



The Global ESG Handbook

A Guide for Practitioners

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The basics of ESG finance

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1. Introduction

Since 2018, ESG investment has been exploding. As the corporate and legal sectors have increased focus on ESG values and developed more sophisticated policies and standards, ESG investing has become increasingly popular. As a result, a significant number of borrowers/issuers have taken advantage of such investments in recent years.

As of 2013, there were just shy of US\$29 billion in ESG investments, primarily comprised of green loans and green bonds.¹ That number increased dramatically year over year, with the market seeing almost US\$763 billion in ESG investments in 2020. In addition to green loans and green bonds, 2020 saw significant investment in sustainability-linked financings and social bonds. By 2021, ESG investments exploded to over US\$1,643 billion. This increase more than doubled the market from the previous year while maintaining a roughly equal proportion of investment in the above mentioned ESG products.

In this chapter, we provide an overview of the most common financial vehicles to advance ESG objectives: (i) the so-called ‘green’ bonds; and (ii) the newer alternative, ‘sustainability-linked’ instruments. We explain key terms, detail the main differences between ‘green’ and ‘sustainability-linked’ financings, explore best practices and highlight certain benefits and challenges of ESG financing.

2. Getting started

The first step for a borrower/issuer pursuing an ESG financing is to create a suitable framework – a green bond framework for green bonds or a sustainability framework for sustainability-linked instruments. In preparing its framework, a company should conduct a thorough assessment of its ESG goals in collaboration with its stakeholders and outside advisers. In either case, the framework should define ESG goals, outline the company’s strategy and demonstrate alignment with applicable standards, as further detailed below.

1 www.bloomberg.com/news/articles/2022-02-03/esg-by-the-numbers-sustainable-investing-set-records-in-2021.

2.1 Green bonds

Prior to marketing a green bond, an issuer will create either: (i) a green bond framework for the issuance of one green bond in a single offering; or (ii) a broader framework for multiple sustainable finance transactions. This framework should be reviewed by an independent, external reviewer, the most popular type being a second-party opinion (SPO) provider.² The SPO provider should be independent from any advisers used in the development of its bond framework, and the SPO should affirm that the bond is in compliance with market principles, assess the credibility of the environmental and/or social features of the eligible projects, and highlight any benefits or risks of the projects.³ The issuer will then post the framework and the SPO on its website to demonstrate to potential investors that the financing qualifies as a green bond in accordance with the Green Bond Principles (discussed under section 4 below). Potential investors will use this information to evaluate the basis of the framework and determine whether the bond will meet the investors' ESG investing requirements.

2.2 Sustainability-linked loans or bonds

Prior to marketing a sustainability-linked loan or bond, a borrower/issuer will create a sustainability framework. This process involves selecting one or more key performance indicators (KPIs), setting sustainability performance targets (SPTs) and formulating specific loan/bond characteristics (discussed under section 7.3 below). Here, borrowers/issuers will also obtain an SPO from an independent, external reviewer who will assess the relevance of the KPIs, the rationale and level of ambition of the proposed SPTs, the relevance and reliability of the selected benchmarks, and the credibility of the selected strategy to achieve each such benchmark.⁴

Sometimes when a company is not yet ready to create a sustainability framework or commit to a sustainability feature in its financing but is working toward that goal, it will enter into what has become known as a 'sleeping' sustainability-linked loan which incorporates the flexibility to add sustainability-linked terms within a pre-determined range through an amendment that generally requires approval only of the agent and sustainability coordinator (discussed under section 8 below).⁵

2 While the Green Bond Principles (discussed under section 4 below) do not make an external review mandatory, a recent Climate Bonds Initiative survey of Group Treasurers from 2020 found that 85% of respondents commissioned an SPO for their bond offering: "2020 Green Bond Treasurer Survey", www.climatebonds.net/files/reports/climate-bonds-gb-treasurer-survey-2020-14042020final.pdf.

3 International Capital Markets Association, "Guidelines for Green, Social, Sustainability and Sustainability-Linked Bonds External Reviews" (June 2022), www.icmagroup.org/assets/documents/Sustainable-finance/2022-updates/External-Review-Guidelines_June-2022-280622.pdf.

4 *Ibid.*

5 Loan Syndications and Trading Association, "Summer Series 2022: Key Considerations In Sustainability Linked Lending Recap" (20 July 2022), www.lsta.org/news-resources/summer-series-2022-key-considerations-in-sustainability-linked-lending-recap/, noting that in some SLLs, the ESG amendment must be agreed to by a majority of lenders.

3. Green, social and sustainability bonds

Green, social and sustainability bonds (collectively referred to as ‘green bonds’) are fixed-income securities that are used to finance projects offering environmental or social benefits. The European Investment Bank and the World Bank issued the first green bond in 2007. Since then, the World Bank has issued approximately US\$18 billion equivalent in green bonds,⁶ and the market has expanded rapidly. In the past several years, the green bond market has been fuelled by the broader trend of ESG investing. Issuers are increasingly looking for ways to highlight their commitment to ESG, while investors are seeking opportunities that align with their own ESG targets. The Climate Bonds Initiative has calculated the average annual growth rate of the green bond market at approximately 95%, observing that, between 2007 and 2020, the annual market for such bonds grew from US\$807.2 million to US\$1 trillion.⁷

Green bonds are the largest category of sustainable debt as measured by aggregate principal amount issued, and they are the most common type of ESG debt issued by sovereigns.⁸ While there are various structures, such as green revenue bonds, green project bonds, and green securitised bonds,⁹ this section discusses the most common form, ie, so-called ‘use of proceeds’ bonds, or asset-linked bonds. The main feature of these bonds is that they are used exclusively to finance eligible projects. Largely similar to green bonds, green loans have a use of proceeds covenant tying the loan proceeds to designated eligible projects. Green loans comprise a much smaller (though growing) share of the sustainable finance market, and as such are not discussed further in this chapter.

There are three general categories of these use of proceeds bonds: traditional green bonds, social bonds, and sustainability bonds.¹⁰ The documents and

6 World Bank, “IBRD Funding Program: Green Bonds”, <https://treasury.worldbank.org/en/about/unit/treasury/ibrd/ibrd-green-bonds#:~:text=Since%202008%2C%20the%20World%20Bank,quality%20credit%20fixed%20income%20product>.

7 Climate Bonds Initiative, “Explaining Green Bonds” (19 October 2023), www.climatebonds.net/market/explaining-green-bonds.

8 Caleb Mutea, “Green Bonds Post Record Quarter as Issuers Pounced Before Banking Turmoil”, Bloomberg (6 April 2023) www.bloomberg.com/news/articles/2023-04-06/green-bonds-post-record-quarter-as-issuers-pounced-before-tumult#xj4y7vzkg; (2020 statistics can be found in Jochen Schmittmann and Chua Han Teng, “How Green are Green Debt Issuers?”, IMF Working Paper: WP/20/194 (July 2020), www.imf.org/-/media/Files/Publications/WP/2021/English/wpiea2021194-print-pdf.aspx); Peter Lindner and Kay Chung, “Sovereign ESG Bond Issuance: A Guidance Note for Sovereign Debt Managers”, IMF Working Paper No 2023/058 (10 March 2023), www.imf.org/en/Publications/WP/Issues/2023/03/11/Sovereign-ESG-Bond-Issuance-A-Guidance-Note-for-Sovereign-Debt-Managers-530638.

9 International Capital Market Association, “Green Bond Principles (GBP)”, www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/green-bond-principles-gbp/.

10 Traditional green bonds finance projects that focus on environmental conservation or climate change mitigation, such as renewable energy, energy efficiency and green buildings. There are many other terms used to define specific types of green bonds, including blue bonds, which finance projects focused on conservation of marine ecosystems, and transition bonds, which finance projects that assist a company progress toward decarbonisation goals aligned with the Paris Climate Agreement. Social bonds finance projects that address issues such as housing, unemployment, education or sustainable food systems: International Capital Market Association, “Social Bond Principles (SBP)”, www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/social-bond-principles-sbp/. Social bonds have been gaining traction recently as investors are increasingly interested in investing in projects that extend beyond the ‘E’ in ESG: Rebecca Isjwara, “The ‘S’ in ESG here to stay after pandemic-induced surge

process are largely the same for green bonds as for conventional bonds, but with features to demonstrate the link between an issuer's sustainability goals and the use of proceeds. While issuers may incur additional transaction costs for at least the first issuance of green bonds due to the resources required to establish the necessary framework and reporting mechanisms, green bonds remain attractive to potential issuers as the benefits of appealing to new investors and promoting green initiatives outweigh these increased expenses.

4. Green bond structure

There are currently no mandatory, enforceable standards for green bonds, though some governments are beginning to develop standards. In November 2023, the European Parliament and the Council of the European Union adopted the voluntary European Green Bonds (EuGB) Standard, which will allow labelling for bonds that fund environmentally sustainable objectives so long as the uniform requirements of the EuGB Standard have been met.¹¹

Given the lack of government standards to date, the market has converged around the International Capital Market Association's (ICMA) Green Bond Principles, Social Bond Principles and Sustainability Bond Guidelines (collectively, the GBP).¹² These voluntary guidelines have become the generally accepted framework to evaluate the ESG principles of these bonds and have been used by nearly all green bond issuers.¹³ To qualify as a green bond under the GBP, a bond must align with four core components: (i) use of proceeds; (ii) process for project evaluation and selection; (iii) management of proceeds; and (iv) reporting.

4.1 Use of proceeds

The net proceeds of a green bond must be applied to fund 'eligible projects' that advance the issuer's defined sustainability goals as set forth in the underlying

in social bond sales" S&P Global Market Intelligence (29 July 2021), www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/the-s-in-esg-here-to-stay-after-pandemic-induced-surge-in-social-bond-sales-65663064. Sustainability bonds fund a combination of both green and social projects: International Capital Market Association, "Sustainability Bond Guidelines (SBG)", www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/sustainability-bond-guidelines-sbg/.

11 "Regulation (EU) 2023/2631 of the European Parliament and of the Council of 22 November 2023 on European Green Bonds and optional disclosures for bonds marketed as environmentally sustainable and for sustainability-linked bonds", <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32023R2631>. Projects will be evaluated against the EU Taxonomy Regulation. The Council will publish standardised templates that can be used regardless of adherence to the EuGB Standard, and create a registration system for external reviewers: "European Green Bonds: Council adopts new regulation to promote sustainable finance", www.consilium.europa.eu/en/press/press-releases/2023/10/24/european-green-bonds-council-adopts-new-regulation-to-promote-sustainable-finance/.

12 International Capital Market Association, "Green Bond Principles (GBP)", www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/green-bond-principles-gbp/. For green loans, the Green Loan Principles substantially mirror the GBP: Loan Syndications and Trading Association, "Green Loan Principles (GLP)", www.lsta.org/content/green-loan-principles/.

13 International Capital Market Association, "Sustainable bonds based on GBP, SBP, SBG and SLBP in 2020" www.icmagroup.org/assets/documents/Sustainable-finance/GBP-Infographic-040521.pdf.

framework. What constitutes an eligible project will vary for each issuer and each bond issuance and must be clearly disclosed to potential investors in the offering document. While the GBP does not favour specific project types or technologies, it includes a list of eligible project categories, such as renewable energy, energy efficiency, pollution control and climate change adaptation. The eligible projects do not have to be selected at the time of the bond issuance and can be selected on an ongoing basis during the life of the bond based on described criteria and goals. Additionally, the proceeds of green bonds can be applied to projects already underway or completed within a lookback period. Although there is no rule on the maximum length of the lookback period, market preference is between three and five years, with two years being a common preference.¹⁴

4.2 Project evaluation and selection

The GBP requires that issuers clearly communicate to investors the process of evaluating and selecting eligible projects. Project selection should conform to the issuer's sustainability goals as outlined in its green bond framework and should show how the green bonds strengthen the issuer's corporate strategy or goals. As a best practice, the issuer should form a committee to manage this effort,¹⁵ and disclose to investors the decision-making process for selecting the respective green projects or assets. Also, the green bond framework should demonstrate alignment with the four core GBP components, indicate any reference standards adopted by the issuer and explain the issuer's broader sustainability goals and strategy. Additionally, the issuer, with assistance from external consultants if necessary, should establish a process for identifying and mitigating risks and negative impacts of the projects.

4.3 Management of proceeds

To satisfy the GBP, the net proceeds of a green bond must be tracked, whether through moving it to a sub-portfolio, crediting it to a sub-account, or by other means, and then be formally certified by the issuer.¹⁶ Tracking efforts should include placing the proceeds in a segregated account, earmarking such funds for the identified green projects and estimates, and managing any unallocated proceeds.

14 International Finance Corporation, "Green Bond Handbook: A Step-by-Step Guide to Issuing a Green Bond" (2020), www.ifc.org/content/dam/ifc/doc/mgrt/202203-ifc-green-bond-handbook.pdf noting that for some investors, the "lookback period" cannot exceed two years.

15 International Finance Corporation, "Green Bond Handbook: A Step-by-Step Guide to Issuing a Green Bond" (2020), www.ifc.org/content/dam/ifc/doc/mgrt/202203-ifc-green-bond-handbook.pdf.

16 An issuer can have its green bond or associated green bond framework or use of proceeds certified against a recognised external green standard or label. A standard or label defines specific criteria, and alignment with such criteria is normally tested by qualified, accredited third parties, which may verify consistency with the certification criteria. An example is through the Climate Bonds Initiative which is based on the Paris Climate Agreement: www.climatebonds.net/certification.

The issuer can manage proceeds using a bond-by-bond approach (where the proceeds are managed for each bond issuance separately) or a portfolio approach (where the proceeds for multiple green bonds are managed on an aggregate basis). If a bond has multiple tranches with only one or some used for green purposes, separate accounting for each is vital. The ICMA strongly recommends that the issuer employ an external auditor or other independent, third party to verify the issuer's tracking and allocation processes.¹⁷ The remaining balance of the tracked proceeds should be periodically adjusted to account for allocations made to eligible projects. Investors will want clear proof that their investments have been used to fund only eligible projects. The disclosure in the offering documents will generally detail how any proceeds will be tracked and allocated as well as the treatment of any unallocated proceeds and the anticipated timeline for full allocation of the green bond proceeds. Many issuers choose to hold the unallocated proceeds in short-term, liquid assets to reassure investors that the funds will not be deployed in non-green projects.¹⁸

4.4 Reporting

The GBP provides that issuers should prepare an annual report to be posted on the issuer's website detailing how the proceeds have been allocated, along with a description of each project and the expected impact, until all proceeds are allocated. If an issuer is using a portfolio approach, the issuer may report the allocation of proceeds on an aggregate basis.¹⁹ Performance against relevant parameters, such as qualitative and quantitative performance indicators of the expected and/or achieved impact, as well as the underlying methodology and assumptions used by the issuer, should be disclosed in this annual report.²⁰ It is also recommended that the issuer reports if there is a material change in the framework, such as a change in the targeted projects or a shift in the scope or scale of the eligible projects or assets.

This is an extract from the chapter 'The basics of ESG finance by Helene R Banks, Gregory J Battista, Patrick Gordon and Meghan McDermott in *The Global ESG Handbook: A Guide for Practitioners*, published by Globe Law and Business.

17 International Capital Market Association, "Green Bond Principles (GBP)", www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/green-bond-principles-gbp/.

18 International Finance Corporation, "Green Bond Handbook: A Step-by-Step Guide to Issuing a Green Bond" (2020), www.ifc.org/content/dam/ifc/doc/mgrt/202203-ifc-green-bond-handbook.pdf.

19 This might be necessary if confidentiality considerations restrict the detail that can be disclosed, or if a large number of small-sized projects are financed by a green bond (eg, green bonds financing a loan programme).

20 International Capital Market Association, "Handbook: Harmonised Framework for Impact Reporting" (June 2022), www.icmagroup.org/assets/documents/Sustainable-finance/2023-updates/Handbook-Harmonised-framework-for-impact-reporting-June-2023-220623.pdf.

The Global ESG Handbook

A Guide for Practitioners

The Global ESG Handbook: A Guide for Practitioners

Environmental, social and governance (ESG) issues are increasingly considered as core business priorities for companies, boards and investors, with ESG representing an area of significant opportunity for many. Navigating the broad range of topics that fall under ESG, including regulatory developments, political impacts and stakeholder sentiment, requires multidisciplinary and global expertise from experienced practitioners.

Featuring cross-jurisdictional insight, this important title covers a range of ESG topics in depth, containing contributions from leading legal professionals, industry experts and consultants. The book firstly discusses “what is ESG?” before covering areas including supply chain topics, financial regulatory impacts, ESG disclosure obligations, M&A and private equity, among many other important subjects. Further, the book contains regional specific insights from practitioners on the ground and includes analysis of the diverse themes which underpin the current and future direction of ESG. Specific chapters are also dedicated to the emerging matters of ESG litigation, the evolving nature of technology in ESG, and the incorporation of ESG into enterprise risk management. The final part of the book looks at broader trends and developments in the area.

Despite the large volume of information already available, this is one of the first publications to draw together the various strands of ESG into one book and provides a valuable source of information in this fast-evolving area. It will make essential reading for all legal and other advisers and professionals with an interest in furthering their ESG knowledge.

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ISBN 978-1-787429-76-5



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