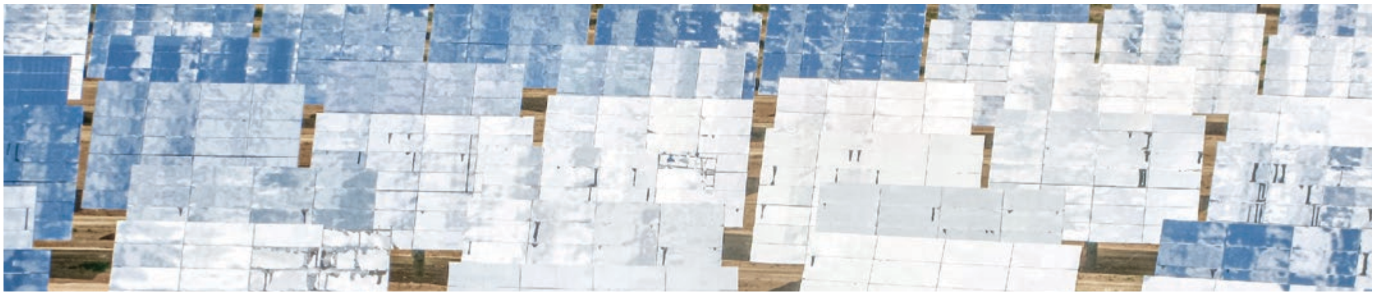
UBS

Demystifying 'Green,' 'Social' and 'Sustainable' Bonds



What are green, social and sustainable bonds? What is their purpose?

The proceeds fund a specific environmental, social or governance (ESG) project, achieve a goal or fulfill an ambition.

Green, social and sustainable bonds are a type of debt instrument issued mostly by governments, supranationals, corporates and municipalities. In almost every respect they are identical to the traditional bonds that investors are already completely familiar with, and probably already hold as a core allocation in their portfolios.

In a traditional bond the issuer has complete freedom to use the money raised for just about any purpose they wish. This use is often not even disclosed beforehand, except in a very general sense. However, when a bond is categorized as green, social or sustainable (GSS) then it simply means the issuer intends to use the proceeds to fund a specific environmental, social or governance (ESG) project, achieve a goal or fulfill an ambition.

The great majority of GSS bonds are so-called 'use of proceeds' bonds where the proceeds are earmarked for particular investment purposes – these can be new projects, or the money may be used to refinance spending that has already happened. In other cases, rather than specify a particular use of proceeds, some GSS bonds raise funds to help companies or governments meet certain ESG goals or targets. In both cases, however, these securities are otherwise identical to conventional bonds.

What can be called a 'green', 'social' or 'sustainable' bond is not *legally* defined (certain market standards and conventions are emerging). That said, the following summary highlights what characteristics investors might expect to find in bonds with the various labels.

Green Bonds – the bond proceeds are invested, for example, across activities in renewable energy, green buildings, sustainable water or clean transport.

Social Bonds – the bond proceeds fund activities that achieve positive social outcomes or address a particular social issue, such as investment that targets poverty or provides access to essential services, affordable housing or healthcare.

Sustainability Bonds – the bond proceeds are used to refinance a combination of green and social activities described above.

Sustainability-linked bonds – the bond proceeds are not targeted at a particular investment but the issuer agrees to hit certain key performance indicators, in green or social themes, and usually accepts certain financial penalties if these are not met. For example, an increase in the bond coupon if a certain CO_2 emissions target is not met in the future.

Whatever the label, the key point to bear in mind is that in every other respect these bonds will be identical in form to conventional bonds issued by the same entity. They will have a regular coupon and a fixed maturity date. And, importantly, the same seniority as conventional bonds. So if the worst happened, and the issuer defaulted, the GSS bonds and the conventional bonds will rank equally. In other words, they carry the same credit risk.

Market size and structure

Are GSS bonds an investable opportunity? Where are they issued, and by whom?

Although the first 'green' labelled bonds were issued as recently as 2007 the market has grown a lot since then. On one hand this follows the need of issuers to address climate change in a meaningful way and, more recently, the efforts by governments, corporates and investors to drive positive change on a broad range of social and sustainability metrics. The evolution of the market has also been supported by the wide acceptance of various voluntary principles discussed below.

Using the ICE Green, Social and Sustainable Bond Index as a reference point, the total market value of qualifying GSS bonds today is about USD 1.6tn, and comprises about 1,700 bonds. Despite the rapid growth we should not forget that GSS bonds are still a relatively new phenomenon and it will not be a surprise to learn that they constitute just a fraction of the broader bond universe. For instance, the Bloomberg Global Aggregate Index (a popular bond benchmark tracked by many investors) has a market value today of USD 65tn, across nearly 33,000 bonds.

The following chart compares the GSS bond index with the global aggregate across several factors including currency, sector, rating, yield and duration. Europe has a much higher weighting in the GSS index and European governments are becoming key issuers in this market. In part this reflects regulatory and policy initiatives such as the European Green Deal which is the plan to make Europe climate-neutral in 2050 and the EU's Pandemic Recovery Fund which aims to raise 30% of the funding with green bonds. In the US, to date, issuance has been led by corporates and municipals and the government has played a less active role than is the case in Europe.

Comparing the Sustainable Bond Universe

ICE Green, Social and Sustainable Bond Index vs. Bloomberg Global Aggregate Index

Regional Breakdown	SSAG	Global Agg
APAC	5.75%	21.30%
Europe	48.70%	26.58%
North America	7.85%	41.05%
South America	1.60%	0.92%
Supranational*	36.10%	10.15%

*Supranational includes Supranationals and Foreign Agencies

	YTM	Mod Duration	Average Rating
SSAG	1.183	8.132	Aa3
Global Agg	1.553	7.434	Aa3

Sector Breakdown	SSAG	Global Agg
Government Bonds	13.45%	54.22%
Agencies*	24.15%	11.59%
Supranationals	24.51%	2.19%
Corp – Utilities	10.18%	1.52%
Corp – Financials	14.62%	6.91%
Corp – Industrials	13.10%	9.86%
Securitized	0.00%	13.71%

*Agencies includes Agencies, Foreign Agencies, Local-Authorities and Government Guaranteed Bonds

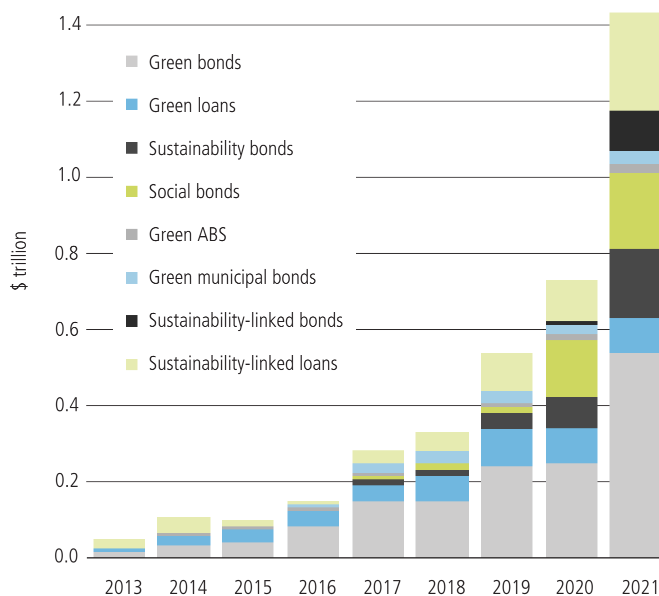
Currency	SSAG	Global Agg
AUD	1.98%	1.36%
CAD	2.37%	2.78%
EUR	57.90%	22.45%
GBP	4.71%	4.75%
JPY	1.48%	12.83%
USD	27.84%	43.31%
Other	3.92%	12.27%

Source: ICE, Bloomberg, as of January 31, 2022

Despite the relatively small size, at least when compared with the Global Aggregate universe, GSS bonds are an investable universe today because governments and 'blue chip' corporates tend to dominate the supply. Bonds from these issuers are generally well known and tend to attract large followings which means good availability and liquidity. Indeed the goal of most issuers is to ensure good liquidity in these bonds in order to support their GSS funding and ambitions in future. The following chart highlights the near exponential growth rate in issuance and we have every reason to believe that this should continue in the future.

Global sustainable debt issuance hit a new record of over 1.4 trillion in 2021

Global sustainable debt issuance



Source: Bloomberg,BNEF, IIF, as of December 31, 2021.

Market standards and conventions

Can we trust the label? Who polices how funds are used?

As a relatively new market without fully established protocols and standards, GSS bonds carry the potential risk that unscrupulous issuers 'bend' their GSS credentials to achieve better funding terms at the expense of investors. That said, in the last few years there has been enormous progress in improving the standards in these markets, to the extent that today there are some widely accepted standards that have become a de facto requirement for a successful bond launch. The principal ones investors should be aware of are:

- **The International Capital Markets Association (ICMA) Green Bond Principles, Social Bond Principles, Sustainability Bond Guidelines and the Sustainability-Linked Bond Principles.** These are a collection of voluntary frameworks to promote the role of capital markets in financing progress toward environmental and social sustainability. For instance, the ICMA Green Bond Principles are a voluntary framework for issuers that provide transparency around the use of proceeds, the process for project evaluation, management of the proceeds and reporting. Indeed, the standard for inclusion in the ICE GSS index described above is that they must be ICMA aligned.
https://www.icmagroup.org/sustainable-finance/

- **Third party NGO assessments**. Several non-governmental organizations provide credibility assessments of GSS issues. One of the highest profile is the Climate Bond Standard published by the Climate Bond Initiative (CBI). The CBI document sets out international best practice for labelling green investments. The appropriate certification confirms that the bond is fully aligned with ICMA Green Bond Principles, using best practice for internal controls and reporting, and that the bond is financing assets consistent with reaching the goals of the Paris Climate Agreement.
https://www.climatebonds.net/climate-bonds-standard-v3

- **The European Green Bond Standard.** As a leading proponent of green bonds the European Commission has created a European Green Bond Standard (EUGBS) which should become the 'gold standard' for how companies and public bodies can raise green bonds and provide tough sustainability standards to protect investors. The EUGBS will be open to any issuer of green bonds, including those located outside of the EU. The basic standards are the funds should be allocated fully, and in a transparent way, to projects consistent with the EU taxonomy and subject to external review by third party registered reviewers. For the time being the EUGBS will be a voluntary standard but it could well become mandatory for issuers in future.
https://ec.europa.eu/commission/presscorner/detail/en/QANDA_21_3406

Even though these principles are almost all voluntary, many issuers already understand the need to adopt them, not least in order to establish credibility with investors and therefore to help maintain orderly and liquid markets in their GSS bonds.

A sound investment strategy in GSS bonds will include a rigorous assessment of how closely a particular issue is true to the green, social or sustainable 'label'. In our experience investors, at a minimum, look for close alignment with ICMA standards and CBI principles.

The investment case for GSS bonds

What will drive returns? What investment styles make sense? How should allocations to green bonds be managed?

As we highlighted above, although the market is still relatively small, GSS bonds are an investable opportunity, particularly for those investors looking for a clear 'impact' element in their portfolios.

That said, a straightforward switch from a core allocation today in the Global Aggregate universe to the GSS universe is probably not the way to go. The reason becomes clear when looking more closely at the comparisons above; the GSS universe is overall lower yielding, has a longer duration and yet with lower credit quality than the global aggregate universe. So a straight switch would imply taking on more credit risk and more downside sensitivity to higher yields, while earning less. (The reasons reflect a skew towards Europe and more corporate bonds in the GSS universe).

A passive allocation to GSS bonds would also invite problems because not all bonds in the universe will match investors' own standards about what is truly 'green' or 'sustainable'. This can only really be done through a bond-by-bond assessment and an understanding of how closely a bond follows ICM and CBI standards.

So if active management is the way to go, how might an active manager drive returns in an allocation to GSS bonds?

- **Exploiting global opportunities —** Despite the GSS label, as should be clear by now, these bonds share all the other characteristics of conventional bonds (the way the proceeds are used accounts for almost all the difference). And despite the relatively small size, this is a global and diverse opportunity set. Therefore, all the traditional active tools for global bond managers will be available; so decisions about which countries to invest in, what sectors of the economy and where on the yield curve will all be important. Any sound GSS strategy will need to account for all these factors.

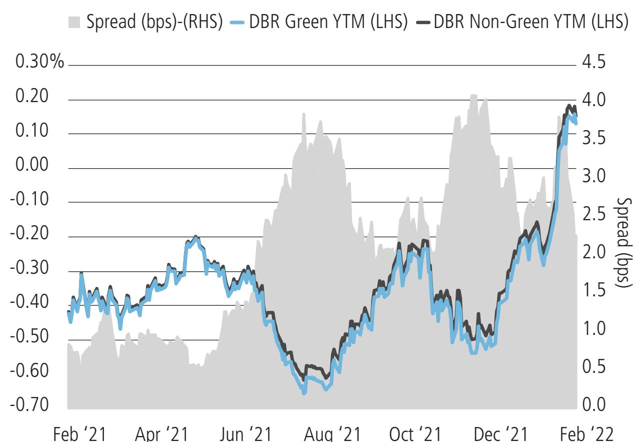
- **Good fundamental credit research —** All the tools of traditional credit research and bottom-up bond selection are still relevant – many of the issuers are corporates after all, with all the associated risks; fundamental forward looking credit research, an assessment of material environmental and sustainability factors and a view about how these factors affect the business and financial profile of the company still apply. This assessment, as in traditional bond investing, will contribute to making an informed a decision about the attractiveness of the bond pricing.

- **Understanding pricing anomalies —** In the case of almost every GSS bond available today the issuer also has outstanding 'non-GSS' conventional bonds. It should be clear from the earlier description that these bonds will have exactly the same default and recovery risk. Because the credit risk and default risk in each bond is the same (but still hopefully remote), one should expect equivalent bonds to have exactly the same yield. But in fact, this turns out sometimes not to be the case.

Consider the following chart. This shows the yield on two securities issued by the German government; they have exactly the same maturity date and coupon; they are obviously both highly liquid with minimal default risk. You will notice though that the designated green bond has consistently traded with a lower yield than the conventional bond.

In theory, in a totally efficient market, this should not happen – the bonds should yield the same. The slightly lower yield on the green bond implies some 'inefficiency' in the market.

Green vs Non-Green Bund Yields and Spread



Source: Bloomberg,BNEF, IIF, as of February 16, 2022.

In practice this difference is probably explained by investor preferences for bonds with green labels that help them fill an impact or GSS target allocation in their portfolios. But unwary investors need to be careful because this difference is effectively a cost to the holder that may not be worth paying. And this yield difference (where the GSS bond is slightly more expensive to hold than the conventional bond) will vary across issuers and across time. A sound active strategy will weigh these yield differentials carefully. A conventional bond from an issuer with a strong ESG profile and credentials might be a better bet than a GSS bond. So an approach that has the freedom to choose between both is best.

Key Takeaways

- We believe that the GSS market is now firmly established as an important subset of the global bond universe, and one that is likely to maintain a very high rate of growth.

- GSS bonds may offer attractive long term investment opportunities and we see an active approach is a 'must-have' to drive good risk adjusted returns over time.

- GSS bonds have a role to play for investors looking to make hard-wired 'impact' allocations in their portfolios. Some features of the GSS universe mean that it is not yet ready to fully supplant more established traditional core bond allocations. But GSS bonds should be taken seriously as an active investment opportunity nonetheless.

- A sound active investment approach will rotate freely across sectors and markets.

- GSS and conventional bonds should be assessed in tandem and investment decisions made on the relative merits of the pricing of risk, not the label.

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