Shades of green bonds: Questions and answers

Sustainable investing

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- The green bond market will soon hit the USD 1tr mark. This year, USD 215bn worth of new green bonds have been issued, complemented by USD 133.5bn of social and USD 61.4bn of sustainability bonds, taking total issuance of environmental, social and governance (ESG) labeled bonds to a new record of over USD 400bn. Innovations such as sustainability-linked bonds are gaining ground, demonstrating the developing nature of this still fairly young sustainable investment (SI) asset class.

- For issuers with sound ESG strategies, we saw a small “greenium” (i.e., a green bond valuation premium) emerging in the market, and strong investor demand rewarded some issuers with lower yields when issuing new bonds. Overall, green bonds achieved total returns similar to non-green ones.

- As green bonds have turned more mainstream and a first official standard defining the asset class is due to be enacted soon by the European Union, there is a lively debate among investors and observers on a number of issues. These include: 1) the actual greenness of existing green bonds; 2) the environmental credibility of the issuers of these bonds; and 3) the actual impact of buying green instead of non-green bonds. We address these topics below by answering some frequently asked questions and describing our approach for selecting green and other ESG bonds.

Source: Climate Bonds Initiative, Bloomberg, CIO GWM, as of 15 December 2020

Related CIO reports

Green, social and sustainability bonds, 14 October 2020

Fig. 1: Annual new issuance of GSS bonds (in USD bn)

Source: Climate Bonds Initiative, Bloomberg, CIO GWM, as of 15 December 2020

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1) Who defines what a green bond is and who can issue it?
There is currently no official regulation defining a green bond, and no institution that can officially assign or withdraw a green label. Theoretically, any issuer can label a newly issued bond as a green, social, or sustainability (GSS) bond. However, in practice, an established process exists to assure investors of adherence to minimum standards. For each type of GSS bond, the International Capital Markets Association (ICMA) has published voluntary principles and guidelines that define the eligible use and management of proceeds, the evaluation process for projects, and the regular reporting to investors.
Before launching their first green bond, most issuers typically publish a framework in which they define the eligible project categories and cover all the criteria required by the ICMA principles. A specialized auditor then provides a second opinion on the framework. Once a green bond is out, the issuer starts to disclose the details regarding the allocation of funds to specific projects. In some cases, an external verification can be made available to investors. Over the life of the bond, the issuer is also expected to report at least annually on details regarding the use of proceeds and the environmental impact achieved by its green projects.
In the US market, some green bonds are currently lagging these standards, where self-identification is far more common for municipal issuers who dominate the US green bond market. But we believe that green bond activity in the US corporate market should pick up and that companies will follow the trends set by their global competitors.

2) Is there an advantage to buying a green instead of a non-green bond?
From a financial point of view, green and non-green bonds represent the same creditor claim on the issuing entity and should therefore, all else equal, offer the same yield. While issuers report the use of proceeds for green bonds, this does not mean that an investor’s claim is linked or limited to these assets, although they could be in the case of asset-backed securities (ABS). Regardless of the specific green project, green bonds can be issued as senior, subordinated, hybrid, or collateralized bonds, and they have the same claim against the issuer as non-green ones of the same capital structure ranking. Due to strong demand and a more diverse and longer-term-oriented investor base, green bonds have shown relatively good resilience during volatile market periods, but over time we think investors should expect similar financial returns as for non-green bonds.

From a sustainability point of view, it could be argued that investors seeking green or sustainable exposure, in general, could simply select higher ESG-rated issuers, rather than specific environmentally linked issuance. However, the assessment of the underlying “E,” “S,” and “G” factors is complex, and specific rating providers apply different weighting priorities. Therefore, in our view, green bonds provide greater transparency for investors with a focus on environmental issues, while also enabling them to build a specific portfolio exposure. Furthermore, buying a green bond also sends a strong signal to the issuer and market participants that specific environmental topics matter. With increased demand for green bonds, issuers should be incentivized to focus on eligible green projects, helping to ease the transition of businesses with a greater environmental focus in mind.

3) How credible is a green bond from an issuer that is not green across its business?
Few issuers can claim to be 100% green. However, many companies intend to become greener and aim to invest gradually in clean and efficient business processes and infrastructure. Such transformations can take many years for capital-intensive businesses. So we think that answering this question requires analyzing the company’s strategy and actions to determine whether the green investments form part of an ambitious transition plan. If this is the case, we think investor demand for such green bonds can motivate issuers to become greener faster. Excluding companies in transition and only investing in already fully green ones may actually result in fewer positive effects on the environment overall.
For issuers in industries with high greenhouse gas emissions, so-called “brown industries,” a new bond category called “transition bonds” is developing. Industries that may
not be able to change their business models entirely to become green can nevertheless adopt changes to become more sustainable. Industry sectors falling into this category include, for example, mining companies, heavy industry, certain utilities, and transport and mobility companies.

4) If an issuer simply (re)finances projects it would have done anyway, why should an investor buy the green bond?

Clearly such cases do not offer additional climate-related action. Nevertheless, we think it would be wrong for investors to exclude, for example, bonds from issuers that have long focused on green projects, but have only recently decided to switch to green bonds to refinance these. In addition, projects may have investment cycles spanning over more than a decade, so an issuer using short to medium tenor bonds may need to roll over the financing several times. Nevertheless, critical judgement is required to identify cases where issuers may undertake projects for very different motivations and only use green bonds as a marketing opportunity or in hopes of achieving a lower yield. Examples include investments into emission reduction just to meet new regulatory standards, or the replacement of copper lines with more efficient fiber that may aim to increase network speed rather than use less energy. Banks typically have large mortgage books, some of which happen to finance energy efficiency renovations or new green buildings, allowing banks to use green bonds to refinance the loans (likely by rolling over several green bonds over time, given the typically long tenors of mortgages). Positive examples of such green bank bonds are those where the bank actively encourages green investment by offering an interest rate discount or other incentive to clients using a mortgage for green buildings.

5) Do green bonds lack transparency?

Typically, information on green bonds is available on issuers’ investor relations portals. Currently, the most widely respected market standard for green bond reporting is ICMA’s Green Bond Principles (GBPs). These are voluntary guidelines, but larger institutional investors are increasingly embracing the fulfillment of the GBPs as minimum criteria. According to the GBPs, “issuers should make, and keep, readily available up-to-date information on the use of proceeds to be renewed annually until full allocation, and on a timely basis in case of material developments.” The GBPs go on to specify that the annual report should include a list of the projects to which green bond proceeds have been allocated, as well as a brief description of the projects, the amounts allocated, and the expected impact. Furthermore, the GBPs also recommend that, in connection with the issuance of a green bond or a program, issuers appoint external reviewers to confirm the alignment of their bond or bond program with the four core components of the GBPs as defined above.

There is no strict standardization of the reporting, and while third-party data providers offer summarized information, investors should ultimately decide based on their own assessment of the issuer’s full disclosure and degree of transparency. We see green bond reporting as a helpful tool for investors to steer a dialogue with issuers and to provide feedback regarding missing and controversial information.

Providing transparency of green bond information is not necessarily an easy undertaking for issuers. To avoid confusing details, some issuers may choose to keep reporting on a rather general level. Nevertheless, to standardize and simplify reporting, the GBPs recommend the use of qualitative performance indicators and, where feasible, quantitative performance measures (e.g., energy capacity, electricity generation, greenhouse gas emissions reduced or avoided, number of people provided with access to clean power, decrease in water use, reduction in the number of cars required, etc.) and the disclosure of the key underlying methodology or assumptions used in the quantitative determination. Furthermore, EU standardization projects including the introduction of green taxonomy should help to align reporting deliveries and requests.

6) What are the warning signs of greenwashing? Are there “shades of green”?

There are no official differentiations of “shades of green” for green bonds (although Cicero, a provider of second opinions, uses graded shades of green to score the environmental quality of green bonds). However, typically when investors refer to “shades of green,” they are talking about how they assess the sustainability and environmental profiles of green bonds. Only a few issuers, such as specialized utilities or dedicated public-sector development banks (many of which have a climate-related mandate), tick all the boxes for their green bonds to be considered dark green, meaning they are fully aligned with climate (net zero) targets. Many corporate issuers of green bonds with defined environmental targets will regard investing in green projects as a core part of their strategy, even if not all of their business activities may be considered green. Light green is typically associated with activities that reduce carbon emissions, but that are not aligned with the long-term climate targets.

To identify greenwashing, we suggest considering whether the green bond issuer in question is only refinancing existing activities or projects they must implement anyway (e.g.,
due to regulation); is at the same time investing mostly in non-green business or aims to maintain existing polluting activities for as long as possible; fails to set any ambitious environmental targets on a corporate level; or offers only minimal reporting and transparency (including secondary reviews) on the use of proceeds from their green bonds. We think such cases form a small portion of the market, and as regulation and external reviews become more widespread, incentives for issuers to attempt greenwashing should diminish.

7) Is there any sanctions mechanism for issuers who fail to comply with the voluntary standards?
Short answer: not officially. The Green Bond Principles are not laws. But there is still significant downside for issuers if they fail to comply. They incur the cost of launching a green bond (such as additional green issuance program documentation and possibly external reviews), but may not get access to sustainable benchmarks. Investors who analyze their green bonds may exclude them from their investible universe. In addition, the growing community of SI market observers and research houses may flag the issuer publicly as non-compliant, and the media would also likely highlight such cases. This poses a reputational risk. As a result, many companies from industries that are broadly perceived as less environmentally friendly have so far refrained from issuing green bonds, even if they have qualifying projects. We think this currently unused potential to issue green bonds will be unlocked once further standardization and regulation provides assurance to investors and issuers alike.

8) How can I select a portfolio of credible green bonds?
Verifying credibility requires an analysis both of the specific green bond, its use of proceeds, and impact reporting, and of the issuer’s overall activities, strategy, and track record. This demands significant effort, but is, in almost all cases, possible based on publicly available information on the issuers’ investor relations portals. We also note the rapid growth in the number of independent providers who verify green bonds and provide ESG ratings and assessments of issuers. These are, however, often only available to fee-paying subscribers, and the standards applied also differ. Nevertheless, we think that ESG ratings, like credit ratings, may at some point also become more widely available, and that some consolidation among providers should occur. Once the eligible universe is filtered based on instrument and issuer level criteria, traditional bond portfolio management techniques can be used to construct an efficient portfolio in line with individual risk appetite.

9) If there is a greenium emerging, are we heading into a green bubble?
If a green bond trades too far inside the issuer’s yield curve, it is expensive, even if this is simply a reflection of too much demand chasing a pool of assets that is failing to grow fast enough. The green bonds of some prominent issuers are trading at a small greenium (i.e., a slightly lower yield than for comparable non-green ones), but these are exceptions right now. Most green bonds trade fair on the issuer’s yield curve. We think such scarcity premiums will remain small (a few basis points of yield) or fade as issuance rises. In our view the greenium should be compared to the situation with well-known household names (companies associated with prominent brands) that have just a couple of bonds outstanding. These bonds have often traded rich for their credit ratings, but hardly ever sold off. Indeed, they have tended to hold up well during market corrections.

10) How will new EU regulations affect green bonds? Will the EU taxonomy hurt pricing?
Two important changes will impact the green bond market over the next few years: an EU green bond standard and the new EU taxonomy.

Following an initial assessment, EU leaders in December tasked the European Commission with proposing an EU green bond standard by June 2021. We believe this new standard will enhance the effectiveness, transparency,
accountability, comparability, and credibility of the green bond market, benefiting issuers and investors alike. A European standard could also drive international standardization, as the largest green bond investor base is in Europe, and foreign issuers will want to access this market.

The EU taxonomy came into force on 12 July 2020, and is expected to start applying in practice from 1 January 2022 at the earliest, as various delegated acts need to be adopted beforehand. The taxonomy aims to harmonize the criteria for determining whether an economic activity is to be classified as environmentally sustainable. This will also form the basis for future standards and the labeling of sustainable financial products.

One of the main barriers to increasing the supply of green debt instruments, as pointed out in a report on taxonomy in 2019 from the Climate Bonds Initiative, is the difficulty of identifying green assets and projects. This is due to the inherent challenge of defining such assets and projects, for example green mortgages or low-carbon transport. A paucity of sufficiently green projects is another related problem. In our view, clear definitions for green assets are key to safeguarding the market from greenwashing, supporting governments in targeting their action against climate change, and helping financial market players decide which sustainable investments to focus on. However, we still see various harmonization barriers to the implementation of the EU taxonomy, given varying measures and standards currently applied in different countries.

Already, issuers that are perceived as delivering the highest green standards tend to enjoy a moderate greenium on their bonds. Green bonds from issuers with less sound green credentials typically trade fair versus non-green bonds. This differentiation may become more pronounced once new indexes based on the EU standard emerge and more financial assets track those benchmarks. As we discussed above, given only moderate greeniums of 2–3 basis points right now, we think the potential for price corrections in green bonds that fail to meet the new standard is minimal.

11) What is the actual impact of green bonds? Are green bonds considered an impact investing solution?

We do not regard green bonds as impact investing solutions. We define impact investing as investments in companies or organizations with the intent to contribute to measurable positive social or environmental impact alongside financial returns. Another important part of the impact investment process is the assessment, measurement, and verification by a third party. Although green bonds feature some of these components, the intent of and accountability for the outcomes is not aligned with typical impact investing standards, in our view. Furthermore, green bonds are focused on the use of proceeds for particular assets, whereas impact investing takes a more holistic approach.

However, various studies give some promising indications of the actual overall effect of green bond issuance on the wider environmental topic. For example, the European Commission points out in one of its recent technical reports (see: The pricing of green bonds: Are financial institutions special?) that the sheer magnitude of environmental challenges requires mobilizing considerable funds. As a result, finance undoubtedly has a key role to play. Among the activities and instruments of sustainable finance, green bonds represent one of the most promising market-based solutions to channeling funds to environmentally beneficial projects, as well as to raising awareness of environmental risks. The commission’s study focuses on financial institutions and finds that for these entities, resorting to the green debt market often also involves engaging in green lending, instead of investing directly in environmentally friendly projects. Further, the results suggest that banks that have issued a green bond typically reduce their exposure to more polluting activities.

Another report by the commission (see: Study on the potential of green bond finance for resource-efficient investments) emphasizes that green bonds can provide an additional source of financing, next to bank lending and equity financing; and green bonds can also enable long-term financing for green projects, particularly in countries where the availability of long-term bank loans may be limited.

A study of corporate green bonds by Boston University (see: Corporate Green Bonds) suggests that such bonds serve as a credible signal of companies’ commitment to the environment. And as this commitment grows, companies tend to reduce their CO₂ emissions and achieve higher environmental ratings.

However, a recent Bank for International Settlements (BIS) study (see: Green bonds and carbon emissions: exploring the case for a rating system at the firm level) found that green bond projects have not necessarily translated into lower or falling carbon emissions at firm levels. The study argues that the current system of green bond labels does not necessarily guarantee a material reduction in carbon emissions. Green bond labels would signal emission reductions only if the relevant projects were to transform the activities of the bond issuer radically enough for its carbon emissions to fall.
12) How are sustainability-linked bonds different?
In contrast to green bonds, sustainability-linked bonds (SLBs) are not asset-linked, but rather depend on whether the issuer as a whole institution meets certain predefined key performance indicators, or so-called KPIs. Typically, these KPIs are defined by sustainability performance targets. This means that the issuer of an SLB will commit to improvements in certain sustainability outcomes for its business, such as carbon reduction goals, net zero emission targets, or UN Sustainable Development Goals (SDGs)-linked targets, on a pre-agreed timeline. The attributes of the bond can change according to whether the committed KPIs are achieved. The changes typically relate to the coupon of the bond, which may step up if the issuer fails to meet its KPIs in the time agreed. SLBs are a relatively recent innovation in both loans and bonds, with a first issuance in 2019 and a limited number of transactions so far.

ICMA introduced Sustainability-Linked Bond Principles in early 2020, and we expect third-party assistance in assessing SLB issuance will develop soon. From an issuer point of view, SLBs are an easier way to access funding markets, as the bonds are related to an issuer’s own defined KPIs, and in contrast to green bonds, no specific asset pledges are needed. SLBs may incentivize issuers to address broader ESG factors and to change their business in the spirit of the SDGs, but they also add further complexity to the assessment process for investors.

KPIs are unique to each issuer and are typically hard to compare across various SLB issuers. It is also difficult to determine whether certain KPIs are ambitious enough for individual issuers. Various further questions that investors should consider when investing SLBs include:

- Are any financial penalties for missing the set targets adequate?
- Should an investor consider selling the bond if targets are missed?
- Can investors track and detect a likely failure early?
- If the KPIs underlying the bond are met, how does a corporation proceed from there?

The SLB market is still in its infancy. We expect rapid growth of corporate issuance from next year. However, some of the questions raised above about KPIs can only be answered closer to the bonds’ maturity. It may therefore still take a while for this new market segment to become fully established.
Appendix

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