MAY 2022

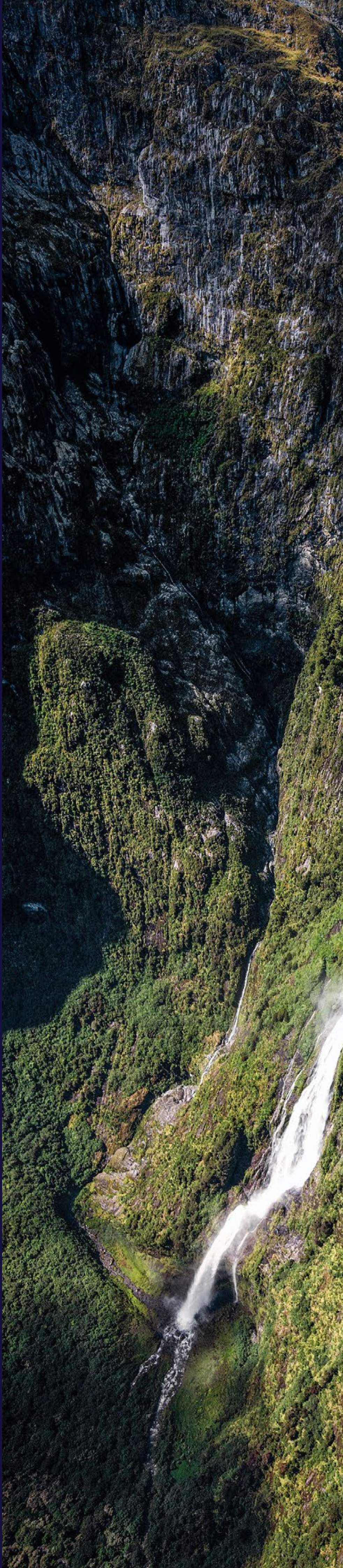
Investing for impact

Sustainable finance in New Zealand

Trends & Insights

chapman tripp

Steady growth off a low base – but about to go up a gear?



Contents

Steady growth off a low base – but about to go up a gear?

Sustainable finance across its various forms – green bonds, sustainability-linked loans, impact investment, responsible or ethical investment – is on a growth trajectory in New Zealand. But other countries are setting a cracking pace, leaving us still in their dust.

The question, explored in this publication, is whether we can turn this around, and what that would take.

Environmental Finance Data reports that sustainable bond issues rose from US$326 billion in 2019, to US$606 billion in 2020, to US$1.03 trillion in 2021 and that they are set to reach US$1.5 trillion this year.

Sustainable bond issuance here over the same three years has hovered at around $2-3 billion, which is not insignificant in a country our size but means we finished 2021 further behind in world rankings than we were in 2017, when we issued our first green bonds.

The position is not as static as this figure would suggest. Over the same period, sustainability-linked bank loans have become more widely-used among New Zealand corporates and are now beginning to rival the bond in popularity. And there are a number of reasons to suggest that demand for sustainable financing options will pick up sharply in the near future.

The Government has a range of direct initiatives, in place or in prospect – including NZ Green Investment Finance, the upcoming Sovereign Green Bond programme, and the Crown Responsible Investment Framework, signed up to last year by the New Zealand Superannuation Fund, ACC, the Government Superannuation Fund and the National Provident Fund.

Then there is the multi-billion dollar spend anticipated in the newly released *New Zealand Infrastructure Strategy 2022 to 2052*. As much of this investment will be dedicated to decarbonising the economy, with a greater emphasis on debt funding, we expect a mix of sustainable bonds and loans to be natural capital raising choices.

In the private sector also there is cause for optimism about the market's immediate growth potential.

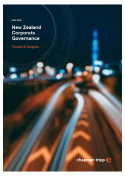
From *Values to Riches 2022*, a report by the Responsible Investment Association of Australasia (RIAA) and Mindful Money, shows continuing strong support for ethical investment among the New Zealand public – a trend we expect will strengthen as the physical effects of climate change intensify, and as the millennials and subsequent generations become more influential in the investment marketplace.

And the latest RIAA annual survey has the proportion of fund managers who have achieved Responsible Investor Leader status almost doubling – which accords with Chapman Tripp's experience that the industry is investing more effort in its ESG (environment, social and governance) policies.

Targeted "impact investment" – being investment made with the intention to generate positive, measurable social and environmental impacts alongside a financial return – continues to grow.

Typically these investments are made at community or local level, and in New Zealand, they are often Māori-led or informed by te ao Māori values. We provide some examples, talk about some of the legal forms available and give our view of possible future developments.

Change requires commitment and resources beyond the State.



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For corporates, ESG is also about to get a big kick-along through the introduction of mandatory climate-related disclosure (a world-first) for listed issuers and large financial/insurance institutions, beginning in financial years on or after 1 January 2023.

The reporting requirements are still being developed by XRB but already it is clear that they will be rigorous and expensive to implement. Our message is that to treat them as a compliance exercise will be to miss an opportunity as – properly implemented – they will provide a useful business resilience tool which can be deployed to manage a range of business risks.

One reason New Zealand has lagged behind other comparable economies, is that we have lacked urgency – so have dawdled while others have dashed. But the effect of climate change and COVID-19, in combination with inflation pressures after years of relative price stability, has put us – and the rest of the world – at a crossroads.

We know the future will be different, we just don't yet know how different and in what ways. We can be sure, however, that there will be a much bigger role for sustainable finance.

It would be a mistake to just settle back and see what happens when a more active response is possible. Elements this might include are:

- commoditising and right-sizing sustainable finance products, so that the majority of our market can access them and participate
- taking a simple and understandable approach to labels and disclosure
- bringing impact investment from the few to the many, including by connecting investment opportunities to traditional distribution networks, and
- taking a clear and consistent path to regulation, focusing on building up participation rather than punishing mistakes.

Luke Ford
Partner

Global sustainable bond issues (USD)

2022
$1.5 trillion

2021
$1.03 trillion

2020
$606 billion

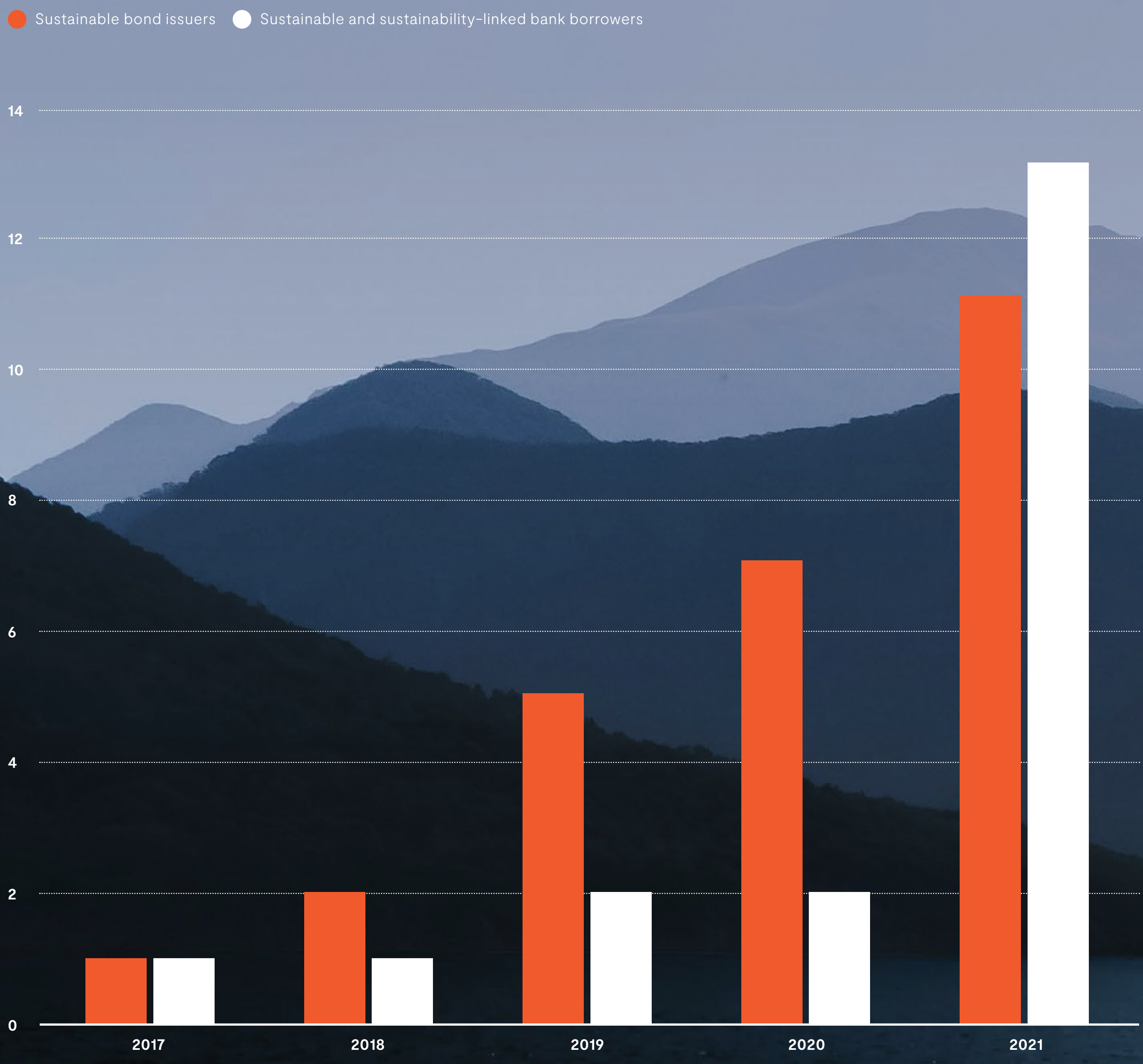
2019
$326 billion

(Environmental Finance Data)

Sustainable finance market by numbers

The sustainable finance market grew steadily through 2021 and seems set to continue that trend this year – but there has been a tectonic shift, with sustainability-linked bank loans now beginning to challenge the dominance of the sustainable bond.

Total number of New Zealand sustainable issuers and borrowers



The first New Zealand sustainability-linked loan (where interest rates are pegged to the achievement of ambitious ESG targets) was entered in 2019, but 2021 was the year the option took off, with 11 new borrowers committing to at least $3.3 billion in loans.

This equalled the total number of New Zealand entities ever to issue a sustainable bond, and the $3.3 billion exceeds the volume of sustainable bonds ever to be issued in a single year.

This growth was not, however, at the expense of sustainable bonds which, from small beginnings in 2017, have made up 19% to 25% of new domestic bond issuances[1] in each of the last three years (excluding tender programmes and Government bonds), and in 2021 had their biggest year ever.

$2.9b

total sustainable bonds issued by New Zealand entities in 2021, the largest year yet.

$3.3b

total committed sustainability-linked bank facilities entered in 2021 (minimum).

1 Excluding tender programmes and government bond issuances. Except as otherwise noted, tables and statistics in this article are sourced from public announcements and KangaNews data. In some cases publicly-available information may not be complete.

Bond issuers

# issuers	Industries represented
5	Electricity
2	Local Government
1	Telecommunications
5	Property/housing
1	Financial Institution

Loan borrowers

# issuers	Industries represented
2	Electricity
1	Local Government
1	Telecommunications
3	Agriculture
2	Transport
2	Aged Care
2	Retail
2	Education

Another big year ahead...

Three new bond issuers have already emerged in 2022 and more heft will be added later in the year with the Crown's Green Bond programme. Apart from the direct increase in sustainable bond volumes this will promote, Sovereign green bonds provide benchmark pricing, liquidity and a 'canary effect' for local issuers so should make New Zealand a more intriguing prospect for international sustainable finance investors.

We have so far relied almost entirely on 'use of proceeds' sustainable bonds (where money raised is earmarked against eligible projects). While this was the experience of other jurisdictions, it has also stifled the diversity which bank borrowing can offer.

Spark's wholesale sustainability-linked bond this year is a sure sign of things to come, but the additional complexity of taking these to retail investors continues to slow supply, showing parallels to our green bond market a few years ago.

Almost all sustainable finance bank loans opt for a sustainability-linked format. For many businesses, a focus on transition and sustainability performance is more feasible than allocating funding to a specific project, backed by the ongoing relationship banks have with their customers that encourages improvement across the board rather than to being the arbiter of what projects a business should undertake.

New Zealand has diverged from international practice in the number of key performance indicators (KPIs) that are typically included in a sustainability-linked loan to determine interest rates changes. **Environmental Finance Data** suggests that the majority of loans internationally have one or two KPIs while here, there will typically be three or more. This may reflect a 'whole of business' approach to improvement, rather than focusing on a single area of concern.

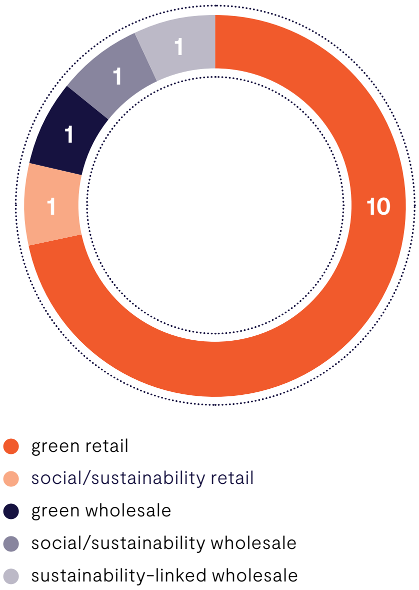
Environmental KPIs are the most common, covering a broad range of areas – from biodiversity to recycling, sustainable sourcing, and water quality. Governance is least represented, as is the case globally.

Expect more activity from the banks

Following 2021's massive increase in uptake, we expect to see banks continue to diversify the number of sectors and borrower types represented in the market. Our economy is highly represented by small and medium enterprises (SMEs), so if banks are to continue the pace they set in 2021, then we expect a focus on making such loans viable on a smaller scale and on a more commoditised basis. BNZ has launched a sustainability-linked loan product for agribusiness customers. Other lenders are sure to follow.

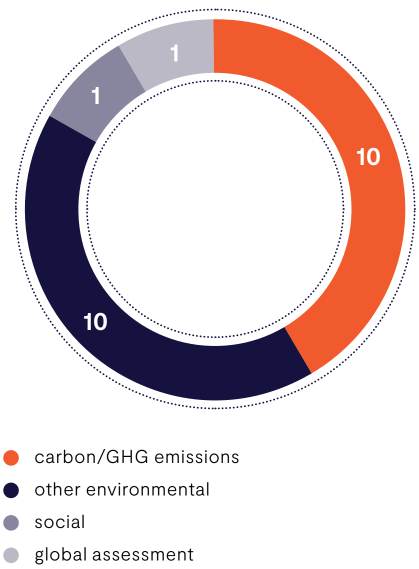
New Zealand sustainable bond issuance formats

(by number of issuer)



New Zealand sustainability -linked loan KPIs

(number of KPIs)



Except as otherwise noted, tables and statistics in this article have been produced based on public announcements and additional KangaNews data. In some cases publicly available information may not be complete.

Green bonds remain the most favoured bond, both in New Zealand and globally.

Impact finance

Impact investment responds to a desire by investors to facilitate solutions to society's persistent problems.

The Global Impact Investing Network (GIIN) defines it as 'investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return'. In Aotearoa, this necessarily incorporates Māori values and perspectives.

Impact investments may be in a range of asset classes and have a range of returns (but at a minimum a return of capital).

Key elements are:

- an intention to have a positive social or environmental impact, and
- a commitment by the investee to measure and report on the impact achieved.

Ideally, they will also provide "additionality" – meaning that they will deliver benefits beyond what would have occurred in the absence of the investment.

Impact investment is of keen (but certainly not exclusive) interest to philanthropic investors and community trusts wishing to use their capital (as well as their grants) to drive positive change in alignment with their mission. As with iwi, these investors can take a longer term view of the impact they seek.

GIIN estimated the size of the global market at US$715 billion assets under management (AUM) in June 2020. Our information on what's happening here, beyond our direct legal experience, comes from:

- the latest **RIAA Benchmark Report**, showing total AUM at $3.3 billion in 2020 (having grown nine-fold since 2018), of which 82% was in green, social, and sustainability bonds and $608 million was 'other' impact investment products
- two impact fund directories (**retail** and **wholesale**), released by Mindful Money in December 2021, both quite slender, indicating that, even after the strong growth reported by RIAA, Aotearoa remains a laggard by international comparison. The wholesale directory listed 10 impact funds – the majority of which had an estimated internal rate of return (IRR) of 6% to 20%, with the rest ranging between 2% and 4.5% IRR, and
- **research** jointly promoted by Philanthropy NZ, the Connective and WEL Energy Trust commenting that a few key philanthropic investors and foundations were the early adopters of impact investment, and philanthropic capital continues to be critical to build the ecosystem. It noted that strong partnerships early in the process, including with Māori, were crucial to success and that further work is required to develop impact management approaches that are relevant in an Aotearoa context.

EXAMPLE

Te Puna Hapori

Sponsored by Trust Waikato and managed by Brightlight, an Australian impact investment firm, this fund will focus on disability housing, affordable rental housing, inclusive retirement housing, healthcare and education property, and water infrastructure. The fund's newest product is the Verdi Social Housing Bond, in which the Generate KiwiSaver scheme has invested.

EXAMPLE

Salvation Army Community Bond

This was a wholesale bond issue and debt raise in 2019 by Community Finance for the Salvation Army to build 118 homes in Royal Oak, Flat Bush and Westgate, Auckland. The bonds were asset-backed debt securities (no credit rating) with a five year term. Return on investment was 2% per annum. The debt was to be repaid via tenants' income-related rent subsidy. The success of this model led to subsequent projects with Habitat for Humanity's CORT (Community of Refuge Trust) and Elim Property Trust education community bond.

EXAMPLE

Te Pai Roa Tika

Māori-owned Te Pai Roa Tika o te Taitokerau focuses on ways to aid the Māori economy in Te Taitokerau. Although still in its early stages, Te Pai Roa Tika operates according to te ao Māori values and principles, including adopting an intergenerational perspective and meaningfully engaging with whānau and hapū to recognise their rights to self-determination.

EXAMPLE

Te Pae ki te Rangi

This is a wholesale impact-first investment fund structured as a limited partnership and sponsored by Foundation North, the community trust serving Tāmaki Makaurau and Te Taitokerau. Investees must meet one of the fund's three objectives (increased equity, social inclusion and regenerative environments), be transformative in their community or sector and have a deep understanding of the outcome they are looking to create. The investment approach is informed by te ao Māori values, in particular the interconnectedness of communities and environment, Whanaungatanga, Mana Motuhake and Toitū Taiao.

> "We see Impact First Investing as a potential solution to a wide array of mahi we are working on such as our commitment to Te Tiriti o Waitangi, our focus on Climate Change, driving a more inclusive and equitable society right through to helping directly with the housing needs across our rohe. We can't do this alone, so we will be looking for partners to help us achieve this. It could not be a better time for collaboration."

Peter Tynan
CEO of Foundation North

Legal form

Impact investments take a variety of legal forms, from simple to complex. The distinctive characteristics of the impact investment sphere – the focus on impactful outcomes, the preparedness of investors to accept slow and/or sub-market returns, and the fact that the State can be the key revenue provider (in a social housing context at least) – create scope for ingenuity which would not be available in conventional financing.

A local example is the adaptation by Community Finance of a securitisation structure to a smaller deal size with fewer independent entities, a single obligor and a single income stream from the Ministry of Housing and Urban Development – income-related rent subsidies and service payments.

Blended finance

To really raise the numbers involved in impact investing, it is necessary to attract more conventional capital flows, like institutional investors. This can be achieved with blended finance strategies.

Blended finance combines capital with different levels of risk appetite to attract market-rate-seeking financing into impact investments. The use of the philanthropic (or catalytic) capital as a lower-cost layer can restructure a formerly unsuitable investment due to risk-adjusted returns into an attractive investment.

This was used in California to finance work to reduce fire risk and water contamination in the Tahoe National Forest. The Californian Forest Resilience Bond, launched by Blue Forest Conservation in 2018, incorporates loans at different rates – 1% for charitable sources and 4% from market, but still 'impact interested', lenders. The beneficiaries, including the US Forest Service, the State of California and Yuba Water Agency, repay the funders over time.

There is also the sovereign 'blue bond' launched by the Seychelles in 2018 to develop a sustainable blue economy in their marine environment, ensuring food security. The interest rate borne by the Government of the Seychelles was discounted by a grant from the World Bank partly guaranteeing the bond and a concessional loan from the Global Environmental Facility.

Where to from here?

We need both public finance and broader investment for climate change mitigation and adaptation, including for nature-based solutions. Existing Government funding lines include Jobs for Nature, Predator Free 2050 and the Green Investment Fund Limited. However, iwi, business and private philanthropy are critical stakeholders and partners in climate finance solutions.

The Aotearoa Pledge launched by Community Finance pledged to raise $100 million of private investment for homes and has achieved almost 75% of that target for projects around Aotearoa in less than a year. We see no signs of this momentum stalling while the numbers on waiting lists for social and transitional housing continue to climb.

We hope that the global success in blending types of finance and applying adapted commercial structures will encourage more ambitious structuring in Aotearoa. We also see the need for teams of advisers with differing skill sets to collaborate across traditional boundaries and transcending traditional fee arrangements.

More support needs to be given to impact entrepreneurs to create their impact and scale up their solutions. This might be funding for capacity building, impact consulting and commercial and professional advisory services. The work of Ākina Foundation in their delivery of the government's impact investment readiness grant programme is a good example of this support.

"More support needs to be given to impact entrepreneurs to create their impact and scale up their solutions."

Phillippa Wilkie
Special Counsel

Te ao Māori values-based investing

Te ao Māori is weaving its way through mainstream Aotearoa through a complex web of developments, some top down but many bottom up.

The elevation of Te Tiriti in political discourse, public policy and private governance, the Aotearoa history curriculum, launched in March, the teaching of tikanga in our law schools, and the burgeoning Māori economy, valued at over $68 billion in 2018, are all changing the way we see ourselves and our relationships with each other and with our environment.

All of this is feeding into the investment sphere. The general trends toward impact investing and ESG principles dovetail neatly with, and are reinforced in the Aotearoa context by, te ao Māori.

In te ao Māori, whānau, hapū and iwi live according to inherent values that underpin and inform all decisions. This includes whanaungatanga (maintaining and strengthening familial and social relationships), manaakitanga (extending care and support), kaitiakitanga (protecting and preserving the environment and resources) and tikanga (laws which govern the correct way to operate).

These values culminate in a forward looking approach that cares and provides for current and future generations.

A Māori approach to investing necessarily incorporates a focus on social and environmental outcomes as well as financial – multiple "bottom lines". For example, iwi may consider whether a particular investment includes opportunities for job creation for its members, evaluate the likely impact of an investment on the environment and on the welfare of their whānau, and take a long-term view.

EXAMPLE

Tahito Investment Fund

Tahito Investment Fund undertakes tikanga-based investing that rewards ethics, genuine care for the community, and long-term investments for intergenerational results. The success of their wholesale fund led to the launch of a retail offering this year.

"We expect this will be a fast-growing area as Māori and non-Māori investors bring a te ao Māori perspective to the use of their capital."

Te Aopare Dewes
Hoa Rangapū (Partner)

New energy around sustainability in funds management

The stand-out result in the Responsible Investment Association of Australasia's (RIAA's) benchmark report for 2020 is that the assets under management (AUM) of "Responsible Investment Leaders" increased 28% over the year against an overall increase of just 11% in total AUM.

To be a Responsible Investment Leader (RI), survey respondents must get at least 15 out of a possible 20 on RIAA's Responsible Investment Scorecard, and the number who achieved this almost doubled in 2020 – from around a quarter of all fund managers that had self-declared as practising RI to around a half.

Which means that, although various surveys have shown there is a strong interest among New Zealanders in ethical investment, the main driver in this case seems to have been an increasing commitment to RI within the industry, rather than consumer choice.

This accords with Chapman Tripp's experience, which is that fund managers are investing more effort into their ESG policies and strengthening them by making them more transparent and more prescriptive where in the past, they might have given themselves more flex.

This new focus is scarcely surprising given the context.

RI is like a train hurtling down the track and gathering speed as it goes, leaving those in its path with two choices – jump on board or jump out of the way. All the trends are in the same direction and can be expected to intensify.

As the weather effects of climate change become more evident, and as the millennial and post-millennial generations become more influential in the investment sphere, both as consumers and as providers – we can expect an increasing emphasis on sustainability.

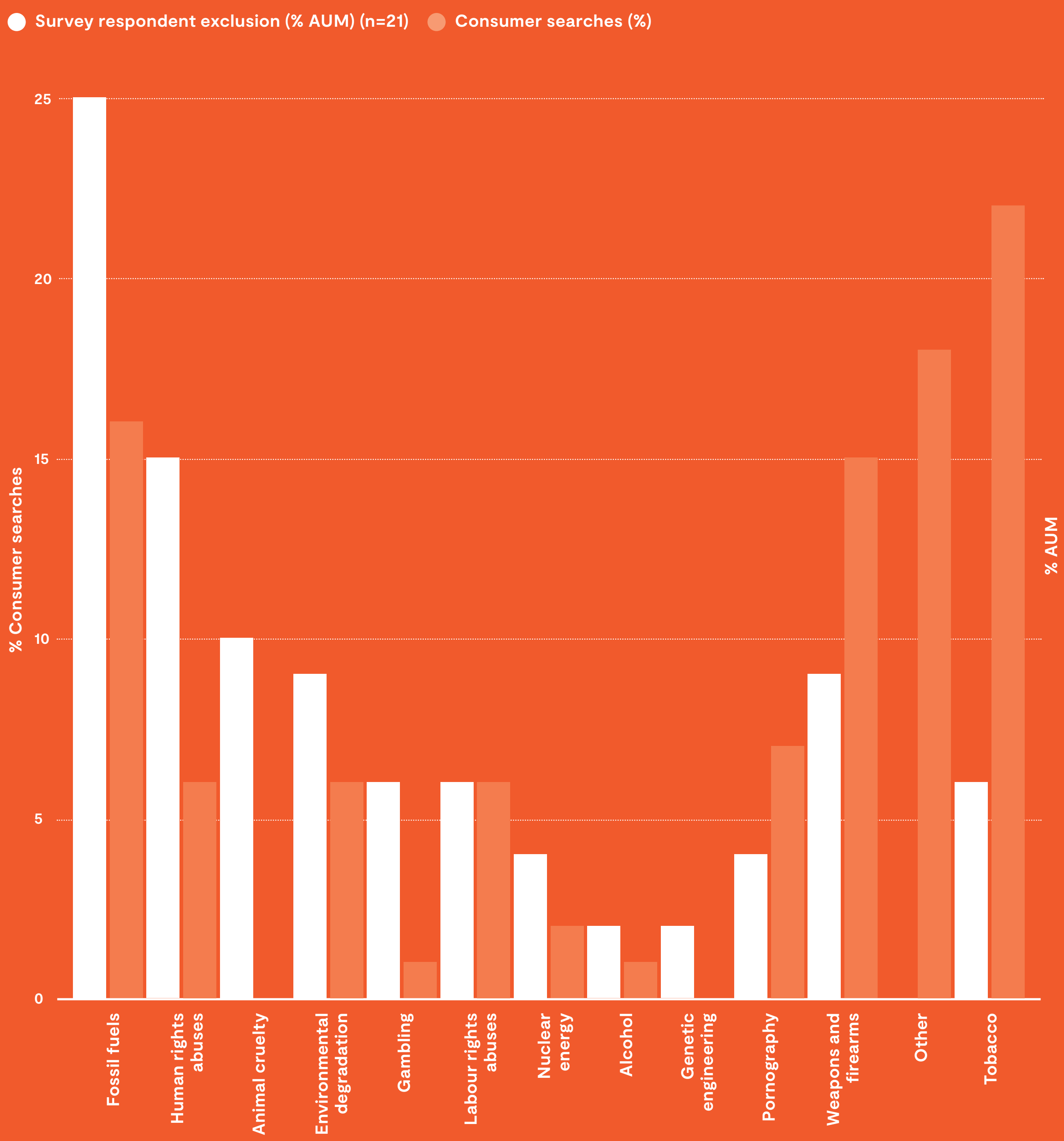
This will flow through to the regulatory environment, which has become conspicuously more insistent around these issues in recent years, and will become more demanding still as politicians seek to deliver on their emissions reductions targets and to reflect voter sentiment.

Interventions in the last couple of years include:

- an updated **ESG Guidance Note** from NZX
- a new **disclosure framework** for integrated financial products (being products which incorporate a non-financial element) from the Financial Markets Authority (FMA) and more general comments on **ethical investing**
- a **Letter of Expectations** from the Minister of Finance to all Crown financial institutions requiring that they "maintain robust ethical investment policies which are reviewed regularly and reflect best practice standards, both in New Zealand and internationally"
- the new criteria for KiwiSaver default providers, which ban investments in fossil fuels or illegal weapons, and
- the Financial Sector (Climate-related Disclosure and Other Matters) Amendment Act, which received Royal Assent in October last year and will come into effect this financial year. XRB is currently developing the associated standards.

> "Responsible Investment Leaders demonstrate strong collaborative stewardship and consider ESG factors explicitly and systematically in the valuation of assets, construction of portfolios and allocation of capital. They are decidedly transparent, reporting publicly on their activities to improve environmental and social sustainability, and increasingly striving to do the same on the outcomes they achieve."
>
> **Responsible Investment Association Australasia**

Exclusion categories of survey respondents (% AUM) compared to consumer searches for exclusions on RIAA's Responsible Return online tool



Note:
Weapons and firearms includes armaments and controversial weapons manufacturing; 'Other' category includes recreational cannabis, anti-corruption and Sudan divestments; and tobacco includes tobacco growing and production.

Overview of the 2020 Research Universe and the New Zealand responsible investment market

$328b
Total Funds Under Management (RBNZ)

$221b
Research Universe (n=47)

Survey respondents (n=21) & **Desktop research** (n=26)

$142b
Responsible Investment Leaders / Responsible Investment AUM (n=20)

Responsible Investment AUM includes only the responsibility managed assets of Responsible Investment Leaders. Responsible Investment Leaders are responsible investment managers that achieved a score or ≥75% (at least 15 out of 20) in RIAA's Responsible Investment Scorecard.

The **Research Universe** is the 47 investment managers that have self-declared as practicing responsible investment.

Total Funds Under Management is $328 billion according to the Reserve Bank of New Zealand (RBNZ) and other sources.

Where to from here?

In addition to the above, we are aware of several initiatives in New Zealand which may have a wider influence on the investment sector.

It's early days yet, but the investment community is developing a "Stewardship Code" for New Zealand. This was a key investor governance recommendation from the Sustainable Finance Forum's Roadmap for Action, published in November 2020.

Stewardship in this context is about how investors preserve and enhance long-term value as part of their (responsible) investment approach. The Code would be a principles-based framework, setting out how investors, including asset owners, fund managers and financial intermediaries, can achieve this.

The Code is expected to enhance and support existing legal obligations by bringing together wide-ranging stewardship expectations into one place. It will bring New Zealand more into step with global convention and international practice, including jurisdictions such as the UK and Australia.

Also, ACC, the New Zealand Superannuation Fund, the Government Superannuation Fund and the National Provident Fund last year signed up to a Crown Responsible Investment Framework that commits them to aligning their portfolios (collective value more than $100 billion) with a net zero emissions economy by 2050 or earlier.

The NZ Super Fund has for many years taken a leadership role on RI and seems intent to keep the pressure on.

- It flagged, via an **interview** with *AsianInvestor* this year, that it expects all fund managers it employs in Asia to be able to demonstrate best practice ESG standards within five years.
- It is currently working on a "reset" of its responsible investment strategy to reflect evolving thinking and increased external standards and expectations. This includes discussion of the continued evolution to a sustainable financial system.

Should these developments proceed and be widely taken up, they suggest that sector participants can look forward to increased prescription and accountability and to progressively escalating performance requirements.

"It's early days yet, but the investment community is developing a "Stewardship Code" for New Zealand. This was a key investor governance recommendation from the Sustainable Finance Forum's Roadmap for Action, published in November 2020."

Penny Sheerin
Partner

Case study

Turning investment returns into a force for good

More than 40 million people are enslaved worldwide – many working without pay, trafficked into commercial sex, and forced into unwanted marriages. For all of them, it means a life without freedom.

The Nikko AM Freedom Fund is targeted to "dormant savings" earning little or no interest and gives investors and all involved an opportunity to turn this passivity into a force for good. Established by Nikko Asset Management New Zealand Ltd in September 2021, as at 31 March 2022 it had a value of around $415,000.

Rather than generating income for the investor, 100% of the pooled returns from the Fund and all of the management fee charged by Nikko AM is donated directly to Tearfund NZ, for use in its work to combat human trafficking and modern slavery.

The donations are made monthly, with a final year end wash-up payment, so all eligible investment returns are fully paid to the charity each year. Investors receive quarterly updates on what has been achieved with the donations.

The innovative product structure enables investment returns to be paid to Tearfund NZ gross of tax, which is more efficient for the charity than donating the money from post-tax returns. There are no charges or expenses recovered in the Fund, as all service providers agreed to assist at no cost.

Investors retain full ownership of their capital and can request a full or partial return of their investment at any time.

> "Traditionally, charitable financial support has relied solely on people or businesses giving their money away. With the Freedom Fund, what we're offering is to employ our investment expertise so that capital, which is otherwise potentially sitting idle, can be used to create income to help fight modern slavery and trafficking. This is a new option for people to support this essential work, while still being able to access their money at any time".

George Carter
Nikko AM NZ Managing Director

The Fund's product disclosure statement is available here

Nikko AM NZ is a wholly owned subsidiary of Nikko Asset Management Co., Ltd, headquartered in Tokyo, Japan. Nikko AM is a dedicated global asset manager with investment professionals across the world's major financial centres. Chapman Tripp is proud to have worked with Nikko AM to assist with bringing the Fund to market.

ESG a moving target

NZX noted in its updated **ESG Guidance Note** on 10 December 2020 that there was no "definitive list" of ESG issues anywhere and that, had one been developed, it would soon go out of date.

A running example of this is the rethink which has been provoked in the EU by the Russian invasion of Ukraine and the need to strengthen Ukraine's defence capability.

"What a difference a war makes", the Financial Times reported on 9 March, noting that Swedish bank SEB had reversed a blanket prohibition, adopted barely a year ago, on investing in defence stocks and that plans by the EU to classify the defence industry as socially harmful had been ditched in the **Final Report on Social Taxonomy**, published in February 2022.

Further indicative of a change in position is that the EU has since released a policy paper, which underlines the importance of ensuring that initiatives in sustainable finance remain consistent with EU efforts to ensure that the defence sector can access sufficient finance and investment.

Whether out of disgust at Russia's aggression, or simply to avoid any presumption that they might support the attack, many corporates have scaled back or cut ties with Russia.

Among them, according to the CBS News list, are: BP, Equinor (Norway's biggest energy company), ExxonMobil, Shell, Airbus, Boeing, Daimler Truck, Ferrari, Ford Motor Company, Harley-Davidson, Mercedes-Benz, Renault, Toyota, Volkswagen, Volvo, Adidas, Nike, Puma, Airbnb, Disney, Estée Lauder, Ikea, General Electric, McDonalds, Nestle, Unilever, Goldman Sachs, JP Morgan, Moody's, Visa, Mastercard, American Express, Fedex, UPS, Alphabet, Apple, Dell, Trimble and TikTok.

New Zealand businesses to disengage from Russia include Fonterra, Xero, Mainfreight and Sanford.

Mindful Money has been tracking retail investment fund providers.

As at September 2021, 35 had divested or were in the process of divesting at least one of their funds that contained investments in Russian Government bonds or companies aligned with the Putin regime. These were the ones that did their risk analysis early, divesting before the Russian troops actually invaded.

Mindful Money founder, Barry Coates, says those that waited until the invasion occurred paid a price for their inaction – losing more than 90% of their investment in many cases.

NZX's Guidance Note can be viewed here

The Final Report on Social Taxonomy can be downloaded here

Guide to issuing a sustainable bond

The bond market creates a direct connection between corporates and public stakeholders, providing significant opportunities to build reputation, engagement and a strong investor base that is willing to lend money for six to 10 years – or more.

These benefits multiply for sustainable bonds where investors buy into a company's long-term sustainability strategies as well as its credit risk.

Sustainability considerations are commonly raised at New Zealand investor presentations for both sustainable and conventional bonds, as the New Zealand market starts to replicate trends already well-established internationally.

Luke Ford
Partner

Emma Sutcliffe
Partner

EXAMPLE

Kāinga Ora

Kāinga Ora – Homes and Communities was the first sustainability bond issuer, and is the largest, in New Zealand. Its wellbeing bonds have been offered to wholesale investors around the world since 2018.

"Many of our international investors review our sustainability reports in detail and engage with technical, science-based questions. We are starting to see more and more from local investors as well. This active engagement has given us a real opportunity to tell the message of what Kāinga Ora is delivering to New Zealand."

Jason Bligh
Kāinga Ora Treasurer

EXAMPLE

Mercury NZ

Mercury NZ issued its first retail green bond in 2020 and in late 2021 became the first New Zealand corporate to issue green bonds in the Australian (AMTN) market.

"We had good engagement from investors on all of our sustainability issuances. In the Australian offer, investors really focused on the impact those bonds were going to have, and provided great feedback that will help shape our future reporting."

Geoff Smits
Mercury NZ Acting Treasury Manager

Five key tips for issuing a sustainable bond

01

Know your messaging

It is vital to determine an overarching sustainability message and to act consistently with that – bond financing should be linked to the business' core outcomes and assets. Meeting technical requirements is only one aspect that investors will focus on. Of equal importance is a clear and authentic strategy that can be conveyed to investors, demonstrating a step-change in behaviours.

02

Identify your eligible assets

Almost all sustainable bonds in New Zealand adopt a 'use of proceeds' structure, earmarked to eligible assets or projects that meet sustainability criteria. The extent of your existing assets and future asset plans determines what options are available (or whether transition-based financing may be more suitable, as discussed below). For example: Do you have enough eligible assets to reclassify existing bonds as sustainable? Will you rely on eligible projects that are undertaken by a subsidiary, or are at risk of sale?

03

Choose a bond structure – use of proceeds or transition-based

For many issuers, 'use of proceeds' sustainable bonds will be viable only for a small portion of their funding needs. Alternatives are emerging that can be used as part of a transition to a more sustainable business. These include both sustainability-linked bonds (similar to sustainability-linked loans) and new transition bonds, where proceeds are earmarked for a project designed to assist transition.

04

Choose sustainability criteria and verification process

Sustainability criteria and standards should be chosen to provide confidence to investors. Specific technical criteria may be available (such as those published by the Climate Bond Initiative) but these will not be relevant in every circumstance or may not be appropriate for use in New Zealand. In those cases more general standards (such as the Green Bond Principles) may be a better fit. In all cases appropriate external verification should be arranged.

05

Emphasise clear disclosure and reporting

Offer disclosure should be carefully drafted to ensure it is not misleading and does not overstate the potential impact of the bonds. Ongoing reporting against sustainability metrics is at least as important and should be treated as such – reflecting that investors are looking for both financial and non-financial returns from these instruments. Establishing strong internal infrastructure to collect and present relevant data is vital.

Guide to taking out a sustainability-linked loan

The great appeal of sustainability-linked loans (SLLs) is their flexibility. They can be used by businesses in any sector to incentivise business-wide sustainability improvements.

Lower relative margins will be applied to interest costs where meaningful and ambitious targets, agreed in advance by the borrower and the lender, are achieved (conversely, margins can also go up where those targets are not achieved).

The change in margin can be relatively small. However, much of the benefit of an SLL comes from having financing that aligns with the borrower's overall sustainability strategy – providing a clear financial incentive to achieve those objectives and enabling business to better demonstrate to their stakeholders that sustainability is a priority.

Cathryn Barber
Partner

Gerard Souness
Partner

In New Zealand, the targets generally encompass two to four specific ESG (environmental, social and governance) objectives and measures. While the lender will have input into the design, ultimately the borrower must determine targets that make sense for its particular business.

Targets need to be based on the issues identified in the sustainability strategy, the robustness of data available, and the level of improvements that are possible based on past and industry wide performance, science and benchmarks. Even if a business is not considering an SLL immediately, establishing a sustainability strategy now and capturing data will prove a significant advantage when the time comes.

EXAMPLE

KMD Brands

KMD Brands committed to its first SLL in 2021, targeting the group's greenhouse-gas emissions including science-based targets, achieving B Corp certification across the group, and increasing accountability of suppliers in its supply chain to the KMD Brands Code of Conduct. KMD Brands has been preparing sustainability reports since 2012.

"We developed our sustainability strategy from our own materiality assessment, which allowed us to identify and target industry-wide problems in the apparel sector, and to clearly demonstrate to our lenders appropriately ambitious targets across the term of the loan."

Frances Blundell
KMD Brands General Manager ESG and Company Secretary

Five key tips for taking out a sustainability-linked loan

01

Establish your sustainability strategy

The flexibility of an SLL means that the targets will look different for every borrower. There is no standard format, domestically or globally. Each SLL needs to be designed to complement the borrower's sustainability strategy and its industry context, rather than the strategy being built around an SLL. Getting your strategy locked in and obtaining assurance on key non-financial metrics and baselines will clear the path forward.

02

Select your KPIs and SPTs

Key performance indicators (KPIs) must reflect meaningful issues confronting the business or its sector (such as reducing greenhouse gas emissions) and are generally a combination of social and environmental indicators. Sustainability performance targets (SPTs) set how achievement of these KPIs will be measured (such as reducing CO_2 emissions below a certain level).

Borrowers should consider the extent to which meeting those targets is within their control, including how integrated into the business those sustainability goals are. Lenders will need to be comfortable that the SPTs are sufficiently ambitious, based on the business' history or other metrics, and are capable of being externally verified through audit processes.

03

Ensure you understand the SLL provisions in the loan

Whether a SPT is achieved should affect the margin (and potentially fees) on the loan but should not cause a standard loan default or review event (reflecting that the targets should be ambitious). Other matters, however, such as a failure to report, will typically give rise to other consequences – which can include an obligation to make a public statement in relation to the non-compliance. It is important to review and understand the obligations on the borrower and what will happen in the event of a breach.

04

Be prepared for public reporting

Public reporting of KPIs and progress towards achievement of SPTs is generally encouraged by lenders, even for private companies. Reporting should be reviewed to ensure it is clear and avoids any overstatement or misleading comments.

05

Set yourself up for the future

It is expected that sustainability-linked mechanics will continue to expand into other products (such as US private placements and aligned hedging) and indeed to set businesses up to issue sustainability-linked bonds. SLLs can be used as an opportunity to test KPIs, embed sustainability governance and establish reporting processes with bank lenders before expanding into other markets.

How to get the best out of the 'E' in ESG

As governments around the world seek to generate action around the emissions reduction targets they have signed up to under the Paris Agreement, climate change has been parachuted out of the 'E' in ESG reporting to a whole new prominence.

Even three years ago, board engagement with climate risk was relatively niche in New Zealand – confined mostly to progressive corporates or those with hefty emissions, either direct or indirect, through their supply chains. Now the issue is top of mind for directors up and down the country.

This change is in part a response to the **Financial Sector (Climate-related Disclosures and Other Matters) Amendment Act**, which will require listed issuers and large financial/insurance institutions to prepare mandatory climate related disclosure (CRD) statements for financial years beginning on or after 1 January 2023.

The CRD requirements to support the legislation, now being developed by XRB, draw on the Task Force on Climate-related Financial Disclosures (TFCD) and International Sustainability Standards Board (ISSB) recommendations, already in wide use internationally.

XRB proposes that climate reporting entities will be required to disclose:

- climate-related risks and opportunities over the short, medium and long term
- their impact on the group's business strategy and financial planning, and
- the resilience of the business model to different climate-related scenarios – including, at a minimum, a 1.5˚C scenario and a greater than 2˚C scenario, the underlying methodologies and assumptions, and the scenario analysis employed.

The standard XRB is proposing is rigorous and will demand a lot of sophisticated work, including, in a few years, assurance of some disclosures, with not a lot of time to build the required internal, or external, capability.

CRD a game-changer

The downside to relying on compulsion to force change is that it may encourage the less motivated in the target audience to see CRD as an expensive compliance exercise. There is no getting around the fact that it involves huge amounts of data – both internal and externally sourced – and it is resource-intensive to implement. That is undoubtedly a message that will come through strongly in submissions to the XRB in the most recent consultation round.

But seeing CRD through a compliance lens would be an opportunity missed. Properly used, it can be a powerful business resilience tool, building skills and perspectives that can be harnessed to other environmental and social concerns, within and beyond the boundaries of ESG.

For example:

- CRD scenario analysis and CRD methods can be used to forecast other relevant regulatory and litigation trends and to anticipate and stress test strategy against changes in law, policy, technology, markets and consumer preferences
- CRD implementation requires cross-team collaboration which can dissolve business silos and foster broader organisational buy-in to risk strategies
- CRD requires that businesses track their progress against specific metrics and targets. This discipline, supported by robust governance feedback loops, can be used to substantiate 'green' actions and to protect the business against greenwashing claims
- the detailed geographic information system (GIS) mapping, required by CRD to assess physical risks to assets from climate change, can promote more efficient management across a business's entire asset stock, and
- the standardisation of reporting methodologies to comply with CRD strengthens the process requirements that inform strong governance practices.

We are already seeing first-hand through our practice how the early adopters have been able to deploy capabilities developed through CRD to manage other risks – e.g., stakeholder management, supply chain disruption, geopolitical risk, technological shifts, and reputational/social licence risks.

See our recent commentary on mandatory climate reporting

More to come

CRD is not an exercise which allows a done-and-dusted mentality. The business strategy developed and refined by CRD has to evolve in response to external factors. These are changing sharply now and will continue to change.

The carbon price in the Emissions Trading Scheme is near historic highs and faces considerable additional changes that will affect the economy-wide cost of climate change mitigation. Other policy interventions are also about to be unloaded through:

- the Government's Emissions Reduction Plan and the first three emissions budgets which will outline greenhouse gas (GHG) emission reduction policy until 2035 – announced 16 May 2022
- the National Adaptation Plan, a **draft** of which was released at the end of April, which will provide guidance to support local government and the business sector "to make effective adaptation decisions" – promised by August 2022, and
- the ongoing Resource Management Act (RMA) reforms.

The RMA changes include amendments passed in 2020, which will commence at the end of November 2022, and allow district and regional councils to make rules in their planning documents around GHG emissions and to consider GHG effects in consenting applications. Those councils which have declared a Climate Emergency or otherwise taken a strong climate change position will be under political pressure to take a strong stance.

The net effect of these developments will be to make the regulatory heavy breathing around climate change a lot heavier, and a lot closer. Executives with robust CRD practices may sleep a little easier knowing that their CRD frameworks will be able to adapt to support effective business decision making throughout that state of change.

CRD and the wider ESG context

The most obvious areas for a CRD type approach in the wider ESG sphere are within other the environmental aspects including:

- the production and management of waste – particularly plastic and construction waste – in an increasingly circular economy
- business impact on biodiversity – both direct and indirectly through domestic and global supply chains, and
- efficiency of energy and resource use. Should the international experience be replicated here, we would expect efficient water and energy use to start looming larger in the corporate and public consciousness.

The 'S' in ESG is more disparate but includes issues that can also lend themselves to CRD-style risk management, such as health and safety practices, geopolitical risk (now at historically high levels), human rights practices (e.g., the recent policy developments related to modern slavery), and tangata whenua relationships (particularly for businesses that are heavily reliant on natural resources).

None of this is to say that CRD practices for non-climate ESG issues will necessarily make their way into public facing annual reports or sustainability statements. But lessons taken from CRD are likely to better inform ESG reporting practices far beyond the legislated climate-related context.

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Our thanks to Patricia Herbert, Paige Thomas, Eru Kapa-Kingi and Amelia Kendall for helping us write this publication.

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