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Companies Going Green Should Add Finance To Sustainability Strategies

As the climate crisis gathers pace, many companies are building sustainability plans around measures such as switching to renewable energy sources, discontinuing single-use plastic or reducing water usage.

The operational side is, of course, vital. Companies large and small must take a serious look not only at how they contribute to environmental damage but also at how they will be impacted by the changing climate. That involves evaluating the physical risks to operations, markets and supply chains, along with the transition risks of moving toward a low-carbon economy in terms of new regulations or greater restrictions on water or land use.

In addition, climate change fundamentally alters corporate assets, and companies must understand their potential exposure to stranded assets as well as determine how to value their companies in terms of future income statements, balance sheet and cash flows.

But companies with a long-term view should also pay attention to a less visible but still important piece of the sustainability puzzle: finance. That's because climate impacts finance, as it alters companies' fundamentals, with eventual consequences on the financial sector and investors. But finance also impacts climate, whether it's investors demanding credible sustainability strategies or financial institutions creating new instruments with environmental terms built into them.

Green bonds, first issued about 15 years ago, were among the first instruments to emerge. But there's a developing portfolio of green financing options that companies should be aware of, and those include:

· **Green bonds or loans**, whose structure is essentially identical to other bonds or loans, except that they commit the issuer/borrower to using the funds for green projects, assets or business activities.

· **Sustainability-linked bonds and loans**, whose coupons or rates are contingent on the accomplishment of a predefined environmental, social and governance (ESG) goal.

· **Transition bonds**, debt securities issued by "brown" industries with high greenhouse gas emissions, to raise capital to fund the shift to greener activities and thereby become less brown.

· **Project finance**, which involves setting up an off-balance sheet item and shifting corporate investments to a special purpose vehicle (SPV) and is an increasingly important source of funds for renewables and other environment-related projects.

· **Supply chain financing,** which involves linking the supplier's payment terms to the achievement of agreed-upon sustainability standards and performance.

Opportunities and Challenges of Green Finance

Green finance is an opportunity, both for companies and for financial institutions. Companies that green their finances are showing a commitment to their own longevity, and are responding to demands from stakeholders including consumers, bondholders, regulators and investors. It is also an opportunity to mobilize the organization internally, due to KPIs that have been committed to externally (to markets, banks, or investors).

And financial institutions have the opportunity to develop and offer these instruments. According to a report by Moody's credit agency, the global issuance of green, social, sustainability and sustainability-linked bonds will grow by 10% in 2023 from 2022 to approximately $950 billion. Of that, green bonds are expected to represent the lion's share, at $550 billion.

That's slightly lower than in 2021, which saw a record $1.05 trillion of issuance. The decline from the historic high is partly because of the macroeconomic situation but also because companies are facing increasing scrutiny over greenwashing. Green finance is not a marketing ploy, and companies must demonstrably complete specific climate projects or achieve specified goals – or face financial consequences.

This raises another important issue that has dogged climate finance as well as other sustainability-related arenas. There is an urgent need for global standards on metrics and accounting and disclosure, in order for sustainability to be as transparent as possible.

Accounting standards and contingent loan rates may seem less appealing to companies than social media-friendly announcements of recycled glass coffee cups. But companies looking to be truly green shouldn't ignore the grey world of finance.

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