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Policy Brief

# Turning green into gold

## How to make the European green bond standard fit for purpose

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#SustainableFinance
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Green bonds can play an important role when it comes to financing a more sustainable European economy. However, lack of transparency in today's market for them prevents green bonds from achieving their full potential. The European Commission's proposal for a European green bond standard (EuGBS) does little to fight greenwashing and foster investor confidence. To establish the EuGBS as the new gold standard, the European Parliament and EU Council should improve it in three respects. They should (i) strengthen its environmental credentials, (ii) regulate the entire green bond market and not just the EuGBS niche, and (iii) ensure the enforceability of investor rights. That way, a credible EU public standard can become the new benchmark on financial markets and make a positive impact on the environment.

The market for green bonds is growing at breathtaking pace. In 2021, banks for the first time earned more fees arranging green-related bond sales and loans than they did helping fossil-fuel companies raise money in the debt markets. Green bonds work like conventional bonds, but the money raised from investors is used exclusively to finance projects that make a positive environmental – aka 'green' – contribution, such as in renewable energy or energy-efficient buildings. More and more companies and sovereigns want to reap the reputational and financial benefits associated with the issuance of green bonds. Since demand has been outstripping supply, they trade at a premium compared to regular bonds – it is cheaper for companies to issue green bonds. This is good news as green bonds are meant to finance a substantial part of the transition towards a more sustainable European economy. Yet, there remains a problem in clearly measuring and comparing the contribution of green bonds towards improving the environment.

To date, the green bond market is entirely based on privately developed labels. They set out high-level guidelines or give process-based recommendations, but the underlying definitions of green projects lack standardisation and enforceability. Standards also vary regarding the information provided on the use of proceeds, making it impossible for investors to compare the

environmental performance of different green bonds. As they cannot be certain that their money is being used for legitimately green investment purposes, greenwashing is now the biggest challenge for investors. But this uncertainty about which economic activities can be rated green also creates difficulties for green bond issuers who are keen to avoid any accusation of greenwashing, especially in transitional sectors. Altogether, this opacity is preventing green bonds from growing to their full potential and creates the serious risk that large sums of private money is financing projects that do little or nothing for the green transition. The lack of high-quality green bonds is thus a drag on Europe's plan to become the world's first climate neutral region.

To shed light on the true 'greenness' of green bonds and foster investor confidence, the Commission proposed a European green bond standard (EuGBS) in July 2021. At the time of writing, the European Parliament and EU Council are debating the draft legal text and potential amendments. The Commission proposal is supposed to help investors identify, compare and trust in environmentally sustainable bonds and it does indeed raise the bar for green bond issuances. However, this paper argues that the proposal will fall short of establishing the new gold standard for several reasons. It has weak environmental credentials and therefore undermines its own credibility. It misses out on raising environmental ambitions for the entire green bond market by leaving untouched private labels that remain unregulated. And it is poor on creditor rights protection regarding the 'greenness' of how proceeds are used.

To establish the EuGBS as the new gold standard, EU member states and MEPs should improve the Commission proposal in three respects. First, the EuGBS should be split into two labels to allow for the introduction of a truly green "EuGBS+" that excludes not only nuclear power and natural gas investment, but any transitional activity. Second, the legislation should require all green bond issuers to provide comparable information on the 'greenness' of their use of the proceeds before the EuGBS becomes the mandatory standard over the medium term. Third, the EuGBS should come with an effective enforcement mechanism relying on national authorities and a minimum of actionable rights. A credible EU public standard could then become the new benchmark on financial markets and ensure that green bonds genuinely contribute to greening the European economy.

## 1 Features of the European green bond standard

Issuers of green bonds commit to spending the money raised from the investor on environmentally sustainable projects and activities. However, there is so far no common set of rules on what qualifies as a green bond. Issuers can choose from more than 20 industry-developed green bond labels that lack clarity, reliability, and enforceability. For example, ICMA's Green Bond Principles, the dominant market standard, relies on high-level principles for eligible green projects, not detailed criteria. As for CBI's more prescriptive Climate Bonds Standard, its privately maintained definitions omit many potential sectors of green economic activities. Working to make allocation and use of bond proceeds transparent and assure investors, many labels recommend issuers should publish pre- and post-issuance reports and seek verification from external reviewers. However, given their non-binding nature, existing standards remain unenforceable.

The EuGBS is different. It contains binding requirements for issuers wishing to put the EU label on their green bonds. However, the European Commission does not make the EuGBS mandatory for all green bonds. Green bond issuers would continue to be free to choose among the EuGBS and available privately developed labels.

The EuGBS rests on two legs. First, it is completely aligned with the EU Taxonomy that provides a harmonised definition of sustainable economic activities. These criteria are that an activity a) contributes substantially to at least one of the six specified environmental objectives; b) does not significantly harm any of the other five ('do-no-significant-harm-principle', DNSH); c) complies with minimum social safeguards, mainly in terms of fundamental labour rights; d) meets the technical screening criteria adopted by the European Commission for each objective.

The EU Taxonomy is the most detailed and comprehensive framework for classifying sustainable economic activities to date. It covers 13 sectors such as energy, transport, manufacturing and construction, which together account for nearly 80% of EU greenhouse gas emissions. However, it is by no means the strictest one given the Commission's decision to consider industrial logging and the burning of crops as sustainable and its intention to qualify nuclear power and natural gas as transitionally green. European green bonds must finance an economic activity that clears the bar set out in the EU Taxonomy or will do so within five years after issuance. Where the Commission amends the Taxonomy's technical screening criteria following the issuance of a European green bond, issuers have five years to reflect these changes in how they allocate bond proceeds.

Second, the EuGBS requires issuers to fulfil comprehensive disclosure requirements. Before issuance, they must publish a green bond factsheet outlining the intended allocation of bond proceeds to green projects and their estimated environmental impact. After issuance, they must regularly report on the actual allocation and impact of the green bond's proceeds. This is meant to provide investors with much greater transparency on how their money is used. With the aim of minimising the risk of greenwashing, green bond issuers are required to hire external reviewers who verify that the allocation of proceeds adheres to the EuGBS and projects align with the EU Taxonomy. External reviewers need to register with the European Securities and Markets Authority (ESMA) before verifying EU green bonds. In case of non-compliance, ESMA may issue penalties for external reviewers and national competent authorities may sanction green bond issuers failing to abide by the rules.

Since the EuGBS and the EU Taxonomy are still in the making, they cannot serve as a basis for the green bonds that the European Commission began issuing last year to finance part of the NextGenerationEU (NGEU) recovery fund. As outlined in Box 1, NGEU green bonds

create a class of their own: more transparent than many existing green bonds but not fully abiding by the rules of the EU Taxonomy.

**Box 1: The framework for NGEU green bonds financing the European recovery**

To finance the NGEU recovery fund, the European Commission intends to issue 30% of the up to EUR 750 billion debt as green bonds. However, since the EuGBS is still being discussed by the European co-legislators and the technical screening criteria of the EU Taxonomy are under development, the Commission ignores the EuGBS for its own green bond issuances. Instead, the green bond framework governing NGEU issuances is based on the current market benchmark, the Green Bond Principles (GBPs) established by the International Capital Markets Association (ICMA). For its own issuance, the EU Commission discloses allocation and impact reports reviewed by an external party as recommended within the GBPs. The criteria for the qualification of climate investment under the recovery and resilience facility (RRF), the main instrument of NGEU, borrow from the EU Taxonomy, but they are not entirely aligned with it. Instead, the methodology for climate tracking in Annex VI of the RRF Regulation and the specific DNSH RRF Guidance define which investments count towards the 37% green spending target required in member states' national recovery and resilience plans. Investment in building renovation will, for example, generally receive a 40% climate coefficient. If additional Taxonomy-aligned criteria are met, e.g. in the case of building renovation at least 30% reduction in energy use, the investment will receive a 100% climate coefficient. In contrast, investment in building renovation not meeting the EU Taxonomy requirements would not be eligible for green bond financing under the EuGBS. The NGEU green bond framework is thus on the one hand more lenient than the EuGBS. On the other hand, the NGEU climate tracking methodology provides incentives for member states to adhere to the stricter EU taxonomy requirements because that would allow for upgrading a 40% coefficient to 100%, where appropriate.

In many respects, the EuGBS as proposed by the European Commission would be superior to existing green bond labels. In terms of transparency, the EU Taxonomy provides a clear and harmonised definition of 'green', putting the vague principles listed by private labels in the shade. Under the EuGBS, regular reporting and external review are mandatory requirements and not mere recommendations. In addition, issuers as well as external reviewers are subject to national and European oversight. Nevertheless, the EuGBS is missing some important elements that prevent it from really improving comparability in the green bond market and ensuring a positive impact on the environment.

## 2 Room and ideas for improvement

There is a clear need for a harmonised green bond standard to be applied across Europe. However, the draft regulation on the table does seem ill-suited to effectively fight greenwashing and ensure that all green bond issuers keep their promises to use the bond proceeds for truly sustainable investment. Before the EuGBS becomes law, the EU Council and European Parliament should therefore improve it in three respects:

1) Strengthen environmental credentials
2) Regulate the entire green bond market
3) Ensure enforceability of investor rights

### 2.1 Strengthen environmental credentials

The Commission proposal is not ambitious enough when it comes to its environmental credentials. First, the alignment of the EuGBS with the EU Taxonomy means that transitional activities such as hybrid cars or electricity generation via nuclear power and natural gas are, under certain conditions, eligible for financing through European green bonds. While these technologies potentially reduce CO2 emissions, they are not low carbon or may cause other forms of environmental harm. The privately developed taxonomy of the Climate Bonds Initiative, therefore, excludes transitional activities from being eligible for green bond financing. Including them under the EuGBS would thus be weaker than an already established private label and heavily undermine the green credibility of the new public standard.

Second, issuers of European green bonds are not obliged to gradually align their entire business with the Paris Agreement and the 1.5 °C global warming target. It is sufficient for the investment in question to comply with the requirements of the EU Taxonomy. This practice prevents existing green bond projects from achieving a substantial reduction of carbon emissions at the firm level. There is thus the risk that issuers will use also European green bonds to finance certain activities cheaply without ever putting their entire company on a sustainable footing.

To become the gold standard, the EuGBS must be stricter than existing private labels. A truly green label cannot compromise on its environmental credentials. Only a credible standard will gain investor confidence and make a demonstrable contribution to the economy's green transition. Therefore, it must – from the outset – prevent potential allegations of greenwashing:

- The EuGBS label should be split into two. Both labels should respect the strict criteria laid out in the EU Taxonomy. However, there should be a differentiation between a 'normal' EuGBS that includes activities classified as transitional, and a more ambitious 'EuGBS+' that is beyond doubt and excludes transitional activities. Two labels would dissolve the conflict between, on the one hand, environmentally conscious investors calling for a harmonised and reliable green bond standard that is truly green and, on the other hand, the need to finance not only activities that are already green but those that may support the transition to a sustainable economy. Two labels would of course fragment the market for European green bonds and reduce liquidity, but it is preferable for the legislator to make this distinction in a transparent way rather than leave it to the market via pricing. Concerns that the EuGBS may not deviate from the EU Taxonomy are unjustified. Since the later law (EuGBS Regulation) always prevails over the earlier (Taxonomy Regulation), it would be legally safe to split the EuGBS into two labels.

- To minimise greenwashing concerns attached to green bonds that finance transitional activities, the standard should clearly prescribe that the maturity of these bonds must not go beyond these activities' eligibility under the EU Taxonomy. However, the requirement to mirror amendments to the Taxonomy's screening criteria in the allocation of bond proceeds within five years should be abandoned. Changing the requirements for bonds that have already been issued could have negative impacts on financial stability and would jeopardise legal certainty for both issuers and investors. For these reasons, the Commission's own technical expert group (TEG) and the European Central Bank (ECB) both recommend exempting bonds that have already been issued ("grandfathering"). Given green bonds' average maturity of 8.75 years, requiring only newly issued bonds to apply the latest screening criteria seems to be sufficient.

- The EuGBS should address also the broader environmental strategy adopted by green bond issuers and require them to align their overall activities with the EU's environmental objectives. Companies that wish to benefit from the reputational and financial benefits of issuing green bonds should back up any issuance with credible transition plans. Therefore, European green bond issuers should set out in the investor factsheet concrete steps on how they will adhere to a 1.5°C global warming scenario and make their business compatible with Europe's aim of climate-neutrality by 2050.

### 2.2 Regulate the entire green bond market

A strict EuGBS is a necessary condition for raising environmental ambitions on the green bond market, but not a sufficient one. The legislative proposal on the table would not affect private green bond labels. The introduction of another – albeit public – label alone will not put an end to the lack of transparency of the current market. Unless the current confusion about the green credentials of available private green bond standards is mitigated, investors will still face difficulties when trying to cut through the jungle of labels. Consequently, the lack of transparency in the green bond market is bound to persist – in particular, if the take-up of the EuGBS remains limited. Put differently: there is a material risk that after introducing the EuGBS, greenwashing will continue with unregulated green bonds.

As a first and immediate step to enable investors to compare the 'greenness' of bonds using different labels, certain disclosure requirements foreseen only for European green bonds should apply also to green bonds issued under other standards. For this purpose, these other bonds do not necessarily need to limit their use of proceeds to activities included in the EU Taxonomy. However, they should report on how much their use of proceeds is aligned with the EU Taxonomy. To provide reliable and comparable information throughout the green bond universe, all green bond issuers should disclose the EuGBS green bond factsheet as well as allocation and impact reports and they should seek verification by an external reviewer accredited at ESMA. This would mitigate the opacity of the existing green bond market and allow investors to make informed investment decisions. More generally, this would limit potential detriments to investors and increase the trustworthiness of the entire sustainable bond market.

In the medium term, establishing the EuGBS as the gold standard for green bonds will aid the greening of the economy only if *all* issuers make use of it. For fears of constraining the green bond market in the short term, the Commission rejected the idea of making the EuGBS mandatory for all green bond issuances in Europe. But if the EuGBS remains voluntary, issuers can continue to issue green bonds under other standards that may simply have no positive impact on the environment. To effectively support the green transition, there is thus no alternative to making the EuGBS mandatory for all green bonds sold in

the EU. While action to save the climate is needed sooner rather than later, there should nevertheless be an appropriate timeframe allowing issuers to prepare for the use of the EuGBS. Making it compulsory overnight could lead to unintended market disruptions. To provide issuers and investors with sufficient planning security, the standard should become mandatory for all green bond issuers no later than three years after its entry into force.

### 2.3 Ensure enforceability of investor rights

All good rules are of no use if their non-application remains without consequences. A key problem compromising investor confidence in green bonds is that the issuer's environmental promises are often unenforceable in practice. Either the issuer does not commit in the bond's legal documents to use the money raised for sustainable investments, but in a separate document that has no legal force. Or the green bonds' terms and conditions contain stipulations that exculpate the issuer from any liability if the bond proceeds are not used for environmentally-friendly purposes. The EuGBS as proposed by the Commission requires issuers to describe the sustainable use of proceeds in the green bond factsheet and to include this information in the prospectus, i.e. the legal document containing all relevant details of a public bond offering. Issuers violating these transparency requirements risk penalties from national competent authorities (NCAs). However, the Commission proposal does not give NCAs sanctioning or supervisory powers over the alignment of economic activities with the EU Taxonomy requirements. Furthermore, the numerous exemptions in the EU Prospectus Regulation mean that not every green bond has to have a prospectus. Last but not least, member states' liability regimes vary quite substantially with some countries even allowing issuers to limit civil liability in the contract. There is thus a big risk that issuers would face no consequences if the economic activities financed by a European green Bond turned out to be unaligned with the EU Taxonomy.

The EuGBS must provide legal assurance to investors that their money is invested in truly green projects. This is the prerequisite for investor confidence. To deter issuers from greenwashing, the EuGBS should be equipped with a two-pronged enforcement mechanism. First, NCAs should be empowered to check issuers' compliance with the EU Taxonomy alignment of the use of proceeds and to impose penalties in case of infringements. Second, the EuGBS should require issuers to include in the bond's legal documentation a minimum of actionable rights regarding the green use of proceeds that cannot be set aside except for reasons beyond the issuer's control. This requirement should not be limited to cases where the issuer must publish a prospectus but should apply to any green bond offering. It is only when provided with legal grounds for a lawsuit that investors can secure redress from civil courts. Strengthening investors' contractual rights would not only provide relief to authorities that may lack the capacity to go after every incident but is the sharpest weapon to ensure that green bond proceeds are used exclusively for sustainable purposes.

## Conclusion

Encouraging investment in an environmentally sustainable economy is vital for achieving Europe's goal of becoming the first climate-neutral continent by 2050. The green transition requires substantial funding, with a major contribution to the shift towards sustainable technologies and business models due to come from sustainable finance.

The dispute over the inclusion of nuclear power and natural gas in the EU Taxonomy has caused upset and uncertainty among financial market participants. The EuGBS should be kept out of the line of fire and make no compromise on the 'greenness' of eligible investments. This is the prerequisite for investor confidence. To green its economy, Europe needs not only more green bonds, but above all high-quality green bonds.

If the European Parliament and EU member states turn the Commission proposal into a strict and enforceable European standard, it can become the new benchmark on financial markets. This would not only serve the interests of pro-environment issuers and investors, but also a rapid transition to a sustainable economy.

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