Green bonds: from strength to strength

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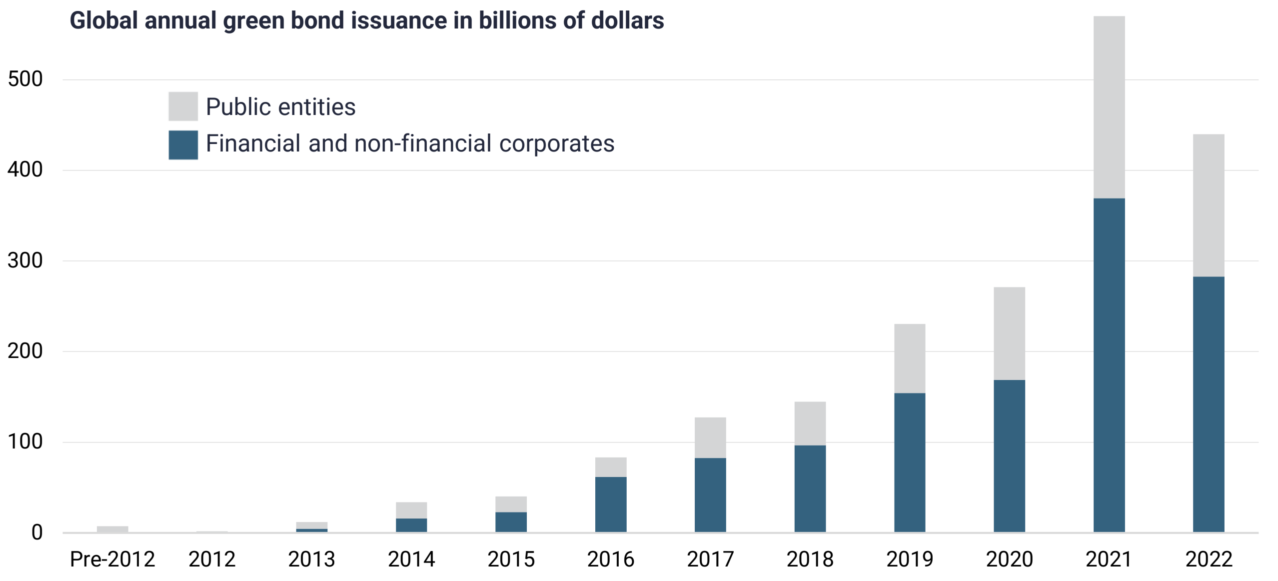
Green bonds have never been so popular. The segment has gone from strength to strength in recent years with governments and companies launching green bonds that have proved popular with investors keen to reduce their portfolios' carbon footprints.

The green bond market has expanded from niche to mainstream in the past ten years and especially since the Paris Agreement of 2015. Green bonds have become a key tool for financing projects contributing to the climate and energy transition with issuance having reached the USD 1 trillion[1] milestone, which is about 1% of total debt issued across all segments.

What are green bonds?

It may be useful to begin with some background, starting with what gives a bond its 'green' status. A green bond is a debt security designed to finance projects that support sustainable development. The debt may be issued by corporate, sovereign or

[1] Source: Climate Bond Initiative. Global aggregate issuance.



Source: BloombergNEF, data as of 18 November 2022.

public entities. Issuers commit to financing specific projects that are related to the energy transition, preserving natural resources, limiting global warming or reducing harmful emissions.

The green bond market was pioneered in 2007 when the European Investment Bank (EIB) issued the world's first Climate Awareness Bond exclusively dedicated to financing green projects. The World Bank followed suit along with various other public and corporate entities. Since then, financial and non-financial corporates have become the largest issuers of green bonds (see the chart above).

While corporates currently dominate the green bond market, sovereign issuance remains at significant levels, especially in Europe. In 2017, France became one of the first sovereign green bond issuers with an inaugural offering of €7 billion. The European Commission has been an issuer since 2021 when it raised €12 billion in green bonds under the NextGenerationEU funding plan. It intends to issue €250 billion in green bonds by the end of 2026 to finance the energy transition.

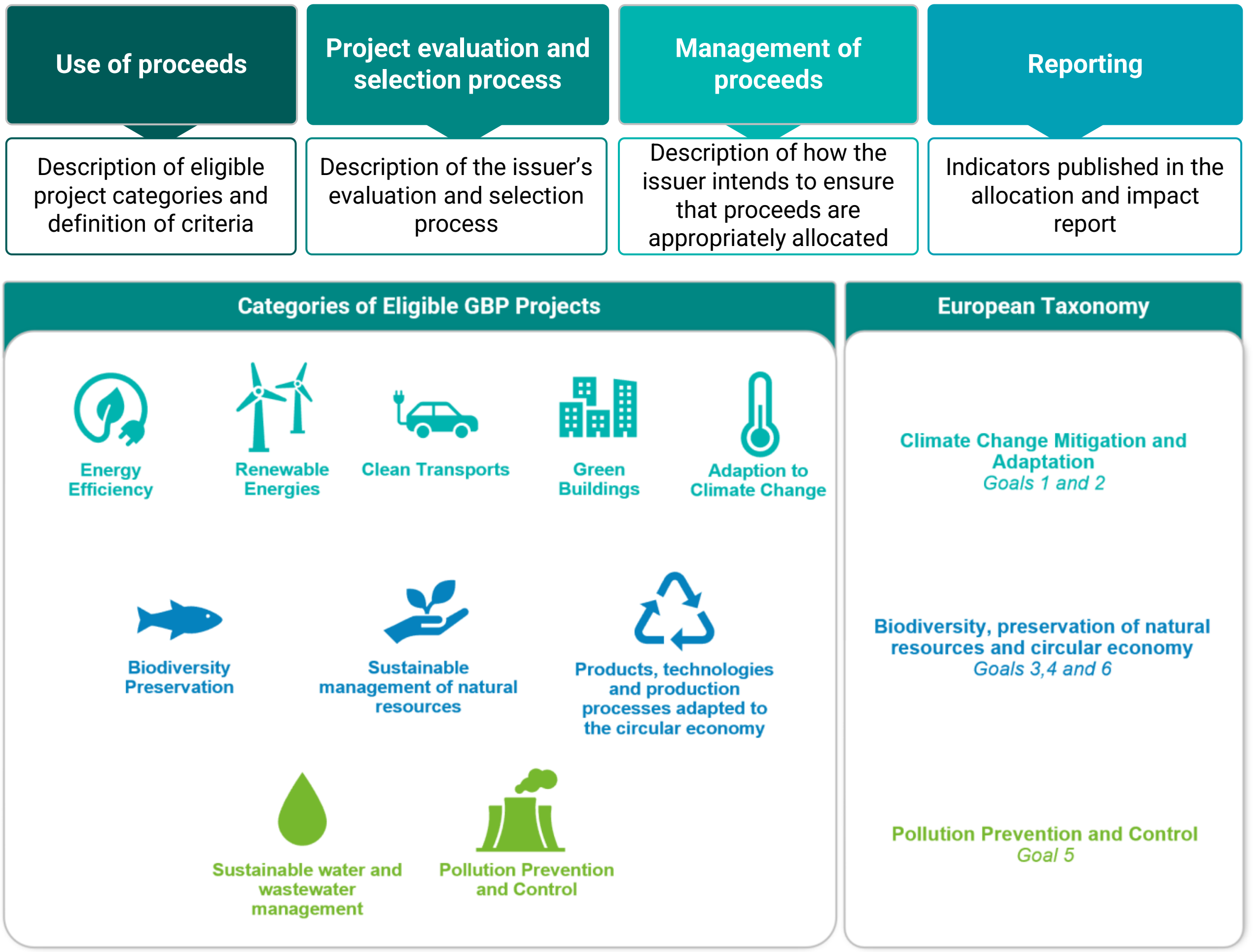
Commitments and principles

Green bond issuance must comply with a framework in which the issuer commits to reporting on impact indicators. These commitments and indicators typically include:

- a list of Sustainable Development Goals (SDGs) to which the funded project contributes;
- the project's alignment with the issuer's environmental and climate objectives;
- an estimate of the CO_2 emissions avoided as a result of the project.

Ahead of the bond issue, these commitments are reviewed by an external ESG audit company, which issues a Second-Party Opinion (SPO). The aim is to ensure that they align with the Green Bond Principles developed in 2013 as guidelines to best practice (see the infographics on the next page). The issuer also commits to reporting annually on the allocation of proceeds and the environmental impact of the projects financed.

Green Bond Principles (GBP): four core components



Source: ICMA.

Significantly, the European Union has also proposed to define new standards for green bonds. The proposal, called the Green Bond Standard (EU GBS), was presented on 6 July 2021 by the European Commission and is expected to enter into force in 2023 or 2024. Eventually, the Green Bond Principles and the European Green Bond Standard may converge.

By definition, not all companies can issue green bonds. So far, the predominant sectors are local utilities (recycling, waste management), electricity producers (renewable energy) and property companies (energy efficient renovation). Other sectors such as banking and telecommunications are also present.

A success reflected in the "greenium"

Strong investor appetite is the main driving force behind the success of green bonds. Financing sustainable projects makes sense to investors who then become part of a virtuous circle. Green bonds help reduce bond fund carbon footprints by meeting the environmental, social and governance (ESG) criteria that now underpin asset management.

High demand for green bonds comes at a cost to investors. Green bond yields are slightly lower than those of comparable conventional bonds and the green premium (or 'greenium') refers to this difference (or 'spread'). The greenium is negative: green bond yields are currently 2–10 basis points lower than in the conventional bond market.

For issuers, this is an advantage: in addition to bringing a positive brand image, these issues enable them to borrow at lower cost, offsetting the expense of preparing the required regulatory paperwork. Furthermore, the greenium may climb higher in the years ahead with demand buoyed by:

- the EU Green Bond Standard, which will refine the screening of high-impact green projects;
- the ECB's focus on ESG criteria when reinvesting matured bonds purchased under quantitative easing programmes.

A market open to all investors

The success of green bonds has helped diversify the market, with green bonds now present in both the investment grade and high yield segments. This diversity means that decarbonised instrument can be used in an ever-broader range of investment strategies.

The market's development is good news for investors and governments alike. Most European countries have committed to drastically reducing their greenhouse gas emissions and to introducing compensation mechanisms to achieve carbon neutrality by 2050. This ambitious goal requires both public and private investment in which green bonds can play a key role.

The green bond market will undoubtedly continue to go from strength to strength in the years and decades ahead. The scale-up will also be fuelled by the development of instruments such as sustainability-linked bonds (SLBs) for companies unable to issue green bonds. Similarly, social bonds will enable investors to align their strategies with another key challenge of sustainable development: social issues.

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