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ANALYSIS OF THE DRAFT EuGB REGULATION

On 6 July 2021, the European Commission published its proposal for a [Regulation on European green bonds](#) (“EuGBs”), which will be negotiated in the European Parliament and among Members in the European Council as part of the co-legislative process.

ICMA welcomes the proposed voluntary nature for the EuGB and the Commission’s intention to ensure its co-existence with the existing European and international green bond market. We also note that many of the recommendations of the [Technical Expert Group](#) (TEG) to which ICMA contributed as a member have been adopted. The provision allowing for Taxonomy alignment within a 5-year period is a strong positive allowing for the use of EuGBs in transition-enabling projects.

There are however areas of concern notably the absence of any of the flexibility provisions recommended by the TEG for alignment with the Taxonomy. We believe this may hinder among other things the potential for international uptake of the label. There is also only partial grandfathering for an EuGB if the Taxonomy criteria change during the life of the bond. This creates a number of significant challenges that we detail in this paper, which could very likely hinder the success of the label.

The draft Regulation also provides extensive rules for registration and supervision of external reviewers of EuGBs, which we do not analyse in detail in this paper. Readers may also find useful the detailed comparison table in annex that compares the TEG’s recommendations, the draft proposal, and the GBP.

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Voluntary Nature of EuGBs

The most notable feature of the draft Regulation is that it establishes a voluntary label. ICMA welcomes the proposed voluntary nature for EuGBs which is in line with the TEG’s recommendation. Accordingly, the draft Regulation also acknowledges that the EuGB label is built on current market best practices and aims to minimise the disruption to the existing green bond market. It also recognises the green bond market’s inherent international nature.

Main Features of and Requirements for EuGBs

The main features and requirements for EuGBs are mostly consistent with the TEG’s recommendations, which we welcome. In this respect:

- There is a mandatory requirement for the Use of Proceeds (UoPs) to align with the EU Taxonomy;
- Issuers are required to draw up a “Factsheet” document (specified under Annex I) and obtain a pre-issuance external review on it, both of which need to be published on the issuer’s website prior to public offering;

- Issuers are required to report annually on the allocation of proceeds until the proceeds have been fully allocated and issue an impact report at least once after the final allocation and during the lifetime of the bond; and
- Issuers are required to obtain a post-issuance external review on the final allocation report (except for FIs issuing portfolio-based EuGBs, who need to obtain an external review on each allocation report).

Divergences from the TEG’s Recommendations

Nevertheless, there exist some important divergences from the TEG’s recommendations under the draft Regulation.

Most notably, the draft Regulation does not accommodate the [TEG’s recommendation](#) to apply flexibility in relation to the requirement for EU Taxonomy-alignment where (i) the Technical Screening Criteria (TSC) may not be directly applicable because of the innovative nature, the complexity, the location, and/or other legitimate factors related to the projects or (ii) TSC have not yet been developed. This is likely to impede the potential uptake of the EuGB label and especially outside of the EU.

Secondly, the EuGB designation is not preserved for the entire maturity of an EuGB if the relevant Taxonomy criteria change during the life of the bond. This may lead to various concerns and practical challenges which are hard to fully anticipate and may eventually impede the success of the label. Also, the TEG’s recommendations for a potential methodology to convert activities into projects has not been included in the draft Regulation. We provide more details on these two issues below (see the section on *Taxonomy-alignment of the Use of Proceeds*).

Other divergences include:

- Well-established terminology on “Green Bond Frameworks” has been changed to “EuGB Factsheet”. Perhaps more significantly, the format for the EuGB Factsheet is prescribed in the Regulation in a way that appears to be structurally different to GBFs used by issuers currently.
- The draft Regulation describes CapEx and eligible OpEx more prescriptively¹.
- Also, UoPs as financial assets include debt and equity (the inclusion of equity is not a TEG recommendation), which can finance:
 - a. Fixed assets, CapEx and eligible OpEx; or
 - b. Other financial assets that finance the fixed assets, CapEx and eligible OpEx in line with the draft Regulation (i.e., the items listed in a.)².

¹ For the purposes of the EuGB Regulation:

- **CapEx**: either additions to fixed tangible and fixed intangible assets during the financial year considered before depreciation, amortisation and any re-measurements, including the additions resulting from revaluations and impairments for the financial year concerned, and excluding fair value or any additions to fixed tangible and fixed intangible assets resulting from business combinations.
- **OpEx**: direct non capitalised costs which relate to research and development, education and training, building renovation measures, short-term lease, maintenance and repair, and any other direct expenditures relating to the day-to-day servicing of fixed tangible or fixed intangible assets of property, plant and equipment that are necessary to ensure the continued and effective functioning of such assets.

² We understand that the primary intention under the point (b.) is to include the intermediated lending model which is common for development banks. Regarding equity finance, it remains unclear how such financing can be

Taxonomy-alignment of the Use-of-Proceeds (UoPs)

The draft Regulation contains detailed provisions on how/when to determine the Taxonomy-alignment of the UoPs. As the general rule, the UoPs should relate to activities that (i) already meet the Taxonomy requirements or (ii) that will meet the Taxonomy-criteria within a 5-year timeline in the context of a Taxonomy-alignment plan (which can be extended up to 10 years if justified and documented). This reflects the Commission's intention to render the EuGBs a useful and dynamic tool for financing the transition.

a. Timing of Taxonomy-alignment and timelines for Taxonomy-alignment plans

The determination of Taxonomy-alignment for fixed assets, CapEx and eligible OpEx, equity, and the listed sovereign expenditures will be made based on the Delegated Act (DA) applicable at the time of the EuGB issuance. The timeline for Taxonomy-alignment plan, (which we understand covers CapEx, eligible OpEx, and sovereign expenditures) starts accordingly as of the issuance date.

For debt (e.g., loans), the DA applicable is the one at the time of the creation of the debt. Where UoPs are allocated as financial assets (i.e., debt or equity) to CapEx and eligible OpEx under a Taxonomy-alignment plan, the timeline for Taxonomy-alignment starts from such date of the creation of respective financial asset.

We also note that while the draft Regulation states that an EuGB can be refinanced by a new EuGB, there is no specific provision on how/when to determine the Taxonomy-alignment of the refinancing EuGB.

b. Grandfathering of EuGB designation vs. the changes in the EU Taxonomy

Indeed, one of the most problematic issues is that EuGB designation will not be fully grandfathered for the full maturity of the bond. In case the relevant Taxonomy criteria change, issuers of EuGBs must apply the amended DA within five years after its entry into application. This means that only a partial and temporary grandfathering is allowed, and the TEG's recommendation for full grandfathering has not been adopted.

In this context, "grandfathering" can be understood as a provision in which an old rule continues to apply to some existing situations while a new rule will apply to all future cases. Those exempt from the new rule are said to have grandfather rights or acquired rights, or to have been grandfathered in.

We believe the lack of full grandfathering may create serious problems such as unpredictability of the EuGB designation both for issuers and investors, potential sudden devaluation in outstanding EuGBs in

practically ringfenced to the fixed assets, CapEx and eligible OpEx once provided. Under [the Climate Bond Standard v.3](#), the eligible equity financing is the following: "Acquisition costs/purchase price for an entity (company, division or similar) which holds physical assets or projects or share thereof which approximately corresponds to the Market Value of the physical asset or projects holdings".

case of changes to the Taxonomy. More generally, it may impede the uptake of and cause mistrust against the label as well as reluctance to invest in transitioning activities via EuGBs, etc. Our initial thinking on practical challenges includes:

- Does “*applying the amended DA within 5 years as of its entry into force*” mean that (a) an EuGB issuer must reallocate the funds to new eligible UoPs that will align with the amended DA, or (b) does it constitute an obligation to adapt its (already funded) assets or projects to the new version of the DA?
- In case of (a), what happens if the EuGB issuer does not have any new UoPs that are eligible under the amended DA? Will it lose the EuGB label automatically for its bond? How will this impact the pricing of the bond? Also, would such reallocation be imposed on the outstanding amount, or the full amount initially raised?
- In case of (b), how to ensure that this provision works consistently with the timelines under the Taxonomy-alignment plans? For example, it would be unrealistic to expect that a EuGB issuer with a 5-year Taxonomy-alignment plan changes its investment programme in the middle of its project due to the amendment of the DA. Or what happens if an EuGB issuer has a 10-year Taxonomy-alignment plan, but the TSC change in the 2nd year? Does this mean that the EuGB issuer must now change its Taxonomy-alignment plan and has only until the year 7 to complete the project?
- Does the obligation to “apply the amended DA within 5 years” go beyond an EuGB’s original maturity? For example, if the EuGB is a 5-year bond and the DA changes in the 3rd year after the issuance, will the EuGB issuer have only 2 years to apply the amended DA?
- How to treat dynamic portfolio based EuGB which may contain for example various loans which themselves may align with the different versions of the Taxonomy? How to make sure that FIs will remain keen to provide loans to transition sectors if they think the Taxonomy criteria may change and they need to exclude the previously Taxonomy-aligned loans from their portfolio within 5 years following the change and find new eligible UoPs?

c. Conversion of activities into projects

There is no provision on how to convert the EU Taxonomy’s activity-based approach to a project-based approach. The TEG’s [Usability Guidance](#) could be a starting point (p.16-18) as it had also promoted the idea of a “process-based” Do No Significant Harm (DNSH) and Minimum Safeguards, especially where Technical Screening Criteria are qualitative. In such cases, the DNSH requirements could be satisfied based on the presence of entity-level due diligence processes as well as of project-level permits and authorisations. However, these are currently not reflected in the draft Regulation.

d. Flexibility for sovereign issuers

There are two main flexibilities for sovereigns: (i) Taxonomy-alignment of the terms and conditions of the funding programmes is sufficient (i.e., there is no need for an external reviewer to confirm the Taxonomy alignment of each economic activity funded by such programmes) and (ii) state auditor/any other public entity can issue external reviews without being subject to the registration and supervision requirements of the draft Regulation.

Regulation and supervision of external reviewers

The draft Regulation sets forth overarching and detailed provisions on external reviewers of EuGBs. In this respect, external reviewers will register with ESMA before taking up any activity. There are also various organisational requirements, processes, documents concerning governance, including a requirement to mitigate potential conflicts of interests. There are also detailed rules on (i) pre-issuance and post-issuance external reviews; (ii) provision of services by third-country external reviewers; and (iii) supervision by competent authorities and ESMA, etc. A more detailed analysis is needed to understand the consistency of this regulatory regime of external reviewers with the existing market-based guidance for external reviewers, but a move towards regulatory oversight of external reviewers is likely to be welcomed by some market participants.

Annex - Detailed comparison of the draft Regulation with the TEG recommendation and the GBP

Matter	TEG's recommendation	Draft Regulation	GBP
Framework document	Mandatory publication of a Green Bond Framework (GBF), <u>before or at the issuance.</u>	Terminology changed to a “factsheet” which should be published <u>before</u> the issuance. The structure of the proposed Factsheet under Annex I is structurally different than the GBFs currently used by issuers in the market.	GBF is a “key recommendation” for heightened transparency under the GBP version 2021.
Use of proceeds – Taxonomy Alignment	Mandatory Taxonomy-alignment with exceptions recommended for: (i) specific cases where the TSC may not be directly applicable and (ii) where the TSC have not yet been developed.	<p>Mandatory alignment is maintained; but <u>the TEG’s recommendation on the exceptions is not included.</u> It seems that activities for which TSC have not yet been developed cannot be included in a EuGB. Also, there will be no flexibility for location-based exceptions or innovative nature of projects.</p> <p>There are also specific provisions on the Taxonomy-alignment of the use of proceeds, which include the following:</p> <ul style="list-style-type: none"> • Possibility to meet the Taxonomy criteria with a Taxonomy-alignment plan (which shall describe the planned actions and expenditures) within 5 years from the issuance (or 10, if justified with specific features); • Taxonomy-alignment determination for fixed assets, CapEx, eligible OpEx, the listed sovereign expenditures/assets, and equity (Art.5) will be based on the Taxonomy criteria at the time of the EuGB issuance, while, for debt (e.g., loans) will be based on the time of the creation to the debt. 	<p>Recommendation on voluntary disclosure of official and/or market-based Taxonomy-alignment has been introduced in the 2021 version of the GBP under the Pillar 2 on the Process for Project Evaluation and Selection.</p> <p>Under the GBP, issuers should also communicate the complementary information on processes by which they identify and manage perceived social and environmental risks associated with the relevant projects. Issuers are further encouraged to have a process in place to identify mitigants to known material risks of negative social and/or environmental impacts from the relevant project.</p>
Use of proceeds – Eligible UoPs	<p><u>Eligible use of proceeds:</u></p> <p>(i) physical assets and financial assets;</p> <p>(ii) CapEx and selected OpEx (with a 3-year lookback period);</p>	<p><u>Eligible use of proceeds are:</u></p> <p>(i) Fixed assets;</p> <p>(ii) CapEx;</p> <p>(iii) OpEx – with a 3-year lookback limitation;</p> <p>(iv) Financial assets (i.e., debt and equity) which can only finance (i); (ii); and (iii) above, but not other financial assets except</p>	Green Projects include assets, investments and other related and supporting expenditures such as R&D that may relate to more than one category and/or environmental objective.

	(iii) relevant public investments, expenditure, and subsidies (for sovereigns).	where such financial assets are financing other financial assets with the proceeds allocated to fixed assets, CapEx and eligible OpEx (as defined under the draft Regulation).	
	Refers to “an amount equivalent to the net proceeds net proceeds”.	Proceeds should be allocated without deducting costs.	GBP refer to “the net proceeds of the Green Bond, or an amount equal to these net proceeds”.
Reporting (Allocation)	(At least) annual reporting until the full allocation has been recommended by the TEG.	Annual allocation report requirement is maintained and will be based on a template under Annex II . Art. 9(6) limits the period when the final allocation report should be submitted, which may prove impractical.	Annual allocation reporting under the draft Regulation is consistent with the GBP’s Pillar 4 on reporting (except the timing limitation under Art.9(6)).
Reporting (Impact)	At least once during the bond’s lifetime and after the full allocation of proceeds.	TEG’s recommendation is maintained without any change; Annex III will provide a template for impact reporting.	Both the TEG’s recommendation and the draft Regulation require less than the GBP that recommends annual impact reporting under the Pillar 4 on Reporting.
External reviews (Pre-issuance)	Mandatory (<u>pre- or at issuance</u>) external review on the GBF.	Requirement maintained as <u>pre-issuance</u> external review of the “Factsheet” while the elements of the review are set out in Annex IV .	Pre-issuance review of the GBF is a “key recommendation” for heightened transparency.
External reviews (Post-issuance)	Mandatory post-issuance review of the final allocation report.	TEG’s recommendation is maintained; however, FIs using a portfolio-based allocation need to obtain post-issuance review on each allocation reports. Also, Art. 9(6) limits the period when post-issuance report on the final allocation should be submitted and made public, which may prove impractical.	The post-issuance review of issuers’ management of proceeds (e.g., internal tracking) and allocation of funds to eligible projects is a key recommendation.