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ESG Finance: Regulatory framework and challenges

ESG finance is a fundamental tool for transitioning to a sustainable economy, enabling the financing of environmentally sustainable investments through specialized financial products.

Despite their significance, the absence of a unified regulatory framework for green loans presents challenges, unlike green bonds, which are now governed by Regulation (EU) 2023/2631.

Green bonds and the European Green Bond Standard (EuGBS)

Green bonds are financial instruments that allow the raising of capital for projects such as renewable energy sources, energy-efficient building upgrades, and clean transportation. The need for increased transparency and reliability led to the issuance of Regulation (EU) 2023/2631, which establishes the framework for European Green Bond (EuGBs).

The Regulation establishes transparency and standardization obligations to enhance the credibility of the green bond market, stipulating that the title "European Green Bond (EuGB)" may only be used if specific conditions are met. At least **85% of the proceeds** from the bond issuance must be invested in environmentally sustainable activities in accordance with the EU Taxonomy, while issuers must publish **allocation reports** detailing the investments made. Additionally, issuers are required issue **impact reports** detailing the environmental benefits obtained from financing the projects. Compliance with the Regulation is guaranteed through **independent auditors** who confirm that issuers adhere to the EuGBS criteria.

In Greece, implementing provisions have been established to align with the Regulation. The **Hellenic Capital Market Commission** is responsible for overseeing the use of the term "European Green Bond," with issuers required to submit related reports for review. Furthermore, cooperation between the Hellenic Capital Market Commission and the European Securities and Markets Authority (ESMA) is foreseen for managing compliance issues. Penalties for non-compliance can reach up to 5 million euros for legal entities and up to 1 million euros for individuals.

Green loans: Lack of a unified definition and challenges

Unlike green bonds, green loans, which are loan products provided by banks and financial institutions to finance environmentally sustainable investments, are not subject to a unified regulatory framework at the EU level. These loans support businesses and individuals in acquiring energy-efficient properties, upgrading equipment, and investing in the green industry, but their classification and regulation remain inconsistent across different jurisdictions.

The absence of a regulatory framework presents multiple challenges, with the most important being that there is no single, universally accepted definition of what constitutes a green loan, leading to inconsistencies in how such loans are structured and assessed. Moreover, the lack of regulatory oversight **increases the risk of greenwashing**, where financial products are marketed as environmentally sustainable without meeting clear, verifiable criteria. Transparency is also a major concern, as borrowers and investors often lack standardized reporting mechanisms to ensure that green loan proceeds are allocated to genuinely sustainable projects.

A particularly significant issue arises from the **strict criteria of the EU Taxonomy**, which establishes a classification system for environmentally sustainable activities. The Taxonomy excludes many transitional activities—projects that contribute to sustainability but do not yet fully meet the stringent environmental thresholds set by the EU. As a result, businesses engaged in incremental sustainability improvements may struggle to secure financing under the current framework, limiting the effectiveness of green loans as a tool for supporting the green transition.

The **Green Loan Principles (GLP),** established by the Loan Market Association (LMA), serve as a set of voluntary guidelines rather than legally binding regulations. These principles emphasize that loan funds should be used exclusively for environmentally sustainable projects. They also outline criteria for evaluating and selecting borrowers, require proper documentation and segregation of funds from other financing sources, and mandate reporting on loan usage. However, adherence to these principles is not subject to mandatory verification, meaning there is no formal enforcement mechanism to ensure compliance.

Establishing a coherent regulatory framework for green loans

To address these regulatory gaps, the **European Banking Authority** (EBA) has proposed the creation of a structured legal framework for green loans, inspired by the EuGBS model. One potential approach involves issuing **non-binding recommendations** to financial institutions on how to classify and monitor green loans, aiming to provide a degree of standardization while maintaining flexibility for market participants. Alternatively, a more robust legislative framework could be introduced, establishing **uniform and enforceable rules** on what constitutes a green loan, how such loans should be reported, and what oversight mechanisms should be implemented to ensure compliance.

A key element of these regulatory proposals is the introduction of a multi-tiered classification system. This system would distinguish between **strictly green loans**, which fully align with the EU Taxonomy, and **transition loans**, which finance projects that progressively improve environmental performance but do not yet meet the strict Taxonomy criteria. This approach would allow financial institutions to support a broader range of sustainable investments while ensuring that financing remains directed toward genuine environmental improvements.

Furthermore, there is increasing discussion about implementing **independent verification mechanisms** similar to those required for green bonds. Introducing third-party audits and standardized reporting obligations for green loans would enhance transparency and credibility, mitigating concerns over greenwashing and increasing investor confidence in the sector.

Green finance is essential for achieving long-term sustainability goals, yet the absence of a clear and binding regulatory framework for green loans remains a significant challenge. While the EuGBS provides a structured approach to green bonds, green loans still operate in a fragmented and loosely regulated environment. Establishing a well-defined, enforceable framework will enhance transparency, ensure market integrity, and facilitate the broader adoption of sustainable finance practices across the banking sector. Addressing these regulatory gaps is crucial to unlocking the full potential of green loans as a financing mechanism for the green transition, ultimately contributing to a more resilient and sustainable economy.

If you have questions or would like additional information, please contact the author:

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