EU Regulation

EU GREEN BOND STANDARD

cep**PolicyBrief** No. 26/2021

Centrum für Europäische Politik
FREIBURG | BERLIN

KEY ISSUES

Context: According to the Commission, existing global market standards for green bonds have some shortcomings.

Objective of the Regulation: An EU green bond standard will make it easier for investors to invest in economic activities which meet the sustainability criteria of the EU's green taxonomy. Bonds will be assessed by external reviewers. Use of the EU standard will be left up to the issuers.

Affected parties: Investors in and issuers of green bonds, external reviewers.

Pro: (1) Use of the EU standard will be voluntary so the existing market standards will not automatically be forced out of the market.

(2) Linking the EU standard to the taxonomy may provide the market with guidance about the permitted use of proceeds.

Contra: (1) By linking the EU standard to the taxonomy, however, there is also a risk that the EU standard will not be used because the green taxonomy cannot reproduce the very varied ideas which investors have about sustainability.

(2) Both issuers and investors should be able to rely on the fact that a green bond will not lose its status as an EuGB, even if there are changes to the green taxonomy. The Commission should therefore grant comprehensive grandfathering.

The most important passages in the text are indicated by a line in the margin.

CONTENT

Title

Proposal COM(2021) 391 of 6 July 2021 for a **Regulation on European Green Bonds**

Brief Summary

- **Context and objectives**
  - "Green bonds" are fixed interest securities
    - which are mainly issued by governments, banks or businesses and
    - the proceeds of which are used to finance or refinance environmentally friendly investments.
  - The market for green bonds in the EU is growing vigorously. In 2015, bond issuances amounted to about € 20 billion; by 2020 this had already reached € 129 billion. [Impact Assessment p. 87] Green bonds, however, only accounted for about 4% of overall corporate bonds issuance [p. 1].
  - There are two standards for green bonds which have been developed by market players and which are finding broad acceptance [Impact Assessment p. 7]:
    - the "Green Bond Principles" (GBP) developed by the "International Capital Market Association" (ICMA) and
    - the "Climate Bonds Standard" (CBS) developed by the "Climate Bonds Initiative" (CBI).
  - According to the Commission, these market standards have some shortcomings. In particular [p. 2 and 4]
    - their definition of environmentally friendly investment is "insufficiently standardised, rigorous, and comprehensive" which may pose reputational risks due to greenwashing,
    - the "transparency and accountability" of external reviewers of bonds is not adequately secured, particularly as they are not subject to supervision.
  - The Commission is therefore issuing the Regulation in order to create its own EU green bond standard [p. 1].

- **Basis of the EU green bond standard**
  - The Regulation establishes a voluntary EU green bond standard. Issuers can decide whether they want to issue a green bond according to the EU standard, an existing market standard or without applying any standard. [p. 6] If they opt for the EU standard, they must meet the requirements of the Regulation [Art. 1].
  - The EU standard may be used [Recital 3, p. 11, Art. 2 (1)]
    - by financial and non-financial undertakings, as well as sovereign issuers, from the EU and third countries,
    - for various bond forms incl. covered bonds, securitisations and project bonds.
  - Green bonds under the EU standard are given the protected designation "European green bond" or "EuGB" (hereinafter: EuGB) [Art. 3].

Author: Philipp Eckhardt| eckhardt@cep.eu
cep | Kaiser-Joseph-Strasse 266 | 79098 Freiburg | Telephone +49 (0)761 38693-0 | www.cep.eu

► **Use of proceeds of EuGB**

– The proceeds of EuGB may be used to finance "fixed assets", "capital expenditure and selected operating expenditure" as well as "financial assets" [Recital 9, Art. 4 and 5]:
  - "fixed assets" - e.g. wind turbines, buildings, production facilities - can be tangible or intangible in nature and also include those of private households;
  - "capital expenditure and selected operating expenditure" in particular, can be expenditure that is used for the acquisition, modernisation or maintenance of fixed assets, including servicing, research and development costs; operating expenditure must be incurred not more than three years ago;
  - "financial assets" can be debt or equity - e.g. a loan or a share - the proceeds of which are used for fixed assets, capital expenditure or operating expenditure.

  Issuers that are sovereigns may also use the bond proceeds in particular for tax relief or subsidies granted not more than three years prior to the issuance [Recital 16, Art. 4 (2)].
– The bond proceeds must be used [Art. 4 (1)]
  - before maturity of the bond,
  - in full and
  - without deducting the costs of allocating the proceeds to different uses.

► **Taxonomy-aligned use of the proceeds of EUGB**

– Under the Taxonomy Regulation [(EU) 2020/852, see cep**Adhoc**], economic activities are deemed to be environmentally sustainable ("taxonomy-aligned") if they [p. 11; Art. 4 Taxonomy Regulation]
  - make a "substantial contribution" to at least one of the six environmental objectives (e.g. climate change mitigation),
  - do not "significantly harm" any of those environmental objectives,
  - comply with the minimum safeguards on human rights and rights under labour law, and
  - comply with the technical screening criteria established by the Commission in delegated acts.
– The proceeds of EuGB must be used to finance economic activities which [Art. 6 (1) and (2)]
  - are already taxonomy-aligned or
  - will be taxonomy-aligned within a maximum period of five years, or ten years in exceptional cases.
– EuGB are taxonomy-aligned if the activities being financed meet the technical screening criteria applicable at the time of issuance. If bond proceeds are used for debt, the relevant time is the date on which the debt was created. [Art. 7]
– If the screening criteria change after the issuance, or after creation of the debt, the use of the bond proceeds must be aligned with the new criteria within five years [Art. 7].

► **Reporting obligations and their external review**

– Prior to issuing EuGB, issuers must publish a "factsheet" containing information about the intended use of proceeds, the environmental strategy and the environmental objectives [Art. 8, Annex I and IV].
– After issuing an EuGB, issuers must publish
  - an allocation report every year until full allocation of the issue proceeds, and thereafter another one [Art. 9 (1) and (3), Annex II and IV],
  - following full allocation of the issue proceeds and at least once during the lifetime of the bond an "impact report" on the environmental effects achieved [Art. 10, Annex III]].
– Issuers must engage external reviewers – e.g. Second Party Opinion providers (SPOs), auditors, ratings agencies – [Art. 8 (1) and (3), Art. 9 (7)]:
  - prior to issuance, to assess the factsheet and whether the issuer is planning to use the proceeds in accordance with the Regulation, and
  - after issuance, to assess the allocation report as to whether the issuer has complied with the allocation indicated in the factsheet and has allocated the proceeds in accordance with the requirements of the Regulation.
– An EuGB can only be issued if an external reviewer has given a "positive opinion" regarding the factsheet [Art. 8 Abs. 1].
– In addition to external reviewers, issuers that are sovereigns can also engage a state auditor or any other public entity to assess its factsheet and allocation report [Art. 11].
– Where sovereign issuers use bond proceeds for tax relief or subsidies, the review of the allocation reports only has to assess whether the "terms and conditions" of the relief or subsidies comply with the requirements on the allocation of proceeds and on taxonomy alignment [Recital 16, Art. 9 (8)].

► **Requirements applicable to external reviewers**

– External reviewers of EuGB must register with the European Securities and Markets Authority (ESMA) [Art. 14].
– ESMA will only register them if [Art. 15 (2)]
  - their management is of sufficiently good repute and sufficiently skilled,
  - the number of staff involved in assessments is sufficient and they are sufficiently qualified, and
  - they have made "effective arrangements" to ensure compliance with the requirements of the Regulation.

Author: Philipp Eckhardt | Telephone +49 (0)761 38693-0 | eckhardt@cep.eu

– External reviewers of EuGB must also
  - ensure that staff who are involved in assessment activities have the necessary knowledge for the duties assigned to them and do not take part in negotiations on fees or payments [Art. 20],
  - establish and maintain a compliance function for the assessment activities [Art. 21],
  - ensure that their business interests do not impair the independence or accuracy of their assessments [Art. 22],
  - ensure that assessments are based on a "thorough" analysis of all the available information, which must be of "sufficient quality" and derive from "reliable sources" [Art. 23],
  - identify, eliminate and disclose any conflicts of interest among the staff involved; e.g. fees for reviews must not depend on the result of the review [Art. 27],
  - ensure that the reviewer's assessment activities do not create conflicts of interest with the latter's other activities [Art. 28] and
  - make their reviews available to the public on their websites prior to maturity of the EuGB [Art. 30].

► **Supervision**
  – The national supervisory authorities appointed under the Prospectus Regulation [(EU) 2017/1129, see cep**PolicyBrief**] are responsible for the supervision of issuers of EuGB [Title IV, Chapter 1].
  – ESMA is responsible for the supervision of external reviewers of EuGB [Title III, Title IV, Chapter 2].

Statement on Subsidiarity by the Commission

The markets for green bonds and for external reviewers are cross-border markets. National legislative measures would therefore result in a fragmentation of the internal market and distortions of competition.

Policy Context

In January 2018, the High-Level Expert Group on Sustainable Finance recommended the introduction of an EU Green Bond Standard. In its Action Plan on Financing Sustainable Growth [COM(2018) 97, see cep**PolicyBrief**], the Commission announced the development of such a standard. In June 2019, the Expert Group submitted recommendations to introduce the standard. In the coming years, as part of NextGenerationEU, the Commission will issue green bonds in the amount of up to € 250 billion. In this regard, it will principally draw on the ICMA market standard but already wants to align the bond issues "as far as possible" with the EuGB.

Legislative Procedure

6 July 2021	Adoption by the Commission
Open	Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union, entry into force

Options for Influencing the Political Process

Directorates General:	DG Financial Stability, Financial Services and Capital Markets Union (leading)
Committees of the European Parliament:	Economic and Monetary Affairs, Rapporteur: Paul Tang (S&D group, NL)
Federal Ministries:	Finance (leading)
Committees of the German Bundestag:	Finance (leading)
Decision-making mode in the Council:	Qualified majority (acceptance by 55% of Member States which make up 65% of the EU population)

Formalities

Competence:	Art. 114 TFEU (Internal Market)
Form of legislative competence:	Shared competence (Art. 4 (2) TFEU)
Procedure:	Art. 294 TFEU (ordinary legislative procedure)

ASSESSMENT

Economic Impact Assessment

According to the Expert Group on Sustainable Finance, the "green bond market [...] is not faced with any major market dysfunction" [EU Green Bond Standard, Interim Report, March 2019, p. 21]. According to the Commission, use of existing standards for green bonds, developed by the market, is "widespread" and they are "commonly accepted as setting a standard" [p. 2]. There is actually therefore no need for an additional standard. **Use of the EU standard will** at least **be voluntary so the existing** and potential future **market standards will not automatically be forced out of the market.** Competition for the best standard is thus basically upheld and all standard developers – including the EU

Commission – still have the incentive to continually improve their respective standards and adapt them to market trends. This competitive pressure would be lacking if the EU standard were to be mandatory.

The fact that, for the EU standard, the Commission requires the allocation of bond proceeds to be aligned with the taxonomy, is understandable in view of its efforts to develop the green taxonomy. **Linking the EU standard to the green taxonomy may** take away some liability risks for issuers and **provide the market with guidance about the permitted use of proceeds.**

However, there is also a risk that the EU standard will not be used because the highly detailed **green taxonomy cannot** adequately **reproduce the very varied ideas which investors have about sustainability.** This is already apparent from the open dispute over the classification of nuclear power and natural gas, which reflects industrial policy interests. If the green taxonomy fails to meet the sustainability preferences of investors, there is a risk that the EU standard will impede the green bonds market rather than supporting it. This is especially true if market standards for green bonds, which set their own criteria for the green allocation of proceeds, are pushed out. This risk undoubtedly exists because the Commission is aiming to gradually make the green taxonomy the sole reference point for the definition of sustainable financial products (see cep**Input**). It is debatable whether market standards for green bonds, which pursue their own ideas about sustainability, will be able to withstand this in the long term.

Both issuers and investors should be able to rely on the fact that a green bond will not lose its status as an EuGB in its lifetime **even if there are changes to the green taxonomy.** Firstly, such a loss would give rise to legal and economic uncertainty, and secondly, it would mean that assets that were, but are no longer, taxonomy-aligned would have to be exchanged for new, taxonomy-aligned assets. Thirdly, it would result in issuers focussing on EuGB bonds with short maturities. The Commission should therefore grant comprehensive grandfathering as it announced in the Impact Assessment (p. 28) but then failed to implement in the proposal for a Regulation.

The existing market standards already include transparency requirements for issuers. With its reporting requirements, the EU Commission has largely and rightly followed this market practice: it reduces information asymmetries between issuers and investors, promotes the transparency and comparability of bonds and ultimately strengthens market confidence in EuGB.

The proposed registration and supervision rules for external reviewers aim to remedy shortcomings in the existing market standards. They may in fact boost confidence in EU-standard green bonds and their issuers, and also increase investor confidence as to whether bond proceeds have been properly allocated. This may also reduce reputational risks arising from greenwashing. At the same time, however, these rules will make it more costly to issue green bonds under the EU standard. Whether investors are willing to bear these additional costs for the sake of more confidence in green bonds, remains to be seen. It is in any case appropriate that the Commission has – at least for the time being – refrained from proposing state support measures – which were recommended by the Expert Group – to compensate for the additional costs. This would, firstly, distort competition with market standards and secondly, impose costs on tax payers which should be borne by private investors.

Legal Assessment

Legislative Competency

The Regulation is correctly based on Art. 114 TFEU.

Subsidiarity

Unproblematic.

Proportionality with Respect to Member States

Unproblematic.

Conclusion

Use of the EU standard will be voluntary so the existing market standards will not automatically be forced out of the market. Linking the EU standard to the green taxonomy may provide the market with guidance about the permitted use of proceeds. However, there is also a risk that the EU standard will not be used because the green taxonomy cannot reproduce the very varied ideas which investors have about sustainability. Both issuers and investors should be able to rely on the fact that a green bond will not lose its status as an EuGB, even if there are changes to the green taxonomy. The Commission should therefore grant comprehensive grandfathering.

Author: Philipp Eckhardt | Telephone +49 (0)761 38693-0 | eckhardt@cep.eu