Green Finance: Drivers, challenges and developments

What is Green Finance?

"Green finance" broadly covers the financing or re-financing in full or in part of a wide range of new and existing public and private investments with environmental objectives such as renewable energy, conservation, carbon capture and storage, energy efficiency, industrial pollution control, land management, green buildings, green products and materials, transport, waste management, processing and recycling and water sanitation. Such financing can take many different forms, including by way of bond or loan.

Green Bonds v Green Loans

Green bonds are debt capital market instruments. To date, they have tended to be medium-term and highly-rated instruments ranking pari passu with the issuer's conventional senior vanilla bonds.

Green loans are loan facilities such as term loans, (including those structured on a corporate or project finance basis), revolving credit facilities and working capital facilities. There are a range of lenders in the market offering these loan facilities, including commercial banks, development banks, multilaterals, institutional lenders and funds.

While green bonds and green loans are different financial products, their common aim is to finance sustainable environmental development.

Drivers and Challenges

The green finance market and particularly the green bond market have experienced significant growth and development in recent years; this has been facilitated by the development of ICMA's Green Bond Principles (GBP), discussed below.

According to the Climate Bonds Initiative (CBI), the green bond market doubled to almost US$83bn in 2016 (up from US$42.4bn in 2015). Issuance in 2017 reached US$160.8bn[1]. The CBI has estimated that the green bonds market has capacity to reach US$1tn by 2020[2]. Therefore, while green bonds still account for a very small proportion of the total bond market, the demand for and supply of green investments is increasing rapidly.

Following the entry into force of the Paris Climate Agreement (COP 21) in 2016, there has been increasing international and governmental recognition that green finance is fundamental to the long-term growth of the global economy and the need for decreased dependency on fossil fuels. According to the European Commission[3], Europe alone has to close a yearly investment gap of almost €180bn to achieve the EU's climate and energy targets by 2030.

Some countries, such as China, have already developed ambitious green financing action plans providing preferential lending rates for green investments and there are also proposals to introduce tax incentives for green financing, allow green loans/bonds to be eligible for use as collateral in central bank operations and implement preferential risk-weightings for green assets and reduce liquidity constraints for medium-long term green funding. The European Commission has recently published its action plan for sustainable finance (discussed further below).

In addition, in the last couple of years, there has been a push from the world's largest investors, central banks, regulators and market organizations for new frameworks setting out market terms and standards for green finance to be developed. While the green bond market is considered to be fairly advanced in terms of the development of definitions and tracking, as a consequence of the development of ICMA's GBP, it is apparent that action is needed at an international level to develop standardized policies for the regulation and evaluation of and infrastructure for green bonds and other green financial instruments in order to make the market more readily accessible to a wider range of investors.

1 https://www.climatebonds.net/resources/reports/green-bonds-market-summary-q1-2018 .

2 Address by Climate Bonds CEO Sean Kidney to Luxembourg Stock Exchange: https://www.climatebonds.net/address-climate-bonds-ceo-sean-kidney-luxembourg-stock-exchange

3 EC's Action Plan: Financing Sustainable Growth published on 08 March 2018.

Current Market Standards

Although various market standards have been developed defining what constitutes a green bond or a green loan, these guidelines currently have no legislative or regulatory backing or authority.

The most widely recognized green financing principles are ICMA's GBP which seek to enhance transparency and integrity in the green bond market. The GBP have four key components:

- **Use of proceeds:** proceeds must be used for green purposes with clear environmental benefits, which must be specified in transaction documentation.
- **Process for evaluation and selection:** the issuer must disclose its green objectives and the process determining eligibility for green finance as well as its environmental risk management processes.
- **Management of proceeds:** the issuer must implement a formal tracking and attestation process linked to the issuer's green lending and investment operations to ensure ring-fencing of the proceeds.
- **Reporting:** the issuer must maintain up-to-date information on the use of proceeds and the GBP recommend reporting against qualitative and quantitative performance indicators.

The GBP have been typically updated annually since their introduction in 2014 to reflect the development and growth of the global green bond market.

The Climate Bond Initiative has also developed its own certification that is available for assets and projects that meet the requirements of the Climate Bonds Standard. The Climate Bond Standard allows certification of a bond prior to its issuance, enabling the issuer to use the Climate Bond Certification mark in marketing efforts and investor roadshows. The latest version of the Climate Bonds Standard is fully aligned with ICMA's GBP.

It is recommended in the GBP and required by the Climate Bond Standard that green bond issuers use external reviewers or verifiers to confirm alignment with the key features of green bonds; this review can be carried out by various specialist external green assessors including rating agencies, which have now developed criteria for green bonds assessment.

In addition, some countries, such as China, India and France[4] have developed national green bond principles which are largely aligned with those published by ICMA and the CBI's Standard.

In relation to the loan market, the Loan Market Association published on 21 March 2018 its Green Loan Principles (**GLP**). The GLP build on and refer to ICMA's GBP with a view to promoting consistency across the financial markets. They incorporate the four GBP core components outlined above.

All published standards to date focus on use of proceeds rather than the general "greenness" of a corporate issuer/borrower and none provide for contractual consequences (such as acceleration or coupon step-up) in the event of a failure to maintain green eligibility.

Recent Developments

There are now a significant number of green finance initiatives at an international and European level in addition to the national and market initiatives (a few of which are mentioned above); these include the work of the G20 Green Finance Study Group which is currently looking at ways to mobilize private capital for green investment, specifically focusing on banking, the bond markets, and institutional investors, the FSB Task Force recommendations on climate-related financial disclosures and ISO's guidelines on climate finance and the first internationally accepted certification of climate performance.

4 France has implemented its "Transition Energetique Climat" label

On 8 March 2018, the European Commission published its Action Plan for Sustainable Finance which is based on the recommendations of the High-Level Expert Group on sustainable finance established by the Commission in 2016 and sets a range of goals for sustainable finance for 2018 and 2019. Most of these will, subject to consultation processes, result in some form of legislative proposal being published by the Commission. The Commission considers the Action Plan instrumental in helping to deliver on the Paris Climate Agreement and the Sustainable Development Goals set out in the Commission's Communication on 'Next steps for a Sustainable European future: European actions for sustainability'. The Commission intends to report on the progress of the Action Plan on sustainable finance in 2019. Among other measures, the Commission's Action Plan proposes to establish a common taxonomy for sustainable finance, create EU labels for green financial products (including in all likelihood a green bond standard), incorporate sustainability into prudential requirements, enhance transparency in corporate reporting and support investment in sustainable infrastructure projects.

It is also worth noting that as part of the new European framework for securitizations applying from 1 January 2019, the EU's Securitization Regulation[5] requires issuers seeking the simple, transparent and standardized (STS) label for a transaction to disclose available information on the environmental performance of any underlying residential mortgage and auto loan assets being securitized. A CBI article[6] reports that the OECD has estimated that between US$280-380bn of green asset-backed securities could be issued by 2035 for renewable energy, energy efficiency and private electric vehicles, with US$84bn of that being issued in the EU alone[7].

A number of institutions have created indices to exclusively cover green bonds as well as various indices which capture the development of China's fast growing green bond market. Stock markets which have developed specialist green bond markets include Luxembourg, London, Oslo, Stockholm, China and Mexico.

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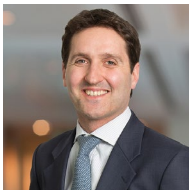

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5 Regulation (EU) 2017/2402

6 CBI Briefing Paper " Green Securitisation: unlocking finance for small-scale low carbon projects" February 2017

7 CBI and CCCEP Policy Paper: Stimulating private market development in green securitisation in Europe: the public sector agenda: April 2017