Masters Programmes: Group Assignment Cover Sheet

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Have you used Artificial Intelligence (AI) in any part of this assignment?	**Yes AI has been used for code debugging, forming a Sanchy Plot.**

Ethics, Financial Regulation and Corporate Governance Green Bonds

April 12, 2025

Submitted in partial fulfilment of the requirements for

IB9KB0 Ethics, Financial Regulation and Corporate Governance

Contents

1. Introduction

Green bonds promise environmental impact through fixed-income financing, yet their integrity rests on voluntary commitments rather than binding obligations. Under frameworks like ICMA's Principles, issuers self-declare use-of-proceeds while investors rely on non-enforceable reviews. As highlighted by legal critiques, this creates reputational risk without legal recourse. This essay identifies five systemic risks in the wholesale green bond market and proposes institutional reforms to restore trust, improve transparency, and empower small regulators within a structurally weak ecosystem.

2. Risks Overview

2.1 Risk 1 Lack of enforceability

A foundational flaw in the green bond market is its reliance on voluntary commitments. As outlined in the ICMA Green Bond Principles (Martin Mills, Green Bonds Presentation, 2025). Issuers are often encouraged and not obligated to adhere use of proceeds declarations, environmental reviews, or impact disclosures. As per Baker Mckenzie Report, 2019, this structure offers investors no legal recourse if proceeds are misused, as seen in the Mexico City Airport case (Appendix A). From ethical lens, Fehr & Schmidt (1999) inequity aversion theory explains why investors withdraw capital when fairness is breached, a pattern seen in post-scandal green bond sell-offs (Climate Bonds Initiative, 2023)

Solution - Dual-Mandate Green Bonds, combining legally binding environmental KPIs with minimum financial return obligations. This restores ethical salience while aligning with fiduciary duty essential for institutional credibility and long-term investor protection.

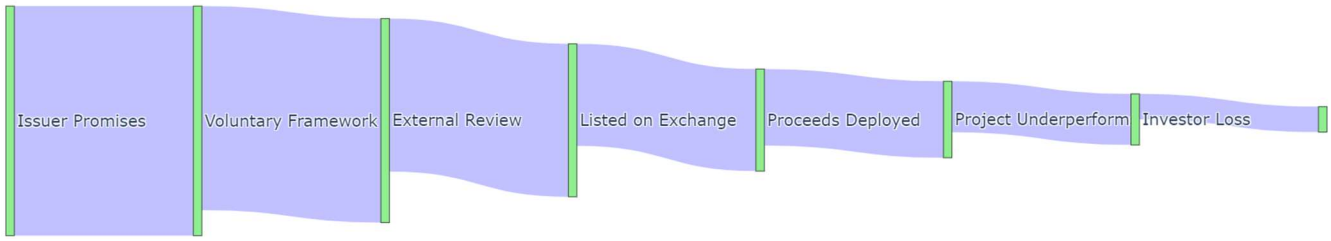


Figure 1: Green Bond Lifecycle: Disappearing Legal Accountability (Appendix B)

2.2 Risk 2 Reporting failures

A green bond's ethical credibility hinges not only on pre-issuance promises but also on post-issuance transparency. Yet according to the Climate Bonds Initiative, only 53% of bonds include impact reporting, and merely 38% report both use-of-proceeds and outcomes. This reporting fragility undermines informed investor decisions. From a behavioural lens Shleifer (2012), it can be explained that bounded rationality will weaken ethical judgement under uncertainty, while Green et al (2001), shows us a certain collapse in moral intuition, when information clarity is

lacking. As shown in Figure 2, sovereign and corporate issuers frequently underperform on disclosure.

Solution – Implementing a ‘Ethical Penalty Auction’, issuers who fail to report a portion of future issuance rights, which is redirected into a green development trust. From the perspective the of a small developing country, the penalty cannot be high so as to not scare away new businesses, but this mechanism enforces accountability without requiring litigation.

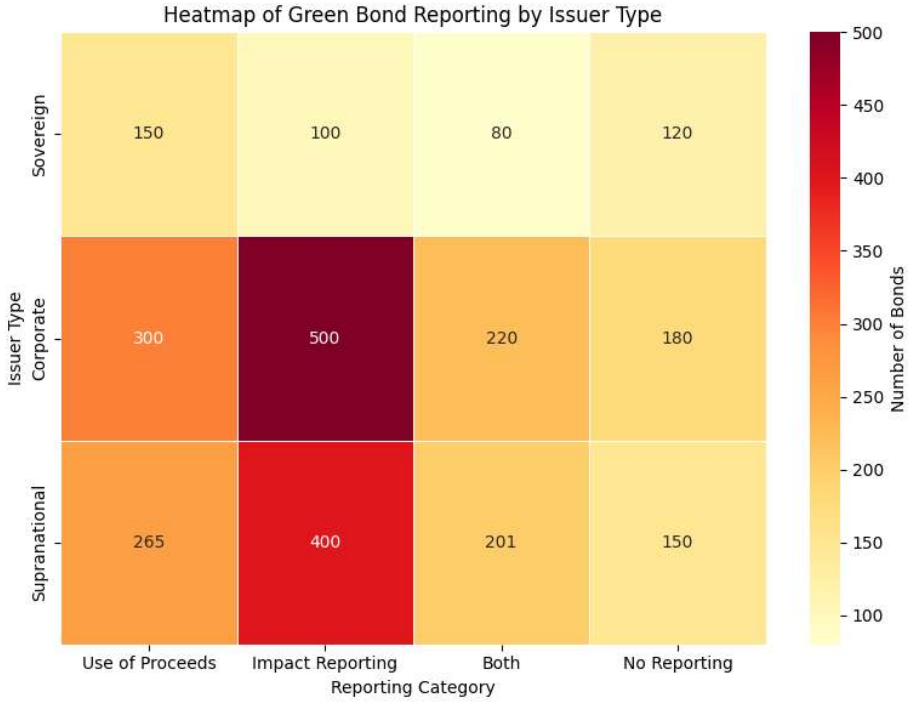


Figure 2: Heatmap of Green Bond Reporting by Issuer Type (Appendix c)

2.3 Risk 3 Incentive misalignment

Issuers would often find, even when their green bonds are verified and reported, there is little to no benefits. Firms see no pricing benefits i.e. a ‘Greenium’ yet bear the cost of external reviews and ESG disclosures (Figure 3). The event study shows global green bond issuance surging past USD 600 billion by 2023, while verified reporting barely reaches one-third of that total. This creates a disincentive to maintain high standards. Misconduct can become a rational strategy in competitive, high-margin environments (Thanassoulis 2023), further revealing how financial industry norms can normalise dishonest behaviour when profit incentives dominate (Cohn et al. 2014).

Solution – Requirement of a ‘Green Project Insurance’ for large issuers, ensuring that if projects underperform or ESG targets fail, investors receive compensation. This shifts the burden of truthfulness onto insurers, restores ethical pressure through pricing signals, and aligns with small-country capacity by outsourcing due diligence to private third parties.

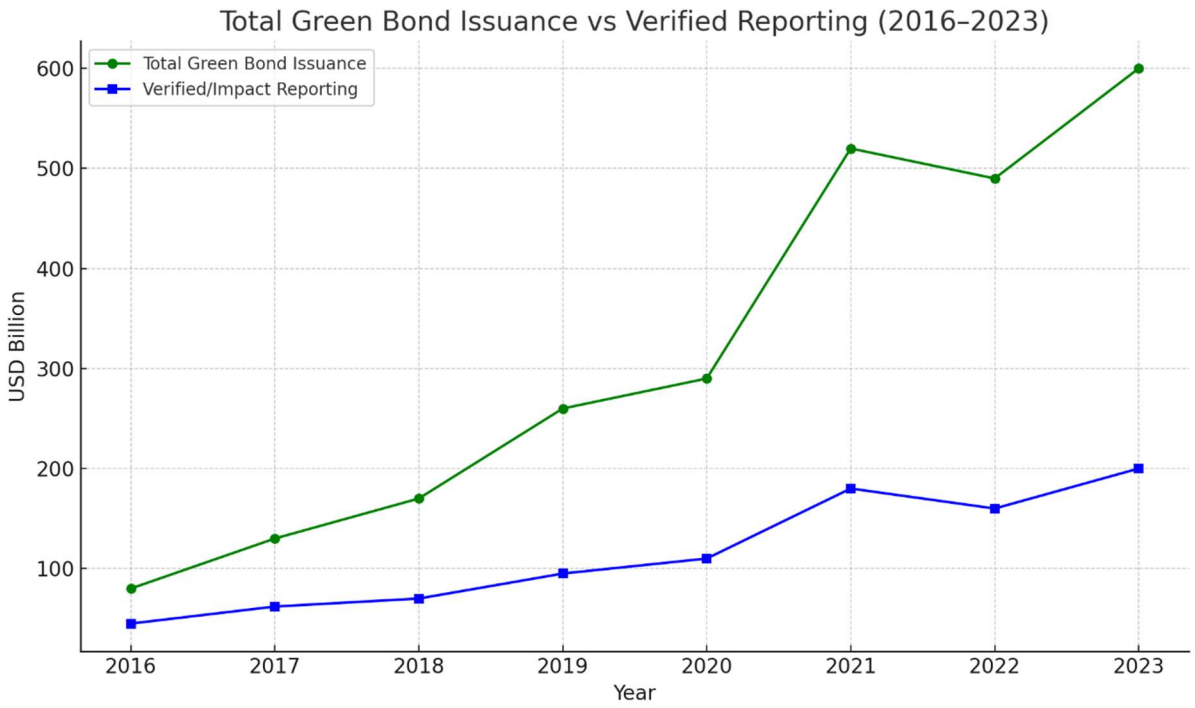


Figure 3: Total Green Bond Issuance vs Verified Reporting (2016–2023) (Appendix D)

2.4 Risk 4 Investors Trap

Green bond investors often face limited protection when financed projects underperform or collapse. Bonds that were once marketed as climate-positive may fail to meet their environmental goals, yet investors are left with little recourse. In many cases, there are no clear mechanisms for early exit, compensation, or escalation. This is especially problematic in retail-focused markets or for smaller institutions, where technical due diligence is harder to conduct. Despite buying into ethical finance, investors may end up holding stranded or underperforming assets that deliver neither returns nor environmental impact. The lack of post-issuance enforcement further erodes trust in the market.

Solution – Regulators should mandate a “Green Contingency Clause” that enables partial redemption or investor withdrawal when targets are missed, ensuring fairness without relying on litigation.

2.4 Risk 5 Regulator Constraints

Small developing countries face structural limitations such as, limited regulatory capacity, fragmented borrowing needs, and underdeveloped legal/financial systems create enforcement vacuums. As shown in the Figure 4, issuer types vary significantly: Development Banks and Supra-nationals lead in verification and proceeds clarity, while Financial Corporates underperform in contingency and disclosure. This asymmetry exposes them to higher risks of greenwashing and makes alignment with global taxonomies (like EU/China’s) infeasible without external aid.

Solution - Create a regional third-party ESG verification pool subsidised by multilateral green funds. This scalable model ensures baseline accountability while offloading the enforcement burden from stretched national regulators

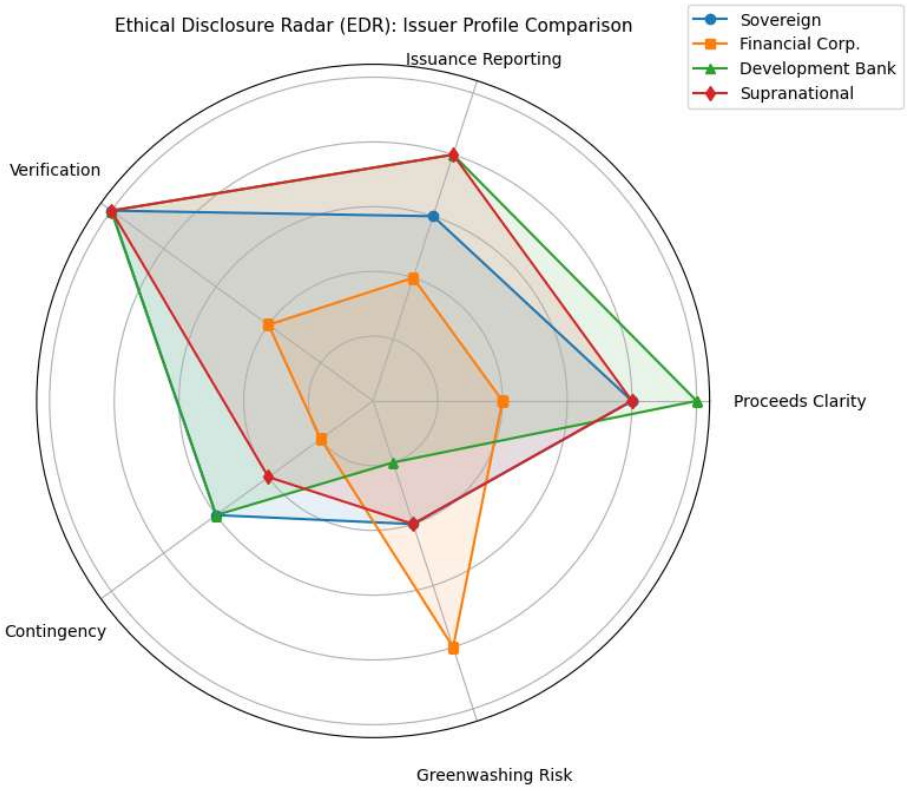


Figure 4: Ethical Disclosure Radar (Appendix E)

3. Conclusion - Policy Blueprint

The green bond market suffers from ethical fragility, voluntary rules, misaligned incentives, and weak enforcement erode investor trust. For small developing countries, the challenge is deeper, limited regulatory power meets global complexity. This paper proposes three reforms:

(1) Mandatory EDR scoring for listed green bonds to improve ethical transparency,

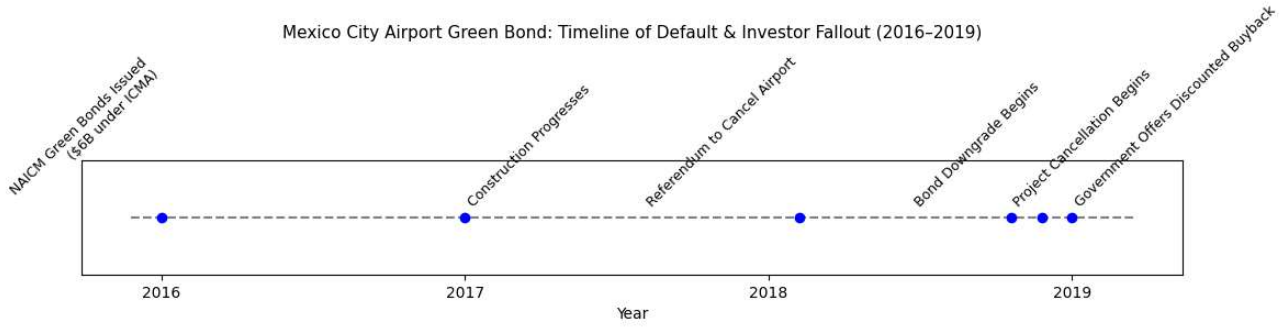
(2) Contractual enforcement tools like dual KPIs, exit clauses, or insurance to protect investors,

(3) Regional ESG verification pools subsidised by climate funds.

Together, these restore ethical pressure, reduce greenwashing, and build trust. A soft-law framework anchored in fairness and credible commitment, an essential for long-term climate finance legitimacy.

4. Appendix

4.1 Appendix A



Timeline

4.1 Appendix B

This Sankey diagram models the progressive loss of legal accountability in the green bond process. Node sequencing reflects real market architecture: issuer promises feed into voluntary frameworks like ICMA, which permit optional reviews and light-touch listing requirements. Downstream, capital deployment often lacks rigorous tracking, and investors face limited legal recourse when projects underperform. Data structure and flow weights were inferred from legal case reviews (e.g., Mexico City Airport), ICMA principles, and Climate Bonds reports. The declining flow highlights the ethical void embedded in green bond governance when frameworks emphasise disclosure over enforceability.

4.1 Appendix C

The heatmap is based on synthetic data derived from Climate Bonds Initiative figures (Baker Mckenzie), proportionally distributed across sovereign, corporate, and supranational issuers. It reflects observed reporting gaps, especially in “both” categories, and visualises the behavioural inconsistency in post-issuance transparency that undermines investor decision-making and ethical accountability.

4.2 Appendix D

This chart visualises the divergence between total green bond issuance and the subset that includes verified impact reporting. Data for 2019–2023 are sourced from Climate Bonds Initiative (CBI) Market Reports, which indicate only 38–53% of bonds meet post-issuance disclosure standards. Values for 2016–2018 are estimated using historical issuance patterns and industry benchmarks. The widening gap highlights a key ethical concern: that market growth is outpacing transparency and accountability. This discrepancy underpins Risk 3 (Incentive Misalignment) by showing that ethical effort often fails to yield financial reward, discouraging integrity-driven issuance in both wholesale and retail segments.

4.3 Appendix E

The Ethical Disclosure Radar (EDR) is a qualitative visual framework constructed to evaluate and compare green bond issuers across five ethical dimensions: Proceeds Clarity, Post-

Issuance Reporting, Verification, Contingency Provisions, and Greenwashing Risk (reversed scale). The chart's purpose is to highlight structural asymmetries in ethical compliance—particularly relevant for small-country regulators assessing issuer quality.

Scores were assigned on a 0–5 ordinal scale, using a combination of structured judgment, Climate Bonds Initiative (CBI) market reports (2019–2023. For example, Sovereigns were scored high in Verification due to national-level auditing channels but lower in contingency handling. Development Banks scored highest overall, reflecting strong post-issuance transparency and alignment with global taxonomies. Financial Corporates scored lower across the board, particularly in contingency and external verification, due to inconsistent ESG practices in emerging markets.

The EDR thus visualises not absolute compliance, but relative ethical robustness—making it ideal for regulators with limited enforcement tools. It serves as a diagnostic tool to identify issuer types requiring enhanced oversight or external ESG audit support.

5. Reference list

Coase, R.H. (1937). The Nature of the Firm. *Economica*, [online] 4(16), pp.386–405. doi: https://doi.org/10.1111/j.1468-0335.1937.tb00002.x.