Green bonds – More than a fashion trend?

COP21 and its consequences

Since the historic COP21 agreement, which seeks to make a transition towards renewable and more sustainable energy, interest in green finance and securities has increased dramatically. With studies showing that more than US$1tn annually will need to be spent each year in order to support low-emission projects, this former “niche” has now become a sector which offers numerous opportunities for the green securities market, and in particular the green bond market, to grow.

Background

Climate finance through the green bond market has grown substantially in 2016 with issuances having almost doubled since 2015. This growth has been driven by government action and substantial issuances in China, which is soon to be the world’s largest green bond market. It is worth examining the reasons behind investors’ appetite for green bonds compared to other emerging markets.

What are the Main drivers for the issuance of green bonds and the development of green bond market?

- **Satisfy investor demands for responsible business practices**: Investors are increasingly demanding socially responsible investment (**SRI**) opportunities. Consequently, issuances of green bonds have been repeatedly oversubscribed. Conscious retail investors are looking to invest in sustainable investments, increasingly demanding such products from their brokers. On the other hand, institutional investors, coming under scrutiny by having to comply with best practices and corporate social responsibility, are using green bonds to satisfy ESG (Environment, Social and Governance) requirements, something that had been difficult to address with more traditional financial instruments in the pre-green bond era. As a result, green bond issuances have attracted new types of investors, providing a potential audience for future issuances.
- **Securing project finance**: Green bonds are an attractive means of financing large environmental investment projects, such as wind and solar development which often require a large capital investment. This is thanks to the larger audience that green bonds attract, the lower costs of raising capital (as opposed to traditional funding) and the use of proceeds in sustainable and environmentally conscious projects.
- **Reputational advantages and differentiation**: With the press generally covering green bond issuances favorably, green bonds provide issuers, regardless of whether they are corporate or public entities, with an opportunity to differentiate themselves from their competitors and promote them as conscious, innovative and sustainable.

General features of green bonds

How does a “green bond” differ from a regular bond?

Like other bonds, a green bond is a financial instrument for raising capital from investors on the debt capital market, repaying the capital when the bond matures and distributing a set amount of interest during the life-span of the bond.

By labeling the bond as “green”, the issuer commits to using the proceeds of the bond in a transparent manner and exclusively to support climate-related or environmental projects.

This specific use of the funds raised distinguishes green bonds from regular bonds. Therefore, in addition to assessing the financial characteristics of the financial instrument (such as price, credit rating of the issuer or maturity), investors also assess the specific purpose of the projects which the bonds intend to support.

There is however, not yet a single set of globally-agreed criteria to which a green bond must conform. The principal markets are actively working towards developing an agreed set of criteria. The two sets of standards which are widely followed by investors and issuers alike are:

– the Green Bond Principles (**GBP**), published by the International Capital Markets Association (**ICMA**), which recommend transparency and promote integrity.
– the Climate Bond Standard (**CBS**), a set of best practice recommendations published by the Climate Bonds Initiative.

Luxembourg as pioneer in green bonds

– **The Luxembourg Green Exchange**: In September 2016, the Luxembourg Stock Exchange (**LuxSE**) added, in addition to its two existing markets, a new platform for securities: the Luxembourg Green Exchange (**LGX**).

  LGX is the first "green" platform and currently is the exchange with the highest number of listed green bonds worldwide, listing currently more than 50% of all listed labeled green bonds. The value of green bonds on the LGX has already passed €50bn, in the first six months of its existence.

– **LGX entry requirements**: Once listed on one of the LuxSE's two markets, issuers must self-label their security as "green" by disclosing the green nature of the use of proceeds, providing an independent pre-issuance external review and committing to regular post-issuance reporting. These details will then be assessed by the LGX admission team before the security can be listed on the LGX. Both the GBP and the CBS are recognized by the LGX.

– **On-going obligations and fees**: Once listed on the LGX, LuxSE will conduct an annual review to ensure the issuer complies with its commitment to disclosure and transparency. While no standards or rules on documentation for post-issuance reporting are imposed by LGX, there is a discretionary right of withdrawal of the security from LGX if its requirements are not fulfilled.

No additional fees or costs, other than those levied for admission to one of LuxSE's markets and those associated with additional reporting obligations will apply for admission to the LGX.

– **Excluded project categories**: Clearly Securities whose proceeds will be invested in projects such as nuclear power production or fossil fuels (specifically oil, gas and coal, including so-called "clean coal") will not be admitted to LGX.

– **Notable admissions**: Since the listing of the world's first green bond by the European Investment Bank on the LuxSE in 2007, other notable issuances have followed. The Bank of China has issued four green bonds with a total issue amount of US$2.8bn, which have been listed on the LGX, making it the first Chinese bank to list a green bond on LuxSE Furthermore, the world's first sovereign green bond, issued by the Republic of Poland, was listed on the LGX in December 2016.

Outlook: Exciting times ahead

With green bond markets currently enjoying tremendous success, it remains to be seen whether they will eventually be able to develop and diversify. This may be achieved by entering emerging or developing markets where significant green investment is needed or by unlocking the green bonds market to other groups of investors, in particular through high yield green bonds.

From a legal perspective, it will also be interesting to see whether the standards which are currently prevailing on the green bond market and which seem to enjoy a high rate of acceptance amongst market participants may eventually translate into binding legislation.

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