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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.

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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.

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