How do market players view the European Green Bond Standard?

Q&A with Erste Group and RBI

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This is the third and final article in a series that includes: (1) The European Green Bond Standard - Gold standard for green bonds or regulatory burden? and (2) Sustainable Securitisation: too complicated or worth the effort?

This Wolf Theiss Q&A on the new European Green Bond Standard brings together the valuable insights of two key market participants, Raiffeisen Bank International and Erste Group, represented by experts Jörg Liesenfeld and Danijel Ficulovic, respectively.

What will the EuGBS bring in practical terms?

The European Green Bond Standard has been proclaimed by the European institutions as the new "gold standard" for green bonds, helping market participants to raise funds while meeting sustainability requirements and protecting investors from greenwashing. The aim is to create a market standard that would set the benchmark for green bonds and protect market integrity, ensuring that only legitimate environmental projects are financed.

The success of the European Green Bond Standard will first depend on whether the level of transparency and protection granted towards investors outweighs the additional costs and regulatory burdens imposed by the regulation on the issuers. Second, the question arises as to whether and to what extent the envisaged gold standard may impair the issuance of green bonds that use alternative standards.

This Q&A with ESG bonds experts from Raiffeisen Bank International and Erste Group seeks to understand the view of leading market participants concerning topical developments with the emergence of the EuGBS, the legislative framework that is currently used in practice and implications for the future of EU legislation when it comes to ESG bonds.

Wolf Theiss would like to extend its sincerest thanks to Jörg Liesenfeld from RBI and Danijel Ficulovic from Erste Group for providing their valuable insights and expertise on this important and developing topic.

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He joined RBI in 2014 as a lawyer, qualified in and admitted to the courts in Germany. He is currently a leader of the Transaction Management Team of RBI's investment banking business. Prior to joining RBI in 2014, Jörg spent more than 12 years as an associate and partner of two international law firms and holds a Master of Laws degree (LL.M.) from the University of Sydney.

Danijel Ficulovic
Erste Group

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Wolf Theiss

What do market participants have to say about the EuGBS?

WT | 1. In your view, will the new European Green Bond Standard (EuGBS) regulation have a positive effect on the green bond market in Europe?

Jörg Liesenfeld (RBI): The European Green Bond Standard could be an effective tool to reduce green washing and may therefore contribute to more reliable legal protection and help the green bond market exclude 'brown companies', i.e. those with highly polluting industries, from issuing green bonds. The EuGBS will provide for stronger supervision than is currently the case, and authorities will have the power to ban companies from issuing green bonds if they fail to comply with the rules. In addition to voluntary internal ESG rules which a variety of market participants such as RBI have already implemented, it is likely that the EuGBS will contribute to an increased confidence in the green bond market and will therefore have a potential positive effect.

On the other hand, if the EuGBS will become mandatory and no voluntary rules will be allowed to give issuers a more flexible tool to enter the green bond market, it cannot be excluded that this may create a certain level of uncertainty and the market will suffer a temporary setback.

Danijel Ficulovic (Erste): The EuGBS is certainly one of the biggest developments in the sustainable debt capital market in the last few years. The EuGBS can be expected to bring new momentum to the green bond market. Market participants will for sure closely observe the first issuances under the new regime. Due to taxonomy alignment, not all of the green bond issues that have been placed to date would have complied with the requirements that the EuGBS will set for such issues. It is therefore likely that there will be a tight initial offering of EuGBs, even while there is a high demand - that will most likely lead to a higher green premium, or "greenium".

WT | 2. Are there currently problems regarding green bond issuances due to a missing standardised regulation?

Danijel Ficulovic (Erste): The current market-based and industry group standards, such as the ICMA Green Bond Principles, have proven to be effective guidelines. Aside from some vagueness with regard to what exactly is considered "green", these Principles have become well-established. Investors in general know what to label as green, because they have their own processes and checklists for the primary market. Accordingly, there is an expectation in the market as to what may be labelled green, and issuers are well advised to adhere to that expectation.

Jörg Liesenfeld (RBI): I wouldn't say that a missing standardised regulation is per se causing problems regarding the issuance of green bonds itself. Most green bond issuers in Europe follow the ICMA Green Bond Principles, green bonds are backed by second party opinions and issuers have reliable green bond frameworks in place. The risk of green washing is certainly the biggest threat which issuers and distributors of green bonds are currently exposed to. As mentioned before, such risk could be mitigated with a more standardised regulation on eligible green assets and clear rules for transitional industries in order to avoid green washing. Another problem facing green bond issuances at the moment is that investors do not have legal recourse if issuers fail to comply with the voluntary green bond standards. Furthermore, underwriters of green bonds and portfolio managers incur an increased reputational risk if environmental targets are not fulfilled even if such failure does not necessarily constitute a breach of a formal legal requirement.

WT | 3. How do the margins and profitability of green bonds compare to non-green assets?

Jörg Liesenfeld (RBI): Investors in green bonds often have to pay a so-called "greenium" or "green premium" when they buy green assets. The greenium is the amount by which the yield of the green instrument is lower than the yield of a comparable conventional instrument and accordingly the percentage amount of the greenium represents the saving for the issuer.
A reason for paying a greenium can be that the sustainability in the use of proceeds implies a reduction in the risk of the cash flows used to service the borrowing. But it may also be the case that internal investment rules imply that asset managers should invest in green assets and there is a limited supply of green instruments that lead to a higher price and a lower yield.

Generally, it can be noted that green bonds and comparable conventional bonds are subject to the same market dynamics and therefore green bonds do not necessarily need to have a different price tag. With a further increase in volume, green bonds may become the new normal, and greeniums may completely disappear in the future. At the beginning of 2023 investment bank Goldman Sachs already reported that high grade borrowers in the US and Europe who seek to sell bonds for ESG projects should expect no cost discount as in the past.

Danijel Ficulovic (Erste): According to various research and analyses, a greenium, i.e. lower pricing compared to non-green bonds, exists and therefore provides an additional argument in favour of green issuances. Another argument lies in increasing the investor base to include "dark" and "light" ESG investors, which additionally allows for a better pricing. On the other hand, strong demand causes the prices of green bonds to rise disproportionately, which also benefits investors.

WT | 4. Could a price on carbon possibly be a big boost to the green bond market and green assets?

Danijel Ficulovic (Erste): A carbon price would benefit the green bond market in different ways. Part of the profits would flow to governments instead of emission-intensive industries, such as fossil energy companies; the market would be punishing rather than rewarding these companies. Such funds could be used to reduce other taxes and to achieve greater climate justice. In addition, a study has shown that there are interaction effects, and that carbon pricing improves the performance of green bonds. A price on carbon would create an incentive for companies and individuals to reduce their carbon emissions, which in turn would increase demand for green bonds and other green assets. This leads to increased investment in renewable energy and other environmentally friendly initiatives.

Jörg Liesenfeld (RBI): Internal carbon pricing is seen as a voluntary method for companies to measure the opportunity costs of emitting greenhouse gas emissions. With increasing carbon prices, business models of certain industries would potentially need to be reviewed or sources for the funding of carbon lean productions would need to be collected. The leading contributor to greenhouse gas production is the power generation industry. If a price on carbon will lead the public and private sector to invest more financial resources into renewable energy, this could very well have a positive effect and be a further boost to the green bond market and green assets.

WT | 5. What is your general outlook on the future of green bonds? Will green bonds become even more relevant in your view?

Jörg Liesenfeld (RBI): The energy crisis caused by the geopolitical situation in Russia and Ukraine has made it more evident that dependencies on traditional energy sources can be a threat to an entire national economy, in particular in highly industrialised countries. Since green bonds and ESG products in general are effective tools to boost the financing of the green transition and alternatives to oil and gas green bonds will remain a no-alternative future trend and may even play a more important role in terms of market share.

Danijel Ficulovic (Erste): Despite growing popularity, green bonds are still the exception rather than the rule. We are of the opinion that the demand for and relevance of green bonds will increase steadily, ensuring continued strong growth. This trajectory also reflects the fact that major private and public investments are needed to achieve the transition to net-zero. Moreover, the benefits of combating the climate crisis by far exceed the costs, which is why more funds will have to be moved in this direction.

WT | 6. In your view, will the new regulation strengthen the European green bond market?

Jörg Liesenfeld (RBI): Generally, I believe that aligned rules will certainly strengthen the European green bond market. A reliable legal framework will support trust in the market and facilitate access to new participants on the issuer side but also on the investor side. However, law makers and regulators should always have a look at other jurisdictions outside Europe as well. If laws are too strict and do not provide for a certain level of flexibility, market participants may try to escape to less regulated markets and find loopholes by way of forum shopping. Therefore, it may be good to have different quality standards as have been successfully established for stock markets in the past, where there are regulated and non-regulated “over the counter markets” in co-existence.

WT | 7. Do you think that a fear of greenwashing because of very strict regulation can lead to "green hushing"?

Danijel Ficulovic (Erste): Actually, we think that regulation will have the opposite effect: "green hushing" as a way to avoid accusations of green washing will decrease with the implementation of rules that are strict, but clear.

Jörg Liesenfeld (RBI): I think that the aim of greenwashing prevention by a stricter regulation is to avoid misleading information on the green asset. In particular companies in transitional economies still need to be able to issue green assets, but investors also need to be informed about the level of transition which has already been achieved. If this can be achieved by a stricter regulation, it will be a win-win situation for issuers as well as for investors.

WT | 8. From your practice, what is the most promising sector in which proceeds from green bonds are invested?

Danijel Ficulovic (Erste): A significant part of global emissions is generated in the real estate sector, both during construction and when buildings are used. Therefore, we place a special focus in our sustainable finance framework on green buildings (residential and commercial).

Jörg Liesenfeld (RBI): This is hard to predict. Throughout the last few years, almost all industrial sectors and the financial industry were very keen on being eligible to issue green bonds. Financial institutions used the proceeds from green bonds for the financing of green loans. Companies are using the green proceeds in order to finance sustainable projects and achieve their ESG targets. The Austrian energy company Verbund AG was the first green bond issuer in a German speaking country in 2014, and the financing of energy efficiency measures in hydropower plants, as well as renewable energy projects in the wind power sector will remain in the focus of energy providers even more due to the problems caused by the war in Ukraine.

Last but not least, also sovereign and supranational issuers will enter into or tap the green bond market in order to collect funds for the financing or re-financing of eligible green projects with positive environmental and/or climate benefits and thereby become more independent from mineral fuels.

WT | 9. There have been thoughts of making the EuGBS mandatory for all sustainable bonds. How would this impact the European green bond market?

Danijel Ficulovic (Erste): In our view, this would have a rather negative impact on the market. Additional costs and liability for issuers could lead to a fragmentation of the market, because issuers might access ESG finance from other jurisdictions or simply change to other sources of the European market or bank finance. Some issuers might be discouraged to enter the debt capital market at all if they lack the organisational structure needed to comply with mandatory reporting requirements.

Jörg Liesenfeld (RBI): As I have mentioned before, I think that an aligned legal framework is generally beneficial for new or further developing markets such as the green bond market. Generally, ESG topics are related to each other. Sovereign issuers which are financing the transition of energy sources are not only fulfilling its environmental (green) and governmental purposes but are also reaching its social goals. There are many other examples for green bonds also including governmental and social aspects. On the other hand, social and governmental assets may also have some particularities compared to pure green assets. Therefore, lawmakers should take a hands-on approach since legal frameworks which are considered to be a regulatory burden by not providing for enough flexibility may have a detrimental effect to the further evolution of the green bond market.

WT | 10. Could it be possible that the benefit of using the EuGBS label does not justify the cost or liability of using it?

Jörg Liesenfeld (RBI): This question will usually be answered by the market. In the long-term, sustainable finance will become the new normal, and there will no longer be a discussion about potential benefits of a label. Issuers which already have a good standing and credibility in the sustainable finance market will potentially be able to save on costs for getting a EuGBS label, whereas issuers from transitional economies or countries in development will need to apply for the label in order to get the widest investor reach.

Danijel Ficulovic (Erste): We believe that issuers will have to be willing to pay additional costs and assume broader liability if they want to make use of the new "gold standard" that the EuGBS offers. However, time will tell whether these additional hurdles will be accepted by most issuers.

WT | 11. Is it possible that the EuGBS will be more attractive to issuers and/or investors than the ICMA GBP?

Danijel Ficulovic (Erste): It can be assumed that the EuGBS in combination with the EU taxonomy disclosure will trigger a shift in demand towards EuGBs. Divergence in financing costs between taxonomy-compliant assets and the rest will increase significantly as soon as strict disclosure requirements and bond guidelines are introduced. EuGBS-compliant bonds, once fully implemented, will have a significant advantage over other ESG investments, as they will then automatically be included in the taxonomy quota that fund managers must regularly disclose.

Jörg Liesenfeld (RBI): On the one hand, the internal investment rules of big institutional investors like to have legal certainty on where they can and where they cannot invest. As such the EuGBS will create new rules for the green bond market and will make it clear if bond proceeds will be used in the gas or nuclear sectors and will prevent issuers from countries that are on the EU's grey or blacklist of tax havens from issuing EuGBS. On the other hand, ICMA Green Bond Principles may be less formalistic and therefore remain for certain issuers and market participants an alternative to EuGBS in particular for those issuers which already fulfil high standards of being ESG compliant. Accordingly, voluntary industry standards, such as the ICMA Green Bond Principles, should remain applicable in co-existence with the EuGBS.

WT | 12. In 2020 the green bond market only represented approximately 3 - 3.5% of the overall bond issuance and is thus rather small compared to the overall bond market. Nevertheless, green bonds are gaining in popularity. Do you think that this popularity gain will continue, or will it reach a plateau?

Jörg Liesenfeld (RBI): Yes, it is likely that green bonds will further gain popularity even though the ESG bond market suffered setbacks in 2022 for the first time in its young history. Temporary setbacks can never be excluded due to geopolitical or other reasons as we saw when the war in Ukraine began with a heavy impact on sustainable assets. However, as long as long-term climate targets are not reached, it is very likely that the green bond market will on average continue to grow.

WT | 13. Recently, the market has developed sustainability-linked bonds (SLB) as a new asset class. These are obviously becoming more and more popular. What makes this type of fixed income product relatively attractive from the perspective of issuers and investors compared to green bonds based on a use of proceeds approach such as ICMA-GBP or the forthcoming EuGBS?

Danijel Ficulovic (Erste): Sustainability-linked bonds have recorded impressive growth rates. Due to their flexible nature, sustainability-linked bonds allow a wider range of borrowers to obtain sustainable financing. This includes issuers who do not have enough green and social projects (particularly corporates with traditional, non-ESG applicable industrial assets such as utilities, materials and industrials) but also those who do not have the capacity or are not willing to comply with the disclosure requirements arising from green bonds.

The omission of the "use of proceeds" requirement corresponds with the desire of many sustainable investors to assess sustainability holistically at the corporate level rather than at the individual project level, which also further increases borrower diversification. In addition, it also appears that the Greenium is not present in the case of sustainability-linked bonds or only to a lesser extent, making the price favourable for investors.

Jörg Liesenfeld (RBI): From the issuer perspective, SLBs have the advantage that issuers do not need to commit to a specific use of proceeds but to achieving certain sustainability improvements. This can be particularly important for issuers in markets in transition where in the beginning also small steps towards a sustainable economy need to be acknowledged. SLBs also give issuers with smaller capital structures a way to enter into ESG financing since these companies often do not have enough projects that can qualify for a green bond issue. On the investors side, access to smaller credits can be attractive since these issuers often pay for a higher coupon, and SLBs usually grant for a step-up coupon if certain sustainable targets are not reached, i.e. bond investors in SLBs get compensated for a lack of sustainability progress.

WT | 14. Will green bonds with a focus on the use of proceeds remain the most important type of sustainable bond or is it possible that Social/Sustainable/SLB takes over?

Jörg Liesenfeld (RBI): In addition to the increased attractiveness of SLBs as set out before, the war in Ukraine and in particular the associated consequences such as the energy crisis have shown that with the issuance of green bonds (use of proceeds) alone, environmental change cannot be achieved. Social bonds will become increasingly important in particular for countries in transition and developing countries since categories which are eligible for social bonds include socioeconomic advancement, affordable housing, access to essential services and affordable basic infrastructure and social projects which also have an environmental benefit. It is therefore indeed likely that issuance volumes of social, sustainability-linked bonds and SLBs will increase.

Danijel Ficulovic (Erste): As combating the consequences of the climate crisis will be the most important challenge in the future, we assume that green "use of proceeds" bonds will continue to have the largest share of all ESG issuances. However, other types such as SLB and social bonds have seen relatively strong growth and will continue to do so.

WT | 15. How large of an impact does the situation in the world economy have on green bonds in the EU, especially regarding the Russia/Ukraine conflict? Are higher gas prices beneficial to green assets?

Jörg Liesenfeld (RBI): In my observation, the war in Urkaine brought the ESG primary market to practically a standstill in the first quarter of 2022, and in the weeks that followed, investors focused more on credit ratings than on ESG ratings. The war also demonstrated that current labels such as green bonds for certain Russian companies but also the selection methods of investors are at least partly of a questionable nature. Higher gas prices and the prolongation of non-sustainable energies (such as nuclear power) may be a further boost for green assets since the urgent need to the transition to new and renewable energies has become even more evident because of the war in Ukraine and the resulting energy crisis.

Danijel Ficulovic (Erste): The Russia/Ukraine conflict has been a major source of uncertainty in the global economy, and this uncertainty may affect the demand for green bonds. In the current crisis, European fund flows indicate a mismatch: a rush to resurgent fossil fuel activities, but also the awareness of the need to prepare for an acceleration of the energy transition. However, further research would be useful to help analyse and provide evidence on how the war is affecting the flow of capital to the transition.

Higher gas prices can be beneficial for green assets, as they can make renewable energy sources more competitive. Assuming that a green bond has value as an environmental asset, then a positive correlation is expected between green bond and crude oil prices. It is likely that when oil prices rise, investments into renewable energy will increase, as there is an inclination to shift away from crude oil and into alternative energy. This should lead to an increase in the issuance of green bonds, particularly in oil importing economies.

WT | 16. Is it a problem that worldwide there are many different taxonomies (i.e. 26 taxonomies)? How important is the interoperability of these different taxonomies?

Danijel Ficulovic (Erste): Our activities as issuer and joint lead manager in syndicated issues of other issuers mainly relate to the European Union, which is why the EU taxonomy has the first and foremost relevance for us. However, interoperability is a key requirement, especially for investors, and the lack of such interoperability can raise transaction costs. Alignment and comparability across different jurisdictions should therefore be promoted, as doing so will foster ESG markets.

Jörg Liesenfeld (RBI): Generally, a harmonised set of taxonomy rules will lead to a higher predictability and would allow investors to compare EuGBs with existing green bonds. On the other hand, existing sustainability standards very much differ from country to country. Some countries are more exposed to carbon related industries than others. A worldwide taxonomy standard shall also need to take into consideration that some countries would need more detailed transitional rules than other countries. So yes, harmonisation is important and only interoperability will make assets comparable and thereby strengthen the green bond market, but local aspects of highly exposed countries also need to be taken into consideration.

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