Green finance: Financing environmental benefits

Green finance is drawing huge interest in light of climate change, but it needs to be about more than financial returns

Key points:

- **Green bond issuance totalled €182bn worldwide in 2018**
- **Investors must pay attention to the underlying projects**
- **A European Union expert group is developing unified standards and a single taxonomy**
- **Innovations like green CLOs are expected**

Interest in green finance has exploded in recent years, with strong appetite from investors and policymakers. Two manifestations of this are the G20's Green Finance Study Group, set up in 2016, and the European Commission's multi-faceted sustainable finance action plan, which is focusing on environmental matters.

The G20 group has since been renamed the Sustainable Finance Study Group to reflect a reorientation to that concept, but before the change it said green finance "can be understood as the financing of investments that provide environmental benefits in the broader context of environmentally sustainable development".

Today, it is often about climate finance, for climate change mitigation or adaptation measures. The financing can come from both private and public sources. It is not only about discrete asset classes, but about cross-cutting activities such as risk analysis. One of the best-known facets of green finance are green bonds. There are different types of green bonds, but the most common one is where the proceeds are earmarked for environmental projects.

In a paper last May, the think tank 2° Investing Initiative described use-of-proceed green bonds as "among the more visible market-based initiatives" to develop instruments capable of financing the investment required to bring about a low-carbon economy.

The green bond market can be traced back to issues from the European Investment Bank (EIB) in 2007 and the World Bank in 2008. It took until 2013 before issuance took off but since then, more than $550bn (€481bn) of green bonds have been issued, according to SEB.

Growth stalled in 2018, slowing to 5% year-on-year compared with 68% in 2017, according to BloombergNEF. It attributes this to an attention shift towards a broader range of sustainable bonds and loans, noting that "sustainability-linked loans" grew 677% in the same period.

According to SEB, which uses Bloomberg data, issuance in 2018 reached

$182bn, up from $173bn in 2017.

“We stated one year ago that 2018 would be a year of healthy consolidation and very modest growth with the potential for $185bn of issuance,” says Christopher Kaminker, SEB’s head of research for climate and sustainable finance and senior adviser for large corporates and financial institutions. “It appears that our characterisation was accurate.”

The bank is bullish about 2019 and medium-to-long-term prospects. Kaminker cites the growing refinancing backlog and a “relentlessly strengthening investment proposition across a wide range of green infrastructure projects and activities”.

According to SEB issuance could hit $210bn in 2019 in what it calls its “organic evolution” scenario. In its “green growth” scenario, the market could surprise to the upside with $240bn of new deals. Either would be a record.

New cousins

Green bonds have been joined in the market by sustainability bonds – bonds where the proceeds will be exclusively applied to finance or re-finance a combination of both environmental and social projects.

These emerged in 2018 alongside social bonds, according to SEB, which describes them as cousins of green bonds. Mimicking the early days of the green bond market, supranationals have been behind these initial sustainability bonds: the World Bank has a Sustainable Development Bond issuance programme and in September the EIB issued its first Sustainability Awareness Bond.

Integrity and utility

Marc Briand, head of fixed income for Mirova, the sustainable investment subsidiary of Natixis Investment Managers, is a big fan of green bonds. He describes them as “a way [for portfolio managers] to act on climate change” and “the best way to decarbonise portfolios”.

Mirova considers green bonds to be “double impact bonds,” he says. “They deliver return as commercial debt, of course, plus they deliver an impact for financing the environmental transition.”

A key challenge for the green bond market, however, is integrity, with investors needing to be able to “separate the wheat from the chaff”. This involves paying attention to the quality of an issuer and the underlying projects. As new issuers have entered, Briand says Mirova has excluded more than 10% of issues – a figure anticipated to increase as more corporates tap the market.

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> Frédéric Samama

Integrity is also on the mind of the European Commission and the technical expert group (TEG) that is advising it on the development of an EU green bond standard and other targeted outputs like a classification – “taxonomy” – of environmentally-sustainable economic activities.

According to Nicholas Pfaff, managing director in the market practice and regulatory policy team at the International Capital Market Association (ICMA) and a member of the TEG, “the stated objectives of the EU Green Bond Standard are to further protect the integrity of, and trust in, the green bond market by giving detailed guidance to issuers as well as enabling wider access for investors seeking such a product”.

> **“We stated one year ago that 2018 would**

The TEG is supposed to issue a

report on an EU Green Bond Standard in the second quarter of 2019. For Frédéric Samama, deputy global head of institutional and sovereign clients at Amundi, the main problem with the green bond market is a lack of yield.

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He says: "Most green bond issuers are from the developed markets, and very safe issuers. The consequence of that is that yields are pretty low. Investors are complaining about that."

Relatedly, according to Timothée Jaulin, relationship manager for supranational entities at Amundi, investors are looking for green bonds from issuers other than "the usual suspects" – multilateral development banks or large corporates.

Jaulin says: "Now I think investors want to see green bonds from smaller issuers, emerging market issuers or down market in the developed market."

From a market perspective, Samama says he is "very concerned about the lack of clarity of what the utility function of a green bond is".

He continues: "The messaging around green bonds is sometimes confusing: some people are saying that with green bonds you reduce your financial risks compared to standard bonds from the same issuer, and that's not the case.

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Mirova's Briand says the act of issuing a green bond is a signal that "this issuer is aware of climate change and the challenge for its business model".

"I'm sure that in the long run this type of company will outperform competitors and survive," he says.

Impact questions

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Green finance discussions often point to the vast sums needed to achieve the goals of the 2015 Paris Agreement on climate change or the energy transition more broadly. But some believe it is unclear whether green bonds are the solution.

"[T]he link between issuance and impact is not automatic," wrote Antonio Vives, principal associate at Cumpetere, a consulting firm on sustainability and infrastructure finance, and adjunct professor at Stanford University, in an article for GreenBiz, a US-based media and events company in May 2018.

In his view, there is too much emphasis on issuance volumes and not enough on the impact of completed projects. According to 2° Investing Initiative, there is not the evidence to conclude that "as currently designed use-of-proceeds green bonds contribute – or can without further enhancement contribute – to scaling up the investments in green projects."

The key issue, according to 2° Investing Initiative, is whether green bonds lead to an overall shift in issuers' balance sheets over time, allowing green investment above a business-as-usual baseline.

Issuing green bonds, according to 2° Investing Initiative founder and CEO, Stan Dupré, and three analysts, does not increase an issuer's capacity to invest in more green projects compared with issuing conventional bonds.

Another issue is whether the green bond market would be constrained by the main potential financial incentive for issuers – investors paying a premium – seeming "structurally limited by the lack of a tangible financial benefit for these investors".

The authors refer to arguments about "soft benefits" of green bonds, such as being able to access new investors, but said they had yet to find any evidence indicating these benefits would eventually contribute to increasing investment in environmentally friendly projects.

"[T]he booming green bond market," they wrote, "might be comparable to a hot air balloons festival: great to raise awareness and turn people's heads towards the sky, but if the objective is to reach the moon, we will need more than hot air."

Amundi's Samama says this view on scaling up is "partly true, partly wrong".

Apple, for example, "does not need to issue green bonds to change their green activity," he says. "They just send a signal. So for Apple I could say yes." Where green bonds can make a difference, he says, is with smaller companies and emerging markets.

He points to the $1.4bn emerging market green bond fund that Amundi and the International Finance Corporation (IFC) launched in 2018 to encourage banks in developing countries to issue green bonds.

The Amundi Planet Emerging Green One fund was designed to bridge the gap between large green infrastructure financing needs in the emerging markets and the large asset pools in developed markets. "For most investors it's too risky to invest in emerging market debt and most also aren't familiar with green infrastructure," he says.

The project with IFC tackles this in two important ways, according to Samama. First, the fund provides a risk-sharing mechanism: a junior equity tranche is mainly subscribed by the IFC, which would therefore absorb any first losses.

According to Samama, this allowed investors to back the fund who had never before invested in emerging market debt. "So this really proves that emerging market banks suddenly had access to a new pool of investors through the fund," he says.

The second important decision was to use green bonds issued by local banks as an intermediary between the investors and local infrastructure projects, adds Samama.

"More and more we're saying that maybe this is the real utility function of the green bonds: to create this capability to disconnect, with the banks, the risks associated with infrastructure projects. We take the risk of the banks but the money is channelled toward green activities, including some green infrastructure projects."

The IFC made a $256m cornerstone commitment, with European pension funds among the institutional investors providing the rest of the fund's backing.

The fund is expected to deploy $2bn over its lifetime as proceeds are reinvested through to 2025.

Next stop CLOs?

Green bonds and their cousins are not the only form of green finance in town. There have also been some securitisations, and policymakers have begun to explore whether more could be made of securitised and structured financial products in the battle against climate change.

A November 2018 white paper commissioned by the G20 Sustainable Finance Study Group, for example, focuses on the case for collateralised loan obligations (CLOs) as a way to connect bank loans for sustainable energy infrastructure projects with "deep pools of institutional investor capital".

Currently, most infrastructure projects are funded by bank loans, the paper notes, making it important that banks be able to replenish their lending capacity by transferring loans off their balance sheets.

The thinking is that securitisation, and 'sustainable CLOs' in particular, could achieve this. CLO asset managers would jumpstart the market by purchasing existing sustainable infrastructure loans from banks with funds raised by securitised bonds.

The white paper included an investor perspective in the form of a contribution from the Dutch pension manager APG, which set out a hypothetical evaluation approach to a sustainable CLO.

It recommended that a broader assessment of institutional investor demand for the underlying assets be carried out, given that, in its experience, "securitising assets does not necessarily change their relative attractiveness".

Other questions to consider, according to APG, would be how a sustainable CLO would fit within overall credit portfolios and how large an allocation to "real infrastructure", sustainable or not, makes sense from a strategic view.

SEB has said it expects to see the first green CLOs launched this year. S&P Global Ratings has said it sees a lack of collateral as the main drawback to the development of a green CLO market, but that "2019 and beyond looks big for investor and issuer activism in green CLOs".

Just as with use-of-proceed green bonds, it would be good to keep a close eye on the environmental benefit generated by any green CLOs and not just their investment potential.