GREEN FINANCE KEEPS THE SKY BLUE

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The EC has set up a High-Level Expert Group (HLEG) focused on sustainable finance. Why now?

The first definition of sustainability was formulated back in 1992 at the Earth Summit in Rio de Janeiro, but it was the Paris Climate Summit in December 2015 and then the G20 meeting in September 2016 that marked the change and are the drivers of all the recent initiatives focused on climate action. By signing the Paris Agreement, more than 180 countries, accounting for 88 percent of global emissions, committed to keeping global warming well below 2˚C. In practice this means that governments took on the responsibility to finance climate action. This is a huge milestone and defines the ambition over the coming decades.
The current challenge, however, is that the process of financing sustainable development is starting without any legal framework. We face a number of risks, including the risk of financial stability (linked to failing to integrate ESG factors into mid- to long-term valuations), the risk of misallocation of capital, and even the obvious greenwashing risk.

Current risk models, in particular the Basel III regulation, mostly focus on short-term scenarios, whereas sustainability requires at least a 20- to 30-year perspective. There is a need to tackle this challenge and come up with a framework that will support this paradigm shift. More decisive action is required now and it needs to be supported by an adequate regulatory framework.

What purpose does the EC HLEG serve?

By the end of 2017, the group will present recommendations for a comprehensive EU strategy on sustainable finance as part of the Capital Markets Union. The Commission will draw on these recommendations to determine how to integrate sustainability considerations into the EU's rules for the financial sector. Mid year, the HLEG will present an interim report already disclosing some of its recommendations.

The absence of a definition for what is green, the lack of clarity, and awareness in the sector suggests there is a need for a framework. This will incentivize private firms to get involved, a crucial addition for governments' commitment from COP21 to materialize. We need private capital to support green finance, therefore we need incentives for issuers and investors. To develop green finance first we need to define it, then harmonize it, standardize the sector, incentivize it and finally regulate it. The last step is the *raison d'etre* of HLEG.
I hope that in five years from now we will no longer discuss sustainable finance because all of finance will be sustainable, or at least most of it will be. Boards of directors should be responsible and held accountable for introducing and supporting

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sustainability. The strategy of any company should encompass sustainability, e.g. in the production, supply chain process, and labor relationships. Through green finance we will ensure that the sky will stay blue for the generations to come.

What if meeting sustainability requirements becomes too complicated in terms of return on investments?

It should rather go the other way around- not meeting sustainability criteria will eventually discourage investors. Some pension funds, e.g. the CalPERS in the US, the Swedish AP4, the Dutch ABP, and the French FRR, have all already adopted ESG quotas in their portfolios, as they are one of the investor groups with the longest investment horizon. We can gradually introduce peer pressure to make sustainability requirements more relevant. A good way forward could be, for instance, to impose an obligation for asset managers to include information on sustainable assets and the percentage of their portfolios that abide to the criteria in the KID document. These requirements can increase over time and the approach has to be progressive.

From a capital markets perspective, what are the most urgent topics in green finance and how should we tackle them?

The key challenge is a lack of a common language, even more aggravated by the conflicting interpretation of taxonomies. This is combined with the intrinsic complexity of the taxonomies and projects themselves. The situation is also quite messy when it comes to KPIs, metrics, and reporting preferences.
Additionally, the market faces difficulties applying common and comparable standards to different sectors and types of issuers. There will never be a one-size-fits-all solution and sector-specific standards will need to be developed for all relevant sectors.

Investors also face the challenge of poor comparability of projects. The difficulty here is the open approach of the industry where many overlapping, and occasionally conflicting, approaches are possible. The onus of comparing projects is on the investor side, but they need to be guided by preparing and displaying information in a clear and structured framework, like the one we adopted on the Luxembourg Green Exchange. Overall, there is a strong need to introduce better tools for due diligence at lower transactional costs for issuers of green financial instruments.

LuxSE has recently launched LGX. It has been live for more than six months now. What trends have you observed so far?

We have already reached an important milestone: the €50 billion threshold in the value of bonds displayed on LGX. The first ever sovereign green bond, issued by the Republic of Poland, is also among the instruments on the Green Exchange. In total, we now display 110 green bonds listed by 25 issuers in 19 currencies. We believe these numbers will grow substantially in the short and medium term.

Over the past couple of months, issuers and investors have moved from asking the simple question “Is this instrument green?” to “How green is the project it is financing?”. The demanding entry criteria and a “green transparency bar” that we put much higher than other exchanges has been widely appreciated by the market, from both the issuers’ and investors’ side.

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Are there any trends observed among green issuers?

Development banks and supranational agencies, of the likes of the World Bank and the European Investment Bank (EIB), have been paving the green way since EIB's first "climate awareness bond" issued in 2007 and listed on the Luxembourg Stock Exchange. The same trend is also clearly visible on LGX, as currently 58 percent of the green bonds displayed on the green platform come from supranational issuers. The times are changing though.

Among green bonds on LGX, 16 percent represent private issuers. This is crucial, as on-boarding the private sector is *a sine qua non* for a solid growth of green finance. Also municipalities and local development banks increase their green funding. Overall, 25 percent of labelled green bonds worldwide are already displayed on LGX. This constitutes half of all listed green bonds globally.

Poland, France, Nigeria; it seems more and more countries are issuing green bonds. Is this the right way forward?

There is no right or wrong approach. The market and society are facing a paradigm shift, which requires a shift of resources and capital allocation toward sustainability, more clarity to investors on climate and system risks on the valuation of their assets and portfolio, and better overall disclosure transparency.

It is obvious that the public sector, and governments in particular, are in the driving seat. Yet they will also have to prove effective in bringing private initiatives to the pool of sustainable projects to be financed through capital markets. In this respect, they have three responsibilities: to educate and raise awareness of all market participants; to directly promote green projects; and finally to introduce a favorable framework that brings in more eco-friendly projects.

Is green enough? What about positive/social/sustainable finance instruments?

Sustainable securities will come in many different varieties. OECD studies suggest that annual green debt issuance worldwide alone will need to rise to US$620 billion-US$720 billion per year by 2035 if the G20 is going to meet its climate change targets. There's about US$100 trillion of institutional money in the world, and less than one percent of that is invested in anything green. We have to make it attractive to investors.

A full spectrum of products is already emerging (social bonds, sustainable bonds, positive impact bonds, ESG funds, etc.). We are living in fascinating times for financial innovation! From an institutional player's perspective, green bonds are the best instrument to get engaged in green finance; on the retail investors' side, green ETFs are an interesting option.

Some financial instruments are starting to measure both the positive and negative impacts of the projects they finance, going the extra mile with offering unprecedented granularity and transparency on the additionality they bring to society. For example, in October 2016, Société Générale issued a positive impact bond based on both the Positive Impact Manifesto and the bank's own Positive Impact Assessment Framework, in which the holistic dimension of the projects' ESG impact was defined. This approach also took into consideration the possible negative impact on soil and biodiversity that the same projects benefiting climate and employment can have.

Another example of this innovative approach comes from the World Bank. In March 2017, the World Bank issued its first ever set of green bonds that directly link financial returns to companies performing in line with the standards and aims on the United Nation's Sustainable Development Goals (SDGs).

Are there other initiatives that focus on the development of sustainable finance?

Indeed, there are quite a number of these initiatives. Just to name a few, the United Nation's Integrated Reporting-promoting a holistic approach to internal company assessment and public information; the Recommendation of the Task Force on Climate-related Financial Disclosure; the Green Investment Bank that assesses the impact of green projects; or the 2 Degrees Investing Initiative with the ambition to develop tools to measure portfolio exposure to climate risk. Furthermore, most rating companies are developing their own methodologies in relation to combining financial and ESG assessment of companies and debt instruments.

Following the success of LGX, what will be the distinctive features of the new social/sustainable segment on the Luxembourg Green Exchange?

The new segment on LGX gives visibility to instruments that are issued to fund social and sustainable projects. To be eligible, the issuer will have to declare (similarly to green bonds) the social or sustainable nature of the financed project in line with the GBP social/sustainable taxonomy.

As with green bonds, there is a need for the issuer to provide an external review in the form of a third-party review and a commitment to conduct ex-post reporting on the way the proceeds are used. Issuers are also encouraged to make their KPIs/ metrics well known and report against these with special attention to anticipating the social/sustainable additionality of the projects behind the financial instrument. Today, most ESG/SRI investors do not differentiate their sustainable investments. Yet as the market goes more mainstream and knowledge improves, more specific product/project/additionality identification might become crucial in making investment choices.

What is the potential of the sustainable market? What type of issuers do you plan to attract and what should trigger their interest in joining Luxembourg Green Exchange?

The potential is huge for the sustainability category as it is much wider than the green one. Much like with green bonds, the key added value of having social and sustainable bonds displayed on LGX is the increased visibility of the bonds and sustainable activity of the issuer, improved transparency, and better communication with investors.

For instance, Instituto de Credito Oficial's social bonds aim to promote employment in the most economically depressed regions in Spain, i.e. those that have a per capita income below the national average (these zones currently have an unemployment rate that is equal to or greater than 19 percent). The Dutch BNG Bank's social bonds finance sustainable social housing by providing financing to best-in-class housing associations, while other issuers tackle education, youth and unemployment issues.

If you were to host COP25, in the year 2020, where do you hope the sustainable economy will be? What would your goals be?

In the perfect world, many of the core issues being debated now will have been solved and streamlined by then. The debate will have shifted toward material elements of additionality, in particular a clear measure or comparability of how issuers and projects additionally contribute. This would lead to investors becoming not only more knowledgeable, but also fully conscious of their power to contribute to a groundbreaking shift. Instead of stress tests, we will have sustainability tests.

In particular, I would hope for an alignment of Chinese and EU standards in green finance. I would like us to have introduced a GreenConnect-a platform connecting green investors and issuers all over the globe. And last but not least, LuxSE's red logo should be replaced by the green LGX logo to reflect the radical shift toward green and sustainable finance.