Environmental and social risk guidance note for bond investments

European Bank for Reconstruction and Development

Introduction

The EBRD recognises the important role of international capital markets and makes strategic investments in a number of ways, including by participating in capital market transactions. This guidance note focuses on the EBRD's environmental and social (E&S) requirements when investing in bonds issued by financial institutions, or issuers such as banks and debt funds.

EBRD investments in bonds

The EBRD has three primary strategies by which it invests in bonds issued by financial institutions such as banks:

- direct investment in **general-purpose bonds** not labelled as green or sustainable under International Capital Markets Association (ICMA)/Climate Bonds Initiative (CBI) principles
  - where the EBRD use of proceeds does not include Green Economy Transition (GET)-eligible activities
  - where the EBRD use of proceeds includes some GET-eligible activities.
- direct investment in **labelled bonds**, such as green, sustainability and sustainability-linked bonds (SLB), in accordance with the ICMA principles, the CBI and/or other international standards widely accepted in the market.
- indirect investment by participating in private debt funds whose investment strategies include some or all of the bond types summarised above.

The scope and depth of E&S due diligence, mitigation and monitoring that is feasible and expected depends largely on the nature of the relationship with the issuer (whether it is a new or existing client) and the type of information that is available to bond investors. This is determined mainly by the investment method used. The main investment methods typically consist of:

- private placements or club deals negotiated directly with the issuer and its advisers
- participation in the public issuance of listed bonds on regulated markets (similar to an auction)
- purchasing existing bonds on the secondary market[1] (the EBRD does not normally consider this, but debt funds investing in bonds may do so).

While this guidance note focuses solely on bonds issued by financial institutions, it is worth noting that the EBRD (and the private debt funds in which it participates) may also invest in corporate bonds (bonds issued by real sector companies) and that similar principles apply in that asset class too.

Because of the wide range of circumstances that may apply, the EBRD will determine its precise requirements under Performance Requirement 9 (PR9)[2] on a case-by-case basis.

The EBRD may also provide non-investment support to financial institutions in relation to labelled bonds. For example, the Bank may provide technical assistance funding to help the financial institution engage consultants to conduct relevant preparatory work, such as market assessments, portfolio and pipeline mapping, and labelled bond framework development. It is recommended that such technical assistance take PR9 and this guidance note into account to ensure the eventual product offering is aligned with the EBRD's Environmental and Social Policy (ESP).[3] Where the EBRD is involved in labelled bond development work via technical assistance, this is always done with explicit "Chinese walls" in place to ensure material non-public information is compartmentalised to prevent conflicts of interest and/or the dissemination of insider information.

E&S requirements for all types of bond issued by financial institutions

The EBRD requires the issuing financial institution to have an environmental and social management system (ESMS) commensurate with the E&S impacts and risks that may be reasonably expected given the use of proceeds, which will normally be clearly defined. The scope of the E&S risk management system must cover all lending products that may be supported under the use of proceeds (for example, small and medium-sized enterprise (SME) lending, corporate lending or project finance).

Relevant E&S risk management policies and procedures must include the following:

- Proceeds must be allocated only to projects that comply with national regulations and standards.
- Proceeds must not be allocated to projects listed on the EBRD's E&S exclusion list or to Category A projects.

In cases where the full list of the above exclusion list is not explicitly mentioned in the client's E&S risk management policies and procedures, the EBRD will engage with the financial institution to obtain confirmation that no such project will be allocated in the use of proceeds for labelled bonds, or towards the share of EBRD investment in general-purpose bonds.

1 A secondary market is a market where investors purchase securities or assets from other investors, rather than from issuing companies themselves. Bonds can be bought and sold on the secondary market after they are issued. While some bonds are traded publicly through exchanges, most trade over-the-counter between large broker-dealers acting on their clients' or their own behalf.

2 See EBRD (2019), p. 44.

3 See EBRD (2019).

Additional E&S requirements for labelled bonds and GET-eligible bonds

In addition to the above requirements, labelled bonds and the GET portion of GET-eligible bonds (irrespective of the GET share and including the multiplier where applicable) must not allocate proceeds to:

- activities listed on the GET exclusion list
- projects associated with the following types of high environmental and social risk or carbon-intensive activity:
    - large dams, large water reservoirs or large hydropower projects associated with potentially significant environmental and social risks and impacts
    - fossil-fuel extraction, transportation and power generation projects (including "clean coal" projects) and energy-efficiency projects associated directly with coal or oil extraction, transportation and power generation
    - liquid biofuel production (pending the adoption of internationally recognised sustainability criteria)
    - large infrastructure and extractive industry projects exposed to considerable environmental and social risks, such as significant resettlement, impacts on critical habitat, impacts on indigenous peoples, significant impacts on local communities or impacts on critical cultural heritage.

This list of non-eligible areas is non-exhaustive and may be adjusted by the EBRD from time to time, however, changes will only apply to newly signed transactions.

Additional guidance for labelled bonds

In addition to the minimum requirements summarised above, the EBRD encourages financial institutions to adhere to the following good practice advice in relation to the E&S risk-management aspects of labelled bond issuance:

- To the extent permissible by relevant securities regulations, issuers and their consultants or advisors are encouraged to engage with the EBRD as early as possible in the structuring process (ideally, before the framework is finalised) to ensure they have a good understanding of the EBRD's requirements in relation to PR9.
- Issuers should regard the applicable ICMA principles and guidelines as a minimum requirement and aim to follow this voluntary and flexible guidance as fully as possible with the aim of being "best in class".
- The EBRD encourages issuers to also consider aligning their bonds' sustainability criteria and reporting with frameworks that complement the ICMA principles by providing additional levels of assurance and transparency, such as the European Union Green Bonds Standard, the Climate Bonds Standard and/or sustainable finance taxonomies adopted by relevant markets.
- Similarly, issuing institutions should indicate clearly what E&S due diligence standards will be applied to loans financed from the use of proceeds, with reference to recognised frameworks such as the EBRD's PRs, International Finance Corporation Performance Standards[4] and the Equator Principles,[5] as well as the Green Loan Principles,[6] Sustainability-Linked Loan Principles[8] and/or Social Loan Principles[7] adopted by the Loan Syndications and Trading Association (LSTA)
- Issuers should strive for best practice in their use of impact indicators for steering and reporting purposes, focusing on outcome-based key performance indicators (KPIs) rather than activity-based KPIs, especially in the case of positive social impact indicators if the bond in question is intended to target such objectives. Any challenges to collecting suitable data should be set out by the issuer, along with any plans to try to improve the availability of this data, where appropriate
- In the absence of clear regulatory or voluntary frameworks to benchmark the quality of second-party opinions (SPOs), issuers should consider ensuring that SPO providers continue to push forward the boundaries of best practice and compete on credibility. Examples of the best practices the EBRD looks for include evidence that the SPO provider has checked the issuer's tracking and monitoring systems and ensured that the issuer has robust E&S risk management policies and procedures in place.

Reporting

Annual environmental and social reporting (AESR)

In all cases, the issuing FI must provide the EBRD with information on an annual basis on the FI's overall environmental and social management system (ESMS) in compliance with PR9 (in addition to PR2 and PR4),[9] including any changes or updates over the reporting period. In most cases, the issuing institution will be a client of the EBRD and such E&S reporting arrangements will already be in place at the institutional level. In the event that the issuing financial institution is not already an EBRD client, so does not already provide an annual E&S report to the EBRD bilaterally, the EBRD will require a side letter agreeing to provide this report (if side letters are permissible). Alternatively, the EBRD must be satisfied that the relevant information is available in the FI's public disclosures, such as an annual sustainability report. See the *Reporting* guidance note in this series for more detail.

In addition to the AESR, additional reporting is required for labelled bonds and bonds with GET-eligible sub-projects, as outlined in Table 1.

4 See IFC (2012).

5 See Equator Principles Association (2020).

6 See LSTA (2023a).

7 See LSTA (2023b).

8 See LSTA (2023c).

9 See EBRD (2019), p.16 and p.23.

Table 1. Annual environmental and social reporting

Labelled bonds	Bonds with GET-eligible sub-projects
Uses-of-proceeds reporting The issuing FI will provide all investors with a clear description of all the project categories[10] to which the labelled bond proceeds have been allocated and their expected impacts, at least once a year and as per ICMA and/or other internationally accepted guidance, starting 12 months after issuance until full allocation is achieved. The EBRD would encourage the issuing FI to provide ex-ante indicative allocation prior to issuance where feasible, noting the actual allocation could include new projects and could differ from the ex-ante indicative allocation. Where confidentiality agreements, competitive considerations, local regulatory environment or a large number of underlying projects limit the amount of detail that can be made available, the information should be presented on an aggregated portfolio basis (for example, percentage allocated to certain project categories).	**Uses-of-proceeds reporting** The issuing FI will provide the EBRD with a list and a clear description of all the projects to which the green portion of the bond proceeds have been allocated and their expected impacts, at least once a year, until the allocation period defined in the policy statement is over. The Bank would encourage the issuing FI to provide an ex-ante indicative allocation prior to issuance where feasible, noting the ex-post allocation could include new projects and could differ from the ex-ante indicative allocation. Where confidentiality agreements, competitive considerations, local regulatory environment or a large number of underlying projects limit the amount of detail that can be made available, the information should be presented on an aggregated portfolio basis (for example, percentage allocated to certain project categories). Use-of-proceeds reporting should follow the reporting template provided to the FI issuer in the policy statement.
Impact reporting The issuing FI should provide the EBRD and other investors with an impact report on the mitigation, adaptation and environmental benefits of the green projects, with the underlying methodology used to estimate the impacts. Alternatively, it should provide sufficient information to estimate their relative positive environmental impact and absolute environmental impact. The impact report should be based on the ICMA Handbook – Harmonized Framework for Impact Reporting. It is typically not available ex-ante because final allocation would not be known by the issuer and is usually disclosed to investors 12 months after the time of issuance. Furthermore, clients should commit to providing sufficient information to estimate the positive environmental impact of the projects and promote a set of environmental KPIs. Clients will have to make the reports (both use-of-proceeds and impact reporting) publicly available to the extent that the local regulatory framework allows. The ex-post impact report should illustrate outcomes (for example, capacity, electricity generation, greenhouse gas (GHG) emission reductions, absolute GHG emissions and so on) achieved as a result of the green projects to which proceeds have been allocated.	**Impact reporting** The issuing FI should provide the EBRD with an impact report on the mitigation, adaptation and environmental benefits of the green projects, with the underlying methodology used to estimate the impacts. Alternatively, it should provide sufficient information to estimate their relative positive environmental impact and absolute environmental impact. The impact report should be based on the reporting template provided to the issuing FI in the policy statement. If an impact report is not available at the time of issuance, the EBRD will require a commitment from the client (via the policy statement) to provide this report. Furthermore, clients should commit to providing sufficient information to estimate the positive environmental impact of the projects and promote a set of environmental KPIs. The ex-post impact report should illustrate outcomes (for example, capacity, electricity generation, greenhouse gas (GHG) emission reductions, absolute GHG emissions and so on) achieved as a result of green projects to which proceeds have been allocated as per the reporting template provided to the issuing FI in the policy statement. Any divergences between ex-ante and ex-post assessments should be analysed in as much detail as possible.

Information disclosure to assist EBRD due diligence

Issuing FIs must ensure they provide the EBRD (and other investors) with sufficient information on their E&S risk management system to enable the Bank to confirm alignment with PR9 and this guidance note. This may be accomplished through publicly available information issued by the financial institution (such as annual reports or similar disclosures, as well as the issuance documentation itself) or, to the extent permissible under relevant securities regulation, through information shared bilaterally with the EBRD (for example in response to an E&S due diligence questionnaire). Where the EBRD identifies material gaps in the E&S risk management system, it will seek to engage with the FI on steps to address these (such as in the case of private placements, where feasible), including via agreement on a formal ESAP if appropriate.

Indirect investment through private debt funds

As noted, the EBRD may also be an indirect investor in financial-sector bonds through participation in specialist investment funds, especially private debt funds. Depending on their specific investment strategy and eligibility criteria, such funds may invest in some or all of the bond types discussed in this guidance note (including labelled bonds) and by methods including private placements, initial bond offerings and secondary market transactions.

In all cases, the EBRD requires such funds to implement E&S policies and procedures that align with PR9 and are designed to ensure that the underlying investments made by the fund conform with the same requirements the EBRD applies when investing in bonds directly. Additional or more detailed requirements will be determined by the EBRD on a fund-by-fund basis, depending on the specific circumstances.

10 Noting that, for FI labelled-bond issuance, the market practice is to report on an aggregated portfolio basis, including, when possible, some case studies of certain projects as illustration.

References

EBRD (2019), *Environmental and Social Policy*, London. Available at: https://www.ebrd.com/news/publications/policies/environmental-and-social-policy-esp.html.

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LSTA (2023a), *Green Loan Principles,* New York. Available at: https://www.lsta.org/content/green-loan-principles/.

LSTA (2023b), *Sustainability-Linked Loan Principles*, New York. Available at: https://www.lsta.org/content/sustainability-linked-loan-principles-sllp/.

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Five Bank Street
London E14 4BG
United Kingdom

www.ebrd.com

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