CLIMATE, CREDIT & CANADA - GROWTH OF GREEN BONDS, SUSTAINABILITY-LINKED CREDIT AND NET-ZERO BANKING

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Canadian lenders and borrowers are increasingly turning to sustainable finance instruments (such as sustainability-linked loans) to highlight their commitment to sustainability, enhance relationships with stakeholders and gain access to new markets. According to a Bloomberg report, ESG-linked loans may reach $20 billion by the end of this year. Several companies, including blue-chip firms like CN Rail, have signed or converted conventional credit facilities into sustainability-linked loans.

In this article, from McMillan's ESG Initiative, we discuss the different types of sustainable finance, debt and structured products that are gaining traction in the marketplace. Subsequently, we discuss developments related to international net-zero commitments such as the industry-led Net-Zero Banking Alliance (NZBA). Lastly, we also look ahead to potential responses from the Canadian financial regulators to address climate change related risks.

Green Bonds

The green bond market has developed on a self-regulatory and voluntary basis through several initiatives. Some jurisdictions, industry associations and stock exchanges have set out their own standards for designating certain types of securities as "green bonds". One of the most frequently utilised standards for corporate issuances of green bonds is the International Capital Market Association's ("**ICMA**") Green Bond Principles ("**GBPs**").

Broadly speaking, the GBPs outline the following four criteria that a securities offering must meet in order to qualify as a green bond. Most GBPs aligned green bonds adhere to these four components, albeit to varying degrees:

- **Use of proceeds**: The proceeds must be utilized to finance or refinance green projects with respect to eligible green project categories, including, but not limited to, climate change mitigation, natural resource conservation or pollution prevention and control.
- **Management of proceeds**: The green bond proceeds must be managed in a sub-account or otherwise tracked and should be attested to by the issuer in a formal internal process. The issuer's internal process

should be linked and aligned with the issuer's lending and investment operations for green projects.
- **Process for project evaluation & selection**: Green bond issuers should clearly communicate the environmental sustainability of the projects and the process by which it determines the green eligibility of the project.
- **Reporting**: This is usually communicated in an annual report where the issuer can specify the list of green projects, and stipulate the respective allocations and expected impact of its green bonds.

In other words, green bonds issued under the GBPs are a type of "use of proceeds" bonds, as the proceeds of the financing are ring-fenced or otherwise tracked and exclusively applied to eligible green projects.

The stringent disclosure obligations, from a practical perspective, can expose green bond issuers to criminal or civil liability to underwriters and/or investors for misstatements or misrepresentations made in a prospectus. Such liability could arise, for instance, if the issuer discloses in the "use of proceeds" section, that it will use the proceeds of the issuance for certain eligible investments, and subsequently it does not. Many jurisdictions also have secondary market liability provisions under which issuers can be held liable for misstatements and omissions, including in annual impact reports.

Given the liability concerns, some issuers are reluctant to include green undertakings as a breach may trigger an event of default under bond documentation, which could result in cross-defaults in other agreements. There are also examples of exclusions of liability for investing in projects not meeting the relevant green criteria or requiring the issuer to reallocate bond funds to a different project that is aligned with the use of proceeds.

In the Canadian market, green bonds have gained popularity and recent issuances have included:

- **Manulife**: In May 2018, Manulife Financial Corporation issued $600 million of its first green bond in Canada. Manulife's green bond framework is aligned with the ICMA GBPs, and directs the use of proceeds towards renewable energy, green buildings, sustainably-managed forests, energy efficiency, clean transport, sustainable water management and/or pollution prevention and control.
- **Granite REIT:** In June 2020, Granite REIT issued $500 million of its inaugural green bonds. Eligible projects under Granite's green bond framework include green buildings, energy or water efficiency programs, clean transportation, and renewable energy.
- **Alimentation Couche-Tard**: In May 2021, Alimentation Couche-Tard Inc. issued its inaugural green bond consisting of US$350 million aggregate principal amount of 3.625% Senior Unsecured Notes due 2051. Couche-Tard's green bond framework provides that the proceeds of the green bond offering are to be used for environmentally friendly projects in six categories: clean transportation, energy efficiency, renewable energy, pollution prevention and control, sustainable water and wastewater management, and green buildings.

Sustainability-Linked Bonds

Unlike the "use of proceeds" green bonds discussed above, proceeds from the issuance of Sustainability-Linked Bonds ("**SLBs**") are not ring-fenced to green or sustainable purposes and may be used for general corporate purposes. Instead, SLBs are linked to key performance indicators (the "**KPIs**"), and financial characteristics of the bond can vary depending on whether the issuer achieves those KPIs.

Similar to GBPs, ICMA published the Sustainability-Linked Bond Principles (the "**SLBPs**") in June 2020. The SLBPs are voluntary in nature and consist of five core components:

- **Selection of KPIs**: KPIs should be material to the issuer's business, and of high strategic significance to the issuer's operations. They should be measurable, externally verifiable and capable of being benchmarked.
- **Calibration of SPTs**: Sustainable performance targets ("**SPTs**") for the issuer's KPIs must be set in good faith and the issuer should disclose strategic information that may decisively impact the achievement of the SPTs. The SPTs must be determined on a predefined timeline which is set before the issuance of the bond.
- **Bond Characteristics**: The bond should include a financial and/or structural impact involving trigger event(s).This has predominantly been in the form of a coupon variation (typically between 10 to 75 basis points) depending upon whether or not the SPTs are achieved.
- **Reporting**: Issuers should publish regularly, and at least annually, up-to-date information on the performance of the selected KPI(s), and a verification assurance.
- **Verification**: Issuers should, at least annually, seek independent and external verification of their performance level against each SPT for each KPI by a qualified external reviewer.

As financial characteristics of SLBs (such as interest rate) can vary depending upon the achievement of particular SPTs, significant attention is paid to their calibration. For climate-related SPTs the focus is on reduction of key emissions calculated in accordance with the methodology of the Greenhouse Gas Protocol ("**GHG Protocol**"), a widely used international accounting tool developed by the World Resources Institute and the World Business Council for Sustainable Development to understand, quantify, and manage greenhouse gas ("**GHG**") emissions.

The Corporate Standard of the GHG Protocol classifies a company's green house gas emissions into three scopes. Scope 1 emissions are direct emissions from owned or controlled sources. Scope 2 emissions are indirect emissions from the generation of purchased energy. Scope 3 emissions are all indirect emissions (not included in scope 2) that occur in the value chain of the reporting company, including both upstream and downstream emissions. For example, while some companies have more emissions in Scopes 1 and 2 – directly generated by the company (from production plants, for example) or related to its upstream activities, such as its power sources – others, such as automotive manufacturers, have more emissions in Scope 3.

The SLBs are meant to complement green bonds, and enable more issuers to access sustainable finance opportunities. Corporate issuers that do not have readily available green projects may find it easier to tap into SLBs since the use of proceeds is not restricted.

SLBs are a relatively new instrument and, as such, few issuers internationally have opted for them. Recent SLB issuances include:

- **Novartis**: In November 2020, Novartis Finance SA, a subsidiary of Novartis AG, announced the issuance of EUR1.85 billion of SLBs due 2028 with an interest rate of 0.00%. The SLBs also incorporate social targets, with bondholders entitled to receive a higher amount of interest if Novartis fails to meet its targets for expanding access to its innovative medicines.
- **NRG Energy**: In December 2020, NRG Energy Inc. completed the issuance of US$900 million of SLBs in North America. The SPT is absolute reduction of GHG emissions of 31.7 million metric tons of carbon dioxide equivalent by the end of 2025.
- **Verallia**: In May 2021, Verallia SA, a Paris based glass packaging company, announced the launch of its EUR 300-500 million SLB offering with a maturity of 5 to 7 years. The SPT under the offering is to reduce Scope 1 and 2 CO_2 emissions by 27.5%.

Green Loans

Green Loans are a type of loan instrument that aligns with the Green Loan Principles ("**GLPs**"). The GLPs were published in 2018 by the Loan Market Association ("**LMA**"), the Asia Pacific Loan Market Association ("**APLMA**") and the Loan Syndicated and Trading Association ("**LSTA**") to promote the development and integrity of the green loan market.

Similar to the GBPs, the four core components of the GLPs are:

- **Use of Proceeds**: The proceeds must be used for green projects that provide clear environmental benefits. The GLPs provide non-exhaustive categories of eligibility, including renewable energy, clean transportation, eco-efficient adapted products, and more.
- **Process for Project Evaluation and Selection**: The borrower should clearly communicate its environmental sustainability objectives and the process by which it selects green projects which are eligible to use the proceeds of the financing.
- **Management of Proceeds**: The proceeds of a green loan should be tracked by the borrower to maintain transparency.

- **Reporting**: The borrower is encouraged to keep readily available information on the use of proceeds and the expected impact. While internal verification is permitted, external review is recommended under the GLPs where lenders do not have a broad working knowledge of the borrower, or the borrower lacks internal expertise to self-certify.

The updated guidance published by the LMA in May 2020 clarifies that the GLPs can be satisfied either by a green project identified as such at the outset, or by the establishment of a framework under which green projects are identified as eligible during the life of the loan (for example under a revolving credit facility).

The guidance also directs the parties to "give due consideration as to whether or not a failure to apply the proceeds of a green loan towards a Green Project will trigger an event of default" and makes it clear that the loan should not be considered green from the date of occurrence of such event, subject to any cure rights.

In Canada, some recent green loans include:

- **Concert Properties**: In July 2020, Vancouver-based Concert Properties Ltd. and HSBC Bank Canada announced the first Canadian green loan. The transaction involved the conversion of a $71.5 million construction loan into a green loan to finance a building project with a lower carbon and energy footprint versus a comparable building.
- **Dream Hard Asset Alternatives Trust**: In October 2020, Dream Hard Asset Alternatives Trust announced that it had received a $120 million green loan for its Sussex Centre complex in Mississauga from HSBC Bank Canada. The proceeds of the loan (which is compliant with the GLPs) will be used to lower the carbon and energy footprint of the development.
- **Atlantic Packaging:** In February 2021, Bank of Montreal provided a Green Loan to Atlantic Packaging Products Ltd. to finance a new 100 percent recycled containerboard facility. The loan, aligned with the GLPs, will be used for the construction of a new containerboard facility in Whitby, Ontario.

Sustainability-Linked Loans

Similar to SLBs, sustainability-linked loans ("**SLLs**") are finance instruments in which the terms of the loan (usually the interest rate) are linked to the borrower's performance on defined ESG metrics. SLLs are usually structured as a revolving credit facility for general corporate purposes, with an incremental pricing benefit to the borrower for meeting certain sustainability targets.

A frequently utilised framework for corporate issuances of SLLs is the Sustainability-Linked Loan Principles ("**SLLPs**"). The SLLPs were issued in March 2019 jointly by the LMA, the APLMA and the LSTA.

The SLLPs are based around four key elements:

- **Relationship to a business's overall corporate social responsibility strategy**: Borrowers should clearly communicate their sustainability objectives to the lender group and align the proposed loan's SPTs with their existing corporate social responsibility ("**CSR**") strategy. SPTs for loans may include key performance indictors, external ratings or other metrics related to borrowers' sustainability profile. Borrowers are also encouraged to disclose any sustainability standards or certifications to which they aim to conform.
- **Target Setting**: Borrowers must agree to a set of SPTs with their lenders, possibly with the assistance of a sustainability coordinator or a sustainability structuring agent who will help negotiate the targets. These targets should be tied to improvements against agreed benchmarks in the borrower's sustainability performance over the life of the loan. The loan terms will be aligned to performance against those targets and benchmarks.
- **Reporting**: Details of performance against the pre-agreed targets should be kept up to date and be readily available to lenders. Ideally this information will also be made public by a borrower via its annual reporting or through a separate CSR or sustainability report
- **Review**: The need for external review varies depending on the circumstances and should therefore be negotiated on a transaction-by-transaction basis. Where SPT performance data is not reported publicly or otherwise accompanied by an audit statement, the SLLPs strongly recommend that a borrower seek independent review of their sustainability performance at least annually.

In market practice, SLLs typically rely on a borrower's existing ESG strategy – which, in the case of publicly traded companies, are typically reported in public disclosure documents. This approach requires ongoing reporting against the SPTs. This also avoids the need for on-going monitoring of SPTs by a lender or third party verification. Reporting to lenders commonly takes the form of a sustainability certificate, which sets out target and SPT performance delivered in conjunction with the annual consolidated audited financial statements.

Usually, neither the failure to meet any or all SPTs, nor the failure to deliver an SPT certificate generally constitutes an event of default under SLLs, and an explicit carve out is included in the facility agreement to cover such instances. However, a direct consequence of meeting or failing to meet SPTs or to deliver a SPT certificate is an adjustment to the margin.

Some examples of SLLs in Canada include:

- **Maple Leaf Foods**: In December 2019, Maple Leaf Foods Inc. amended its existing credit facilities to include financing terms that reduce the interest rate on the lending facility as key sustainability targets are met. The credit facilities consist of an unsecured committed revolving line of credit and two unsecured committed term facilities totaling $2 billion in funding for a period ranging from 2019 to 2024.
- **Gibson Energy:** In April 2021, Gibson Energy Inc. transitioned its principal revolving credit facility into a

SLL. The 5-Year, $750 million revolving credit facility includes terms that reduce or increase the borrowing costs as sustainability and ESG targets are met or missed. The ESG targets include the reduction of Scope 1 and Scope 2 GHG emissions intensity by 15% by 2025; increasing the representation of women in the workforce to 40% – 42%; increasing the representation of women on the Board to at least 40% and having at least one member of the Board who identifies as a racialized or ethnic minority and/or Indigenous by 2025.

- **Enerplus:** In April 2021, Enerplus Corporation announced that it had increased and extended its senior, unsecured credit facility to US$900 million with a maturity date of October 31, 2025 and incorporated sustainability-linked performance targets with no changes to its existing pricing grid or covenant package. Amongst its targets, Enerplus' committed to a 50% reduction in corporate Scope 1 and 2 GHG intensity by 2030, using 2019 as a baseline.

Sustainability Focused Financial Sector Alliances

On April 21, 2021, on the eve of the 2021 United Nations Climate Change Conference (COP26) in Glasgow, the following three new sustainability focused alliances for the financial sector were announced:

- **Glasgow Financial Alliance for Net Zero (“GFANZ”)** is a new industry-wide group, chaired by Mark Carney, designed to bring together the leading net zero initiatives from across the financial system into one sector-wide strategic forum. GFANZ requires signatories to set science-based interim and long-term goals to reach net zero emissions by the target of 2050 or earlier. In addition, GFANZ members are required to supplement these goals with short-term targets and action plans, including 2030 interim target setting.
- **Net-Zero Banking Alliance (“NZBA”)** is a coalition of banks with a common commitment to transition their lending and investment portfolios to reach carbon emission neutrality by 2050 at the latest. NZBA is convened by the UN Environment Programme Finance Initiative (UNEPFI). An initial group of 43 of the world’s biggest banks from 23 countries have joined NZBA with a focus on delivering the banking sector’s ambition to align its climate commitments with the Paris Agreement goals.
- **Net-Zero Insurance Alliance (“NZIA”)** will comprise some of the world’s leading insurers and reinsurers. The NZIA is expected to be launched at the UN Climate Change Conference in November 2021.

OSFI Consultation and Pilot Project

In January 2021, the Office of the Superintendent of Financial Institutions (“**OSFI**”), an independent agency of the Government of Canada responsible for regulating and supervising federally regulated financial institutions, launched a discussion paper to kick start consultations on climate-related risks. Through this consultation, OSFI is seeking to engage federally regulated financial institutions (“**FRFIs**”), federally regulated pension plans

(“**FRPPs**”) and other interested stakeholders in a dialogue on climate-related risks.

The aim of the consultation is to understand how FRFIs and FRPPs define, identify, measure and build resilience to climaterelated risks. OSFI is also seeking feedback on how it can facilitate FRFIs’ and FRPPs’ preparedness for, and resilience to, these risks. This input will guide the development of regulatory and supervisory approaches that meet OSFI's mandate of protecting depositors, policyholders and private pension plan beneficiaries while allowing institutions to remain competitive and to take risks in accordance with their internal risk management policies and procedures.

The regulator has also teamed up with the Bank of Canada, banks and insurance companies on a pilot project to build climate change scenarios that could help assess potential effects for financial institutions. OSFI plans to publish a report in 2021-22 sharing details on the specific scenarios, methodology, assumptions and key sensitivities.

Growing Pains

While the reorientation of credit to sustainable investments has increasingly become an important feature of the mainstream financial markets, it is reaching a critical juncture. Without some way to evaluate the application of these concepts, there is a risk of reducing them to mere marketing tools.

For instance, in the case of SLBs, Nuveen, a global investment manager with over US$1 trillion of assets under management, recently stated “digging deeper, we are underwhelmed by the goals and penalties associated with recent SLB deals. The goals or targets can be gamed to make them relatively easy to achieve, sometimes based on the issuer’s current trajectory, and without the need for meaningful new investment.”

Figuring out which issuers are walking the walk on sustainability is not easy, however, and transparency is not just an idealistic goal but also an important ingredient for developing a credible sustainable finance marketplace. As the experience in the EU shows this is not a simple task. The EU Sustainable Finance Taxonomy — a classification tool that sets requirements for activities to be considered as sustainable — was designed to solve this issue. However, some have raised concerns that it is too permissive and could open the door to greenwashing.

Domestically, the CSA Group (formerly known as the Canadian Standards Association) has been working with banks, pension funds, and industry groups to develop a green taxonomy for resource-heavy economies such as Canada’s. The recently announced Sustainable Finance Action Council is also expected to look into the development of a sustainable finance taxonomy for Canada. However, these efforts will need time to bear fruit.

All told, there is promise in the transition to sustainability-oriented credit flows. Increasingly, investors are looking to reallocate capital to businesses that perform better on ESG issues and away from those that ignore them.

Learn about new developments in sustainability and how McMillan LLP can help you reach your ESG goals here.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.