Sustainable finance: perspectives on some of the difficult questions

This article explores some of the current thinking behind “sustainable finance”. After briefly describing what is involved and offering up some perspectives, it raises questions and sets out modest proposals in reply. Several different questions are raised but the common theme explored is – whether or not sustainable finance as currently envisaged risks making the situation any worse than it already is.

TERMS OF ART

Even mention of the phrase “sustainable finance” invites mystery and confusion. How might finance be sustainable? After all, finance or more broadly credit, involves the use of money over time. If finance is sustainable through repayment, surely it is not finance at all, or at least, it is not credit. The better rationale is that when finance is described as being sustainable, it is the purpose of the financing which is intended to be sustainable – this type of finance is meant to provide a more sustainable environment for us all to live in. In particular, if the purpose of the finance involves investment in tangible assets such as energy or infrastructure projects, those assets themselves are intended to be of a sustainable variety.

But what might “sustainable” really be referring to in this context? There are no precise answers but perhaps the best explanation is a matter of history. In 1987 at the World Commission on Environment and Development, the Norwegian prime minister (Gro Harlem Brundtland) issued a famous report entitled Common Future. After briefly describing what is involved and offering up some perspectives, it raises questions and sets out modest proposals in reply. Several different questions are raised but the common theme explored is – whether or not sustainable finance as currently envisaged risks making the situation any worse than it already is.

TERMS OF SCIENCE

Rightly or wrongly, within the agenda of environmental protection, the spectre of climate change recruits most followers and takes up most of our attention. But whenever on the one hand the rising temperature of the earth, and on the other, the concept of sustainable finance are mentioned in the same breath, there appears to be a glaring gap in understanding between them, which increasingly should not be overlooked. Many important global institutions working in this area have stated with confidence (and some might say with a degree of arrogance) that
in order to maintain the temperature of the earth within certain limits, from now on, a specific amount of capital is required to be invested or otherwise provided each year. But are things really as simple as this?

Depending on the circumstances, it can be helpful to set goals so as to drive ambition, and it can also be beneficial to try to calculate the price of specific assets needed to help with such things as transition away from heavy fuels or other areas of business for which there are pollutants and externalities. However, for much of the time in the area of sustainable finance, we seem to shy away from serious discussion of this enormous gap in comprehension between incredibly complex scientific matters, for which conclusions and certainty still allude us, and the mundane event of one entity simply extending finance and becoming a creditor of another entity. Is it any wonder we struggle to reconcile these matters?

In the face of this, we do have Science Based Targets (SBTs), prepared by a collection of international bodies including certain agencies of the United Nations; and so it sometimes seems, precious little else. It is generally considered that the SBTs represent a serious body of work; the methodology appears intelligent and painstaking. But for those who have played the game of trying to grapple with the modelling, the validation techniques, the assumptions, the timeframes, the targets and pathways, it quickly becomes apparent that those involved are only dealing with approximations; the subject-matter is very difficult; there are seldom bright lines at all in the methodology and its results. Likewise, enormous work has been undertaken by certain international bodies which have set up teams of academics to try to uncover the mysteries surrounding this gap in comprehension, such as, to name just one such work, the International Energy Agency’s report entitled: *Pathway to Net Zero*. Naturally we all struggle to embrace and digest these enormous documents. They seem to pave the way for virtually unimaginable projects which would transform all of our existence and activities. Whilst we need to try to come to terms with these vast reports as best we can, it is contended that something else is eventually going to be needed to bridge the gap between climate change and sustainable finance: something which allows each of us to visualise the question in terms of small scale practical reasoning.

**WHERE WE ARE**

The architecture of most financial products considered to be sustainable – including those established by the important trade bodies in this area such as the International Capital Markets Authority (ICMA) and the Loan Market Association (LMA) and its US and Asian counterparts, the Loan Syndications and Trading Association (LSTA) and the Asia Pacific Loan Market Association (APLMA) – is grounded in one of two pillars:

- **First**, products for which the purpose may directly help the environment in various ways, and
- **Second**, products which help to incentivise businesses to improve their behaviour so as to protect the environment in various ways.

These products are known, respectively, as "green loans/bonds" and "sustainability-linked loans/bonds". They are still evolving; month by month they are becoming increasingly sophisticated. They command impressive attention in the loan and debt capital markets, reportedly huge volumes are being borrowed and financed using these bases.

The purpose of green products and of sustainability linked products is different. In the case of green loans and bonds, the purpose is intrinsic: to fund a green project or purpose of some description. However, sustainability-linked products do not require a specific purpose – they may be advanced for general corporate purposes but they are intended to drive good environmental behaviour indirectly by rewarding behaviour with financial incentives such as reduced margins. Despite their differences, the two types of products also have several features in common. For example, they share detailed reporting and review requirements, including voluntary and some mandatory requirements to involve external reviews by third party experts on a transaction-by-transaction basis.

Clearly sustainable financial products contain a lot more variety, complexity and discussion than summarised in this article. For example, certain sustainable financial products relate to "social" goals and goods, as opposed to environmental ones, and there is focus on devising a new type of product catering for "transition finance" to assist areas of industry which find it difficult to abate carbon emissions. There is also much discussion around whether non-observance with green covenants and other features should lead to defaults in the traditional sense and whether products can or should be capable of being de-classified away from being green and sustainable after funding.

In the case of sustainability-linked products, increasing time and market-wide regulation is being taken up with target-setting and, as it is sometimes described, attempting to measure the sustainability behaviour of the borrower or issuer. And so it goes on, the products are developing fast.

But what do these products really provide and do for us? Are they helping or is their view of life perhaps too facile? Is there therefore a risk that some of the various projects and activities being financed make the environmental situation worse than it already is? For example, it seems relatively infrequent that participants involved in certain markets consider in detail the overall sustainability of the supply chain of raw materials to be used in projects; or the relative merits between using up resources on one project as opposed to another; or the footprint of energy involved in assembling and constructing certain projects; or the basic usage and footprint of other assets, raw materials and resources to be used in any given project; or the waste or pollution which the project may need to export during its lifetime; or the environmental cost of the eventual decommissioning of the project; or the timeframe during which the relevant technology is expected to have a useful life beyond the term of the debt; as well as a large variety of other difficult questions not directly related to the project’s financial model, which do not always appear to receive consideration.

Accordingly, in the case of green financial products, is it desirable and, crucially, might it ever be feasible to try to introduce increased
“checks and balances” in ways carefully
designed to be business-friendly and so as
not to risk hampering, slowing down or
otherwise disturbing deal-flow in the market?
Care would need to be taken so as not to
distort or impede the market, and also so
as not to impose top-down solutions which
may restrict freedoms and have unintended
consequences.

As for sustainability-linked products,
is it not conceivable that these may become
obsolete at some stage? Do they have any
long-term future at all or are they liable to
become increasingly unavailable as financial
institutions adopt a simpler approach
whereby to attract any new credit at all,
corporates may need to evidence a certain
amount of good behaviour environmentally?
In putting these financings together, we see
the much-discussed drive for meaningful
and ambitious targets but the rewards and
incentives in play are particularly small, the
sanctions for failure to meet targets are often
without much consequence, and increasingly,
it would not be surprising if the market
adopted a glide path away from the intricacies
of these financings into more customary ones
whereby relatively easy credit is available
only to those entities who agree to maintain
certain environmental standards.

DO NO SIGNIFICANT HARM
Do No Significant Harm (DNSH) is
a requirement which has its genesis in
international treaties relating to use of
resources, especially water resources between
states. Originally couched as more a diligence
item than imposing strict liability, states
have been required to take efforts to ensure
that, for example, in utilising a common
waterway or water resource, they would
“do no significant harm” to neighbouring
states which might otherwise risk harm or
interference. Over the years, this concept
has been picked up by domestic and cross
border business arrangements in a variety of
different ways.

The principle has metastasized into the
various EU sustainable finance initiatives,
including the EU Green Taxonomy which
specifies, pursuant to the Sustainable
Finance Disclosure Regulation (SFDR)
that, in order to be classified as green, it
will need to be demonstrated, among other
things, that the investment or development
does not significantly harm other relevant
environmental objectives listed in the
taxonomy. The basis for this policy is thought
to be that a myopic or slavish attention to an
overriding goal such as reduction of carbon
emissions, may give rise to other unintended
harm or troublesome consequences. In
addition to use in the SFDR, DNSH has
most recently been deployed within the
introductory papers establishing the EU
Green Bond principles, albeit these are not
yet fully operational.

In fact, whilst not described so much
in terms of “harm”, DNSH may in one
sense be thought of as already largely
being incorporated within certain existing
transactions. For example, policies of multi-
lateral development banks and export credit
agencies (ECAs), virtually since inception of
those various institutions, provide that they
will not be able to participate in financings for
which the relevant environmental and social
diligence and report is subject to a major
blemish or serious discrepancy. Likewise,
a certain amount of this approach and caution
takes place within other sustainable finance
deals in the market which may require
lenders’ approval of basic environmental
and social due diligence prior to closing.

Naturally, there may be overriding political
or commercial motivations driving forward
any particular project or business but all of us
who operate in the international project and
sovereign loan markets will have experience
of certain transactions, especially with multi-
laterals and ECAs, being subject to delay or
cancellation if various environmental or social
criteria are not satisfied.

Perhaps the key question which arises
at this juncture is whether some type
of formal DNSH requirement should
become mainstream outside of the EU
and within the existing suite of green and
sustainable financial products available
across commercial lending and the debt
capital markets? This would provide at least
one additional layer of “check and balance”
to counter situations where a financing is
being extended in the name of a perceived
environmental good but for which there
may lurk an overriding problem which
creates a degree of harm which should
not be overlooked. In fact, rather than
producing a “zero sum” approach to any
harm encountered, perhaps the DNSH test
should be adjusted so that it establishes a
cost-benefit analysis. In other words, perhaps
certain types of projects could stand a degree
of harm, so long as this is not significant in
relation to the benefit being bestowed on
a jurisdiction under consideration.

In practical terms, the answer to whether
or not DNSH might be introduced going
forwards may depend upon such things as:
given the immaturity of many corporates
even considering the idea of “harm”, which
of them may be able to provide sufficient
data to enable a sensible judgement to be
made about the issue; which party or advisor
might be required to make the assessment
regarding the presence of significant harm
—and the cost and burden thereby involved;
but moreover, is the market really able to
cope with a further hindrance and potential
obstacle to completion of these kinds of
transactions? There is already disquiet about
the amount of time and cost required to get
transactions across the line – perhaps the
market will continue to push back against
further stipulations, especially if there is
more of a focus on trying to reach successful
completion of transactions considered to be
critical in enabling corporates to attain the
so-called “net zero” status.

All in all, DNSH may remain
unacceptable for general inclusion in the
sustainable finance market.

DOING ANY SIGNIFICANT GOOD?
Market participants may also wish to ask
themselves – if DNSH were to be adopted,
would it provide sufficient comfort that
particular green financial products establish
the correct priority for achieving the various
environmental and sustainability goals and
standards which have been set? Should
there be some additional requirement in
order to be comfortable that a transaction
is classified as being “sustainable”? Should
further assurances be obtained that the
overall scheme of a new transaction and
the purpose of the financing is not likely to
make the situation any worse than it already
is – not just in terms of “harm” but in terms
of whether or not the transaction should
be implemented at all, because it will surely
involve using up more of the world’s resources
– why should any particular financing take
priority over any other? Alongside this
question, the basic question could be raised
whether achieving the relevant purpose of the
financing really will do any significant good?
To counter these types of questions, it is
almost as if the market may need to consider
introducing a new test of causation, such as a
“but for” test so as to determine if the relevant
project is justified. This test could attempt
to encapsulate the following new threshold
question: but for the relevant purpose being
satisfied, would the relevant aspect of the
environment under consideration be taken
care of in an acceptable manner? Or, to
formulate this question differently: is it really
necessary to use up further resources so as to
carry out the proposed project? Just by
way of example, presumably a new source of
clean energy supply should add additional
generating capacity to the relevant grid. But
the key question may be – is this additional
capacity required? Will the proposed project
allow high-polluting generation capacity to
be retired from the grid, or would the project
merely add supplemental capacity without
changing the emissions for the jurisdiction
under consideration? This kind of example
seems to show that consideration may need to
be given to some other kind of environmental
or ecological test, not just by reference to
“harm”. And much like the commentary
above in relation to DNSH, perhaps the
solution to the conundrum of including a new
“but for” test, might be to explore whether
the market should adopt a further variety of
cost-benefit analysis whereby it is permissible
to use up an amount of resources, so long
as there is a significant overall benefit being
bestowed.
Again, whether or not these kinds of
supplemental checks and balances would ever
be approached with any level of seriousness
by the market may depend upon a range
of practical questions. What would be the
remit of those required to form a view and
pass judgement on any such considerations
– presumably they would need to take into
account a wide range of factors so as to be
able to express a view on the relative priority
of any particular project under consideration
as against others; it could also be problematic
to expect anyone to understand enough
about the overall context of the proposed
project – in terms of larger political and other
priorities within any particular geography or
industry, so as to be able to express a view;
and, it would be important to understand
which party or advisor might be responsible
for providing their judgement in respect of
these types of questions? Perhaps the market
would simply reject any kind of new causation
test on the basis it might impede the number
of transactions being taken forward.
All in all, such additional tests may
remain unacceptable to the general
sustainable finance market.

MODEST PROPOSALS
To keep things simple for present purposes,
sticking with the example of a basic “green
loan”, the current approach of the principles
for green loans established by the LMA
(and the APLMA and LSTA) include the
following types of questions and criteria
(admittedly greatly paraphrased for present
purposes):
1. is the purpose of the loan “green and
sustainable”? (This is usually expressed
by reference to the use of proceeds of the
financing, which needs to be for projects
which are defined as being “green”
in accordance with the APLMA/LSTA
environmental risk list included in the market
standard documentation);  
2. has the borrower communicated to the
lender its rationale for the loan being
“green”, including its environmental
sustainability objectives and any
environmental risks arising?
3. are the proceeds of the loan tracked
and managed to ensure they are not
commingled with other funds and so
that they are used exclusively for the
proposed green project? and
4. is the borrower following the necessary
reporting requirements, including with
respect to qualitative and quantitative
performance indicators to be made
available to the lender?

In conclusion, if the market were to adopt
just some of the proposals mentioned earlier
on in this article, the approach of the main
questions and criteria might be adjusted and
supplemented as follows:
1. Is the purpose of the loan green and
sustainable?
2. But for the purpose being achieved
by way of the project, would the
environment fail to be protected in an
acceptable manner? ie can the project
be justified? (Consider undertaking a
cost-benefit analysis with respect to
the benefit to the environment
being bestowed and the use of
resources.)
3. Will the project cause significant
harm? (Consider undertaking a further
cost-benefit analysis with respect to
the benefit to the environment
being bestowed and the amount of
harm.)
4. Has the borrower communicated to the
lender its rationale for the loan being
“green”, including its environmental
sustainability objectives and any
environmental risks arising?
5. Are the proceeds of the loan tracked
and managed to ensure they are not
commingled with other funds and so
that they are used exclusively for the
proposed green project? and
6. Is the borrower following the necessary
reporting requirements, including with
respect to qualitative and quantitative
performance indicators which are to be
made available to the lender?

Further Reading:
- EU Sustainable Finance Taxonomy
  (2021) 7 JIBFL 506.
- Sustainability-related disclosures:
  EU SFDR v UK SDR (2023) 3 JIBFL
  174.
- Lexis® UK: Banking & Finance:
  Interactive toolkit: ESG and
  sustainability toolkit.