Why Are Green Bonds All the Rage, and What's in it for Business?
Sam Gandhi, Benedetta Pacifico, and Matt Feehily
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Sam Gandhi:
Finance is finally catching up with the environmental movement. Green bonds, which are debt raised by companies whose proceeds are used for environmentally beneficial purposes, are all the rage, and more of them are being sold than ever before. But not all green products are equal, and the politics and regulation are complex. Why are investors buying in? What are the compliance challenges, and what are the incentives for businesses to do so? We'll find out in today's podcast.

Benedetta Pacifico:
There is more and more regulatory requirements that, in a way, are pushing corporates to issue these products.

Matt Feehily:
So, if I'm an asset manager, and I market my product as having a particular ESG focus, these new disclosure rules require me to justify that ESG focus. And so, we've seen a real broad range of U.S. managers that are interested in exploring these ESG issues.

Benedetta Pacifico:
Profit just for profit is no longer the only consideration investors make when they invest. I actually think it's a revolution of the financial industry.

Sam Gandhi:
From the international law firm Sidley Austin, this is *The Sidley Podcast*, where we tackle cutting-edge issues in the law and put them in perspective for businesspeople today. I'm Sam Gandhi.

Hello, and welcome to this edition of *The Sidley Podcast*, episode number 26. Today we speak with two thought leaders about the skyrocketing interest in green bonds, the investment products available, and the associated regulatory challenges. The two we're speaking with are Benedetta Pacifico and Matt Feehily.

Benedetta is a counsel in Sidley's London office and a member of the firm's Capital Markets practice. She has extensive experience in acting for corporate and financial institutions on financing transactions, which include regulatory and hybrid capital instruments, ESG-themed debt offerings, debt restructurings, tender and exchange offers, and the establishment and update of EMTN and GMTN programs. Benedetta founded Sidley's ESG-focused cross-practice Sustainable Finance and ESG working group in Europe.

Matt is a senior managing associate in Sidley's London office and a member of the firm's banking and financial services practice. He advises UK, EU, and U.S. asset managers in relation to UK and EU financial services' regulatory issues. Matt is also a member of Sidley's cross-practice Sustainable Finance and ESG working group.

Benedetta and Matt, great to have you on the podcast.

Benedetta Pacifico:
Thank you for having us.

Matt Feehily:
Great to be here, Sam. Thanks for having us.

Sam Gandhi:
Let me start with the global sales of green bonds. That's the largest category of sustainable debt by dollar volume and that hit a record of 513 billion U.S. dollars, according to data compiled by Bloomberg. And sales could reach highs of what we understand of between 900 billion dollars and 1 trillion dollars by the end of this year, according to the London-based Climate Bonds Initiative. Benedetta, let me start with you. What exactly do we mean when we think of ESG-themed bonds, and why are they now so popular?

Benedetta Pacifico:
So, focusing on climate — putting social to a side for the purpose of this podcast, if we focus on climate — the biggest kind of bond is green bond, which they're structured in a way that is called the "use of proceeds" bond. So, the proceeds raised from the bond are used to invest in green projects

or green assets. Another big category that has developed lately, since 2019, are the sustainability-linked bonds. Those are slightly different. They're not traditionally green bonds because proceeds raised from the issue of those bonds could be used for any general corporate purpose or whatever the issuer likes. The difference with that is that the issuer sets a number of KPIs, so key performance indicators, and some target goals. If it does not reach those goals and targets by a set date, then typically the coupon of the bond will raise — so the cost of the money it raised will be more expensive, will increase. So, these are the two biggest, let's say, green-themed financial products out there in the capital markets.

Why have they increased so much lately? I think there's a number of factors. One is just social pressure and the need for companies and financial institutions to show that they have a climate strategy and they're looking at their carbon footprint. You can't open a paper today without discussions about climate change and the impact on the planet. And then there's also, the reason that there is more and more regulatory requirements that, in a way, are pushing corporates to issue these products. The reason for that is after the Paris Agreement, which sets the goal of making Europe carbon neutral by 2050, in Europe, the EU published in March 2018 an EU action plan in order to support the achievement of the Paris Agreement goals.

In this action plan, European regulators have reacted by implementing a number of disclosure requirements, and on corporates and investors alike. And so, corporates and investors today need to show their commitment in the race of making the economy carbon neutral, and as a consequence, investors are increasingly seeking green investments, and issuers are increasingly issuing green products.

Sam Gandhi:
Can any company do this, or is it only certain companies that are related to either green or sustainable or social goals can do it? Do you have to be in the environmental area, or you have to be in an industrial area to really be able to have the credibility to issue these types of bonds?

Benedetta Pacifico:
So, I think that's exactly the major distinction between green bonds and sustainability-linked bonds. If we look at green bonds, theoretically, any

company can issue a green bond. All you need to do is have the green assets and the green projects in which to invest. In practice, as you well know, bond issuances are quite large in amount, are large tickets. So, it’s a lot of money to invest. So, unless you are in a certain field or you have certain projects, it will be very difficult for you to find projects and assets that are green, that meet the green standard and require such large investments.

There’s also a question of greenwashing. More and more when we look at high emitters — the brown companies — if they just issue a green bond but then the entire business has no climate strategy; it’s seen as greenwashing because it’s seen as hypocritical. So, increasingly there’s a requirement for these bonds to be issued within the context of an ESG or green strategy and climate strategy. It cannot just be a tick the box, I’ve done something, but then, you know, 90% of my business is really brown.

So, when we look at those high emitters, there’s another product called transition bonds, which are still in their early stages and have not largely developed like the other products. And those are basically issued so that the proceeds from a transition bond helps these high emitters shift to cleaner operations, so from brown to green.

When we look at sustainability-linked bonds — which are not traditionally green bonds because the use of proceeds can be used in anything — as long as you follow the ICMA frameworks, which we can discuss about, and as long as you tick those boxes and you have KPIs which are material and relevant, and you set ambitious targets, then any company can issue that kind of product. And that is why sustainability-linked bonds are becoming increasingly more popular because you don’t require large investments in green assets and green projects. Any type of issuer can issue a sustainability-linked product, as long as it has a green strategy on how to clean up its operations and targets that it’s trying to reach.

Sam Gandhi:
Matt, from your perspective, what’s attracting businesses to raise green debt, and how does regulation factor into any of those motivations?

Matt Feehily:

So, I think regulation is something that Benedetta touched on briefly already, particularly in an EU context, and the way I think you can characterize this is to look at regulation as providing both the supply side and a demand side driver. So, in particular from a supply side, we've got new rules that are coming into force this year under the EU's Taxonomy Regulation that tell you in detail which economic activities qualify as "sustainable," and the idea is then that that should attract investment to finance those sorts of activities. And then on the other hand from a demand side, we also have new disclosure rules for asset managers that came into force last year that are really designed to increase the scrutiny on their claims to be investing sustainably or to be investing in a way that promotes a particular environmental or social characteristic. And so, from that perspective where you have asset managers that are pursuing those objectives, they're now in search of better quality green assets, and so, maybe just in a little bit more detail in terms of what the Taxonomy Regulation requires.

We've had now rules since the start of January that address activities that contribute to a climate change mitigation or a climate change adaptation strategy. Now, at the minute, the criteria only cover about 5% of the EU's economy, but companies that are in those sectors and that have qualifying economic activities, so this idea of companies that have these green activities, and potentially have better access to green funding, whether that be through issuing sort of specific green products, including green bonds. But what that means is that they can turn around to the market and then there's this demand being driven through certain asset managers who can then align themselves and their own portfolio with an asset that has, in effect, an EU green label, and they can turn around then to their investors, and their investors can turn around to their stakeholders and make very clear the green credentials all the way along the investment chain. So, I think that's certainly an interesting driver of demand in the sector.

On one particular point to note here is that the way that the disclosure rules work in particular is there's a concept of what's called taxonomy alignment. So, it asks you in your portfolio, to what extent are your investments aligned with the EU's criteria for these environmentally sustainable activities? Now, where you have more traditional or general investments, so maybe I'm invested in the equities of a public company, now that public company might have 10% of its activities that we can now label as green by reference to the EU's taxonomy. I'm going to have to weight my investment, so I get maybe 10% credit towards being taxonomy aligned. The rules in the EU though, for green bonds in particular — and the EU green bond standard is something that we're going to come see through in development, and Benedetta is very close to those developments — but if you're invested in a green bond, you get to have 100% weighting. So, my 10 million dollars or more, I can attribute 100% taxonomy alignment to a green bond that meets those EU standards, and so, there is, again, a regulatory driver towards those types of assets.

Sam Gandhi:
Is there a target for an asset manager to hit a specific percentage over the period of time? I mean, an asset manager can pretty much invest in anything that they really want that's driving yield and is in accordance with their guidelines, but is there a target that they're trying to hit and that the EU is really trying to drive asset managers towards?

Matt Feehily:
So, from the asset management perspective, really what the EU is focused on is obtaining better quality information for investors, and so, ultimately, it's about investors being able to make more effective capital allocation decisions when they're weighing up the green credentials of a perspective investment. So, there isn't a target as such, but the idea is really that you, as an asset manager, are making verifiable claims as to what you're going to do, and in particular, there is a focus on what the binding elements of your investment strategy are. So, if I'm an asset manager ,and I market my product as having a particular ESG focus, these new disclosure rules require me to justify that ESG focus by reference to the investment strategy that I'm going to follow, and there's this idea, in effect, of creating almost the risk of misselling. So, if I say one thing and do another, then I'm on the record and I potentially am exposed then to a liability. So, it's about improving outcomes through improving access and quality of information.

Sam Gandhi:
And one last follow-up on this one, Matt, is that I know that you said the European Commission has released criteria in certain sectors, and those are what we would think of as green sectors, like energy and forestry and buildings and transport, et cetera. Do you see further regulation getting into what Benedetta was talking about sustainability bonds, such as

investments in housing for the indigent, or businesses for minorities, et cetera, in the future?

Matt Feehily:
So, it's a really interesting point, and actually this goes to a distinction between the environmental and the social, and I think one point to bear in mind is that there is a split at the moment. So, with respect to the Sustainable Finance Disclosure Regulation, or SFDR, which is the framework that's really applying to asset managers, that covers a broad range of environmental and social issues. And you can construct a product that looks to promote any particular environmental or social issue, so that covers the ERS, and then there's a condition related to good governance as well, which covers off the G. But when we get to the actual EU criteria for determining sustainable activity, at present that is just focused on activities that can qualify as environmentally sustainable rather than a taxonomy or a categorization for socially sustainable activities, but that is, again, something that's in the pipeline. And so, in time what we are likely to see is an EU social taxonomy, and that's potentially quite interesting because arguably those sorts of social outcomes that you're looking to achieve can potentially be more difficult to quantify.

So, in an environmental context, we can clearly look to, for example, climate science. We can see what climate science tells us about particular activities and their impact on greenhouse gas emissions and climate change. When you're trying to quantify social outcomes, that can be potentially more tricky, and so, there's an interesting balancing act that of course will have to go into the design of that social taxonomy framework, but for sure that's something that's in development, and so, we can expect to see that over the next few years.

Benedetta Pacifico:
If I may add something on that. You see the same transition also in the bond market. Social bonds do exist, and they had a boom, especially in the pandemic. But as Matt was saying, the focus is very much on green for exactly the same reasons because when an issuer goes out there with a green bond, sets a number of assets and targets, they're quantifiable. We're talking about CO2 emissions mainly, and so, it's much easier to justify and explain what you're doing. When you go with social being less objective and quantifiable, you do have social bonds out there, but it just

becomes a bit more tricky, and that's why social bonds, as of today, even if they have increased a lot, have still not reached the status that green bonds have, but I do agree that things might develop in this space in the future.

Sam Gandhi:
You're listening to *The Sidley Podcast*. We've been speaking with Sidley thought leaders Benedetta Pacifico and Matt Feehily about why investors are attracted to green bonds and how regulatory incentives are driving that trend. Green bonds are viewed as a way for issuers to show their commitment to the environmental, social, and governance space, and they're also an investment investors are increasingly using to prove their commitment to the net zero transition. Benedetta, let me dig a little deeper into the particulars of some of these ESG-themed products, and what are some of the differences in the offerings? I know we've talked a little bit about it, but maybe dig a little deeper, if you could.

Benedetta Pacifico:
I think the first distinction is between these products and traditional bonds because a lot of the skeptics will tell you that there is no difference and it's all pure marketing. And that is because legally speaking and from a structuring of the product itself, there isn't much of a difference. If you look at a green bond or a social bond, so a use of proceeds bond, as we discussed, you are stating in your marketing document, in your offering memorandum, that you are going to use the proceeds of that bond issue in order to invest in a number of green projects and green assets, and usually an issuer would cross refer to its green bond framework. So, they would set up a framework ahead of issuing the bond where they list what are the criteria for an asset to classify as green? And those usually will be aligned to an external definition of green.

Now, with the development of the EU taxonomy, what will be expected increasingly is for these projects and assets to align to the EU green taxonomy, but there's no requirement as of today for that alignment. So, the definition of green is completely left to the issuer. So, you issue those bonds, but then there is no event of default if you don't do so. There's no put option if you don't do so, and actually, in every prospectus out there, there will be a risk factor that says that if you don't find such products, you'll have to use the proceeds in some other way. And that is why a lot of skeptical people will say, this is just, you know, a marketing stint, in reality, nothing is happening. But I think that it's misreading how capital markets work.

In reality, if you're issuing a green bond, you will follow the International Capital Market Association green bond principles, which are voluntary principles and guidelines, but that ultimately, it will be very difficult to market your product as a green bond if you don't follow them. So, yes, they're not a legal requirement, but they are a market requirement, and those principles tell you that your proceeds need to be linked to green assets. There's no definition of green in those principles.

It also tells you that you need to ring-fence the proceeds and clearly account every year how you invested them. So, every year you need to report how they've been invested, and they also recommend that you obtain a second party opinion from an independent party that vets your framework and vets that it is in compliance with the principles and that you are indeed doing what you say you're doing.

Even if there is no legal fallback if you don't follow that, obviously your reputation will be down the drain. Like, if you go out there with a green bond and then use the proceeds for something completely different, it'll be very difficult to go to market again. So, the fact that there's no kind of legal enforcement mechanisms doesn't really mean that an issuer can do what they want. And that is why issuers are quite wary of issuing green bonds, unless they are fully prepared to do so because they know that their reputation is at stake. So, that's the big difference between a traditional bond and a green bond.

We already seen the difference between sustainability-linked bonds and green bonds quite in detail before, and if one looks from a practical point of view, there's also a question of do I have a greenium, and what's the yield on a green bond compared to a traditional bond? So, there is an argument. You're starting to see a pattern that green bonds actually are issuing at a lower yield. So, issuers can raise capital cheaper. There's a debate on why that is. The most obvious reason is what Matt was saying, it's a demand and offer mechanic.

Because of these regulations in place, asset managers, investors, need to invest in green products, and there are simply not enough green products out there. So, when an issuer goes out with a green bond, which will be weighed at 100% when you're in your disclosures, everyone wants to buy it. And so, usually on a green bond issuer, the book will be oversubscribed by over 100%, if not more, and that is because there is not enough offer and there's a lot of demand, and there's not a lot of offer for what we were saying before. Capital markets have large tickets. You're not going to raise, you know, a couple of million thousand pounds. Like, you're raising a lot of money, and there's just simply not enough green assets and projects out there to invest in, and so, that's why you have that greenium.

Another argument is that in investing in a green bond, you are investing in a company that is considering its climate risks and has an ESG strategy, and usually it's a company that in the long term will perform better. So, it's a more secure investment, and that's why you are able to issue at a lower yield than companies that don't have such a strategy.

Sam Gandhi:
And I would think that you would have companies who are able to do this and have the flexibility to move those proceeds into environmentally focused activities are actually more like investment grade issuers anyway, and so, those yields are generally at the investment grade level, which are generally lower than what we would think of as more speculative investments in companies that may not have that financial flexibility to do this. Is that the case?

Benedetta Pacifico:
Yes. We are largely looking at investment grade issuances, and usually for a pure green bond, you're also looking at utilities or financial institutions because they then go on land in the form of loans or whatever to green projects. For a pure corporate, it's much harder to issue a green bond.

The EU is taking this a step forward. The International Capital Market Association bond principles, just to be clear, are like international. They're not regionally based. The EU is actually now published a proposal for a EU green bond standard. So, what requirements does a bond need to fulfill in order to be labeled as a European green bond? And they sort of mirror the ICMA green bond principles. They're not too different. There are a number of technicalities that are different, but I'm not going to go into those, but the key difference is that for the first time, there's a definition of green.

With the ICMA bond principles, it was up to the issuer to decide what was a green asset or a green project. With the EU green bond principles — once they will come into force, they still are not into force — your proceeds need to invested in an asset or project that is aligned with the EU taxonomy, and so, it's bringing things a step forward in that way. But in either case, green bonds issued under ICMA, even those are interesting for investors because they would still be able to weigh them in some way when they have to do their disclosure. They can still show commitment in green when they have to do their ongoing disclosures, even though maybe that weight might not be the same as when the EU green bond standard will be in force. And that is why we have this supply and demand discrepancy because there's not enough supply and there's a lot of demand, and that is one of the reasons it brings the yield of these bonds down.

Sam Gandhi:
Matt, the *Wall Street Journal* just ran an opinion piece that said ESG investing can do good or do well, but don't expect both. What do you think of that statement?

Matt Feehily:
I would say certainly a lot of my clients would disagree with that statement, and indeed, we've been fortunate at Sidley in the London office to be involved in many matters where clients really are bringing innovative solutions to finance for transitioning to a global, low carbon economy — and that's both in an asset management context, in a capital markets context, but also across our corporate and finance teams as well. So, I would resist that conclusion, but what I would acknowledge is that one of the challenges for investors is finding investment opportunities that both match their level of ESG ambition, but that also satisfy their return profiles from a financial perspective.

Now, from an asset management perspective where you are investing in green bonds but then turning around to your investors and touting your own ESG credentials. As we discussed already, there is now this legal and regulatory obligation to disclose what you're doing with respect to that, but specifically there is also an obligation to disclose the risks associated with your investment strategies, and in respect to sustainability risks themselves. So, that is the risks to the value of your portfolio emerging from environmental or social or governance related events or conditions. So, that could be climate change risks, the physical risks from climate change. That could be so-called transition risks, which are government policy changes as we move to a lower carbon economy, and I think that that in itself will obviously affect the returns of investments as well, and indeed, this is something that's been reflected in the EU framework more broadly. and it's the concept of double materiality.

So, this idea that you have traditional financial materiality, which is what are the risks to the value of your investment. But then you also have the double materiality where you're looking out the other way, so what is my impact on the environment? And so, we're seeing a number of initiatives related to that concept, both at an EU level — it's reasonably fundamental to the way that that framework is set up — but also in the UK. In the UK, as listeners will know, is no longer a member of the European Union, but we're pursuing our own particular ESG-focused regime, and again, that will look at bringing in aspects such as double materiality.

Sam Gandhi:
Benedetta, what is your thought on that? Is that also true for green bonds? Can they only do good or well?

Benedetta Pacifico:
I would disagree with that statement. I read the article, and I think the point one is making is that one of the issues with green bonds is that you could be refinancing existing projects, so there is no real achievement and improvement in the situation, and then there's the argument that because the yield is lower, an investor is not really making more money out of it. But I think that that's a very narrow vision of what's going on, and one should look at the bigger picture. So, the fact that an instrument is not perfect doesn't mean it doesn't work and it cannot be used as a tool for a goal.

The goal here, the ultimate goal, especially in Europe, is to decarbonize the economy by 2050. Rome was not built in a day. That's not something you're going to obtain in a couple of years. It'll take time, and so, the markets have to develop and push and be ambitious, but in a way that the stakeholders can follow. If you become too prescriptive and you try to do too good immediately, the risk is that no one is going to buy into the whole philosophy and you're not going to even make a little good because the reality is that if you're making these products too difficult to issue and too prescriptive and too complicated and the bar is set too high, no one will even try because we are too far away from being carbon neutral to even start getting there. While if we develop it slowly, and we have seen it, it is developing. It is changing. Now our green bond needs to be part of a general climate strategy, before there wasn't this market requirement. We have ICMA bond principles, before we didn't have them. The EU now is looking at EU green bond standards, which are even more prescriptive than the current bond principles. We didn't have that. It's slowly developing, and if one sees it as a process rather than just, you know, a snapshot picture of a narrow vision of what is it now, then I disagree. I think they can do both well and good.

Also, from an investment point of view, profit just for profit is no longer the only consideration investors make when they invest. In general, investors in companies on the corporate side and financial institutions, when they lend money — when we decide where our pension money goes, or which utility we subscribe for our home heating — we start looking at different elements. We're not looking anymore only at what costs less or what will make me more money. And so, if the vision that someone has is just for profit, within five to 10 years' time, they will become irrelevant if they don't start being part of this movement. I actually think it's a revolution of the financial industry. They will become irrelevant, and 10 years down the line, they'll find it very, very difficult to raise finance at all because they have not kept up.

So, yes, maybe if you just look at one single product and a picture, snapshot of what's happening today, they're not necessarily doing as good as they could do, and probably your return is not as high as it can be. But if you look at the bigger picture, I disagree with that statement. I think there are very important tools in process, that is to be carbon neutral by 2050.

Sam Gandhi:
We have focused on international standards. We've really focused mostly on the EU and the growth of green and sustainability bonds in the EU. The largest debt market continues to be in the United States. Where do you see the United States bond market getting to in terms of green bonds and

sustainability bonds versus the EU over the next few years? Is it catching up? Is it slow to catch up?

Benedetta Pacifico:
What I find interesting, if I look at what clients have been asking lately and colleagues have been asking lately, in the last six months, I got way more questions coming from my colleagues in New York and Chicago than I did in the previous years. In the European market by now, more or less, everyone in this field understand how these products work and how the different frameworks apply, maybe not the development, but how they work today. And there is more and more interest and questions from clients and colleagues in the U.S. asking how all of these frameworks have been working in Europe, and how we're helping our clients set up these frameworks, what the different dynamics are. I saw a considerably increased interest in the last six to 12 months compared to before.

So, the U.S. is the biggest market, and I think in this they're playing a bit catch up, not in the sense of size, but in the sense of development, but they're getting there. They can't ignore it. So, it's not as heavily regulated as maybe it is in Europe, not that in Europe it's that regulated, the capital market itself. It's more the disclosures, but I think the U.S. will catch up.

Sam Gandhi:
And we're seeing that with the SEC's rules on climate disclosures, et cetera, and ESG governance. Matt, what are you hearing from your clients over the last year, and what seems to be the key issues on their minds?

Matt Feehily:
So, I think that one of the interesting conversations that we often have in the regulatory team with U.S. clients is the friction potentially between the EU's positioning on ESG, and the perhaps more cautious approach that managers want to take in light of the SEC's rules on ESG disclosures. So, perhaps on the one hand whereas the EU is requiring you to say more in some senses to justify your ESG positioning, quite often we have the feeling from our clients that they would prefer to say less on some of these issues for fear of regulatory liability potentially. But I think as we see changes in rules from the SEC, as we see changes in policy from the new U.S. administration, it's possible that some of those tensions will ease to some extent.

Having said that, for the first 12 months of this new SFDR regime that we've been talking about — and of course this only came into force in March 2021 — we've seen a steady increase in interest from U.S. asset managers in particular, in issuing products that have an ESG focus, and we've been having some really interesting conversations about the form that those products can take across a variety of investment strategies. So, on the one hand, you'll have classic public markets investors. You'll have investors that are interested in debt instruments and bonds, but you'll also have investors that are interested from a private equity perspective, from a real estate perspective, and so, we've seen a real broad range of U.S. managers that are interested in exploring these ESG issues.

Sam Gandhi:
We've been speaking with Sidley thought leaders Benedetta Pacifico and Matt Feehily about ESG-themed bonds and the associated advantages and challenges for issuers and investors. Benedetta and Matt, this has been a great look at green bonds. Thanks for being on the podcast today.

Benedetta Pacifico:
Thank you, Sam.

Matt Feehily:
Thanks, Sam.

Sam Gandhi:
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