Latest Developments in the Sustainable Finance Market

ECB Bond Market Contact Group

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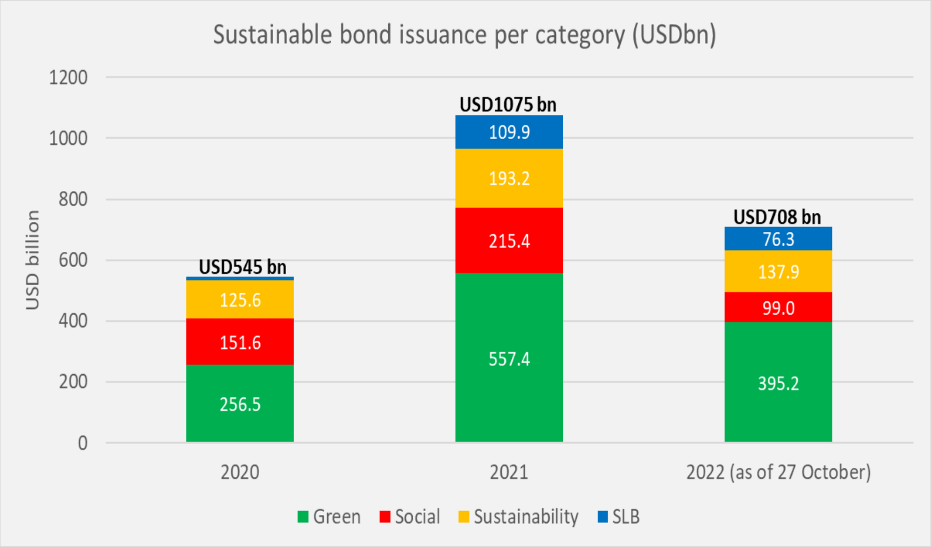
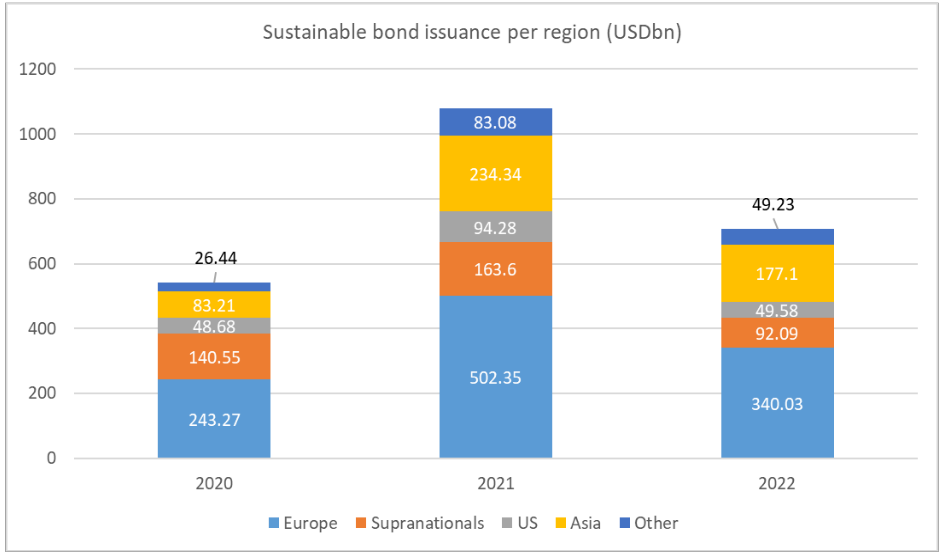
Sustainable bond market developments

- After a record issuance of over US$1trillion in 2021 issuance of sustainable bonds down 23% y-o-y as of end October, mainly a result of the broader bond market issuance conditions (-18% y-o-y) and Covid-19 themed social/sustainability bonds coming to an end
- Green bonds dominate the market with sustainability-linked bonds (SLBs) still an emerging product and increasingly favoured by corporates
- Green and SLB issuance down by -15% and -17% respectively (annualised)
- European issuers continue to lead the market with nearly 50% of the issuance volume consistently over the recent years
- Chile became the first sovereign SLB issuer with targets linked to its Paris commitments, followed very recently by an SLB from Uruguay which includes a target related to the country's native forests (and includes 2-way ratchet)

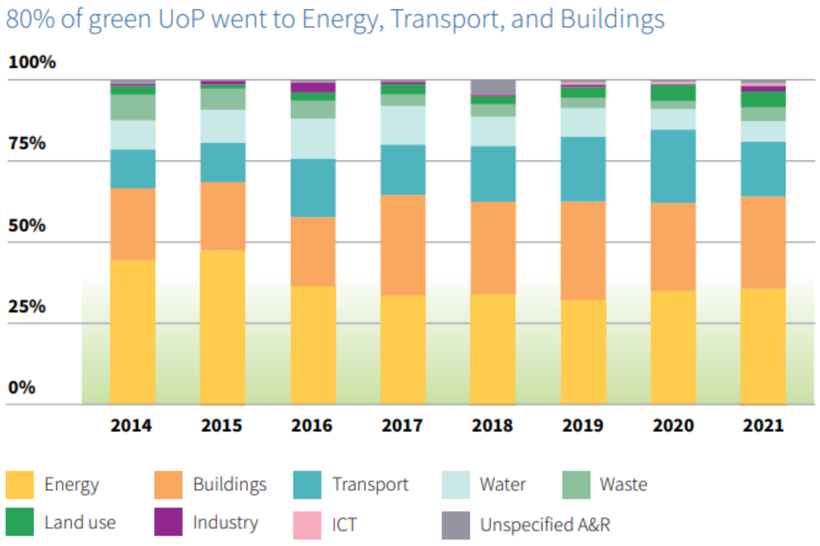




Source: ICMA based on BBG data (27 Oct. 2022)

Role of sustainable bonds in transition finance and innovation

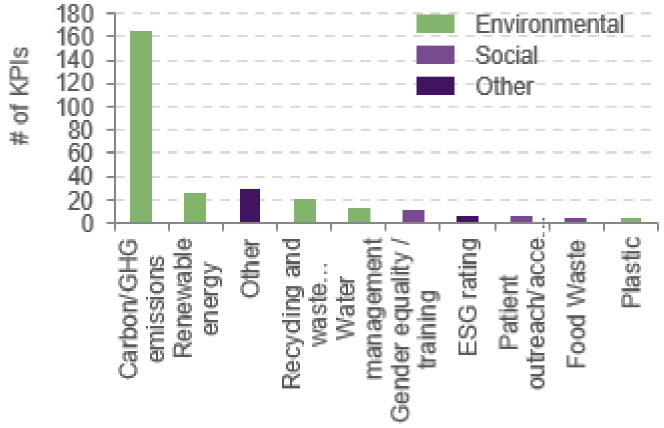
- **Green bonds**
  - Most established sustainable finance asset class
  - Historically, 80% of green allocations have gone to the decarbonisation of energy, buildings, and transport sectors
  - Green bonds can also be used to finance R&D, innovative energy technologies and adaptation solutions, which are already common use-of-proceeds types in sovereign issuances
  - Moreover, papers from ECB and ESMA demonstrate wider benefits of green bonds - the former finds "greenium" in credible green bonds while the latter positively correlates GB issuance with GHG disclosure and emission intensity reduction

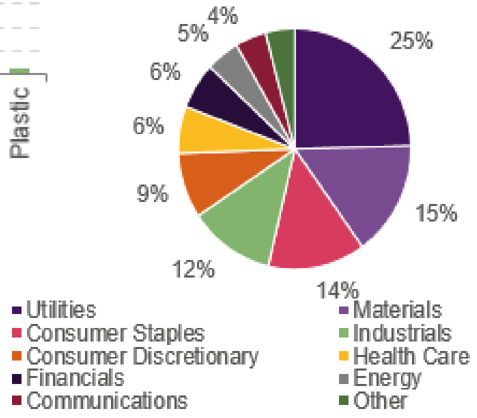


Source: CBI

- **SLBs**
  - As an entity level instrument provides genuine scalability
  - SLBs are overwhelmingly used by corporate issuers (over 90%) for decarbonisation purposes with an estimated 70% of SLBs including GHG targets
  - Overall, SLBs are complementary to green bonds and bring a diverse range of businesses, particular hard-to-abate sectors to sustainable finance markets
  - Over 60% of SLB issuance to date from European issuers
  - Limited sovereign issuance so far (moral hazard overhang)

SLB KPIs and issuer sectors





Source: Natwest Markets, Apr. 2022

Transition finance: challenges and areas of action

- Scoping the funding gap: estimated US$271 trillion of investment gap to reach net-zero by 2050, which translates into an annual gap of >US$9 trillion between 2022 and 2050 (source: Swiss Re)
- Transition finance concept needs to be underpinned with a common understanding, definition and standardisation
- SLBs - alongside Green UoP bonds - are critical to driving the transition given scalability, but take-up is still in early stages
- Robust market practice and complementary regulatory action are required to boost investor focus and appetite
    - Clear, relevant and ambitious standards KPIs and SPTs needed to meet investor expectations on materiality and ambition
    - Robust and consistent regulation on more holistic corporate sustainability reporting and transition plans (GHG disclosures, business strategy change, decarbonisation targets and levers, and involvement of management)
    - Enhanced oversight and supervision needed of external reviewers, ESG rating and data providers etc. to build investor confidence
- EMs account for the majority of the requirements to bridge the funding gap goals so broadening access to financing on a consistent basis is critical
    - EMs suffer from structural deficiencies (e.g. lack of robust capital markets infrastructure and capacity, regulatory and governance challenges) and inconsistent access to deep international capital markets
    - Increasing pressure on MDBs to do more by utilise additional lending headroom based on credit rating and capital structure as well as more risk taking

Recent regulatory developments in sustainable finance

- EU Green Bond Standard – standard should be simple and avoid issuer deterrence for a successful market adoption
  - Ongoing trialogue process converging on the voluntary nature of the standard (which may potentially be subject to a review in future)
  - Risk of a low market uptake for the EU GBS due to: (i) challenges related to the EU Taxonomy; (ii) increased liability risks, (iii) further complexity of the standard with duplicative entity-level disclosures.
  - Current proposal to extend requirements to wider sustainable bonds issuance would go against the original intention to create a voluntary, gold standard (see ICMA's latest position paper)
- Enhanced corporate sustainability reporting – critical but need to avoid international fragmentation, inconsistency in data and metrics while ensuring implementation is proportional
  - ISSB, EFRAG, SEC, UK TPT have recently consulted on their upcoming standards (ICMA's position papers on EFRAG, ISSB, and UK TPT)
  - Potential market relevance of transition plans
- Intensifying regulatory and market scrutiny on greenwashing – challenge to strike the right balance between setting highest standards of behaviour and encouraging market activity
  - EU: SFDR implementation guidance + comprehensive mandate to ESAs on "greenwashing" + EC's newly proposed greenwashing consumer legislation
  - UK: the FCA's recent consultation on fund labels and terminology restrictions
- Other key recent market developments / initiatives
  - ECB announcement to green corporate debt portfolio and collateral framework, and climate scoring methodology
  - ICMA KPI registry to standardise SLB issuance / definitions for sustainable securitisation / high-level categorisation of sustainability in repo market
  - Sustainability-linked Sovereign Debt Hub (SSDH) providing technical input and tools to boost development of sovereign SLBs

Update on the EU Taxonomy

- What next for the EU Taxonomy?
  - After one year of "eligibility" reporting in 2022, NFRD companies will start "alignment" reporting as of January 2023 (for the year of 2022) for climate mitigation and adaptation objectives
  - EC expected to release further Level 3 guidance (e.g. Q&As) on the implementation of Taxonomy reporting.
  - PSF 2.0 will mainly focus on the usability issues (PSF 1.0's mandate came to an end with several reports delivered including the recent ones on usability and data and minimum safeguards)
  - Based on the PSF input, EC will finalise environmental technical criteria for the remaining four environmental objectives

- Market feedback on the Taxonomy
  - Challenging overall complexity of the regulatory framework
  - Anticipated very low alignment numbers at an economy-level (0-5%), mainly due to: (i) the narrowness of the current green thresholds/definitions (particularly for hard-to-abate transitional activities) and (ii) usability challenges (e.g. difficulty in full alignment with the DNSH and Minimum Safeguards, EU-centric testing criteria, etc.)
  - If issues of inclusivity, usability, and complexity are addressed, Taxonomy can be relevant for transition as: (i) it includes transitional activities and thresholds; (ii) it counts forward-looking CapEx and CapEx plans into entity-level reporting metrics; and, (iii) entity-level Taxonomy alignment can serve as KPI and SPT in SLBs
  - In case of a no/late action, the Taxonomy's relevance in driving the transition can face competition from more actionable frameworks

- Global context - with over 25 jurisdictions developing taxonomies, international fragmentation and lack of interoperability can increase the complexities and costs especially for cross-border climate finance flows

High-level discussion points

- How does your organisation see and approach green bonds & SLBs and the wider transition finance topic? What are the perceived challenges and/or positive developments in further scaling up the availability of transition finance?

- Regulators and media have intensified their focus on “greenwashing”. How can policy makers strike the right balance between the scale vs. the quality of sustainable finance markets? Is the current/upcoming regulatory framework fit-for-purpose in this respect?

- DM frameworks such as EU Taxonomy are sometimes criticised for being “too niche” or “high bar” to achieve by EMs issuers. How can policy-makers ensure that their regulatory frameworks help with cross-border climate finance flows and avoid unintended consequences (such as reducing DM investors’ appetite towards EMs)?