Green Bond Standard White Paper

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KEY TAKEAWAYS

Scope and timeline

Any financial institution that meets the requirements can apply for an EU GBS-labelled bond. The first proposal was made in July 2021 and the final text is expected in the latter half of 2023.

Requirements for GBS issuers

The core requirement is centered around alignment with the EU Taxonomy, which is to say it must meet the following criteria:

- Contributes substantially towards one of the 6 core environmental objectives of the Taxonomy.
- Does not significantly harm any of the other environmental objectives.
- Is carried out in compliance with minimum social safeguards.
- Complies with certain technical screening criteria (TSC).

The issuer is also subject to reviews from both their National Competence Authority (NCA) and an ESMA appointed reviewer.

Potential market response

It may be the case that investors invest heavily into GBS bonds to achieve their taxonomy alignment targets. With this high investor demand, issuers would be drawn towards the market with the likelihood of receiving a greenium discount. However, there are a multitude of barriers that still face the GBS bond market such as data gathering problems for smaller issuers, potential low interest from investors active outside of the EU and the fact that only 3% of current global economic activity qualifies as Taxonomy aligned. Investors and issuers may decide to focus on Article 9 funds instead, which are also taxonomy aligned but with less strict criteria and potentially lower costs associated with external reviewing.

DEFINITIONS AND TIMELINE

GREEN BOND

Change in Sustainable Finance: Analysing the impact of the Green Bond Standard

In 2007, the Intergovernmental Panel for Climate Change published a report that linked global warming and human activity, shortly after in 2008, the World Bank issued its first green bond in response to growing demand. Since the issuance of the first green bond, the market's grown considerably, and in 2022 alone it was worth USD 487.1bn. However, there is a lack of standardised definitions, reporting metrics and auditing in the green bond market which calls into question the true positive impact of these financial instruments and if they are merely greenwashing tools.[1]

A green bond is a debt security issued by an organisation for the purpose of financing or refinancing projects that contribute positively to the environment and/or climate.[2]

What is the GBS and why was it created?

The EU intend to make the GBS the "gold standard" for green bonds and a key pillar in their sustainable finance strategy. In summary, the EU GBS requires that all bond net proceeds are allocated in alignment with the EU Taxonomy and that the EU green bonds (EuGB) carrying the GBS label are to be supervised by competent authorities under the EU prospectus regulation. This means that National Competent Authorities (NCA) will supervise and ensure that issuers comply with their obligations. NCAs have then the ability to impose admin sanctions and other administrative measures to issuers if they don't comply with the Regulation. The EU GBS further establishes a registration and supervisory regime for external reviewers supervised by the European Securities Markets Authority (ESMA). Issuers from inside and outside the EU may issue and market their bonds as EuGBs if they comply with the requirements of the EU GBS.[3] Therefore, investors can invest in GBS labelled bonds to meet their ESG targets, specifically those that concern EU Taxonomy alignment.

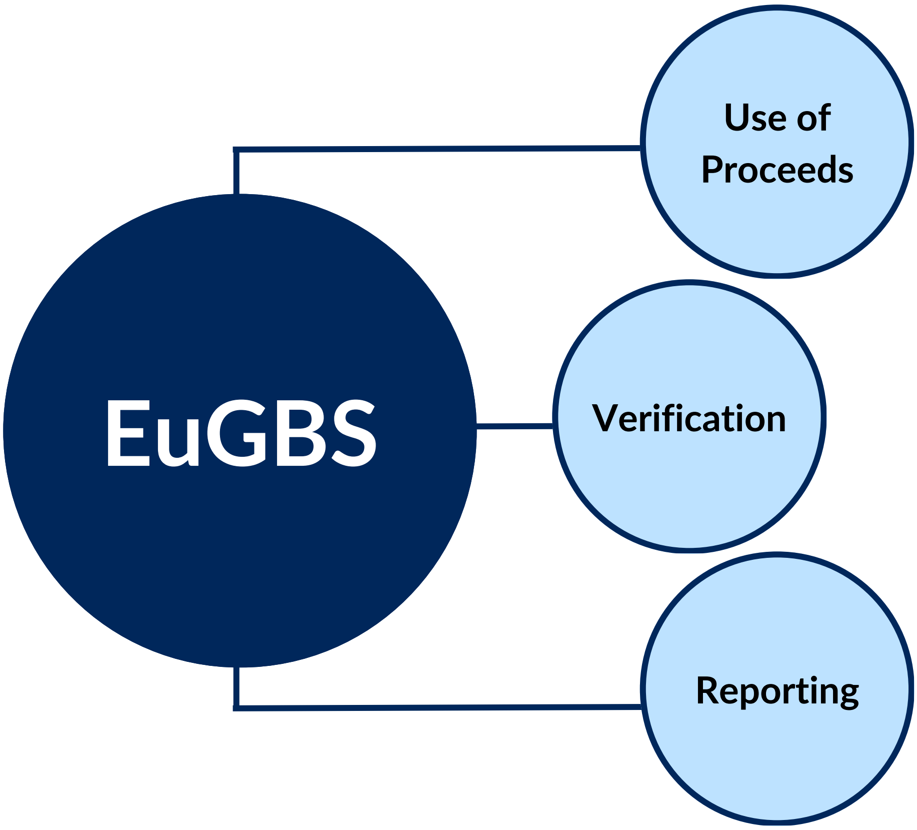
Timeline of the EU GBS

- **July 2021: European Commission's proposal** for a European Green Bond Standard
- **April 8th , 2022: Council's version** of the EU GBS
- **May 16th, 2022:** vote of the **ECON Commission of the European Parliament** on its version of the EU GBS
- **Beginning of June 2022:** vote on the **European Parliament's final version** in plenary session
- **From June 2022: trilogue negotiations** between the European Commission, the European Parliament and the Council
- **2023 - 2024:** potential **entry into application**

Source: https://gsh.cib.natixis.com/our-center-of-expertise/articles/the-eu-green-bond-standard-intense-negotiations-on-instrumental-aspects

[1] https://www.bakermckenzie.com/-/media/files/insight/publications/2019/09/iflr--green-bonds-%28002%29.pdf
[2] https://corporatefinanceinstitute.com/resources/esg/green-bond/
[3]https://www.lw.com/admin/upload/SiteAttachments/The-European-Green-Bond-Standard-The-New-Green-Bond-Gold-Standard.pdf

HOW THE EU GBS FUNCTIONS



A. Use of proceeds

Issuers may only allocate the net proceeds of an EuGB in accordance with a criterion that is centered around EU taxonomy alignment. The EU Taxonomy is a classification system that defines criteria for economic activities that are aligned with a net zero trajectory by 2050 and broader environmental goals other than the climate.[4] Under the Taxonomy, an economic activity is environmentally sustainable if it contributes substantially towards one of the six core environmental objectives, does not significantly harm any of the other environmental objectives, is carried out in compliance with minimum social safeguards and complies with certain technical screening criteria (TSC).

The EuGB proceeds must be allocated towards any of:

1. Fixed assets (but not financial assets), relevant capital expenditures (CapEx), relevant operating expenditures (OpEx),
2. Financial assets created no later than five years after the issuance, and/or
3. Assets and expenditures of households that will meet the Taxonomy requirements before the EuGB reaches maturity.

[4] https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-taxonomy-sustainable-activities_en

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In the case of CapEx and/or OpEx use of proceeds, the issuer is further required to publish a CapEx plan on their website. From the criteria emerges the definition of green projects eligible for the GBS-labelled bond financing.[3]

B. Verification

1. External Reviewer Supervision:

External reviewers essentially verify if the EuGBS bond is Taxonomy-aligned. The aim of having external reviews is to provide investors with reliable information on EuGB. External reviewers review:

- Compliance of Factsheet and Allocation Report (see below) with the requirements of the EU GBS, including alignment with the TSC,
- Whether the proceeds have been allocated in line with the EU GBS and the Factsheet,
- The Taxonomy-alignment of CapEx and OpEx as set out in the CapEx plan.[13]

These external reviewers must be registered with the European Securities and Markets Authority (ESMA). Hence, EuGB external reviewers will be supervised by the ESMA, which will charge fees for external reviewers for its registration/supervisory role. Through this supervisory role, the ESMA ensures that "potential conflicts of interest are properly identified, eliminated or managed, and disclosed in a transparent manner."[5] It also has the right to impose fines if external reviewers commit certain infringements.[3]

Prior to issuing an EuGB, issuers must publish a "European green bond factsheet" that is subject to a pre-issuance review by an external reviewer.

Key items include the following information:

- How the EuGB is expected to contribute to the broader environmental strategy of the issuer, including the environmental objectives under the Taxonomy.
- If the issuer is subject to Art 8 of the Taxonomy, a description of how and to what extent bond proceeds are expected to contribute to the issuer's Taxonomy-aligned assets, turnover, CapEx, and OpEx.
- To the extent available at the time of issuance and in case the issuer publishes a transition plan, how the proceeds are intended to contribute to such transition plan and a link to where such plan is published.
- The intended allocation of bond proceeds to EU taxonomy-aligned economic activities.
- Information on reporting.[3]

[5]https://www.europarl.europa.eu/news/en/press-room/20230227IPR76596/legislators-strike-deal-on-new-standard-to-fight-greenwashing-in-bond-markets

The issuer must also publish a prospectus in compliance with the EU Prospectus Regulation and investor presentations at this pre-issuance stage, which are also subject to review.[3]

2. NCA Supervision:

EuGB issuers will also be supervised by their NCA which will review and approve the relevant bond prospectus under the EU Prospectus Regulation in the relevant Member State. This authority will have powers and sanctions to enforce compliance. For instance, the NCA has the ability to suspend an offer or admission to trading for up to 10 days if there are reasonable grounds to suspect that the issuer has failed to comply with an obligation under the transparency and external review requirements such as those outlined in aforementioned factsheet. The issuer may even be denied admission to trading if there are reasonable grounds to believe that they have continued to fail in complying.[3]

C. Mandatory Reporting

Issuers must publish annual allocation reports until all proceeds have been fully allocated and also must obtain a post-issuance review from the external reviewer after full allocation. Furthermore, issuers must publish an impact report after full allocation and at least once during the lifetime of the bond. Templates for the impact report, as well as the annual allocation report, will be set out in annexes to the final publication of EU GBS.[3] These reports must also include progress made with regard to the achievement of the CapEx plans.

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THE ROLE OF EU GBS IN CLIMATE RISK ALLEVIATION

How can EuGB protect investors from climate-related financial risk?

Currently, some of the greatest financial risks threatening investment management companies are those related to climate change, namely physical and transitional risks.

Transitional Risks are "associated with the pace and extent at which an organisation manages and adapts to the internal and external pace of change to reduce greenhouse gas emissions and transition to renewable energy." [6]

TRANSITIONAL RISKS		PHYSICAL RISKS
Policy and Legal	**Markets**	**Acute**
Increased pricing of GHG emissions Enhanced emissions-reporting obligations Mandates on and regulation of existing products and services Exposure to litigation	Changing Customer behaviour Uncertainty in market signals Increased cost of raw materials	Increase severity of extreme weather events such as cyclones and floods *(Causing damages on facilities, reduction or disruption in production capacity...)*
Technology	**Reputation**	**Chronic**
Substitution of existing products and services with lower emissions options Unsuccessful investment in new technologies Upfront costs to transition to lower emissions technology	Shift in consumer preferences Stigmatisation of sector Increased stakeholder concern or negative stakeholder feedback	Changes in precipitation patterns and extreme variability in weather patterns Rising mean temperature Rising sea levels *(Causing damages on facilities, increased operating costs, impacts to workforce management and planning...)*

To have a chance of achieving the 1.5-degree climate scenario, many remaining fossil fuel reserves must remain unused. To achieve this goal, governments and the EU have begun to introduce policies that force investors to devalue their fossil fuel investments.

[6]https://www.epa.gov/climateleadership/climate-risks-and-opportunities defined#:~:text=Transition%20risks%20are%20those%20associated,and%20transition%20to%20renewable%20energy.

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This concept is known as stranded assets and is defined as "assets that have suffered from unanticipated or premature write-downs, devaluations, or conversion to liabilities".[7] For example, new government regulations could limit the use of fossil fuels through carbon pricing, and emission ceilings, or bans of future drilling projects as already established by many EU countries such as Denmark, Spain and Ireland.[8]

Additionally, there is likely to be a drop in demand for fossil fuel powered energy due to a change in corporate behaviour as companies prepare for mandatory disclosure regulation. Banks, insurers and pension funds that have outstanding loans or corporate stocks in the fossil fuel industries will see the value of their investments decrease in the long term.[9] If investors do not begin to strategise a smooth transition to more climate friendly investments, they pose the risk of an abrupt global transition which would have destabilising effects on the financial system through rapid loss of value of assets.[10]

Furthermore, with sustainability performance becoming an ever more relevant factor in customers' and communities' perception of organisations, investment managers risk reputational damage if they continue to invest in carbon intensive assets and other unsustainable financial products. This reputational risk is heightened by new SFDR disclosure requirements that expose any non-climate friendly investing. This reputational damage would be compounded with fines arising from litigation issues.

Additionally, increased production costs due to changing input prices (e.g., fossil fuel energy) and output requirements (e.g., waste treatment) may put strain on the finances of the investee and hence threaten the security of the investment. The physical risks from climate change will also negatively impact the return on investment reducing the investee's revenue through decreased production capacity (e.g., transport difficulties, supply chain interruptions) and increased operating costs.[6]

Conversely, sustainable business models, such as those that are circular, often translate to concrete financial opportunities for companies in the form of lower costs of production and waste management. For example, it has also been demonstrated that energy efficient homes on average have a lower risk of default thanks to these cost efficiencies.[11] The EU GBS label would allow financial institutions to send a signal to the market that they are preparing for the transitional climate risks.

[7] https://www.iisd.org/itn/en/2020/06/20/valuing-fossil-fuel-assets-in-an-era-of-climate-disruption/
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[10] https://www.lse.ac.uk/granthaminstitute/explainers/what-are-stranded-assets/
[11] https://energyefficientmortgages.eu/wp-content/uploads/2021/07/Extended-Dutch-Correlation-Analysis.pdf

CONCESSIONS FOR USERS

Some Concessions to ease the transition to the EU GBS bond market

Flexibility Clause	Grandfathering Period
Until the taxonomy framework is fully functional, 15% of EUGBS bond proceeds can be invested in economic activities for which taxonomy criteria don't exist.	An Issuer has seven years to adjust alignment of proceeds if there is an amendment in the EU Taxonomy.*

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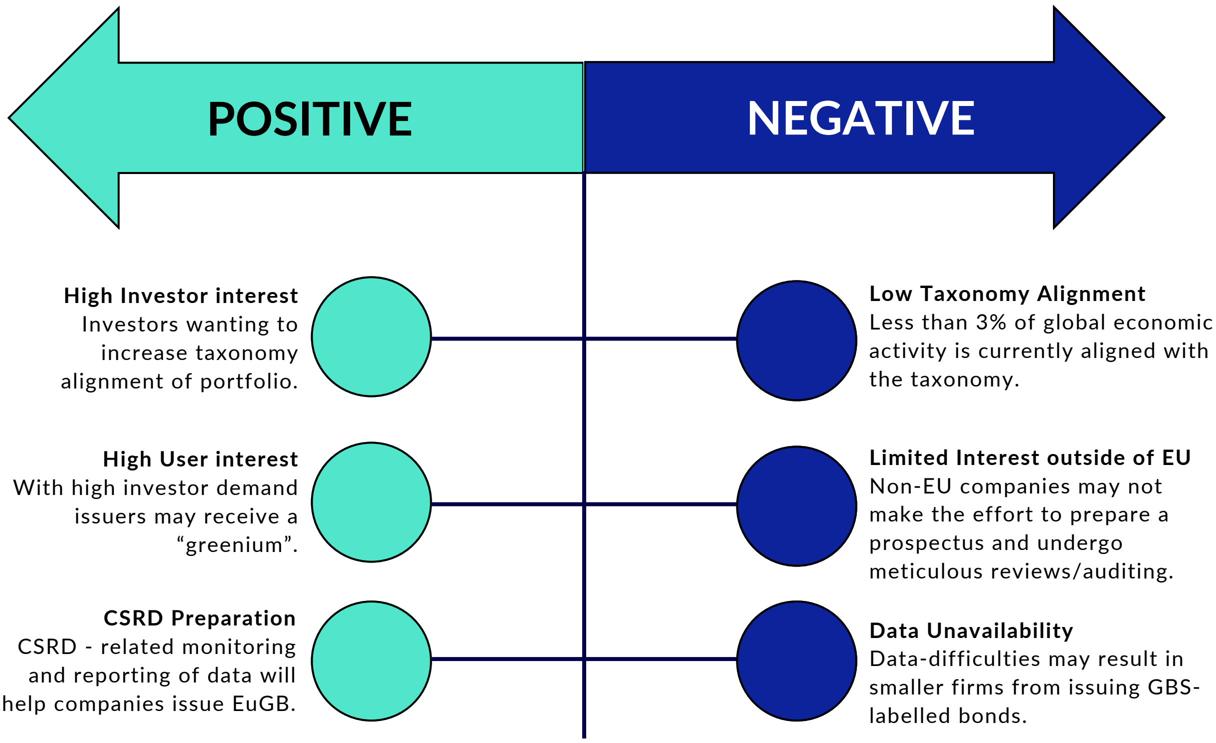
***Grandfathering Period:** This relates exclusively to proceeds that have not been allocated yet, or those included in the CapEx plan and do not yet meet the Taxonomy requirements. Issuers that predict that their activity financed by the EuGB is at risk of not complying with the amended EU Taxonomy within seven years must publish an alignment and how it will mitigate the impact of the non-alignment. An external reviewer will audit this plan. For those issuing EU GBS as part of a portfolio approach, they must ensure the financial assets are aligned with the EU Taxonomy criteria that was applicable during the seven years prior to the publication of the allocation report.[12]

The issuer must publish a CapEx plan wherein they state if the EuGB funded expenses are CapEx and/or OpEx that are not fully EU Taxonomy aligned at the issue date. This plan must specify when all expenditures funded by the EuGB will be EU Taxonomy-aligned and this date must be before the bond maturity date. Additionally, full EU Taxonomy alignment must be reached within five years from the issuance date.[12]

[12]https://www.abnamro.com/research/en/our-research/another-step-closer-to-the-end-of-the-eu-green-bond-standard-journey

POTENTIAL MARKET RESPONSES

What is the expected impact of EU GBS-labelled bonds on the bond market?



Positive Response:

Potentially high demand?

The EU GBS bonds allow investment managers to grow the share of their taxonomy aligned financial assets, which, as explained previously, offers key risk management benefits. With this strong demand for taxonomy alignment, it is possible that we will see a significant demand for this new financial product and a resulting high greenium that issuers can enjoy.

Furthermore, once companies that are subject to applicable EU sustainability regulation (such as the Taxonomy and the Corporate Sustainability Reporting Directive) are consistently monitoring, reporting, and disclosing in accordance therewith, they may feel more capable (and hence may be more inclined) to elect to align their green bonds with the EU GBS.[3] The market might then experience an increase in the number of bonds being issued under the EU GBS.

Negative Response:

Potentially low demand?

However, there are multiple factors that may prevent this sustainable finance instrument from scaling up in the financial markets. One of the most significant factors is that less than 3% of global economic activity is currently aligned with the taxonomy.[13] In this sense, we may see that, at least initially, only a handful of issuers such as utility companies will qualify for EuGB financing.

Non-EU countries issuers may have limited interest:

Issuers mainly active in other green bond markets such as those in the United States, Canada, Australia, or Switzerland may be unable and/or unwilling to prepare an EU prospectus for their issuances and subject themselves to the regulatory scrutiny of the relevant EU competent authorities. Currently, privately held issuers and non-investment grade issuers only seldom list on regulated markets, and therefore do not commonly prepare prospectuses. Issuers that are not subject to such European regulation may fail to develop such internal capabilities and hence may be less inclined to use the EU GBS. However, elements of the EU GBS may diffuse into and be adopted by the broader green bond issuer market and therefore best practices may trend towards embracing some of the elements in the EU GBS, such as Taxonomy-alignment, voluntary disclosure templates, the Factsheet and CapEx plan.[3]

Data issues that may result in low issuing:

Some types of issuers may find it difficult to comply with the CSRD obligations and hence may not be able to confidently establish their taxonomy alignment. For instance, according to the ICMA, there is widespread data unavailability for firms affected by the CSRD.[14] Furthermore, the ICMA found that it is more difficult for smaller projects and businesses to comply with the disclosure regulation given the high costs involved.[14] These data-related issues may limit the amount of eligible assets for EU GBS investment and hinder the EU GBS market.

[13] https://finance.ec.europa.eu/system/files/2022-10/221011-sustainable-finance-platform-finance-report-usability_en_1.pdf
[14]https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/cpil-2719951-article_news_title-textbox-new-eu-green-bond-standard-may-see-low-uptake-with-challenges-exceeding-ben-75544999

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Article 9 may be favoured by the market instead:

However, even if these reporting issues are overcome, we may see taxonomy aligned products such as Article 9 funds become the favoured investment choice over the EU GBS labelled green bonds due to the potentially lower associated costs. If the external auditors decide to pass down their ESMA registration and supervision costs down to the issuer, the issuer may not opt for green bonds issuing unless they receive a greenium from an investor to offset these costs. However, with article 9 funds likely to become more available for investment in the near future, investors may decline to invest in these EuGB with such greeniums. Furthermore, the EU's loosening of the definition of Article 9 funds could result in more Article 9 funds having less strict targets linked to the EU Taxonomy. This could reduce the demand of investors towards EuGBs. The potentially high costs of issuing a GBS labelled green bond may be slightly reduced thanks to the standardised external reporting procedures to be put in place.

To solve this issue, the EU could provide a subsidy for those issuers that decide to apply for GBS labelled bonds to alleviate the aforementioned costs. However, if the issuer fails their auditing and is therefore unable to issue EuGB, the EU will have provided money for essentially no upside. Perhaps the subsidy could be provided on the condition that the issuer passes their auditing and reviewing, but this may scare off issuers from applying in the first place.

CONCLUSION

Nobody can be absolutely certain on how the EU GBS market will perform. Possible solutions to the data disclosure requirements include:

- more publicly available data,
- more market requirements,
- and the application of Taxonomy requirements in subsidy schemes and permits.

However, the question that remains is “is there a business case for investors to invest in, or issuers to issue, EU GBS-labelled bonds?”

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