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ANALYSIS OF THE DRAFT DELEGATED ACT SUPPLEMENTING ARTICLE 8 OF THE TAXONOMY REGULATION

Commentary on the treatment of green and sustainability bonds issued by central governments, central banks and supranational issuers

On 6 July 2021, the European Commission adopted a draft Delegated Act supplementing Article 8 of the Taxonomy Regulation. The draft is subject to a scrutiny period by the European Parliament and the Council of the European Union until 6 November 2021, before its final adoption and potential application as from 1 January 2022. It specifies among other the methodology for the Green Investment Ratio and the Green Asset Ratio to be reported notably and respectively by asset managers and banks. Central governments, central banks and supranational issuers are excluded from both the numerator and the denominator of both these ratios (subject to review by June 2024).

This note focuses on the potential unintended negative consequences of this exclusion for the further growth of green and sustainability bond issuance by sovereigns and supranationals, and for the development of the overall market, as well as the risks of setting a precedent for the future Delegated Acts for Articles 5 and 6 of the Taxonomy Regulation. In that respect, it underlines the relevance of the approach proposed by the draft Regulatory Technical Standards (RTS) on taxonomy-related product disclosures published by the ESAs on 22 October.

Background

The Taxonomy Regulation¹ creates a classification system for sustainable economic activities while also establishing new disclosure requirements for different types of market participants. On 6 July 2021 a draft Delegated Act (DA) regulation was proposed by the Commission as a supplement to Article 8 of the Taxonomy Regulation further specifying the obligations for financial undertakings, mainly large banks, asset managers, investment firms and insurance/reinsurance companies which will have to disclose the share of environmentally sustainable economic activities in the total assets they finance or invest in.

Asset managers should report the proportion of their Taxonomy-aligned managed investments in the value of all covered assets under management from both their collective and individual portfolio management activities in the form of a Green Investment Ratio (GIR). Following recommendations from the European Banking Authority (EBA), banks will report using the Green Asset Ratio (GAR) which measures the share of a credit institution's Taxonomy-aligned balance sheet exposures versus its total eligible exposures.

Asset managers and banks will be required to complete their first set of disclosures against the Taxonomy, in the course of 2022 and 2023. These disclosures will initially consist of the proportion of

¹ Taxonomy Regulation, https://ec.europa.eu/info/law/sustainable-finance-taxonomy-regulation-eu-2020-852/amending-and-supplementary-acts/implementing-and-delegated-acts_en

“Taxonomy eligible” exposures and excluded exposures (e.g., sovereigns, derivatives, non-NFRD entities²) in their total assets, as well as qualitative information. From 1 January 2024, asset managers and banks will start to disclose on the Taxonomy alignment of exposures using the GIR and GAR of the Delegated Act:

Separately, asset managers and pension providers within the scope of the Sustainable Finance Disclosure Regulation (SFDR), are also facing disclosure requirements at the product level (e.g. managed portfolios/funds) under Articles 5, 6 and 7 of the Taxonomy Regulation. On 22 October 2021, the European Supervisory Authorities (ESAs) published their draft [Regulatory Technical Standards](#) on taxonomy-related financial product disclosures under these articles.

Exclusion of exposures to “central governments, central banks and supranational issuers”

It is important to note that “central governments, central banks and supranational issuers” are excluded from both the numerator and the denominator of the GIR and GAR under Article 7.1 of the draft Article 8 Delegated Act. The Commission services will review this at a later stage (by 30 June 2024) to decide whether and how to develop a methodology for assessing the environmental performance of sovereign and supranational exposures. Financial undertakings may, on a voluntary basis, provide information in relation to exposures to Taxonomy-aligned bonds and debt securities that are issued by central governments, central banks or supranational issuers³.

Unintended consequences of this exclusion on the sustainable bond market

As a result of the exclusion of sovereigns and supranational issuers under the draft Delegated Act, green and sustainability bonds partially or fully aligned with the Taxonomy from sovereigns and supranationals (e.g. past issuance, existing and future Next Generation EU Green bonds, potential future issues aligned with the EU Green Bond Standard from Member States) will not be able to contribute to the GIRs and GARs of financial undertakings. This could have several potential negative consequences in that it may:

- Discourage issuance – Sovereigns and supranationals may cancel or defer issuance pending the resolution of the debate on the appropriate assessment methodology.
- Cause lower demand - Financial undertakings subject to the reporting requirement are incentivised to favour exposure to corporate green and sustainability bonds rather than those issued by sovereigns and supranational entities.
- Create price distortions – Excess demand for corporate and financial issuance in the green and sustainability bond market would create price distortions for those issuers which could lead to opportunistic behaviour and arbitrage.
- Reduce sustainable financing flows – because of lower demand, financing flows from European investors to sustainable activities conducted by sovereigns and supranationals may be reduced.
- Hinder market development – Issuance from sovereigns and supranationals is a key contributor to market expansion and liquidity (i.e. an estimated 25% of the market for green and sustainability bonds between 2019 and 2021).

² These are entities which are not obliged to publish non-financial information pursuant to Article 19a or 29a of Directive 2013/34/EU.

³ European Commission, FAQ: What is the EU Taxonomy Article 8 delegated act and how will it work in practice? P.11 https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sustainable-finance-taxonomy-article-8-faq_en.pdf

Alternative approach needed for the disclosure of taxonomy alignment at financial product level

The upcoming delegated acts for Articles 5 and 6 (financial product disclosure) will need to consider what is currently proposed under the Article 8 DA. It is important to note that the draft Regulatory Technical Standards (RTS) on taxonomy-related product disclosures published by the ESAs on 22 October already proposes an alternative approach to the one at the entity level currently written into the draft Article 8 DA. Indeed, under the draft RTS products making sustainable investments contributing to environmental objectives will have to disclose their percentage or taxonomy alignment with and without sovereign exposures (including green and sustainability sovereign bonds). This dual approach would be mandatory, whereas, under the draft Article 8 DA, the voluntary consideration of sovereign exposures is only optional.

We believe the draft RTS proposal is positive as disregarding exposure to green sovereign bonds would have put certain products on an unlevel playing field especially when considering other regulatory developments such as the new MiFID requirements (i.e. consideration of sustainability preferences) that incentivise investors to demand a minimum proportion of Taxonomy alignment. If they followed the precedent set by the draft Article 8 DA, future delegated acts for Articles 5 and 6 would indeed make it harder for funds to meet these expectations as sustainable instruments issued by sovereigns and supnationals represent a significant portion of the Taxonomy aligned investible universe (specifically an estimated 25% of the market for green and sustainability bonds between 2019 and 2021).

Recommendation

We recommend the urgent review of the exclusion of green and sustainability bonds of central governments, central banks and supranational issuers from the calculation of the GIR and GAR in the draft Delegated Act supplementing Article 8 of the Taxonomy Regulation. This can be done with reference to the proposed approach included in the draft RTS on taxonomy-related product disclosures of the ESAs.

Alternatively, if the exclusion in the Article 8 DA of central governments, central banks and supranational issuers from the calculation of the GIR and GAR is not changed, we call for a firm commitment to develop and finalise as soon as possible a Taxonomy alignment assessment methodology for sovereign and supranational exposure with a deadline of 30 June 2024.

References

Draft Taxonomy Article 8 Delegated Act

Article 7 Disclosure rules common to all financial undertakings

1. The exposures to central governments, central banks and supranational issuers shall be excluded from the calculation of the numerator and denominator of key performance indicators of financial undertakings. [...]
4. Without prejudice to paragraph 1, environmentally sustainable bonds or debt securities with the purpose of financing specific identified activities that are issued by an investee undertaking shall be included in the numerator of key performance indicators up to the full value of Taxonomy-aligned economic activities that the proceeds of those bonds and debt securities finance, on the basis of information provided by the investee undertaking.

Final Report on draft Regulatory Technical Standards (with regard to the content and presentation of disclosures pursuant to Article 8(4), 9(6) and 11(5) of Regulation (EU) 2019/2088)

Background and Rationale (p10)

The draft RTS covering how and to what extent investments underlying the financial product are in economic activities that qualify as environmentally sustainable under the TR require that the financial product calculates the extent of taxonomy alignment of investments in two ways: a first one, by calculating the ratio between a weighted average of taxonomy-aligned investments in the numerator divided by all investments in the denominator. A second ratio is calculated in the same way as the first except by also excluding all sovereign exposures from both the weighted average of taxonomy-aligned investments in the numerator and from all investments in the denominator. These two KPIs should be graphically presented and accompanied by the breakdown between enabling and transitional activities in accordance with Article 5 TR. The rules also propose an indication of whether the compliance of taxonomy-aligned activities will be subject or (for periodic disclosure) has been subject to an assurance provided by an auditor or a review by a third party.