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European Sustainable Finance

Introductory Notes on the EU Green Deal and New Green Finance Perspectives

José Manuel Alves

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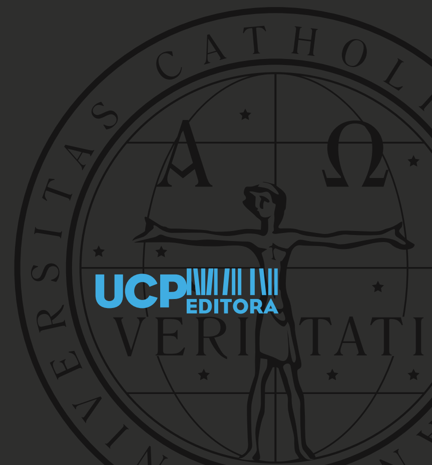

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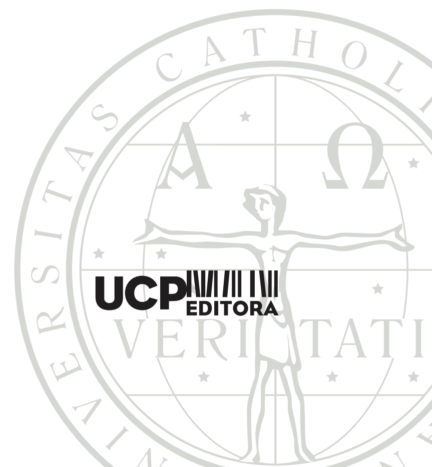

Contents

Agradecimentos 4
Abstract 6

1. Introduction 7
2. The EU Green Deal: Description and key topics 9
3. Green Finance 15
3.1. Preliminary remarks on green finance 15
3.2. The need of clear EU Green Standards and a status update 22
3.3. ‘Market Practice Common Standards’ — green bonds and green loans 39
3.4. Engaging stakeholders — Still an issue? 48
3.5. Sustainability-Linked Lending: A Contractual Approach 52
4. Conclusion 58
5. Bibliographic references and other sources 60

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À minha Mãe, a minha maior referência. À minha avó, à minha irmã e à minha noiva Joana. A todas, pelo seu infindável carinho e compreensão.

Abstract

This work starts by analysing the main features of the EU Green Deal and then delves deeper into one specific workstream of this master plan: sustainable finance (green finance). The initial objective is to highlight the importance of the linkage between climate change and environmental laws and regulations with the field of banking and finance law in general, but our primary aim is to analyse what can be done to support the EU Green Deal in its segment of sustainable finance, and how a modern, comprehensive and forward-looking approach can decisively foster it. This work analyses the subject of green finance, underscores the importance of the creation of robust EU Green Standards, provides a snapshot of the current (market-driven) regulation on green finance, elaborates on the need of engaging all stakeholders in the quest and introduces the new trend of sustainability-linked lending.

Palavras-chave: EU Green Deal; Sustainable Finance; Green Finance; Banking and Finance law; EU Green Standards; Sustainability Linked-Lending; EU Green Financing; Climate-related Policy Instruments; Green-Economy; Green Bonds; Green Loans; ESG; Sustainable Activities; Sustainability Performance Targets; EU Taxonomy Regulation; Common Standards; Green Loan Principles; Green Bonds Principles; Sustainability Linked-Lending Principles; Green Bond Standards; Transition; Incentives; Investment; Engaging Stakeholders.

1. Introduction

Niels Bohr is quoted for saying that 'prediction is very difficult, especially about the future.' But when it comes to climate change, there is a surprising consensus among scientists regarding its causes and the likely outcomes triggered by such disruption in the Earth's atmosphere.[1] Predictions can be wrong, but they can also be correct – and data already suggest that scientists' predictions have actually been very accurate. As climate change is a defining issue of our era,[2] *to act decisively* should be a moto for our time.

But climate change is a very complex issue – and there are no simple solutions for complex problems. For that reason, it has also been mentioned that the State-centred system of global governance is not genetically prepared for the adoption of appropriate mitigation or adaptation policies. Therefore, deep changes are required at the governance level also, calling for a wide range of (multi-level) players to participate in the new 'Labours of Hercules' – including supranational entities as the European Union ('**EU**') and private individuals and corporations. In this light, we focus on the specific EU approach to climate change, and will

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[1] See, *inter alia*, Naomi Oreskes, 'The Scientific Consensus on Climate Change', 306 *Science* (2004).

[2] Ban Ki Moon, United Nations Press Conference, 'High-Level Event on Climate Change with the Secretary-General, the President of Indonesia, and the Executive Secretary of the UN Framework Convention on Climate Change', 24 September 2010, available at https://www.un.org/sg/en/content/sg/press-encounter/2007-09-24/press-conference-high-level-event-climate-change-secretary (last accessed on 14 March 2022).

elaborate on its strategy concerning 'sustainable' or 'green finance' – a key mechanism to support the EU Green Deal and that aims to a swift, efficient, solid, and balanced transition that will only be attained by engaging all market players, creating the correct incentives, and designing win-win situations.

At the root of this concept of 'green finance' lies an idea of environment-friendly financing and environmentally sustainable investment. As a legal concept, however, it requires clarification. To this end, we will discuss its meaning and role for achieving the EU's objectives, so that we may afterwards reflect on the steps that must be taken to develop an adequate financing platform.

Moreover, we will analyse whether the 'market' is currently able to provide the EU with any contribution on designing a more robust framework for green finance. In this respect, we focus on the incentives of a particular stakeholder (the lender/financier) and assess whether its engagement is still an issue or rather a major opportunity.

Afterwards, we provide some suggestions that we believe may be helpful to the various market stakeholders, as they confer efficiency, greater incentives to comply, and better monitoring over the activity being financed.

To conclude, we will shed some light over the recent trend in green finance – the so-called 'sustainability linked lending" – and see what it entails from a practical perspective, namely, in the drafting of standard finance contracts.

2. The EU Green Deal: Description and key topics

The EU's recent effort in tackling climate change and to build a coherent and comprehensive system for a sustainable economy has its roots both in the adoption of the UN 2030 Agenda for Sustainable Development[3] and in the objectives set forth in the Paris Agreement.[4] The latter has been particularly important, since it included a commitment to align financial flows with a pathway towards a low-carbon economy and sustainable development. In fact, the transition to a resource-efficient and environmentally friendly economy is posited as having paramount importance by the European Commission in order to achieve the 2030 targets agreed in the Paris Agreement. In order to achieve them, however, the EU will need to gather financial resources to fund such a transition.

On 11 December 2019, and following two other important steps concerning the matter of sustainability (the EC Action Plan on Financing Sustainable Growth[5] and the Regulation (EU) 2019/2088[6]), the European Commission delivered its master plan for tackling climate change through

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3 See https://www.un.org/pga/wp-content/uploads/sites/3/2015/08/120815_outcome-document-of-Summit-for-adoption-of-the-post-2015-development-agenda.pdf (last accessed on 14 March 2022).

4 See https://sustainabledevelopment.un.org/content/documents/17853paris_agreement.pdf (last accessed on 14 March 2022).

5 See COM/2018/097 final on the Action Plan: Financing Sustainable Growth.

6 Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019.

a new holistic and comprehensive growth strategy which, in a nutshell, purports to engage society and the markets with the ultimate goal of transforming the EU economy into a future-oriented, resource-efficient, sustainable, and competitive economy (and with no net emissions of greenhouse gases in 2050) (the '**Green Deal**' or '**EU Green Deal**').[7]

The strategy outlined by the European Commission also states that all future EU's actions and policymaking shall take into account those objectives and should put sustainability and the well-being of citizens at its core priorities. In this regard, one can expect future EU policies (i) providing for a just transition of the economy (ensuring that no one is left behind, particularly considering the existing asymmetries between countries, industries and regions); (ii) reducing greenhouse gases emissions and seeking decarbonisation; (iii) investing in renewable energies, environment-friendly activities and in the modernisation of the energy-intensive industries and in circular economy; (iv) supporting a climate-friendly transportation platform (taking into account the positive trend of electric vehicles); (v) providing for a wider but responsible access to EU funds; (vi) contributing with financial support (either through EU's investment vehicles and own sources or by developing adequate regulations and legislation and creating the necessary incentives to engage the private investment sector); (vii) 'greening' national budgets; and (viii) embracing green public investment.

From a regulatory standpoint, future changes to the (European and states') legal framework are expected. With regard to financial regulation more specifically, one can expect (i) further measures regarding sustainability proofing and contribution screening of projects (in order to access 'EU green financing');[8] (ii) new corporate governance rules on sustain-

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7 See COM(2019) 640 final on the European Green Deal.

8 Namely, measures which complement the Regulation (EU) 2021/523 which established the InvestEU Programme and amends Regulation (EU) 2015/1017. See as

ability; (iii) further disclosure rules on climate and environmental data; (iv) further eased assessment on capital requirements for green assets or investments; and (v) new economic governance rules (to include the green public investment as a factor for assessing the quality of public finance).

The EU Commission has already uncovered a considerable set of transformative policies. Those measures shall involve not only new regulations and new legislation, but also the update of the existing relevant legal framework in order to make it fit for the new purposes. The intended revision (the so-called 'Fit for 55') of the climate-related policy instruments (e.g., the Emissions Trading System;[9] the Regulation (EU) 2018/842;[10] the Regulation (EU) 2018/841[11]) and tax instruments (e.g., Energy Taxation Directive[12]) are the most illustrative examples of updates that should be able to strengthen EU's position on the matter and

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an example C(2021) 2632 final Commission Notice on Technical guidance on sustainability proofing for the InvestEU Fund.

9 See the following links for the new ambitions of EU in this regard: (i) https://ec.europa.eu/clima/eu-action/eu-emissions-trading-system-eu-ets_pt; and (ii) https://ec.europa.eu/clima/eu-action/european-green-deal/delivering-european-green-deal/increasing-ambition-eu-emissions-trading_en (both links last accessed on 14 March 2022).

10 See the amendment being proposed to the Regulation (EU) 2018/842 at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52021PC0555 (last accessed on 14 March 2022).

11 See the amendment being proposed to the Regulation (EU) 2018/841 at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52021PC0554%2801%29 (last accessed on 14 March 2022).

12 See the discussion around its revision at https://ec.europa.eu/taxation_customs/green-taxation-0/revision-energy-taxation-directive_en (last accessed on 14 March 2022).

the recently adopted European Climate Law[13] should also be seen as an important stepping stone for all these changes.

As previously mentioned, the gathering of financial resources and investment will be decisive for this strategy and the European Commission clearly understands that the public and private sectors must cooperate and direct their efforts towards climate and environmental action. The European Commission will not be able to attain its goals by simply relying on its sources of funding and investment capacities or those of the EU as a whole (and that is not only because it probably lacks sufficient funds). In our view, common private investors and lenders (irrespective of the type of financing, and whether traditional or modern enterprises, including fintech companies and modern lending corporations) are often closer to clients and businesses – and that proximity is key for providing liquidity to corporations (as it naturally eases access to funding and investment). That is key, and the European Commission knows it as well. In fact, this is the reason why it presented the European Green Deal Investment Plan (on 14 January 2020[14]), which purports to meet the additional financing needs for the Green Deal by (i) mobilising public investments and help to unlock private funds – a figure of EUR 1 trillion is expected to be channelled to sustainable investments within the next decade thanks to this plan – and by (ii) creating a coherent framework to facilitate public and private investment and to strengthen cooperation between public and private sector[15] (the '**Green Deal Investment Plan**').

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13 Regulation (EU) 2021/1119 of the European Parliament and of the Council of 30 June 2021.

14 Where the Commission clearly states that '*The European Union is committed to becoming the first climate-neutral bloc in the world by 2050. This requires significant investment from both the EU and the national public sector, as well as the private sector*.' See https://ec.europa.eu/commission/presscorner/detail/en/ip_20_17 (last accessed on 14 March 2022).

15 '*The success of the European Green Deal Investment Plan will depend on the engage-*

Furthermore, precisely due to the European Commission's view regarding the need of a closer connection and interaction between private and public investment sectors, it reinforced its intention to develop an EU green bond standard that facilitates sustainable investment. Clear common EU standards that are both capable of easing access to financing and of providing greater legal certainty would most certainly be decisive.

Meanwhile, other measures have been taken by the European Commission, such as the creation of the 'Just Transition Fund' (a fund with the single objective of ensuring that those regions and sectors that are more dependent on fossil fuels and energy intensive industries, or simply the regions where such a transition entails particularly challenging and profound economic and social transformations, receive adequate and tailored support) and the European Commission is expected to foster the provision of EU's budgetary guarantee to secure 'green financings' funded by InvestEU Fund, not to mention EIB's objective of contributing to green financing.[16]

As already anticipated, to make the financing workstream succeed, the EU, its Member States, investors, and businesses in general will need clear guidelines and frameworks in which to operate. Not only common EU standards are needed, but also a coherent sustainability proofing and screening mechanism in order to monitor and assess whether the investors and companies are either effectively seeking a change, investing or contributing for a 'green economy'. A close monitoring and cooperative process is thus needed – it is more than an understandable concern; it

ment of all actors involved,' in the European Commission press release on the European Green Deal Investment Plan (see the link in the above footnote).

16 For two examples of its very recent involvement see: (i) https://www.eib.org/en/press/all/2021-344-eib-to-provide-galp-with-eur732-million-to-promote-climate--action-and-social-cohesion-in-spain-and-portugal and (ii) https://www.eib.org/en/projects/pipelines/all/20200410 (both links last accessed on 14 March 2022).

shall benefit all stakeholders – but we stress that it should be both efficient and as less bureaucratic as possible. Following this concern, the Green Deal also put forward the need of a taxonomy classifying environmentally sustainable activities as well as more robust disclosure standards and new accounting practices.

With this brief description in mind, one can easily understand the major impact of the EU Green Deal in the European economy and countries. It is arguably one of the major strategies ever designed and delivered by the European Commission due to its ambition and complexity. The legal intricacies of such policy, however, still need a further clarification, so we will now delve deeper in such front.

3. Green Finance

3.1. Preliminary remarks on green finance

In this work, we specifically address and analyse one specific workstream of the European Green Deal – sustainable finance (or ‘green finance’) – which aims to target and channel private investment to the transition to a climate-neutral economy, complementing public investment and public policies. While the workstream mainly intends to capture private investment, the main ideas it presents shall undoubtedly apply to public institutions and governments.

Also in this work, with regard to means of providing financing, we shall primarily focus on two options which (currently) constitute the main subsets of green finance: green bonds and green loans. But first, a few other considerations regarding the subject matter need to be made.

‘Finance’ and ‘sustainability’ being shoulder to shoulder may appear as a relatively recent trend.[17] One that is closely linked both to climate change mitigation and to recent and widespread concerns related with environmental, social and governance matters (“**ESG**”).[18] It may be so, but it is also important that all stakeholders grasp their symbiotic

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[17] See https://www.afme.eu/Publications/Data-Research/Details/ESG-Finance-Q2-2021---European-Sustainable-Finance (last accessed on 14 March 2022).

[18] While the ESG domain per se is not the point nor focus of this work, we will be referring to it throughout this account due to its importance and connection with the matter, most of times referring to it to evidence the rapidly growing conscious of individuals and corporations regarding sustainability matters in general.

relationship and understand they are increasingly more interconnected. Indeed, as we will see further on, it is not only that corporations need liquidity to propel their businesses or to assist them in a transition, investors and financiers also see value in allocating resources to sustainable projects and while some look for monetizing 'sustainability' and construe it as a new product, others are starting to perceive the risks of climate change (either in their investment strategies or activities).

This said, we still see that investment and strategic decisions often lack to take into account environmental and social concerns or climate change, because such risks are said to only materialise in longer time horizon – this is not necessarily correct and even central banks across Europe already voiced their concern long ago, including the European Central Bank, which already reported on the issue.[19] In fact, there is recent evidence that banks' adaptation to their practices in this regard (managing environmental risks) has been too slow and that '*the clock is ticking for banks to manage climate and environmental risks*'.[20] Indeed, while this concern is being increasingly more perceived,[21] from an investment perspective, there are little doubts of the liquidity of green products and of sustainability interests – they do not necessarily lead to lower returns and they should be seen as an attractive investment.[22]

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19 See https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.202111guideonclimate-relatedandenvironmentalrisks~4b25454055.en.pdf (last accessed on 14 March 2022).

20 See Sem Jo Houben, Guan Schellekens and Kathrin Zander, 'The Clock is ticking for banks to manage climate and environmental risks', available at: https://www.bankingsupervision.europa.eu/press/publications/newsletter/2021/html/ssm.nl210818_5.en.html (last accessed on 14 March 2022).

21 See Madison Condon, 'Market Myopia's Climate Bubble' (2021) Utah Law Rev, Forthcoming https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3782675 (last accessed on 14 March 2022).

22 There is a considerable demand for 'green products' and the *Financial Times*

Now, 'sustainable finance' or 'green finance' has been defined throughout the recent years in various forms, but we will simply put it as the process of investing taking into account sustainability, environmental and social considerations, as well as funding environmentally friendly activities. While the environmental considerations usually refer to climate change mitigation and adaptation, the social considerations may refer to issues of inequality, inclusiveness, labour relations and the investment in human capital – all are nowadays included in the broader 'ESG' concept that quickly became the mainstream word in this domain.

Furthermore, green finance – whether viewed from an overarching perspective as a workstream of the EU Green Deal or construed as the mentioned '*process of investing (…)*' as referred in the paragraph above – shall be viewed by and presented to the (professional) community as delivering a three-pronged solution: (i) it purports to gather the necessary tools and raise the amounts for an ambitious transition in the economy – decisively assisting the EU in pursuing its objective; (ii) it provides for immediate and tangible support for industries, companies and businesses investing in sustainable products and environmentally friendly activities; and (iii) it constitutes a new investment opportunity for investors/lenders which ideally would be fostered in the nearer future with new regulations and the most needed benefits (e.g., regulatory requirements taking into account green financing and sustainability-linked investments, tax incentives, etc.).

It should now be relatively clear for everyone that the private investment sector is key for the EU, in the sense that it is decisive to raise the necessary funding and to channel liquidity to the businesses and

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even reported on 18 June 2019 that a Verizon's $1bn green bond attracted demand in a proportion of eight times the amount of issuance – see https://www.ft.com/content/7d64d1d8-91a6-11e9-b7ea-60e35ef678d2 (last accessed on 14 March 2022).

therefore unleash EU policies such as the Green Deal.[23] And it is also clear that such a transition in the world's economy is not only needed but arguably inevitable.

Notwithstanding, it is our view that discussions (and the EU's public discourse) around the role of green finance should become increasingly more oriented to the existent and potential synergies that the subject of green finance is able to explore, rather than speaking of it as an inevitable solution. If not, discussions may stall due to difficulties in engaging the market and its players, who often prove to be far too imaginative and reluctant to accept one-way solutions without evident benefits. To be entirely clear, sustainable finance was already in the EU agenda long before the Green Deal was presented. However, it undoubtedly increased in importance as it became an extremely relevant part of a rather major plan.

In this context, the EC Action Plan on Financing Sustainable Growth (the '**EC Action Plan**'),[24] adopted by the European Commission in March 2018, must be highlighted. It was fundamental in aggregating prior efforts around sustainability, in clearly pointing not only the symbiotic relationship between finance and environmental policies,[25] but also the importance of redirecting private investment towards a

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23 In this regard, on 18 October 2019, the EU and other countries launched the International Platform on Sustainable Finance, whose ultimate objective is to scale up the mobilisation of private capital towards environmentally sustainable investments; see https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/international-platform-sustainable-finance_pt (last accessed on 14 March 2022).

24 See COM/2018/097 final on the Action Plan: Financing Sustainable Growth.

25 '*The financial system has a key role to play here. The financial system is being reformed to address the lessons of the financial crisis, and in this context, it can be part of the solution towards a greener and more sustainable economy,*' in the EC Action Plan on Financing Sustainable Growth.

greener economy,[26] and the need to start factoring environmental, social and governance concerns into investment decision-making (since, for instance, decisions are often taken without considering (or seeking) long-term benefits or financial gains). Another key takeaway from the EC Action Plan is that it recognised that the shift of capital flows towards more sustainable activities has to be underpinned by a shared, holistic understanding of the environmental sustainability of activities and investments.

In relation to green finance specifically, the EU Green Deal (and its related framework) clearly built on the EC Action Plan, and not only decisively voiced the EU's concerns on the matter and the plan to tackle them but introduced new mechanisms and had the merit of directing policies to address those concerns. In this matter, the EU Green Deal updated and conferred traction to the action plan, and eventually created the Green Deal Investment Plan (as mentioned in section 2. above) and – more recently – delivered the EU's Strategy for Financing the Transition to a Sustainable Economy[27] as a sort of update concerning the entire strategy of directing financing to help attaining the EU Green Deal priorities and objectives.

Due to the current market features (and also taking into account the uncertainty within the markets brought by the Covid-19 pandemic and the conflict between Russia and Ukraine), one can immediately observe the current paradox: while the market is perfectly aware of the need of a transition in the economy, some of its players may not appear

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26 *'The financial system is being reformed to address the lessons of the financial crisis, and in this context, it can be part of the solution towards a greener and more sustainable economy. This is necessary if the EU is to develop more sustainable economic growth, ensure the stability of the financial system, and foster more transparency and long-termism in the economy,'* in the EC Action Plan on Financing Sustainable Growth.

27 See https://ec.europa.eu/info/publications/210706-sustainable-finance-strategy_en (last updated on 14 March 2022).

sufficiently willing to deploy their limited resources in such transition (no one can argue that no additional transaction costs are to occur). This is a major problem and one that can only be tackled by putting greater efforts in designing the tools and mechanisms that the EU Green Deal already provided for and presented. The EU should therefore pursue the relentless execution of the master plan, since an integrated and holistic approach is the only possible answer.

Considering the multiplicity of issues that gravitate alongside finance – and particularly, green finance (for instance, the most visible of which being the common lack of willingness for considering long-term investments) –, we strongly believe that any given green financing policy may only work if the following three pre-conditions are met: (i) the existence of clear and common standards that provide certainty as to what is a sustainable activity and a sustainable investment (which would inevitably foster the creation of new businesses and the continued investment in sustainable activities); (ii) the existence of a robust legal framework covering financial regulation, [28] climate regulation, disclosure rules and taxation rules, capable of creating benefits, increase transparency and spur investment; and (iii) the convergence and engagement of the various stakeholders and market players towards a single objective, with such participation being attained by creating and providing them with the right incentives (from a certain perspective, this specific point may be seen as a typical law and economics or corporate governance subject).[29]

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[28] The European Securities and Markets Authority (ESMA) shall be of great importance here since it may be able to better screen the markets and advise on their needs (and market failures).

[29] For a corporate governance analysis this specific problem, See Madison Condon, 'Market Myopia's Climate Bubble' (2021) Utah Law Rev, Forthcoming, in particular chapter 3 'Misaligned Managerial Incentives', available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3782675 (last accessed on 14 March 2022).

In the next section of this work (3.2.), we will elaborate on the first pre-condition mentioned above – the much-needed common standards to guide all stakeholders – and will assess what has been done by the EU (to this date) in relation to it and what else can be done. Amidst such effort, we will also take the opportunity to shed light over important disclosure and regulatory regimes (particularly upcoming financial regulation which is expected to complement the existing one[30]), which form an important part of the second pre-condition. Aware that the entire 'EU sustainability regulation package' is incredibly vast,[31] and that a thorough analysis of each piece of regulation and legislation would probably result in a rather extensive document of ours (and considering wording limitation for this account), in section 3.2. below we will focus

[30] From the existing regulation, the Markets in Financial Instruments Directive (MiFID II) arguably stands out as the most relevant one for the purposes addressed in this work, therefore being important to complement it with further inputs and connect it to new taxonomies (such amendments are expected to occur around November 2022).

[31] It includes, amongst others, legislation such as / regarding: (i) upcoming delegated acts integrating sustainability into MiFID II (already mentioned above); UCITS Directive (Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009), AIFMD Directive (Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011), Solvency II Directive (Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009) and IDD Directive (Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016); (ii) expected amendments to the Capital Requirements Regulation II (Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013) and to the Capital Requirements Directive; (iii) expected new rules on stress testing and scenario analysis; (iv) rules on prudential treatment of green exposures; (v) Solvency II Directive review; (vi) new rules concerning systemic risk and Basel Accords related regulation and legislation; expected amendments to Regulation (EU) 2019/2089 on Low Carbon Benchmarks; (vi) expected updates to the Prospectus Regulation (referred further in this work); (vii) changes to the EU Securitisation Regulation (Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017); and (viii) expected adoption of rules concerning green mortgages and retail lending.

on what we deem as the most relevant regulations, directives and legislation delivered or to be delivered by the EU which specifically concern and/or are fundamental to its green finance strategy.

Lastly, the third pre-condition mentioned above (engaging stakeholders) shall be addressed further in section 3.4.

3.2. The need of clear EU Green Standards and a status update

3.2.1. The EU Taxonomy Regulation and Disclosure Regimes

If the green finance market is to be pivotal in the transition to a climate-friendly economy, then common standards for classifying activities and financial products are needed. The reason for that is crystal clear: economic agents are likely to be risk-averse and long for clarity in a legal regime. The existence of common standards allows the shareholders and managers not only to understand whether their companies meet the environmental requirements and therefore whether they may be classified as 'green', but also to provide the business with some sort of a 'label' that may be used and marketed with the appropriate leverage to seek financing and investment (which is a strong reason for investee companies to make their business models even more environmentally sustainable). On the other hand, from an investors' perspective (that of a bank, an investment fund or investors in the bond market, etc.), those common standards ensure they are undoubtedly investing 'within the purpose' – that is, they are assured that they are investing in sustainable activities and that their portfolio may therefore become greener.[32]

[32] Applying the same rationale, see Clare Hatcher, 'How can Borrowers tap into Green Finance' available at: https://www.clydeco.com/en/insights/2020/02/how--can-borrowers-tap-into-green-finance (last accessed on 11 January 2022).

The existence of legal requirements for marketing activities and financial products (such as bonds) as 'environmentally sustainable activities' enhances investor confidence, awareness, and increases visibility and transparency. It also contributes to tackle the problem of 'greenwashing', which refers to the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly when in fact the basic environmental standards have not been met (e.g., the underlying business does not comply with green standards). Greenwashing is a market issue that creates information asymmetries, lowers confidence, and thus increases transaction costs (e.g., burdensome due diligence exercises, individual screening and complex monitoring processes, etc.), leading to an evident market fragmentation.

Aware of that fact, some States have their own labelling strategies in force, meant to classify activities and/or investments by imposing them environmental standards. However, if national labelling strategies are asymmetric and use different criteria, investors tend to invest in their own geographies and refrain from investing across borders as they would have increased difficulties in comparing different investment opportunities. As a result, an absence of these common standards would disincentivise players from cross-border deals and slow down the traction towards green finance capital markets in the EU. If we recall the purposes of the Green Deal and those of its green finance strategy, the need for harmonisation is even more evident, as it would remove barriers to the functioning of the EU internal market and then foster the ability of raising funds for sustainability projects.

This question is deeply intertwined with that of the need of engaging the various market players and different stakeholders – a point which we have previously mentioned as being a third key pre-condition to an efficient green finance comprehensive policy –, since the EU cannot afford to have barriers which constitute another burden to private investment and contribute for general scepticism.

Furthermore, for a classification system to operate efficiently, it needs to be complemented by robust disclosure rules (as well as a clear

technical screening criteria), which will be key in assisting market stakeholders to seek information both in relation to potential investee companies and to any financial products marketed by companies, in order to assess the proportion of investments directly being channelled to green activities. Disclosure rules provide for transparency and contribute to expedite commercial and financial flows as they allow private (and public) investors to screen activities and (if needed) test their labels against public information and records. These rules may arguably constitute a second layer of legal certainty that should provide the market with the necessary degree of confidence. Moreover, 'getting climate disclosures to be comprehensive and correct at the issuer level is a fundamental step to oversight greenwashing'.[33]

Up to this point, we have mentioned the need of common standards, but what has been done so far in this matter?

In December 2016, the Commission mandated a High-Level Expert Group to develop an overarching strategy on sustainable finance, which delivered its report on 31 January 2018 (and that was used as basis for the EC Action Plan). Such report already evidenced, back then, the need for creating a technically robust classification system at the EU level, in order to provide clarity on which activities qualify as 'green' or 'sustainable'. The EC Action Plan (March 2018) itself mentioned that the lack of clarity among investors regarding what constitutes a sustainable investment was (and continues to be) contributing for the overall investment gap that needs to be filled for the EU to achieve its climate targets by

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[33] For a short analysis covering disclosure and greenwashing (taking the US legal system as example), see Madison Condon, 'Chapter 2. The Sprawling Problem of Financial Greenwashing' in page 6 'Business Law and the Transition to a Net Zero Economy', Beck, Hart Publishing and Nomos, December 2021.

2030 – and, more importantly, it also mentioned the urgent character of the matter.[34]

Following the delivery of the EC Action Plan, the European Commission continued through on its action regarding the establishment of an EU classification system for sustainable activities and delivered a first proposal[35] for a regulation on the establishment of a framework to facilitate sustainable investment on 24 May 2018 (a taxonomy regulation).

Afterwards, and while the proposal for the taxonomy regulation followed the proper legislative procedure, two other important steps have been taken by the EU (which were deeply connected with the need of a taxonomy regulation): the adoption of the Regulation (EU) 2019/2088 (27 November 2019) and the delivery of the EU Green Deal. While the latter was already depicted, the first (also known as the 'Sustainable Finance Disclosure Regulation' (the "**SFDR**") is mainly connected with sustainability-related disclosures in the financial services sector, which had the merits of aggregating existing rules on disclosure as well introducing others (e.g., increased disclosure for policies integrating sustainability risks in investment decision-making processes). This said, and without discussing the overall efficacy of the SFDR, one may query whether – from the perspective of designing an architectural framework suited for green finance – it would not have made more sense to have the taxonomy system (regulation) adopted prior to this one. To be clear, the point here is not that of querying why SFDR was adopted, but more why an EU taxonomy was not already in place, since,

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34 '*A shift of capital flows towards more sustainable economic activities has to be underpinned by a shared understanding of what 'sustainable' means. A unified EU classification system - or taxonomy - will provide clarity on which activities can be considered 'sustainable'. It is at this stage the most important and urgent action of this Action Plan.*'

35 The draft proposal can be found at https://www.europarl.europa.eu/RegData/docs_autres_institutions/commission_europeenne/com/2018/0353/COM_COM(2018)0353_EN.pdf (last accessed on 14 March 2022).

from an efficiency standpoint, it probably already missed some timing – and we are currently still observing some inefficiency, as most relevant delegated acts on the Taxonomy Regulation (as defined below) are still being discussed. For instance, it is still do be decided whether nuclear and natural gas shall be classified as "green" under the regulation – a subject which is bound to propel important discussions at the EU level in the times ahead.

On 15 April 2020, the Council adopted its position[36] on the taxonomy regulation by written procedure at first reading and was immediately followed by the European Commission Communication to the European Parliament that such positions correctly reflected what had been discussed previously and its outcome.

After two more months of discussions within the preparatory bodies, and subsequent to the completion of necessary legislative steps, the European Parliament ultimately adopted the Taxonomy Regulation on 18 June 2020[37] (the '**Taxonomy Regulation**') – a much awaited (and needed) piece of legislation was therefore put in place and in force from 12 July 2020 onwards.

Now, with the Taxonomy Regulation in force, the work is far from being finished as delegated and implementing acts are to follow and those should be deemed as being key to confer efficacy to the main regulation. Indeed, delegated acts are still urgently needed since the actual list of environmentally sustainable activities is not yet clearly defined and the regulatory technical standards ('RTS') delivered in February 2021 (supplementing the SFDR) do not entirely solve the problem. Moreover,

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[36] See Council's position on the Taxonomy Regulation at: https://data.consilium.europa.eu/doc/document/ST-5639-2020-INIT/en/pdf (last accessed on 14 March 2022).

[37] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020.

in practice, because it still lacks fundamental inputs, the Taxonomy Regulation will not be running at full speed at least until 1 January 2023 (at the earliest), date on which all the delegated acts related with technical screening criteria for each of the six environmental objectives[38] (as determined by the Taxonomy Regulation) are envisaged to be in place.[39]

In relation to disclosure regimes, and besides the already mentioned SFDR, a Corporate Sustainability Reporting Directive is expected[40] to be adopted by October 2022 and it shall replace the Non-Financial Reporting Directive (Directive 2014/95 EU). Its aim is to help improve the flow of capital toward sustainable activities across the EU by standardising the collection and analysis of reported ESG data and thus preventing greenwashing. That is most certainly a relevant change but – again – we query about the overall efficacy of its regime considering the yet 'incomplete' version of the Taxonomy Regulation, which should be first building block for the entire regime. We are not entirely sure how stakeholders will receive it, but it seems that the EU sustainable finance regulation puzzle is lacking coordination and timing, therefore running the risk of turning it into a 'jigsaw'.[41]

[38] Those objectives being: climate change mitigation; climate change adaptation; sustainable use and protection of water and marine resources; transition to a circular economy; pollution prevention and control; and protection and restoration of biodiversity and ecosystems.

[39] It is also worth noting that the Platform on Sustainable Finance is currently also tasked with advising the European Commission on extending the scope of the Taxonomy Regulation to social objectives.

[40] See the proposal for such directive at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0189 (last accessed on 14 March 2022).

[41] Acknowledging such 'jigsaw', see Oliwia Berdak and Luis Deya, 'The European Union's Sustainable Finance Regulation Jigsaw is Almost Complete', available at: https://www.forrester.com/blogs/the-european-unions-sustainable-regulation--jigsaw-is-almost-complete/ (last accessed on 14 March 2022).

To be clear, the main point of criticism regarding the Taxonomy Regulation and the ancillary disclosure regimes is that the EU seems to be struggling in building a comprehensive legal framework in due time. This is a matter where legislators and policymakers in general should strive to harness the momentum generated by sustainability concerns and the growing interest of the financial markets in monetising this 'asset'[42] and to put efficiency and effectiveness as top priorities.[43] We do not neglect the fact that the matter raises diverse concerns across Member States, but our point is more that policymakers should focus on resolving those divergences and discussing substance. As we will see further on, the financial markets – which, to reiterate, are key to enable the green transition – are already there and eager to operate in a market free from 'greenwashing' risks.

On the other hand, and in spite of the above critiques, it is worth noting that in this respect (common standards and taxonomies), the EU appears to be yet again in the forefront of change to climate related legislation and other international players such as the US seem to be incentivised to join efforts.[44]

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[42] See https://www.afme.eu/Publications/Data-Research/Details/ESG-Finance-Q2-2021---European-Sustainable-Finance (last accessed on 14 March 2022).

[43] In the same rationale (and calling on policymakers to consider coherence of the framework): See https://www.afme.eu/Publications/Data-Research/Details/ESG-Finance-Q2-2021---European-Sustainable-Finance (last accessed on 14 March 2022).

[44] See Geneviève Helleringer, 'Chapter 5. EU vs Greenwashing: The Birth of Transparency, Comparability, Cooperation and Leaders' in page 19 of 'Business Law and the Transition to a Net Zero Economy', Beck, Hart Publishing and Nomos, December 2021.

3.2.2. EU Green Bond Standards

A different, but related topic is the EU's intention of creating its own Green Bond Standards – another 'common standard' which, to anticipate, is deeply needed.

In July 2018, the Commission requested a technical expert group (the '**TEG**') to prepare a report on an EU Green Bond Standard ('**EU GBS**'), building on the then current best practices. This is of course deeply connected with the common taxonomy and complements it – particularly with regard to designing standards and/or labels for sustainable financial products (i.e., to assist in classifying financial products/financial instruments as 'green').[45] These standards, aiming to address bonds instruments, are said to be of great importance to protect the integrity of and trust in the sustainable financial market and to enable easier access for investors seeking those products.

On 18 June 2019, the TEG published its Report[46] on the EU GBS (the '**TEG's Proposal**'), proposing the EU, amongst other measures (which we will further point out), to create a voluntary and non-legislative EU green bond standard in order to ease investors, issuers and remaining stakeholders to identify green projects and green products, enabling them to invest with greater confidence.

The expression 'green bonds' relates to a specific financial instrument (bonds) which allow entities (either companies, banks, governments, investment funds, etc.) to borrow money from investors in order to finance or re-finance 'green' projects (an operation based on the risk

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[45] See article 4 of the proposal for the Taxonomy Regulation, which evidences that both standards are deeply intertwined; https://data.consilium.europa.eu/doc/document/ST-5639-2020-INIT/en/pdf (last accessed on 14 March 2022).

[46] See https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190618-sustainable-finance-teg-report-green-bond-standard_en.pdf (last accessed on 14 March 2022).

profile of the issuer (usually) represented by its credit rating and the remuneration offered in the form of interest). 'Bonds' are arguably the most negotiable and traded financial instrument in nowadays markets and they may play an important role in the EU Green Deal, both in expanding the market of sustainable products/activities and by channelling liquidity to it.[47] However, one must note that the TEG's Proposal is to treat '*any type of listed or unlisted bond or capital market debt instrument issued by a European or international issuer that is aligned with the EU Green Bond Standards*' as an EU Green Bond.[48] Interestingly, it should be noted that the text of the TEG's Proposal refers not only to bonds but also to a wide variety of capital market debt instruments.

But, from a market perspective, what is the difference between ordinary bonds and the so-called 'green bonds'? While both ultimately serve the purpose of (re)financing an activity, the latter provide the investor with increased assessment and monitoring capacity (as green bonds are benchmarked against green taxonomies) and thus enable them to constantly evaluate the green component over time. In fact, green bonds are linked to issuer's sustainability objectives (as the 'use of proceeds' needs to be described and agreed in the contractual phase of the finance documents underlying each bonds issuance[49]), which explains why they actually enable the market to monetize climate and sustainability. From

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[47] The truth is that, since 2014 – when the professional community started regulating green bonds – these financial instruments quickly mapped how the sustainability and green trends of public debate were being reflected in the real economy.

[48] See the Usability Guide to the TEG Proposal for an EU Green Bond Standards: https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200309-sustainable-finance-teg-green-bond-standard-usability--guide_en.pdf (last accessed on 14 March 2022).

[49] The 'use of proceeds' component is a key difference, as in the green bonds their net proceeds are allocated to specific uses (green projects), and they are ringfenced and tracked accordingly.

an issuer's perspective, 'green bonds' not only constitute a new different product to be marketed (which may attract new types of investors), but according to a recent study,[50] they may lead to lower long-term financing costs and even have a positive impact on share prices in the short term.

In accordance with the TEG's Proposal on the EU GBS – which, to anticipate, served as basis for a formal proposal for a Regulation – an 'European green bond' would be defined as any type of listed or unlisted bond or capital market debt instrument issued by any European or international issuer that would be aligned with the EU GBS regime as a whole, and therefore it would need to meet the following requirements: (i) the issuer's green bond framework shall confirm the alignment of the green bond with the EU GBS; (ii) the proceeds, or an amount equal to such proceeds, shall be exclusively used to finance or refinance in part or in full new and/or existing Green Projects (as defined by the EU GBS), as it shall be described in the bond documentation; (iii) and the alignment of the bond with the EU GBS shall have been verified by an approved 'Verifier'.

The market shows that these types of financial products are not only highly appreciated by experienced (professional) investors but also by retail investors (and this would bring even more participants to sustainable finance markets), who are increasingly more concerned with ESG matters and want to green their portfolios, as public scrutiny in this matter is rapidly increasing as well.[51]

However, the EU will only be able to capitalise such demand if it creates labels and standards that confer legal certainty as to the treatment

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[50] See https://ci.natwest.com/insights/articles/greeniums-and-halo-effect--green-bonds-make-financial-sense/ (last accessed on 14 March 2022).

[51] After an initial period, when the green bonds market was dominated essentially by banks, it has now spread into all debt capital market classes from corporate issuers, sovereign issuers, asset-backed securities, project bonds, etc.

of a given financial instrument and thus boosting confidence in the market.

In our opinion, the most important recommendations that TEG delivered in the mentioned report were as follows: (i) the rapid creation of a voluntary EU Green Bond Standard;[52] (ii) to align the definition of 'Green Projects' and the underlying requirements with those derived from the Taxonomy Regulation; (iii) to establish a Green Bond framework that takes into account the 'use of proceeds' component and that requests issuers to report their strategies in this regard; (iv) to design and operate an accreditation regime; (v) investors should use the requirements of EU Green Bond Standard in their investment strategy and communications with bond issuers; (vi) the promotion of a greener financial system must also come from Central Banks, who should be encouraged to preferably purchase green bonds; (vii) the development of financial incentives to support the EU green bond market; and (viii) issuers should use EU Green Bond Standards to design their green bond issuances.

At this point, it is worth noting that the European Commission put forward on 7 July 2021 a first draft of the Proposal for a Regulation on European green bonds (hereinafter referred to as '**EC Proposal on EU GBS**').[53] Such draft was strongly influenced by the TEG's Proposal which we have analysed so far and apart from a few minor points, it is fair to say that in substance it is very close to what had been proposed by the TEG.

The EC Proposal on EU GBS has the merit of being capable to provide a considerable degree of transparency and legal certainty to the

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52 Which TEG recommends being created and published as soon as practicably feasible, and the latest at the moment when the Taxonomy Regulation has been agreed by the co-legislators (since the Taxonomy Regulation is already in force, the EU already missed some momentum): see TEG Proposal for an EU Green Bond Standards.

53 See the Proposal at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0391 (last accessed on 14 March 2022).

market, as well as to contribute to engage the multiple market players by providing them with some incentives. The current text of the proposal sets forth, amongst others, (i) the need for the issuers to draw up an 'European green bond' factsheet (which shall be considered as 'regulated information' and then incorporated by reference in a prospectus), (ii) allocation reports concerning bonds' proceeds allocation; (iii) pre-issuance and post-issuance review/confirmation of the factsheet; and (iv) an impact report on the environmental impact of the use of proceeds. It is also worth noting that it shall be ESMA the entity responsible for supervising the external 'Verifiers'. It is also worth noting that the designation of 'European green bond' is to be available to all issuers both within the EU and outside for their bond issuance, provided that those bonds are made available to investors in the EU and that they meet the requirements of the upcoming Regulation.

With regard to the incentives, the TEG's Proposal was particularly well designed and moulded the EC Proposal on EU GBS and (hopefully) upcoming legislation decisively. Broadly speaking, it divided incentives into two categories depending on the time needed for their implementation (whether a short-time period or a long-time period).

With regard to those incentives that can be rapidly implemented, one should highlight both the proposal to develop a disclosure rule regarding a 'green bond ratio' (which basically would serve to flag the market what is the ratio of green bond investments of a given bank/insurance company, boosting competition and arguably create a race to comply with Green Bond Standards) and the proposal to the Central Banks to promote greener investment and lead by example (by starting to integrate sustainability factors into the management of some of the portfolios at hand).

As to the incentives that may be more complex to implement, we have the tax incentives (which fall into this category thanks to the unanimity rule of the EU regarding taxation policy), and the financial sector prudential rules which shall only be ready to be implemented once there

is sufficient clarity on what are the differences in risk profile between green and non-green financing.

To reiterate, and for the avoidance of doubt, not all of the aforementioned incentives have been included in the EC Proposal on EU GBS itself. In fact, it is not for the EU GBS to capture them all. It is therefore needed that the EU continues to act on and implement them across sector-specific legislation.

It should be noted that TEG performed its work and delivered its recommendations based on the then current best practices. One of the works that served as basis was precisely the Green Bond Principles[54] (the '**GBP**'). This illustrates the importance of the existent market-practice standards, that were designed by the professional community in advance and thus played (and continue to play) a vital role in the development of the EU green finance framework.[55] The 'use of proceeds point' is a good example of a concept derived from the GBP – basically meaning that the proceeds generated by green bonds issuances must be allocated by the issuer to specific pre-selected and contractually described 'green projects'. Furthermore, and following TEG's view, the green bond market does not suffer from significant market dysfunction and it benefits from the reactive market practice embodied by the GBP.

The EC Proposal on EU GBS is meanwhile following the ordinary legislative procedure[56] and this will naturally involve negotiations be-

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[54] The GBP were initially published by a group of leading banks and subsequently supported by the International Capital Market Association (the 'ICMA').

[55] '*The green bond market has also provided policy makers an example of a largely market driven and successful initiative addressing green challenges and climate change mitigation. This has stimulated debate on how it may be further supported and how it may inform wider policy initiatives.*' See TEG Proposal for an EU Green Bond Standards.

[56] For further insights as to its status please see https://www.europarl.europa.eu/legislative-train/theme-an-economy-that-works-for-people/file-eu-green-bond--standard (last accessed on 14 March 2022).

tween the European Parliament and Council via trilogue procedure. Since this legislative procedure has an average length of 18 months, a regulation is only expected to be adopted in June/July 2023 which is not ideal to capture green bonds momentum and propel green financing.

While we are awaiting for the EC Proposal on EU GBS to follow the proper legislative procedure, Christine Lagarde, in the quality of President of the European Central Bank, already voiced the intention of delivering a bond-buying program specifically designed to tackle climate change[57] and a few steps have already been taken in that direction[58]. The move makes the ECB the first main central bank to use a flagship bond-buying programme to pursue green objectives and it would be important (even from a market perspective) if the ECB aligns its programme with the forthcoming EU GBS regime.[59]

Now, the rationale behind this ECB policy is welcome, but still, it is not exempt from doubts. A first concern refers to the mandate of this institution, because central banks have a specific mandate to keep monetary policies and financial markets under control – not to fight climate change. The challenges of climate change are, of course, a matter for the entire political community – but central banks lack the necessary democratic background to lead this fight: not only they do not have the legitimacy of being elected by the people, but also these policies risk increasing the outsourcing of our political agenda to technocrats. On the other hand, one understands that climate change affects the economy

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[57] See https://www.ft.com/content/00d5dc18-b95d-4a15-b936-e87c98fb17fc (last accessed on 14 March 2022).

[58] See https://greencentralbanking.com/2021/01/16/ecb-first-to-buy-climate--bonds/ (last accessed on 14 March 2022).

[59] See ECB's opinion on the EC Proposal on the EU GBS at: https://www.ecb.europa.eu/pub/pdf/other/en_con_2021_30_f_sign~17d7dd770b..pdf (last accessed on 14 March 2022).

and, from a financial perspective, there is already evidence that the yields of eligible green bonds significantly declined following ECB's pledge on purchasing bonds and that additional demand via asset purchase programmes improved financing conditions for eligible green corporate bonds.[60] However, to define asset purchases is to outcast specific polluters. The problem is that this task should be part of the political turf, not of the financial institutions.

3.2.3. EU Green Loan Standards

At this point and trusting no doubts remain as to the urgent need of common EU standards (both in relation to the taxonomy and the EU GBS), the most attentive readers may pose one final question regarding the coverage of the financing means: what about ordinary loans (e.g., those not made through bonds issuance)? Are they included in the prospective EU Green Bond Standard? If not, do they justify separate common standards?

Before delving into this question, one should note that it is expected that the European Banking Authority will further develop guidance in this regard. However, this point undoubtedly needs clarification (for instance, some market-driven standards specifically include such mean of financing in their list of eligible instruments), as both investees and investors are keen to understand what is coming. The question gains even more importance once one realizes that the bank loan market is still the largest source of financing for the corporate sector in Europe.[61] Moreo-

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60 See Bremus, Schuetze and Zaklan, 'The Impact of ECB Corporate Sector Purchases on European Green Bonds', available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3810492 (last accessed on 14 March 2022).

61 This may also be linked to the idea presented in 2. (*The EU Green Deal – short description and key topics*) regarding the fact that the private sector is often closer to clients and businesses and that proximity is key for providing liquidity to corporations

ver, while investment grade companies dominate the corporate bond markets (as issuances usually require elements such as credit ratings and minimum issuing sizes, etc.), small and medium-sized companies usually tend to seek finance from the more common bank loans (whether syndicated term loans, bullet loans, revolving credit facilities, etc.).

While the TEG's proposal does refer the potential synergies between EU GBS and the green loans market, the actual draft of the EC Proposal on EU GBS does not make a reference to such point. More importantly, the EC Proposal on EU GBS in its article 3 only specifies 'bonds', leaving other financial assets to its article 4 which only deals with the use of proceeds component (meaning that those assets can be 'refinanced' via green bonds). In other words, it does not purport to cover this mean of financing as it intends to do for bonds (and other *capital market debt instruments*).

Throughout the EC Proposal on EU GBS, references to 'loans' are easily found. However, those references are solely used in relation to 'green bonds' that intend to *refinance* 'green projects' – a definition which can include 'loans' (i.e., green bonds may be used to refinance loans previously connected with green assets / projects).

Of course, this type of financing (loans) does not have the same characteristics of those of capital markets instruments (e.g., different tradability) where investors (usually) have greater visibility over the market due to the wider marketing of financial products (such as bonds). Moreover, this type of financing is not systematically verified by external sources and the levels of mandatory disclosure are relatively lower when compared to investments in bonds. However, due to its market importance (at least if we consider the final aggregated figures), it may deserve a better and suited approach.

(this is particularly visible in relation to banks / insurance providers).

Currently, there are mainly three types of asset-based green loans in (and labelled by) the market: (i) green loans (typically syndicated term loans or revolving credit facilities) made available to (re)finance Green Projects; (ii) bilateral green loans that development banks offer to borrowers to finance specific green projects with set criteria and requirements; and (iii) loans offered to retail borrowers which are used to finance, for instance, the acquisition of electric vehicles. Mainly because of the overall amounts it deals with and the size of the investments, the first type is fundamentally based and increasingly aligned with the Green Loan Principles (the **'GLP'**),[62] which somehow evidences a similarity with the evolution of the legal framework of Green Bonds. Both start(ed) from the market practice.

In addition to the more common loans, there is another type of loan that is increasing in its importance. It is sometimes called 'sustainability improvement loan' and, in short, sets forth remuneration and/or financial covenants that are linked to the borrower's achievement of pre-determined environmental benchmarks. As opposed to 'asset-based green loans', this type looks to performance across the whole borrower and not to just a part of its operations/business.[63]

While we may understand the comment that green loans are a subset that stakeholders and the market are not that eager to develop or, in other words, an area where the incentives are not sufficiently strong compared to those of the green bonds market to justify a similar effort in designing standards, we strongly believe that the right incentives are still to be created (e.g., tax benefits to green loans that follow a specific green standard; lightening regulatory minimum capital requirements by taking into account the percentage of green loans provided by the credit

62 See section 3.3. below.

63 For further considerations in respect to this type of lending, see section 3.5. below.

activity of a bank, etc.) and that the EU should push for a shift in this market as well. For that end, building on the current best market practices may well be the best solution.

In the following section of this work, we will analyse when and how the market and the professional community developed its own voluntary regimes to target and market sustainability-related financial products. More importantly, we will (i) evidence that the regime being built by the EU for green bonds is very similar to the one developed by the market participants long ago, (ii) suggest that the EU GBS may still use extant work developed by the private sector, (iii) propose that a EU Green Loan standards may find its basis and support in the existing framework drawn up – as well – by the professional community and (iv) underscore the current trend of monetising sustainability.

3.3. 'Market Practice Common Standards' – green bonds and green loans

3.3.1. Preliminary notes

Although green finance is consolidating itself as a market trend,[64] as anticipated, the matter is not new for the professional community. In fact, it was precisely the professional community who developed the first framework of standards and voluntary rules on the subject. The vision and creativity of the industry was key to understand that there was an 'asset' (i.e., climate change) that was not being sufficiently monetized, and later on indeed confirmed that the market was there for it.

When we refer to 'professional community' we mean the most reputable entities that are usually, actively and professionally engaged

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[64] See https://oxfordbusinessgroup.com/news/esg-trends-2021-rise-green-finance (last accessed on 14 March 2022).

in modern commercial and financial transactions, entities that are used to deal with financial products and have sufficient means and know-how to excel in such area. We mean leading banks, insurance providers, investment funds and even central banks and stock exchanges. These were the type of entities that managed to kick-start voluntary regulation for green finance, as they were conscious that rules and standards were needed in order to deliver legal certainty and confidence to their market platforms.

These 'market practice common standards' are mostly visible in the markets of green bonds and green loans.[65] This work now analyses what has been done by this community so far, how the market is currently functioning without EU standards (as the EC Proposal on EU GBS is still being discussed), and what is already there to assist the EU to strengthen or (re)design its policies and to serve as basis for future legal developments – as seen, while the prospective EU Green Bond Standards are deeply influenced by the market practice (i.e., the GBP), the EU may well take into account other market-based solutions concerning green finance.

3.3.2. Green Bonds

Starting with some interesting figures on green bonds, the first landmark dates back to 2007,[66] when the European Investment Bank is-

[65] ICMA recently published a set of high-level definitions for commonly used sustainable finance terms which may be helpful to serve as reference guide for concepts used in this matter as well as for providing a better convergence on this terminology. See. https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/Sustainable-Finance-High-Level-Definitions-May-2020-110520v4.pdf (last accessed on 14 March 2022).

[66] With regard to companies, the first to issue green bonds was Vasakronan AB on 20 November 2013 (selection of the projects had come from the Norwegian Center

sued the world's first green bond (the '**Climate Awareness Bond**'). Curiously, as of the end of December 2019, the European Investment Bank remained a world leader issuer of green bonds with over EUR 26.7bn raised across 13 currencies, of which the EUR equivalent of 3.4bn was raised in 2019.[67] With these climate awareness bonds, the European Investment Bank managed to pioneer the ring-fencing of proceeds in a dedicated liquidity portfolio – a first step to the 'use of proceeds' component, an approach that has been followed by organisations and market-practice standards until now.

With regard to market practice regulation, the debate amongst the professional community on what is 'green' facilitated the emergence of market-based regulatory definitions of green eligibility. At that time, green bonds were indistinguishable from other 'plain vanilla' securities, however, as its market developed (arguably boosted by the increased presence of ESG concerns in investment decision making), voluntary regulation appeared likewise.

It all started in 2014 with the advent of the GBP, 2014 - Voluntary Guidelines for Issuing Bonds[68] which had set out 4 types of green bonds: (i) the 'Green Use of Proceeds Bond' (a standard bond (recourse to the issuer), whose proceeds are allocated by the issuer to a sub-portfolio of their investments in Green Projects); (ii) the 'Green Use of Proceeds Revenue Bond' (bonds with no recourse to the issuer, which put credit

for International Climate and Environmental Research). Other corporate entities such as Bank of America and Eletricité de France followed Vasakronan's steps on promoting green investment.

[67] See https://www.eib.org/en/investor_relations/cab/index.htm# (last accessed on 14 March 2022).

[68] Initially developed by a consortium of banks, it was published in January 2014 and later on gained the support of the International Capital Market Association. See https://www.climatebonds.net/files/uploads/2014/01/Green-Bond-Principles-FINAL.pdf (last accessed on 14 March 2022).

exposure linked to the cash flows of a green project, the rest of the mechanics being the same as the Green Use of Proceeds Bond); (iii) the 'Green Project Bond' (may have recourse to the issuer or not – the investor having direct exposure to the risk of the Green Project); and (iv) the 'Green Securitised Bond' (a bond collateralised by as specific Green Project).

In the absence of common standards for green bonds, the abovementioned partition in 4 types of green bonds initially assisted the market in designing their products and making them attractive from a sustainability point of view.[69] In addition, the GBP through its guidelines intended to foster transparency and disclosure to the contractual documentation regarding green bonds and reflect such transparency to the green bond market itself.

The GBP have 4 main components which one can easily relate with recent EC Proposal on EU GBS: (i) Use of Proceeds (necessary disclosure of the Green Projects which will receive the proceeds); (ii) Process for Project Evaluation and Selection (investment decision-making process being disclosed); (iii) Management of Proceeds (issuer's actions/decisions of investment should be consistent with the objectives); and (iv) Reporting (disclosure of amounts being invested). Furthermore, the GBP also assisted with the identification of Green Projects by providing a list covering the following areas: renewable energies, energy efficiency, sustainable waste management, sustainable land use, biodiversity conservation, clean transportation and clean water and/or drinking water.

In 2014, and to provide further coherence to market-practice standardisation process, the World Bank defined 'Eligible Projects' for the purpose of granting financing as '*all projects (…) that promote transition*

[69] As of April 2014, banks such as Bank of America Merrill Lynch, Citi, BNP Paribas, Crédit Agricole CIB, Credit Suisse AG, Lloyds Bank, Nomura, JP Morgan Chase and Société Générale announced their support to the GBP.

to low-carbon and climate resilient growth in the recipient country (…)'. Moreover, Eligible Projects might be those targeting mitigation of climate change, investments in low-carbon and clean technology, energy efficiency and renewable energy programs ('Mitigation Projects'); or those seeking adaptation to climate change and climate-resilient growth ('Adaptation Projects'). This dichotomy follows the terminology used in climate change treaties, whereby mitigation policies include those aimed at stabilizing or reducing the total amount of greenhouse gases, whereas adaptation policies are aimed at fostering community resilience and reducing community vulnerability under the inevitable detrimental effects of climate change.[70]

More recently, the International Capital Markets Association (the '**ICMA**') published in 2021 its revised Green Bonds Principles which, in terms of main components, follow a substantially similar approach to that of the first version of the document[71]/[72].

The GBP undoubtedly represent a milestone in terms of regulatory framework, and they had considerable impacts in multiple perspectives. From a legal perspective (particularly that related with contractual and transaction documentation), the GBP are expected to mould future prospectus so that documents are completely aligned with the principles. The changes are far beyond natural changes in the definitions – for instance, the 'use of proceeds' (a watermark of green bonds) shall need

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70 See, *inter alia*, Benoit Mayer, *The International Law on Climate Change* (Cambridge University Press, 2018), 108-9, & 163-5.

71 Notwithstanding the strong support given to design and implement the GBP, ICMA also provided for process guidelines in respect of Social Bonds — which target social issues and intend to achieve positive impact in societies and local communities.

72 See the mentioned revised GBP at: https://www.icmagroup.org/assets/documents/Sustainable-finance/2021-updates/Green-Bond-Principles-June-2021-140621.pdf (last accessed on 14 March 2022).

to be detailed in the documentation[73] - and some of them were already enshrined in the Prospectus Regulation.[74]

We have made reference to stock exchanges previously as being part of the professional community who started to develop market-practice standards. This is indeed true. For instance, in 2015, the London Stock Exchange delivered its green bond segment which was fundamentally aligned with the GBP and more recently launched a sustainable bond market segment to aggregate bonds issuers primarily aligned and operating towards a greener economy. The Luxembourg Stock Exchange followed a similar approach and also contributed to the green bonds market by designing the new Lux. Green Exchange, which purports to serve as a platform for green, social and ESG bonds.

Precisely due to these market-practice early developments, to the particular features of capital markets debt instruments (e.g., higher tradability and versatility on monetization) and the increased concern and interest on ESG and sustainable products, the green bonds market in Europe is quite considerable. It is now for the EU to pursue the EU GBS and complement its approach with the already existent market solutions.

3.3.3. Green Loans

Now, with regard to green loans, while the use of loan finance to fund green projects is not new,[75] the professional community understood

[73] The use of common wording ('(…) to finance general corporate purposes') would probably decline – ('thankfully', regulators would say).

[74] Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017.

[75] In Project Finance, for instance, the use of the Equator Principles (first published in 2003) was the first step taken by the professional community for determining, assessing and managing environmental and social risks. The most recent form of the Equator Principles was implemented in 2020.

the benefits of creating a voluntary framework under which it should act and carry its business. Thus, in March 2018, the Loan Markets Association delivered what is currently the main industry benchmark – the alluded GLP.[76]

The GLP emerged in a context where ESG concerns were rapidly spreading amongst the professional community and private investors and, without surprise, are strongly influenced by the GBP and pursue the same degree of transparency in project selection, allocation of capital, disclosure and reporting for the sake of consistency across financial markets. The GLP purport to clarify on what instances a loan may be categorised as 'green'.

First and foremost, these voluntary guidelines define 'green loan' as 'any type of loan instrument made available exclusively to finance or re-finance, in whole or in part, new and/or existing eligible Green Projects'.[77] This is arguably a very broad definition, but the guidelines provide further insights on what are the core components of green loans: (i) the Use of Proceeds (the 'fundamental' characteristic, which needs to be accurately described in the finance documents[78] and that entails the need of allocating loan proceeds to Green Projects); (ii) the Process for Project Evaluation and Selection (a checking procedure to analyse whether the investee's project fit the eligibility criteria); (iii) the

[76] See the (updated version) GLP at: https://www.lma.eu.com/application/files/9716/1304/3740/Green_Loan_Principles_Feb2021_V04.pdf (last accessed on 14 March 2022).

[77] The eligibility criteria are also delivered by the GLP through a non-exhaustive list of projects and activities that may be perceived as 'green'. See Appendix 1 of the GLP.

[78] Interestingly, the GLP also advise that in those circumstances where the loan facility is divided in tranches, the 'green tranche' must be clearly designated, and its proceeds channelled to a separate account – what we may call a 'green proceeds account'.

Management of Proceeds (a segregation of the green loan proceeds should exist in order to foster transparency); and (iv) Reporting (borrowers should maintain a breakdown register on the utilisation and allocation of green loan proceeds, and details of the projects should be given to the extent possible). Finally, the GLP recommend the use, to the extent possible, of third-party independent reviewers to assist the borrower on the formulation of their green loan process – either through consultation services, verification checks, certification process (potentially the next big trend in the markets) and rating.

Furthermore, in February 2021, aiming to provide further clarity on the application of the GLP, the Loan Market Association published its 'Guidance on Green Loan Principles'[79] where, amongst others, it delivers an interesting illustrative list of the benefits of entering into a green loan (both from a lender and a borrower's perspective), and an extremely interesting response to a frequently asked question within the market ('*Would a project be eligible for inclusion in a green loan if it were to improve energy efficiency on projects associated with fossil fuel production or industrial processes linked to fossil fuel production?*'). The response was affirmative with two interesting caveats: (i) such project has to comply with the 4 core components of the GLP; and (ii) provided that the borrower commits to an '*ambitious decarbonisation pathway reasonably considered to be aligned to the Paris Agreement.*'

This said, market-practice solutions often need a careful review in order to serve as basis for legal frameworks. For instance, in our view, the abovementioned second caveat adds little to the point and is counterproductive, and the EU should refrain (to the extent possible) from using similar approaches on future legislation and frameworks. It

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[79] See the recent Guidance on GLP at: https://www.lma.eu.com/application/files/2416/1303/5144/GLP_Guidance_Feb2021_V02.pdf (last accessed on 14 March 2022).

is ‘counterproductive’ because clear guidelines should not use broad, vague or ambiguous concepts and, ultimately, channelling liquidity to fossil fuel activities through green finance should be followed by strict and robust monitoring and screening mechanisms and that is not sufficiently ensured in this LMA document.

Finally, a new trend within the market of green loans must be highlighted, as it is growing exponentially and may constitute a decisive tool for the EU envisaged transition (provided that the EU is able to capture it and boost it with the necessary regulations and taxonomies): the sustainability-linked loans. Broadly speaking, while the term ‘green loans’ is usually used to cover loans that follow the GLP as well as sustainability-linked loans, these are two different products. But what is the difference between sustainability- linked loans and a ‘normal’ green loan? The fundamental determinant of a green loan is that the proceeds are used for Green Projects while the sustainability-linked loans do not depend on how the proceeds are used – their main feature is that pricing and key loan terms are aligned with the borrower’s performance against certain pre-determined sustainability performance targets. This difference may appear subtle, but it arguably provides for a more interesting contractual framework and incentives to the borrowers.[80]

Overall, the EU may well take the opportunity to strengthen its framework by grasping these existent market-practice common standards on green loans and therefore deliver a more robust legal framework capable of capturing the most relevant means of financing and consequently attracting more lenders and borrowers, who would undoubtedly benefit of having a detailed but wider regime for green finance.

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80 See 3.5. below.

3.4. Engaging stakeholders – Still an issue?

The green finance market is gaining impressive traction and the industry in general now understands that taking longer-term sustainability interests into account makes economic sense.[81] This was arguably the first burden in terms of engaging stakeholders (particularly lenders/financiers), and it is now being somehow circumvented.

Indeed, although the International Monetary Fund already warned against potential risks posed by an overspeed transition on the financial system,[82] not even the global pandemic of Covid-19 appears to slow down the movement towards the market of green finance[83]/[84] and that of ESG.[85] The truth is that climate change monetization is a trend in the current financial markets, and it is also undisputable that there is a growing interest in the market for green activities (arguably spurred by the same global pandemic), which is sometimes elegantly described as *ethical investment* – a new trend.

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[81] To be precise, it is posited that (at least) banks gained this knowledge immediately after a ground-breaking speech delivered Mark Carney at Lloyds (in 2015). See. https://www.clydeco.com/en/insights/2020/02/how-can-borrowers-tap-into-green-finance (last accessed on 14 March 2022).

[82] See https://www.imf.org/en/Publications/GFSR/Issues/2020/04/14/global-financial-stability-report-april-2020 (last accessed on 14 March 2022).

[83] See https://ec.europa.eu/commission/presscorner/detail/en/ip_21_5207 (last accessed on 14 March 2022).

[84] See https://www.clearygottlieb.com/news-and-insights/news-listing/alphabet-in-inaugural-5-75-billion-sustainability-bonds-issuance (last accessed on 11 January 2022).

[85] See https://m.marketscreener.com/BLACKROCK-INC-11862/news/BlackRock-Scottish-Widows-Invests-2-6Bln-in-BlackRock-s-Climate-Fund-31060498/ (last accessed on 14 March 2022).

To illustrate, a recent example of a large company factoring in sustainability concerns into its operations has been BP – who reported that it will slash its oil and gas production by 40% in order to increase its annual investment in low-carbon technology to $5 billion so as to become a leading purveyor of clean energy.[86] This simple shift put the company's share price soaring 7% on the 4th August 2020, evidencing the positive share price effects that climate-related investments can trigger.

To give another example of the mentioned market trend and of the increasing investor's attention in sustainability, we highlight another very recent case (now in the US): In contrast with BP, while acknowledging the need for carbon emission, Chevron and ExxonMobil did not compromise with final measurable targets and that created a reaction from institutional investors who launched an extraordinary proxy contest against ExxonMobil in late 2020, leading to the appointment of three new members to ExxonMobil board, specifically allocated to explore avenues for change.[87]

As Armour, Enriques and Wetzer correctly put it,[88] the question is whether these pledges from big companies constitute credible commitments and whether incentives are already in place to make them meaningful and consistent.

From a different angle, when assessing the growing conscience about climate change and sustainable finance, one may argue that the

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86 See https://www.ecowatch.com/bp-green-energy-investment-2646892538.html?rebelltitem=1#rebelltitem1 (last accessed on 14 March 2022).

87 See John Armour, Luca Enriques and Thom Wetzer, 'Chapter 3: Corporate Carbon Reduction Pledges: Beyond Greenwashing', page 10, in 'Business Law and the Transition to a Net Zero Economy', Beck, Hart Publishing and Nomos, December 2021.

88 See John Armour, Luca Enriques and Thom Wetzer, 'Chapter 3: Corporate Carbon Reduction Pledges: Beyond Greenwashing', pages 9 to 15, in 'Business Law and the Transition to a Net Zero Economy', Beck, Hart Publishing and Nomos, December 2021.

financial system in general is now recognizing that climate change poses two different types of risk: physical risks (those arising from damage to property, infrastructure and land); and transition risks (resulting from changes in climate policy, technology and consumer/market behaviours during the adjustment to low-carbon economy). Some even go further and say that overlooking climate risk contributes to misplacements of investment capital and that, in a macroeconomic scale, it may generate a systemic risk for the financial system.[89]

Climate-change exposure became a reality and now emerges as a relevant variable in the risk assessment of loan portfolios or corporate credit portfolios.[90] It might even turn oil companies reserves into 'un-burnable oil' and drastically impact their business; indeed, even regulators in the UK are applying climate change scenarios for stress tests to financial institutions and insurers.[91]

Nonetheless, and while it is a fact that companies and lenders are starting to acknowledge that there is an economic/financial interest in sustainability, it may be debatable whether the market – particularly from a lender/financier perspective – already has the proper incentives to engage these players in the green finance market and provide the necessary liquidity levels to the businesses. Indeed, our view is that the current EU framework provides little incentives to the private lending sector to engage in this transition (and we are now conscious of the relevance of

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89 See Madison Condon, 'Market Myopia's Climate Bubble' (2021) Utah Law Rev, Forthcoming https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3782675 (last accessed on 14 March 2022).

90 See https://www.marketwatch.com/story/pge-bankruptcy-the-first-major--corporate-casualty-of-climate-change-2019-01-18 (last accessed on 14 March 2022).

91 See https://www.reuters.com/business/sustainable-business/bank-england--launches-climate-stress-test-banks-insurers-2021-06-08/ (last accessed on 14 March 2022).

these stakeholders).[92] In order to capture the attention of these key players, the EU should not simply rely on the current climate change monetization trend nor solely on taxonomies (which are instrumental but do not exhaust all needs). We have given examples such as the lightening of minimum capital requirements or other regulatory aspects that might be good options for attracting these players but more tangible measures such as tax benefits[93] or subsidies for screening, evaluating and labelling businesses and investors' portfolios (through independent third-party assessments) and even robust penalties[94] will inevitably and perhaps decisively foster a much-needed engagement.

As a final answer, engaging stakeholders (particularly lenders/ financiers) is not as problematic as it was. However, the engagement levels are still too modest and far from what is needed. In fact, only the market itself is prompting the entrance of the players in the green finance area (the newly adopted Taxonomy Regulation will surely play its part though). This is a matter that the EU should revisit in the future and align it with the recent developments on taxonomy and green bonds(loans) strategies.

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92 Even the 'old' EC Action Plan emphasized this: '*Banks, insurance companies and pension funds are the main source of external finance for the European economy and an important channel of savings for investments. As a result, they could provide the critical mass of investments needed to close the gap for the transition to a more sustainable economy*.'

93 The US examples of *Clean Renewable Energy Bonds* (CREBs) and *Qualified Energy Conservation Bonds* (QECBs) programmes are two good examples of tax incentives that may be adopted within the EU. See https://www.energy.gov/savings/clean-renewable-energy-bonds-crebs and https://www.energy.gov/eere/slsc/qualified-energy--conservation-bonds (last accessed on 11 January 2022).

94 For two examples (one being in the US, but whose rationale also applies) where lack of penalties disincentivize market players see: https://www.theguardian.com/business/2021/nov/02/bank-of-england-under-fire-over-climate-stress-tests and https://www.bloomberg.com/news/articles/2021-09-08/esg-financing-comes-with--few-penalties-for-missing-goals (both links last accessed on 11 January 2022).

The next section delves deeper into the matter of sustainability-linked lending, which arguably provides for illustrative examples of tangible incentives being designed and agreed between parties when entering into financing transactions. It would certainly be of interest if the EU would be able to capture the benefits of this market trend and boost it with other significant measures.

3.5. Sustainability-Linked Lending: A Contractual Approach

We have pointed out in the previous section some of the current trends in (sustainable) finance markets. Sustainability-Linked Lending is arguably the newest one.

To recall, while the fundamental determinant of a green loan is that the proceeds are used for Green Projects, sustainability-linked loans (sometimes called sustainability improvement loans) do not depend on the well-known 'Use of Proceeds' component. Their main feature is that loan pricing and the key terms of facility agreements shall be aligned with the borrower's performance compared against certain pre-determined sustainability performance targets (the '**SPTs**').

We have referred before that it would be of interest if the EU (particularly for the purposes of the EU Green Deal) would be able to capture the benefits of this new innovation from the professional community (as well as its approach to the green bonds and green loans voluntary frameworks) – and that is indeed our view.[95]

Firstly, it would provide a newly different route for businesses to seek finance (in some cases, for instance, some companies might be

[95] Interestingly, the TEG Proposal on the EU GBS does mention sustainability linked loans. However, and curiously, while it refers that the EU GBS should constitute a 'useful reference' for the green loan market, it would probably be better to develop and incentivise this approach across the lending sector (including in relation to monies lent by the EU institutions and investment vehicles).

prevented from accessing certain types of financing due to their ratings, etc.), one that is linked with their sustainability performance, thus also contributing for the engagement of market players (e.g., private lending sector) in this area and boosting the Green Deal objectives.

Secondly, this approach may also provide new incentives to parties since, for instance, businesses would be able to agree on better terms for their facility agreements (e.g., margin, interest rates, fees) and lenders would be able to better monitor borrowers' performance and somehow decrease their exposure risk (as borrowers' will always be tempted to punctually comply with their obligations and meet the SPTs so as to benefit from what sustainability linked loans have to offer).

Thirdly, if the EU would be able to connect this approach with the Taxonomy Regulation and ultimately categorize these loans as 'green'/'sustainable' for the purposes of the entire regime, the lending sector would significantly improve their 'green' portfolios.

Prior to diving deep into a more contractual approach regarding the impacts of sustainability-linked lending on facility agreements, let us analyse the voluntary framework provided by the professional community on this matter – the Sustainability Linked Loan Principles (the "**SLLP**").[96]

The SLLP were delivered in March 2019 by the Loan Market Association, Asia-Pacific Loan Market Association and the Loan Syndications and Trading Association and are to be applied on a deal-by-deal basis depending on the underlying characteristics of the transaction. This framework defines sustainability-linked loans as '*any types of loan instruments and/or contingent facilities (such as bonding lines, guarantee lines or letters of credit) which incentivise the borrower's achievement of ambitious, predetermined sustainability performance objectives*', and clarifies that, in

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[96] See https://www.lma.eu.com/application/files/8416/2210/4806/Sustainability_Linked_Loan_Principles.pdf) (last accessed on 14 March 2022)

some cases, a loan may be structured to allow for its categorisation as both a green loan, aligned with the GLP, and a sustainability-linked loan. Furthermore, it provides for five (5) core components of this type of loans: (i) 'Relationship to borrower's overall Corporate Social Responsibility Strategy' (whereby the borrower of a sustainability-linked loan should communicate to its lenders its sustainability objectives and how they align with its proposed SPTs); (ii) 'Target Setting', measuring the sustainability of the borrower (the SPTs should be negotiated with particular care and they should be ambitious and meaningful to the borrower's business and tied to common market-practice sustainability benchmarks); (iii) 'Loan Characteristics' (the parties to the loan having to set forth the economic outcome achieved by meeting the SPTs – e.g., margin ratchet where pricing changes in accordance with borrower's performance); (iv) 'Reporting' (borrowers should provide, on a regular basis, the relevant information around their SPTs such as ESG ratings); and (v) 'Review' (external review by third-party auditors is to be agreed between the parties to the agreement but it is encouraged for those cases where information around borrowers' SPTs is not made available to the public).[97]

One can therefore easily observe that the hallmark of sustainability-linked loans is that the terms of the loan incentivise the borrower to improve its performance against certain pre-determined sustainability criteria – the pricing of the loan is directly linked to such performance. Furthermore, while these loans do not have the restriction of the 'use of proceeds' component, external review of the performance of SPTs is to be agreed between borrowers and lenders (although the Sustainability

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[97] The LMA recently delivered the Guidance on Sustainability Linked Loan Principles, a helpful tool to help professionals navigating the SLLP. See https://www.lsta.org/content/guidance-on-sustainability-linked-loan-principles-sllp/ (last accessed on 14 March 2022).

Linked Loan Principles encourage external review for those cases where information on such matters is not publicly disclosed, and in any case at least annually).

From a contractual perspective, and while an 'SPTs clause' shall be the watermark of sustainability regulation in the contract (clearly defining the key performance indicators), one of the clauses (of a common LMA-based facility agreement[98]) that is most impacted by sustainability-linked lending is the 'Interest' clause (particularly regarding 'margin') which shall now include new figures (some discounts might amount to 0.10% or 0.20%) that shall vary depending on the performance and compliance with the SPTs. One interesting note shall be added: this dynamic approach and the linkage against SPTs might imply not only discounts on margin but also margin premiums (this time a penalty for non-compliance) in order to better incentivise borrower's performance – that is the so-called 'two-way pricing ratchet',[99] which, as explained previously, is arguably the way to go for both parties.[100]

The 'two-way pricing ratchet' is arguably the most significant mechanism brought by sustainability-linked lending. It captures all parties' incentives correctly and avoids resorting solely to penalties for

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[98] We are using general reference to a more common facility agreement draft of the Loan Market Association, since there is currently no market standard drafting for the sustainability linked loan.

[99] See Linklaters report on Sustainable Finance '*The rise of green loans and sustainability linked lending*,' available at: https://lpscdn.linklaters.com/-/media/files/thoughtleadership/green-finance/linklaters_the-rise-of-green-loans-and-sustainability--linked-lending-where-are-we-now_may-2020.ashx?rev=0ab8a16b-eb65-4dc9-8252-f704a29f0bc2&extension=pdf&hash=5F5F53A60A140E74EC6A7550704EC927 (last accessed on 14 March 2022).

[100] See the LMA 'Best Practice Guide to Sustainability Linked Leverage Loans' for similar insights regarding leverage financing – available at: https://www.lma.eu.com/application/files/5416/2745/5555/LMA_ELFA_Best_Practice_Guide_to_Sustainability_Linked_Leveraged_Loans.pdf (last accessed on 14 March 2022).

non-compliance with the SPTs (which is currently the most common solution for sanctioning non-compliance in facility agreements).[101]

Other typical (LMA-based facility agreement) contract clauses that may be impacted by sustainability-linked lending and therefore would arguably need increased efforts in terms of negotiating and drafting are the following: (i) Information Undertakings (as lenders would require robust, updated and expedite disclosure); (ii) Representations and Warranties (representations on the accuracy and completeness of reporting are necessary with their repetition arguably needed more than ever); and (iii) Breach/Events of Default (while failure to meet SPTs may not constitute an 'event of default', inaccuracy on reporting or failure to comply with particular information undertakings may well constitute one). The facility agreement will also need to densify and detail in crystal clear terms the method and scope of the potential third party suppliers who shall verify borrower's compliance with sustainability targets.

The abovementioned clauses should be the more obvious ones that will surely be impacted, but others might also suffer some interesting tweaks in specific deals. To give an example, if we think of the noteworthy view of those who see climate change posing both physical risks and transition risks, and recall that the physical risks are those arising from damage to property, infrastructure and land, we may consider that deals such as real estate finance which most times work on a portfolio of physical assets and use financial covenants on facility agreements such as LTV (loan to value), we query whether (like the dynamic linkage to margins) we can also link SPTs to that financial covenant and ultimately

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101 With a similar opinion, See John Armour, Luca Enriques and Thom Wetzer, 'Chapter 3: Corporate Carbon Reduction Pledges: Beyond Greenwashing', page 13, in 'Business Law and the Transition to a Net Zero Economy', Beck, Hart Publishing and Nomos, December 2021.

grasping a lightening of such covenants from a borrower's perspective in case of good performance.

In some recent transactions, finance documents include specific provisions targeting the 'discount amount' or the 'premium amount' gained or incurred (as applicable) by the borrower as a result of its performance and allocating such amount to specific purposes (e.g., donations to charity, reinvest in sustainability targets).[102]

Another interesting outcome of the widespread use of sustainability-linked loans is the appearance of a new role/agent in financing transactions – the Sustainability Agent which shall be the party (usually one of the lenders) responsible to negotiate with the borrower (on behalf of the co-lenders) any future modification of the SPTs.

In fact, it would be extremely helpful for the parties to specifically agree on the conditions under which it would be possible to revise/update/modify the SPTs. Indeed, it follows that the lack of worldwide regulatory frameworks around the matter (although the EU Taxonomy Regulation may help here) might open the door for unexpected changes in ESG rating methodologies or similar third-party assessments, which therefore would impact what has been agreed contractually (ultimately, thresholds of the agreed SPTs may not be met or otherwise cease to be meaningful). Even a 'white-list of third-party evaluators or rating providers' is recommended to be included in the finance documents to circumvent any unexpected issue.

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102 See Linklaters report on Sustainable Finance '*The rise of green loans and sustainability linked lending*,' available at: https://lpscdn.linklaters.com/-/media/files/thoughtleadership/green-finance/linklaters_the-rise-of-green-loans-and-sustainability--linked-lending-where-are-we-now_may-2020.ashx?rev=0ab8a16b-eb65-4dc9-8252-f704a29f0bc2&extension=pdf&hash=5F5F53A60A140E74EC6A7550704EC927 (last accessed on 14 March 2022).

4. Conclusion

The EU Green Deal may well be considered one of the most ambitious and hard to implement plans ever designed by the EU. However, it is arguably one of the most important and undoubtedly shows that the EU is in the forefront of the battle against climate change and environment degradation and depletion.

While the goals of the EU Green Deal are arguably quite clearly depicted and an overarching strategy is being designed and put in place, *green finance* is the most important workstream of the master plan and absolutely key for its success. When designing (and executing) a *green finance* strategy, the EU should integrate all market players and strive to offer them the right incentives – since only then (with all stakeholders side-by-side in this quest – or, more realistically, with all of them redirected and incentivised for new opportunities) the masterplan would have gained sufficient strength to go forward with no looking back and with high chances of success.

In parallel, the EU should further analyse what is being done by the market in general, build up on those practices and most likely delve deeper in some areas which are already 'voluntarily regulated' by the professional community and that would benefit from a strong, coherent, forward-looking and integrated approach – the examples of the voluntary guidelines on green bonds and green loans might be extremely relevant as well as the emergence of the new approach on sustainability-linked lending (which the EU institutions and investment vehicles should consider and strengthen).

All in all, the *green finance* market is there and clearly on the rise. This might be an interesting opportunity for speeding up EU's efforts on building a sustainable finance framework and system so that it is able

to harness the market's momentum and ultimately propel the EU Green Deal and the transition in the economy.

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