Deutsches Aktieninstitut

EU Green Bond Regulation should properly reflect corporate practice

Make the standard voluntary, feasible, appropriate and flexible

Position Paper on the proposed amendments to the European Green Bond Standard Regulation adopted by the ECON committee of the EU Parliament, 1.7.2022

Introduction

Deutsches Aktieninstitut followed the legislative process regarding a Regulation on European green bonds (EU GBS) very closely expressing the view of bond issuers. As such, we have commented on the European Commission's proposal as well as on the discussion in the European Council and in the European Parliament.

The Commission, the Council and the European Parliament have **divergent views** on several contentious points, particularly (1) Taxonomy-alignment of the Use-of-Proceeds, (2) grandfathering clause, (3) transition plans at issuer-level, (4) the scope of the EU GBS and (5) the voluntary use of the EU GBS. In a nutshell, the **Parliament** has proposed to **extend and reinforce** EU GBS requirements, while the **Council** has advocated for **more flexibility** for issuers. Nevertheless, Deutsches Aktieninstitut notes that it is important to strike a balance between a strict oversight regime and innovation-friendly framework.

In this paper we scrutinize the final position of the Economic and Monetary Affairs Committee of the European Parliament adopted in May 2022. Although there are amendments which would increase attractiveness of the EU GBS from an issuer perspective, a lot of aspects would lead to an inappropriate level of additional costs and liability risk. As a consequence, we believe that issuers would refrain from applying the EU GBS which would in turn contradict the aim of the legislator "to further increase investment opportunities and facilitate the identification of environmentally sustainable investments through a clear label".

In particular, the following general principles should be properly considered:

- The nature of the EU GBS should remain **voluntarily,** the **scope should be restricted to EU green bonds** and should **not cover other environmentally sustainable bonds** and sustainability linked bonds.

- The EU GBS should be **feasible** and appropriately reflect common market practices like the **portfolio approach and the necessity of re-financing** large green projects like wind parks. In addition, auditors should also be allowed to perform the mandatory external reviews of impact reports etc.

- The EU GBS should be **appropriate** and should **not require transition plans** and the incorporation of bond details in the prospectus.

- The EU GBS should **provide flexibility** for issuers to supplement activities that are not yet covered by the Taxonomy requirements to a certain degree (**"flexibility pocket" approach**).

Nevertheless, there are some proposals in the ECON report that we very much welcome

- Both issuers and investors should be able to rely on the fact that a green bond will not lose its status even if there are changes to the Taxonomy. In its proposal, the ECON report clarifies that allocated bond proceeds shall not be required to be reallocated following a change to the delegated acts (partial grandfathering). This is a clear improvement over the Commission's proposal. However we agree with the stance of the Council wich proposes a full grandfathering clause. The regulation should make it clear that outstanding EU green bonds, regardless of subsequent changes to the screening criteria of the EU taxonomy, remain EU green bonds. The ECB opinion also supports full grandfathering on the basis that it would provide certainty for issuers and investors, and consequently facilitate the functioning and growth of the EU GBS market.[1]

- Furthermore, we welcome the proposal to extend the reporting deadline to 90 days following the end of the year (see Art. 9(6)).

- We appreciate the proposal stating that the issuer is allowed to settle the issuance costs from the proceeds of the issuance (see Art. 4(1)).

[1] https://eur-lex.europa.eu/legal-content/EN/TXT/?home=ecb&uri=CELEX:52021AB0030

1 The EU GBS should remain voluntary and not expand its scope

Green bond markets have grown steadily. According to the Climate Bonds Initiative more than 16,000 sustainable debt instruments have been used since 2007 with a cumulative volume of USD 2.8tn.[2] It is therefore not surprising that market standards have emerged. This is what the EU Commission also states: The use of existing standards for green bonds, developed by the market, is "widespread" and they are "commonly accepted as setting a standard"[3].

The proposal of the European Commission and the European Council ensure the co-existence with other green bond standards, e.g. the ICMA Green Bond Principles. In contrast, the ECON report proposes in Art. 63(2) that the European Commission should prepare an impact assessment two years after the EU GBS entered into force considering whether the standard should become mandatory.

Another significant amendment is the expansion of the documentation, reporting and certain other requirements of the EU GBS to all types of sustainable bonds (including social bonds, sustainability bonds and sustainability-linked bonds).

We strictly oppose these proposals for the following reasons:

- In the case of a mandatory EU GBS application for all green bonds, **many companies could be cut off from the entire sustainable bond market**, in particularly those issuers that are currently transforming their business model or whose activities are not yet covered by the EU taxonomy. This would contradict the legislator's goal of accelerating the transition to more sustainable business models and jeopardize the entire sustainable finance market.

- **Competition for the best standard** forces all standard developers – including the EU Commission – to continually improve their respective standards and adapt them to market trends. This competitive pressure would be lacking if the EU standard were to be mandatory.

- Mandatory disclosure requirements for all types of environmental sustainability and sustainability linked bonds would create an **unlevel-playing-field and could have the potential to dissuade ESG bond issuance in Europe alltogether**. European or international issuers would simply

[2] https://www.climatebonds.net/resources/press-releases/2022/04/sustainable-debt-topped-1trillion-2021-huge-volume-climate

[3] https://eur-lex.europa.eu/resource.html?uri=cellar:e77212e8-df07-11eb-895a-01aa75ed71a1.0001.02/DOC_1&format=PDF

switch to other financing sources, or access sustainable finance from other jurisdictions with less constraining and costly requirements. Small and medium-sized enterprises (SMEs) not having the necessary resources available to cope with the complex EU GBS, could be squeezed out of the sustainable finance market and return to bank finance which would put them at a competitive disadvantage.

- A mandatory regime could lead to a **fragmentation** of the international green bond market with the EU following different rules from an international market. We are not aware of any important bond market restricting the issue of green bonds to a specific disclosure standard. All of them provide flexibility for other standards, e.g. the ICMA principles. This can lead to a major disruption of the European green bond market and undermine the scale, liquidity and growth of sustainable capital markets globally.

- As the EU GBS is focusing on environmental features, rules covering environmental, social and governance categories under the EU GBS will become **unreasonably complex**.

- Furthermore, setting a concrete time period for the standard to become mandatory is not necessarily straightforward. **Making the standard mandatory could potentially result in market disruptions and volatility** in the green bond market, as investors would divest from than old and non-compliant green bonds

- With regard to a number of details the draft regulation grants power to the Commission to adopt delegated acts or regulatory technical standards that will have to be adopted a significant time after the regulation will have entered into force, partly 12 months, partly even (more than) 24 or 36 months). As long as these **delegated acts** or **regulatory technical standards** are **pending**, it appears **premature** to conduct a review on the functioning of the new regime to be esptablished under the draft regulation.

2 Do not restrict the feasibility

The EU GBS should build on best market practices. Against this background we suggest to evaluate the following points carefully:

- Although Art. 8 and 9 proposed by the ECON report allows the preparation of a factsheet and an allocation report for bond portfolios, the **portfolio approach** is limited to financial assets. As **fixed assets, capex und opex, which are relevant for non-financial green bond issuers** in particular, are not covered by the financial asset definition in Art. 5(2), **corporates are de facto excluded from the portfolio approach.** We do not see any rationale to **discriminate against corporate green bond issuers**. This will likely result in corporate issuers with large portfolios that otherwise comply with the EU taxonomy **refraining from using the EU GBS** as the reporting burdens will be too great.

- The proceeds of Green Bonds can be managed per bond (bond-by-bond approach) or on an aggregated basis for multiple green bonds (portfolio approach). **The Portfolio approach reporting covers several bonds, not an individual bond, financing many eligible projects**. It is typically for the portfolio approach, that the composition of the bonds and the eligible projects changes over the time. In a portfolio approach, a portfolio of several green bonds is used to finance a portfolio of green eligible projects (assets, capex and or opex). The issuer combines multiple components of a lot of projects (e.g. in the automotive sector thousands of small pieces) to one big portfolio. The portfolio of green eligible projects is dynamic over time, with new projects coming in and projects expiring / divested every year. This is especially relevant for frequent green bond issuers with eligible green projects from different Taxonomy compliant economic activities. **Furthermore, when eligible projects need to be replaced, this generally can be handled more efficient within a bigger portfolio than on a bond by bond basis**

- The **portfolio approach also offers several advantages for investors**: since the portfolio is dynamic, the issuer will create a new allocation and impact reports annually over the lifetime of its bonds (not only until full allocation as it is the case with the bond-by-bond approach). Furthermore, the issuer shows in the allocation report the proportion of new green eligible projects financed in the reporting year. A frequent issuer of green bonds produces only one allocation report covering all green bonds and also make it simpler for investors to access the information as they only need to look in one place for all their bonds holding of that issuer**. Investors will**

get the same information, no matter if he/she is looking into several individual reports or into a combined report for the whole portfolio.

- In contrast to the European Commission, the European Parliament **no longer explicitly allows a European green bond to be refinanced** by issuing a new European green bond. It should be clarified that it is not the explicit intention of the legislators to limit the application of the EU GBS to new project only, as the exclusion of refinancing would limit options for follow-up funding. Taxonomy-aligned activities, which are financed by green bonds in particular, are often long-term projects of 25-year (or more) lifetime, e.g. wind parks, which require long-term financing (and therefore re-financing) beyond the normal tenor of green bonds. Another example could be the refinancing of green construction projects that were financed in advance with a plain vanilla bond. Here, it should be possible for such projects to be refinanced with a green bond as well, as long as it meets the taxonomy requirements.

- We oppose the requirement proposed by the ECON report that the external review of the fact sheet, the allocation and impact report shall be designated **as prohibited non-audit service** (Art. 28). As auditors are already obliged to comply with many requirements addressing conflict of interests the exclusion is not appropriate. The auditor has the necessary expertise available to conduct a comprehensive and meaningful review. From the perspective of issuers “new” external review agencies have to become familiar with the company's processes which would involve additional costs.

3 Provide flexibility

The EU GBS should provide more flexibility for issuers to supplement activities that are not yet covered by the Taxonomy. As the Taxonomy does not yet cover all relevant activities, a certain degree of flexibility should be granted in terms of eligible activities/projects. Although we are aware that the acceptance of the EU GBS among investors would be highest by providing a strong link to the Taxonomy, limiting the use of proceeds to only those currently listed in the Taxonomy would significantly lower the opportunities for many potential issuers to become active in the market. In this context we suggest that the European Parliament and the European Commission should **follow the proposal of the EU Council to grant flexibility around the alignment of the use of proceeds** to the Taxonomy in cases where either the technical screening criteria are not directly applicable or have not yet been developed (see Council proposal for Art. 7 para. 1a).

4 Avoid inappropriate requirements

Inappropriate requirements like developing transition plans or the mandatory incorporation of bond details in the prospectus would negatively affect the attractiveness of the EU GBS.

Therefore, we see areas of improvement regarding the following points:

- The ECON report suggests requiring issuers of European green bonds and of sustainability-linked bonds to create, before issuance, **transition plans** indicating how the company as a whole will reach climate neutrality by 2050 at the latest (Art. 7b). Such obligations **could pose an additional hurdle to sustainable financing,** particularly for smaller issuers, which often face the conundrum of whether to focus on actual sustainability efforts or just reporting thereof. In additon **the proposal does not specify how external reviewers would be required to verify such plans**, nor develop the structure that such transition plan would take.

- According to Art. 6(2a) of the ECON position the requirements for **Taxonomy alignment plans** (capex plans) for green bonds shall be subject to a review by an external reviewer. The failure to achieve these targets twice would lead to the loss of the EU GBS designation, which is **an inappropriate punishment.**

- 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. Since the main risk, the loss of the designation "green", is already incorporated among the risk factors in the prospectus, **we do not see the necessity for the mandatory incorporation of further details (proposed in Art. 12).** Nevertheless, the issuer may also incorporate the pre-issuance fact sheet published on the website by reference on a voluntary basis. It is important to keep the prospectuses simple and short.

5 Welcome improvements

In its proposal, the European Commission specified that in the event of a change in the EU Taxonomy Technical Screening Criteria (TSC) after bond issuance, issuers can make use of pre-existing criteria for five more years. Due to this transition period, the clause is defined as a "partial" grandfathering. The ECON report agrees to keep the grandfathering partial but clarifies that allocated bond proceeds shall not be required to be reallocated following a change to the TSC. This is a clear improvement over the Commission's proposal.

However, we agree with the stance of the Council which proposes a full grandfathering clause. The regulation should make it clear that outstanding EU green bonds, regardless of subsequent changes to the screening criteria of the EU taxonomy, maintain their designation until maturity. The ECB opinion also supports full grandfathering on the basis that it would provide certainty for issuers and investors, and consequently facilitate the functioning and growth of the EU GBS market.[4]

Furthermore, we welcome the proposal to extend the reporting deadline to 90 days following the end of the year (see Art. 9(6)). In addition, we also appreciate the proposal stating that the issuer is allowed to settle the issuance costs from the proceeds of the issuance (see Art. 4(1)).

[4] https://eur-lex.europa.eu/legal-content/EN/TXT/?home=ecb&uri=CELEX:52021AB0030

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