The European Central Bank’s vision for green bond standards forgoes inclusivity

*The European Central Bank has suggested that the proposed EU Green Bond Standard (EU GBS) become mandatory for all green bonds. **Karim Henide** disagrees. He writes that the EU GBS is so narrow that only a fraction of the current green bond market is eligible under this standard. Issuers on the margins may not have the capacity to adhere to the degree of ambition and scrutiny expected at the level of the EU GBS label.*

On 5 November 2021, the European Central Bank (ECB) published a landmark opinion paper regarding the proposed EU Green Bond Standard regulation, in which it suggests that the EU GBS should be made mandatory. Those familiar with the market did not expect the EU GBS to supersede the prevailing market (based on the ICMA principles and guidelines), but to supplement it with an additional voluntary label. The EU GBS in particular was expected to be a ‘gold standard’- a standard so high that many issuers would not be able to access it. Those issuers could have, hypothetically, still issued green-labelled bonds based on the ICMA principles. Under the ECB’s vision, issuers “on the margins” could not participate at all.

In its 2017 report, the European Commission’s High-Level Expert Group on sustainable finance proposed the establishment of green bond standards, building upon the International Capital Market Association’s (ICMA) Green Bond Principles, currently referenced by the majority of green bond issuers. Cognisant of the risks of greenwashing and the need to align with the science-based targets that paved the road to the Paris Agreement in 2015, the High-Level Expert Group recommended the key requirements for issuers previously only recommended by ICMA and otherwise unenforced.

The group’s report suggests that ‘Use of Proceeds’ (the use of the bond’s proceeds for green projects) must be integrated in legal documentation, that the proportion of proceeds used for refinancing should be disclosed, and that issuers must now undergo external review, with eligible external reviewers overseen by and adhering to the requirements set out by the European Securities and Markets Authority (ESMA). Furthermore, all ‘eligible’ projects are now expected to align with the ‘EU Taxonomy’ for sustainable activities, where there was previously a perceived lack of clarity amongst issuers as to which projects could be definitively classified as ‘eligible projects’ under ICMA’s guidance.

As a projected ‘gold standard’, it was expected that the EU GBS would encompass a narrower pool of securities that would sit high in the pecking order of ‘greenness’ and ‘improve the ability of all financial actors, including the ECB, to reliably identify and evaluate environmentally sustainable bonds’, something the ECB recognises in their published opinion. Similarly, it was understood that the EU GBS would be introduced as an additional voluntary label. The ambition was not to supersede the green bond labelling based on ICMA’s principles.

The ECB’s opinion, however, proposes that the EU GBS should become a mandatory green label. From the perspective of the ECB, mandating the EU GBS would help to align issuances and investor expectations, supporting rules-based approaches to engaging with the green bond market. Greening corporate asset purchases, for example, would benefit from a common architecture and centralised supervision. Indeed, the additional supervision and mandated requirements would be expected to improve the allocative efficiency of investment and, by extension, the impact per unit of investment. The clear trade-off, though, would be the higher obstacles for issuers to engage with the label, which would be expected to reduce the market’s inclusivity and the breadth of issuers.

For all of its shortcomings and susceptibility to greenwashing, the prevailing labelling regime provides a greater degree of inclusivity for issuers on the margins who may be structurally disadvantaged and/or may not have the capacity to adhere to the degree of ambition and scrutiny expected at the level of the EU GBS label, for example. Whilst it would be ideal to asymmetrically disincentivise greenwashers from engaging with the green bond market, replacing it altogether with a mandatory EU GBS risks alienating light green issuers from engaging altogether; Commerzbank estimates that less than a mere 50% of the outstanding EUR-denominated corporate and sovereign bond market is EU GBS-eligible – this figure falls to 35% and 30% for the government-related and securitized bond markets, respectively. Allowing the prevailing regime and the EU GBS to operate in parallel allows for issuers to send signals to the market of differentiated quality, creating a ladder of greenness which unlocks an opportunity for issuers of relatively low green ambition to participate (at the lower rung).

When the G20 Green Finance Study Group mulled over the purposes of the green bond markets, they concluded that it was to 'internalise environmental externalities and adjust risk perceptions'. The latter is a gradual social behavioural pattern that can be reinforced by a less rigorous and more inclusive labelling regime. Is it more desirable to have only the most ambitious issuers of green bonds engaging with sustainable finance? Or should we also encourage inclusivity and a pathway for incremental greening? If the impetus for proposing that the EU GBS be made mandatory is the desire to accelerate greening, we should consider that for issuers on the margin, shifting to the EU GBS may not be an alternative. Rather, a mandatory gold standard may dissuade engagement with green finance altogether.

Through alienating issuers on-the-margins from participating in the impact finance market, this proposed amendment also risks widening the margins of inequality and entrenching issuers that lag in sustainable development by virtue of the phenomena of 'greenium', the premium of green bond relative to their non-green curve, and the 'halo effect', the tendency of green bond issuers' non-green curves to trade tighter to the benchmark. The academic literature points to other benefits of green bond issuance too.

For those able to issue green bonds under a hypothetically mandatory EU GBS label, the greenium presents a capital arbitrage; the prospect of a lower cost of capital allows issuers to maximise value and undertake projects that may not be viable for identical issuers of exclusively non-green debt. The greenium that is currently observed in the market may also be reasonably expected to increase under a mandatory EU GBS, as the market upholds a higher standard. This may result in further capital bifurcation that advantages more developed and structurally privileged EU member states relative to their less developed and structurally disadvantaged peers; perhaps a mandatory gold standard risks exacerbating the rift of the North-South divide. The ECB does, however, propose that sovereign issuers are not made subject to supervision, which provides some consolation.

Prior to assuming the presidency of the European Central Bank, Christine Lagarde delivered a poignant public address that was reminiscent of her accomplishments at the IMF and emphasised addressing 'imbalances'. Madame Lagarde suggested that nations with 'chronic budget surpluses' should redress the 'imbalances' through investment in infrastructure, education and innovation. It is these maxims of inclusivity and camaraderie that the institutions and bodies of the EU should uphold; yet it is the sentiment of these maxims that may be flouted by the divergence in the vision of the very EU institution that Mme Lagarde presides over. It begs the question: "Madame, disregarde?".

Disclosure: The author served as a member of an ICMA Technical Working Group at the time of writing. All opinions expressed are his own and do not necessarily represent those of ICMA.

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Notes:

- *This blog post is based on Green lemons: overcoming adverse selection in the green bond market, Transnational Corporations, Volume 28, Issue 3, Dec 2021, p. 35-63.*
- *The post expresses the views of its author(s), not the position of LSE Business Review or the London School of Economics.*
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