Green Contingent Convertible Bonds – How “Green” are they?

Research Group for Natural Resource Law, Environmental Law, and Development Law

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About me

- Eyolf Aarø
- Fifth year law student at UiB
- LL.M. from UC Hastings College of the Law, San Francisco
- Master thesis within green banking and finance:
  - “Don’t Let the Green Grass Fool You – Green Contingent Convertible Bonds and their Role in the Pursuit of a Sustainable Economy”
- August 2022: Associate at Thommessen’s Banking and Fiannce Team

Agenda

1. Green/Sustainable Finance
2. Primer on Capital Adequacy Regulation and AT1 Capital
3. The Paper: “Don’t Let the Green Grass Fool You”
4. Inadequate Regulation of Green Financial Instruments
5. Green CoCos’ (In)compatibility with AT1 Eligibility Criteria
6. EBA’s Take on Green AT1 Instruments
7. Proposal: Green Ring-Fencing
8. Q&A / Discussion

Green Finance: An Overview

- Definition
  - The EU Taxonomy Regulation
- Importance: Paris Agreement and Glasgow Pact
- The (huge) “green financial gap”
- Green financial instruments
  - The (proposed) EU Green Bond Standard

Capital Adequcacy Regulation

- **Capital adequacy** is the statutory minimum reserves of capital which a bank or other financial institution must have available
  - Capital Adequacy Ratio = Capital (Tier 1 + Tier 2) / risk weighted assets
- Background: The 2008 financial crisis; the Basel Accords
- Main EU Legal Acts: CRR/CRD
- Norwegian Adaptations:
  - Finansforetaksloven
  - Forskrift om beregning av ansvarlig kapital for banker, kredittforetak, finansieringsforetak, pensjonsforetak, oppgjørssentraler og verdipapirforetak
  - CRR/CRD IV-forskriften

Regulatory Capital; AT1

- **Tier 1** capital = Common Equity Tier 1 (CET1) and Additional Tier 1 (AT1).
- **AT1** = capital that meet the requirements in CRR/CRD (particularly Articles 51—55, supplemented by Commission Delegated Regulation (EU) No 241/2014 (the regulatory technical standards (RTS) on own funds).
- Importantly: **Contingent Convertible Bonds ("CoCos")** can meet these requirements
- Some features of CoCos:
  - Hybrid of debt and equity
  - Loss absorption and trigger mechanisms
  - Perpetual
- So: *Can a CoCo be "green"?*

“Don’t Let the Green Grass Fool You”

- Core Argument: Labeling CoCos as green is incompatible with the regulatory function CoCos (are meant to) serve.
- Proposed solution: Creating green bank entities – a “green ring-fence”

Consequences of Inadequate Regulation

- Current and proposed regulation: e.g., CBS, EuGB Regulation
- Allows for:
  - Vague and flexible issuer commitments to sustainability
    - “intention”
    - “no assurance”
    - “substantially”
  - Lack of additionality
    - The issue of refinancing

Green CoCos' Compatibility with AT1 Eligibility Criteria

- Are green CoCos not only problematic, but straight out incompatible with the CRR/CRD framework?
- Criteria in Article 52(1)(g):
  - "… the provisions governing [AT1 instruments] include no incentive for the institution to redeem them"
- What is an "incentive to redeem"?
  - Links between the performance of the notes and underlying (green) assets? → Yes
  - Fear of reputational harm for the issuer?
    - Wording and context
    - Commission Delegated Regulation (EU) No 241/2014 Article 20(2)(f): "marketing of the instrument in a way which suggests to investors that the instrument will be called."
    - The broader definition in Article 20(2)

EBA's Take on "Green" AT1 Instruments

- *EBA REPORT ON THE MONITORING OF ADDITIONAL TIER 1 (AT1) INSTRUMENTS OF EUROPEAN UNION (EU) INSTITUTIONS – UPDATE*
- In summary, the EBA accepts the concept of green AT1 instruments
  - The EBA insists on forcing the square peg through the round hole.
- The EBA guidelines underline, rather than counter, the problems with greening regulatory capital instruments that I've highlighted.
  - In other words: EBA does not view the green label as incompatible with CRR.
- → The argument stands: **Capital instruments are unsuitable as climate change tools due to their regulatory purposes.**

Where is the Market Going?

IFR

BONDS LOANS STRUCTURED FINANCE RATES FX EQUITIES ECONOMICS P&M

BONDS

De Volks revs up green AT1

07 Jun 18:07 | 2 min read | EMEA | Julian Lewis

De Volksbank is accelerating the glacial take-up of ESG structures in deeply subordinated bank capital with investor calls today for only the second green Additional Tier 1 capital offering. As much as two years after Spain's BBVA broke new ground with the first green AT1, the state-owned Dutch lender is marketing a €300m follow-up in the format.

The no-grow non-call seven perpetual is set for launch later this week. *ING, Goldman Sachs, Morgan Stanley, Societe Generale* and *UBS* are joint lead managers.

https://www.ifre.com/story/3396261/de-volks-revs-up-green-at1-rzppbnmq4l (June 8, 2022)

Proposal: Green Ring-Fencing

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- What is ring-fencing?
- Proposal for a green structure
- Viable, or too naïve of a solution?

A Broader Perspective: Greening the Financial Sector

- What is being done on the EU level?
- Prudential regulation does have a role to play
- What can be done? Technical proposals to amend/compliment prudential frameworks:
  - Climate-risk adjusted capital requirements (GSF/BPF)
  - Climate related stress tests
  - Align liquidity requirements with green objectives (LCR and NSFR)
  - +++ (*Inter alia*, CCyB, sectoral leverage ratio, credit ceiling/floor, outright bans, SIFI designations)
- Anticipated 2025 EBA report

Thank You!

Questions or Comments?

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