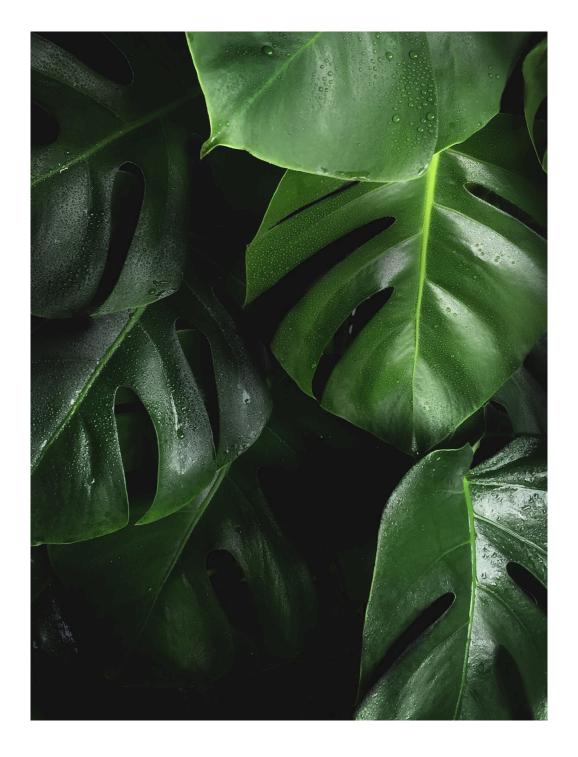


July 19, 2022

The name is Bond, Green Bond



I'm always struggling to understand why bonds, as an asset class, continue to be given the cold-shoulder by investors. Fixed income investment is often thought to be boring - but it's not. Not to mention that bond investors are generally more introverts than equity investors, but obviously the pedigree of those two traditional asset classes are not the same. When it comes to sustainable finance, it could be that bonds, and even more so green bonds, pack more of a punch in terms of impact than stocks...

Historically, sustainable finance was the field of equity investors who screened their investment choices based on companies' environmental, social and governance (ESG) characteristics. An obvious paradox that most traditional buy-and-hold fixed income investors only discovered later on, is that investing for the long-term naturally requires sustainability considerations.

Tomorrow never dies?

In 2007, the UN IPCC (Intergovernmental Panel for Climate Change) published, a now famous, report linking human activity to global warming. Recognizing the urgent risks posed by climate change, some institutions, in association with the World Bank and climate change experts, collaborated to establish a process for debt markets to be part of the solution. Subsequently, in 2007-2008, the EIB and the World Bank successfully issued the world's first green bonds. Since then, they have gained prominence as an important tool in the mission to cut carbon emissions and achieve sustainable development goals.

But before entering the world of green bonds, the first observation is that the global bond market is the largest by market cap. Even if the relative size is maybe not pertinent to address the role of the different assets, ESG factors are worth considering when it comes to both the profitability considerations of equity investors and the creditworthiness considerations of debt investors.

While every investor can have a strong view on a particular company or a particular economic activity, investing in a responsible manner is much more demanding than simply divesting from the ESG laggards or excluding the controversial activities. From an investment perspective, ESG factors provide important information to assess risks and opportunities. As such, and for both equity as well as fixed income investors, an exclusion policy and ESG integration are common sense and simply represent best practice inside of investment methodologies.

But from an impact perspective, there is a significant difference. Investors should understand the limitations of different asset classes when it comes to having an impact. By simply selling your equity holdings and divesting from company with a high carbon footprint, you are obviously decarbonizing your portfolio, but you are not decarbonizing the economy. Those shares will go back into the secondary market to be bought by another investor. Selecting only companies that develop solutions to the world's most critical sustainability challenges is definitely a great ambition but not a suitable solution for investors as it could potentially mean

that you were not adequately diversified.

If the ambition behind sustainable investment is to generate a positive feedback-loop by rewarding the good companies with cheaper capital while keeping money away from those doing harm: in real life this is not actually that simple. New capital fundraising happens in the debt markets far more often than the equity markets and it is this bond issuance that's often used to finance new capital projects. Unlike equities, bonds mature, prompting companies to return to the market to refinance.

NEW CAPITAL FUNDRAISING HAPPENS IN THE DEBT MARKETS FAR MORE OFTEN THAN THE EQUITY MARKETS

Unless the vast majority of asset owners decide to divest the listed equity of a specific company, it does not directly affect the cost of capital the firm has to pay. In fact, listed equities have already been sold by a company during its Initial Public Offering (IPO) and so divesting from shares does not directly affect the funds flowing into the company.

UNLESS THE VAST MAJORITY OF ASSET OWNERS DECIDE TO DIVEST THE LISTED EQUITY OF A SPECIFIC COMPANY, IT DOES NOT DIRECTLY AFFECT THE COST OF CAPITAL THE FIRM HAS TO PAY.

But if only a few asset owners, however, deny to continue subscribing to new debt issues of the same company, it immediately increases the cost of capital. Indeed, debt has to be re-issued regularly, as the usual practice is to recycle debt, repaying old debt with new debt. The interest a company has to pay directly depends on the number of people willing to invest. If there are fewer investors willing to invest, the company will need to pay more to attract them.

On the equity side, if you are looking for impact, it's obviously more effective to use your voting rights in favour of sustainable development and to engage in dialogue with corporate leaders via direct or collaborative engagement.

In that prospect, and while definitely not without controversy, Robert Eccles, a leading authority on the integration of ESG factors in resource allocation decisions by companies and investors, as well as the world's foremost academic expert on integrated reporting, believes in the possibility that a good company can be one that does less of something bad. In 2019, he started consulting Philip Morris (a multinational tobacco company) on sustainability, social impact and investor engagement. Anticipating outrage, Eccles simply replied that activists who have been pressing investors to divest from tobacco, via their exclusion policy, have accomplished nothing, as roughly 1 billion people still smoke.

But sustainable investing in fixed income does not only focus on issuers 'credentials. With a focus on project objectives at their heart, sustainable bonds effectively shifted the attention of responsible investors away from issuers right towards the actual environmental and/or social

impact that their proceeds are expected to make.

This area of the fixed income investment landscape has enjoyed amazing - and still healthy - organic growth. New green and sustainable bond issuance declined in 2022 vs. 2021, the result of unfavourable macroeconomic and financial market conditions, but the overall volume of those bonds remains on the rise, reaching €2 Trillion (all currency, source Natixis) at the end of June 2022. In contrast, green sovereign bonds picked up markedly during Q2 2022 with roughly €29 bn in issuance during the period and France launching the first ever inflation-linked green bond[1].

Several upcoming initiatives will likely further reinforce the role of fixed income investors in sustainable development. The new ECB green bond framework, for instance, will be an important milestone to scale up and raise the environmental ambitions of the green bond market by setting up a gold standard as to how issuers can use green bonds to raise funds on capital markets while protecting investors. Furthermore, corporate bond receipts from the Corporate Sector Purchase Programme (CSPP) ECB portfolios will be reallocated. From October, the ECB will begin reinvesting the proceeds of its maturing bonds in low-carbon-footprint corporate bonds. Additionally, the ECB will consider climate change risks when reviewing haircuts applied to corporate bonds used as collateral.

All those initiatives will definitely have an impact on corporate bond market valuations at some point. And when discussing green bonds, there is a concept that is intensively comment, the concept of greenium.

GREENIUMS

The greenium, or green premium, is nothing other than the spread of a green bond relative to the issuer's non-green curve (aka "vanilla" bonds). This refers to the logic that investors are willing to accept lower yields in exchange for sustainable impact. And indeed, the existence of such a premium is mostly justified by higher demand for green bonds because, in theory, there is no reason for such a premium as there is no greater nor smaller default risk attached to green bonds vs. vanilla bonds[2]. In essence, there is a scarcity effect at play.

It's estimate that the greenium for the €-corporate bond market is currently around 4 basis points (currently being close to its record high level). While such a narrow differential could be perceived as peanuts, it's worth to remember that this is an average. A deep dive into the secondary market demonstrates that 65% of green and sustainable bonds display a premium. The greenium is not a given and some green bonds are traded at discounts due to bond peculiarities (issue size too small or too large; investors' perceptions of the green bond framework or the company's sustainability profile) and/or on greenwashing concerns. Furthermore, the greenium has some sort of personality, as it trades differently by sector.

But if issuing green bonds requires considerable effort for an issuer (identifying the use of proceeds, project valuation, management of the proceeds, reporting, external assurance, ..), one could ask if the benefits are worth it? The answer is also that the reduction in the cost of capital is far from the only factor. Signalling benefits to stakeholders and the benefits that flow from ESG ratings are also worth considering.

As of now, sustainable investment is definitely not an investing nirvana with perfect clarity. Broadly speaking, the narrative of a finance world supposedly saving the world via the ecological and energy transition, is not a serious scenario. But sustainable investment is definitely part of the toolbox that should be use to limit the "tragedy of the horizon"[3]. The shift to a low-carbon economy involves massive investment in eco-friendly assets and projects. Getting public and private investors to buy green bonds is an important way of raising the necessary capital.

Sources

- Andreas Hoepner How to impact climate justice: engage in equities, deny debt! –
 August 2015
- Candriam Bonds making impact: financing a sustainable future May 2022
- Natixis Green and sustainable bond market update 2Q 2022
- ING Sustainable Finance, the search for 'greenium' June 2021

References

- [1] Indexed to the European HCPI (ex-tobacco), the Green OAT€I 0.1% 2038 was a clear success with €27bn orders book of which €4bn were allocated.
- [2] But it's also worth to mention that Finance 101 emphasize that the appropriate discount rate for a project depends on the project's own characteristics, not the firm as a whole.
- [3] "Breaking the tragedy of the horizon; climate change and financial stability" is a famous speech of Mark Carney, at that time the governor of the BoE, September 2015.

Disclaimer

All financial data and/or economic information released by this Publication (the "Publication"); (the "Data" or the "Financial data and/or economic information"), are provided for information purposes only, without warranty of any kind, including without limitation the warranties of merchantability, fitness for a particular purpose or warranties and non-infringement of any patent, intellectual property or proprietary rights of any party, and are not intended for trading purposes. Banque Internationale à Luxembourg SA (the "Bank") does not guarantee expressly or impliedly, the sequence, accuracy, adequacy, legality, completeness, reliability, usefulness or timeless of any Data. All Financial data and/or economic information provided may be delayed or may contain errors or be incomplete. This disclaimer applies to both isolated and aggregate uses of the Data. All Data is provided on an "as is" basis. None of the Financial data and/or economic information contained on this Publication constitutes a solicitation, offer, opinion, or recommendation, a guarantee of results, nor a solicitation by the Bank of an offer to buy or sell any security, products and services mentioned into it or to make investments. Moreover, none of the Financial data and/or economic information contained on this Publication provides legal, tax accounting, financial or investment advice or services regarding the profitability or suitability of any security or investment. This Publication has not been prepared with the aim to take an investor's particular investment objectives, financial position or needs into account. It is up to the investor himself to consider whether the Data contained herein this Publication is appropriate to his needs, financial position and objectives or to seek professional independent advice before making an investment decision based upon the Data. No investment decision whatsoever may result from solely reading this document. In order to read and understand the Financial data and/or economic information included in this document, you will need to have knowledge and experience of financial markets. If this is not the case, please contact your relationship manager. This Publication is prepared by the Bank and is based on data available to the public and upon information from sources believed to be reliable and accurate, taken from stock exchanges and third parties. The Bank, including its parent,- subsidiary or affiliate entities, agents, directors, officers, employees, representatives or suppliers, shall not, directly or indirectly, be liable, in any way, for any: inaccuracies or errors in or omissions from the Financial data and/or economic information, including but not limited to financial data regardless of the cause of such or for any investment decision made, action taken, or action not taken of whatever nature in reliance upon any Data provided herein, nor for any loss or damage, direct or indirect, special or consequential, arising from any use of this Publication or of its content. This Publication is only valid at the moment of its editing, unless otherwise specified. All Financial data and/or economic information contained herein can also quickly become out-of- date. All Data is subject to change without notice and may not be incorporated in any new version of this Publication. The Bank has no obligation to update this Publication upon the availability of new data, the occurrence of new events and/or other evolutions. Before making an investment decision, the investor must read carefully the terms and conditions of the documentation relating to the specific products or services. Past performance is no guarantee of future performance. Products or services described in this Publication may not be available in all countries and may be subject to restrictions in some persons or in some countries. No part of this Publication may be reproduced, distributed, modified, linked to or used for any public or commercial purpose without the prior written consent of the Bank. In any case, all Financial data and/or economic information provided on this Publication are not intended for use by, or distribution to, any person or entity in any jurisdiction or country where such use or distribution would be contrary to law and/or regulation. If you have obtained this Publication from a source other than the Bank website, be aware that electronic documentation can be altered subsequent to original distribution.

As economic conditions are subject to change, the information and opinions presented in this outlook are current only as of the date indicated in the matrix or the publication date. This publication is based on data available to the public and upon information that is considered as reliable. Even if particular attention has been paid to its content, no guarantee, warranty or representation is given to the accuracy or completeness thereof. Banque Internationale à Luxembourg cannot be held liable or responsible with respect to the information expressed herein. This document has been prepared only for information purposes and does not constitute an offer or invitation to make investments. It is up to investors themselves to consider whether the information contained herein is appropriate to their needs and objectives or to seek advice before making an investment decision based upon this information. Banque Internationale à Luxembourg accepts no liability whatsoever for any investment decisions of whatever nature by the user of this publication, which are in any way based on this publication, nor for any loss or damage arising from any use of this publication or its content. This publication, prepared by Banque Internationale à Luxembourg (BIL), may not be copied or duplicated in any form whatsoever or redistributed without the prior written consent of BIL 69, route d'Esch I L-2953 Luxembourg I RCS Luxembourg B-6307 I Tel. +352 4590 6699 I www.bil.com.

