

EUROPEAN GREEN BOND REGULATION

European Green Bond Regulation – A Look at the (Legislative) Train Schedule, the ECON Report and Next Stops

INTRODUCTION

Since the European Commission published its proposal for a Regulation on European green bonds ("**EU GBS**") in July 2021 as part of its agenda on sustainable finance to meet the goals of the Paris Agreement and the European Green Deal, the draft EU GBS has been widely discussed and commented on – most recently by the Report of the Committee on Economic and Monetary Affairs of the European Parliament (A9-0156/2022) ("**ECON Report**") published end of May 2022.¹

Currently, the green bond market is mainly organised through market-based and industry group standards. This includes the International Capital Market Association's ("**ICMA**") Green Bond Principles and the Climate Bond Initiative's ("**CBI**") Climate Bond Standard which are voluntary standards that significantly supported the growth of the green bond market to date. While these voluntary standards provided a basis for the development of the green bond market, the European Commission aims to provide issuers and investors with a more extensive and uniform regulatory framework based on Regulation (EU) 2020/852 (the "**EU Taxonomy**") with the introduction of a European green bond standard which will address obstacles issuers and investors face with the present market standards and facilitate the further development of the green bond market.

What does the EU GBS comprise?

The EU GBS is focused on the alignment of the use of proceeds of European green bonds with the EU Taxonomy, additional reporting requirements for issuers of European green bonds (pre- and post-issuance) as well as regulating the external review process. The EU GBS is voluntary and can be applied by both EU and non-EU issuers and by all types of issuers, i.e. from the private and public sector, including financial and non-financial undertakings, and sovereigns.

- Use of Proceeds: Definition of "green" and EU Taxonomy alignment

The main characteristic of green bonds is the financing of environmentally sustainable activities of the issuer. This includes the transformation of any ongoing "brown" activities into "green" activities. However, there is no uniform or standardised definition of "green" or "sustainable". The proposed EU GBS

Key issues

- Proposal for extended scope of EU GBS
- Alignment of EU GBS with other aspect of the EU's sustainability legislation
- Additional disclosure requirements for issuers
- Administrative Sanctions and Civil Liability

¹ https://www.europarl.europa.eu/doceo/document/A-9-2022-0156_EN.pdf

requires that any green bond with the "European Green Bond" label must fund only environmentally sustainable economic activities that align with the EU Taxonomy. The EU Taxonomy and respective delegated acts will provide a classification system for economic activities by categorising economic activities based on their environmental impact. The process of determining which economic activities shall be included in the EU Taxonomy is still ongoing.

The alignment of the EU GBS and the EU Taxonomy and the categorisation of activities under the EU Taxonomy is also an important aspect for non-EU issuers which may be subject to regulations on bond issuance imposed by their respective jurisdictions as compliance with deviating regulations results in additional costs and efforts. The European Economic and Social Committee ("EESC") previously flagged this issue and proposed the International Platform on Sustainable Finance ("IPSF") as a forum to discuss alignment among taxonomies in different jurisdictions.² The EESC also highlighted that it can be particularly difficult for small and medium enterprises ("SMEs") to issue bonds in accordance with the EU GBS. The EU's Capital Markets Union Action Plan aims to provide SMEs with better access to financing option since SMEs are mainly depended upon bank loans and less engaged in the debt capital markets. However, by creating a complex European green bond standard, SMEs may be further discouraged to enter the debt capital market as they lack the internal infrastructure to comply with extensive reporting and review requirements.

- Reporting requirements

Under the draft EU GBS, issuers of European green bonds will be required to disclose information pre-issuance by completing a so-called European Green Bond Factsheet (based on the template provided in Annex I of the EU GBS) and to comply with post-issuance allocation and impact reporting requirements. The pre-issuance disclosure, including the European Green Bond Factsheet, prospectuses and investor presentations, is focused mainly on information on the activities which the issuer intends to finance with the bond proceeds.

The issuer's post-issuance reporting will consist of a so-called European Green Bond Annual Allocation Report (based on the template provided in Annex II of the EU GBS) which will confirm the allocation of the proceeds of European green bonds in accordance with Articles 4 to 7 of the EU GBS. The European Green Bond Impact Report (based on the template provided in Annex III of the EU GBS) for its part will contain information on the financed activities or projects and reflect the influence such activities or projects have in regard to the environmental objectives which the issuer disclosed in its pre-issuance documentation.

By referencing the EU Taxonomy and technical screening criteria, the EU GBS reporting requirements enable issuers to adequately present the impact of the activities or projects and provide a basis for investors to compare issuer reporting, thereby reducing the risk of so-called greenwashing. While issuers will be required to report according to these criteria, they may also employ additional metrics under the condition that the underlying methodologies are properly disclosed.

² EESC Opinion on the EU green bond standard (<https://webapi2016.eesc.europa.eu/v1/documents/EESC-2021-03634-00-00-AC-TRA-EN.docx/content>).

- External review

The disclosure and reporting provided by issuers of European green bonds will be subject to external review under the draft EU GBS, which follows the concept established by the ICMA and CBI principles. The EU aims to optimise and regulate the external review process in the EU GBS by enhancing accountability and transparency of providers of external reviews. Accordingly, the EU GBS proposes to establish a registration and supervisory regime for external reviewers that will fall within the European Securities and Markets Authority's ("ESMA") responsibility.

In order to include third country external reviewers under the EU GBS, the European Commission intends to establish a third country regime based on an equivalence decision similar to the regime existing for rating agencies. The European Commission will assess the supervisory regime for external reviewers in the respective country and decide whether the regime is equivalent to the EU's.

Recent Publication of ECON Report on the EU GBS

Based on the European Commission's proposal, the Committee on Economic and Monetary Affairs (ECON) of the European Parliament published its report at the end of May 2022 and suggested several substantive amendments. These include increasing disclosure requirements and extending the scope of the EU GBS to all issuers of "bonds marketed as environmentally sustainable" in the EU and issuers of sustainability linked bonds, and this would therefore include issuers of green bonds where the proceeds are not applied to taxonomy-aligned projects and sustainability linked bonds issued in accordance with the ICMA Green Bond Principles and Sustainability-Linked Bond Principles. However, the ECON Report suggests a "dual track" approach with certain of the more stringent requirements only applying to "European green bonds" (i.e. those where the proceeds are aligned with the EU Taxonomy compliant activities). The ECON Report further provides for increased liability and sanctions in case of non-compliance. More generally, the ECON Report attempts to align the EU GBS with other aspect of the EU's sustainability legislation, namely disclosure requirements under Regulation (EU) 2019/2088 on sustainability-related disclosure in the financial services sector ("SFDR"), the EU Taxonomy and the Corporate Sustainability Reporting Directive (Proposal for a Directive COM(2021) 189 final, "CSRD"). Certain of the amendments requested by the ECON Report are described below.

The European Commission, European Council and European Parliament will be entering trilogue discussions and while it is unlikely that all the ECON committee proposals will be taken forward into the final agreement the expectation is that the final Regulation on European green bonds will adopt some elements of both the ECON Report and the European Council's general approach, meaning it may differ substantially from the initial Commission proposal from July 2021.

- Disclosure Requirements

The ECON Report expands on the European Commission's idea of a "gold standard" by providing that issuers of all bonds marketed as environmentally sustainable (i.e. both European green bonds with taxonomy-aligned use of proceeds and other green bonds where the proceeds are not applied to taxonomy-aligned projects) and sustainability-linked bonds in the EU will be required to publish statements "on due diligence policies with respect to

principal adverse impacts of investment decisions on sustainability factors, taking due account of their size and the nature and scale of their activities" on their websites. It is not entirely clear what is anticipated by this requirement but it aligns with similar SFDR requirements. The European Supervisory Authorities, i.e. the European Banking Authority; ESMA and the European Insurance and Occupational Pensions Authority, will be mandated to develop regulatory technical standards the content, methodology and presentation of the information required.

– Transition Plans

On 21 April 2021, the European Commission published its proposal for the CSRD. The proposed CSRD includes the requirement for large undertakings with securities listed on an EU regulated market to disclose certain non-financial information regarding sustainability, e.g., a brief description of the undertaking's or the group's business model and strategy, including *inter alia* the resilience of the undertaking's or the group's business model and strategy to risks related to sustainability matters, opportunities for the undertaking or the group related to sustainability matters and the plans of the undertaking or the group to ensure that its business model and strategy are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement.³

Issuers subject to non-financial reporting requirements under the proposed CSRD will be required to receive a positive auditor opinion on the alignment of their transition plan with the objective to achieve climate neutrality by 2050 at the latest, as set out in Regulation (EU) 2021/1119 (European Climate Law) prior to issuing any European green bond or sustainability-linked bond. Note that the requirement for the transition plan to align with the objective to achieve climate neutrality by 2050 has not yet been agreed in the final CSRD proposal but has been suggested by the European Parliament in its final position before trilogue. The requirement to obtain a positive auditor opinion is not a CSRD requirement and therefore is an additional hurdle for potential green bond issuers which may present significant practical difficulties even for taxonomy-aligned businesses because external reviewers have already expressed doubts about their ability to issue such opinions in the absence of a specific standard to which they are supposed to be auditing. In addition, the pre-contractual disclosures for sustainability-linked bonds, in particular prospectuses, shall include the information regarding environmental strategy and rationale as set out in the European Green Bond Factsheet (Annex I EU GBS) and shall be reviewed by external reviewers that meet the requirements stipulated by the EU GBS.

– European Green Bond Factsheet and Prospectus Disclosure

The European Green Bond Factsheet (Annex I EU GBS) was initially intended to be incorporated by reference into prospectuses relating to European green bonds. While the incorporation by reference would make factsheets legally part of the prospectus, the ECON Report stipulates that the factsheet shall be reproduced ("fully integrated") in the prospectus. The European Green Bond Factsheet provided in the ECON Report will require disclosure of information on the entity-level taxonomy-alignment of the issuer and on transition plans where issuers are subject to the obligation to create a transition plan pursuant to the

³ <https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2021/05/esg-european-commission-proposes-corporate-sustainability-reporting-directive.pdf>

CSRD. Since the non-financial information on sustainability to be reported under CSRD may (at least in part) be forward-looking, it remains to be seen how and to what extent such information will be included in European Green Bond Factsheets (and consequently in prospectuses).

– Allocation of Proceeds and CapEx Plans

Issuers should allocate proceeds of European green bonds towards eligible activities, i.e. activities aligned with the EU Taxonomy on the date of allocation, or towards activities that will meet the requirements within a set period of time. Issuers that prepare and publish CapEx plans (as defined in Delegated Regulation (EU) 2021/2178 (supplementing the Taxonomy Regulation)) will be able to apply proceeds to eligible activities that are identified in such CapEx plans as meeting the EU Taxonomy requirements within a defined period of time. CapEx plans would be subject to review by an external reviewer and set out the annual intermediate steps, including all actions and expenditures, necessary for the transformation of the economic activity in order to meet the EU Taxonomy requirements.

For economic activities that do not meet the EU Taxonomy requirements on the date of allocation, the relevant period referred to in the paragraph above shall not exceed five years from issuance. Although certain economic activities may qualify for an extended period of up to ten years if they are listed in a delegated act to the EU GBS to be adopted by the European Commission within one year after entry into force of the EU GBS. Where the bond proceeds are allocated to transitional economic activities within the meaning of Article 10(2) of the EU Taxonomy, these shall meet the taxonomy requirements within two years.

• Extended Scope of EU GBS

Even for issuers of green bonds in the EU which do not apply the "European green bonds" or "EuGB" label, but which provide investors with a commitment or any form of pre-contractual claim that the bond proceeds are allocated to economic activities that contribute to an environmentally sustainable objective (e.g. green bonds where the proceeds are not applied to taxonomy-aligned projects) or of sustainability-linked bonds, the ECON Report sets out more onerous disclosure requirements. This includes the disclosure of the environmental strategy and rationale of the bond and information on the entity-level taxonomy-alignment of the issuer. Further, issuers of green bonds where the proceeds are not applied to taxonomy-aligned projects need to provide a clear and reasoned explanation of how the bond takes account of principal adverse impacts on sustainability factors and include information about the intended allocation of the bond proceeds (e.g. estimated time until full allocation, process for selecting green projects and estimated environmental impact) as provided in the European Green Bond Factsheet. In addition, such issuers will be required to include a description of the extent to which environmental characteristics are met in their annual reports in line with the so-called European Green Bond Annual Allocation Report (Annex II EU GBS). This will limit the extent to which the EU GBS will be voluntary and may impact the intention to be less disruptive for the green bond market.

While the conversation surrounding the taxonomy-alignment of fossil gas and nuclear energy continues, it appears that ECON expects that both will be included in the EU Taxonomy. Accordingly, the ECON Report introduces additional disclosure requirements and warning labels in case the proceeds (in

whole or in part) are intended to be allocated to activities related to fossil gas and nuclear energy.

- Administrative Sanctions

In addition to the administrative sanctions provided in Article 41 of the EU GBS, the ECON Report proposes to expand administrative sanctions and administrative measures to apply to infringements of the additional disclosure requirements described above. For example, national competent authorities shall be vested with the power to prohibit issuers from issuing European green bonds for a period up to one year for infringements of certain disclosure and reporting obligations established by the EU GBS.

Further, the ECON Report excludes issuers located in jurisdictions on the EU list of non-cooperative jurisdictions from issuing bonds under the EU GBS. While this is in line with some other European countermeasures against listed jurisdictions and companies located in such jurisdictions (e.g., non-deductibility of costs incurred in a listed jurisdiction or withholding tax measures), its practical relevance to the "green-ness" of the bonds seems limited.

- Civil liability

The ECON Report proposes changes to civil liability in connection with European green bonds. Since such civil liability is not harmonised on the EU level, the newly added Article 12a (Civil Liability) addresses responsibility for the taxonomy-aligned allocation of proceeds to attach to the issuer or its administrative, management or supervisory bodies as well as any damages incurred by investors due to an infringement of Articles 4 to 7 of the EU GBS (the current drafting does not appear to cover Articles 7a to 7c as proposed by the ECON Report). Civil liability already attaches to those persons responsible for the information given in a prospectus, where information in a prospectus which is material to the assessment of the bonds is incorrect or incomplete. However, it appears that ECON intends to lower the threshold for liability in this regard. While it remains to be seen if this provision will be included in the final EU GBS and the implementation may differ between Member States, it is clear that the European Parliament intends to hold issuers responsible for progressing in their taxonomy-alignment and to ensure compliance with the extended disclosure and reporting requirements as suggested by the ECON Report.

- Grandfathering

The draft EU GBS provides that allocation of the proceeds of European green bonds must comply with the delegated acts adopted pursuant to the EU Taxonomy applicable at the time of issue of such bonds. This protects issuers from increasingly onerous allocation requirements after a bond is issued and which they may not be able to comply with. Where the delegated acts adopted pursuant to the EU Taxonomy are amended following the issue of bonds, and the proceeds of the bond have not yet been allocated, issuers will be required to allocate the proceeds in accordance with the amended delegated acts within five years after their entry into application. Once proceeds have been allocated, there is no requirement to re-allocate them in case of further changes to the delegated acts adopted pursuant to the EU Taxonomy. Further, bonds issued as green or sustainability-linked which are already issued at the date of the (eventual) entry into application of the EU GBS will not be required to comply with the EU GBS as regards disclosure requirements and the use of external

reviewers. With regard to the allocation of bond proceeds of financial assets additional rules apply.

- Securitisation

Pursuant to Article 6a, as suggested by the ECON Report, the taxonomy-alignment of the use of proceeds shall apply to the entity from which the issuance economically originates. This provision is widely viewed in the securitisation markets as a helpful step in the right direction. It is equally as widely acknowledged, however, that a significant amount of technical work still needs to be done in order to make this in-principle solution a practical reality. Much thinking along these lines has been done by the European Banking Authority in its report published on 2 March 2022,⁴ but that work will need to continue and be translated into legislative text as part of the trilogue process.

One area that will need to be thought about carefully is the question of whether taxonomy-alignment should be measured at the level of the collateral, at the level of the use of proceeds by the originator, or some combination of the two. Requiring all of the collateral to be green is currently considered to be impractical due to the limited availability of green collateral. Any workable solution will need to allow some level of flexibility to vary the approach in line with the circumstances of the relevant market and transaction as appropriate, on the one hand, but nonetheless effectively control the risk of greenwashing on the other.

Next Steps of the European Green Bond Regulation

The EU GBS is subject to the EU's ordinary legislative procedure. The European Parliament is expected to commence the trilogue negotiations with the European Council and the European Commission. The European Council already agreed on its general approach on 13 April 2022.

In addition to the legislative procedure on the EU GBS, the further development of the EU Taxonomy is crucial to the EU GBS. The EU Taxonomy Delegated Acts will dictate how strict the requirements for activities labelled "green" will be.

While a global standard seems unlikely, the forum of the IPSF provides the opportunity for policymakers to achieve more standardisation on the green bond market across jurisdictions.

Finally, the development of the EU GBS may serve as an example for the development of further standards in the ESG bond market, e.g. social bonds or securitisation-specific green or sustainable frameworks.

⁴ EBA Report Developing a Framework for Sustainable Securitisation, EBA/REP/2022/06.

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