THE EU GREEN BOND STANDARD

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Green bonds constitute one of the most important sources of funds for the transition to a low carbon society, bringing about substantial reallocation of resources within the economy. In 2021, the global volume of outstanding green bonds amounted to more than USD 1.2 trillion, highlighting a shift from a niche financial asset to an asset class that financial market participants can no longer ignore. Nonetheless, considering that the overall market size of the global bond market is estimated to be at USD 128 trillion[1], the market for green bonds still offers significant growth potential.

Currently the bond market lacks a common framework that defines what constitutes a green bond, which hinders further growth. The principles of the International Capital Markets Association (ICMA) or the Climate Bonds Initiative provide some guidance on what characteristics bond issues should fulfil in this area, but they remain voluntary and do not make use of a uniform definition for environmentally sustainable economic activities.

Alongside the renewed sustainable finance strategy[2] and a delegated act on sustainability KPIs[3], the European Commission published a proposal for an EU Green Bond Standard (EU GBS)[4] on 6 July 2021. In this article, we will examine the requirements green bond issues must meet to be labelled as an “European green bond” or “EuGB”, look at the requirements external verifiers face and analyse the potential impact of the proposed standards on the sustainable bond market.

WHAT ARE THE MAIN DIFFERENCES BETWEEN A CONVENTIONAL AND A GREEN BOND?

The ICMA defines green bonds in the Green Bond Principles 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**”[5].

Therefore, the key differentiator between a conventional and a green bond issue is the exclusive use of proceeds for investments in green projects, which needs to be laid down in the legal documentation of the issue. Besides that, green bonds are structured in the same way as a conventional issue by an entity and are thus exposed to the same level of credit risk.

1. International Capital Market Association: Bond market size (August 2020)
2. Strategy for financing the transition to a sustainable economy
3. Commission Delegated Regulation supplementing Regulation (EU) 2020/852
4. Proposal for a regulation of the European Parliament and of the Council on European green bonds
5. ICMA Green Bond Principles Voluntary Process Guidelines for Issuing Green Bonds June 2021

HOW DID THE MARKET FOR GREEN BONDS DEVELOP?

In 2007, the European Investment Bank (EIB) laid the foundation for the green bond market by issuing a Climate Awareness Bond, with the proceeds earmarked for projects in the fields of renewable energy and energy efficiency[6].

Since then, the market has seen significant growth, facilitated by the emergence of frameworks providing guidance for the issuance of green bonds, but also by an increasing investor demand. With the publication of the first iteration of the Green Bond Principles in 2014, the ICMA established a market consensus for the issuance of green bonds, providing guidance on the use of proceeds, project selection, management of proceeds and transparency. Besides the Green Bond Principles, the ICMA today also offers voluntary guidelines for social, sustainability and sustainability-linked bonds, and thus constitutes a major facilitator for the progressive integration of sustainability considerations in the bond market.

The chart below provides an overview on the current market for green bonds.

Considering that in the first half of 2021 green bonds worth USD 202 billion have been issued globally[7], compared to USD 290 billion in the entire year 2020[8], the green bond market is on a strong expansion course, with analysts expecting up to USD 375 billion of green bonds issued in 2021[9].

THE GREEN BOND MARKET IS DRIVEN BY INCREASING DEMAND OF INVESTORS

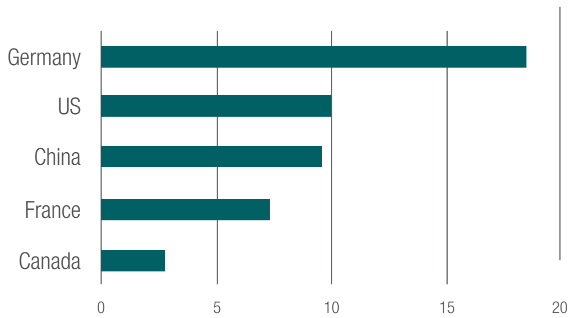
EUROPE HAS BECOME THE CENTRE OF SUSTAINABLE INVESTMENT

of issuers seeking external reviews to credibly proof the legitimacy of their sustainability claims.[1]

of green bonds proceeds are directed towards investments in renewable energy (36%), buildings (26%) and transport (23%) projects.[1]

of the overall green bond issuance in 2020 come from developed markets, where European issuances accounted for 48%.[1]

Green bond issuance in Q2 2021 (in USD bn)[2]



2021: USD 650 bn
Estimated volume of global sustainable bond issuance.[3]

2025: USD 11.000 bn
Potential volume of the ESG debt market in 2025, assuming it expands at half the pace of the last 5 years.[4]

Sources: [1]Climate Bonds Initiative: Sustainable Debt Global State of the Market 2020; [2]S&P: Global green bond sales may set record in 2021 on Europe´s sustainability push; [3]Moody´s Research Announcement: Moody´s – Sustainable Bond issuance to hit a record $650 billion in 2021; [4]Bloomberg Intelligence: ESG assets may hit $53 trillion by 2025, a third of global AUM

6. EPOS II – The "Climate Awareness Bond" EIB promotes climate protection via pan-EU public offering
7. S&P: Global green bond sales may set record in 2021 on Europe´s sustainability push
8. Climate Bonds Initiative: Sustainable debt global state of the market 2020
9. Research Announcement: Moody´s – Sustainable bond issuance to hit a record $650 billion in 2021

WHY IS AN EU GREEN BOND STANDARD NEEDED?

The absence of a common definition of environmentally sustainable activities among market-based frameworks, such as the principles provided by the ICMA or the Climate Bonds Initiative, creates uncertainty among investors regarding potential greenwashing and associated reputational risks. By using the EU Taxonomy[10] as a reference, the EU GBS resolves this issue and supports issuers of green bonds to credibly demonstrate their sustainability claims. Moreover, the current fragmentation of the green bond market creates additional confusion among investors, limiting the funds invested. Thus, if the EU GBS becomes the gold standard for green bonds in the EU, this will certainly facilitate future growth.

WHICH INVESTMENT CRITERIA MUST A EUROPEAN GREEN BOND FULFIL?

The designation as European green bond or EuGB is voluntary, meaning that only those issuers willing to label their issue as EuGB must comply with the requirements laid down in the EU GBS.

Most importantly, the use of proceeds must relate to economic activities aligned with the EU Taxonomy or activities that will be aligned with the Taxonomy within five years from bond issuance, unless the specific features of the activity justify a prolonged period of up to ten years.

The chart below shows the criteria that investment projects must fulfil in order to be eligible under the EU GBS, i.e. for an investment to be Taxonomy-aligned.

As the Taxonomy's technical screening criteria continue to be amended, the EU GBS foresees that issuers of European green bonds will allocate proceeds based on the delegated acts in effect at the time of issuance, but must apply any amendments to the regulation within five years of entry into application.

WHAT ARE THE TRANSPARENCY REQUIREMENTS OF THE EU GBS?

Prior to issuing a European green bond, issuers must submit the so-called EuGB factsheet, which, inter alia, includes information on the intended allocation of bond proceeds, the process for selecting green projects and their estimated environmental impact. Importantly, the factsheet must be verified by an external reviewer.

10. Regulation 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088

In addition, issuers must prepare an annual allocation report until the EuGB proceeds are fully allocated, demonstrating that funds have been invested in accordance with the requirements of the EU GBS. Once the proceeds have been fully allocated, a certified third-party must conduct a review, assessing whether the issuer has allocated proceeds in accordance with the EU GBS and whether the issuer has complied with the intended use of the proceeds as set out in the previously described green bond factsheet.

Finally, issuers must report on the environmental impact of the use of proceeds after the proceeds have been fully allocated and at least once during the life of the bond.

SUSTAINABILITY AS DEFINED BY THE EU TAXONOMY REGULATION

THE EU TAXONOMY OFFERS A LEGALLY BINDING DEFINITION OF ENVIRONMENTALLY SUSTAINABLE ACTIVITIES, PROVIDING THE BASIS FOR THE EU GBS.

CRITERIA FOR ENVIRONMENTALLY SUSTAINABLE ACTIVITIES

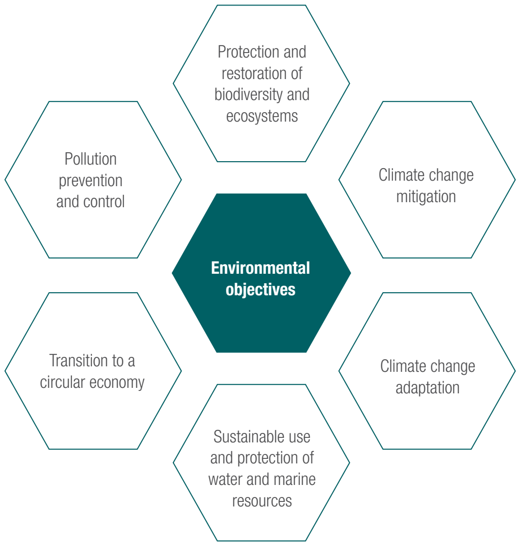
An economic activity shall qualify as environmentally sustainable where that economic activity:

01 Contributes substantially to one or more of the environmental objectives

02 Does not significantly harm any of the environmental objectives

03 Is carried out in compliance with the minimum safeguards (ILO Conventions, UN Guiding Principles on Business and Human Rights, OECD Guidelines for Multinational Enterprises)

04 Complies with the technical screening criteria (until now only published for the objectives of climate change mitigation and adaptation; a delegated act covering the remaining objectives to follow in 2022)



WHAT ARE THE REQUIREMENTS FOR EXTERNAL REVIEWERS OF EUROPEAN GREEN BONDS?

The EU GBS foresee that all bonds issued under the designation as EuGB or European green bond need to be checked by an external reviewer in order to ensure compliance with the regulation and Taxonomy-alignment of the investment project.

External reviewers for European green bonds must be registered with the European Securities and Markets Authority (ESMA) and meet certain qualification requirements, relating to the expertise of senior management, but also to the experience and training of analysts. Most importantly, external reviewers must have control mechanisms in place to ensure that the assessment performed is independent and accurate, eliminating actual or potential conflicts of interest.

The supervision of reviewers by ESMA will certainly increase the credibility of the EuGB label, and thus further contribute to the attractiveness of the label for investors and issuers.

CONCLUSION

The integration of the EU GBS into the EU sustainable finance framework will certainly be beneficial for the green bond market within the EU. The multitude of frameworks currently used in the green bond market creates confusion for investors, but also among issuers, as it becomes increasingly difficult to determine whether an activity can be considered environmentally sustainable. Aligning the EU GBS with the Taxonomy will improve the understanding of what constitutes a sustainable project underlying a European green bond.

As a result, the regulation will help direct capital flows to environmentally sustainable investment projects, supporting the transition to a net-zero carbon economy as envisaged by the EU and further advancing the market for sustainable financial products within the EU.

Contact us to learn more about how we can leverage the growing interest of investors in sustainability for your institution and how to set up the necessary environment for ESG data management and analysis. Take advantage of the opportunities that the shift towards sustainable growth offers your organization.

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