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Exchanges should support the growth of sustainable finance

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Robert Scharfe, CEO, Luxembourg Stock Exchange writes about the role of exchanges in facilitating the development of the sustainable finance market.

Exactly ten years after the issuance of the first ever green bond by the European Investment Bank, one of today's major challenges remains the lack of universally accepted definitions and standards, as well as a non-existence of a legal framework in green finance.

The risk of green-washing is underestimated by some, while it potentially threatens the integrity of the green bond market. The same applies to instruments that finance social and sustainable (a blend of green and social investments) projects. As the market evolves, there is an ever-growing need for greater transparency.

A drop is not enough

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 $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 ($81 billion) compared to 2015 ($42 billion) . 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.

Luxembourg Stock Exchange's (LuxSE) 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.

Focus on transparency

In this spirit, at LuxSE we decided to move from words to action: in September 2016, we introduced the Luxembourg Green Exchange, or LGX, the world's first platform that displays exclusively securities that raise proceeds for projects that are fully aligned with the international green taxonomy. Since the launch of LGX, there's been a push, from both investors and issuers, to expand the green bond platform into the broader sustainability area. Interest for sustainable investments can only grow, driven by more climate risk-aware investors (millennials 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.

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. 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.

A joint effort

European exchanges can support the integrity and growth of the green bond market by encouraging both the application and development of robust standards, leveraging existing standards to better promote international harmonisation of definitions, comparability of projects 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. However, we need others to adopt similar thinking: only through combined efforts can we help sustainable finance to evolve from being a niche, to standard.

** The topic of additionality is hugely important in the current green bond market and it is generally understood to reference finance to projects that are enabling something to happen that otherwise would not have e.g. without financing from a green bond an investment in an emerging markets solar project would not actually happen.*

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