Green bonds – is green the new black?

CLIFFORD CHANCE

Green Bonds – is green the new black?

Green bonds are all the fashion. Although multilateral investment institutions such as the European Investment Bank and the World Bank have been issuing green bonds since 2007, the first corporate green bonds were only issued in November 2013. Since then the market has seen exponential growth, from USD11 billion in 2013 to approximately USD40 billion in 2015, and the number and range of issuers entering the green bond market continues to expand. The emergence of the green bonds market has been recognised by the United Nations in its "Trends in Private Sector Climate Finance" on 9 October 2015 as representing "one of the most significant developments in the financing of low-carbon, climate-resilient investment opportunities".

As this nascent market grows there is an increasing amount of interest in the investor, issuer and underwriter communities. This brochure provides a basic overview of what a green bond is, outlines the major initiatives in the space and identifies current key themes.

What is a green bond?

There is no formal or statutory definition of a green or climate bond, nor are they always easily identifiable by a green moniker or a "green bond" title. Essentially a green bond or climate bond is a fixed income product the proceeds of which are used for projects which have environmental benefits and typically promote a low carbon economy. There is a wider pool of environmental, social and governance (ESG) bonds into which green or climate bonds loosely fall but this brochure does not seek to address that broader category.

Currently widely recognised green bond types			
Use of proceeds	**Use of proceeds (no recourse)**	**Project bonds**	**Securitised bonds**
The proceeds of the bonds are assigned to an eligible green project with traditional recourse to the issuer.	The proceeds of the bonds are assigned to eligible green projects. Bondholders have recourse to a specified revenue stream (which may be unrelated to the projects) but not to the issuer.	Proceeds are invested in a specific green project and the investor has direct exposure to the green project itself.	The relevant revenue stream is generated by assets that are considered green.

There may of course be other variants of existing bonds that are considered green in the market and, as the market is in its relative infancy, it is inevitable that other structures will develop.

Why are green bonds popular?

Green bonds are popular amongst issuers for various reasons, although at the moment improved pricing on issue does not seem to be one of them. Corporate green bonds (or, using the above categories, use of proceed bonds) are currently pricing flat on issuance with the issuer's other debt. There is logic to this as the credit is the same. Interestingly however, many of the green bond issuances are creating demand from a wider range of investors, and in some cases investors who are new to the particular issuer. For example, on the GDF Suez issuance (see Focus on transactions below) it was reported that 64% of investors were sustainable investors many of whom were investing in GDF bonds for the first time. Increased investor demand and diversification may eventually translate to a pricing differential. A recent report by Barclays indicates that green bonds trade at a premium in the secondary market, up to 17 basis points tighter than conventional bonds, attributed in part to demand from environmentally-focused funds. In addition, issuers benefit from positive publicity resulting from green bond issuance – green bonds present an opportunity to align corporate strategy with fund raising.

Self certification

Given, as noted above, there is no legal definition of a "green bond", it is effectively issuers themselves who determine if their bonds are green and market them as such. Similarly, the ongoing commitments of green bond issuers, such as ensuring that the proceeds are used for the green purposes described in the bond offering documentation and complying with any reporting obligations that they have agreed to adhere to, are not generally included as contractual covenants enforceable by investors – investors must rely on market reprobation to ensure issuer compliance. The key players in the green bond market see benefit in self-regulation by the market, but also recognise that minimum standards and criteria give confidence to investors, enable better and quicker execution and trading and improve comparability across bonds. To address the lack of uniform standards the Green Bond Principles (GBP) and the Climate Bonds Initiative (CBI), amongst others, have sought to develop general principles and certification programmes. In conjunction with these initiatives there is an increased focus across the sector on standardising the provision of assurance, verification and reporting.

The Green Bond Principles (GBP)

The GBP are a set of voluntary principles developed by a group of investors, issuers and underwriters. They are relatively non-prescriptive and designed to encourage the growth of the market without imposing unduly high barriers to entry. The purpose of the GBP is to promote integrity in the development of the green bond market by clarifying the approach for issuance of a green bond. The GBP are coordinated by the International Capital Markets Association as secretariat and there are currently 103 members.

The original GBP were launched in January 2015 and a revised set of principles was published in March 2015. It is intended that the GBP be reviewed and revised annually following consultation with the GBP members and observers. There are four components of the GBP:

1. *Use of proceeds* – proceeds must be used for a designated eligible green project and must be clearly documented. The GBP recognises several broad categories of eligible projects which aim to address climate change, natural resources depletion, biodiversity conservation and/or pollution.
2. *Process for Project Evaluation and Selection* – the issuer must describe the process by which it evaluates and selects projects that comply with the eligibility categories outlined in the GBP.
3. *Management of Proceeds* – the proceeds of a green bond issuance must be formally tracked and accounted for internally.
4. *Reporting* – the issuer should report annually on the use of proceeds, provide a brief description of the projects invested in and the expected environmental impact.

As the GBP have been endorsed by the key stakeholders in the market, adherence to the principles has become accepted practice in green bond issuance.

The Climate Bonds Initiative (CBI)

The Climate Bonds Initiative is a not for profit organisation dedicated to growing the market in climate bonds and promoting a low carbon and climate resilient economy. The CBI describes itself as having three main workstreams – market tracking, developing standards and providing policy models and advice.

The standards developed by the CBI provide sector-specific eligibility criteria for asset classes and projects, for example solar, wind and low carbon buildings. The aim of the standards is to be a "screening tool" to enable investors to assess the environmental impact of a bond. Subject to third party verification, a bond which satisfies the standards can be awarded the "climate bond certified" stamp. The Climate Bonds Standard v1.0 was released in late 2011 and, as at December 2015, five bonds have been certified under the programme. The CBI have consulted on, and intend to publish in 2016, Version 2.0 of the Standard which incorporates the 2015 GBPs. As with the GBP the intention is to create minimum standards that can be used by the mainstream market.

Other market standards

There are a number of other market-led projects that also look to develop or harmonise standards and practice.

- ***The Ceres Investor Network on Climate Risk*** (a major group of investors in green bonds, including pension funds, insurance companies and asset management groups) released a "Statement of Investor Expectations" in February 2015 to support the development of the green bonds market. The Statement supported the development of the GBPs and identified four key areas of focus - eligibility; initial disclosure and use of proceeds; ongoing reporting on use of proceeds and project impacts and independent assurance. The investor group, while recognising the potential extra cost involved for issuers in complying with the Statement requirements, "urge issuers to follow them to the extent feasible."
- ***The World Bank published its Green Bond Impact Report*** in June 2015. This seeks to provide best practice guidance on impact reporting. It details the renewable energy and energy efficiency results of each green bond eligible project financed by the International Bank for Reconstruction and Development and explains the underlying reporting approach.
- ***The Green muni bonds playbook*** focusing on the US muni market was published by the Green City Bonds Coalition (which includes Ceres and the CBI) in July 2015. This looks to provide standard guidance to US cities looking to access the green bond market.

- ***The Green Investment Handbook*** was published by the Green Investment Bank (GIB) in 2015. It sets out the tools GIB uses to assess, monitor and report on green investments. The stated aim of publishing the handbook is to "start a discussion across the investment community about how green impact assessment can be further improved and standardised".

Focus areas: transparency, assurance and reporting

There is broad agreement between the GBP, the CBI and market commentators and participants that the green and climate bond market should be mobilised and incentivised without imposing prescriptive standards. The argument is that low barriers to entry will attract the widest possible pool of issuers and investors ultimately bringing green and climate bonds into the mainstream market and out of a "niche" classification. The flip side to a low level of prescription in terms of standards is the need for a high degree of transparency, independent verification and reporting.

To participate fully in the market investors need to have confidence in the environmental credentials and performance of green bonds, therefore the GBP and Climate Bond Standards stress the need for issuers to be as transparent in their project evaluation and monitoring processes. Independent assurance and third party verification as to compliance with the relevant principles or standards and post issuance impact reporting are recommended for the GBPs and required for CBI certification. At present there is no indication that, as a general practice, investors are looking to embed in the legal documentation of a 'use of proceeds' green bond the ability to enforce an issuer's commitments to on-going reporting and its stated green use of proceeds.

Type of independent "review"	What does it mean
Second opinion	These are usually provided by an environmental consultant which has been employed by and worked with the issuer to develop a process for green project eligibility and selection. A second opinion may also cover the management of use of proceeds process.
Third party audits	These are provided by third party assurance companies instructed by the issuer. There is no set format for a third party audit but the auditor/assurer may assess and report on proceeds management and tracking; prepare annual impact reporting for the green projects funded by the green bond or otherwise assess the issuer's on-going compliance with its green bond commitments. Ideally these audits should be measured against available industry specific standards.

There is a current focus on how to best standardise the quality of assurance provision, including impact reporting. The ambition is to establish robust industry wide criteria to improve confidence and comparability across the market and there are a number of current initiatives:

- An informal working group of 11 international financial institutions, including a number of multilateral development banks, published its conclusions "Green Bonds: Working Towards a Harmonized Framework for Impact Reporting" in December 2015.
- A number of the assurance firms, including KPMG, Ernst & Young and PWC, are in discussions with the CBI on how best to achieve a market assurance framework.
- The GBP Executive Committee has also announced that it is establishing a number of working groups looking at standards and assurance, the definition of 'green' and impact reporting.

'Third party' market developments

Separately from the GBP, CBI and other developments on principles and certification the past year has seen a number of third parties become involved in developing tools to assist investors in their green bond investment decisions.

- **Green indices**: a number of these now exist, such as the S&P Green Bond Index and Barclays MSCI Green Bond Index, and they seek to provide more and better data on green bonds and their performance to investors. As the market grows these indices are likely to become more sophisticated to provide more granular information and deeper analysis.
- **Green market segments**: the London and Oslo Stock Exchanges each launched specific green market segments to tap into the growth in the green bonds market in the past year. Both exchanges require a bond listed on a green segment to be issued with a second opinion. The LSE also requires that the entity providing the second opinion meets certain criteria. As of December 2015 there were 25 bonds listed on the LSE's green market segments and nine on the Oslo Bors.
- **Green ratings**: GIB intends to launch a green ratings system in the coming months. A pilot system, DART (Deal Assessment Ratings Tool), was included in its Green Investment Handbook published in 2015 (referred to above).

- **Secondary market ratings**: are increasingly being issued to assist "dark green" investors in the secondary market. For example, Oekom Research, which covers around 80 per cent of the secondary market in green bonds, issues sustainability bond ratings based on a detailed ESG analysis of the bond and the issuer. Key elements of the bond rating relate to transparency and external assurance and the sustainable impact of the bond.

The development of such tools is likely to encourage issuers to adopt a more consistent approach to disclosure, verification and reporting.

Growth markets

A surge in the growth of green bond issuance coming out of China and India is expected over the next few years.

China: The Chinese government is committed to encouraging the growth of a green financial system as part of its wider financial market reforms, as set out in its Twelfth Five Year Plan published in 2011. The People's Bank of China (PBoC), together with The United Nations Environment Programme, published a report "Establishing China's Green Financial System" in April 2015 and the recommendations include the promotion of a green bond market. The report looks at how 'green' should be defined in the Chinese context and a specific evaluation system – a green bond in China will need to achieve regulatory approval to be called green, although there is likely to be a fast track approval system. The report also considered how to incentivise the market for example by providing tax incentives and offering preferential regulatory treatment for green bonds. It is estimated that two trillion of RMB green finance will be required to meet China's green policy goals over the next five years. The PBoC and the CBRC (China's banking regulator) are developing green bond guidelines which are expected to be published before the end of 2015. These are likely to be far more detailed that the GBP and the domestic green bond market in China will be based on regulation rather than self certification. In July 2015 Goldwind became the first Chinese issuer to issue a green bond and the Agricultural Bank of China issued the first bank green bond on 14 October 2015. Both bonds were oversubscribed several times.

India: The Indian government has published ambitious environmental targets, particularly in renewable energy. In its recent submission to the UN, prior to the UN Paris Climate Change Conference in December 2015, India pledged to source 40 per cent of its electricity from renewable and other low carbon sources by 2030. Government ministers have stated that they want private capital to assist with reaching their renewable targets. A report by Moody's Investor Services published on 19 October 2015 states that "India has established itself as an early leader in Asia's nascent green bond market." Yes Bank issued India's first domestic green bond in February 2015 and CLP Wind Farms issued the first corporate green bond. In the autumn of 2015 ReNew Wind Energy and Hindustan Power also issued corporate green bonds.

What next

To conclude, as the table on the next page demonstrates, green bonds have already been used to raise significant amounts, using varied structures and by varied types of issuers. Indications are that the market will continue to grow, buoyed particularly by the Chinese and Indian markets, and that green bonds are likely to become an important vehicle in delivering internationally agreed climate standards.

Focus on transactions

Issuer	Key terms	Notable features	Second opinion/verification/reporting
GDF Suez **May 2014**	■ Euro 1,200m 1.375% due 2020 ■ Euro 1,300m 2.375% due 2026	■ **Largest green bond to date** ■ Use of proceeds bond ■ Used for renewables plus energy efficiency projects ■ Oversubscribed	■ Green bond project eligibility and criteria developed with and second opinion given by ESG rating agency Viego ■ Regular reports by GDF Suez's auditor on compliance with proceeds allocation ■ Regulator reporting by GDF Suez on green projects and environmental indicators financed by the green bond proceeds
Advanced Semiconductor Engineering **July 2014**	■ USD 300m FRN due 2017	■ **Asia's first corporate green bond** ■ Use of proceeds bond ■ Proceeds used to improve energy efficiency, waster and water management ■ Oversubscribed	■ Criteria for eligible projects developed with Cicero ■ Cicero also to monitor use of proceeds ■ ASE to issue annual investor letter on use of proceeds
Agricultural Bank of China **October 2015**	■ USD400m 2.125% due 2018 ■ USD500m 2.750% due 2020 ■ CNY600m 4.150% due 2017	■ **First Chinese Bank green bond** ■ Use of proceeds bond ■ Proceeds to be used exclusively for lending in support of environmental protection ■ Oversubscribed	■ Deloitte provided an independent limited assurance statement in relation to the Bank's Green Bond Management statement ■ Annual reporting
Shanks Group plc **May 2015**	■ EUR 100m 3.65% due 2022	■ **First retail offering to be listed on LSE's green market segment** ■ Retail bond offered publicly to retail investors in Belgium and Luxembourg ■ Use of proceeds bond	■ Eligibility criteria developed by Sustainalytics ■ Sustainalytics also provided a second opinion ■ Specific reference to and compliance with GBP ■ Annual reporting on eligible projects to be provided in Shanks Corporate Responsibility Report
BerlinHyp **April 2015**	■ EUR 500m 0.125% due 2022	■ **First green covered bond** ■ Mortgages over certified green buildings made up the green asset in the cover pool ■ Oversubscribed ■ Investor diversification with 15 new investors in BerlinHyp ■ 48% bought by socially responsible investors	■ Eligibility criteria developed by Oekom Reserach ■ Oekom Research provided a second opinion ■ Annual reporting

Contacts

Cedric Burford
Partner
T: +33 14405 5308
E: cedric.burford@cliffordchance.com

Clare Burgess
Partner
T: +44 20 7006 1727
E: clare.burgess@cliffordchance.com

Angela Chan
Partner
T: +852 2825 8891
E: angela.chan@cliffordchance.com

Stewart Dunlop
Partner
T: +44 20 7006 2787
E: stewart.dunlop@cliffordchance.com

David Dunnigan
Partner
T: +44 20 7006 2702
E: david.dunnigan@cliffordchance.com

Matt Fairclough
Partner
T: +852 2825 8927
E: matt.fairclough@cliffordchance.com

Connie Heng
Partner
T: +852 2826 2457
E: connie.heng@cliffordchance.com

Eric Green
Senior Associate
T: +44 20 7006 4538
E: eric.green@cliffordchance.com

Poppy Mitchell
Senior Associate
T: +44 20 7006 4748
E: poppy.mitchell@cliffordchance.com

Julia Machin
Managing Senior PSL
T: +44 20 7006 2370
E: julia.machin@cliffordchance.com

Jessica Walker
Senior PSL
T: +44 20 7006 2880
E: jessica.walker@cliffordchance.com

C L I F F O R D
C H A N C E

Worldwide contact information
35* offices in 25 countries

Abu Dhabi
Clifford Chance
9th Floor, Al Sila Tower
Abu Dhabi Global Market
Square
PO Box 26492
Abu Dhabi
United Arab Emirates
T +971 2 613 2300
F +971 2 613 2400

Amsterdam
Clifford Chance
Droogbak 1A
1013 GE Amsterdam
PO Box 251
1000 AG Amsterdam
The Netherlands
T +31 20 7119 000
F +31 20 7119 999

Bangkok
Clifford Chance
Sindhorn Building Tower 3
21st Floor
130-132 Wireless Road
Pathumwan
Bangkok 10330
Thailand
T +66 2 401 8800
F +66 2 401 8801

Barcelona
Clifford Chance
Av. Diagonal 682
08034 Barcelona
Spain
T +34 93 344 22 00
F +34 93 344 22 22

Beijing
Clifford Chance
33/F, China World Office
Building 1
No. 1 Jianguomenwai Dajie
Beijing 100004
China
T +86 10 6505 9018
F +86 10 6505 9028

Brussels
Clifford Chance
Avenue Louise 65
Box 2, 1050 Brussels
T +32 2 533 5911
F +32 2 533 5959

Bucharest
Clifford Chance Badea
Excelsior Center
28-30 Academiei Street
12th Floor, Sector 1,
Bucharest, 010016
Romania
T +40 21 66 66 100
F +40 21 66 66 111

Casablanca
Clifford Chance
169 boulevard Hassan 1er
20000 Casablanca
Morroco
T +212 520 132 080
F +212 520 132 079

Doha
Clifford Chance
Suite B
30th floor
Tornado Tower
Al Funduq Street
West Bay
P.O. Box 32110
Doha, Qatar
T +974 4 491 7040
F +974 4 491 7050

Dubai
Clifford Chance
Level 15
Burj Daman
Dubai International Financial
Centre
P.O. Box 9380
Dubai, United Arab Emirates
T +971 4 503 2600
F +971 4 503 2800

Düsseldorf
Clifford Chance
Königsallee 59
40215 Düsseldorf
Germany
T +49 211 43 55-0
F +49 211 43 55-5600

Frankfurt
Clifford Chance
Mainzer Landstraße 46
60325 Frankfurt am Main
Germany
T +49 69 71 99-01
F +49 69 71 99-4000

Hong Kong
Clifford Chance
27th Floor
Jardine House
One Connaught Place
Hong Kong
T +852 2825 8888
F +852 2825 8800

Istanbul
Clifford Chance
Kanyon Ofis Binasi Kat. 10
Büyükdere Cad. No. 185
34394 Levent, Istanbul
Turkey
T +90 212 339 0000
F +90 212 339 0099

Jakarta**
Linda Widyati & Partners
DBS Bank Tower
Ciputra World One 28th Floor
Jl. Prof. Dr. Satrio Kav 3-5
Jakarta 12940
T +62 21 2988 8300
F +62 21 2988 8310

London
Clifford Chance
10 Upper Bank Street
London
E14 5JJ
United Kingdom
T +44 20 7006 1000
F +44 20 7006 5555

Luxembourg
Clifford Chance
10 boulevard G.D. Charlotte
B.P. 1147
L-1011 Luxembourg
T +352 48 50 50 1
F +352 48 13 85

Madrid
Clifford Chance
Paseo de la Castellana 110
28046 Madrid
Spain
T +34 91 590 75 00
F +34 91 590 75 75

Milan
Clifford Chance
Piazzetta M. Bossi, 3
20121 Milan
Italy
T +39 02 806 341
F +39 02 806 34200

Moscow
Clifford Chance
Ul. Gasheka 6
125047 Moscow
Russia
T +7 495 258 5050
F +7 495 258 5051

Munich
Clifford Chance
Theresienstraße 4-6
80333 Munich
Germany
T +49 89 216 32-0
F +49 89 216 32-8600

New York
Clifford Chance
31 West 52nd Street
New York
NY 10019-6131
USA
T +1 212 878 8000
F +1 212 878 8375

Paris
Clifford Chance
1 Rue d'Astorg
CS 60058
75377 Paris Cedex 08
France
T +33 1 44 05 52 52
F +33 1 44 05 52 00

Perth
Clifford Chance
Level 7
190 St Georges Terrace
Perth WA 6000
Australia
T +618 9262 5555
F +618 9262 5522

Prague
Clifford Chance
Jungamannova Plaza
Jungamannova 24
110 00 Prague 1
Czech Republic
T +420 222 555 222
F +420 222 555 000

Riyadh
Clifford Chance
Building 15, The Business Gate
King Khalid International Airport
Road
Cordoba District, Riyadh, KSA.
P.O.Box: 3515, Riyadh 11481,
Kingdom of Saudi Arabia
T +966 11 481 9700
F +966 11 481 9701

Rome
Clifford Chance
Via Di Villa Sacchetti, 11
00197 Rome
Italy
T +39 06 422 911
F +39 06 422 91200

São Paulo
Clifford Chance
Rua Funchal 418 15ºandar
04551-060 São Paulo-SP
Brazil
T +55 11 3019 6000
F +55 11 3019 6001

Seoul
Clifford Chance
21st Floor, Ferrum Tower
19, Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
T +82 2 6353 8100
F +82 2 6353 8101

Shanghai
Clifford Chance
40th Floor, Bund Centre
222 Yan An East Road
Shanghai 200002
China
T +86 21 2320 7288
F +86 21 2320 7256

Singapore
Clifford Chance
Marina Bay Financial Centre
25th Floor, Tower 3
12 Marina Boulevard
Singapore 018982
T +65 6410 2200
F +65 6410 2288

Sydney
Clifford Chance
Level 16, No. 1 O'Connell
Street
Sydney NSW 2000
Australia
T +612 8922 8000
F +612 8922 8088

Tokyo
Clifford Chance
Akasaka Tameike Tower
7th Floor
2-17-7, Akasaka
Minato-ku
Tokyo 107-0052
Japan
T +81 3 5561 6600
F +81 3 5561 6699

Warsaw
Clifford Chance
Norway House
ul.Lwowska 19
00-660 Warsaw
Poland
T +48 22 627 11 77
F +48 22 627 14 66

Washington, D.C.
Clifford Chance
2001 K Street NW
Washington, DC 20006 – 1001
USA
T +1 202 912 5000
F +1 202 912 6000

*Clifford Chance's offices include a second office in London at 4 Coleman Street, London EC2R 5JJ. **Linda Widyati and Partners in association with Clifford Chance. Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.

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