Aegon Asset Management

GREEN BONDS: PEELING BACK THE LABEL

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Green bond issuance has surged in recent years as companies tapped capital markets to fund environmental initiatives. At the same time, issuance of social and sustainability bonds also increased exponentially. Despite the growth, the absence of common industry standards within the so-called "labeled" bond market creates investor confusion and greenwashing concerns. By peeling back the label, we outline how to potentially avoid green bond pitfalls and uncover sustainable investment opportunities in fixed income.

History of green bonds

Green bonds emerged in 2007 when the European Investment Bank issued Climate Awareness Bonds (CAB), which had proceeds ring-fenced toward renewable energy and energy efficiency. Shortly after, the World Bank issued a sustainability-linked bond that became the first issuance to use the term "green" bond. Today, a green bond is essentially a debt security aimed at raising capital to support climate or environmental projects. More broadly, the labeled bond market has expanded to include social, sustainability and other bond issuances aimed at targeted environmental or social projects.

Market growth: How has the green bond market evolved?

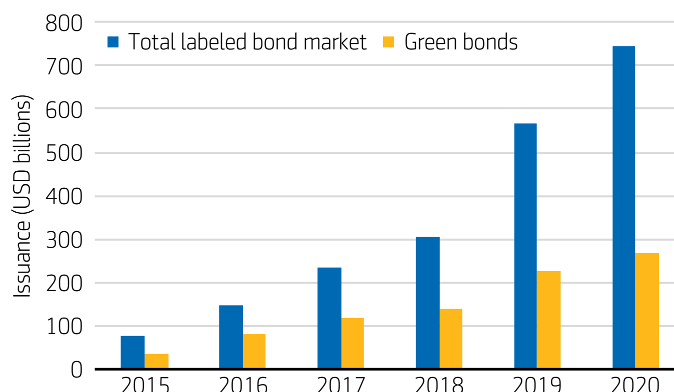
Green, social and sustainability bonds—collectively referred to as labeled bonds—are increasingly becoming an important part of global fixed income markets. For the year 2020, the labeled bond market issuance exceeded $745 billion according to Bloomberg. Demand and supply have accelerated in recent years as investors hunt for sustainable investment solutions and companies pursue financing for environmental or social projects. We believe the recent growth in the labeled bond market is evidence of the broader secular shift toward a more sustainable global economy.

Green bond issuance has accelerated in recent years. At the end of 2020, global green bonds totaled $226 billion, which was up from approximately $39 billion at the end of 2015—close to a six-fold increase during the period (Exhibit 1).

Green bonds represent approximately 40% of the labeled bond market, but social and sustainability bonds are seeing increasing interest from issuers and investors. As social issues like Covid-19 and the Black Lives Matter movement rose to the forefront in 2020, issuance of social bonds grew to about 20% of the total labeled bond issuance in 2020 compared to 2% in the previous year.

Although EUR-denominated bonds have historically dominated the marketplace, we have witnessed rapid growth in US dollar-denominated debt. In 2021, USD-denominated labeled bonds are expected to surpass EUR-denominated for the first time, according to JP Morgan, indicating that interest in labeled bonds is broadening globally.

Exhibit 1: Labeled bond market issuance



Source: Bloomberg. Reflects annual issuance through December 31, 2020.

Technicals: Do you expect continued growth in new green bond issuance? Will it be enough to meet increasing demand?

Despite the strong growth in the supply of labeled bonds in recent years, demand appears to be outstripping supply, suggesting there is room for continued growth in supply. As evidence, within the investment grade corporate bond market, we estimate that labeled bonds have recently traded about five basis points tighter than a plain vanilla bond issued by the same company with a similar duration. While this premium, or the so-called "greenium", may vary across issuers and sectors, we anticipate this premium will eventually close as the supply of labeled bonds continues to grow to meet investor demand. In the coming years, we think there will be continued supply coming to market to match elevated demand.

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Issuance: Are issuers taking advantage of investor demand for labeled bonds?

The significant growth in the labeled bond market is a function of rising investor demand for sustainability linked investments coupled with issuers securing financing for environmental, social and sustainability related projects. Amid low interest rates and high investor demand, some issuers are opportunistically taking advantage of market conditions to secure cheaper financing. As a result, the risk of greenwashing is growing. Issuers may be prone to false promises as the use of proceeds may not align with the intended projects and/or reporting may not provide sufficient transparency. To mitigate this risk, fixed income investors need to carefully assess each issuance on a case-by-case basis.

Greenwashing: What are the potential pitfalls of labeled bonds?

According to a Journal of Environmental Investing report in 2020, we have 29 different labels which creates complexities in the absence of common standards. Labels were designed to provide this dynamic market credibility and help investors to measure and compare their investments. All labels tend to share common ground by focusing on the use of proceeds and aim to identify contribution to sustainability or ESG goals. However, navigating this space becomes unnecessarily complex given the quantity of various labels. This complexity does not promote transparency, reduces the ability to compare different bonds on green credentials and can increase the risk of greenwashing.

In the absence of a common industry standard, issuers of labeled bonds can be prone to false promises. Many companies fail to publish promised reports on their labeled bonds or inadequately report on the metrics that are most relevant to measure the success of the identified projects. While the labels may imply certain expectations for reporting and other metrics, they lack a credible enforcement mechanism. A Climate Bond Initiative study in 2019 found that approximately two-thirds of issuers provide post-issuance reporting and almost 50% of issuers report both allocations to projects and impact metrics.

Standardization: What is being done to foster standardization?

In Europe, the EU Sustainable Finance Taxonomy is partly trying to solve these problems by giving clear guidance and outlining a high-level framework to help define sustainable investments. The Taxonomy proposes a simple process to determine the sustainability of an investment:

1. Does the economic activity enabled by the investment contribute substantially to one or more of the six environmental objectives outlined by the taxonomy?
2. Does the economy activity harm any of the other environmental objectives in a significant way?
3. Does the particular investment (company, project) have minimum social safeguards to uphold human rights and social concerns?

Assessment framework: How can investors identify the most compelling labeled bonds?

As with any growing market that lacks standardization, a thorough case-by-case assessment is key. A rigorous evaluation of the use of proceeds and reporting can help assess the true sustainability profile of the investment. Furthermore, active engagement can help address problems related to frameworks, labels and post-issuance reporting. Five key steps include:

1. **Use of proceeds:** Scrutinize alignment of the green bond use of proceeds to stated initiatives.

   First and foremost, it is important to ensure that the offering documents outline the projects and the intended allocation. A detailed review of the documents can help ensure the alignment of use of proceeds with sustainable themes. We measure the green bond's use of proceeds against relevant sustainable themes.

2. **Governance:** Evaluate corporate governance around the use of funds.

   Second, we ensure that the corporate governance surrounding the use of proceeds is robust. An evaluation of corporate governance can help investors understand how the company thinks about this green bond and evaluate their commitment to sustainability. Ideally, we would want the green proceeds to be ring-fenced to prevent fungibility. However, in practice it is rare for issuers to adopt this approach.

3. **Frameworks:** Evaluate the use of green bond frameworks.

   We evaluate if the issuance is supportive or aligned with a particular framework such as ICMA Green Bond Principles, which could help us verify if the issuance is aligned with a particular green investment criteria. Despite the criticism towards frameworks, labeled bonds are transaction level decisions, in which frameworks can still bring value in terms of seeking standardization. The use of standards often brings third-party verification which can bring some assurances of the overall labeled issuance program.

4. **Reporting:** Assess the green bond reporting framework.

   Post-issuance reporting, also known as green bond reporting, is fundamental to verify the impacts of the issuance proceeds on eligible projects listed at the outset of green bond issuance. The most robust issuance clearly outlines that the proceeds are allocated and includes relevant metrics to measure to success of each project. However, since green bond reporting is not enforced, often companies will not follow through on reporting after issuance. In those situations, we engage with companies to encourage sufficient reporting.

5. **Alignment:** Is the green issuance a one-off or aligned with the long-term strategy of the business?

   This key step can help focus on the issuer's broader approach to long-term sustainability. Is the issuer capitalizing on the investor demand of labeled bonds today with no intention of building towards long-term sustainability or making credible steps towards a more sustainable future?

Investment opportunities: Are there other sustainable investment opportunities beyond labeled bonds?

Within public fixed income, we've found that the sustainable fixed income opportunity set extends well beyond labeled bonds. In other words, labeled bonds represent merely one way to advance sustainability initiatives.

Labeled bonds can be an attractive sustainable investment when the use of proceeds is fully aligned and transparent. However, there are numerous issuers with products, services and business practices that address sustainability issues that do not issue labeled bonds. In those cases, companies that provide products and services that are aligned with sustainable initiatives and pivoting their business toward sustainability could easily get overlooked in a green-bond-only strategy. Further, while green bond market growth has been impressive, the issuance pales in comparison to the size of global debt markets with $6.86 trillion of total issuance in 2019.

By identifying issuers with products, services or practices that align with sustainability initiatives, investors can widen the opportunity set to include labeled and unlabeled bonds that align with environmental, social and sustainability initiatives. From corporate credit and sovereign debt to securitized credit and municipals, a comprehensive proprietary research approach can identify numerous opportunities to invest sustainably while pursuing competitive excess returns over the long term.

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