the issuer-level disclosures which are recommended to credibly position the issuance of Green, Sustainability or Sustainability-Linked bonds to finance the transition, particularly of 'hard-to-abate' sectors. This helps issuers that find it difficult to build credibility around sustainability.

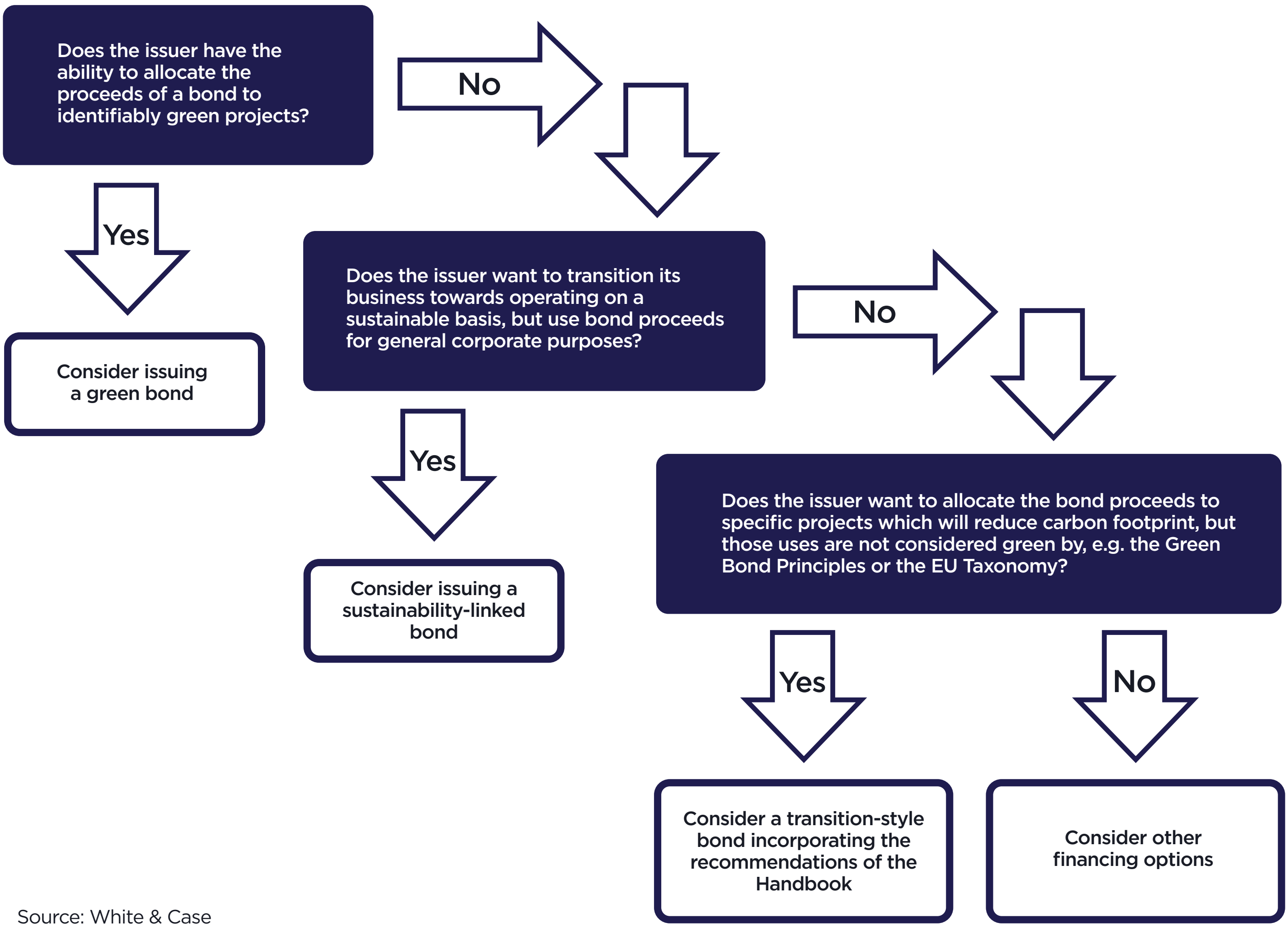
"The handbook provides a framework for disclosure at the issuer level and the development of a transition strategy," Pfaff says. "If you look at the four pillars, the handbook tells you what should be in your transition strategy. And overarching all of this is the idea that everything has to have a clear path to net zero and the goals of the Paris Agreement."

Disclosure recommendations revolve around four pillars: issuers should disclose how their debt instrument serves to help transform their business model in a way that addresses climate-related risks; they should provide details on their planned climate transition trajectory; they should identify the science-based targets and transition pathways at the heart of their transition strategy; and they should be transparent about the capital and operational expenditures that the debt instrument will be financing.

"We find that it takes a good three to six months for our guidance to work its way through the market and the preparation for transactions," Pfaff adds. "Right now, the market is looking at our guidance and figuring out how they are going to implement it. It is not straightforward, because this time, what we are saying is that it is not just a question of providing lots of information as to what your transaction is going to do. You have to tell the market how your entire company or group is moving towards net-zero in a credible science-based target-driven manner."

While the Climate Transition Finance Handbook does not define transition bonds, issuers will likely use it to back the labelling of their bonds.

Climate finance decision tree



Source: White & Case

In January, Bank of China issued the first benchmark bond to be marketed in alignment with the handbook. Alignment was confirmed through an audit verification conducted by Ernst & Young. While market participants questioned the "transition" status of the bond, the bond was highly oversubscribed.

Discrepancies between the 'greenness' of an asset and that of the issuer's profile also have the potential to make or break a deal: "We look at the issuer's profile before we look at the structure of a deal," says Marayka Ward, Senior Credit & ESG Manager at QIC. "Our credit analysts are thinking about whether the deal is consistent with the company's public statements, the actions they are seeing, their CAPEX plans and more. They want to understand whether this sort of financing makes sense for the company, and whether the targets they are setting make sense for the industry in which the company operates."

Thus far, at least 18 transition bonds have been issued globally. Whether transition bonds will become as widely used as other transition-themed instruments remains to be seen.

"With new ideas, you really need the market to start proposing potential solutions," Takatsuki adds. "This is one of those discussions where we started to create the outline so that issuers can start filling it with real-life examples and investors and other stakeholders can start having a view to say what works and what needs to be adjusted. When the market is growing rapidly and new ideas are being adopted, we have to strike the balance between it being open for innovation, but at the same time not being too prescriptive with backward looking ideas."

The rise of SLBs and SLLs

SLBs are another new instrument that are suited to financing a transition strategy. Much like SLLs, these behaviour-based instruments are tied to the issuer's sustainability goals. Both can be used to incentivise issuers to take measurable steps towards lower emissions solutions.

SLBs, for instance, carry at least one institutional target that the company tries to reach. Missing it results in a penalty. A step-up in the coupon rate is the simplest and most common penalty, though it is not the only approach. Other options include purchasing a carbon offset.

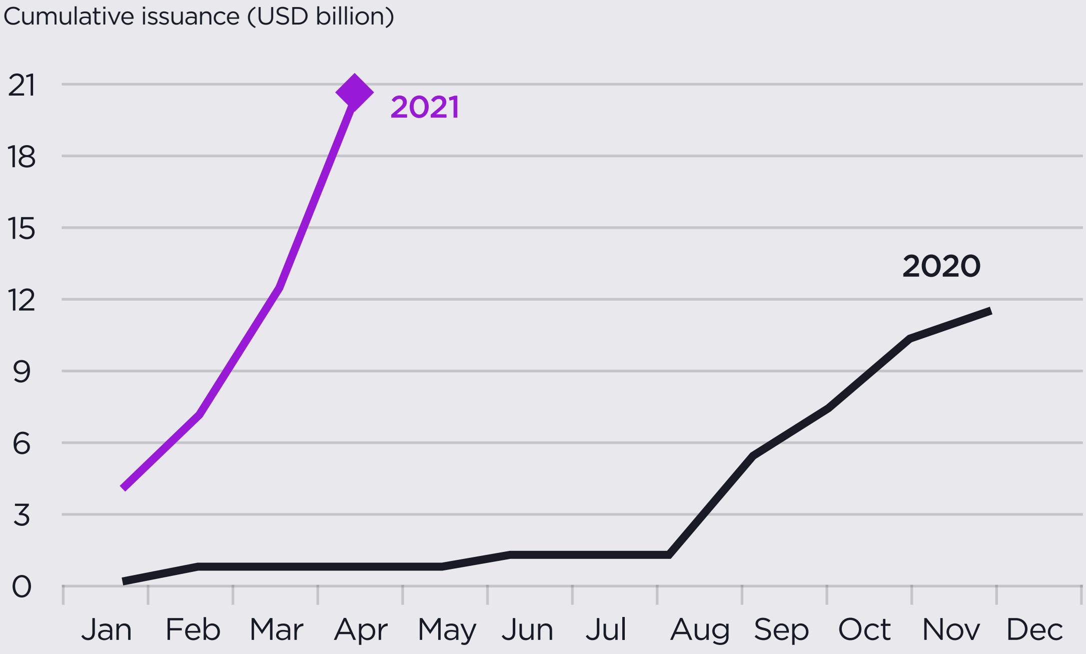
"When we think about SLBs, we really want the KPIs to be meaningful," Ward adds. "We also want them to be measurable using some sort of independent criteria, and we want them to be impactful. We also feel that there should not be too many KPIs for the company to focus on, otherwise they start to lose a bit of their meaning. And when it comes to reporting, if an issuer is not releasing an impact report, then we probably would not consider the deal."

Unlike green bonds, which can only be used to fund projects with a direct environmental impact, issuers can use SLBs to finance general corporate purposes. Issuers do not have to invest in green projects or activities. Instead, they must achieve measurable improvements in environmental, social or governance outcomes in their business over a predetermined amount of time.

Australian company Wesfarmers, for instance, issued in June this year a A$650m and A$350m SLB with 7 and 10 year maturities. The company will need to increase the use of renewable energy in the Group's retail divisions and reduce the CO2e emissions intensity of ammonium nitrate production in the Wesfarmers Chemicals, Energy and Fertilisers division.

"There are two-way coupon adjustments in the loan market, but we have not seen that in the bond market yet," Ward says. "There are a couple of reasons for that. A lot of investors have fiduciary responsibilities, whereas the loan market tends to be dominated by banks that are investing their own money. And the bond market is not yet prepared to contractually reward issuers for achieving targets."

Sustainability-linked bonds



Source: BloombergNEF

Offerings and uptake were limited when SLBs hit the market in 2019. They began to gain momentum after the ICMA published its Sustainability-Linked Bond Principles in June 2020. This provided guidelines that recommend structuring features, disclosure and reporting. The goal was to drive the provision of information needed to increase capital allocation to such financial products. Issuance reached USD11 billion by year-end, and momentum continued to pick up in 2021, with issuance close to USD21 billion by May.

Of particular note is the diversity of companies that have issued SLBs and the different ways they are using them. Swiss drug-maker Novartis, for instance, benchmarked a EUR1.85 billion SLB against increasing access to medicine in developing nations. French clothing and apparel retailer Chanel benchmarked a EUR600 million dual tranche SLB against reducing its Scope 1 and 2 Greenhouse Gas Emissions 50 per cent, and reducing Scope 3 emissions 10 per cent by 2030. Brazilian pulp producer Klabin benchmarked its USD500-million SLB against its ability to reduce water consumption by 16.7 per cent, increase the reuse/recycling of solid waste to 97.5 per cent, and reintroduce at least two species of native animals into the local ecosystem.

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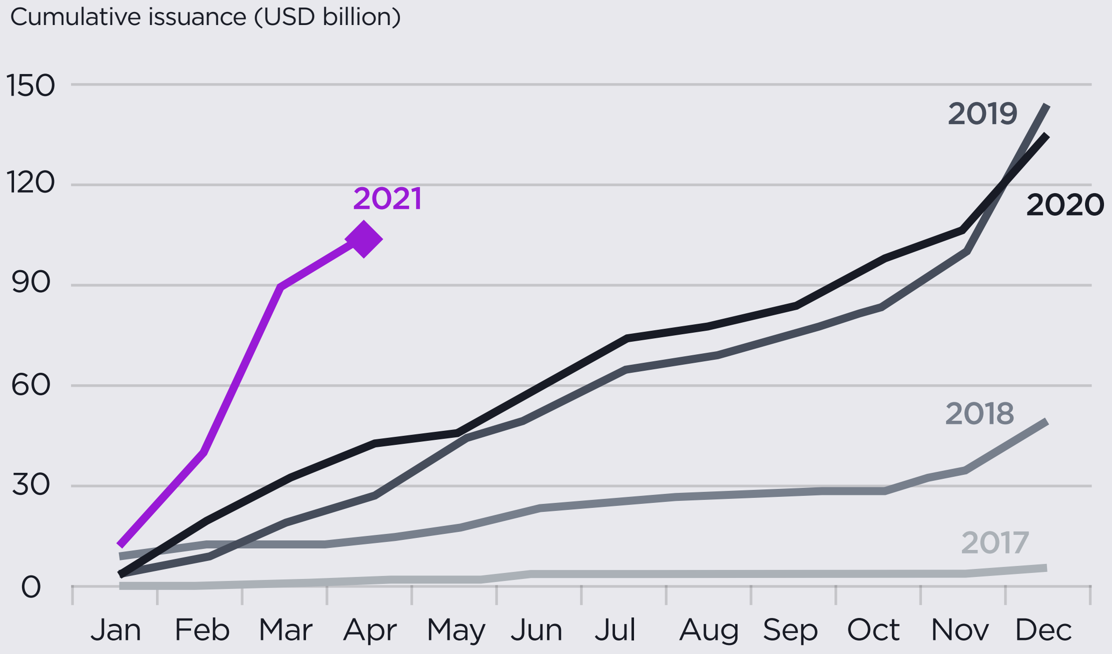
Sustainability-linked loans



Source: BloombergNEF

While the sharp rise in issuance put SLBs in the spotlight last year, SLLs remain another popular option. From their inception in 2017 to the end of 2020, around USD311 billion worth of SLLs went to market. A broad range of industries have tapped SLLs, given relatively easy accessibility compared with green loans.

In order to stay on track with critical targets outlined in the Paris Agreement, net carbon emissions must fall 45 per cent from 2010 levels by 2030. Missing those targets would put the world on course for the worst consequences of climate change. At the going rate, instruments including transition bonds, SLBs and SLLS could accelerate the investments necessary to make net zero a reality.

"ESG investing practices have relied a lot on exclusion to create value," Pfaff says. "Creating value is important, but we also need to effect change. Financing an existing renewable company has a lot less impact than bringing a hard-to-abate issuer several steps closer to sustainability. If the market can reach that conclusion, the path to net-zero should become clear. This would work extremely well for all of those hard-to-abate sectors and activities in Australia."

Takatsuki agrees: "The hard part is the scale of the challenge. Taking the first few steps may not be enough within the context of how quickly we need to be tackling these challenges. But we cannot abandon them. We must partner with them [emissions intensive industries] on ambitious and courageous changes over time. And that is the rationale behind transition finance."