The European Green Bond Standard –

Gold standard for green bonds or regulatory burden?

November 2022

This is the first article in a series of articles that will be continued with "Sustainable Securitisation - too complicated or worth the effort?" and "Green Bonds and Securitisation - the market participants' view" that will be published in early December 2022 and January 2023, respectively.

The European Green Bond Standard has been proclaimed by the European institutions as the new "gold standard" for green bonds, helping market participants to raise funds while meeting sustainability requirements and protecting investors from greenwashing. The aim is to create a market standard that would set the benchmark for green bonds and protect market integrity ensuring that only legitimate environmental projects are financed. These objectives shall be achieved by the following key elements:

- The funds raised by a European green bond should be allocated to projects aligned with the EU Taxonomy.
- There must be transparency through reporting and disclosure on how European green bond proceeds are allocated.
- Generally, all European green bonds must be assessed by an external reviewer.
- Generally, external reviewers must be registered with and supervised by the European Securities Markets Authority (**ESMA**)

Although the idea to introduce a harmonized set of rules and increased transparency is very much to be supported, the current proposal for the European Green Bond Standard nevertheless raises certain doubts as to whether it actually is the desired gold standard. In particular, the extensive reporting and disclosure obligations may not only increase costs but also the liability of the issuers. This would be further aggravated in case the European Green Bond Standard were to be made mandatory from the beginning or at a later stage. The success of the European Green Bond Standard will therefore first depend on whether the level of transparency and protection granted towards investors outweighs the additional costs and regulatory burdens imposed by the regulation on the issuers. Second, the question arises as to whether and to what extent the envisaged gold standard may impair the issuance of green bonds that use alternative standards. The latter effect could lead to private investors withdrawing from funding, for instance, the transition to a low-carbon economy.
It thus remains to be seen if the European Green Bond Standard, once adopted, will incentivise the green bonds capital market and accelerate the transition to a sustainable economy.

Terminology

In line with the overall concept of "ESG" (environmental, social, and governance) criteria in business decision making, the generic term sustainable bond is used to describe a bond which pursues ESG-related goals. In principle, such fixed income products may be performance-based - thereby focusing on borrowers (e. g., sustainability-linked bonds) - or transaction-based and having a focus on assets as is the case with the European Green Bond Standard. In general, green bonds are used by both governments and private-sector issuers to finance or re-finance investments, projects or assets that address environmental issues specifically. Social bonds on the other hand, use generated funds for projects that address social issues or seek to achieve positive social outcomes.

It appears that the fulfilment of governance-related goals is not viewed by market participants as a goal of its own but is rather used to complement the environmental and/or social aspect of a given bond issuance. In the absence of a dedicated framework for sustainable securitisations, a similar terminology for green and for social securitisations, respectively, is generally used by market participants. One of the challenges that these bonds face is using the correct key performance indicators, as this is directly related to how their success is measured.

This article series is a cooperation of:

TRUE SALE INTERNATIONAL

verified STS Verification International

Wolf Theiss

Legislative developments

To fight climate change and meet the commitments under the Paris Agreement the European Union has set itself the goal of climate neutrality by 2050. This requires a social and economic transformation in Europe, which must be cost-efficient, fair and socially balanced. The European Green Deal, published in December 2019, is the European strategy to achieve this goal. The European Green Deal consists of several policy initiatives to enable a holistic and cross-sectoral approach. The most recent legislative focus is on the establishment of a European Green Bond Standard in order to foster the EU-wide green bond market

For steering private investments into activities and sectors that are necessary to achieve climate neutrality, initially an extensive and uniform regulatory framework based on Regulation (EU) 2020/852 (the **"EU Taxonomy"**) was created in 2020. It defines what economic activities are classified as (for the time being, environmentally) sustainable and therefore serves as an EU-wide guideline and classification system for investors. More specifically, the EU Taxonomy provides a guideline for issuers and investors to verify the primarily environmental sustainability of a bond and its financial projects. In brief, a bond would be classified as environmentally sustainable if (i) a substantial contribution of the proceeds of a bond is in line with one or more of the six environmental objectives set out therein (climate change mitigation, climate change adaptation, the sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control, and the protection and restoration of biodiversity and ecosystems), (ii) no other environmental objective is significantly harmed in the process, (iii) social standards are met, and (iv) the substantiality of the contribution can be demonstrated on the basis of technical criteria.

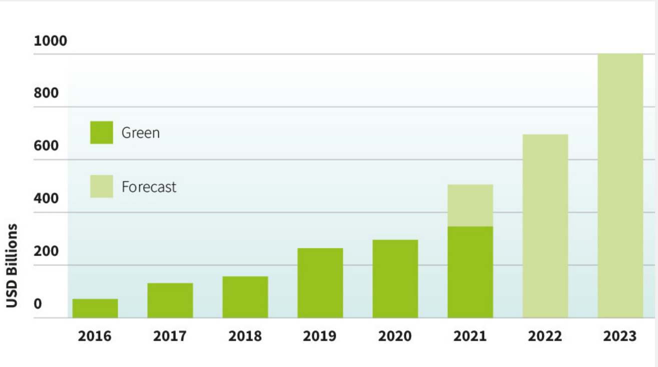
In addition, and with the goal of transparency ensuring that investors can properly assess whether products meet their sustainability objectives, the EU Taxonomy contains disclosure and reporting obligations regarding certain sustainability criteria for companies that are within the scope of the EU Non-Financial Reporting Directive 2014/95/EU. Companies should in particular include in their non-financial reporting information whether and to what extent their activities are sustainable. The EU's Sustainable Finance Disclosures Regulation (EU) 2019/2088, which was adopted in 2019, contains certain further disclosure requirements, consisting of both company-related and product-related elements.
In 2021, the EU Commission adopted a proposal for a Corporate Sustainability Reporting Directive which would, inter alia, amend and extend existing reporting requirements and introduce EU sustainability reporting standards. The Corporate Sustainability Reporting Directive has been adopted by the European Parliament on 10 November and it is expected to be adopted by the European Council on 28 November and thereafter published, with the rules becoming enforceable between 2024 and 2028. All these disclosure and reporting requirements should ensure the transparency of green investments and that greenwashing is minimised in the EU.

In 2021, the European Commission published its proposal for a Regulation on the European Green Bond Standard as part of its European Green Deal agenda. The draft European Green Bond Standard has been widely discussed and commented on – for instance, by the 2022 Report of the Committee on Economic and Monetary Affairs of the European Parliament (**"ECON Report"**) and the International Capital Market Association's (**"ICMA"**) 2022 analyses. The final shape of the European Green Bond Standard depends on the outcome of the current trilogue negotiations.

Relevance of the green bond market

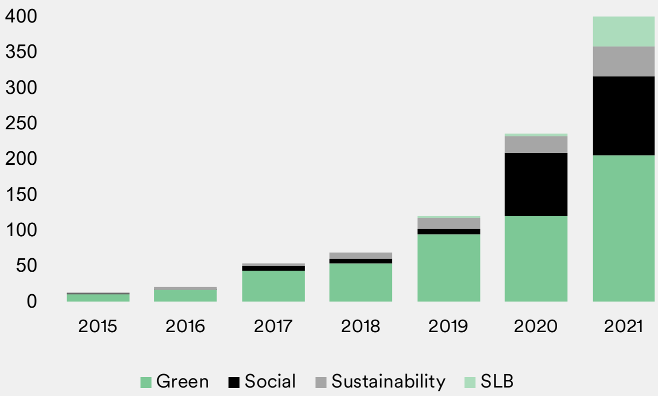
The European Union's commitment to reach the environmental goals of the Paris Agreement alongside the ambitious European Green Deal will require a considerable amount of investment and funding. Therefore, capital markets play a key role in the EU's plan to be carbon neutral by 2050. According to estimates by the European Commission, additional investments of EUR 480 billion per year in the course of this decade are required to meet the EU's 2030 emissions reduction goal. In order to achieve this, capital markets that include a green framework are needed for proper mobilisation and allocation of the required funds. To that end, green bonds, sustainable securitisation and other debt instruments across the capital markets will be the key instruments to finance environmental projects.

Chart 1



Source: Climate Bonds Initiative[3]

Chart 2



Source: DZ Bank Research, Stats from Bloomberg

The green bond market[1] in 2020 only represented approximately 3 - 3.5% of the overall bond issuance and is thus rather small compared to the overall bond market . Nevertheless, green bonds are gaining in popularity. The green bond market, both globally and at EU level grew by an average of 50% per year in the period 2015-2020[2]. Forecasts predict that the green bond market will amount to USD 1 trillion of yearly global issuance in 2023 (**Chart 1**). Sustainable bonds are currently in high demand. The introduction of many key performance indicators and continued innovation in transaction structures offer opportunities for further growth. The EU green financial markets possess huge growth potential, considering the additional investment needs to achieve the EU's carbon neutrality goal and other sustainability objectives.

Among the green bonds the emergence of sustainability-linked bonds (**SLB**) is a rather new trend (**Chart 2**). The expansion of fixed income products reflects both the high demand of borrowers and the different risk preferences of investors in the green bond market. In this respect, standardisation offers potential for positive economies of scale. In order to avoid any obstacles for further growth, any new standard should be voluntary in order to maintain diversity as well as volume in the growing green bond market.

1 European Parliamentary Research Service, 2022

2 Commission Impact Assessment, page 87, Table 18: Annual data on green bond issuance

3 https://www.climatebonds.net/2021/11/2021-already-record-year-green-finance-over-350bn-issued

Regulatory frameworks at present and in the future

Current market standard

Currently, i.e. prior to the European Green Bond Standard becoming effective, the predominant regulatory framework in the field of green bonds consists ICMA Green Bond Principles (**"ICMA GBP"**), outlined below.

ICMA Green Bond Principles (ICMA GBP)

The green bond market is currently organised primarily through market-based and industry group standards, where the ICMA Green Bond Principles (**"ICMA GBP"**) are dominant. They are voluntary process guidelines that provide support to issuers of green bonds and recommend transparency and disclosure standards, which investors, banks, underwriters, arrangers and other market participants can refer to in order to define the characteristics of a green bond. The ICMA GBP define green bonds as "any type of bond instrument where the proceeds or an equivalent amount will be exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible green projects and which are aligned with the four core components of the Green Bond Principles (**"GBP"**)". The defined four core components for alignment with the GBP are: (i) use of proceeds, (ii) process for project evaluation and selection, (iii) management of proceeds, and (iv) reporting. The ICMA GBP recommends that issuers use external assurance, such as third-party reviews or certification, audits or ratings, to confirm the alignment with the GBP.

European Green Bond Standard

The European Green Bond Standard provides for a "green bond framework" in cases where issuers decide to apply for and make use of the European green bond label for their issuances. Originally intended as a voluntary standard, it remains to be seen if, following the trilogue negotiations between the European institutions, the European Green Bond Standard may generally become a mandatory regulation in the future.

In general, the European Green Bond Standard can be used by both EU and non-EU issuers and by the issuers of a different type, i.e. from the private and public sector, including financial and non-financial undertakings and sovereigns. As mentioned in the beginning, there are four key requirements under the proposed framework which will be focused on in more detail below.

"European green bond" label

The European Green Bond Standard will require that any green bond bearing the European green bond label must fund only environmentally sustainable economic activities that align with the EU Taxonomy. Namely, the allocation of the funds raised from the issuance of European green bonds should be made merely for funding activities aligned with the EU Taxonomy (either on the date of allocation or in the future subject to a qualifying explanation on how EU Taxonomy-alignment will be achieved). In this respect, the European Green Bond Standard focuses on assets. Sustainability-linked bonds with their focus on the overall performance of the issuing entity will probably also be within the scope of the European Green Bond Standard. The compliance with the European Green Bond Standard provisions must be explicitly declared by the respective issuer in its prospectus (if drawn-up and published).

The EU Taxonomy and respective delegated acts are intended to provide for a classification system for economic activities by categorising them based on their environmental impact. However, the process of determining which economic activities will be finally included in the EU Taxonomy is still ongoing

Disclosure and reporting requirements

To increase transparency and combat greenwashing the European Green Bond Standard foresees extensive pre- and post-issuance disclosure and reporting obligations for issuers of labelled European green bonds. The most important obligations can be summarized as follows:

The pre-issuance disclosure obligations require, among others, the disclosure of certain key information as regards the green aspects of the transaction by completing a so-called European green bond factsheet to be externally reviewed (which, according to the ECON Report, shall form part of the respective prospectus if to be drawn up and published). Furthermore, the European Green Bond Standard provides for a detailed information regime to be included in the disclosure documents, with the main goal of providing investors with transparent information on the activities that the issuer intends to finance with the European green bond proceeds.

The respective European green bond issuer's post-issuance reporting will consist of: (i) an externally reviewed European green bond annual allocation report confirming the European Green Bond Standard compliant allocation of the bond proceeds and (ii) an externally reviewed European green bond impact report, which should contain information on the European Green Bond Standard compliant financed activities or projects and reflect the influence such activities or projects have with regards to the environmental objectives which the issuer disclosed in its pre-issuance documentation. Both reports are required to be made publicly available.

The goal of such standardised reporting requirements (with reference to the EU Taxonomy) is to enable investors to compare green projects and issuers to present their green projects in a transparent manner, which in turn should minimise the risk of greenwashing.

It is worth noting that the European Green Bond Standard provides for administrative measures to sanction any violations of the disclosure requirements described above, while the ECON Report proposes further prohibitions for non-compliant issuers (such as a one year prohibition to issue new European green bonds). Additionally, the ECON Report suggests the introduction of civil liability of inter alia issuers' management bodies for infringement of the European Green Bond Standard disclosures and reporting requirements.

ESMA as supervisory authority

In order to ensure further security for the investors in European green bonds, the European Green Bond Standard provides for a supervisory and registration regime (for issuers and external reviewers) that should fall within the European Securities and Markets Authority's responsibility. The ECON Report however does not suggest an increased supervisory role for the national competent authorities.

Outlook

The European Green Bond Standard as the new "gold standard" for green bonds may help to direct private investments into activities and sectors that are necessary to achieve climate neutrality. It is particularly encouraging that the framework seeks to apply a common standard for all types of fixed income products such as sovereign bonds, corporate and FI bonds and secured instruments such as covered bonds and securitisation, thereby avoiding any competing regimes that might erode the achievable market volume.

In case of an inadequate design, however, the European Green Bond Standard will most probably constitute a regulatory burden squelching the potential for the greening of European economies in the near and medium term.

About Wolf Theiss

Wolf Theiss is one of the leading European law firms in Central, Eastern and South-Eastern Europe with a focus on international business law. With over 360 lawyers in 13 countries, over 80% of the firm's work involves cross-border representation of international clients. Combining expertise in law and business, Wolf Theiss develops innovative solutions that integrate legal, financial and business know-how.

About STS Verification International GmbH and True Sale International GmbH

STS Verification International GmbH ("SVI") is a third party verifier authorised to perform the STS verification of compliance of true sale ABCP and non-ABCP securitisations and synthetic on-balance sheet securitisations with the STS criteria. Since having become operational in early 2019, SVI has verified more than 150 securitisations across all eligible transaction types, asset classes and throughout the European Union.

SVI is wholly owned by True Sale International GmbH ("TSI"), a leading securitisation industry body in the German and European structured finance markets. TSI emerged in 2004 from a banking initiative in Germany to promote the German securitisation market. Today, the topics of the TSI go far beyond this and cover broad areas of the asset-based finance market.

If you would like to know more about the topics covered in this memorandum or our services in general, please get in touch with your usual Wolf Theiss, SVI and TSI contact or with:

Wolf Theiss Schubertring 6, 1010 Vienna, Austria
E wolftheiss.com

STS Verification International GmbH Mainzer Landstrasse 61, 60329 Frankfurt/Main, Germany

True Sale International GmbH Mainzer Landstrasse 61, 60329 Frankfurt/Main, Germany

Contact details

We would be happy to answer any of your questions.

Matthias Schimka
Partner
E matthias.schimka@wolftheiss.com
T +43 1 51510 1394

Matthias Schimka is a member of the Banking & Finance team. He specialises in financing, including structured finance with a focus on factoring, securisation, loan portfolio sales, and restructuring. His expertise also includes ESG and Fintech related matters

He has been involved in various publications in particular regarding capital markets law. Before joining Wolf Theiss, Matthias worked as Research and Teaching Assistant at the Institute for Civil and Business Law at the Vienna University of Economics and Business.

Nevena Skočić
Senior Associate
E nevena.skocic@wolftheiss.com
T +43 1 51510 1396

Nevena Skočić is a member of the Banking & Finance team. Nevena speclializes in capital markets law, as well as finance and tax. Prior to joining Wolf Theiss, Nevena worked at a prominent, international professional services firm as a business tax advisory assistant with respect to capital markets, focusing on the tax treatment of money market and financial derivatives transactions in Serbia and other countries in the region.
Her expertise also includes ESG related matters.

She is a graduate of the University of Belgrade School of Law and also holds LL.M. from ISDE, Madrid.

TRUE SALE INTERNATIONAL

verified STS Verification International

Sign up to receive our latest updates and insights

Wolf Theiss

Learn more about us
⟶ wolftheiss.com