SUSTAINABLE DEBT AND THE ROLE OF PROFESSIONAL ACCOUNTANTS IN BUSINESS AND THE PUBLIC SECTOR

OVERVIEW

To achieve their sustainability commitments, companies are increasingly focused on financing sustainability-related transition projects that require extensive capital at lower cost.

Achieving net zero commitments and emission reduction targets requires trillions of dollars in capital.

Significant growth in responsible investor commitments from groups such as the Glasgow Financial Alliance for Net Zero, The Net Zero Asset Owners Initiative, and UN Principles for Responsible Investment signatories is driving demand for both ESG-linked investments to reduce financed emissions to meet net-zero commitments, and consequently enhanced transparency from companies on their sustainability target setting and performance.

The sustainable-debt finance market relies on confidence in companies achieving sustainability and climate-related targets. A significant risk to the availability and performance of sustainable finance is greenwashing and inaccurate or misleading claims around the allocation of proceeds and sustainability-related performance targets and KPIs.

The continuing expansion of sustainable finance - loans, bonds and markets - to fund decarbonization and sustainability commitments requires the skills of professional accountants and treasurers to:

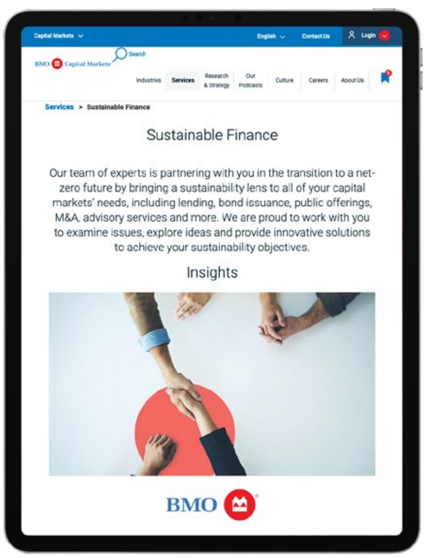
- Secure the right type of financing with the right issuers,
- Ensure financing is deployed to the right projects,
- Measure and verify impact and sustainability performance,
- Quantify the "green" and/or "social" benefit from the investments, and
- Ultimately provide investors with confidence that these financial instruments are leading to the achievement of impact and targets.

This report is based on a session at IFAC's Professional Accountants in Business Advisory Group meeting in September 2022 involving John Uhren, Head of Sustainable Finance, Products and Strategy at BMO, who presented on sustainable finance trends, product types and important considerations in securing, and ensuring confidence in, sustainability debt instruments. It supplements the CPA Canada and IFAC report, *Navigating the Sustainable Debt Market: Enhancing Credibility in an Evolving Market*.

The role of accountants in the issuance of sustainable finance and post-issuance performance is critical to the continued growth of the sustainable finance market.

Sustainable Finance at BMO

- $300 billion committed to sustainable finance by 2025
- Dedicated sustainable finance team responsible for raising capital, financing and advisory services
- $9.8 billion of sustainable equity and debt financing and $31.6 billion of sustainable bonds underwritten in 2021
- BMO has attained carbon neutrality across its operations since 2010, and is a member of the Partnership for Carbon Accounting Financials to support the development of methodologies to track and report financed emissions.



BMO Sustainable Finance Insights

BMO provides end-to-end support for sustainable finance products including structuring the financing framework aligned to market principles and best practices, navigating the Second Party Opinion process (an independent assessment of the sustainability debt issuance framework provided by an institution with environmental/social/sustainability expertise), as well as post execution support including guidance on allocation and impact reporting. BMO's advisory services now include board and management engagement to embed and align sustainability strategy, implement a roadmap, and develop action plans for enhancing ESG disclosure and investor communications.

Trends in Sustainable Finance

The sustainable debt universe surpassed USD$4trillion in 2022 cumulative since 2012.

Sustainable debt exceeded $1.7trillion globally in 2021 (of which around $600billion was Sustainability-Linked Loans), an all-time high and up by more than twofold from 2020.

Emerging and frontier markets are issuing greater volumes of sustainable debt as are supranational government-backed entities.

AN OVERVIEW OF SUSTAINABLE DEBT PRODUCTS

Sustainable debt covering bonds and loans takes various forms including:

Activity-based instruments defined by dedicated use of proceeds

- Proceed bonds (green, social and sustainability bonds) where the proceeds are used exclusively to finance new or refinance existing eligible projects that provide clear environmental and/or social benefits. Use of proceeds can be backed by a single project or aggregation of projects through asset-backed securities. Pricing is determined at issuance and fixed throughout the term.
- Transition bonds for investments related to climate transition by issuers in traditionally non-green industries and that fund a commitment to longer-term net zero transition strategies.

Behavior-based instruments aligned to the company's performance against pre-determined sustainability performance targets

- Sustainability-linked bonds (SLBs) are emerging as a newer form of sustainable debt product that can be used for general corporate purposes which typically have greater flexibility. The coupon rate is determined at issuance, but could subsequently vary depending on whether the company achieves pre-defined sustainability targets, which can be tied to more general sustainability (environmental and social) objectives comprising KPIs (e.g., reduction in emissions) and related sustainability performance targets (reduce absolute emissions by x by target/maturity date).

Other sustainable debt instruments include credit facilities and loans that link interest rates to their performance with greenhouse gas emission reductions and/or other ESG targets. Periphery products include sustainable trade finance programs including those that incentivize sustainable behavior and impact across the value chain. For example, BMO established a commodities supply chain program with Olam Agri to align with best practices in the sourcing of cocoa.

A4S AND IFAC CLIMATE WEEK EVENT TAKEAWAYS: FINANCE LEADERS PLUGGING THE NET-ZERO INFORMATION GAP

Kee Chan Sin, Assistant Treasurer - Capital Markets & Corporate Finance, Verizon explained Verizon's use of green financing.

- Since 2019, Verizon has issued four-green bonds totaling $4 billion, making it one of the largest issuers of corporate debt in the US.
- Verizon developed a Green Financing Framework to provide a common language and understanding between the company, its investors and stakeholders. This Framework has led to the acceleration of capital into Verizon to scale its investment in renewable energy and speed up the transition to greener electrical grids.

USE OF PROCEEDS (UoP) BONDS – ELIGIBLE PROJECT CATEGORIES

New Investments: Up to 36 Month Disbursement Period;
Refinancing of Existing Investments: Up to 36 Month Look Back Period

Use of Proceeds Green, Social and Sustainability Bonds

Eligible project categories for green, social and sustainability bonds (a combination of environmental and social projects) are outlined below.

For social bonds, it is important to identify populations who are targeted to benefit from the investment, including in the sustainability financing framework and in any subsequent investor disclosures about performance.

GREEN BONDS

Alignment with ICMA's Green Bond Principles (GBP)

- Green buildings
- Renewable energy
- Energy efficiency
- Clean transportation
- Climate change adaptation
- Pollution prevention & control
- Sustainable water & wastewater management
- Biodiversity conservation
- Sustainable management of natural resources & land uses
- Eco-efficient products, processes & technologies

SUSTAINABILITY BONDS

(Green & Social Projects)

SOCIAL BONDS

Alignment with ICMA's Social Bond Principles (SBP)

- Affordable basic infrastructure
- Access to essential services
- Affordable housing
- Employment generation
- Food security & sustainable food systems
- Socioeconimic advancement & empowerment

Target Populations include, among others:

- Living below the poverty line
- Excluded or marginalized communities
- People with disabilities
- Undereducated, underserved, unemployed
- Women and/or sexual and gender minorities
- Vulnerable youth

Mapping to UN Sustainable Development Goals (SDGs) has become an important element of positioning UoP

SUSTAINABILITY-LINKED BONDS - FINANCIAL CHARACTERISTICS

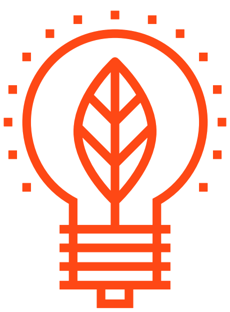
Coupon step-ups have become the dominant incentive structure applied to sustainability-linked bonds. Step-ups can vary widely but across all issuances, most precedents have a coupon step-up of between 25 and 75 basis points. A coupon step-up event at least 3-5 years prior to maturity is most frequent for bonds with tenor of over 5 years.

The step-up can be cumulative (if multiple KPIs) or based on an "all-or-nothing" approach.

There is no clear market consensus on coupon step up materiality. Generally,

- The incentive mechanism should reflect the specificities of:
  - The issuer (e.g., size, industry),
  - The transaction structure (e.g., tenor, call features, SPT evaluation date(s), and credit rating), and
  - The relative and absolute ambition of the target(s).

- When using a cumulative approach, the coupon step-up split between targets generally reflects the meaningfulness of the KPI to the company.
- Investors may consider the meaningfulness of the adjustment offered in the context of the company's overall cost of borrowing.



Sustainability-Linked Loans versus Sustainability-Linked Bonds

Both loans and bonds link pricing to KPIs and corresponding sustainability performance targets (SPTs). For both loans and bonds, KPIs should also measure forward-looking outcomes and should be:

Meaningful, core and relevant to the company's overall business. Pricing adjustments are typically weighted on the meaningfulness of the KPI to the company and its strategic focus.

Measurable on a consistent basis, externally verifiable and benchmarkable.

SPTs must be ambitious and consistent with the company's overall sustainability strategy and objectives and represent:

A material improvement in the respective KPIs beyond a business-as-usual trajectory.

A predefined timeline versus baseline.

There also needs to be clarity and agreement on any exclusions of assets outside a company's direct control, but these exclusions often need strong justification. Scope 3 emissions are increasingly scrutinized especially for carbon-intensive sectors.

In terms of SPT calibration, pricing, reporting and independent review, differences between loan and bond characteristics are outlined below:

	Sustainability-Linked Loan	Sustainability-Linked Bond
SPT calibration	• Usually annually calibrated covering the life of the loan • Strategy to achieve SPTs is communicated to the lender(s)	• Investors prefer SPTs with a track record (e.g., min 3 years) • SPTs can be intermediate and/or longer term, and • Include "most ambitious target" clauses which require future bond issuances to use targets of equal or greater ambition
Pricing mechanism	• Bidirectional interest rate adjustment on drawn margin, possibly with a corresponding price adjustment on undrawn margin • Market practice is +/- 5bps on applicable margin (in US/Canada)	• Coupon step-up based on non-achievement of SPT(s) • Coupon step-up observation date: investors prefer earlier/interim coupon step-up occurrence versus back-end coupon step-up nearer to the end of the term
Reporting	• Borrower submits a Sustainability Certification annually attesting to the progress made on SPTs • Progress does not need public disclosure	• Mandatory public reporting of progress against SPTs • Most companies publish a sustainability-linked financing/bond framework prior to issuance
Independent review	• Third-party verification of SPTs required e.g., by Loan Market Association's sustainability-linked loan principles	• While not mandatory, issuing under an SLB framework and obtention of a Second Party Opinion is market best practice

Four Key Areas for CFOs and Finance Teams to Prioritize

With a sustainable financing arrangement, ongoing reporting and verification are of particular importance to receive a favorable price advantage (i.e., a greenium discount), as well as to combat the risk of greenwashing.

Regardless of the instrument deployed, CFOs and finance and treasury teams need to ensure that companies have:

1. **ALIGNMENT:** internally between sustainable debt financing arrangements and organizational sustainability objectives and strategy, as well as alignment externally by establishing a debt framework with suitable criteria aligned to market best practices such as the International Capital Market Association (ICMA) Green Bond Principles and certification scheme and the Loan Market Association. Alignment between the organization's sustainability goals and those of its suppliers is also a key consideration.

2. **CONFIDENCE:** sustainability impact and performance depend on internal governance mechanisms to track and report on bond/loan performance on a timely basis. Relevant metrics and KPIs must be selected and be supported by robust data and controls and adhere to widely accepted standards and frameworks including those being prepared by the IFRS Foundation's newly established International Sustainability Standards Board and the Global Reporting Initiative's global standards for sustainability reporting. Governance and internal control protocols required over financial information need to be applied to sustainability data targeted at investors. Audit committees may have specific oversight responsibilities for such disclosures.

3. **ASSURANCE:** selecting the right advisors and assurance providers to work with including:

A second-party opinion to assess:

- The alignment of the organization's sustainability finance framework to accepted standards and best practices.
- The alignment of proceeds to market and investor expectations.
- Adequacy of performance targets and KPIs.

Third-party assurance from an independent assurance provider (most organizations select an audit firm given they are subject to professional standards and regulatory frameworks, including requirements for quality management, independence, ethics and competence) to provide post-issuance assurance engagements and opinions.

- For the use of proceed bonds, an engagement relates to the allocation of funds for environmental and/or social projects leading to an assurance opinion over the use of proceeds; and an assurance engagement over the expected impacts of the sustainable debt instrument leads to an opinion on the impact metrics.
- For a sustainability-linked bond, an engagement over the performance level against each SPT and each KPI provides an assurance opinion over KPIs.

KPI performance verification may be done concurrently with the audit of the integrated annual report or sustainability report, especially if external assurance is provided by the statutory auditor.

4. **TRANSPARENCY:** maintaining expectations with investors through issuing a timely report describing projects, capital allocation and expected impacts including:

- Performance against targets and/or KPIs and related impact on the bond's financial and/or structural characteristics,
- Information enabling investors to understand the time horizon of a performance target and an overview of the ambition of the target e.g., updates on the ESG governance or strategy, and analysis of the target and KPIs, and
- The scope and type of assurance provided.

Achieving these four actions is made easier with an integrated mindset that involves a company thinking, measuring, managing and reporting in a more integrated manner across the organization. CFOs and finance functions are well-positioned to champion an integrated mindset to enhance decision-making and reporting. PAIBs are also ideally placed to ensure ethics-related risks, such as greenwashing, are addressed.

ISLAMIC FINANCE

- Islamic Finance instruments are becoming the main sources of funding in specific countries where there are sustainable Islamic Finance markets, for example in Malaysia. Islamic Finance can ensure that more financial resources are mobilized in a sustainable way to achieve the Sustainable Development Goals, in a way that is more inclusive and aligned with Sharia.
- Islamic Finance harnesses a variety of instruments and innovations to drive sustainability goals such as sukuk, waqf, zakat and charity crowd-funding.
- Sukuk is being used to deliver more infrastructure investment to emerging economies to the benefit of the real economy and to investors without conflicting with Sharia principles. The first green sukuk raised $59m to finance a solar power plant in Malaysia in 2017.

IFAC and MIA, *Facilitating SDGs with Islamic Finance (Part 1) Malaysia's Leadership in Sukuk*

Related Resources

Accounting for Sustainability, Essential Guide to Debt Finance

International Ethics Standards Board for Accountants (IESBA) released a staff Questions & Answers (Q&A) publication, *Ethics Considerations in Sustainability Reporting, Including Guidance to Address Concerns about Greenwashing*

Authoritative Principles and Standards

International Capital Markets Association (ICMA) establishes principles and guidelines for all types of ESG bonds

Loan Market Association (LMA) Green Loan Principles

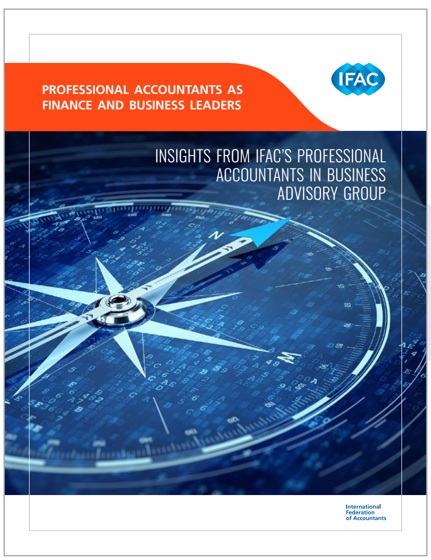
Climate Bonds Initiative provides a labelling scheme for bonds and loans

Proposed EU European Green Bond Standard

Asia Pacific Loan Market Association

Trends in Sustainable Debt

Institute of International Finance's (IIF) Sustainable Debt Monitor



Read more insights from IFAC's Professional Accountants in Business Advisory Group: *Professional Accountants as Finance and Business Leaders*.