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Pitfalls of Green Labelling

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Pitfalls of Green Labelling

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Fixed income investors have a vital role to play in accelerating the shift to a net zero world by 2050. Kris Atkinson, Sajiv Vaid and Ana Victoria Quaas discuss why investors should not solely restrict themselves to the green bond market given its pitfalls.

Summary

Green bonds are a valuable investment class but exhibit a series of drawbacks as a sustainable instrument. Not all green bonds are equal, with the proceeds not always destined for climate related projects. There is no consistent measurement system for assessing the impact of green bond financed projects on the environment and finding reliable and insightful data remains difficult. Green bond investors are likely to settle for reduced diversification, lower yields, and thinner liquidity. Standardisation within the green bond industry would go a long way towards resolving many of these issues. It would include the consolidation of trade bodies, coupled with standardised and auditable pre and post issuance reporting frameworks / schedules, with independent valuations. Nevertheless, sustainable investors should not restrict themselves to the green bond market. A portfolio comprising of a mixture of green and conventional bonds can deliver positive returns, whilst reducing carbon emissions.

Not all green bonds are created equal

Green bond proceeds are meant to finance climate-related projects, but in practice, this has not always happened. The failure among several high-profile projects to deliver on their environmental benefits has renewed investors' fears towards green issuance.

Some entities have been marketing green bonds to finance environmentally friendly projects, which turn out to be routine business activities. In January 2022, the Hong Kong Airport Authority sold a US$1 billion green tranche, with the proceeds earmarked for funding decarbonisation and climate-change adaptation projects, including a third runway. However, critics argued that such expansion in airport capacity would increase carbon emissions and biodiversity risk, especially with regards to the endangered Chinese white dolphin.

There are issuers who pursue legitimate endeavours that do not qualify as 'green'. Microsoft recently committed to removing all the carbon it has ever emitted. Autodesk enabled computer aided designs to allow companies to design buildings in energy efficient ways. Neither corporation fulfilled current green bond standards despite the obvious green credentials and good disclosure provided.

Then there are green bonds that are unable to maintain their sustainable credentials until maturity. In 2016/2017, the Mexico City Airport Trust issued US$6 billion in green bonds to fund the construction of a new, sustainable airport, receiving second party opinions and evaluations from ratings agencies. A year later, a new government cancelled the project and launched a buyback package to placate investors after the bonds underperformed. However, the Trust's residual bonds are still technically labelled as green and their inclusion in green bond indices can further dilute their credibility.

Finally, there is the contentious issue of sustainability-linked bonds (SLB), developed for companies wishing to raise funds to help them transition to more sustainable activities. They appear to address environmental concerns but often make matters worse for climate change. SLBs do not have tight restrictions on how funds are used; instead, they have specific sustainability

targets, coupled with penalties if they fall short - but these features are weak in nature.

For instance, Indian cement maker Ultratech had previously been fined for breaching air pollution limits and had recently borrowed $400m via an SLB (according to Refinitiv), with a goal of reducing emissions by 22% per tonne of cement produced by March 2030. If the company failed to meet this target, the penalty would be an increase in the rate of interest on the bonds of less than 1%. However, with the assessment date six months before the debt is due to be repaid, the total sum amounted to just $3m – or 0.05% of the company's revenues last year.[1]

Measuring the effects of green bonds on the environment remains difficult

There is no consistent measurement system for assessing the impact of green bond financed projects on the environment and finding reliable and insightful data remains difficult. Investors must rely on reporting by the issuer itself as there is no independent analysis nor standardised frameworks. Consequently, the quality, comprehensiveness, and robustness of reporting varies from one issuer to another.

In addition, the issuer has no real incentive to analyse whether the project has generated sufficient cash flows to service the debt. Green bonds tend to be wholly backed by the issuer, not the specific project that was financed. Without being able to accurately measure the impact of green bonds, it is hard to discern how serious issuers are on climate change.

For investors, if they doubt a green project's credentials, they face the dilemma of whether to sell the bond, which means their capital may fail in its climate purpose. Or they may continue to hold their investment and request better reports, in the hope of relatively better returns. Such weaknesses in the sector leaves the market vulnerable to greenwashing.

Size matters in the bond market

The rise of the green bond sector is relatively recent. Until 2012, total cumulative green bond issuance only amounted to US$2.6 billion[2]. In 2016 however, the market began to accelerate, largely due to China, which originated more than a third of issuance. Today, nearly US$2 trillion of green bonds[3] have been issued, but while growth has been rapid, the market is still relatively small, and many of its problems stem from its limited size.

At the core of bond investing is the management of risk through diversification. However, the relatively small and illiquid green bond market and its undiversified issuer base undermines risk management. This forces active green bond funds to hold most of the outstanding bonds in the market and resemble passive strategies. Even passive funds in the sector tend to be relatively undiversified versus other bond funds, given the limited size of the green bond universe.

A raw deal for investors

Ultimately, green bond investors are likely to settle for reduced diversification, lower yields, and thinner liquidity, resulting in worse risk adjusted returns. Investors must pay for the privilege of acquiring green bonds through higher premiums. The green market is selective in accepting issuers, with certain industries such as conventional energy effectively locked out of the asset class. Sovereigns, supranationals, banks, utilities and property are the biggest issuers, but outside of these groups, there are fewer borrowers. As a result, ready demand outstrips supply.

With a smaller issuer base, the market trades at a premium, despite green bonds being mechanically no different to other bonds. There are no credit enhancements or reduction in risk and the principle and coupons are still serviced by cash flows generated by the entire organisation's assets, not those of a specific project.

For example, take Volkswagen's VW 1.25% 2032, an outlier among the issuer's green bonds. Like all

[1] Mines, pipelines and oil rigs: what HSBC's 'sustainable finance' really pays for — The Bureau of Investigative Journalism (en-GB) (thebureauinvestigates.com)
[2] https://www.un.org/sustainabledevelopment/wp-content/uploads/2019/07/EXEC.SUM_SG-Roadmap-Financing-SDGs-July-2019.pdf
[3] https://www.climatebonds.net/files/reports/cbi_susdebtsum_highlq32022_final.pdf

VW green instruments, it has been issued by the Volkswagen International Finance subsidiary, which incidentally also issues the automaker's subordinated hybrids. The bond trades well inside the slightly shorter-duration VW 3.3% 2033, a conventional bond with an older vintage and less liquid. To its credit, the issuer achieved a greenium at issuance in September 2020.

If investors want a detailed project assessment, they are better off opting for asset backed securities or bank loans. Investors could theoretically trade the premium within the sector to generate profits, but in practice green funds must select bonds from the limited menu, removing the scope of trading gains.

Over the course of 2022, green bonds funds have been underperforming because of structural features in the market that have yet to be addressed. Investor fears of being labelled “greenwashers” have forced them into avoiding the sectors with high-emission legacy businesses, such as oil and gas, cement and metals and mining. Consequently, the top three sectors in the ICE BoFA Global Green Bond Index (banks, utilities and real estate) account for 72% of total issuance[4]. These sectors are amongst the worst performers as credit markets have unravelled over the year due to their higher beta, sensitivity to interest rates and challenges associated with the energy crisis. The same sectors account for only 35% of the regular global corporate index making.

The same is true of geographic composition. European investors have been at the forefront of the green bond market. Within the ICE BoFA Green Bond Index, Euro denominated bonds have the greatest weighting at 61%, followed by the US at 24%. However, European bonds only account for 24% of regular credit total index return composition, 67% for US bonds.[5]

VW - Green bond premium versus normal bond

Source: Bloomberg Intelligence, as per October 31, 2022

[4] Source: Fidelity International, Bloomberg, ICE Bank of America Green Bond Index, Oct 31, 2022
[5] Source: Fidelity International, Bloomberg, ICE Bank of America Green Bond Index, Oct 31, 2022

Challenges for the green fund industry

Many green bond funds are serious and discerning investors, but they are still handicapped by the dynamics of the asset class. Even the relatively simple question of what types of projects green investors can invest in is more complicated than it seems.

The market is still undecided on what constitutes a green asset. Historically, green bond issuers defined whether their project was green. Taxonomies have been developed to offer a more objective framework. However, this has not eliminated all disagreements, and when decisions are made, they are often based on bargaining rather than independent consideration.

For example, there is a lively debate in Europe - the global leader in sustainable investing - around whether nuclear energy and gas should be included under the green umbrella. The EU deemed both resources valid following political lobbying by influential member states.

There is also a constant tension between growing the green bond market and loosening standards. A bigger market has obvious advantages but risks diluting the quality of assets. Without reliably green projects, the credibility of the asset class is under question, and the impact of sustainable capital on the environment is compromised. The right balance has yet to be found.

Another complication for green funds is how to choose a lookback period. Green projects are often refinanced in the debt markets. The lookback period is the time scale that investors refer to identify assets to include as part of the project. For example, an issuer building a recycling plant cannot keep refinancing indefinitely claiming fresh sustainability gains each time. Most discerning funds will limit the lookback period to three years to show recent impact, but there is no standardised approach among practitioners.

Rating agencies are an important stakeholder and provide an independent opinion on green bonds. However, in practice, there are too many instances of where agencies simply function to endorse bonds and repeat the issuer's assertions. They are also compensated by the issuer, posing a conflict.

Green market standardisation will resolve many problems for investors and issuers

Standardisation within the green bond industry would go a long way towards resolving many of the current problems. It would involve the consolidation of trade bodies or at the very least, greater co-ordination between them, coupled with a consistent and cohesive set of requirements. Green bonds are currently issued under a variety of voluntary standards and guidelines developed by trade bodies, such as the International Capital Markets Association and the Climate Bonds Initiative.

Green bonds need standardisation, auditable pre and post issuance reporting frameworks and schedules, with independent valuations, detailing how the proceeds will be used and the expected impact of the project on emissions and carbon reduction. It is essential for investors to hold green issuers to account.

Green issuance in the market must widen to increase diversification. The industry should take a broader view of carbon reduction, leading to a more active primary market, instead of disregarding many essential industries that are inherently high emitters. The green industry tends to be myopic in allocating to low emitting issuers, which reduces the incentive for high emitting companies to improve and curtail diversification for investors.

The green industry can achieve better results if it embraces all sectors and issuers irrespective of their starting point. Climate change is a global problem that can only be addressed by working to decarbonise all issuers, irrespective of their origins. Exclusion has never impacted behaviours and green bonds are no exception.

Furthermore, a pragmatic, industry-agnostic and impact-driven approach that funds companies with the most committed and impactful emissions reductions plans will have the greatest impact on the environment. It would allow issuers access to green financing and investors would have better investment outcomes.

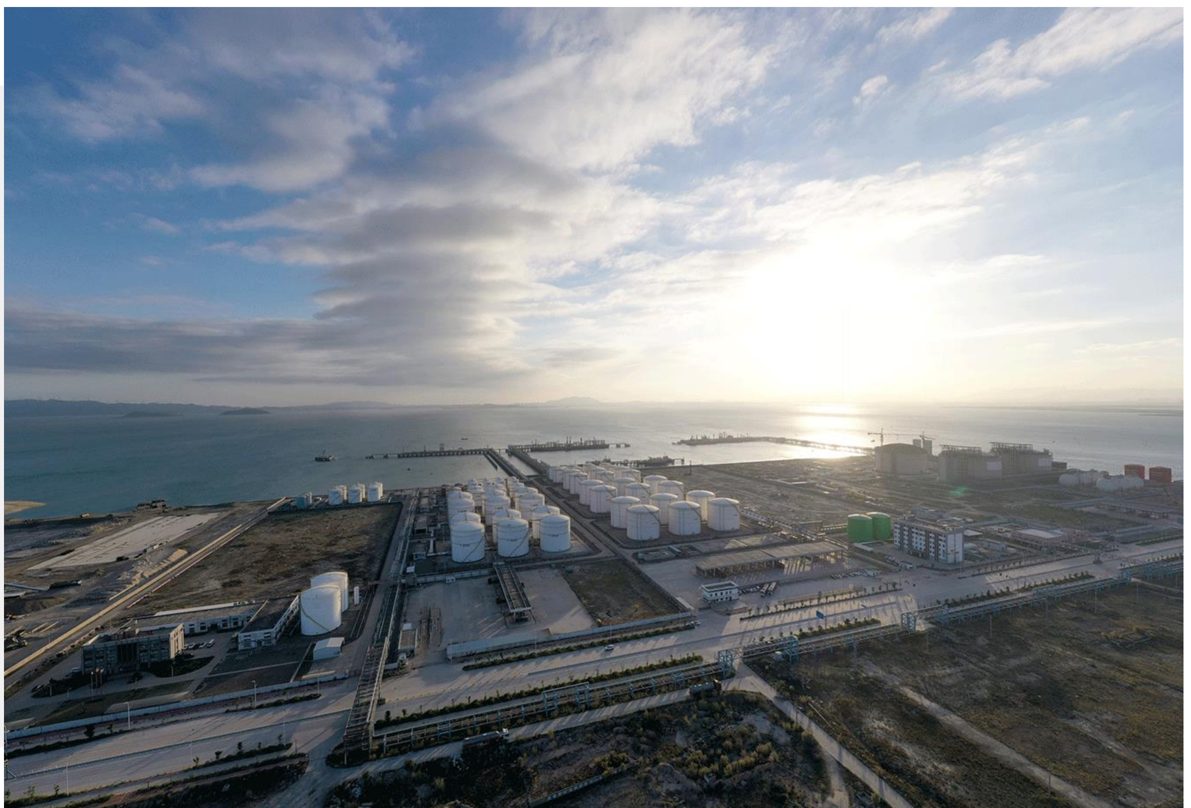
There are many issuers that have ambitious yet achievable transition plans, but because they are in industries such as oil and gas, chemicals, steel, cement and airlines, they are locked out of green financing. Excluding these sectors will not reduce emissions because these organisations play a vital role in our livelihoods and economies. They are also the biggest emitters, so by ignoring them we are tinkering at the margins, not confronting the challenge head on.

For example, the steel and cement industries need access to large and reliable quantities of competitively priced, renewable energy to make their operations sustainable. Green hydrogen is the most realistic and practical energy source for the. However, green hydrogen technology needs investment to develop in scale to become a viable supplier. Without access to green financing, industries like steel and cement face huge challenges in becoming sustainable, leading to a circular predicament.

A mix of green and conventional bonds offers the best proposition for investors

The green bond industry is a worthwhile innovation that has brought welcome attention to the world of sustainability in the fixed income market. Green bond investors are passionate and vocal on environmental issues, helping the whole financial industry in becoming more climate aware.

Sustainable investors should not solely restrict themselves to the green bond market given its pitfalls. Instead, a portfolio comprised of a mixture of green and conventional bonds is best placed to deliver positive returns and reduce carbon emissions. Conventional bonds have the same mechanics as green bonds, but include a vastly bigger set of opportunities, allowing investors to be more selective and diversified, while achieving greater risk-adjusted returns. For issuers in inherently high emitting sectors, the wider fixed income asset class is more accessible, providing funding for transitioning to a zero-carbon economy.



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