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How long will Swedish green bonds market remain self-regulated?

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Introduction

Greenhouse gas emissions have increased dramatically in recent decades and continue to increase globally. The Paris Agreement states that global temperature rise should be limited to below two degrees Celsius, preferably to one-and-a-half degrees Celsius, compared with pre-industrial levels. To reach these levels, the financial industry plays a crucial role.

"Sustainable finance" refers to the process of taking environmental, social and governance (ESG) considerations into account when making investment decisions in the financial sector. To facilitate ESG investments, there has been an increase in the implementation of new rules for sustainable investments, introduced through amendments to existing legislative acts and through completely new regulations and guidelines. The majority of rules have already entered into force. Despite the recent development and increase of regulation within sustainable finance, as yet there is no regulation of green bonds in Sweden.

Green bonds in Sweden

The Swedish green bond market emerged out of demand from Swedish institutional investors that engaged in dialogue with a Swedish bank, resulting in the World Bank issuing the first green bond for institutional investors in 2008. In recent years, the international market for green bonds has grown sharply but still constitutes a small portion of the bond market as a whole. Sweden is far ahead in the development of green bonds and, in 2019, green bonds constituted 20% of the country's total amount of bonds. This is a very large share compared with other currencies such as euro, pound sterling, yuan, Australian dollars, Norwegian krone and US dollars, for which green bonds accounted for between 0.8 and 5% of the issued bond volumes. However, this form of financing is becoming more widespread worldwide and its use is expected to increase further. Green bonds enable capital-raising and investment for new and existing projects with environmental benefits. Green bonds are an important part of sustainable finance and thus play a crucial role in combatting the climate crisis.

What is a green bond?

Market participants must be aware that there is currently no clear definition of what constitutes a green bond. However, the general perception is that "green bonds" are any type of bond instrument where the proceeds or an equivalent amount will be exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible green projects.

It should be noted that green bonds can be distinguished from climate bonds, which focus on projects that address the climate issue – for example, renewable energy or climate-smart infrastructure. The concept of green bonds is broader; the bonds can also finance environmental projects that are not directly related to the climate. Climate bonds are thus a kind of green bond. The concept of a "climate bond" is more common internationally, whereas in Sweden, it is more common to use the term "green bonds", even for pure climate bonds.

Current situation in Sweden

In Sweden, there are currently no laws regulating green bonds and compared with climate bonds, the standardisation of green bonds has not come as far. However, a major step forward was made in 2014, when 13 international banks – including Swedish financial group SEB – agreed on the green bond principles (GBPs).

The GBPs are voluntary processes that outline best practices when issuing bonds serving social and/or environmental purposes through global guidelines and recommendations that promote transparency and disclosure, thereby underpinning the integrity of the market. The GBPs emphasise the required transparency, accuracy and integrity of the information that will be disclosed and reported by issuers to stakeholders through core components and key recommendations. The four core components for alignment with the GBP are:

- use of proceeds – how the issue proceeds are used must be documented in the bond's legal documents;
- process for project evaluation and selection – the issuer must describe the decision-making process to assess whether a project can use capital from the green bond;
- management of proceeds – the issued proceeds must be placed in a separate account or managed so that it is clear that the money from the bond goes to the specified projects; and
- reporting – the issuer must at least once a year provide a list of projects that the bond has financed to investors.

The GBPs recommend using an external party to confirm that the bond complies with the four principles. They also call for an independent audit of, above all, how the issuer follows the handling and traceability of the payment. However, the GBPs are voluntary guidelines that recommend transparency and disclosure and promote integrity in the development of the green bond. Most importantly, they are not a regulation.

The GBPs were used to shape Sweden's sovereign green bond framework and the framework contains the four aforementioned core components under the GBP. The aim of Swedish sovereign green bonds is to finance a portfolio of expenditures that meets the highest green ambitions and is in line with the goal of carbon neutrality by 2045.

Even if the GBPs constitute a market standard, Swedish contracting parties are free to choose contractual obligations in civil and commercial matters and thus the provisions relating to the "green" in the bond. Issuers usually refer to their own "green bonds framework" as set out in their medium-term note (MTN) programme with a reservation in the terms of the bond that their green bonds framework may, from

time to time, be updated to reflect, among other things, the EU Taxonomy Regulation, the EU Green Bond Standard, the GBPs and best practice in the market.

It should be noted that the EU Taxonomy Regulation is not directly applicable to issuers of bonds; however, it has an indirect effect on issuers since the regulation imposes requirements that the actors covered by the regulation, for example, should be able to state to what extent their portfolios are compatible with the EU Taxonomy Regulation.

Future of green bonds in Sweden

As of today, the GBPs and other existing forms of self-regulation pose various challenges, especially for investors. A major problem from an ESG perspective is greenwashing. If companies engage in greenwashing and issue green bonds where the proceeds go to projects that are not actually green, confidence in both the individual company and the market for green bonds could be damaged.

Furthermore, there is a risk that issuers' own frameworks do not suit all investors' requirements, wishes or specific investment mandates. Given that the issuer reserves the right to change the green terms, as well as that market practices may develop after the loan date for a particular MTN, there is a risk that such MTN does not meet future regulations, principles or standards.

On 18 June 2019, the European Commission's Technical Expert Group (TEG) on sustainable finance published the group's final report on an EU Green Bond Standard. The report proposes that the European Commission establish a voluntary EU standard for green bonds. The main objective of the proposal, which the European Parliament is currently negotiating, is to create a new "gold standard" for green bonds that will raise its level of environmental ambition. The Swedish government has explicitly welcomed the proposal for a voluntary EU standard and once an EU standard is adopted in Sweden, the regulation will set a new standard for how companies and public authorities can use green bonds in Sweden to raise funds on capital markets to finance such ambitious large-scale investments, while meeting sustainability requirements and protecting investors.

This will be welcomed as it will be useful for both issuers and investors of green bonds. For example, issuers will have a robust tool to demonstrate that they are funding legitimate green projects aligned

with the EU taxonomy. Also, investors buying the bonds will be able to assess, compare and trust that their investments are sustainable, thereby reducing the risks mentioned above more easily.

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