Matheson

ESG Bonds and Ireland's Offering

1 Overview

This article explores ESG in the context of the bond market and in particular focuses on the legislative and non-legislative frameworks around ESG Bonds (as defined below). We also consider what is creating such market appetite for ESG investment products, the importance of ESG Bonds in this market and the impact of European Union ("**EU**") sponsored COVID-19 related recovery funds on the demand for ESG Bonds. Lastly, we will summarise how Ireland has a key role to play as a leading EU member state for issuing and listing ESG Bonds on Euronext Dublin.

2 What are ESG Bonds?

ESG is a framework for ensuring that business practices have regard for: (i) the environment ("**E**") in which they operate, including energy resources used, output of waste and general impact on climate, (ii) social issues ("**S**"), such as employee health and safety, human rights, data privacy of customers and employment practices, and (iii) governance ("**G**") of the business in an environmentally and socially sustainable manner, including with respect to the supply chain of the organisation, corporate governance and risk management, and compliance.

"**ESG Bonds**" include investment products such as: Green Bonds, Social Bonds, Sustainability Bonds, and Sustainability-Linked Bonds (each as defined below).

The ESG Bond market is growing fast, with over USD 500 billion of ESG Bonds issued globally in 2020 and it is expected to grow by over 20% in 2021. Europe is central to the ESG Bond market and in 2020 it commanded a 61% share of ESG Bond issuance globally. In 2020, almost USD 300 billion of Green Bonds were issued globally (with European issuers accounting for 54% of issuances) and in Europe the market for Social Bonds in particular increased exponentially, growing by 985% compared to 2019.

Matheson are committed to the development and expansion of the ESG Bond market and recently advised the joint lead managers on the issuance of EUR 1 billion in Green Bonds by AIB Group plc on 30 September 2020. This was the first ever Green Bond issuance by an Irish bank, the proceeds of which will be used by AIB to support lending towards renewable energy generation and storage projects, green commercial buildings and green residential buildings (see our previous update here).

3 Regulating ESG

A trio of new EU rules are set to shake up how ESG financial products are regulated, namely: (1) Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment (the "**Taxonomy Regulatio**n"), (2) Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector ("**SFDR**"), and (3) Regulation (EU) 2019/2089 as regards EU climate transition benchmarks, EU Paris-aligned benchmarks and sustainability-related disclosures for benchmarks (the "**Low Carbon Benchmark Regulation**").

The new Taxonomy Regulation entered into force in July 2020 and its most significant provisions will apply from 1 January 2022 (for climate change mitigation or adaptation objectives) and 1 January 2023 (for other environmental objectives). The Taxonomy Regulation seeks to correct the lack of a benchmark for determining how "green" a financial product is and put a halt to so-called greenwashing (where investors are led astray by false, misleading or confusing claims made by financial market participants in relation to their offerings). The Taxonomy Regulation has been subject to lobbying by certain industries and EU member state governments amid concerns that it may be overly prescriptive in its nature, unnecessarily strict and excludes certain green enterprises.

The Taxonomy Regulation works in parallel with the SFDR, most of the provisions of which apply from 10 March 2021, and which will require financial market participants to disclose the degree of environmental sustainability of funds, pension products and certain other financial products that they manage (or to include disclaimers where they do not), as well as requiring most financial market participants to give environmental disclosures in their regulatory filings.

The Low Carbon Benchmark Regulation provides for greater sustainability disclosure for existing benchmarks and introduces two new EU Benchmarks: (i) the EU Climate Transition Benchmark and (ii) the EU Paris-aligned Benchmark.

Framework for ESG Bonds

For ESG Bonds specifically, whilst there is currently no specific regulatory regime to govern the issuance of such bonds there is: (i) the EU Green Bond Standard proposed by the European Commission ("**EC**") and (ii) a number of market frameworks established by the International Capital Market Association ("**ICMA**") known as the "Green Bond Principles", the "Social Bond Principles", the "Sustainability Bond Guidelines" and the "Sustainability-Linked Bond Principles", each of which we address below.

EU Green Bond Standard

To implement the EC's Sustainable Finance Action Plan, it has mandated a Technical Expert Group (the "**TEG**") to prepare a report on proposals for a Green Bond standard (the "**GBS**").

The TEG delivered its report in June 2019 and within it recommended that a Green Bond could be defined as "*any type of listed or unlisted bond or capital market debt instrument issued by any European or international issuer that is aligned with the EU Green Bond Standard*".

The TEG in its report (and in its March 2020 Usability Guide) proposed that the GBS would comprise of four critical elements:

1. Alignment with the Taxonomy Regulation, including, amongst other things, that the proceeds of the Green Bonds in question should go towards financing a project / activity which contributes substantially to at least one of the six environmental objectives determined under the Taxonomy Regulation;
2. Publication of a Green Bond framework by the issuer in question which confirms the voluntary alignment of Green Bonds issued with the GBS, explaining how the issuer's strategy aligns with the stated environmental objectives and providing details on all key aspects of the proposed use of proceeds, processes and reporting of the Green Bonds;
3. Mandatory reporting on use of proceeds and environmental impact; and
4. Mandatory reporting as to compliance with the Green Bond framework together with a report from an external reviewer.

The EC is currently in advanced stages of market consultation regarding the introduction of the GBS and the legislative, or non-legislative, footing upon which it will be based. The TEG proposed in its report that the EC should create a voluntary, non-legislative GBS to enhance the effectiveness, transparency, comparability and credibility of the Green Bond market and to encourage market participants to issue and invest in Green Bonds issued in the EU.

Green Bond Principles and Social Bond Principles

The Green Bond Principles (June 2018 edition) and the Social Bond Principles (June 2020 edition) were produced by ICMA and are intended to serve as a set of voluntary guidelines that recommend transparency, disclosure and reporting be used by market participants and are designed to encourage the provision of information needed to finance Social Projects and Green Projects (each as defined below), respectively.

According to the Green Bond Principles, Green Bonds are defined as "*any type of bond instrument where the proceeds will be exclusively applied to finance or re-finance, in part or in full, new and / or existing eligible Green Projects and which are aligned with the four core components of the Green Bond Principles*".

"**Green Projects**" include, but are not limited to, renewable energy, energy efficiency, pollution prevention, sustainable agriculture and land use, clean transportation, green buildings and sustainable water and waste management.

ICMA's Social Bond Principles define Social Bonds as "*any type of bond instrument where the proceeds will be exclusively applied to finance or re-finance in part or in full new and / or existing eligible Social Projects and which are aligned with the four core components of the Social Bond Principles*".

"**Social Projects**" include, but are not limited to: affordable basic infrastructure, access to essential services (such as education and healthcare), affordable housing, employment generation and sustainable food systems.

The four core components of both the Green Bond Principles and the Social Bond Principles are the same and include: (i) Use of Proceeds (i.e. towards financing Green Projects or Social Projects (as applicable)), (ii) Process for Project Evaluation and Selection, (iii) Management of Proceeds and (iv) Reporting.

Sustainability Bond Guidelines

The term Sustainability Bonds refers to bonds in respect of which the proceeds of issuance will be exclusively applied to finance or re-finance a combination of both Green and Social Projects. Sustainability Bonds are aligned with the four core components of both the Green Bond Principles and the Social Bond Principles (as outlined above). ICMA recognises that certain Social Projects may also have environmental benefits, and similarly certain Green Projects may also have social benefits. ICMA published the Sustainability Bond Guidelines in June 2018 to facilitate the application of the Green Bond Principles and the Social Bond Principles to promote transparency and disclosure in the Sustainability Bond market.

Sustainability-Linked Bond Principles

ICMA published the Sustainability-Linked Bond Principles in June 2020 as a voluntary framework to promote consistency in offerings of Sustainability-Linked Bonds. ICMA defines Sustainability-Linked Bonds as "any type of bond instrument for which the financial and / or structural characteristics can vary depending on whether the issuer achieves pre-defined Sustainability / ESG objectives". Such objectives are: (i) measured through pre-defined key performance indicators and (ii) assessed against a pre-defined set of sustainability performance targets.

The core difference between Sustainability Bonds and Sustainability-Linked Bonds is that the proceeds from Sustainability Bonds must be used to finance or re-finance a project which would be capable of being categorised as either a Green Project or a Social Project in accordance with the Green Bond Principles or Social Bond Principles, respectively, whereas proceeds of Sustainability-Linked Bonds may be used for a variety of purposes and therefore, unlike Sustainability Bonds, it is not necessary to include a "use of proceeds" in its objectives.

4 What is creating demand for ESG Bonds?

International treaties and regulations: Impetus for financial services markets to help combat climate change has come from a series of recent global and EU initiatives derived principally from the United Nations Sustainable Development Goals ("**SDGs**") and the 2015 Paris Agreement (the "**Paris Agreement**") which indicated that the ability to meet the targets set out in those initiatives was dependent on "*making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development*". In March 2018, the EC launched an action plan on sustainable finance in order to meet objectives under the Paris Agreement (the "**Sustainable Finance Action Plan**"). The Organisation for Economic Co-operation and Development ("**OECD**") estimates that, globally, USD 6.9 trillion a year will be required to be invested in infrastructure in order to meet the Paris Agreement goals by 2030. Public sector resources will not be adequate to meet this challenge, and mobilisation of institutional and private capital, or a mix of public private partnerships, will therefore be necessary. Various forms of debt capital markets financing (such as ESG Bonds) will be required to finance such investment.

Changing Investor attitudes: Investor preferences are changing in line with increased public awareness of the climate crisis. Morgan Stanley's 2020 Sustainable Signals survey found that around 95% of institutional asset owners are integrating or considering integrating sustainable and impact investing in all or part of their portfolios. Indeed, many customers of corporates and financial institutions are demanding that they establish and pursue binding sustainability targets.

COVID-19: Market indications are that sustainability will feature heavily in the recovery from the COVID-19 pandemic. The EC has attached "green strings" to the agreed "Next Generation EU" EUR 750 billion post-pandemic recovery plan. In Section 4 below, we explore the role that the EU will play with respect to: (i) post COVID-19 recovery funding and (ii) bond purchasing programmes (which will help fuel the market for ESG Bonds).

US election: Joe Biden's presidency is expected to drive the ESG sector forward in the US. Under the Biden administration the US has already re-joined the Paris Agreement and President Biden has promised that the US will aim for carbon neutrality by 2050.

"**Greenium**": Recent market commentary indicates that the demand for Green Bonds is outstripping supply such that the shortage in supply is creating a "greenium" whereby investors are being forced to pay a premium for Green Bonds, resulting in lower borrowing costs for issuers.

5 ECB Support for the issuance of ESG Bonds

Post COVID-19 Recovery

In July 2020, EU leaders resolved to permit the EC to borrow EUR 750 billion on international financial markets in order to fund a "Next Generation EU" project that will finance grants and loans to assist member states in the post pandemic recovery (see our previous update here). The EC will also borrow an additional EUR150 billion to finance government unemployment insurance schemes.

In September 2020, the EC president Ursula von der Leyen announced that the EC would issue EUR 225 billion of its EUR 750 billion recovery debt in the form of ESG Bonds. This will lead to the EU becoming the world's biggest issuer of Green Bonds.

Bond Purchasing Programmes

In March 2020, the European Central Bank ("**ECB**") announced that it was launching a EUR 750 billion pandemic emergency purchase programme ("**PEPP**") to purchase both private and public sector securities. The ECB Governing Council has since decided to increase the funding to a total of EUR 1,850 billion and extended the scheme until at least the end of March 2022.The PEPP aims to ensure the provision of liquidity across EU member states and to counter the threats to monetary policy posed by the COVID-19 pandemic.

In September 2020, the ECB announced that sustainability-linked bonds will become eligible as collateral in Eurosystem credit operations from 1 January 2021. Sustainability-linked bonds will also be eligible for purchase under key asset purchase programmes of the ECB and the PEPP (which expanded the ECB's corporate sector purchase programme ("**CSPP**")), provided that the applicable CSPP/PEPP eligibility criteria are complied with. In each case, the coupons must be linked to a performance target referring to one or more of the environmental objectives set out in the Taxonomy Regulation and /or to one or more of the SDGs relating to climate change or environmental degradation.

6 Ireland as an EU member state debt issuance jurisdiction for ESG Bonds

In addition to the issuance of ESG Bonds by Irish corporates, Ireland is the jurisdiction of choice for the establishment of special purpose vehicles for a variety of debt issuance transactions, including, but not limited to: ABS transactions (CMBS, RMBS and Auto-Loan securitisations, amongst others), CLOs, MTN programmes, repackaging transactions, loan origination structures and non-performing loan transactions. As ESG considerations and impact investing continue to permeate most of the traditional forms of securitisation transactions into the future, we expect to see Irish special purpose vehicles at the heart of such structures.

Ireland is a member state of the EU and also a member of the OECD. In the evolving investment environment many originators and arrangers prefer to use onshore entities in their transaction structures. In fact, many investors in debt issuance transactions will only invest in debt securities issued by special purpose vehicles located in EU or OECD member countries.

From a tax perspective, Irish tax legislation provides for specific treatment in relation to qualifying special purpose vehicles where such vehicles are intended to be tax neutral entities. In addition, Ireland has a large double taxation treaty network and has a domestic infrastructure capable of implementing the most complex capital markets transactions (such as an experienced listing authority, experienced corporate service providers, lawyers, auditors, etc.) in a cost effective manner.

All of these factors combined make Ireland the leading EU member state jurisdiction in which to locate debt issuance special purpose vehicles.

7 Ireland as a Listing Venue

The Irish Stock Exchange plc, trading as Euronext Dublin is part of the Euronext Group comprised of six market locations across Amsterdam, Brussels, Dublin, Lisbon, Oslo and Paris. In June 2020, Euronext announced that it would be launching a series of ESG products and services to help support sustainable growth in European capital markets as part of a new three-year strategic plan entitled "Let's Grow Together 2022".

One such product is the "Euronext ESG Bonds" offering. Broadly, Euronext ESG Bonds is designed to encourage and promote more sustainable investment in Europe by offering issuers a range of opportunities to list bonds issued to finance their environmental and sustainability projects.

The benefits of Euronext ESG Bonds include: (i) creating a virtual community of ESG issuers on a single platform, enabling such issuers to showcase their ESG products; (ii) granting investors access to easily identifiable ESG investment opportunities and (iii) providing such investors with the ability to source ESG documentation directly from issuers in connection with an investor's ESG investment diligence process.

The Euronext Group is home to 420 ESG Bonds from 150 issuers across the globe, including sovereigns, development banks, municipals, government-backed entities, financial institutions and other corporates. There are currently 217 ESG Bonds across over 70 issuers listed on Euronext Dublin with a value of €71.2 billion[1].

Matheson offers a full range of Euronext Dublin listing services for debt and asset-backed securities and is authorised by Euronext Dublin: as (i) a sponsoring broker and (ii) a recognised prospectus advisor for the Central Bank of Ireland for issuers of debt and asset-backed securities.

8 Matheson's view on the ESG Bond Market

For as long as investor appetite and the political landscape continues to favour ESG investment and the frameworks outlined above continue to develop in a cohesive and uniform way in the EU, it seems that there will continue to be an increased focus on ESG in the debt capital markets, as there would otherwise be a lack of capital to meet the forecasted demand. It is clear that the market for ESG Bonds will continue to grow and develop in Europe for the following principal reasons: (i) as part of the post-COVID-19 recovery as collateral under the CSPP / PEPP programmes, (ii) in order to meet the targets for infrastructure investment under the Paris Agreement and (iii) to support the growing focus on investment in social projects.

As outlined above, Ireland is likely to be central to the development of such debt capital markets financing arrangements due to its established position as the leading EU member state debt issuance jurisdiction and the bespoke listing offering for an ESG Bond provided by Euronext Dublin.

[1] Source: Euronext Dublin

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