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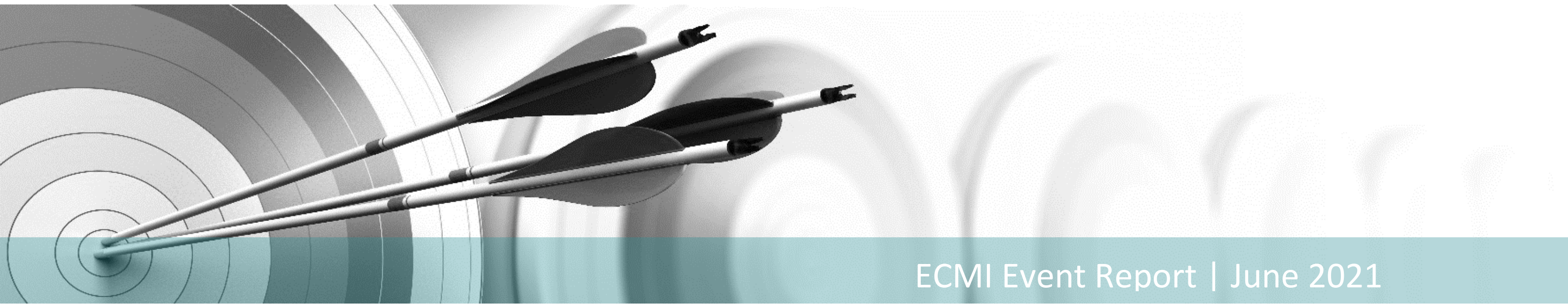

Greening the European Green Bond market

Apostolos Thomadakis*

The green bond market has shown remarkable expansion over the last few years. In 2020, around €236 billion of green bonds were issued globally (+57% compared to 2018), with Germany, France and the Netherlands accounting for a third of them. Green bond fund assets under management are also growing rapidly, although they only represent between 0.1% and 0.2% of total bond fund assets under management.

Several European initiatives, such as the Sustainable Finance Action Plan, the Green Deal, and the Green Bond Principle have already laid the foundations for sustainable finance. The establishment of an EU Green Bond Standard (GBS) – with the Commission's legislative proposal expected in Q2 2021 – aims to provide a common EU framework for the European green bond market. Setting the minimum standards and safeguards for the entire ecosystem (e.g. issuers, investors, banks, and exchanges) requires careful calibration with regards to: the definition of 'green'; reporting; transparency; pre- and post-issuance verification; rating/opinion providers.

- What opportunities is the Covid-19 pandemic creating or has already created for the development of the market for green bonds?
- Does investors' demand for green bonds meet the supply? Is there an impact on the price differential between green and regular bonds?
- How to verify and certify that green bonds remain green throughout their life (i.e. pre- and post-issuance)?
- Is 'green data' reliable and trustworthy? How can the quality be improved? Is there a need for a European data provider?
- How will the GBS affect the volume of green bonds or other sustainability-labelled products (e.g. transition bonds, climate bonds, KPI-linked bonds)?
- How does the EU GBS relate to other green bond standards (e.g. ICMA's Green Bond Principles, Climate Bonds Initiative's Climate Bonds Standard)?

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Speakers:

Axel Fougner, Policy Officer, Asset Management, DG FISMA, European Commission

Cristina Lacaci, Head of Green and Sustainable Bonds, EMEA, Morgan Stanley

Justine Leigh-Bell, Deputy CEO & Director of Market Development, Climate Bonds Initiative

Geert Arlman, Commercial Head of ESG EMEA & Regional Head of Sales, UK, IRE & NL, S&P Global

Moderated by **Karel Lannoo,** CEO of CEPS and General Manager, ECMI

Summary report of the event

Europe's challenge to cut carbon emissions by at least 55% by 2030 will require an estimated €330 billion of energy-related investments (e.g. renewable energy, energy efficient buildings, zero carbon transportation). Green bond markets have the potential to contribute to this ambitious target. Despite the expansion in green bonds over the past six years (an average year-on-year growth of about 50%), green bonds represent only a tiny part of the overall bond market at 1-2%.

More is needed to further develop this market; most importantly – a clear definition of what constitutes green is also needed. The European Commission has tried to address this with the introduction of the Taxonomy. Also necessary is a framework for external reviewers that provide assurance to investors regarding the environmental credentials of green bonds and green bond issuers.

In addition, the Technical Expert Group (TEG) on Sustainable Finance identified several other issues, such as i) the lack of transparency and standardised procedures for evaluating climate-friendly and sustainable investments, ii) the poor quality of reporting and the lack of access to granular green data, and iii) the need to foster long-term investment in sustainable economic activities and mitigate potential conflicts of interest (e.g. between investors and issuers, or between issuers and external reviewers).[1]

To overcome some of the obstacles identified by the TEG and address the absence of a uniform green bond standard within the EU, the European Commission proposes to establish an EU Green Bond Standard (GBS). Currently, the two main green bond standards in the market, and the ones that pioneered and codified the green 'use of proceeds' bonds, are ICMA's Green Bond Principles (GBP) and the CBI's Climate Bonds Standard (CBS). More than a decade ago, when CBI came into operation, it had a twofold premise; on the one hand to get governments

[1] For example, a conflict of interest between investors and issuers may arise when finances gained out of issuance are used to refinance an asset that has been built up using finance from mostly non-green and unsustainable sources. On the other hand, a conflict of interest between a green bond issuer and an external reviewer may arise when the same service provider has other business relations with the green bond issuer or subsequently offers a review aiming to validate frameworks that they themselves have helped to develop.

to act and investors to put pressure on governments to act on climate, and on the other hand to recognise that the institutional capital that is available needs to be mobilised towards green and sustainable solutions. In 2013, CBI put in place the Climate Bonds Taxonomy. Since then, many countries (e.g. China, Japan, France), the European Union and the EIB among others started working towards establishing a taxonomy that lays out the economic activities, metrics and thresholds that define green and sustainable finance.

The EU GBS proposal that is expected to be published before autumn 2021 has three main characteristics. First, it will be voluntary, meaning that no one will be forced to follow and comply with it, except those green bond issuers that wish to make use of it. Second, the EU GBS will be tightly connected to the EU Taxonomy. This means that the issuer will have to make use of proceeds from the bond to finance or refinance projects (either physical or in the form of a financial asset) that are aligned with the taxonomy regulation. Third, the certification of the EU GBS will rely on an external reviewer that will need to be licensed and supervised (e.g. by ESMA). This requirement will only apply to those external reviewers that wish to operate in the EU GBS market.

The creation of an EU GBS would provide many benefits to all market participants. For investors, it will give them the assurance that their investments are making a real contribution to the environmental objectives aligned with the taxonomy. For issuers, it will give them a reliable way to demonstrate their commitment and alignment with the EU taxonomy to investors – for which there is more demand expected in the future. The EU GBS will further strengthen the leading global role of the EU financial sector in the market (about 50% of global green bonds are issued by EU institutions and member states). It will also serve to reinforce the international role of euro, the most popular currency for issuing green bonds.

There is some scepticism among investors about the suitability, or not, of green bonds to deliver on the European green deal, as opposed to sustainability-linked bonds (SLBs). With an SLB the issuer is making a commitment on the financing of the project over the life of the bond, and not necessarily at the project- and asset-level allocation. These commitments are accompanied by a set of key performance indicators (KPIs) which should be met and monitored on a regular basis (a percentage of emission reductions over time, efficiency measures across investments, etc.). This is in contrast to green bonds, of which the proceeds must be exclusively applied to finance or refinance (in part or in full) new or existing eligible projects that promote progress on environmentally sustainable activities.

The KPI-linked model of SLBs offers flexibility on the use of proceeds – as long as they can commit in a transparent and consistent way to improving very specific KPIs – and allow the issuer to allocate their capital more freely. On the other hand, critical voices can be heard when it comes to ensuring what the emission (reduction) targets are; the thresholds/milestones of the KPIs; who checks whether or not they are met; whether there is transparency on where the investor's money is going; and the fact that a brown issuer can still issue a green bond.

Having a strong and sensible regulatory framework in place can encourage market participants and investors to use the market. To this end, the taxonomy and the proposed GBS are considered as favourable and moving in the right direction. Furthermore, external reviewers will play a crucial role in ensuring – at both pre- and post-issuance phase – that the issuer aligns with the perspective green bond standard, and that the proceeds have been aligned and allocated accordingly. ESMA, according to the recommendation of the TEG, should ensure that reviewers are subject to rules, procedures and principles that are based upon a clear methodology, internal process, independence, and conflict of interest concerns. Having a pool of approved verifiers to perform the verifications is key.[2]

As the market will continue to grow and develop, perhaps at a slower pace, the EU taxonomy should be reviewed and updated regularly as some criteria might be revised and tightened. Moreover, there are some sectors for which the extent of revision is unclear today. So there is more work to be done to ensure some form of predictability in terms of how and in what direction the taxonomy will change in the future. Considering a potential grandfathering of green bonds issued under current regimes may be a plausible way forward. This would mean that bonds issued in the near term or those that have been issued in the past would be certain to still qualify under the EU taxonomy.

The green bond market is entering a challenging decade. By upping the ante – compared to 10 years ago – investors are now more sophisticated and markets are much more educated, while regulators and governments are responsive to developments by making decisions and proposals. As the market is growing rapidly the financial ecosystem should not hinder growth or block the momentum. It should however ensure that the appropriate framework is in place: standards and procedures, disclosure and reporting, and investor protection, for example.

[2] It is important to note that this is about supervising only the entity that is acting in an external reviewer capacity (for EU GBS), and not any other activities it may have.

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