dentons.com

Green Bonds

Introduction

The green bond market has been the subject of many capital markets headlines this year, from the first issue of green bonds by France, with a record €7 billion sale, at the start of the year to the first Central and Eastern European corporate green bond issuance, the debut €300 million issue by Lietuvos Energija (the Lithuanian state-owned energy company), on which Dentons acted for the issuer. It is clear that what was once a niche market is becoming more mainstream. This article provides an overview of: what a green bond is, recent developments in the green bond market; the Green Bond Principles and their importance to this nascent market; and practical considerations for participants in this market.

What are green bonds?

Green bonds are structured as conventional bonds, the key differentiating feature being that proceeds are exclusively used to finance projects with an environmental benefit. Green bonds have the same regulatory status as equivalent non-green bonds and can typically be issued through standard prospectuses or base prospectuses.

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 if 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).

The green bond market

The green bond market has been around 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 grown from a few hundred million dollars in 2007 to US$95 billion last year and is expected to grow to US$130 billion this year. The last few months in particular have witnessed a significant increase in green bond issuances, with the second quarter seeing the largest quarter of issuances on record.

There have also been a number of developments by third party market participants in recent years. Since 2014, a number of ratings agencies and financial institutions have created indices to exclusively track green bonds. In 2014, Solactive launched the first green bond index, followed by S&P with its S&P Green Bond Index and the S&P Green Project Bond Index, Bank of America Merrill Lynch with its index and, finally, MSCI collaborated with Barclays to launch a group of green bond related indices.

Additionally, stock exchanges, such as the London Stock Exchange (LSE), have launched a range of dedicated green bond segments (admission typically requires the submission of a "second opinion" certifying the nature of the bonds). SSE plc, a leading UK energy company, recently issued a €600 million green bond which was listed on the LSE, the largest ever green bond by a UK company. In Luxembourg, the Luxembourg Green Exchange is the world's first exchange exclusively for green securities.

Increasing demand for green bonds

Although it appears that green bonds are being priced similarly to ordinary bonds on issuance, 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. Firstly, investors controlling US$60 trillion 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 has increased demand for green bonds, with some institutional investors setting up dedicated funds. Secondly, green bonds have created demand from a wider range of investors which may not have invested in debt capital markets previously or only had minimal participation in debt capital markets. Nevertheless, the green bond market still faces a number of obstacles and challenges. According to Nick Hayday, Capital Markets partner at Dentons in London, the further development of the green bond market will depend on "policy and regulatory factors both at the domestic and international level, market conditions and investor demand".

The Green Bond Principles

The GBP are a set of voluntary 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.

The GBP were originally established in 2014 and have since been updated twice, in June 2016 and most recently in June 2017.

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;**
2. **process for project evaluation and selection;**
3. **management of proceeds; and**
4. **reporting.**

As you will see from the discussion below, the foundations of the GBP are the use of proceeds and transparency, which permeate each of the four core components.

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:

- renewable energy;
- energy efficiency;
- pollution prevention/control;
- environmental sustainability;
- biodiversity conservation;
- clean transportation;
- sustainable water and wastewater management;
- climate change;
- eco-efficiency; and
- green buildings.

2. Process for project evaluation and selection

The issuer should clearly communicate to investors in an information template:

- 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 be supplemented by an external review (discussed below).

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 be 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

As discussed above, the use of proceeds should be appropriately described in the use of proceeds section of the prospectus/base prospectus or final terms. There are typically no "green covenants" such as to ensure the proceeds are used for environmentally-friendly projects.

Recommended templates

In order 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.

External review

As mentioned above, 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.
- **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.

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 the ongoing debate regarding what it means to be "green". The continued development of the market will depend on the evolution of disclosure regimes and market standards.

Contacts

David Cohen
Partner, London
D +44 20 7246 7535
david.cohen@dentons.com

Nick Hayday
Partner, London
D +44 20 7246 7516
nick.hayday@dentons.com

Matthew Sapte
Partner, London
D +44 20 7246 7629
matthew.sapte@dentons.com

Nikolas Colbridge
Partner, London
D +44 20 7246 7102
nikolas.colbridge@dentons.com

Cameron Half
Partner, London
D +44 20 7246 7175
cameron.half@dentons.com

Nicholas Yao
Associate, London
D +44 20 7246 7430
nicholas.yao@dentons.com