They don’t need to be green

The EU needs a liquid market in bonds to fund the recovery programme. Alexander Lehmann argues green bonds would complicate matters

The plan to fund the European Union's recovery programme via debt issuance has raised hopes that a new type of euro-denominated safe asset could emerge. As a priority, the European Commission needs a strategy to create a liquid and transparent market in EU bonds. For now, funding through EU green bonds would complicate that effort.

To fund its future programmes, SURE (employment support, €100 billion) and Next Generation EU (economic recovery, €750 billion), the European Union will expand considerably its role as an issuer in the sovereign debt markets. Political agreement on these programmes earlier this year has raised hopes that at long last a common euro-denominated safe asset – backed by a joint and several guarantee – will emerge.

The EU itself is as yet a minnow in international debt markets. Only €52 billion is outstanding from 18 issues. All were tied to specific programmes and passed on to member states in back-to-back transactions. EU issuance has so far been dwarfed by national issuers with high (AAA) credit ratings and by issuance by the European Stability Mechanism and European Investment Bank.

The EU needs a more modern debt issuance strategy

In issuing such substantial volumes the EU will need to compete for investors alongside other AAA-rated sovereign and supranational issuers. The vision for the EU should be to adopt the practices that it has itself promoted for national capital markets.

Typically, national governments publish a debt management strategy and state their plans for future bond issuance. In each market a small set of dealers is designated to quote a price for trades at all times, and to act as market makers. This in turn means sovereign financing costs can be kept low, and private debt is priced on the basis of a sovereign benchmark.

The European Commission's September 2020 presentation to investors underlines that the EU is not yet close to adopting such practices. With greater transparency and predictability, EU bond issues could become the foundation for more integrated and liquid internal capital markets, and the euro could ultimately become a more significant reserve currency in the international financial system.

The new EU bonds would boost integration between national financial systems, but also reduce the risk of runs on national bond markets and of the destructive interaction between banking and sovereign balance sheets.

In issuing such substantial volumes of debt, the EU will need to compete for investors alongside other AAA-rated sovereign and supranational issuers

The early appeal of sovereign green bonds

A substantial part of the funding of Next Generation EU will need to be devoted to Europe's Green Deal. To make this commitment more credible, the European Commission has now said that 30% of the funding will be raised through green bonds.

Sovereign green bonds are a very recent innovation in capital markets but have been taken up eagerly by investors, though relative to the overall market this segment remains very small. Green bonds are essentially standard bonds that offer enhanced transparency about the use of proceeds for environmental projects and expenditures.

They are invariably backed by the same balance sheet of the issuer that backs standard bonds and have therefore the same credit risk. Poland and France were the first European governments to issue such bonds in 2016-17, since when seven others have joined (Table 1).

Verification standards, the definition of eligible projects and expenditures, and the governance of fund allocation vary widely between the nine issuers.

The EU as an issuer of green bonds?

EU green bond issuance would tap into the strong demand seen so far. But the amount of EU green bonds that has been announced (€225 billion between 2021 and 2026) would be close to the total global issuance in 2019 of such instruments by the private and public sectors.

Three key issues would need to be resolved for international debt markets to absorb such substantial amounts.

Table 1. European country sovereign green bonds

	Cumulative amount (€)	Number of issue	Max maturity (years)
Poland, 2016	3.7 billion	3	30
France, 2017	27 billion	1	22
Hungary, 2020	1.5 billion	1	15
Ireland, 2018	5 billion	2	12
Netherlands, 2019	11.6 billion	1	20
Belgium, 2018	5.7 billion	1	15
Lithuania, 2018	20 million	1	10
Sweden, 2020	8.3 billion	2	10
Germany, 2020	6 billion	1	10

Source: Bruegel.

- The first question is whether there will be a sufficient supply of projects within member states in line with the announced funding targets, and that fit the new EU taxonomy that defines green activities. EU countries have already funded operational as well as capital expenditures from their green bonds. Investors would be wary of past expenditures being refinanced.

- Secondly, a more complex governance system for funds raised would need to be set up. Green bond investors – who seek strict environmental, social and governance (ESG) standards – will expect transparency on the allocation of proceeds, and ideally on the impact of the funds raised.

  Some member states have addressed this by issuing only to the extent and in line with green projects being generated. On occasion, separate accounts have been set up where funds were parked, though it is of course difficult to ring-fence parts of a national budget.

  In France, an independent green evaluation council monitors the use of funds raised. The EU as the issuer of record in all legal documentation would need to offer similar transparency and scrutiny.

  This may well result in tensions between the Commission and member states over allocations, further undermining the quality of the new assets.

- Finally, the requirements of investors seeking a safe asset in a liquid European bond market will need to be reconciled with the expectations of investors seeking ESG attributes in their assets. Standard and green bonds of the same maturity and backed by the same common guarantee would be offered to the market.

This could undermine liquidity and result in pricing differentials, in particular if different EU green bonds are associated with projects or monitoring practices in individual member states.

Priorities for a credible green bond standard

The new EU Green Bond Standard is now doubly needed, though so far no political agreement has been found for the proposal that was published in 2019. The Commission's updated sustainable finance strategy, which is due before the end of 2020, offers a chance to relaunch this initiative.

As sovereign issuers will play a much more prominent role in the green bonds market, new priorities need to be set. This should be done in a way that enables national green bond frameworks to ultimately converge on a strong common EU standard.

A new class of EU green bonds must be limited to a well-defined set of projects, and it is clear the new bond standard will need to refer to the new EU taxonomy. Alongside climate mitigation and adaptation objectives, which have been clarified, four more objectives, including biodiversity, need to be fleshed out within the taxonomy. Trade-offs between the six areas will need to be resolved.

'Greenwashing' by individual issuers would be a key risk, which could undermine the entire asset class. The technical working group on the green bond standard proposed that verification and reporting should be done only by accredited providers and in a standardised process.

The European Securities and Markets Authority, as the EU supervisor of securities markets, would have a key role in the accreditation process, and such powers require legislation.

As for other assets, EU capital markets can become more vibrant and integrated if there is a uniform quality and transparency in each asset class. The new green bond standard should be defined to ultimately allow a single bond type to emerge, comprising both EU and national instruments. ■

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