Luxembourg Green Exchange: the meeting place for ESG-conscious issuers and investors

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In September 2016, the Luxembourg Stock Exchange (LuxSE) launched a unique platform entirely dedicated to green bonds. It is called the Luxembourg Green Exchange (LGX). Such was the success of LGX that, following a strong market push, in May 2017, the platform expanded to also include bonds that finance social and sustainable projects. It has the potential to rewrite the sustainable finance story.

The Luxembourg Green Exchange offers an environment where issuers of green, social and sustainable securities [(1)] can market their instruments and publish information relating to the use of proceeds, both at the start and during the lifetime of a security. At the same time, the platform caters to responsible investors by providing full and unrestricted access to information about securities that are 100% green, social or sustainable, together with their respective security-specific information.

Stock exchanges should lead on sustainability

One of the first definitions of sustainability was formulated back in 1992 at the Earth Summit in Rio de Janeiro, but it was the Climate Summit in Paris, the COP21 in December 2015 and then the G20 summit in September 2016 that accelerated the change and triggered many of the recent initiatives focused on climate action. By signing the Paris Agreement, more than 180 countries, accounting for approximately 88% of global emissions, committed to keeping global warming well below 2°C. The Sustainable Development Goals (SDGs) framework, launched in 2015 under the United Nations' push, further strengthened the global momentum bringing about a global vision for sustainable development. In practice this means that governments are now taking an unprecedented responsibility to finance climate action and that public and private sector alike are increasingly wary of the risks of not aligning to environmental and other sustainable dimensions.

LuxSE's undisputed role as a stock exchange is to facilitate the launch of more climate-aligned projects to the market. I believe stock exchanges are the crucial actors that can facilitate the development of the sustainable finance market, by creating scale and encouraging new issuers to tap into the market while protecting investors from the risk of green- and social-washing. This can be achieved by providing means for enhanced disclosure: facilitating issuance on one side, and controlling quality on the other [(2)].

Within the broad scope of sustainable projects, demand for green investments, in particular, is growing rapidly. The World Economic Forum estimates that by 2020 approximately USD 5,700 billion will need to be invested in green infrastructure annually. In the context of low or even negative yields on traditional bonds, green credentials present an opportunity for issuers to attract (new) investors. If we just consider the green bonds market, it has doubled in 2016 (USD 81 billion) compared to 2015 (USD 42 billion) [(3)]. Still, however, the current share of labelled green bonds in the overall issuance of debt securities, as estimated by OECD, stands at just above 1% – a drop in the ocean – despite the political talk and the COP21 goals. It is clear that action is needed from all market participants to unlock more capital into sustainable projects while upskilling investors' knowledge in the area.

Breaking down sustainability

Since the launch of LGX, there's been a push, from both investors and issuers, to expand the green bonds market into the broader sustainability area. Achieving envi-

(1) ICMA GBP taxonomies: https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/green-social-and-sustainability-bonds/
(2) CBI, The role of exchanges in accelerating the growth of the green bond market, May 2017.
(3) Climate Bonds Initiative: https://www.climatebonds.net/files/files/2016%20GB%20Market%20Roundup.pdf

ronmental and social objectives is not mutually exclusive. Both can contribute to the paradigm shift of having more private capital allocated to social good projects and more and more investors have embraced this holistic mindset. Interest for sustainable investments can only grow, driven by more climate risk-aware investors (millenials play an important role in this drive) and the hunger for new opportunities. With growth, financial instruments will become more diversified around themes and risks.

LGX's recent expansion to social and sustainable bonds is a direct response to what the market needs and expects. The solution proposed for green bonds, around enhanced transparency, works well and since May 2017 is being successfully replicated to the social and sustainable universe.

LGX currently displays dedicated windows for green, social and sustainable [4] bonds. As the market evolves and differentiates, LGX is expected to promote even more granular display of products and themes that will further contribute to sustainability. LGX's existing windows are a trailblazer of what could come next.

At LuxSE we have already achieved some important milestones: we reached the EUR 50 billion threshold in the value of bonds displayed on LGX; we admitted the first ever sovereign green bond, issued by the Republic of Poland; we listed the biggest green Chinese issuance in the Eurozone. In total, we display 125 green, social and sustainable bonds listed by 35 issuers in 17 currencies. We believe these numbers will substantially grow in the short and medium term.

Hurdles when comparing projects

Exactly ten years after the issuance of the first ever green bond by European Investment Bank (EIB) in 2007, one of the major challenges remains the lack of universally accepted definitions and standards as well as the lack of a legal framework in green finance. The risk of green-washing might be underestimated, but it is still there to potentially threaten the integrity of the green bond market. The same applies to social and sustainable instruments (sustainable projects being those that blend green and social investments). As the market evolves, there is a growing need for greater transparency.

For the green, social and sustainable bond markets to thrive, investors need to be confident that what they are buying is actually producing positive impact on the environment and/or the communities. Until recently, the market has relied on the expectation that no company will want to incur the shame of issuing a "green", "social" or "sustainable" bond and not actually using the proceeds for environmentally-friendly and/or social ends. The so-called "reputational damage" is the main driver for issuers not to breach the Green Bonds Principles (issued by the International Capital Markets Association (ICMA), which is the framework that many issuers apply). But that is not enough. Especially, as investors are becoming pickier about how green the investments are.

Greenwashing can also take place through negligence; an issuer may have good intentions, but proceeds may not be properly allocated, or there may be no possibility to monitor them.

Green-washing can be concealed especially when:

- Bond proceeds are not allocated or allocated late;
- Bond proceeds are allocated to assets that have little or questionable environmental benefit;
- There is no reporting to ascertain how proceeds have been allocated.

This "hidden" form of green-washing is equally dangerous, as it can erode confidence in the market very quickly. When there is green on the door, behind that door everything should be green.

With the creation of LGX, LuxSE has committed to creating and screening that every financial instrument that goes through the LGX green door has been declared as truly green, social or sustainable by external experts engaged by the issuer to verify the nature of the issuance. The key objective of the platform is to provide issuers and investors with a dedicated infrastructure where they can post and access information relating to the security's use of proceeds and the impact it has on the environment, in a transparent and efficient way. This will boost investor trust and integrity in the market.

LGX is the first green bond platform to make post-issuance reporting a mandatory requirement. Green, social and/or sustainable is not a status acquired once and for all, it needs validation throughout the whole life-cycle of the security. In other words, it's not enough for issuers to label their bond as green, social or sustainable; they must provide regular evidence of how the proceeds contribute to additionality, with the first report due 12 months after issuance.

Benefits for issuers and investors

LGX is the first platform that makes industry best practices for green, social and sustainable securities a mandatory requirement. It is also the only exchange that requires issuers to commit to post-issuance reporting once a security has been listed. Within the industry's best practices, LGX recognizes, in particular, ICMA's Green Bond Principles (GBP), ICMA's Social Bond Principles (SBP), ICMA's Sustainable Bond Guidance (SBG) and the Climate Bonds Initiative's (CBI) Climate Bonds Standard (for green bonds).

To join LGX, an issuer must first list its security on one of LuxSE's markets, i.e. the EU-regulated Luxembourg Market (BdL) or the exchange-regulated Euro MTF market. Once the security is listed, the issuer will have the opportunity to apply for its security to be displayed on LGX. In

(4) ICMA GBP taxonomies: https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/green-social-and-sustainability-bonds/

the application form, the issuer needs to declare that the net proceeds raised via the bond will be invested in 100% dedicated green, social or sustainable projects, in line with the international taxonomy, and commit to providing both a pre-issuance external review and regular post-issuance reporting: use of proceeds, need of a clear disclosure that the net proceeds are exclusively used for financing or refinancing projects that are 100% green, social or sustainable, ex-ante review and ex-post reporting, issuer's commitment to provide both external review and ex-post reporting – a requirement unprecedented on the market.

LGX acts as a curator of green, social and sustainable information. Strict adherence to its rules and widely-accepted green and social principles reduces the risk of greenwashing, ensuring that only issuers that commit to entry requirements and provide full transparency on their projects can be displayed on LGX. Having securities admitted to LGX, offers issuers the opportunity to raise awareness about their sustainable-oriented projects via more detailed security cards. The LGX-display increases the instrument's visibility and recognition; eases communication with investors; and, in particular, translates into reaching new ESG-focused investors. On top of that, it converts sometimes heavy disclosure efforts and costs into tangible commercial value via the free display of documents in the structured form of a security card.

Investors, on their side, get access to unrestricted free information that is structured in a smart way including material elements carved out in security cards. They get free access to information relating to a security listed on LGX (e.g. frameworks, second opinions, certifications, rating reports, use of proceeds reports, project information, etc.), allowing for a granular due diligence. The above translates into lower research, analysis and comparison costs for investors.

In an environment where definitions and taxonomies are by nature complex and where investors are ultimately held responsible for making choices about what is acceptable for them, transparency is paramount. LGX's model is fully structured around transparency.

Continuing to aim high

Stock exchanges can drive the development of sustainable market-based solutions both in terms of scale and quality of issuance, and act as providers of market infrastructure for sustainable asset classes. Being the leading stock exchange for debt securities and being the stock exchange with half of the world's listed green bonds globally, LGX's role can be seen as one of both market and facilitator and curator of information, i.e. through (i) imposing additional disclosure as mandatory, (ii) imposing a form of an external review to avoid the issuer's self-labelling or weak internal frameworks, and (iii) monitoring post-issuance reporting (consistency with ex-ante objectives and exhaustive information).

European exchanges can support the integrity and growth of the green bond market by encouraging both the application and development of robust standards, promoting existing standards to better promote international harmonization, comparability and over-arching transparency. LGX's philosophy is based on continuity and innovation: by leveraging existing standards and principles proposed by the market, rather than re-engineering them, LGX has been supporting market convergence around best practice and promoting peer-pressure around increasingly higher standards of quality.

Conclusion

The industry is still young and fragmented by many initiatives. On the buy side there is a growing trend to systematically integrate ESG issues that shows growing awareness and interest among investors. This includes, on the one hand, investment strategies where investors significantly value ESG analysis when rating investments and, on the other hand, investment strategies involving mandatory constraints based on findings from ESG research. This is a natural evolution as pension funds and insurance companies have a long-term investment horizon and need to be wary of the non-financial risks linked to certain investments, especially carbon intensive ones, affecting their portfolios. Future challenges would be to encourage issuers to go the extra mile in allowing more transparency and comparability in measuring the impact of each euro invested in their bonds and, at the same time, to encourage transparency to allow holistic risk management on the buy side. With the pace of progress of the industry, the increasing mobilization of investors and the international financial community as a whole, issuers of tomorrow might well be asked to deliver against specific metrics rather than "just" report on the use of proceeds. It's the logical next step, but it will not be easy to meet such expectations.

The mainstreaming of sustainable finance benefits us all. Reaching the Sustainable Development Goals (SDGs), including climate related goals, will only be possible if we all buy in and participate. Only together will the public sector, issuers and investors be able to steer finance away from systemic risks and towards the public good.

Finally, I look forward to the forthcoming analysis and recommendations of the European Commission's High Level Expert Group (HLEG) on Sustainable Finance. And on how the market will embrace the work of HLEG. I expect it to become a milestone in building a comprehensive EU framework that will irreversibly tie sustainable finance with the global economy.