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SUSTAINABLE FINANCE:
FROM NICHE TO NEW NORMAL

TRANSACTIONAL POWERHOUSE

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> This is a fundamental change in the way our financial system and our economy as a whole work. With the adoption of the UN sustainable development goals and the Paris climate agreement one-dimensional short term maximizing of profit is no longer a viable option for companies."

Eva-Maria Ségur-Cabanac
Partner, Vienna, Baker McKenzie

As the global leader in sustainable finance and climate change issues for clients for more than 20 years, Baker McKenzie's 2019 Sustainable Finance Forum brought together leading institutional investors, lenders, corporations, policy-makers and regulators to discuss how environmental and climate considerations are becoming imperative to investment decision.

With both lenders and corporations acknowledging the critical role finance plays in achieving a greener economy, we focussed on discussing **the role of private finance, regulation and measurement in moving sustainable finance from niche into mainstream.**

We are pleased to share with you the forum highlights and hope you will join us in the future as we progress this critical conversation.

There is an increasing sense of urgency and expectation about putting the global economy on a path towards sustainable development. The urgency stems from a massive projected investment gap of EUR 180 billion each year to meet the Paris Climate Agreement goals. In its 2018 Action Plan on Sustainable Finance, the EU Commission calculated an annual gap of EUR 180 billion only within the EU; the EU Green Deal now mentions a number north of EUR 200 billion. (i.e. action through investments, innovation, operations and financial activity to minimize current and future effects of climate change). The sense of expectation relates to the fact that sustainable finance can provide a solution to help plug this massive funding gap.

"The Green New Deal has put sustainable finance at the very heart of the EU's agenda, from Taxonomy to committing to invest EUR 1 trillion to achieve its objectives. During the next five years the Commission will continue to push this agenda strongly; its implications for all sections of Europe's industry are becoming ever more important. Mastering this increasing complex regulatory and legal framework will be essential."

Christopher Jones
Partner, Brussels, Baker McKenzie

"We are at the tipping point year for taking action on climate change. Sustainable investments are not 'nice to have' investments. They are mammoth, essential investments that will change the climate story we will write over the next 20 years."

Caroline Lambert
Senior Policy Officer, European Commission

"Capital markets are exactly the necessary link between commercial banks and much-needed private capital for sustainable finance investments. That is because without private capital, we cannot change the narrative of climate deterioration."

Wilhelm Molterer
Managing Director, European Fund for Strategic Investments

Unlocking the power of private finance

Mobilizing private capital for sustainable development has become a priority for governments and development agencies around the world. For there to be any possibility of achieving the ambitious Sustainable Development Goals (SDGs) by 2030, as much as USD 2.5 trillion (Ministry of Foreign Affairs Denmark, 2018) in private financing worldwide is required per annum to supplement local tax and fee revenues and official development assistance.

Over the past decade, relevant new strategies and tools for leveraging and deploying capital have been generated in two, mostly separate, fields of practice. The first involves innovative forms of financing that use funds and other vehicles to blend private and public capital in the service of development objectives. The second field of practice is known as impact investing, where investments are made with the intention of achieving a social or environmental impact as well as a financial return.

As the private sector makes its basic investment decisions on the basis of three core criteria: risk, return and exit, regulation and impact valuation and measurement are key.

Enablers of private capital in sustainable finance

Enabler 1: Clear regulation

A sound regulatory environment facilitates structured public financing such as public-private partnerships, as well as investor-led initiatives such as start-ups and venture capital. These are all key avenues in channeling private money into sustainable investment. With a higher volume of sustained investments, results will be quick to show in terms of benefits to climate adaptation and mitigation.

When it comes to regulation, clarity is key. According to Roland Mechtler, Head of Group Regulatory Affairs, Raiffeisen Bank International AG, "'sustainable finance regulation needs to be stable and unambiguous, broken down to a granular level it will educate all stakeholders on what is green and what is not, guiding them towards more decisive investments in sustainable projects.'"

Sustainable finance: clearly defined

To date there is no globally-recognized definition of what is **considered** sustainable. A key piece of this puzzle is the EU taxonomy. When formalized, it will be used by EU member states and financial market participants, while credit institutions and other issuers can use it on a voluntary basis.

The EU taxonomy is part of the European Commission's Sustainable Finance Agenda and it lists economic activities that are considered environmentally sustainable for the purposes of investment. It states that economic activity must contribute to one of six environmental objectives whilst doing no significant harm to the other five. It must also comply with minimum social safeguards as well as technical screening criteria.

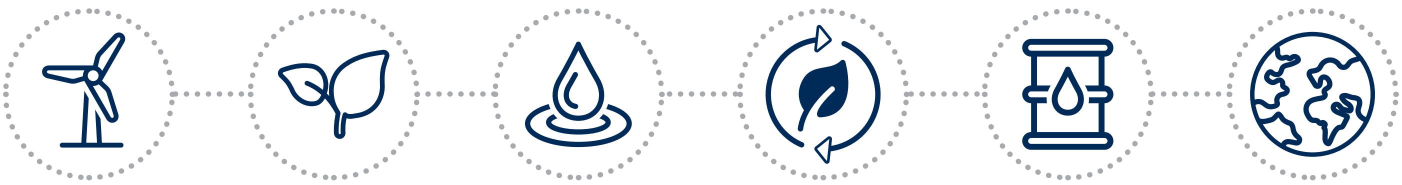
The expectation is that in 2020 the European Commission will set up a Sustainable Finance platform — a formal body that will advise on the EU taxonomy.

Standardization through the EU taxonomy will provide a clear and robust disclosure of obligations while incentivizing actors to enter into or strengthen existing commitments in sustainable investments and acting as a deterrent against greenwashing to boost the real impact of sustainable activities.

> "The EU taxonomy is crucial in giving investors security about sustainable investments. A clear and universally acknowledged taxonomy will standardize a lot of what is relevant to capital markets globally and that, in turn, incentivize investors to embrace sustainable finance opportunities."

Aakriti Chandihok
Head of Legal and Compliance, ÖBAG

EU taxonomy's six key environmental objectives:



1. climate mitigation

2. climate adaptation

3. sustainable water & marine resources

4. transition to a circular economy

5. pollution prevention and control

6. protection of healthy ecosystems

A roadmap for businesses

To complement the EU taxonomy, governments will need to design a road map for investment policy to ensure financial institutions can advise clients on making sustainable investments. Ideally, the road map should have clear guidelines which are based on clear principles, but not prescriptive. Olivier Jaeggi from ECOFACT underlines this importance of this. "What we need is a clear policy roadmap in the real economy otherwise it's very difficult to understand transition risk."

This will help to mitigate greenwashing, which occurs when companies make unsubstantiated or misleading claims about their true environmental impact and help to reduce the overall threat to sustainable investing.

A necessary joint effort to mobilize private finance

The EU is leading the way in encouraging financial institutions to create more conducive environments for private capital to feed into sustainable finance.

The European Investment Bank (EIB) recently cemented its commitment to green banking by announcing its goal to incentivize EUR 1 trillion of sustainable finance investment in the next decade. As it progresses on its trajectory to be known as a 'Climate' bank, it will ensure that 50% of its investments are directed towards climate and sustainable investment projects from 2025 and align its financing activities to the Paris Agreement mandate to "do no harm" from the end of 2020. In terms of climate change mitigation, EIB has introduced a bank-wide movement away from fossil fuels with limited caveats to mitigate greenhouse gas emissions.

The European Fund for Strategic Investments (EFSI) was launched as a joint

> "The more the sustainable finance market develops, the more we will also need to look into the issue of collective consumer protection. This will ensure that the market is committed to transparency and accountability for both suppliers and investors."

Julia Raptis
Head of Section: Legislative Affairs and Supervisory Policy Development, Austrian Financial Market Authority

effort between the EIB Group and the European Commission to manage the EUR 180 billion investment gap to meet the Paris Climate Agreement goals by mobilizing private finance. It will be replaced by Invest EU after the end of 2020 with a target to incentivize EUR 640 billion (this amount may rise to EUR 1 trillion). Invest EU will have four policy windows: environment/climate, innovation, infrastructure and SME. This will enable it to mobilize finance across a wider range of sustainability-linked investment projects.

National central banks and supervisors are also big players in facilitating funding for sustainable finance initiatives. Such stakeholders in France, the UK, Netherlands and China have voluntarily joined the Network for Greening the Financial Sector (NFGS). They share expertise and best practices in order to mobilize mainstream and private finance to support sustainable finance projects.

Case study: ING's sustainability improvement loans

ING has introduced the world's first sustainability improvement derivative, in the form of sustainability improvement loans. It represents a new wave of green finance and highlights the increasing interest of business to participate actively in sustainable finance.

Such loans are linked to a borrower's sustainability performance. The margin of a sustainability improvement loan is linked to the sustainability rating of the company or to specific KPIs.

Olga Zhminko, Sustainable Finance Champion, ING Austria, observed that companies are doing much more in sustainability nowadays; they are interested in decreasing their carbon footprint. "'What ING wants and tries with this sustainability improvement financing structure is to support and acknowledge that clients are doing something good and trying to be more sustainable.'"

Enabler 2:
Impact investment: what is it worth?

Across the globe impact investing was estimated to be equal to USD 502 billion by the end of 2018, GIIN research shows. As the concept of investing with the intention to generate measurable environmental and social impact, alongside a financial return takes flight, the need to measure the true and full impact of sustainable investments grows.

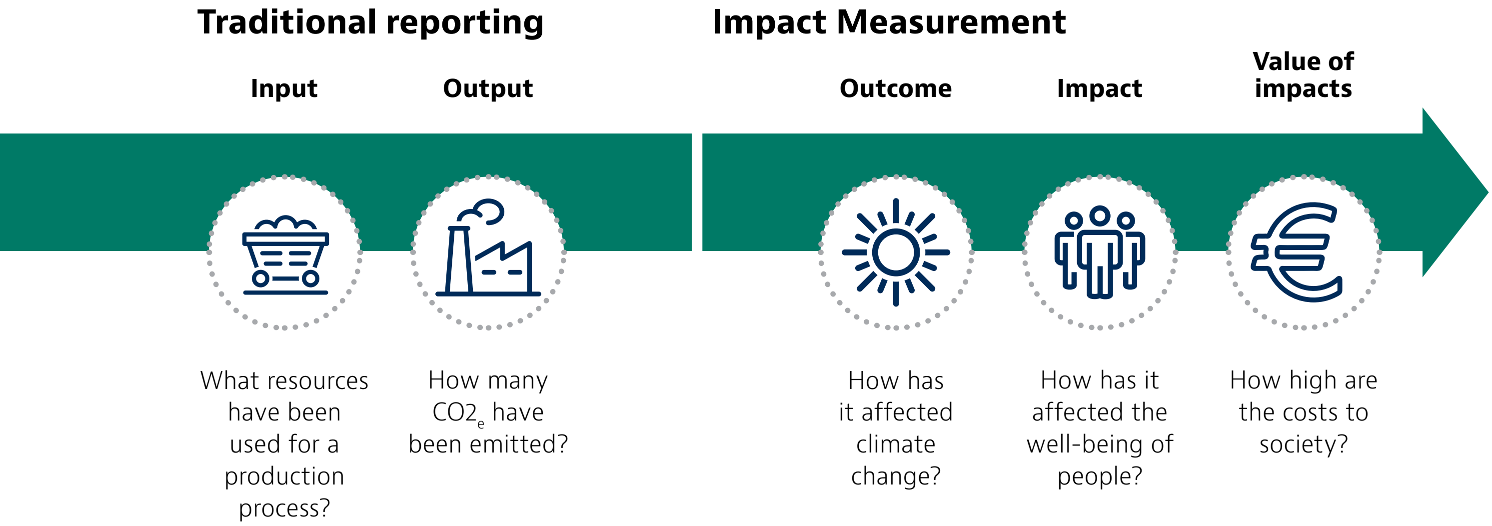
The answer lays beyond the balance sheet - companies can no longer consider profit margins alone or take a purely binary view of positive or negative value drivers (Figure 1). "Key performance metrics must focus on the wellbeing of people and on the role businesses play in influencing society and nature," suggested Christian Heller, CEO, value balancing alliance e.V. This is about "the transformation of the economy from profit maximization to value optimization."

Instead, companies should look at financial and non-financial data in the same measurement metric, giving shareholders and stakeholders an easy way to understand the holistic value generation of a company. This would include the value and impact of operations, processes, as well as supply and customer chains. This new wave of risk management will allow decision makers to assess risks and seek out new opportunities for investment.

> Development financing institutions also play a significant role. Many are focusing their efforts on projects that have sustainability at their heart and are using their vast experience and monitoring capabilities to ensure that sustainability objectives are met. They are also enablers – helping early stage development projects to get off the ground when commercial sources of capital are unwilling to fund."

Marc Fevre
Partner, London, Baker McKenzie

Figure 1. Traditional Reporting to Impact Measurement and Valuation



Source: value balancing alliance e.V.

Companies should also take the lead on thinking about what kind of data shareholders or investors need and the format that would make the most sense to them, according to Antoine Rose, Vice President of Sustainable Banking, Crédit Agricole. To ensure the future of impact valuation and measurement is effective, uniformity or standardization is key. Some challenges to overcome would be to eradicate the complexity of using multiple and often conflicting data sets and measurement tools.

Checks and balances: Disclosures and ESG reporting

In impact investing, reporting clear ESG returns is as important as reporting on financial returns.

In addition to meeting the minimum standards for benchmarking (e.g., the EU Climate Transition Benchmark and the EU Paris-aligned Benchmark), businesses are also required to disclose their ESG objectives and influencing factors.

> "Sustainability assessment and disclosure are increasingly important for companies. The future EU legislation on sustainable finance will reinforce the requirements in terms of climate-related disclosure integrating the new EU Taxonomy on sustainable activities. It will be key for companies to be able to demonstrate how sustainable their activities are."
>
> **Antoine Rose**
> Vice President of Sustainable Banking, Crédit Agricole

ESG reporting criteria (including but not limited to the following):

Types of impact investments

Green bonds

"Green bonds have become crucial to businesses. They have gone from the esoteric to the mainstream, from the financial pages to the front pages of newspapers and the frontline of media."

Michael Doran
Partner, London, Baker McKenzie

Resilient infrastructure

"While there are opportunities on a global scale for resilient infrastructure investment, Latin America offers huge opportunities as an emerging region with high infrastructure needs."

Pablo Berckholtz
Partner, Lima, Baker McKenzie

"Resilient infrastructure has the ability to retain its function and structural capacity despite enduring disturbance due to climate events. It is a lucrative type of impact investment that has a return rate of 4 to 1."

Caroline Lambert
Senior Policy Officer of the European Commission.

Clean technology

"There are over 2,000 investments per year valued at over EUR 30 billion dollars each year. This trend is expected to continue - energy storage batteries (renewable energy) and ocean technologies (blue economy venture investing) in particular are high potential areas for investment."

Adam de Sola Pool
Partner, Clean Energy Venture Group

Debt for nature deals

These are formal agreements between a developing country and another government or bank, allowing the indebted country to offset a portion of its foreign debt by using those funds to finance an environment project.

Robert Weary, Deputy Managing Director, NatureVest, The Nature Conservancy, shared eight focal areas where transaction proceeds are channelled They are:

- biodiversity conservation and management
- disaster risk reduction
- ecosystem-based adaptation
- ecosystem-based fisheries management
- financial tools, mechanisms and instruments
- integrated coastal zone management
- protected areas
- sustainable livelihoods

Case Study: The Seychelles

From 2012 to 2016 The Nature Conservancy bought back USD 20 million of the Seychelles' sovereign debt, which the country had owed to UK, France, Belgium, and Italy.

The deal, which took 4 years to put together, was financed with USD 15 million Nature Conservancy capital and USD 5 million grant money.

Within 4 years, the Seychelles successfully floated their currency, reduced their debt to GDP ratio from 150 to 75%, and ran a budget surplus of 6%.

Source: Naturevest | The Nature Conservancy

> "The Green Bond market has now entered into a new phase in which Green Bonds are not the only use of proceeds bonds dedicated to Green projects but can be also conventional bonds with a coupon indexed on the extra-financial performance of the issuer. These Sustainability-linked bonds are interesting instruments for corporates contributing to energy transition without having enough Green Assets for tapping the Green Use of Proceeds Bond market."

Antoine Rose
Vice President of Sustainable Banking, Crédit Agricole

Green bonds are set to soar

"I am confident in growing investor demand for green bonds" said Silvia Stenitzer, Manager, Market & Product Development, Listing, Vienna Stock Exchange. "Entering the green bond market gives issuers opportunities to find new investors and to be more visible on the international capital market too." With the majority of green bonds currently addressed to institutional investors, Stenitzer noted that retail investors also have great potential to become more active in the green bond market and finance climate change mitigation for a carbon-free future.

Manuel Adamini, Head of Investor Engagement, Climate Bonds Initiative spoke of a positive outlook and urged businesses to act quickly in embracing the world of green bonds. He said that the market is primed to flourish, given that there is scale, technology, financial instruments and a sense of urgency surrounding the green bond market.

Europe currently dominates the issuance of green bonds with a share of over 40%. As a runner up, Asia-Pacific is growing in green bond issuance at a rate of 35%, making it the rising star in the green bond market.

The Climate Bonds Initiative (CBI) shows that Asia-Pacific achieved the second-highest volume of green bond issuance in 2018. The top three Asian-Pacific countries, in terms of volume, are China (USD 31 billion), Australia (USD 4.2 billion) and Japan (USD 4.1 billion).

Case study: Enel Sustainability-Linked Bond

From 2017 to 2019, Enel raised a total of EUR 3.5 billion from issuing green bonds. In September 2019, it altered its strategy to move towards SDG-linked bonds, which, Enel reports, are directly tied to its commitment to lift its renewables base by 25% and boost the renewables share in its installed capacity to 55% by the end of 2021.

Source: Renewables Now

This surge of green bond activity is expected to continue in Asia-Pacific. Ivy Wong, Partner, Baker McKenzie, Hong Kong, said that having more policies, grant schemes, certification schemes will be necessary to further support this growth. Most importantly, notes that Asia-Pacific must keep matching international standards in the green bond market in order to stay competitive.

In contrast, Canada (North America) is still trying to grapple with the complex taxonomy of green bonds and move away from a reliance on fossil fuels. David Palumbo, Partner, Baker McKenzie, Toronto, explains that as a resource-rich nation, Canada struggles with specific market challenges when it comes to sustainable finance and green bonds.

Globally, CBI attributes the overall increase in green bonds to the influx of financial corporate issuers who entered the market in 2018. These include commercial banks, property banks and real estate investment trusts (REITs).

Notably, sovereign green bond issuance is also on the rise. In 2018, one-tenth of the total amount of green bond issuance came from sovereign bonds. This amounted to approximately USD 17.07 billion. Part of this rush of sovereign green bond issuance comes from new players such as Indonesia, Belgium, Lithuania, Ireland and the Seychelles, who were new sovereign issuers in 2018. The trend is set to continue in 2019, given that the Netherlands, Spain, Kenya, Egypt, Hong Kong and Vietnam all have plans to or have already issued sovereign green bonds in 2019.[1]

Top 3 countries

Top 3 countries and issuers of green bond and the corresponding volume of issuance (2018)

USA	China	France
USD 34.2 Billion	USD 31 Billion	USD 14.2 Billion

Top 3 issuers

Fannie Mae, USA	Industrial Bank, China	Republic of France
USD 20.1 Billion	USD 9.6 Billion	USD 6 Billion

Source: Climate Bonds Initiative

1. Climate Bonds Initiative. (2019). Green bonds: The State of the Market 2018 [PDF file]. Retrieved from https://www.climatebonds.net/files/reports/cbi_gbm_final_032019_web.pdf

Green bond principles

In a burgeoning green bond market, issuers and borrowers will be keen to see how regulations change. At this point, to improve transparency, the International Capital Market Association (ICMA) has issued green bond principles (GBP), which are voluntary process guidelines to promote transparency and disclosure. The GBP are not legally binding and ICMA does not verify that issuers have complied with them. Currently, independent third-party reviewers are trusted by the market to confirm whether an issuer has complied with the GBP.

The GBP aim to provide clarity on the process of issuing a green bond and have four components:

1. use of proceeds — typically similar to "to finance and/or refinance, in whole or in part, eligible green projects"

2. process for project evaluation and selection — varies based on individual nature of projects and selection criteria

3. management of proceeds — in some cases "ring-fenced" into separate accounts

4. reporting — using external verifier or can be self-reporting. Generally reports published at least annually (e.g. on website of issuer)

Other market participants such as stock exchanges, index compilers and individual investors, use criteria aligned with or based on the GBP to determine whether or not a given bond is a "green bond."

While the ICMA GBP is focused on European green bond issuance, there has been a rise of both industry body and regulatory efforts in jurisdictions including China, Japan, Kenya and countries that make up the Association of Southeast Asian Nations (ASEAN).

As green loans principles become established, the IFC predicts that investors will have more clarity on what is needed or expected. Principal Investment Officer at the IFC, Gaetan Tiberghien, shared that he thinks this will trigger a huge growth in the green loan market and expects green loans to hit USD 60 billion by 2021.

"We must never forget that what we want is change in the real economy. That's where we can actually have an impact on reducing greenhouse gases. It is important for us to think about how we use the financial economy to drive change in the real economy. Green bonds should not be an objective in itself; they should be a means to an end."

Manuel Adamini
Head of Investor Engagement, Climate Bonds Initiative

Conclusion

Climate change is a global matter and it is now becoming an essential part of how the financial and business worlds operate. Since the ratification of the Paris Agreement, and indeed in recent years, there has been an increasing clarity on how climate change adaptation and mitigation has to be prioritized. While the EU has made great strides in increasing the momentum for legal, regulatory and financial infrastructure and policy, there is more to be done within the continent, as well as globally.

With increasing clarity and direction on regulation, incentives, disclosures and opportunities on impact investing, and green bonds, more institutions will be keen to enter the sustainable finance market or extend their current activity in the market. Greater collective knowledge sharing on strategy and risk-management will further boost the move from mass awareness to mass empowerment.

“We must address the changes required in investment decisions to address the EU’s estimated EUR 180 billion investment gap for climate change. It is clear that we are on the cusp of re-engineering our financial system for these purposes.”

Adam Farlow
Partner, London,
Baker McKenzie

“A new wave of potential private capital paints a promising picture for the future of sustainable finance investment. In the next 20 years, millennials are going to inherit an estimated EUR 25 trillion. This is a stunning opportunity for closing the investment gap for sustainable finance.”

Caroline Lambert
Senior Policy Officer of the European Commission

> "The younger generation seems to have a view that is more aligned with sustainability. This suggests that over the next few decades, a whole new generation of potential investors stands to inherit the accumulated wealth of the previous generation. It will be an unprecedented age for sustainable finance opportunities."

Willem Keogh
Head of ESG, Thematic and Factor, STOXX

Your Strategic Partner for Sustainable Finance Investments

As part of Baker McKenzie's global leadership in its commitment to sustainability and leading market experience in clean energy and climate change, we are proud to leverage our talent, innovation and relationships to make a positive and sustainable societal impact, and partner with our clients from a variety of industries to help them execute their sustainability investments and strategy.

By combining our market-leading climate and clean energy expertise with our global Debt Capital Markets and Banking & Finance expertise, we can help borrowers from a variety of industries fund their transition into a sustainable economy by advising corporates and financiers on structuring and issuance of green bonds, green loans and other emerging debt products. We are superbly placed to lead this momentous paradigm shift in doing business with our clients.

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