Green bonds
a fresh look at financing green projects
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Globally, stakeholders are voicing their concerns about the irreversible damage caused to our ecosystem, and continuously demanding businesses to adopt responsible growth models. Climate change and reducing natural resources affect all of us. Achieving sustainable development must involve both mitigation initiatives — to reduce the adverse impact, and adaptation — to change and reduce the impact of the unavoidable, while maintaining focus on its social dimensions.³

Although the road to sustainable growth is quite simple and clear, businesses are always apprehensive about returns from investments in green projects (renewables, energy efficiency, low carbon, water efficiency, bioenergy, etc.). Green bonds (also known as Climate bonds) provide a convenient, yet risk-managed platform for responsible organizations, both private and public, to invest in green projects. Climate bonds are often depicted as a type of “green” bond. The Green bond can typically have multiple sustainability purposes/objectives (waste reduction, water use reduction, biodiversity, etc.) whereas the Climate bond is focused on mitigating or adapting specifically to climate change. Trends reflect that Green bonds are not only becoming an attractive financing option but also attracting project developers to raise capital for their projects, assets and other activities to showcase their responsible approach toward business.

However, new and fast-paced markets pose certain challenges. Stakeholders are still unclear about the entire life cycle of a Green bond and associated processes. Our clients, with a clear focus on a sustainable tomorrow, have often approached us with queries related to the issuance of Green bonds, the associated green criteria, and managing the proceeds.

EY member firms across the globe are assisting clients in setting the right criteria for Green bond financing mechanisms. We are also involved in verifying the stated criteria and claims of Green bond issuers, providing the confidence to communicate transparently.

A Green bond is functionally a debt instrument, like any other bond. It offers fixed return, and a promise to use the proceeds to finance or re-finance, in part or fully, new or existing sustainable projects. The bond is voluntary and may be issued by a financial institution, the government or even a company to raise funds for a defined period. The issuer has to ensure that the proceeds are invested in green projects, such as renewable energy, energy efficiency, projects leading to reduced carbon emissions, etc.

It is a win-win situation for both the bond issuer and the investor, as they can contribute toward a sustainable future on one hand, and showcase themselves as a responsible organization/institution/individual on the other.

The first Green bond was issued by the European Investment Bank (EIB) in 2007. At that time, the size of the issuance was relatively small. However, the market gained momentum in the last three years and is poised to grow in the coming years.
Evolving guidelines

Guidelines for Green bonds are currently shaping up in the global arena. These are evolving rapidly, becoming increasingly comprehensive and, in certain cases, complex. The different guidelines prevalent in the market include:

**Green Bond Principles (GBP)** are voluntary process guidelines that provide issuers guidance on key components involved in launching a credible Green bond.\(^1\) GBP recommend that the issuer should:

- Define criteria for a green project
- Define processes for evaluation and selection of the green project
- Have systems to trace the green bond proceeds
- Report, at least annually, on the use of the proceeds

The principles also recommend issuers to opt for external verification by adopting one of the following:

- **Second-party review and consultation:** This involves advice from a consultant that may not be made public.
- **Audit:** This denotes verification of the entire process, or a part of it, by third parties. This is required to be made public at issuer discretion.
- **Third-party certification:** This involves certification of green bonds by qualified third parties.

**Green bond indices**

Climate bond indices are either run by a bank or a credit rating agency. However, in certain cases, banks and credit agencies collaborate with each other or with another party (e.g., a research organization).

The Climate bond indices have witnessed an increase in number in the last three years and more such indices are expected in future.

**Climate Bond Initiative (CBI)** has introduced a standard that provides issuers the opportunity to get their bonds certified. Third parties are required to verify that the bond complies with the Climate Bond Standard (CBS) before CBI issues the certificate. This ensures the credibility of the issued bond among investors. EY member firms are approved CBS verifiers.\(^2\) Apart from this, the CBS is accompanied by sector-specific standards that can be easily adopted by issuers.

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\(^2\) [http://www.climatebonds.net/2015/01/ey-confirmed-approved-climate-bond-standards-verifier](http://www.climatebonds.net/2015/01/ey-confirmed-approved-climate-bond-standards-verifier)
3 Why Green bonds?
Some of the most important drivers for issuing Green bonds are:

- They can attract environmentally-conscious investors who may not otherwise invest in your company.
- There is growing investor demand for green/sustainable financial instruments.
- Stakeholder demands for responsible business practices are growing.
- They help project the company as an environmentally-conscious organization, thereby enhancing the brand.
- There is competition from lending agencies that have issued Green bonds.
- They are generally found to be an economical and convenient financing model by project developers.
- Almost all Green bonds issued in the past have been oversubscribed.
- Accessible and powerful instrument for financing a sustainable, low-carbon economy

An annual US$41.8 billion worth of Green bonds were issued in 2015.

Recently, it is observed an increase in the volume and value of Green bonds issued in the market. Investors have also shown an overwhelming response, with several Green bond issues in 2013 and 2014 being over-subscribed. Moreover, investors with US$45 trillion of assets under management have made public commitments to climate and responsible investment. This clearly reflects that the Green bonds market is expected to grow further and faster.

Even though Green bonds apparently hold a promising future, they have certain drawbacks at present.

The foremost challenge for an issuer is to bear the additional cost required to issue a Green bond, while providing returns similar to a normal bond. These costs may include additional expenditure for defining the green criteria, monitoring and maintaining the proceeds as green, and transparently communicating performance to investors over the lifetime of the bonds.

It is clear that while Green bonds are an instrument to project one as responsible, they carry an inherent reputational risk.

Moreover, defining any program or an investment as “green” is a challenge in itself. Although a range of definitions and criteria exists to define what constitutes a green investment or program, it is likely that a prescriptive standard set of definitions of “green” will not meet every investor’s needs. This presents one of the most daunting challenges to issuers – to define a product/process as green, or regularly reflect on its commitment to invest in projects with improved environmental performance.
There are primarily four stages in the life cycle of Green bonds:

1. **Defining “green” criteria:**
   
   There are several evolving standards and guidelines for defining the criteria of a Green Bond. To choose the right guidance or develop your own, in line with investor expectations, is challenging and requires detailed deliberation. Moreover, the green portfolio that should be associated with a Green bond must be carefully chosen to ensure continuous commitment and expected returns over the tenure of the bond.

2. **Issuing the Green bond:**
   
   While issuing a Green bond, several factors such as the tenure, the issue size, the prepayment penalty clause, etc., play an important role. Although the factors are more or less similar to any other bond, the commitment to invest in green projects complicates the process.

3. **Monitoring performance:**
   
   This is on Green e of the most essential stages in the life cycle of a Green bond. Continuous monitoring of proceeds, and the environmental and social performance of associated projects/assets, is important to ensure compliance with the basic commitment and to maintain trust among investors.

   Like the CBS recommendation, EY also believes that continuous monitoring and verification by a third party will be key to build trust among stakeholders and, in turn, increase the demand.

4. **Reporting performance:**
   
   Transparent communication with investors about the performance of the Green bond is expected from all issuers. This will provide the much-needed element of trust among the investor group and will attract potential investors in future.
The developing green market has to deal with several challenges such as clear definition of what is considered “green,” procedures on how the Green bond proceeds should be used, tracked, managed and reported, and the lack of verification requirements over the information reported.

Given that Green bonds are long-term financing vehicles, the reputational risk to issuers extends for many years across the life of the bond and beyond. However, being an investment instrument for sustainable projects, Green bonds present an opportunity for sustained and better returns in future. Therefore, it is recommended to seek expert advice to reduce that risk.

EY can either advise a Green bond issuer on developing the green criteria and maintaining it over the life cycle of the bond, or conduct verification and ensure that the issuer is following the defined green criteria throughout its life cycle.

With its leading role as an advisory and assurance services provider across sectors, in the areas of environment, health and safety, energy, renewables, climate change mitigation and adaptation, EY brings in a multidisciplinary team to help navigate through the process.

The combined expertise of EY’s Transaction Advisory Services (TAS) with debt/capital raising advisory capabilities and EY’s Climate Change and Sustainability Services (CCaSS) group can provide client’s end-to-end assistance as they embark on the Green bond journey.
Green bond advisory

EY provides advisory services to organizations that are interested in issuing Green bonds in the following areas:

- Defining/adopting “green” criteria for Climate bonds
- Bank’s scope
- Financial closure of the bond
- Approaching the market for Climate bond issuance
- Use of proceeds:
  - Quantifying the associated environmental benefits
  - Identifying Green bond category (renewable energy, clean transport, etc.)
  - Outline decision-making process to determine eligibility of investment

Green bond verification

EY is one of the few approved Climate Bond Standards verifiers. We conduct verification of Green bonds issued by banks offering self-issued bonds or third-party issued bonds. The verification process has two stages:

**Stage 1**

**Pre-issuance of Green bonds:** EY conducts verification to assess whether the planned bonds fulfill the criteria of the adopted guidelines/standard.

**Stage 2**

**Post-issuance of Green bonds:** EY verifies, on behalf of the issuer, that the proceeds of the bonds are used for intended projects and the funds are managed as promised throughout the life cycle of the bond.

**Reporting:**

- **Initial reporting:** Use of proceeds and eligible investments for unallocated proceeds
- **Annual or semi-annual reporting:** Information on specific investments made from the Climate bond
- **Identifying and reporting on the quantitative and qualitative performance indicators** that measure, where feasible, the impact of the specific investments (e.g., reductions in greenhouse gas emissions or avoided vehicle miles traveled, etc.)

[1](http://www.climatebonds.net/2015/01/ey-confirmed-approved-climate-bond-standards-verifier)
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