Green Bonds: The demand is higher than the supply – yet, there are good alternative options

KEY POINTS

- Growth in green bond issuance has been extraordinary given they offer no credit enhancement to other bonds and carry additional reporting requirements.
- Demand from investors with an environmentally-focussed agenda appears to be driving green bond prices to a premium.
- A potential opportunity exists to identify 'unlabelled' debt, supportive of a sustainable future but not carrying the green bond premium.
- While 'labelled' green bond growth may no longer be exponential, a clear trend is in place for more sustainability issuance, likely through more diverse instruments.

From its humble beginnings in 2007, when the first Climate Awareness Bond was issued by the European Investment Bank, the green bond market has been the poster child for growth in environmentally responsible assets. Adjectives such as 'robust', 'stunning' and 'exponential' have been used to describe the expansion of the market from $1.48 billion in 2007 to $173.61 billion in 2017. On the one hand, this growth *is* impressive if we consider that green bonds are no more legally secure than regular bonds. On the other hand, the volume of green bonds might appear insignificant when compared with the $6 trillion that we should be investing each year just to climate-proof our infrastructure, according to the *Investing in Climate, Investing in Growth* report by the OECD.

So where exactly is the green bond market headed? Is growth likely to persist and reach the levels cited by the OECD? The volume of green issuance in 2018 suggests in fact that growth is waning: the market grew barely 5% in 2018. What exactly do we know about how the broader market is evolving?

In order to qualify as green, bonds must fund specific green projects. The issuer should also meet additional requirements set out in a voluntary set of guidelines known as the Green Bond Principles (GBP). Adherence to the principles allows investors to assess the environmental impact of their green bond investment; and they assist underwriters by moving the market towards the standard disclosures which will facilitate transactions. It is generally accepted as best practice that an issuer will obtain an external review to demonstrate compliance with the Green Bond Principles, since the principles themselves are voluntary and not a legal requirement.

To recap: green bonds are a debt instrument –just like any other bond, with additional reporting requirements, and no upside in terms of credit enhancement. Viewed this way, the compound annual growth rate of 54% that the green bond market has shown over the past decade is impressive.

Green Bonds without a label – the market is innovative and offers good alternatives

While growth in green bonds might recently have cooled, the issuance of sustainable debt has not. Green loans, sustainability-linked loans, green mortgages –these are all market responses to investors demanding something slightly different, especially when the green bond framework is not a perfect fit for the project, the issuer or the investor. A green bond issuer must demonstrate that 90% of the bond's proceeds are being used to fund a specific sustainable project, such as renewable energy, pollution prevention and control, biodiversity conservation, water and wastewater management, energy efficiency technologies, green buildings, climate change adaptation projects or technologies, clean transportation, or natural resource management.

And while there is no formal minimum issue size mandated by the GBP, investors will look for a size that is big enough to guarantee liquidity and index inclusion. This usually translates to around $300 million – a number that is simply too big for many companies to dedicate to the types of qualifying projects.

For these companies, sustainability-linked loans represent a more accessible way to tap the growing green investor base. These are credit facilities that come with sustainability targets. They can be smaller in size than green bonds and customised to the issuer in question. When the borrower fulfils the pre-agreed criteria –improving the energy efficiency of a real estate portfolio, for example –the interest rate on the facility drops. In this way, the "additionality" is very clear.

Investors will pay for impact

According to the Climate Bonds Initiative roughly half of green bonds are allocated to green investors – which still leaves a sizeable amount of demand coming from investors that have no disclosed mandate to target impact over return. Since investors aren't paying for a better credit profile, it seems reasonable to conclude that investors are willing to pay for this level of transparency around environmental performance, and for the environmental performance itself.

What the data does not clarify is whether investors are willing to look for this environmental dividend, or impact, themselves, or whether they are happy to compete with other investors and pay up for "green" labelled debt. From an investor's perspective, might it not make more sense to search for companies that are making products that are supportive of a low-carbon future, but which are not labelling their bonds as “green”? This would allow investors to earn a higher return on their unlabelled green debt instruments, while providing liquidity to a portion of the market that would seemingly benefit from it. These companies –known as “green pure plays” -should absolutely be recognised as compliant with the Green Bond Principles, according to Suzanne Buchta, one of the original authors of the principles.

The idea that labels and ratings create convenience –and opportunity -is hardly novel in debt markets. Most rigorous debt analysis is predicated on the fact that inefficiencies exist, and it is up to the diligent investor to find them. For the investor who places value on environmental impact, this unlabelled universe of climate-aligned debt represents opportunity.

In keeping with this trend, dedicated green-bond funds are also on the rise – growing by 58% between 2017 and 2018 alone. Globally, there are now four different frameworks under which green bonds can be issued – each with differing standards that factor in regional nuances –and more than five different indices against which investors can benchmark their performance, each with their own inclusion criteria.

Investors are willing to pay for environmental impact. This demand will only grow as the obligations of the Paris Agreement come into effect. Both companies and governments will become more accountable for their climate strategies, and the need to raise capital to fund their strategies will grow. As this demand grows, we will likely see the market continue to respond with a greater diversity of financial instruments that are more finely honed to suit issuer, investor or region.

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