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# **Green Financing and ESG Risk: The Necessity of Regulation**



# Green Financing and ESG Risk: The Necessity of Regulation

Global warming and climate change, along with other environmental issues, such as air pollution, waste disposal, and similar problems, are concerns for the entire world, while loss or impairment of the quality of human life, as well as property damage, are inevitable consequences of pollution and climate change.

Unfortunately, it is also a fact that public authorities alone cannot deal with the increasing pressure of environmental problems and huge investments required for green projects. Therefore, it is necessary, and increasingly popular, to involve businesses and the private sector in the fight against climate change, as well as all forms of pollution.

The efforts of state authorities and international actors to provide incentives for the development of green technology and renewable energy, as well as for improvements in the energy efficiency of both households and production, are increasingly clear. The European Union (EU) has announced that it will support six green energy infrastructure projects in the Western Balkans from a package of a total of 500 million euros in grants for short- and medium-term energy investments in the region. In Serbia, several incentives have been introduced in recent years for producers of electricity from renewable energy, a prosumer system has been established, calls were published to award funds for improving household energy efficiency, etc.

Despite this, states and international organizations are just one group of players in this field, and, in addition to them, banks and other financial institutions – other finance providers – also play an important role.

There is already a global consensus on the need to fight against climate change, and in particular, awareness of the necessity of a green transition and switching to technologies with a less negative impact on the environment. However, the road to the green transition requires huge investments by the private sector, which primarily seeks profit, and which investments the state (or supranational institutions) want to regulate and direct, but do not have complete control over.

In this article we will try to define green projects and green financing and present an overview of green financing instruments, which will allow us to talk about the ways of influence of public institutions and regulators on green financing, influencing factors and problems that have been observed with green financing, proposed ways to solve those problems, and trends in green financing and green transition expected in the near future.

# ■ Green Financing and ESG Risk: The Necessity of Regulation

In general, green projects refer to projects that create products or develop technologies that are primarily aimed at reducing greenhouse gas emissions or supporting the use of clean energy.

Large-scale renewable energy infrastructure projects, similar to many other large infrastructure projects, require extremely complex processes, usually involving the creation of a special-purpose vehicle (SPV) and attracting project financing through project loans, private capital, and often through project bonds. Large, often multinational, commercial banks and infrastructure funds are usually the main actors providing financing for these projects, which face fundamental technological, macroeconomic, and regulatory challenges.

Despite the rapid increase in its competitiveness in recent years, electricity generation from renewable sources still faces unequal conditions compared to conventional power plants that use fossil fuels as an energy source. This is exacerbated by subsidies and other forms of government support for fossil fuels that are still provided in many parts of the world, including in developing countries, and the ways in which banks as financial providers calculate the risk of an investment.

Financial markets in many developing countries lack the maturity and depth needed to provide financing for projects of the scale and duration of infrastructure projects of this type. Foreign financiers and investors who could, in theory, cover the financing gap, tend to avoid local projects given the constant presence of significant risks. Finally, sovereign, political and policy risks are particularly detrimental to investments in renewable energy sources, given the scale of capital investment required and the long life of such projects. Energy efficiency improvement projects typically rely on “balance sheet” financing from project sponsors or may operate through smaller arrangements. In both cases, the main sources of private financing are domestic or local banks involved in corporate or project lending and/or project sponsors themselves as providers of equity capital.

Energy efficiency improvements tend to struggle with methodological issues related to how energy savings, or energy efficiency improvements, are calculated. Often the true amount of savings compared to the actual costs of the intervention remains unclear or appears uncertain to potential project sponsors. Another more fundamental challenge is that companies often favor projects that lead to business expansion, continuity, and revenue growth, rather than investments that primarily result in savings and improvements in energy efficiency or pollution reduction.

When it comes to publicly owned and managed infrastructure, the relevant public body usually provides financing obtained from fiscal revenues or conventional debt instruments such as municipal bonds, municipal loans, or government bonds.

## ■ Green financing

Green finance implies financial investments flowing into sustainable development projects and initiatives, environmental products, and policies that encourage the development of a more sustainable economy. Green finance includes climate finance but is not limited to it. It also refers to a wider range of other environmental objectives, such as industrial pollution control, water sanitation or biodiversity protection.

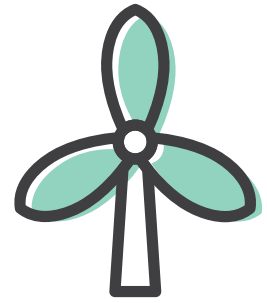
Green financing is a loan or investment that supports environmentally friendly activity, such as purchasing environmentally friendly goods and services or building environmentally friendly infrastructure.

Green financing also implies increased financial flows (from banking, micro-credit, insurance and investment) from the public, private, and not-for-profit sectors aimed at achieving sustainable development priorities. A key part of this is to better manage environmental and social risks, take up opportunities that bring both a decent rate of return and environmental benefit, and deliver greater accountability.

As the fields of environmental protection and sustainable development are new and evolving, so are all the definitions and goals in these areas. In certain situations, it is difficult to draw boundaries between these mutually conditioned and intertwined domains.

To more clearly analyze the way of financing “green” projects and calculate the risk in investing in these projects, this article will focus on green financing. One caveat is that green financing does not necessarily include the social and economic benefits of the investment, but this does not mean that the positive impact of the investment on the economy and the society is excluded: rather, emphasis is placed on the environmental aspect of the subject of the investment. The broadest term, which includes green financing, along with all financing activities that contribute to the goals of sustainable development set by the United Nations Sustainable Development Goals (SDG) agenda (social, management, etc.), is “sustainable financing”, but due to the extremely wide scope of this method of financing and the subject, we will in this text focus on green financing, meaning the financing of projects that mainly focus on environmental protection, and in most cases projects of renewable energy sources.





## Green financing instruments

A study that included a meta-analysis of the literature covering green finance revealed seven of the most prominent green bank financial products, namely green loans and bonds, green investments, climate finance, green infrastructure bonds, green insurance, and carbon finance.

A green loan is a special type of short- or medium-term financial support from banks to start-ups, small businesses, and multinational corporations for research and development of innovative products. In particular, it provides seed funding for green innovations, making them competitive, especially among high-tech companies. Also, green loans strengthen the capital structure of small businesses to withstand the financial crisis and are offered to small businesses at low interest rates.

Carbon financing refers to the financing of biogas plants, solar panels, waste disposal plants, energy treatment plants and others. This banking product is necessary to reduce carbon emissions from fossil fuels, industrial waste and pollutants from manufacturing plants leading to reduction of greenhouse gases. It helps in recycling waste, improving cooking, and providing safe and clean water.

Green traded stocks and bonds generally refers to bank securities that are mainly used to support green industry projects, including green indices and green exchange-traded funds. Stock exchanges and banks in the US and Asia, especially China, are playing a leading role in promoting green securities to support innovation and development of listed companies. Stock exchanges emphasize the development of green bonds, the acceleration of green index product innovation, and the deepening of international cooperation in green finance.

Green bonds lead the green finance sector, as revealed by the increase in their combined value from \$2.3 billion to \$511.5 billion in the observed time period. China and the US are the largest issuers, with a quarter of the total green bonds issued, while France and Germany, two EU countries, are close behind.

Environmental, Social, and Governance (ESG) investing also gained popularity during the period under review, with green lending rocketing by a factor of 200 from 2017 to 2021 alone, as total investments increased from \$432 million to \$78.6 billion annually. Most of these loans were approved in Europe.

States also issue green bonds. In 2021, Serbia issued green bonds valued at €1 billion, with a maturity of seven years, at a coupon rate of 1 percent and a yield to maturity of 1.26 percent, thereby borrowing for the sake of investing in the construction of green projects.



M+ Group is the first company in Croatia to issue sustainable bonds worth HRK 300 million, or nearly €40 million. Strategic partners for this bond issue were Erste & Steiermärkische Bank, a member of the Erste Group, and the European Bank for Reconstruction and Development (EBRD). Other buyers, as announced by M+ Group, are institutional investors, including insurance companies and investment funds, and one benefit of these sustainable bonds is that interest increases if the bond issuer does not meet its sustainable development obligations.

The EU is seeking to introduce common criteria for green bond issues, through the proposed regulation that would set the gold standard for green bonds issued by companies and public authorities to raise finance needed for large projects.

Harmonization in this area would benefit both investors and green bonds issuers, as issuers will have a strong tool to demonstrate that they finance legitimate green projects aligned with the EU taxonomy, and investors in bonds will be able to more easily assess and compare bonds and gain confidence that their investments are indeed sustainable, which will reduce the risk of “greenwashing” (see below for a discussion of this issue in greater detail).

There is already an EU standard for green bonds exists, but changes to it are expected. The proposed alterations aim at better regulating the entire green bond market, not just establishing European green bond labels, and combat greenwashing. Transparency requirements are introduced for all bonds sold as “green”, including compliance with legal regulations on the taxonomy for the use of finance raised using these bonds. This would allow investors to compare EU green bonds with other existing green issues. In addition, all those issuing green bonds must have safeguards in place to ensure they do not harm people or the environment.



## ■ Factors of influence – regulation and risk

The willingness of banks to take action on the demands of environmental responsibility largely stems from increasingly strict global and regional policies and agreements concerning the environment and climate change. The pressure on banks to focus more on sustainability, environmental protection, and climate change has grown since the Paris Agreement was signed in 2015. Global and regional bodies, such as the United Nations, World Bank, International Monetary Fund (IMF), EU, and G20 are increasingly mounting pressure on their members and trading partners to implement green finance policies in their finance systems.

Central banks have begun to require banks to obtain green certification, award green credit scores, and engage in environmental innovation and social inclusion efforts. Banks that adhere to these green finance requirements receive tax breaks and other incentives from central banks. Also, intense competition to gain an advantage over others are driving banks to come under intense mimetic pressure in banking sectors resulting in the growth of green finance.

In addition to strict regulations that affect banks' readiness to offer green financing instruments, other factors, such as social ones, greatly affect banks, which seek to maintain their reputations and customer loyalty, attract new clients, and improve their corporate images.

Furthermore, green project financing poses new risks. While traditional risk is known and predictable, however, the same traditional projects now carry greater risks, primarily of reduced profit due to rising prices of carbon in the European Trading System (ETS), as well as due to other levies payable by greenhouse gas (GHG) emitters. The risks and risk control measures implemented by the banks influence decision-making on green credit and investment in green projects. Credit managers must know the scope of risks associated with green finance and how to apply the green credit risk model when issuing green finance, while loan insurance and credit derivatives can be used to manage green bank loans with risk diversification.

Risk analysis in general involves the loss or gain in the value of something and is most often associated with the consequences of an action or event, multiplied by its probability. This usually requires risk measurement, which enables comparison between different risks and understanding of the possible impacts, often represented through models or scenarios. Risk assessment has, therefore, become institutionalized as a common practice in government, businesses, and other organizations, to direct actions based on the assessment of their consequences, followed by the prioritization of measures to reduce adverse consequences.

The study of risk is especially necessary in the context of an environmental disaster (such as the recent spill of hazardous materials after a train accident in Serbia), where a growing understanding of the interplay between hazard, vulnerability, and exposure has led to more comprehensive and sophisticated risk models and assessment methods.

Risks can be divided into several categories: physical risks, such as direct physical damage to existing infrastructure; regulatory risks, primarily the price of trading carbon emissions; risks of litigation due to GHG emissions; non-competitiveness or reputational risk; reduced production risk; and, finally, financial risk.

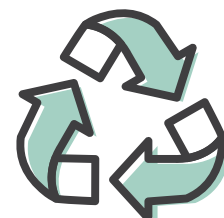
Given the diversity of approaches and the complexity of risk assessment, many public bodies with legal obligations and private companies accountable to shareholders have conducted formal risk assessments of the impacts of climate change. Across the spectrum of experience, they have framed and prioritized climate change risks alongside other risks to implement timely responses. At the level of global public interest, the Intergovernmental Panel on Climate Change (IPCC) has described the benefits of a risk-based approach in terms of improved understanding of the dynamic interactions between risk factors (spatial and temporal) that lead to a specific climate. Both the Special Report on Extreme Events and the Fifth Assessment Report sought to characterize key global risks associated with current policy responses (or lack thereof) to the climate crisis, in order to make recommendations for further intergovernmental action.

Analyses done by consulting firms, such as a 2020 survey by the consultancy McKinsey, provide additional information about climate risk, such as its systematic effect, uneven regional distribution, and the fact that the consequences of climate change currently affect regions with relatively lower GDP more significantly.

Some of the most important parameters that influence risk calculation of when deciding on the financing of green projects are carbon emissions and their cost, as well as regulatory risk. Banks must take into account the fact that in the future the price of carbon units will grow exponentially, and that the profit of investing in a project with a high level of emitted carbon will be lower. On the other hand, major factor that leads to contradictions in the behavior of finance providers is the fact that green projects are often extremely innovative projects, which, compared to traditional technologies, have uncertain results – in other words, that pose increased risk.

A company's non-financial reporting – such as reporting on sustainability, including environmental aspects – is extremely important in trading ESG securities.

Additionally, US research has shown that a business with a problematic environmental impact is associated with a higher cost of debt financing and a lower credit rating, and that a proactive “green” business is associated with a lower cost of debt.





## ■ What is the issue?

A well-conceived system where governments set sustainability strategies, banks invest in green projects, and investors abandon “dirty technology” projects for sustainable projects is not without its flaws.

Environmental problems, above all climate change, are not an isolated problem, but their negative impacts are spread over all aspects of social and economic life: they are unlimited and cannot be measured. Solving the problem of climate change requires a systemic solution and a change in both people’s behavior and the functioning of the economy, while the impact of those changes will not be felt today. This is the context in which green financing operates.

Green financing is aimed at projects that should have a clear profit and less risk than “dirty” projects - green projects are not burdened by the EU Emissions Trading System (ETS), the Carbon Border Adjustment Mechanism (CBAM), or other environmental taxes, as well as not being subject to strict regulations and prohibitions, and the like.

As such, it is quite clear that finance providers (governments and banks) should direct money towards green projects, which have high profit and low risk. However, we run into two related problems here. The first problem is unclear regulation, which enables and leads to the second problem: greenwashing.

## ■ Regulation in the field of green financing

In mid-2022, the European Central Bank (ECB), having published a roadmap and action plan for climate action, took steps to include climate change considerations in its monetary policy framework. The measures will aim to take climate-related financial risks into account on the ECB’s balance sheet and support the green transition of the economy. The ECB will gradually decarbonize its corporate bonds, limit the use of assets with a high carbon footprint as collateral and require companies to comply with the EU Corporate Sustainability Directive (CSRD).

The Eurosystem (a network that comprises the ECB and the national central banks of EU member states) will limit the share of collateral issued by legal entities with a high carbon footprint, when borrowing within the Eurosystem, which will reduce the climate risk when providing financing. It is also foreseen that borrowing in the Eurosystem will be possible only if entities report in accordance with the CSRD. The ECB will also improve its risk management practices to better incorporate climate-related risks.

The European Commission has adopted a package of measures on sustainable financing, which includes, first of all, the creation of a unique classification system for EU sustainable economic activities (Regulation on Taxonomy) and the establishment of a single standard for the issuance of green bonds aligned with this Regulation. In addition, improving ESG requirements for non-financial reporting to facilitate informed investor decision-making (through the CSRD) is also of great importance for sustainable financing.

The objectives of EU regulation in the field of sustainable finance are:

- Expanding the existing tool for sustainable financing to facilitate access to transitional finance;
- Improving the inclusiveness of small and medium-sized enterprises (SMEs) and consumers, giving them the right tools and incentives to access transitional finance;
- Increasing the resilience of the economic and financial system to sustainability risks;
- Increasing contribution to the financial sector in the field of sustainability;
- Ensuring the integrity of the EU financial system and monitoring its orderly transition towards sustainability; and
- Developing international initiatives and sustainable financing standards and supporting EU partner countries.

However, apart from setting strategies, national and supranational institutions, including national central banks, have not set precise mechanisms for facilitating and promoting green financing, and, although they have imposed obligations that make it more expensive and complicated to invest in technologies with a large carbon footprint, such investments are still being made, especially in developing countries. An exception to this may be the further development of a sustainable taxonomy and reporting on corporate sustainability at the EU level.

Imprecise regulation, and insufficiently detailed mechanisms, further enable an imprecise determination of what projects are considered green (one may recall the case of small hydropower plants in Serbia), how accurately the risk of these investments can be calculated, and, finally, whether the investment is really green or, due to insufficient information, it constitutes nothing more than greenwashing.



# Greenwashing

The term greenwashing originated in the 1960s, when the hotel industry, in order to reduce laundry costs, placed notices in hotel rooms, asking guests to reuse their towels to save the environment.

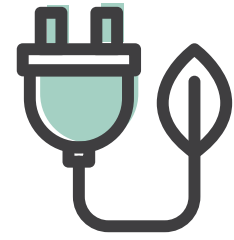
Greenwashing is a practice used to present a product or service as more environmentally friendly than it really is. This term is used when products or services are advertised as “green” or “environmentally friendly” without adequate documentation and verification.

In the context of green projects, it implies the possibility of financial resources being directed towards projects that are not actually green but are only presented as such. This can benefit both the company that owns the project, because it receives funds to finance the project, but also the finance provider, because it legitimizes itself as a financial institution that invests in green projects and technologies. Thus, financial institutions can enter this distorted data into their ESG report (if reporting criteria are not clearly defined) and derive numerous benefits from it.

If there are no clearly defined rules on what is considered a green project, some projects may be presented as green without actually meeting environmental protection standards.

Furthermore, if there are no clearly defined rules on reporting environmental and sustainability parameters, finance providers can gain benefits in the form of positive branding. Therefore, it is important to have clear and precise criteria for defining and verifying green projects, and clear criteria for non-financial reporting to prevent greenwashing and ensure real environmental protection.





## ■ Conclusion

The green transition cannot take place without the involvement of the private sector, in particular banks, in efforts at the international level to reduce greenhouse gas emissions.

It should be added that central banks can be significant factors in promoting green or sustainable financing. This is primarily because the central bank's crucial role is to ensure financial and macroeconomic stability. Environmental, and above all, climate risks are an obvious threat to economic stability, so it is justified to expect greater engagement from central banks in facilitating the financing of green projects.

The role of central banks can be reflected in various activities such as subsidizing credit rates for prioritizing green sectors, or such as improving the market of carbon certificates by accepting carbon certificates as part of legal reserves of commercial banks, with the aim of reducing capital costs for projects with low carbon emissions.

The authority of central banks as regulators, innovators, participants, and catalysts of financial development can be of great importance for the promotion and development of new green market segments or products and fostering sustainable market practices.

In the future, states and international institutions are expected to adopt clearer and more precise norms that define the procedure for investing in green projects, as well as the way to monitor the functionality of those projects. Future regulatory developments, increasing ESG expertise in the industry and improvements in the availability of resulting data should lead to an increase in companies' ability to manage ESG risk.

The expectations we can have from green investments this year are conditioned by the energy crisis, inflation, rising interest rates and general uncertainty, but we can expect a continuation of the movement towards sustainable technologies and an increase in investment in renewable energy sources, especially considering the development of the CBAM, and reporting on environmental parameters as required by the CSRD.

Expecting the further development of the control and verification mechanisms of green projects, as well as the further development of non-financial reporting criteria, we hope that Serbia will also benefit from such projects in the future, and that the state authorities, together with the National Bank of Serbia, will recognize the need for more detailed regulation of this areas.



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