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Green bonds: growth in sustainable capital markets financing

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Expanding public awareness means that sustainability is increasingly forming a core business of entire industries not just individual organisations.

In the financial sector, sustainable financing is an area of ever-increasing focus for all capital markets participants, from issuers and regulators, to investors. This article focuses on green bonds: sustainability-themed bonds where proceeds are exclusively used to finance or refinance (in part or in full) eligible "green projects" providing an environmental benefit. Green bonds have the same regulatory status as equivalent non-green bonds and, therefore, with the appropriate amendments to disclosure, marketing and use of proceeds terms, can typically be issued through an issuer's existing debt issuance programme, or on a standalone basis.

The green bond market has existed since 2007, with the first issuers being multilateral development banks such as the European Investment Bank and the World Bank. The first corporate green bond issuance was in 2013. The market has since grown enormously, with green bond issuance in 2019 amounting to US$230 billion. This growth reflects the interest of both issuers and investors in supporting environmentally-positive projects and the ongoing focus of regulators and market associations on the promotion of sustainable finance. Dentons believes the green bond market will continue to grow and play an important role in meeting internationally agreed climate standards and in the ongoing debate regarding what it means to be "green".

Nick Hayday, international capital markets partner, commented: "Dentons' global coverage and scale as the world's largest law firm, combined with our track record in advising issuer clients on their debut green bonds, means that we are ideally placed to assist potential issuers who may be considering financing for environmental projects to access the green bond market."

Sustainable Debt Capital Market Financing and Dentons

The values of our Firm include a real commitment to doing the right thing by each other, our clients, our community and our Firm.

We are therefore very proud that Dentons has acted on a number of recent notable green bond issuances, including the debut green bond and sukuk financings for:

Ignitis (the Lithuanian state-owned energy company formally known as Lietuvos Energija). €600 million of green bonds were issued by Ignitis, across two separate issues in 2017 and 2018. The 2017 issue was the first-ever international corporate green bond by a central and eastern European (CEE) issuer, and was given the highest green designation by the Center for International Climate Research (Cicero), with proceeds being used by Ignitis to refinance its purchase of several wind farms, to finance new eco-generation projects and to invest in efficiency improvements across Lithuania's power distribution grid, all part of Ignitis' move to invest in green power development.

CPI Property Group (CPI, the leading owner of income-generating real estate in the Czech Republic, Berlin and the CEE region). €750 million of green bonds were issued by CPI in October 2019. CPI has committed to use proceeds from the green bonds to finance and/or refinance green initiatives, such as acquiring and refurbishing certified green buildings, improving energy efficiency and promoting sustainable farming. CPI intends to use a large portion of the proceeds to acquire high-quality certified green buildings, and hence increase the level of certified green buildings in CPI's portfolio. Dentons also advised CPI on the issue of a further £350 million of green bonds under its MTN programme in January 2020.

Majid Al Futtaim (MAF, one of the largest developers and operators of shopping malls and hypermarkets in the Middle East and North Africa region. MAF also develops and operates hotels and complementary leisure and entertainment products and services). US$1.2 billion was issued across two series, in May 2019 and November 2019. This represented MAF's first green sukuk issuance. Proceeds are to be used to fund environmentally-friendly projects in areas such as renewable energy and sustainable water management.

What qualifies as a green bond?

There is no statutory definition of what qualifies as a green bond. Accordingly, the market effectively self-regulates. Issuers decide themselves whether their bonds are green and will be marketed as green bonds. There are clearly advantages to this approach from the issuer's perspective. However, in order to promote integrity and credibility in the green bond market and provide investors with market confidence that proceeds are applied appropriately, the International Capital Market Association (ICMA) has published a uniform set of standards known as the Green Bond Principles (GBP) (see "The Green Bond Principles" below).

Green bonds – new market segments

There have been a number of developments in recent years by stock exchanges to introduce specific green bond segments and exchanges. The London Stock Exchange (LSE) launched its Green Bond Segment in 2015, and in 2019 it also launched a wider Sustainable Bond Market (including the Green Bond Segment). The LSE continues to require an independent expert review certifying the nature of the bonds (as also recommended in the GBP), as well as an acknowledgement and commitment to ongoing post-issuance reporting, for admission to the Green Bond Segment. In Luxembourg, the Luxembourg Green Exchange is a platform for bonds recognised as green, social or a blend of both, and funds that demonstrate a solid ESG, green or social investment policy. Recent initiatives have also been announced by Euronext, to present green bonds listed on all of its six regulated markets (Amsterdam, Brussels, Dublin, Lisbon, Paris and Oslo) on a single consolidated Euronext Green Bonds portal, and the Nasdaq has now also launched a Sustainable Bond Network platform. These initiatives are aimed at improving disclosure, transparency and assisting investors to aggregate data on green bonds.

Increasing demand for green bonds

Although it appears that green bonds are being priced similarly to ordinary bonds in the primary market, there is increasing evidence that green bonds are outperforming regular debt issued by the same entity in the secondary market. There are a number of potential reasons for this:

- Investors controlling US$90,000 billion have signed up to the "Principles for Responsible Investment", a United Nations-supported initiative, pledging to incorporate environmental, social and governance factors into their investment decisions. This growth in "mainstream" investors with green mandates has increased demand for green bonds, with some institutional investors setting up dedicated funds.
- Green bonds have created demand from a wider range of investors, who may not have invested in debt capital markets previously or only had minimal participation in debt capital markets, and help to differentiate bond offerings in a crowded financial marketplace.
- As highlighted by the recent announcements by the Bank of England that it is proposing to stress test the resilience of the largest banks and insurers to the physical and transitional risks associated with climate scenarios, regulators and indeed investors are increasingly considering how sustainability and environmental issues relate to an issuer's potential for future growth and resilience in the long term.
- By issuing a green bond, an issuer is communicating its values and priorities to its stakeholders, regulators and the wider community in which the issuer operates. This can provide a marketing and investor relations benefit and encourage employee and stakeholder engagement with the values of the business.

The Green Bond Principles

The GBP are a set of voluntary process guidelines for green bond issuances that recommend transparency, disclosure and reporting. They:

- provide issuers with guidance on key components of launching a green bond;
- promote availability of information to investors to evaluate the environmental impact of green bond investments and provide them with sufficient information to attract capital allocation to green bond projects; and
- assist underwriters by moving the market towards expected disclosures that will facilitate transactions.

Issuance under the GBP should provide an investment opportunity with transparent green credentials, allowing investors to track their investment into environmental projects and gain an insight into their environmental impact.

The GBP were originally established in 2014 and most recently updated in June 2018. Translations of the GBP are available in 22 languages via the ICMA website.

Under the GBP, green bonds are defined as any type of bond where proceeds are used exclusively to finance/refinance, in part or in full, new/existing eligible green projects and which are aligned with the four core GBP components.

What are the core components of the GBP?

The four core components of the GBP are:

1. Use of proceeds

Proceeds should be used for eligible green projects and appropriately described in the use of proceeds section in the body of the prospectus for standalone bond issues. For EMTN programmes, different listing authorities have taken different views on where the use of proceeds should be disclosed. Depending on the authority, proceeds should be disclosed either in the use of proceeds section of the base prospectus or in the final terms on a drawdown. ICMA has provided an indicative, though not exhaustive, list of broad categories of eligible green projects:

2. Process for project evaluation and selection

The issuer should clearly communicate to investors:

- the environmental sustainability objectives;
- the process by which the issuer determines how the project fits within eligible green projects categories; and
- the related eligibility criteria e.g. green standards and certifications.

To promote transparency, the GBP recommend that this process is supplemented by an independent external review.

3. Management of proceeds

Proceeds should be credited to a sub-account or sub-portfolio of the issuer or otherwise tracked by the issuer.

Again, to promote transparency, the GBP recommend that the management of proceeds is supplemented by the use of a firm of auditors or other third party to verify tracking and allocation of funds.

4. Reporting

The issuer should keep readily available up-to-date records on use of proceeds e.g. list of projects to which green bond proceeds have been allocated and their expected impact.

To promote transparency of the expected impact of projects, the GBP recommend the use of qualitative and quantitative performance indicators and measures e.g. energy capacity, electricity generation, amount of greenhouse gas emissions reduced etc.

Practical considerations

Impact on documentation

The use of proceeds of a green bond should be appropriately described in the use of proceeds section of the prospectus/base prospectus or final terms. There are typically no "green covenants" imposed on issuers in bond conditions to ensure the proceeds are used for environmentally-friendly projects.

Issuer communication of a green bonds framework

In order to meet the obligations arising under the GBP's project evaluation and selection requirements, to help inform the market of the main characteristics of a green bond and illustrate its key features in alignment with the four core components of the GBP, ICMA has created a recommended information template in the format of a summary, which can be used by the issuer to provide a snapshot of these characteristics and features. An issuer would then make such a summary, often referred to as an issuer's "Green Bond Framework", publicly available on its website. An issuer may also decide to incorporate by reference its Green Bond Framework into its offering document/prospectus.

External review

To promote transparency, the GBP recommend that issuers use an external review to confirm the alignment of their green bonds with the GBP. Such reviews may include:

- consultant review – advice sought by issuers from experts in environmental sustainability. This includes "second opinions" i.e. opinions provided by an environmental consultant employed by the issuer to develop a process for evaluating and selecting green projects;
- verification – independent verification of a green bond, its framework or its underlying assets by qualified third parties, such as auditors;
- certification – certification of a green bond, its framework or its use of proceeds against external green assessment standards. This is in contrast to verification, which tends to focus on alignment with internal standards or claims made by the issuer; and
- rating – rating of a green bond or its framework by qualified third parties such as specialised research providers or rating agencies.

There is an external review template published by ICMA, providing an executive summary of external reviews, which is submitted by external reviewers. External reviewers can also submit full reports but not a summary in a format other than the ICMA template. Again, the issuer would make this external report publicly available on its website.

Ongoing monitoring and reporting

Under the GBP, issuers are free to choose how to report on the management of green bond proceeds and the environmental outcomes of the green bonds projects. Such reporting, if conducted regularly and consistently period on period, either via an issuer's ESG reporting framework via its websites and annual reports, or by establishing a new level of ESG reporting, can help to improve employee and stakeholder engagement with the sustainability and environmental objectives of the company, and provide tangible evidence of a company's progress against its environmental objectives.

Recent developments

Although there have not been any updates to the ICMA Green Bond Principles since June 2018, there have been developments in other areas. Political agreement has been reached and the proposed text published in December 2019 of the EU Taxonomy for Sustainable Activities (the Taxonomy Regulation), which provides for a general framework for the development of an EU-wide classification system for environmentally-sustainable economic activities.

The EU's Environmental Objectives

The EU is also in the process of introducing a voluntary, non-legislative EU Green Bond Standard as part of its initiative to align the financial system with sustainability goals and help develop the green bond market.

The proposed core components with which a bond issue must comply in order to fall within the proposed EU Green Bond Standard would include:

- alignment with the EU's Environmental Objectives as defined in the Taxonomy Regulation. For an issue to qualify, an issuer must use all proceeds for activities that contribute to at least one of the six Environmental Objectives and do not harm them;
- the issuer must produce a Green Bond Framework outlining how its strategy aligns with the EU's Environmental Objectives, proposed use of proceeds, and the timing of, and metrics to be used, in reports;
- mandatory reports on use of proceeds and environmental impact; and
- mandatory external verification of the issuer's Green Bond Framework and reports on use of proceeds.

As can be seen, the outline approach proposed by the EU bears several similarities with the GBP. However, at this stage the timing for the introduction of the EU Green Bond Standard is yet to be determined, and details on the form and nature of the mandatory reports required are awaited. It can be hoped that, when introduced, the EU Green Bond Standard will reinforce the momentum for the growth of the green bond market by adding further to the credibility and legitimacy of the "green" label.

Looking to the Future – Beyond Green?

While the green bond market has matured significantly over recent years, other sustainability-themed bond issuances have also begun to develop traction:

Social bonds: to raise funding for projects/activities designed to achieve positive social outcomes. ICMA has published a set of Social Bond Principles, a voluntary process guideline for issuing social bonds. A sub-category of Social Bonds are gender equality bonds, where the proceeds of the bond issue are committed to financing or refinancing projects or companies that meet gender-related criteria. Such gender-related criteria may include that the proceeds will be used to invest in women-led companies, companies that support gender equality in the workplace, or companies that develop products and services benefiting women (for example, project finance and/or loans made to women entrepreneurs and SMEs, including micro-finance).

Sustainable Development Goals bonds: to raise funding for projects/activities promoting the UN's Sustainable Development Goals (SDG).

Coupon step-ups: a recent key development in sustainable finance issuance occurred with the Enel Group's 2019 issue of a US$1.5 billion SDG-linked bond. Innovatively, the use of proceeds on the issue was not tied directly to sustainability or environmentally-beneficial projects. Instead, the bond was for general corporate purposes. The innovation related to the application of a coupon step-up of 0.25%, linked to Enel's ability to achieve, by the end of 2021, installed renewable generation capacity equal to or greater than 55% of its total consolidated installed capacity (in line with the SDG objective of increasing substantially the share of renewable energy in the global energy mix). As at H1 2019, Enel's installed renewable generation capacity stood at 45.9%. If Enel achieves its target, no coupon step-up will apply.

Transition bonds: intended to avoid an argument as to which issuers or industries may be appropriate (or not) to be labelled "green", but rather to encourage "brown" industries to access funding for projects to reduce their negative environmental impacts within a similar framework of use of proceeds disclosure, transparency and reporting.

Blue bonds: to raise funding for the development of maritime resources, issued usually by governments or development banks. Follow a similar approach to the GBP, save that the use of proceeds relates specifically to marine projects and resources.

Sustainability bonds: to raise funding for projects/activities combining environmental and social priorities. ICMA has published guidelines for sustainability bond issuance.

Conclusion

The green bond market has experienced dramatic growth in recent years. Indications are that the market will continue to grow and play an important role in meeting internationally agreed climate standards and in the ongoing debate regarding what it means to be "green". There is also a wider debate about "additionality" – i.e. do green, social and sustainable bonds enable additional funding to be allocated towards positive green, social and sustainable activities, or are they simply funding investment that would happen anyway and thus amounting to merely a re-labelling of existing practices?

With the passage of time, it is to be hoped the accumulation of reported evidence that sustainable financing via green bonds has been making a tangible impact in achieving environmental objectives should engender a positive feedback loop generating further momentum in the green bond market. The ongoing mandatory reporting requirements which are embedded within the proposed EU Green Bond Standard will therefore have a key role to play in enhancing credibility and resolving the "additionality" question.

Further growth of the green bonds market, demonstrating the "additionality" and environmentally-positive impacts of green bond funded projects, is indeed a positive outcome towards which we should all be motivated to work.

Dentons is keen to play its part in this, by continuing to advise and assist its clients in accessing additional funding for environmentally-beneficial projects via green bond and related social and sustainable bond products.

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