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The Future of Sustainable Finance in Russia and the CIS

Considerations for companies seeking to leverage sustainable finance in Russia and the CIS.

Environmental, social, and governance (ESG) and sustainable finance became a more pressing issue in Russia and the Commonwealth of Independent States (CIS) in 2019. However, the spread of sustainable finance in the region is still relatively limited compared with other regions around the world. This *Client Alert* analyses the growing global focus on sustainable financing, and forecasts two key trends in sustainable finance in Russia and the CIS in 2020 and beyond.

A Critical Tool in the Global Climate Change Fight

International efforts to combat climate change intensified in 2019, as it became widely acknowledged that the global community had fallen well behind the key targets and goals set under agreements such as the Paris Climate Agreement and the United Nations' 2030 Agenda and Sustainable Development Goals. The scale of the problem is immense: the Economist Intelligence Unit has claimed that, on current trends, climate change will cost approximately 3% of global GDP by 2050,[1] and the UN Intergovernmental Panel on Climate Change has calculated that, to reach a 1.5°C world, the average annual investment in transitioning the global energy system to reduce greenhouse gas emissions needs to be approximately US$2.4 trillion between 2016 and 2035. This figure represents around 2.5% of global GDP, and annual investment in low-carbon energy technologies and energy efficiency needs to be increased by roughly a factor of five by 2050, compared with 2015.[2] Accordingly, a wide variety of parties — including governments, non-governmental organisations, regulators, investors, and consumers — have increased their focus on the role of business and industry in climate change, demanding further progress in corporate ESG policies and processes. This momentum likely will continue to build in 2020 and beyond.

Given the size of the investment required to combat climate change, sustainable financing is increasingly acknowledged as a critical tool to enable businesses to transition to a sustainable future. Sustainable finance is generally understood to include financings connected to the issuer/borrower's impact on ESG, sustainability, or sustainable development. The investment community — including both mainstream institutional investors and specialist ESG investors — has reacted to this increased attention: according to the Climate Bonds Initiative, investors with approximately US$45 trillion of assets under management have publicly committed to climate and responsible investment, and this figure looks likely to increase. For example, in December 2019, investment manager PIMCO launched the PIMCO Climate Bond Fund, its first fund dedicated to investments linked to combatting climate change, with a remit to invest in green bonds and in other bonds demonstrating an innovative approach to sustainability (such as transition bonds and sustainability-linked bonds — see below). Further, in January 2020, the world's largest asset manager, BlackRock, joined the world's largest global investor initiative, the Climate Action 100+, the mission of which is to engage with corporates to reduce greenhouse gas emissions.

Global Trends in Sustainable Finance

Growth of the Green Bond Market

As the key sustainable finance product, issuances of green bonds have grown exponentially in recent years, from approximately US$10 billion in 2013 to approximately US$270 billion in 2019. Investor demand for green bonds has soared — for example, the ICE BAML Green Bond Index[3] expanded from US$55 billion in 2015 to US$345 billion at 31 October 2019. This demand comes not only from specialist ESG funds, but also mainstream institutional funds that are either required to or choose to allocate a percentage of their capital for green investments. However, in addition to pure access to capital, issuers have used green bonds to develop their ESG story and communicate it to the market. This consideration has become too important for any company to ignore as equity investors, regulators, consumers, and suppliers (amongst others) all pay increasing attention to ESG and sustainability models and performance — even credit rating agencies have announced more express incorporation of ESG criteria as part of their credit ratings decision-making.[4]

Regulators are trying to ensure that the regulatory infrastructure underpinning the green bond market is sufficient to support continued growth. The EU Green Bond Standard (the GBS, developed as part of the EU's Action Plan on Sustainable Finance) is due to be announced shortly and may, in time, replace the ICMA Green Bond Principles as the market standard framework for green bond issuances, particularly in the European market. There have also been preliminary suggestions that the EU favours the introduction of amendments to the Prospectus Regulation to create specific disclosure requirements for green bonds. Green bond stock exchange segments/sectors have also proliferated to provide additional visibility and support for green bonds.[5]

Diversification of New Sustainable Finance Products

A potentially even more significant advancement in the sustainable bond market during 2019 was the emergence of a new product: the "transition" bond. The development of the transition bond, most vocally championed in 2019 by the asset manager AXA, including through its creation of the Transitional Bond Guidelines (based on the Green Bond Principles), has been driven by the general realisation that support for green projects alone will not be sufficient to achieve international climate change and sustainability targets. Transition bonds work on the principle that, arguably, the aggregate environmental "benefit" of supporting the numerous companies looking to reduce (but not necessarily eliminate) their carbon footprint and transition to greener (but not necessarily green) processes and technologies is even greater than the impact of developing wind, solar, and other typical green projects and technologies. The actions and projects required to support such transitions often do not qualify as green, but nevertheless have an outsize impact through the reduction of emissions or other environmental damage.

Further, in a groundbreaking variation on existing thematic bond models, Italian energy company Enel issued the first sustainability-linked bond in September 2019. In Enel's case, the use of proceeds was not targeted to green projects, but rather the interest coupon was subject to a one-time adjustment depending on whether the issuer achieved a specified sustainability target (renewable energy installed capacity as a percentage of its total installed capacity) by a target date. (See Enel Case Study.) Sustainability-linked bonds have the potential to further broaden and diversify the sustainable finance market by opening the market to companies without a benchmark bond-sized amount of green or transition expenditures. Investors have shown themselves to be increasingly prepared to allocate capital to issuers that have credibly committed to transition to a more sustainable business model, and, with the advent of sustainability-linked bonds, to companies articulating a different type of connection between financing and sustainability.

Sustainability-linked loans (SLLs) — or loans whose interest rate is linked to selected sustainability key targets and/or ESG credit ratings — also continue to develop rapidly, with the global SLL market increasing from US$5 billion in 2017 to US$40 billion in 2018, and exceeding US$120 billion in 2019. With the exception of some bonds, which use the target-linked variable interest rate, SLLs generally take the form of revolving credit facilities that function similarly to any normal general corporate loan. SLLs differ from green loans in that they may be used for general corporate purposes rather than for specified green purposes only, thereby removing pressure on the borrower to find eligible green expenditures to finance. In recognition of the development of the market, several leading industry groups (the Loan Market Association, the Asia Pacific Loan Market Association, and the Loan Syndication and Trading Association) created the Sustainability-Linked Loans Principles in the first half of 2019 to provide a voluntary market standard for SLLs.

Sustainable Finance in Russia and the CIS

There was significant development in ESG and sustainable finance in Russia and the CIS in 2019. The first Russian green bond was issued by Resursosberezhenie KhMAO in December 2018 (for investments in sustainable refuse collection and processing), followed by a €500 million green bond by Russian Railways in May 2019 (for investments in electric passenger trains). The Moscow Stock Exchange launched a sustainable development sector in August 2019, and in November 2019, and the first green bond under such framework was issued by Center-Invest Bank, a lender based in Rostov-on-Don, Russia, to finance and refinance loans for energy-saving initiatives, renewable-energy sources, and green transport. Further, the Central Bank of the Russian Federation recently filed draft amendments to the legal regime for the issuance of securities by Russian companies, which contain certain proposals to formalize green bond issuance requirements. Certain large Russian metals and mining companies also entered into SLLs, including: (i) a bilateral credit line with interest rates linked to the borrower's ESG rating in April 2019, (ii) a sustainability-linked facility in September 2019, with interest coupon levels linked to various ESG targets such as implementing a comprehensive climate management system, reducing fresh water use, and supporting local communities; and (iii) Russia's first sustainability-linked pre-export finance facility in September 2019 (See RUSAL Case Study.) DTEK Renewables issued the first green bond out of Ukraine in November 2019 (for investment in solar and wind power projects in Ukraine). (See DTEK Case Study.) And in Kazakhstan, the Astana International Finance Centre recently launched its Green Finance Centre, which is designed to develop and promote green finance in Kazakhstan. The Green Finance Centre is expected to soon implement a new structural framework for the advancement of green finance in Kazakhstan, which will support the recent adoption of the Green Bond Rules prepared by the Astana International Exchange (AIX).

However, given the size and importance of the region, both in terms of economic output and carbon footprint, the penetration of sustainable finance is still relatively limited, though efforts to address this under-penetration continue.

Key Trends in Russia and the CIS

1. Increase in Green Bond Issuances

Given the growing demand from international investors for green bond investment opportunities, and the pressing need for companies in the region to develop and demonstrate their ESG and sustainability credentials, there could well be a significant increase in the amount of capital raised from green bonds to finance renewable energy and other green projects.

DTEK Renewables Case Study: In a landmark transaction for sustainable finance, climate change, and the energy sector in Ukraine, in November 2019, DTEK Renewables B.V., the leading Ukrainian renewables energy company, issued the first green bond out of Ukraine. The bond was issued in a principal amount of €325 million and listed on the Global Exchange Market of the Irish Stock Exchange, with proceeds to be used (primarily) to finance/re-finance wind and solar power projects in Ukraine. The green bonds were issued in compliance with DTEK Renewables' Green Bond Framework, which is aligned with the Green Bond Principles, and the issuance structure was confirmed by Sustainalytics in their "second-party opinion" provided in respect of the offering. The offering generated significant interest from European and US institutional investors, including specialist ESG and green funds.

2. Development of Innovative Sustainable Finance Products

- **Transition bonds** could be very important for the region, which is dominated by large carbon-intensive oil and gas and metals and mining companies, for whom transitioning to more sustainable processes over time is more realistic than immediately switching to green technologies. Indeed, transition bonds will be of most use to companies operating in such industries, which currently do not have (and for the foreseeable future may continue not to have) sufficient green assets or projects to finance, but do have significant financing needs in order to reduce their greenhouse gas footprint and develop their ESG credentials. From an investor perspective, although not necessarily green, the environmental impact of meaningful reductions in the carbon footprint of such industries represents a huge opportunity. Transition bonds (or similar products under a slightly different label) have already been used by issuers for a variety of not-obviously-green purposes, including:

    - July 2017: US$500 million energy transition bond issued by *Castle Peak Power Company Limited (CAPCO), Hong Kong's main electricity generation company*, to finance the construction of a gas-fired generation unit to replace coal generation

    - February 2019: €500 million climate action bond issued by *Italian oil company Snam*, with proceeds to be used in part to finance investments in bio-methane and energy efficiency projects that would improve the environmental impact of Snam's activities

    - July 2019: US$500 million ESG bond issued by *South Korean steel maker POSCO*, with proceeds to be used in part to develop cleaner production processes

    - August 2019: US$500 million sustainable transition bond, issued by *Marfrig, the world's second largest beef producer*, to finance the purchase of cattle from farms in the Amazon that meet specified best practice conditions

- **Sustainability-linked bonds** may be used by issuers to link the interest coupon on their bonds to specific sustainability targets, thereby moving away from a "use of proceeds" approach to a truly "results-driven" analysis, similar to the SLLs currently seen in the Russian market. This structure should give ESG investors more comfort that issuers are appropriately incentivised to transition to sustainability in a prompt and meaningful way, and may encourage such investors to engage with issuers that are not, and have no prospect in the short term of becoming, truly green.

Enel Case Study: In September 2019, ENEL issued the first sustainability-linked bond in a principal amount of US$1.5 billion. Under the terms and conditions of the bond, Enel could use the proceeds of the issuance for any purposes - including for more than half of its power generating business which is currently not green — but if it fails to hit its set target of increasing its renewable power generation capacity (as a percentage of its total power generation capacity) from 45.9% now to 55% by the end of 2021, it will have to pay 25 basis points of coupon step-up for the remaining life of the bond. Management's reporting of this percentage will be reviewed by Ernst & Young as part of Enel's annual audit review. There was US$4 billion in demand for the bonds and Enel said that the deal had saved it 20 basis points compared to a conventional bond. In October 2019, Enel priced an additional €2.5 billion of sustainability-linked bonds on a similar basis.

- **SLLs** are expected to become increasingly popular as borrowers look to build on the example set by certain large Russian extractive company borrowers in 2019, and opt to commit to specified sustainability targets as a trade-off for having the flexibility to use loan proceeds for non-green purposes.

RUSAL Case Study: In September 2019, RUSAL entered into the first sustainability-linked pre-export finance facility in the Russian market. The proceeds of the facility were used to partly refinance an existing pre-export finance facility (that was neither green nor sustainability-linked), but under the terms of the facility, the margin varies according to the borrower's fulfilment of targets relating to environmental impact and sustainable developments.

- **Green striped bonds,** so named because only a specified portion of bond proceeds must be used for green purposes, may also become more popular, primarily with issuers that have some green expenditure requirements, but not enough to justify the issuance of a green bond in a minimum aggregate amount required for a Eurobond issuance (typically from US$250 million to US$300 million).

Conclusion

Sustainable finance inevitably will develop significantly in Russia/the CIS in the future, given that climate change and ESG are so important and pervasive, and the region is too important in terms of environmental footprint and economic output. In particular, given the heavy focus on fossil fuel intensive energy and extractive industries, transition and/or sustainability-linked bonds/loans may be of particular importance. For assistance in looking more closely at the optionality provided by sustainable finance in Russia and the CIS, please contact one of the authors listed below.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

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Endnotes

1 The Economist Intelligence Unit (2019).

2 The UN Intergovernmental Panel on Climate Change (2018).

3 The ICE BAML Green Bond Index is one of the two main benchmark indexes for green bonds.

4 To exemplify this, the UN PRI established the Credit Risk and Ratings Initiative, which is designed to foster the integration of ESG factors into credit risk analyses on a systematic basis. https://www.unpri.org/investor-tools/fixed-income/credit-ratings.

5 For example, in October 2019, the LSE launched its Green Economy Mark initiative, recognising listed companies with 50% or more of revenues from environmental solutions, and its Sustainable Bond Market, and in November 2019, Euronext launched its new Euronext Green Bonds offering across its six regulated markets (Amsterdam, Brussels, Dublin, Lisbon, London, Oslo, and Paris) as part of its new three-year strategic plan to help accelerate the transition towards sustainable finance.