To limit greenwashing and enhance impact a tighter modality of sustainable financing is needed

Sustainability-(tightly)-linked Green, Social and Sustainable Financing

Explosion of sustainable financing: long on financing, short on sustainability, long on promise, short on impact. And this growth is not only in volume but also in modalities, now covering the whole spectrum from credit facilities and credit lines to bonds, to equity and securitizations.

In the rush to issue and particularly to refinance old liabilities in a favorable market (*greeninum* is still positive, strong demand for socially responsible investors, and being fashionable?), many issuers are engaging in structures with little or no impact on the sustainability they are supposed to foster. Many take advantage of the loopholes in the existing Principles. The discussion of the sustainable finance market is driven and dominated by intermediaries, which have an interest in volume. And there is an implicit assumption that volume means impact, and there can be a very wide gap.

Limitations of the current structures

Most of the limitations derive from the existing principles that govern those issues, in particular from the most used ones, the International Capital Markets Association Principles, ICMA, (an industry association) for Green, Social and Sustainability bonds, GSSB and for Sustainability-linked bonds, SLB (Principles for the corresponding loans have been developed by the Loan Syndications and Trading Association, LSTA).

The Principles for GSSB establish that the funds raised must be used in projects that have sustainability contributions, but the typology of investments is open, and the magnitude of the contribution is not specified. They must report on inputs and outputs (amounts invested in which project or activity), which then become the goals, but not on outcomes or impacts (changes achieved that make the world more sustainable), whose achievement would have necessitated changes in the design of the projects.

The Principles for SLB do require a linkage between the issue and some sustainability goals, but the use of the funds and the significance of the goals are not specified; could be something trivial compared to the sustainability impact of the issuer. In general, the achievement of the stated goals is either penalized of rewarded through the cost of the issue, which could, again, be trivial or significant.

Neither of the two set of principles address the sustainability of the issuer, nor the significance of the impact, nor the additionality of the resources, only address the typology of the investments (GSSBs) or the nature of the goals (SLBs). Granted, responsible issuers will go beyond the strict requirement of the principles and concern themselves with the magnitude of the impact.

The framework that guides the issues (not legally binding, and non-compliance may only have an impact of the issuer's reputation) is verified by an independent institution, normally a consultancy, that produces the "Second Opinion", regarding the compliance with the principles, but do not address the significance of the goals, the resources used to achieve them, the significance of the impact and the overall sustainability of the issuer. This can lead to either greenwashing or to a reduced impact on sustainability, or both.

Additionality and impact

From the point of view of sustainability, the issue is not only what is sustainability (eligible items), but what is the impact of the financing and its additionality, i.e., the improvements that they make. Some issuers use the resources to finance or refinance their regular activities, imputing to the issue, ex post, those that are eligible to comply with the principles, with little or no additionality.

So far, the demand side shows little concern for these issues. Many are content with having in their portfolio something that is labelled as responsible assets. And the supply side is pleased with having that market willing to buy. The facilitating industry is content with increasing volumes, and the promoters of the sustainable finance statistics are happy to "increment" the tally, even if there is no incremental impact.

There is a conflict of interest between this industry and societal needs and an implicit collusion between issuers, lenders, investors aided and abetted by the sustainability industry.

A tighter modality

What is needed is an instrument that captures the advantages and minimizes the limitations of the two existing modalities. We propose Sustainability-linked Green, Social or Sustainability bonds (or facilities, or credit lines, or loans, or notes, or equity), SL-GSSB. These instruments would follow the **following "additional" principles**:

- **Sustainability goals must be significant**, commensurate with the issuer's social and environmental impact.
- **Significant portion must be used in achieving those goals,** even if resources can be for general use,
- **Significant impact over the *status quo*, i.e, additionality**.
- **Significant issuer's overall sustainability**.

The way ahead

The system of Principles and reporting will have to include a workable definition and requirements of what are (1) "significant" sustainability goals to be achieved; (2) "significant" use of the resources raised in achieving those goals; (3) significant impact; and (4) the overall sustainability of the issuer (for instance, a minimum rating average of 5 major raters), not only of the goals.

The issuers of Second Opinions and reports should analyze these issues and state their opinion on all three, maybe including a rating for each (beyond light and dark green!). This will require changing the "second opinion" to a "verification" of the material compliance with the "significant" principles above. The current system is akin to the limited assurance of sustainability reports, which are passive ("nothing has been called to our attention that …") and must be "significantly" more proactive and express a judgement. They must include a judgement.

As this modality is implemented it may evolve to include sustainability covenants on the bonds that go beyond the penalties and rewards.

But the coordinated action of all responsible investors is fundamental, not just of some of them. Eventually many asset managers will be unmasked, as is already happening with some companies and financial instruments, especially when the Sustainable Finance Disclosure Regulation of the European Union (Green Taxonomy already in effect) and eventually a similar one in the USA are implemented (in the US, the emphasis is on the E in ESG", with the EU using the unfortunate denomination "green" even if it includes some social issues).

But all of this is easier said than done. There are significant vested interests in the *status quo*, in both the issuers, that can access the market, and the sustainability industry (asset managers, raters, collectors and aggregators of information, second opinion institutions, consultants, promoters of sustainable finance, among others) that profit from it.

Opposition of the industry is to be expected to such an instrument, as the implementation of this financing modality could lead to a reduction in the volume of these instruments, but they would certainly enhance their impact. While it may not achieve universal application, any use will an improvement over the *status quo*.

As such, the intervention of regulatory agencies is urgently needed to force the disclosure of the relationship between intent and impact, not just seeking standardization.

It is unlikely that the two traditional modalities will cease to exist, but at least the SL-GSSBs can create a submarket for really socially responsible instruments, issuers, investors and asset managers, hopefully not just a niche market.

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