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EU's taxonomy and green bonds regulations bolster sustainable finance market

Ana Luís de Sousa and Hugo Moredo Santos of Vieira de Almeida explain why 2021 marked a strong year for the construction of a stronger EU sustainable finance market

2021 proved to be a very relevant year for sustainable finance in Europe and may have paved the way for a turning point on the EU's sustainable finance market.

Since the enactment of the European Green Deal, a series of initiatives have been passed with the aim of making the goals approved by the European Green Deal on climate action a reality sooner rather than later, in response to a defining challenge of our time.

Among those initiatives, the following four are particularly worthy of mention:

- The European Climate Law (Regulation (EU) 2021/1119 of the European Parliament and of the Council of 30 June 2021), establishing a framework for the irreversible and gradual reduction of anthropogenic greenhouse gas emissions by sources and the enhancement of removals by sinks and setting out a binding objective of climate neutrality (i.e. net zero greenhouse gas emissions for EU countries as a whole) in the EU by 2050;
- The European Climate Pact, an EU-wide initiative which, acknowledging that everyone is affected by climate change and may contribute to spread awareness and help implementing solutions, invites all people to become part of the solution and come forward and share ideas and best practices;
- The 2030 Climate Target Plan, under which the Commission proposes to raise the EU's ambition on reducing greenhouse gas emissions to at least 55%, below 1990 levels, by 2030, with the aim of raising the bar in the EU-global commitment to achieve the EU climate-neutrality by 2050; and
- The EU Adaptation Strategy, setting out the strategies for the EU's adaptation to the inevitable impacts of climate change and become climate resilient by 2050.

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Achieving goals

Aligning action in all relevant areas is of paramount importance to ensuring that these initiatives and efforts are efficiently reconciled towards the defined objectives. One of the key areas in this regard is sustainable finance, where the Taxonomy Regulation and the expected Green Bonds Regulation play a critical role.

Taxonomy Regulation

The Taxonomy Regulation (Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020) establishes "the criteria for determining whether an economic activity qualifies as environmentally sustainable for the purposes of establishing the degree to which an investment is environmentally sustainable". It identifies six environmental objectives: (i) climate change mitigation; (ii) climate change adaptation; (iii) the sustainable use and protection of water and marine resources; (iv) the transition to a circular economy; (v) pollution prevention and control; (f) the protection and restoration of biodiversity and ecosystems. With the exception of "transition to a circular economy", the other five objectives were already contemplated in the ICMA Green Bonds Principles, a set of voluntary process guidelines commonly used to assess whether or not a bond can be labelled as green.

The Taxonomy Regulation is also expected to play a cornerstone role in the European Green Bond Standard given that the Green Bonds Regulation, discussed below, requires issuers to allocate 100% of the proceeds raised by their bond issues to economic activities that meet the EU Taxonomy requirements, by the time the bond matures.

Green Bonds Regulation Proposal

The Green Bonds Regulation proposal was presented in July 2021 as the backbone of the of the European Green Bond Standard. The existence of a standard brings obvious advantages to the entire investment ecosystem.

Issuers' credibility is reinforced, their commitment to sustainable finance and ability to assume a strategic position in a leading issue such as climate change gains greater visibility, and the risk of greenwashing and its potential adverse reputational impacts are reduced.

This is also good news for investors considering that the creation of a standard will not only help ensure that funds are actually used for projects with a real environmental impact, but will also identify which bonds are more suitable taking into account the investment profile/policy of each investor.

The European Green Bond Standard is thus expected to enhance transparency and trust, allowing both private and public issuers to more easily issue bonds whose proceeds will be specifically allocated to climate and environmentally-friendly investments, in a scenario of predictability and comparability, which protects investors (and the market in general) from greenwashing.

In the Q&A issued by the European Commission on the matter, the European Commission identified the following key features of the European Green Bond Standard:

- Inclusive – seeing as the use of this standard should be available to all types of issuers, public or private, corporates or banks, resident in the EU or abroad, with the aim of enlarging the number of potential issuers following a standard recommended and approved by the EU;
- Voluntary – as the Green Bonds Standard is not mandatorily applicable to does not make it mandatory for issuers and does not prevent them from using other standards already established in the market, including the aforementioned ICMA Green Bonds Principles and the Climate Bond Standards;
- Alignment with the EU Taxonomy – interlinking the Green Bonds Regulation with the Taxonomy Regulation
- Supporting issuers in transition – taking into account that European green bonds

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can be used to fund long-term projects (duration of up to 10 years) with an economic activity aligned with the EU Taxonomy;

- External review – requiring European green bonds to be subject to the assessment by an external reviewer registered with the European Securities and Markets Authority (ESMA) and subject to ongoing supervision, to ensure that the bonds comply with the Green Bonds Regulation, notably in what regards the Taxonomy-alignment of the projects in which the proceeds will be invested; and
- Grandfathering –contemplating that if there is a change in the EU Taxonomy Technical Screening Criteria (TSCs) after the relevant bond issue date, the respective issuer can still make use of pre-existing criteria for an additional period of five years.

Key features: a closer look

Inclusive

The proposal is based on the assumption that the EU regulation should not raise barriers in addition to those that may already arise from domestic laws. Even with respect to sovereign issuers, frequent issuers who account for a significant number of issues, they benefit from deviations to certain requirements with a view to enhancing flexibility in light of their specific nature, without prejudice to being required to comply with EU Taxonomy alignment.

Voluntary

As mentioned above, the Green Bonds Regulation is not designed to be the one and only standard to be used as a reference for issuing green bonds. This means that the Green Bond Standard will not set aside existing models, including the ICMA Bond Principles and the Climate Bonds Standard, but will rather allow issuers to elect which regime to use when issuing green bonds. The 'voluntary approach' mitigates the risk of hampering the positive moment that green bonds are currently experiencing.

We note that although the number and size of green bonds issues have significantly increased, they still represent a very limited portion of the overall market. In its 2019 Taxonomy Technical Report, the EU Technical Expert Group on Sustainable Finance identified a lack of offer of green bonds, when compared to demand, as evidenced by frequent oversubscriptions. On the other hand, although the proposed Green Bonds Regulation sets a demanding standard, it admits the existence of other standards which different issuers and investors may still find more attractive to use.

A 'mandatory approach' would have helped to decrease the risk of greenwashing by promoting the creation of high-quality green bonds: however, it could simultaneously raise a serious risk of market retraction, especially considering that the Taxonomy Regulation is still untested and its standards may have to be fine-tuned when its implementation comes into effect. All things considered, the proposed Green Bonds Regulation took a more cautious view and opted for the voluntary approach, backed by the intention of creating a competitive market that would stimulate both issuers and investors.

Alignment with the EU Taxonomy

The Taxonomy Regulation is intended to play a critical role in the fight against greenwashing. All market players are aware that this risk can undermine issuers' reputation, investors' trust and ultimately lead to failure in creating a dynamic and transformational green bonds market. One of the main problems in a domain so fundamentally dependent on certainty is the absence of clear definitions or differences between concepts currently in use, a situation that raises doubts and

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uncertainties. The fact is that the ICMA Green Bond Principles contain general principles but not concrete and detailed definitions, while the Climate Bonds Standard contain some definitions but fails to cover all relevant sectors.

The lack of definitions and standardization also raises additional costs for issuers, notably with respect to their own internal organization and the possible implementation of measures that may not be absolutely aligned due to the absence of exact references. To avoid exposure to these risks and fearing reputational damage, issuers may simply choose not to issue green bonds. As regards investors, the lack of definitions and standardization means that they have to devote time and resources to assessing information which would otherwise not be necessary.

In a nutshell, the existence of a taxonomy will foster greater certainty and comparability, thus better informing potential issuers' decision to issue green bonds and providing added comfort to investors when making investment decisions. More reliable information helps establish better conditions to strengthen the green bonds market and increases the possibilities of achieving the transformation envisaged by the European Green Deal.

External review

Interestingly, Articles 8 to 59 (out of 64) of the proposal for the Green Bonds Regulation are dedicated to external reviewers. This reveals the importance of independent external reviews in the issuance of green bonds.

On the one hand, the capacity and role of external reviewers differs if we compare the ICMA Bond Principles, which simply recommend external review without establishing any requirements applicable to external reviewers, to the Climate Bonds Standards, which requires mandatory external review but does not provide rules applicable to such reviewers. On the other hand, external reviewers issuing second party opinions – i.e. opinions confirming the alignment of green bonds with the ICMA Bond Principles or the Climate Bonds Standard, as the case may be – are still as unregulated as credit rating agencies were until the enactment of the Credit Rating Agencies Regulation in 2009.

With the approval of the proposed Green Bonds Regulation, significant changes will be introduced. First, external review will become mandatory, meaning that external reviewers shall provide a pre-issuance review of the European green bond factsheet, and post-issuance reviews of European green bond annual allocation reports. Second, only external reviewers, including from third-countries, who are registered and are subject to ongoing supervision by the European Securities and Markets Authority will be able to carry out the external review to European green bonds. Third, external reviewers will consequently be subject to ongoing supervision.

As previously mentioned, up until now, the market has used standards such as the ICMA Green Bond Principles and the Climate Bonds Standards. Portugal is no exception, having applied these standards since the first green bond issue (by EDP – Energias de Portugal SA in October 2018) up to the most recent issue (by GreenVolt – Energias Renováveis SA in November 2021).

There is a great deal of expectation around what the issuers and investors will require once the Green Bond Regulation is approved and put to the test together with the EU Taxonomy Regulation. However, one thing is certain: the development of pieces of legislation aimed at enhancing the market and raising confidence is always a good omen, especially when issuers and investors continue to have a safe harbour to be allowed to follow the standards that have successfully guided this growing market to its current dynamic form.