What is green finance?

Achieving sustainable development is going to require huge financial investment. According to the European Commission, Europe alone has to close a yearly investment gap of almost €180 billion to achieve the EU’s climate and energy targets under the Paris Climate Agreement (COP 21) by 2030.[1]

“Green finance” refers to the financing or refinancing of new and existing public and private investments with environmental objectives such as renewable energy, conservation, carbon capture and storage, and energy efficiency. Such financing can take many different forms, including by way of bond or loan.

Green investing is not new, particularly in project finance where investors have long sought to target funds at enterprises and projects that satisfy environmentally friendly criteria such as under the Equator Principles and the IFC Sustainability Policies and Standards. Investors and lenders have been driven by their own stakeholders' appetite for green investments moved, in part by recognition that green enterprises and projects may also be more financially sustainable.

However, the size of the market has increased markedly in recent years in particular the green bond market. According to the Climate Bond Initiative (CBI), the green bond market doubled to almost US$83 billion in 2016 (up from US$42.4 billion in 2015). Issuance in 2017 reached US$160.8 billion and the CBI has estimated that the green bonds market has capacity to reach US$1 trillion by 2020.[2] Therefore, while green bonds still account for a very small proportion of the total global bond market, the demand for and supply of green investments is increasing rapidly.

This growth has been accompanied by increased market standardisation and, at least in some countries such as China, by ambitious green financing action plans that, for example, provide preferential lending rates allowing green loans/bonds to be eligible for use as collateral in central bank operations, implement preferential risk-weightings for green assets, and reduce liquidity constraints for medium-long term green funding. Some proposals also include tax incentives for green financing.
In the last couple of years, there has been a push from the world's largest investors/lenders, central banks, regulators, and market organisations for new frameworks setting out market terms and standards for green finance to be developed.

Market standards

The growth of the green bond market has been facilitated by the development of Green Bond Principles (GBP) by the International Capital Markets Association (ICMA) which establish a voluntary high-level framework/methodology of market standards and guidelines based around eligibility criteria for green objectives and the monitoring and the use of proceeds. There is no requirement in the GBP that the green projects or activities in which proceeds are invested offer "additionality" in the real world, whether direct or indirect, or that they consider environmental, social, and governance (ESG) considerations more generally. The GBP leave the final determination of what is "green" to emerge in light of investor consensus and the third party verification, certification, or second opinion process, and to adapt over time to reflect the impact of any changing market consensus over what is "green."

Similar principles have also been developed for range of financial instruments including bonds and loans by the CBI's Climate Bond Standard. Most recently, in March 2018, the Loan Market Association published its Green Loan Principles (LMA GLP) which build on and refer to ICMA's GBP with a view to promoting consistency across the financial markets.

These guidelines, while extremely helpful, currently have no legislative or regulatory backing or authority. Therefore, it is apparent that action is needed at an international level to develop standardised 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.

Recent developments

Green finance initiatives currently running at the international and European level include the work of the G20 Green Finance Study Group which is 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 the ISO's guidelines on climate finance and first internationally accepted certification of climate performance.

In 2018, the European Commission (Commission) has published its legislative proposals for sustainable finance which will, if implemented, introduce a detailed EU taxonomy for green finance activities. During the course of 2019, the Commission is expected to propose rules regarding the content of the prospectus for green bond issuances, amend its non-binding guidelines on non-financial reporting, and publish a study of sustainability ratings and research and a fitness check of EU legislation on public corporate reporting.

Conclusion
We can expect the trend for greater regulation of the green finance market to continue in the next few years, driven by regulatory recognition of the importance of ESG factors in decision-making and of the need for transparency into a company’s ESG performance.

However, given that sustainable investment existed for many years before the development of a "green finance" label, investment is likely to continue to take place both in compliance with and outside of such regulatory frameworks as flexibility and innovation are fundamental characteristics of green finance.


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