

ERCST Reflection Note

The EU Green Bond Standard – state of play *What is in it for transition?*

Sustainable finance is defined as a process of taking environmental, social and governance issues into account when making financial and economic decisions. The EU is currently adopting a set of policy measures in this field. The declared intention behind those actions is to finance the Green Deal's objectives and the transition to a low-carbon and sustainable economy and society. ERCST analyzes the sustainable finance policies through the prism of their suitability to deliver this objective. While doing so, we believe in the right balance between market driven and regulatory solutions.

The EU Green Bond Standard (EU GBS) is the first European financial tool incorporating the EU Taxonomy, the classification system of economic activities contributing to the six environmental objectives. ERCST has taken a critical view at various elements of the EU Taxonomy in its previous papers. Like the Taxonomy, EU GBS is an interesting field of experiment in balancing the desire to create the golden standard of highest purity and an instrument addressing the need to finance the transition of businesses.

1. The “thematic” bonds market

The green, social, and sustainable bonds are corporate or government financial instruments in many aspects resembling traditional bonds. The attached label reflects the intended use of proceeds from issuance of bonds: “green” aims at financing climate or environmental projects; “social” is used to finance social welfare investments; “sustainable” contains elements of both. There is also a subcategory of “sustainability-linked bonds” for which there is no obligation to use the proceeds for a specific purpose or project, but for a more general commitment to achieve sustainability objectives. “Transition” bonds are intended to finance the transformation to the climate-neutral economy.

The above-mentioned “thematic” bonds market, referred to as GSS+, is booming at the yearly pace of 80%¹. Its record issuance took place in 2021 and its current value is estimated globally at more than 1 trillion USD². The green bonds make up the biggest part of this segment, mainly because of existing well-defined and commonly agreed indicators. Due to an increasing emphasis on achieving net-zero commitments this growing trend is unlikely to stop, although the geopolitical turbulences as well as the rising interest rates do not favor the bond market. The recent CBI’s market analysis³ points to the higher average oversubscription for green bonds as compared to basic types of bonds (3.1 times versus 2.4 times). Such bonds are highly tradable on the secondary markets. The CBI report also shows the existence of greenium, that is a pricing benefit for the issuer. Although the level of greenium is not spectacular, it suggests that investors are ready to support the transition strategies and green bonds can help issuers to collect the capital at lower cost than through traditional bonds. The role of greenium may become more significant in light of the rising interest rates.

Investors are looking for transparency and credibility. Therefore, for them green or sustainable bonds provide the possibility to follow investments and make sure that the proceeds are spent as declared. For businesses, green or sustainable bonds offer flexibility: they can serve to refinance debt, to expand the green activities, and give a reputational boost, which should not be underestimated.

The European Union is a global leader in green bonds, with more than 50% of global issuance in 2020 by EU companies and public bodies. However, they represent only a very small part of the EU bonds market, not exceeding 3%, and this proportion is even lower at the global market. Therefore, there is still room to grow.

¹ <https://www.oecd.org/dac/green-social-sustainability-and-sustainability-linked-bonds.pdf>

² <https://www.climatebonds.net/2022/04/sustainable-debt-tops-1-trillion-record-breaking-2021-green-growth-75-new-report>

³ <https://www.climatebonds.net/resources/reports/green-bond-pricing-primary-market-h1-2022>

2. Protection against greenwashing

The problem of greenwashing in the ESG arena, with a catch-it-all approach, general and difficult to verify statements as well as with many different measurement methods, should not be automatically attributed to the green bonds market. For bonds, the risk is rather low for two reasons: first, there are widely used and recognized green bonds market standards (for example of the International Capital Market Associations and the Climate Bonds Initiative), which enables investors and market participants to verify the statements attached to bond issuance and to follow spending of its proceeds; second, the reputational risk stemming from the bond greenwashing is too high for companies as it would seriously affect the ability to raise capital once caught red-handed. Therefore, guidance should prevail over excessive regulation until proven otherwise.

By contrast, greenwashing may be a side effect of overregulation and of complex disclosure requirements imposed without proper instructions and access to good quality data. One example is the obligation imposed on businesses by all the EU disclosure frameworks (SFDR, Taxonomy, CSRD, CSDDD) to prepare transition plans to achieve the long-term global warming objectives of the Paris Agreement. Without proper guidance, it will be very challenging not only to draft those plans by companies in a credible and uniform manner, but also to review them by external verifiers. Interestingly, the European Parliament also wants to impose the requirement of having a plan to transition to net zero on issuers of EU green bonds.

In view of the complexity and risks resulting from overregulation, the market witnesses lowering ambition of investors and backtracking from Article 9 (financial products having sustainable investment as its objective) to Article 8 products (promoting *among other* characteristics, environmental or social characteristics) as defined by SFDR.

In this context, ERCST notes an approach adopted by the UK jurisdiction. The UK government supports the recognized market standards and works with market participants to improve coherence of ESG disclosures, including transition plans, rather than imposing its own standards through regulation.

3. The EU Green Bonds Standard: objective and main features

Against this background it is worth to analyze the developments of the EU Green Bonds Standard (EU GBS).

The EU GBS will be introduced by means of a legislative act and is supposed to set a gold standard for bonds aiming at raising funds on capital markets to finance environmentally sustainable projects and the economic transition. Its design is based on recognized market solutions with several significant additions. The EU GBS is meant to be a voluntary standard, open to any issuer, including companies and public authorities, also located outside of the EU, who are willing to issue a bond labeled as “EU green bond” or “EU GBS”. Availability of a ready-to-use standard can lower

to cost of issuance, make it more accessible and help the market grow. It can serve for financing long term projects as its duration can be up to 10 years. The most significant feature is the alignment with the EU Taxonomy: according to the Commission proposal, the funds raised by the green bond should be fully allocated to projects that are in line with the EU Taxonomy criteria. Those criteria are meant to evolve over time, but the “EU GBS” label can be used based on the alignment with the Taxonomy yardstick binding in the moment of the release of the bond (so-called “grandfathering”). The “EU GBS” label also entails detailed reporting requirements on how the proceeds are allocated, which must be verified by external reviewers accredited by the European Securities Market Authority.

The suitability of EU GBS for financing “transition” is limited by the features of EU Taxonomy itself. The proceeds from green bonds could be used to invest in green projects, but the Taxonomy covers only part of the EU economy and formulates criteria which will allow only very few economic activities to be labelled as “green”. The Taxonomy lacks the intermediate level helping undertakings and investors in defining activities which need to be transformed and require financing. The extension of the Taxonomy beyond a green category to harmful (red) and intermediate (amber), known as the “traffic light” Taxonomy, and its application to the EU GBS might be a long-term solution. But introducing it now brings the risk of overburdening the market with reporting obligations at the early stage of implementation of the Taxonomy when its eligibility, usability, and usefulness are still to be tested. Therefore, for the moment, the priority for policy makers should be to provide guidance in implementing the existing disclosure requirements.

4. Position of co-legislators

The draft EU GBS regulation is currently being negotiated between the Commission and two co-legislators, who started to meet for trilogues in July 2022.

The European Parliament’s (EP) position is driven by concerns of greenwashing. The solution they offer is to set the requirements for EU green bonds very, if not excessively, high. This is illustrated by far-reaching modifications of the initial text. For example, the Parliament proposes to expand transparency requirements by certain elements coming from SFDR and CSRD (e.g., the above-mentioned duty for a green bond issuer to have a plan to align with the Paris Agreement). The EP also wants to extend the EU GBS disclosure obligations to other types of bonds which are marketed as sustainable, arguing it will set a level playing field between EU GBS and other types of green bonds. In such a case, the impact of this regulation would go much beyond the “EU green bond” label and would affect the existing market standards, which will hamper the development of the green bond market. With regards the Taxonomy, the Parliament wishes to limit the grandfathering and shorten the time to align spending of proceeds with the screening criteria in two years, instead of ten. Moreover, the MEPs want Member States to ensure that the Taxonomy-alignment of the proceeds is subject to civil liability of the issuer. Considering the complexity of the Taxonomy it will be a serious deterrent for potential users of the EU GBS.

By contrast, the Council's declared goal is to make the new standard usable. A major and welcomed addition of the Member States in this direction is the 20% exemption from the Taxonomy-alignment of the proceeds from the EU GBS. This is intended as a "flexibility pocket" for activities not currently covered by the Taxonomy. There are very few companies which could be today labeled as green under the tight Taxonomy's criteria. Therefore, such a flexibility may be a minimum necessary to make the EU GBS usable.

5. Conclusion

In the context of usefulness of the EU green bond standard for financing the transition, the policy makers have the following options to choose from:

- The original Commission EU GB proposal
 - It would serve as a "gold" standard for a small part of the EU economy covered and aligned with the Taxonomy. In such a case it can be expected that the market will provide more adequate solutions for financing the transition.
- The European Parliament's "diamond" standard
 - Adding to the requirements for EU GB standard would not only limit its applicability but would also affect the existing GSS+ market standards; this would impact the possibility to issue such bonds.
- The Council's „flexibility pocket“
 - It would provide some flexibility to the obligation of the Taxonomy-alignment of the proceeds from green bonds; it is a modification potentially increasing the applicability of the EU GBS.
- The "traffic light" bonds
 - It would contain a much-needed transition component in the Taxonomy and the EU GBS, but it is not part of the current Taxonomy framework, and its introduction seems premature at this stage.
- The EU transition bonds
 - Introducing an EU voluntary transition bond standard addressing specifically the need to finance the climate and environmental transformation - in addition to the EU green bonds standard; if done with restraint, this might help this market grow by lowering the cost of bond issuance but it also brings the risk of regulatory spillover to the existing market standards.

Businesses are increasingly aware of the necessity to transform in a sustainable manner. This requires vast amounts of financial and other resources. Green bonds can be an attractive option for raising capital to finance transition as there is an increasing appetite of investors for these kinds

of assets. Whether the EU Green Bond standard will contribute to the development of this market depends on the attitude of the legislators and policymakers. The making of the EU Green Bond Standard is a good illustration of the fervor in regulating the European sustainable finance arena. The Taxonomy alone, with its faults stemming from its political nature, complexity, questionable usability, and lack of the transitional element (which we discussed in our previous papers⁴), will put to the test the attractiveness of the EU GBS. The European Parliament, driven by the willingness to fight greenwashing on the bond market, risks imposing an excessive level of requirements without compelling justification. As a result, the EU GBS may become the standard of highest purity but remain a niche instrument in the EU, and certainly not an attractive blueprint to be copied outside Europe. This would be a lost opportunity to help the market grow, which needs innovation, guidance, and close cooperation between private and public sectors, instead of overregulation.

⁴ <https://ercst.org/policy-brief-the-eu-taxonomy-what-next/>