Julie Becker: Sustainable investments need additional regulation to achieve sustainable growth

Members of HLEG share their thoughts on key topics under discussion

by **Julie Becker** | September 8th, 2017

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This article is one in a series of thought leadership pieces written for Responsible Investor by members of the European Commission's High Level Expert Group on Sustainable Finance. To see other HLEG coverage, see here, or to comment, visit our discussion page.

The sustainable finance market has come right into the spot light in recent months, and in particular the green bond market which has been flourishing even in the absence of mandatory standards. As it opens up to more and more issuers and moves from niche to mainstream, the importance of having robust or even legally-binding listing requirements supported by clear definitions is becoming critical. In order to ensure that the market scales up in a credible manner, it's important to ensure that the risk of 'green washing' scandals is minimised.

The growing focus on non-financial disclosure manifested by the implementation of the EU Non-Financial Reporting Directive requirements into national laws, the Commission's Guidelines on non-financial reporting and the Taskforce on Climate-related Financial Disclosure recommendations are a direct response to palpable market expectations. Environmentally-focused individuals, who often buy organic, take public transport or cycle instead of taking their car, are beginning to ask how their cash is being invested and what the impact of their portfolio is.

These new requirements and recommendations revolve around regular ongoing corporate-level disclosures of, for example, climate-related opportunities and climate risk scenarios. More clarity will contribute to analysts' ability to better evaluate impacts on the longer-term performance and equity value of companies. Credit ratings will also benefit from the availability of this data and soon-to-be-expected "ESG adjusted credit ratings" should benefit investors with a stronger sustainability focused agenda.

Spot light on green bonds

The development of the green bond market is an enviable example for other sustainable asset classes. A closer look might give answers of where to start and how to proceed.

When the European Investment Bank issued its first green bond listed on the Luxembourg Stock Exchange, there were no regulatory standards. But over the last ten years, market standards have been developed by market participants who were conscious of the importance that green bonds could have once they grew to mainstream. Issuers understood that putting a framework in place was vital in order to guide "healthy" development and avoid the risk of 'green washing' claims.

Without relying on listing requirements embedded in legislation, LGX has implemented stricter requirements than even the market looks for, typically: to the benefit of investors – who systematically secure an external certification and impact report and as such can compare one green bond to another and make informed investment decisions; and issuers – who gain access to a wider pool of liquidity and a diversification of their investor base and get increased promotion of their environmentally-oriented strategy.

A Key role for regulators

Regulators can now play a role in helping to develop and shape these standards. For the market to grow faster and further, we need a more robust framework, which can mean creating standard definitions and terms of reference, as well as standard obligations related to publishing certain documents on a mandatory basis.

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Article 173 of France's Climate Transition Law, which introduces mandatory extensive climate change-related reporting for larger asset owners and asset managers, is a good example of such an approach. In this instance, regulators have given investors broad flexibility in choosing the best way to fulfil the disclosures, based on a 'comply or explain' approach. It does not impose any specific method, giving leeway to find the most appropriate reporting methodology, depending upon the specific asset classes or investment strategy for the portfolio. Displaying the information creates awareness and gives investors important information to help facilitate the market. China's regulators have also been very forward-thinking in this space by requiring issuers to display how proceeds are used to finance green initiatives within prospectuses of listed conventional bonds, as well as green bonds. In this respect, China is a good example to follow.

The bottom line: it's less a question of using regulation to impose more work on issuers, and more about the broader question on how this sustainable market can be framed to entice both issuers and investors to move in the same direction – and faster – whilst improving credibility, transparency and reliability. As the sustainable finance market goes mainstream it is almost certainly time to provide a more structured framework for issuers

The European and international regulatory landscape has evolved on the basis of standards that have been developed by the industry – like the Green Bond Principles (GBPs) issued by the International Capital Markets Association (ICMA). Industry self-regulation, so far, has worked tremendously well. Most green bond issuers follow the voluntary market best practice of including high-level intended 'use of proceeds' information in final terms or prospectus documents, often followed up with post-issuance reporting disclosing how the bond proceeds were actually spent. The GBPs and the Climate Bonds Standard, developed by the Climate Bonds Initiative (CBI), are indisputably the market reference. The Luxembourg Green Exchange (LGX) has even gone a step further and successfully implemented stricter standards: to list or display bonds on LGX, they must not only fit the GBPs or CBI frameworks, but also undergo certification and do post-issuance reporting.

and investors – this will mean a degree of regulation. Many of us would like to hope that a simple recommendation from the European Commission on the inclusion of relevant sustainability disclosures in listing documents and other reporting would suffice. However, if the market is indeed to scale up with the volumes and speed necessary to meet ambitious Paris Agreement targets and the Sustainable Development Goals, it is likely that some level of regulation will emerge.

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To give feedback on the group's interim report, published in July, see here.

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