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From:	Commission
To:	Working Party on Financial Services and the Banking Union (Sustainable Finance) Financial Services Attachés
Subject:	Non-Paper by the Commission Services on Proposal for a Regulation on European green bonds CWP meeting of 3 September 2021

This non-paper further explains selected aspects of the **Proposal for a Regulation on European green bonds (EuGB)**, with a particular focus on Titles I and II of the proposal.

The EuGB standard – how would it work?

While conventional bonds typically raise financing based on the strength of the entire balance sheet of the issuer and the level of debt it can support, green bonds are an innovation that focuses on green use-of-proceeds. This provides transparency for investors on the green projects that are being financed or refinanced, as well as additional information on the management of proceeds, impact reporting, and external reviews. The EuGB proposal incorporates the use-of-proceeds approach.

1) Who can issue using the EuGB standard?

The EuGB standard is a voluntary standard that can be used by any issuer including EU and third-country private companies and public authorities. While the decision by the issuer to adhere to the requirements of the EuGB standard is voluntary, once an issuer chooses to use the standard it must then comply with all of the requirements (particularly Articles 3-13).

All types of bond issuers can issue European green bonds, including non-financial companies, financial companies, special purpose vehicles, governments, and other public bodies. Different types of bonds, also including covered bonds, asset-backed securities, and project bonds[1] can be issued as European green bonds, provided they meet the requirements of the proposed Regulation at all times.

Issuers remain free to continue using alternative standards such as the Green Bond Principles of the International Capital Markets Association or the standard of the Climate Bonds Initiative, instead of the EuGB. The EuGB standard will represent a gold standard for green bonds with distinct advantages, such as the transparency and reliability provided by the close link to the detailed definitions of environmentally sustainable economic activities provided by the EU Taxonomy, as well as the requirement for external reviewers to be registered with ESMA.

2) What type of green economic activities can be financed by European green bonds?

The key requirement of the EuGB proposal (Article 6, EuGB) is that issuers must allocate 100% of the proceeds of the bond issuance to economic activities that either (1) meet the requirements set out in the EU sustainable finance Taxonomy, or (2) demonstrate that they will meet those requirements by the time the bond matures. This is in line with Article 4 of the Taxonomy Regulation, which requires that the EU shall apply the criteria of the Taxonomy Regulation to determine whether a bond is environmentally sustainable for the purposes of establishing such a standard. Those criteria are set out in Article 3 of the Taxonomy Regulation, and include: Substantial Contribution, Do No Significant Harm (DNSH), Minimum Safeguards, and the Technical Screening Criteria (TSC) set out in relevant Delegated Acts.

[1] Project bonds are bonds that are financed by the cash-flow of ring-fenced projects, and where the investor only has recourse to the project's assets and balance sheet.

3) What type of green assets and expenditure can be financed by European green bonds?

The EuGB proposal requires the proceeds of the bond to be "allocated" to different types of assets and expenditure that must be related to an economic activity that is Taxonomy-aligned according to Articles 6 and 7. The issuer must show in their allocation reports that there is a set of such assets and expenditures whose sum value equals or exceeds the total value of funds raised by the bond.

Typically, assets refer to a stock existing on the issuer's balance sheet, while capital and operating expenditure refer to a yearly flow. For this reason, the financing of assets will typically be backwards-looking while the financing of capex and opex will be on an ongoing basis (the exception being the re-financing of opex for which there is a three-year look-back period. Because capital expenditure is capitalised, it is assumed that a given amount of capital expenditure in year x will be converted into an equivalent amount of assets as of year x+1.

For corporate issuers, the standard differentiates among four types of assets and expenditure:

Type	What is it?	Time-related conditions
Physical assets	Green assets can be tangible, such as property, plant and equipment, or intangible, such as a patent. Household assets, such as a house or a vehicle, are also included. The asset must already relate to an economic activity that is taxonomy-aligned as per Articles 6 and 7.	The re-financing of existing assets on the issuer's balance sheet is allowed, with no time limit (in other words, the "look-back period" is unlimited).
Financial assets	Can include debt (typically loans), as long as the proceeds of that debt are allocated fully to assets or expenditures that are related to taxonomy-aligned economic activities as per Articles 6 and 7. One example is a bank that has a portfolio of mortgages financing the acquisition or construction of buildings that are EU Taxonomy-aligned, to which the proceeds of European green bonds could be allocated. Equity is included for completeness, but the requirement to allocate proceeds exclusively and fully to Taxonomy-aligned economic activities still applies.	As for non-financial assets, there would be no time limit (in other words, the "look-back period" is unlimited).
Capital expenditure (CapEx)	Includes the issuer's capitalised expenditure, i.e. any expenditure that adds to the fixed tangible or intangible assets of the company. This could be construction costs, acquisitions, refurbishments, etc. (see exact definition in Article 4). If the expenditure is aimed at an economic activity that is not yet taxonomy aligned (but that will be so in the future), the requirement to draw up an EU Taxonomy- alignment plan applies (see Article 6, which is covered in point 6 below).	In each of the years following the issuance of the bond and until the bond's maturity, the issuer may allocate bond proceeds to finance capital expenditure.
Operating expenditure (OpEx)	Includes maintenance costs related to green assets, that either increase the lifetime or the present or future value of the assets, education and training costs related to green assets, as well as relevant research and development (R&D) costs (see exact definition in Article 4). If the expenditure is aimed at an economic activity that is not yet taxonomy-aligned (but will be so in the future), the requirement to draw up an EU Taxonomy-alignment plan applies (see Article 6, which is covered in point 6 below).	As for capex, for each year following the issuance of the bond and until maturity, the issuer may allocate bond proceeds to finance eligible operating expenditure. The issuer may also allocate bond proceeds to finance eligible operating expenditures that were incurred up to three years before issuance of the bond (this is known as the look-back period).

Table 1: Use of proceeds available to all EuGB issuers

High level examples of eligible green projects (corporate sector, climate-mitigation objective)

Example 1 – Physical assets (windfarm)
Company A develops, constructs and operates windfarms. It is planning to build a portfolio of six facilities amounting to 500 MW and looks for financing sources. Company A could issue a European green bond to diversify its financing sources. The proceeds could be allocated to (re)financing the windfarms themselves and also to the costs for connecting the project with the grid. This project should be included as assets and/or capex in the issuer's allocation report. The windfarms would need to comply with the relevant Taxonomy Technical Screening Criteria (TSCs) for Substantial Contribution and Do-No-significant-harm set out in Point 4.3 ("Electricity Generation from wind power") of Annex I to the Commission Delegated Regulation setting out TSCs for climate mitigation.

Example 2 – Financial green assets (mortgage loans)
A bank is looking to finance a growing portfolio of EU Taxonomy-aligned real estate mortgage loans. The bank can do it by issuing European green bonds, either not secured by these loans (e.g. senior green bonds), or secured by these loans (e.g. covered bonds, asset-backed securities, etc.). The loans are the financial green assets, which are ultimately linked to real economy green investments. Under the EuGB proposal, the bank would have to ensure that all loans funded by EuGBs are allocated to finance EU Taxonomy-aligned assets or expenditure.

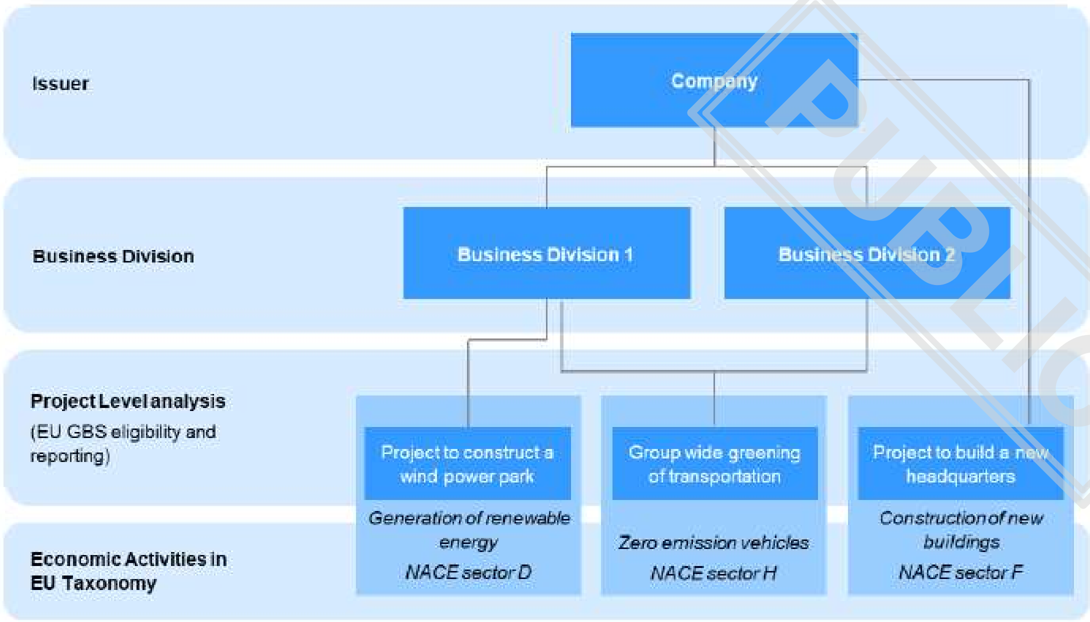
Example 3 – Leasing - Real Estate (capitalization)
The owner (lessor) or financier of real estate can issue a European green bond against the asset, whereas the occupier (lessee) of the building would not. Similarly, where the owner invests in a green refurbishment (expenditure that can be capitalized) this could be financed via a European green bond.

In examples 2 and 3, the real estate assets financed by each of these loans would need to comply with the relevant Taxonomy TSCs for Substantial Contribution and Do-No-significant-harm set out in Point 7.7 ("Acquisition and Ownership of buildings") and/or potentially in Points 7.1 and 7.2 ("construction of new buildings" and "renovation of existing buildings") of Annex I to the Commission Delegated Regulation setting out TSCs for the climate mitigation objective.

Example 4 – Research and Development
A power equipment manufacturer conducts R&D to develop a new generation of more efficient wind farm technology. R&D expenses, including CapEx and associated OpEx, may be financed via a European green bond. The R&D activity would need to comply with the relevant Taxonomy TSCs for Substantial Contribution and Do-No-significant-Harm set out in Point 9.1 ("Close to market research, development and innovation") of Annex I to the Commission Delegated Regulation setting out TSCs for the climate mitigation objective.

Example 5 – Refinancing, asset-related costs
Hydropower plant: A power producer owns and uses several hydro power plants that it has built or acquired during the last 20 years. The company may refinance the acquisition and building costs, as long as the plants meet the Taxonomy TSCs for substantial contribution and Do-no-significant harm (set out in Point 4.5 "Electricity generation from hydropower" of the Commission Delegated Regulation setting out TSCs for the climate mitigation objective) and continue to be in use. Also, they may include in the use-of-proceeds maintenance, efficiency improvement and upgrading costs accumulated during the three years preceding the issuance of the bond. The operating costs for running the plants cannot be included.

Table 2: High-level examples of eligible projects



Graph 1: Schematic overview of identification of EU Taxonomy-aligned projects within a company

4) How does allocation work?

There are two alternative ways in which allocation can work in the EuGB standard:

"Gradual approach": Article 7 of the EuGB proposal requires that issuers allocate their proceeds to one of the assets and expenditures set out in Article 4, and only to activities that are EU Taxonomy-aligned. Under this "gradual" approach to allocation, the allocation of proceeds is done gradually until full allocation is complete, and each annual allocation report must describe all proceeds allocated so far for each EuGB, cf Article 9. When an asset or expenditure has been allocated to a European green bond, it cannot subsequently be allocated to a different European green bond (i.e. no double counting is allowed).

"Portfolio approach": the proposal provides for an alternative method of allocation, for issuers making use of the portfolio approach, cf. Article 9(5). Those issuers must publish yearly allocation reports showing that the total amortised amount of eligible financial assets cf Article 5 equals or exceeds the total outstanding value of European green bonds, cf Annex II, section "3. Allocation of bond proceeds", sub-section B. For such issuers, the entire bond portfolio should be considered to be "re-allocated" every year, which is why external review of every allocation report is required. The portfolio approach is only usable for financial assets, such as loans.

5) How does grandfathering work?

Article 7 describes which EU Taxonomy Delegated Acts the issuer must make use of when allocating proceeds. These rules differ depending on the type of asset to which the issuer is allocating bond proceeds.

Article 7(1): In the case that proceeds are allocated to Opex, CapEx, or assets that are not financial assets, the issuer shall make use of the Taxonomy Delegated Acts in force when the bond was issued. If those delegated Acts change at some point after bond issuance, the issuer shall have five years from the entry into application of the new Delegated Acts before they must start allocating proceeds from an outstanding bond according to the new Delegated Acts. This requirement shall only apply to proceeds that have not yet been allocated – already allocated proceeds do not have to be reallocated.

Article 7(2): In the case that proceeds are allocated to financial assets, the issuer shall make use of the Taxonomy Delegated Acts in force when the relevant financial asset was created. If the delegated Acts change at some point after the creation of the financial asset, then there is a five year grandfathering period, after which time the financial asset may potentially no longer be considered eligible for use of proceeds of the European green bond (if it is not longer aligned with the TSCs).

In the case of the gradual approach mentioned in point 5, this would not affect those financial assets to which proceeds of the bond had already been allocated (i.e. financial assets having already been "refinanced" by the bond"). However, in the case of the portfolio approach mentioned in point 5, those financial assets that are no longer eligible under Article 7(2) would no longer be considered eligible for the yearly allocation, and would have to be removed from the portfolio of EuGB eligible loans.

6) How can European green bonds be used as transition tools?

There are three main ways in which the European green bonds can be used by companies to supports their sustainability transition:

1. **Funding long-term projects:** Issuers may use European green bonds to fund multi-year EU Taxonomy-alignment projects, such as converting a production facility (e.g a steel or cement plant) to reduce its emissions and meet the taxonomy thresholds. The condition is that the transformation results in an EU Taxonomy-aligned project in the end. In this case (the funding of CapEx), Article 6 sets out the requirement for the bond issuer to draw up an EU Taxonomy-alignment plan, explaining how the project will meet the Taxonomy-alignment criteria within five years(or if especially justified up to ten years). In any case, projects must be EU Taxonomy-aligned before the bond matures, so there cannot be a 10-year Taxonomy-alignment plan for a 5 year bond[2].
2. **Step-by-step transition towards EU Taxonomy-alignment:** A company could issue a European green bond to acquire or construct an EU Taxonomy-aligned asset, such as a new energy-efficient headquarters. This way, the company is gradually increasing its share of Taxonomy-aligned assets.
3. **Transitional activities:** the EU Taxonomy sets out a range of criteria for 'transitional activities', such as cement and steel manufacturing, or non-carbon neutral transportation. Companies operating in these sectors may use European green bonds to fund their transition to Taxonomy-alignment.

7) What are the requirements for European green bonds with regards to transparency and external review?

The standard for European green bonds follows current market best practice on transparency and external review.

Before issuing the bond, issuers will be required to publish a '**green bond factsheet**' setting out the environmental objectives of the bond and its concrete funding goal, at project level if available. This

[2] The importance of the date of bond maturity as the deadline for reaching Taxonomy-alignment follows from Article 4, as otherwise the bond would mature (and the EU GBS requirements lapse) before the bond reaches its goal of funding Taxonomy-aligned activities.

factsheet will be subject to a 'pre-issuance review' by a registered external reviewer, to ensure that the bond meets the requirements of the EuGB Regulation.

Once the bond has been issued, issuers will be required to publish **yearly allocation reports** showing how they are allocating the proceeds of the bond to Taxonomy-aligned projects. Once all the bond proceeds have been allocated (this must happen before the bond matures), the issuer will be required to obtain a 'post-issuance review'. For issuers making use of the portfolio approach, the point of full allocation should normally be reached every year. Therefore, the requirement to obtain a post-issuance review will be yearly for those issuers.

There will also be a requirement to publish at least one **report on the aggregate environmental impact** of the bond, before maturity of the bond.

8) Does the proposed standard for European green bonds allow flexibility for SMEs?

For larger corporate issuers who choose to issue bonds according to EuGB there is an obligation to include a reference to the European green bond in their prospectus. As certain smaller bond issues are exempt from the obligation to publish a prospectus, it follows that these issuers would also be exempt from the European green bond-related obligations related to the prospectus.

9) What are the different types of assets and expenditure to which sovereign entities may allocate EuGb proceeds?

According to Article 4(1) EuGB, sovereigns may allocate proceeds to the same uses as non-sovereign issuers, namely to non-financial fixed assets, financial assets, capex and opex (see point 3 above).

In addition, sovereigns may allocate proceeds to the one or more of the items listed under Article 4(2) EuGB, which are drawn from the European System of National and Regional Accounts in the EU Regulation (see Table 3 below).

Type of item (and location in Annex A to the European system of national and regional accounts)	**Definition (according to the European system of national and regional accounts)**
Fixed assets - 7.22 (exact reference is provided in 7.23)	Fixed assets which are used repeatedly or continuously in production for more than one year
Non-produced non-financial assets - 7.24	Economic assets that come into existence other than through processes of production. They consist of natural assets, contracts, leases, licences, permits, and goodwill and marketing assets.
Tax relief - 20.167	Tax relief can take the form of a tax allowance, exemption, or deduction — which is subtracted from the tax base — or of a tax credit — which is subtracted directly from the tax liability otherwise due by the beneficiary household or corporation. Tax credits can be payable, in the sense that any amount of the credit that exceeds the tax liability will be paid to the beneficiary.
Subsidies - 4.30	Current unrequited payments which general government or the institutions of the European Union make to resident producers.
Capital expenditures - 20.104	Capital expenditure comprises capital transfers, in the form of investment grants (D.92) and other capital transfers (D.99), as well as investment expenditure: gross capital formation (P.5, which consists of gross fixed capital formation — P.51g, plus changes in inventories — P.52, and acquisitions less disposals of valuables — P.53); and acquisitions less disposals of non-

	produced non-financial assets (NP). Disposals of non-financial assets, such as buildings, are not recorded as revenue, but as negative capital expenditure, making the net lending/net borrowing (B.9) more positive.

Table 3: use of proceeds available to sovereign EuGB issuers, in addition to those listed under Article 4(1)

10) How does the flexibility for sovereign issuers work?

There are two types of flexibility foreseen for sovereign issuers (states, local authorities, etc) of European green bonds:

1) The ability to use state auditors or other public auditing entities instead of registered external reviewers, in particular to review the allocation report (i.e. the post-issuance review). These entities are statutory entities with responsibility for and expertise in the oversight over public spending, and typically have legally guaranteed independence. Therefore, public authorities should be able to make use of such entities for the purposes of the external review of their own EuGBs. The EuGB proposal does not require that such state auditors or entities be registered or supervised by ESMA or by any other supervisor.

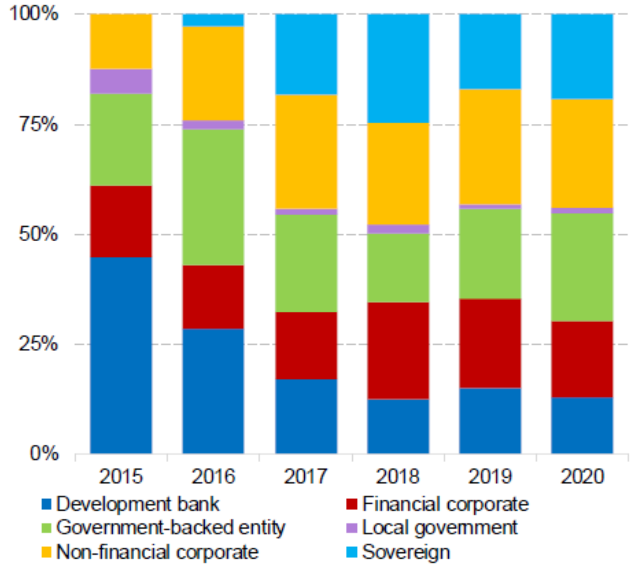
> A few examples of current market practice:
>
> - some Member States such as Ireland and the Netherlands use a private external reviewer such as Sustainalytics to provide the second party opinion and to review the annual allocation reports of their sovereign green bonds. The Netherlands also regularly obtains independent verification of its sovereign green bond by the independent Internal Auditor of the Dutch State.
> - France established The Green OATs Evaluation Council, which oversees its impact reporting. As part of the budgetary process, expenditure data is also audited and certified by the French Court of Auditors with additional auditing by KPMG and a second party opinion by Vigeo Eiris.

2) An exemption from having to demonstrate project-level EU Taxonomy-alignment for certain public expenditure programmes, such as funding or subsidy programmes and tax relief schemes. Given the greater complexity and scale of such funding programmes and the nature of this activity being unique to sovereigns, sovereigns are not required to demonstrate EU Taxonomy-alignment at the individual project level. In those cases (for example a subsidy-scheme for home-owners to install solar panels), it will be enough for the sovereign to show that the objectives and principles of the funding programme are taxonomy-aligned in its terms and conditions.

> A few examples of subsidy-schemes that may potentially be Taxonomy-aligned (in parenthesis, section of Taxonomy Climate Mitigation DA Annex I)
>
> - Subsidy for buildings owners to improve energy and water efficiency (7.2, 7.3, 7.5),
> - Subsidy for buildings owners to install electric car charging stations (7.4)
> - Subsidy for buildings owners to install renewable energy technologies including solar panels, wind turbines, heat pumps, batteries, etc (7.6),
> - Subsidy for procurement of Taxonomy-aligned passenger transport vehicles, such as electric vehicles (6.3) or cargo-bikes (6.4)
> - Subsidy for research, development, and innovation of solutions, technologies, and processes dedicated to the reduction, avoidance, or removal of GHG emissions (9.1).
> - Subsidy for afforestation and reforestation measures (1.1- 1.3)
> - Subsidy for environmental protection and restoration activities (2.1)
> - Subsidy for bringing data processing and hosting facilities in line with Taxonomy (8.1)

<u>Annex 1:</u> What types of issuers are issuing green bonds today?

Chart 3.8: EU green bond issuance by issuer type



Source: Climate Bonds Initiative. DG FISMA calculations.
Note: Market share is based on issuance size.

<u>Annex 2: Comparison of ICMA, CBI, and EU GBS proposal</u>

How does the standard for European green bonds relate to other green bond standards (e.g. ICMA's Green Bond Principles, Climate Bonds Initiative's Climate Bonds Standard)?

European green bonds are based on market best practice and the standard is designed to be compatible with existing market standards for green bonds. However, it also goes further than market-based standards in certain key aspects, including by requiring full alignment of funded projects with the EU Taxonomy, and by establishing a regime for the registration and supervision of external reviewers.

	ICMA Green Bond Principles	**Climate Bonds Initiative**	**European green bond standard (proposal)**
Reach	Dominant international standard (used by most green bonds)	24% of all green bonds issued in 2020	Too soon to tell
Environmental Objectives	Climate mitigation and adaptation, natural resources, biodiversity, and pollution prevention and control.	Low-carbon and climate resilience	6 Environmental objectives of Taxonomy
Main requirements on use of proceeds	100% green (High level categories for eligible projects)	100% aligned with Climate Bonds taxonomy (covering eight sectors)	100% aligned with Taxonomy Regulation
Screening criteria	N/A	Available for some sectors, including power generation, transport, buildings, and others.	Taxonomy technical screening criteria
Grandfathering	Until bond maturity	Until bond maturity	Until 5 years after Delegated Acts are published
External review requirements	Recommended	Pre-issuance certification required	Mandatory pre-issuance review Mandatory post-issuance review

		Post-issuance certification required (2 years after issuance)	(upon full allocation, or every year for portfolio approach)
Requirements for reviewers	High level guidelines for external reviewers	External reviewers must be pre-approved by CBI. High-level requirements	Registration and supervision by ESMA
Reporting requirements:	Green bond framework required Impact report recommended	Green bond framework required Allocation report required Impact report recommended	Green bond factsheet required Allocation report required annually Impact report required once

Annex 3: A sample of potential EuGB–aligned projects

It is difficult to assess potential use of the EuGB standard today, as the usage potential will depend not just on the Taxonomy-alignment of existing assets, but also on future green investments that the public and private sector undertake.

In a September 2020 report[3], the consultancy EY identified over € 20 billion worth of Taxonomy-aligned and "shovel-ready" projects, spread over several sectors (energy, transport, buildings, industry, and land use). This figure should be interpreted as a lower bound, as the study estimates that the true potential for such projects is much higher. These projects are developed and only need a last push (which could be additional financing, or overcoming other barriers) to be realised. These projects may be potential candidates for funding by European green bonds (either by corporates or sovereigns) as capital expenditure. The table below contains a few examples from the report.

EE	Tuuletraal	€ 553 Mn	Tuuletraal Offshore Wind Power Project (380MW)
EL	Power Transmission Operator (IPTO or ADMIE)	€ 1 Bn	Interconnection Athens –Crete
EI	CodlingWind Park Ltd	€ 1,962 Bn	The 1,100MW Codling Wind Park is an offshore wind farm located 16.7km off the coast of Ireland
DE	Munich City	€ 700 Mn	Munich U-Bahn Line 5 Extension Project, Laimer Platz - Pasing, Bayern
ES	Iberdrola	€ 150 Mn	Deployment infrastructure for electric vehicle recharging
HU	The Municipality of the City of Budapest	€ 350 Mn	Boosting energy performance of residential buildings in Budapest
PL	Lubelskie przedsiebiorstwo eneretyk icieplnej SA	€ 25 Mn	Retrofit and extension of the district heating (DH) network in the city of Lublin
IT	Enel Green Power and partners	€ 403 Mn	Italian Photovoltaic Giga Factory
PL	LG Chem Wroclaw Energy SP ZOO	€ 1 Bn	EV battery Gigafactory
SE	LKAB, SSAB, Vattenfall	€ 1,7 Bn	Develop and commercialise a fossil free value chain for steel production.
IT	Comune di Milano	€ 2 Bn	Innovative afforestation project in urban context, with the final aim of planting 3 million trees within the Metropolitan City of Milan by 2030

[3] A summary of the report is available here: https://assets.ey.com/content/dam/ey-sites/ey-com/it_it/news/2020/ey-summary-report-green-recovery-v2.pdf