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Global Asset Management

Green bonds: Not all are equal

Green bonds are fixed income instruments used to fund projects that have positive environmental benefits. Demand is increasing, with total issuance reaching almost USD270 billion in 2020 according to Climate Bond Initiative data, but can they really underpin the environmental transition?

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In our view, green bonds are a necessary instrument but alone are not sufficient to support the shift to a greener, more sustainable world. Here's why:

Positives

Green bonds can be a valuable tool for debt investors to signal to issuers their need to commit to, and take effective action around, sustainability issues. They can also act as a means for investors to allocate capital explicitly to green economic activities and so help finance the transition. The use-of-proceeds model means investors can have confidence in how their capital is being allocated and avoid it being misused, such as to fund 'brown' activities.

For issuers, green bonds are useful for signalling their commitment to environmental issues, as well as broadening their potential investor pool.

Challenges

In terms of constraints, there's a limit to which projects qualify for green bond issuance. As such, sourcing can be restricted to certain sectors, limiting the potential for environmental impact.

Additionally, while green bond issuances are directed towards specific eligible activities, there's no guarantee that they will deliver positive outcomes – and if they do, on the scale they should. This is because, aside from the reputational impact of not delivering promised outcomes, there are no direct financial penalties for not delivering. This sets green bonds apart from sustainability linked bonds (SLBs), which accrue payments to bondholders if they fail to achieve their performance objectives.

While there are International Capital Market Association (ICMA) principles for how to manage the green bond process, there are no guidelines on what constitutes 'green' and what 'good' looks like. This leads to the potential risk of 'greenwashing', where issuances can lack credibility and robustness. This risk is not helped by the rush of issuances we are seeing, as issuers seek to capitalise on the potential to raise financing more cheaply than via vanilla bonds, given the lack of supply and high investor demand.

How to invest

To minimise risks, investors should ensure they have a robust process for evaluating each bond, as not all green bonds are equal. Buyers need to look under the 'hood' and evaluate the quality and integrity of the issuer's specific framework and assess whether it follows current best practice in terms of transparency, governance and process for post-issue monitoring, as well as its use of proceeds accounting and impact reporting. The scope of what is included as 'qualifying activities' and how these link through to real-world outcomes should also be disclosed.

We see the potential for a blended model, where use-of-proceeds and outcomes-linked issuances are combined to produce a hybrid model, which leverages the best of both. More broadly, issuers need to demonstrate to investors they have a well thought out and holistic long-term sustainable finance strategy and to what extent green bonds are an appropriate part of this.

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Published date: October 2021

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