Exchanges Play a Crucial Role in Developing the Sustainable Finance Market

Stock exchanges play a crucial role as an intermediary between investors and issuers, but their role in the sustainable finance market – as platform and infrastructure providers, as facilitators of cross-market standards development, and as educators bringing visibility to new asset classes – is so much wider than that. We speak with Robert Scharfe, CEO of the Luxembourg Stock Exchange, a leader in sustainable finance with over half of the world's green bonds listed on its exchange, on how to attract more investors and borrowers to the market.

Q We have seen an impressive EM rally this year, and some of that has to do with China's better-than-expected performance. How would you assess the outlook for China and emerging markets for the next 12 months? Where do you see the main risks and best prospects?

A China, as one of the largest economies in the world, is of course very influential in determining how the rest of the world economy performs. The most recent news – that China's economy has grown more quickly than anticipated, 6.9% in Q1 2017, reaching an estimated annual growth of 6.4% – is significant. Coupled with improving activity and job growth in the US and Europe, this is good news for emerging markets. Globally, one could say the outlook is cautiously positive.

There are of course a number of caveats and key factors to consider here. China needs to ensure that growing at the current rate is not harmful to the economy itself in broad societal terms, which is part of the reason why sustainability – and the sustainable finance market – has become so immensely important there.

In terms of risks, we still see quantitative easing affecting market prices, and it is likely we will see this come back to the fore as the world's central banks look to unwind or reverse their asset purchases. Uncertainties around the US Administration, and a possible rise in protectionism around US imports, could also have a significant influence on global markets.

Overall, the global picture is cautiously positive, but we need to manage potential interest rate hikes and the unwinding of major QE programmes around the world to ensure distortions can be minimized.

Q The first ever green bond, the "Climate Awareness Bond" was listed in Luxembourg in 2007. How has green financing evolved since then? What has the Exchange done to promote and develop these kinds of instruments?

A The European Investment Bank took a lead in this space with the first Climate Awareness Bond, but the timing was somewhat unfortunate to an extent because the global financial crisis that emerged in 2007 and 2008 largely put a halt to the development of the green bond market. Governments were too busy saving the world economy from collapsing, quite frankly. That said, it became clear by the Paris climate talks in 2015 that the sustainable finance agenda needed to move forward, and public consensus around the importance of sustainability as a broad concept – in energy, finance, and general corporate ethos – was gaining momentum. At the same time, investors globally, for a variety of reasons, are increasingly looking for more transparency in how their money was being used by recipients.

Now, I get the sense we are in the midst of a protracted education process across the market: investors want to invest in initiatives that have a strong ESG angle, but want to be sure that they can still generate adequate returns; corporate and public-sector entities want to access new pools of liquidity, but want to ensure they can generate both internal and external benefits.

Government-backed banks and multilateral development banks have played a leading role in the development of this market, but we need the private sector to enter the picture – not just energy companies, but any entity willing to take a fresh look at their supply chain and make changes to address their carbon footprint through targeted investments. The onus is also on investors. Investors have enormous purchasing power here, given the sheer amount of institutional money they manage, and they are in a sense the guarantor that capital simply won't be available to just any issuer or borrower unconditionally. That's what will push this market forward.

Q The Luxemburg Stock Exchange has signed an agreement to launch a green bond index with the Shenzhen Stock Exchange and Shanghai Stock Exchange, which simultaneously displays green bond quotes in China and Europe. What is the primary purpose of this programme and how can it be replicated in other geographies?

A When this market started 10 years ago with the first Climate Awareness Bond and eventually, the first green bond, nobody was paying much attention to it. It was only following the 2015 Paris Climate Agreement – COP21 – that we found an agreement that could supplant previous pacts, like the Kyoto Protocol or the Copenhagen agreement, and facilitate the growth of the market. Since 2015, the growth has been exponential, despite the fact that the size of the market is still relatively small – less than 1% of the global debt market.

Within that context, we decided to launch the world's first dedicated green exchange, a platform for green bonds that has since expanded to social and sustainable bonds, and is open to a range of instruments and indexes. Looking at the overall market, we cover more than 50% of global listed green bonds. There are also large domestic markets, like China – by far the largest local currency green bond market globally – that are strategically important to partner with in order to heighten the visibility of these assets. Both the Shanghai and Shenzhen Stock Exchanges have indexes that represent the performance of labelled and unlabelled green securities in China. The objective is to open this market further to foreign investors, and in order to do that you need to promote these indexes domestically within Shanghai and Shenzhen, and abroad, which is what drove our partnership with both of these exchanges. The market can use these indexes to set up dedicated investment products, like ETFs, or, through the new Bond Connect programme, make Chinese local currency green bonds available to foreign investors. What we are doing here is bridging the gap between the local green bond market and international investors, and helping to make it more accessible to investors. Partnerships like these are especially important in an environment where the US is retrenching from its climate change mitigation commitments, and creates added scope for Europe and China to work more closely together to move down the path decided at COP21.

Q How has LGX helped to expand the universe of sustainable finance?

A Exchanges in many ways offer the critical infrastructure, indeed a meeting platform for investors and issuers, and we need to make sure that we create a level of transparency that makes both sides comfortable. This means that both need to be able to access the full stock of information available in order to make informed decisions. That's where stock exchanges have a tremendous role to play.

The second role is heavy linked to education. We can inform the market about standards in a way that helps issuers and investors understand this segment; we can show the nuances between issuers of different origin by making data available to the market; and we can bring visibility to new and exciting sustainability instruments. How do we create leverage in all of that? One initiative, the Sustainable Stock Exchanges Initiative - a United Nations initiative which works with over 65 exchanges worldwide - is working to develop guidance to listed companies around the world in order to promote sustainability in terms of environmental, social and corporate governance transparency. Exchanging best practices is extremely helpful in order to accelerate this movement, and very important for the creation of common standards – around reporting the impact of investments – in sustainable finance. These standards are what will enable investors to compare these investments in a common framework, and as such are of supreme importance. If we achieve this kind of alignment across the sector globally, investors can effectively choose what to invest into.

Q Regulations play an important role in stimulating the market, by helping to support the creation of standards as well as incentivise the market. What are the major challenges from the regulatory perspective when dealing with green bonds?

A If you look at the European or international regulatory landscape, most of this has evolved on the basis of standards that have been developed by the industry – like the Green Bond Principles, for instance. Industry self-regulation, so far, has worked tremendously well. We consider frameworks like the Green Bond Principles and the Climate Bonds Standard, developed by the Climate Bonds Initiative, as best practice in the market. In order to list or display bonds on our Exchange, bonds have to fit any of these frameworks – which means mandatory certification and reporting. In other words, we have become stricter than what the market is typically looking for, to the benefit of investors – who secure a second opinion and impact report – and issuers – which gain access to a wider pool of liquidity.

However, regulators can still play a role in helping to develop and shape these standards. If we want to see the market grow faster and further, we need a more robust framework going forward, which can mean creating standard definitions and terms of reference, as well as standard obligations related to publishing certain documents on a mandatory basis. Consider, for instance, Article 173 of France's Climate Transition Law, which obliges institutional investors to display the carbon footprint of their investment portfolio. In this instance, regulators aren't posing restrictions on the market – but by displaying this you create awareness and give investors important information to help facilitate the market. China's regulators have also been very forward-thinking in this space; they have asked every issuer to display how proceeds are used to finance green initiatives within prospectus' of conventional bonds as well as green bonds, which is a significant step forward. In this respect, China is leading the pack.

Regulators should also consider incentives to help boost the market. In any event, it's less a question of using regulation to impose more work on issuers, but about the broader question on how one frames this market to entice both issuers and investors of moving in the same direction – and faster.