Sustainable fixed income investing

Greening the bond market

- The green bond market now represents about EUR 700 billion in assets
- Record issuance in 2019, and a further EUR 32 billion issued in Q1 2020
- Green initiatives and regulatory support will underpin continued growth

Green bond issuance has reached a healthy momentum over recent years, and the market now provides an effective tool for investors to meet a range of objectives, including impact, diversification and financial return.

Introduction

Described as liquid impact investing, green bonds are regular bonds whose proceeds are earmarked for clearly specified projects – with high levels of transparency in reporting – and which create real and sustainable environmental impact.

With a history spanning about thirteen years, the market in green bonds currently represents about EUR 700 billion in assets, with a record EUR 255 billion in new issuance in 2019. The lively primary market in green bonds – which has seen strong growth particularly in recent years – now has issuance from a diversified set of institutions, across the corporate, government, government-related and multi-lateral sectors. The secondary market has been functioning well, with green bonds priced close to their non-green peers.

The increase in issuance volumes in recent years has made it possible to build sizeable portfolios in this market. The financial market crisis which began in March has affected this market, too, but issuers have started returning to the primary market. In parallel with a recovery in global markets, the many new green initiatives on the agenda and a growing environmental awareness within society, we expect continued strong growth for the green bond market in the years to come.

Article
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ROBECO
The Investment Engineers

The development of the market for green bonds

The origins of green bonds date back to 2007 when the EIB launched its first Climate Awareness Bond. The World Bank issued its inaugural green bond in 2008. These were followed by a small but growing stream of issues from government-related entities and local authorities, such as Île-de-France and the City of Gothenburg. This class of issuers dominated the market in its early stages, with annual issuance volumes below USD 20 billion during this time.

'The establishment of the Green Bond Principles helped create more transparency for investors and clarified requirements for issuers'

Green bond principles create transparency

The market really started in earnest after the launch of the Green Bond Principles in 2014. The establishment of these principles helped create more transparency for investors and clarified requirements for issuers. This gave a strong impulse to both the volume and diversity of issuers: high-profile corporate names such as Unilever and Toyota, as well as a growing number of utility companies and banks started to issue green bonds in 2014. The total amount of green bonds outstanding reached USD 54 billion by the end of 2014.

The green bond market experienced rapid growth between 2015 and 2017, with a tilt towards specific segments. Institutions such as the EIB, IBRD and KfW, which by that stage had become relatively established green bond names, expanded issuance, but a substantial part of the growth – particularly in 2016 and early 2017 – came from Chinese names, such as the Shanghai Pudong Development Bank and ICBC. US issuers took over the lead in 2017, with sizeable green bond issuance by US municipalities to finance local transportation and water projects, and by Fannie Mae to finance sustainable housing.

Diversification in the market

This period also marked the start of two further key trends in this market: a strong increase in corporate green issuance and the launch of the first sovereign green bonds. Given the nature of their activities, it seems logical that utility companies, banks, automotive and real estate companies dominated corporate issuance.

Sovereign green bond issuance started in December 2016, but really took off in early 2017 when France launched its EUR 14.8 billion green bond, and immediately became the largest green bond issuer that year. This paved the way for sizeable sovereign green bond issuance in 2018-2019 from Belgium, the Netherlands and Ireland, as well as several emerging sovereigns, such as Indonesia and Nigeria. In early 2020, Chile was the largest issuer. The introduction of sizeable sovereign issuance brought further portfolio diversification opportunities to the green bond market.

The Social Bond Principles were launched in 2017, outlining guidelines for bonds that are aimed at financing social projects in areas such as social housing, employment generation and socioeconomic advancement. Sustainable bonds are another variation on the theme, combining both green and social project financing. Issuance of these bonds gained momentum in 2019, when USD 64 billion in social and sustainable bonds came to the market. Government and government-related issuers dominate this market segment and the Nederlandse Waterschapsbank and the State of North Rhein Westphalia have been large issuers.

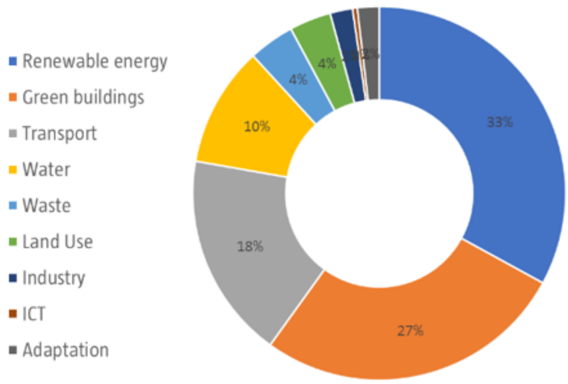
Record issuance in 2019, EUR 32bn issued in Q1 2020

Green bond issuance reached a record high in 2019. A total of USD 255 billion in green bonds were issued, according to data from Climate Bond Initiative, up 49% from 2018 issuance. The EU was the largest market for green bond issuance, at USD 107 billion. Activity remained strong in the first quarter of 2020: despite the severe disruption in markets, USD 32 billion in green bonds were issued in the first three months of the year.

Use of proceeds from 2019 issuance were allocated mainly to renewable energy (32%), green buildings (29%) and transportation (20%). This allocation is in line with that seen over the past five years collectively, as is illustrated in Figure 1.

With the significant increase in climate awareness and with the emergence of new initiatives to combat climate change, it is no surprise that such an important vehicle to finance these initiatives has experienced rapid growth, too.

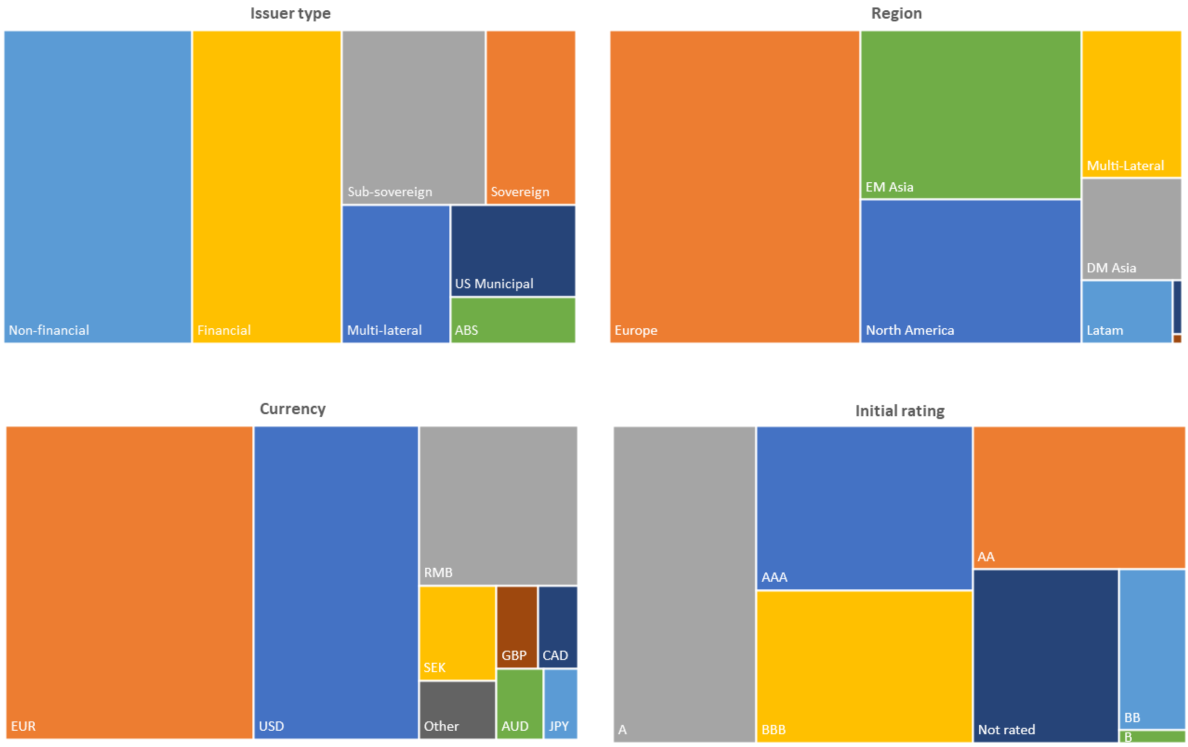
Figure 1 | Allocation of use of proceeds for green bond issued 2015-2019



Source: Climate Bond Initiative

Figure 2a-d provides statistics on the composition of the market as at January 2020. The market has become increasingly diversified in terms of issuers. Financials and sub-sovereign issuers are still important role players, but to a much smaller degree than in the early days. Non-financial corporates are now the largest group of issuers, with 33% of bonds outstanding.

Figure 2a-d | Green bond market characteristics in January 2020



Source: HSBC, Robeco

Europe has remained the leading region for green bond issuance, accounting for 44% of outstanding bonds. Multi-lateral has become less important, while North America and emerging market Asia have grown in market share. Given the importance of Europe in issuance, it follows that a large portion of outstanding bonds (43%) are denominated in euros, followed by US dollars (29%).

Rating characteristics are more evenly distributed, with single-A issuers having a 23% market share, followed by AAA-rated names. A sizeable part of the universe (13%) is not rated. Notably, these unrated bonds are not included in most green bond indices.

More to come

Sizeable issuance is expected in the coming years. For the six largest Eurozone countries alone, ABN AMRO estimates total planned renewable energy and climate-related investment would require EUR 460 billion investment for the 2020-2023 period (ABN AMRO, *EuroWatch*, 21 November 2019). Indeed, the European Green Deal alone, presented last December, would target additional climate-related investments of EUR 260 billion by 2030. Although the start of the year was more difficult due to the coronavirus, 2020 could be another record year for green bonds issuance. Inaugural green issuance is expected from amongst others the governments of Germany, Italy, Spain and Sweden.

The political agreement on the EU Taxonomy in December 2019, which defines activities that can be regarded as environmentally friendly, will also help in further developing the green bond market. It will contribute to the development of a minimum standard for the market. It will also help in setting rules for financing decarbonization activities in industries where *lower* carbon, but no *low* carbon alternatives are available.

Over the past few years the green bond market has grown from a small niche market to a liquid and diversified market. Although many buy-and-hold investors are active in the green bond market, the secondary market has been functioning well, with green bonds priced close to their non-green peers. The increase in issuance volumes has made it possible to build sizeable portfolios in this market. With many new green initiatives on the agenda and a growing environmental awareness within society, we expect continued strong growth for the green bond market in the years to come.

When is a bond green?

Robeco has a five-step framework for determining if a corporate or a sovereign bond is green. The green bond has to pass all five steps in order to be considered eligible as a green bond investment. The decision to include the eligible green bond in the portfolio is ultimately taken by the portfolio manager, based on the regular investment process of the portfolio.

Robeco's five-step framework

The first step is to determine whether there is **alignment** between the issuer's green bond framework and the industry standards, such as those provided by the Climate Bond Initiative (CBI), in the form of its Climate Bonds Standard and Certification Scheme, the Green Bond Principles, or national standards such as the EU Green Bond Standard.

We take into account if the issuer has looked for external verification of its green bond framework.

Secondly, we examine the stipulated **allocation of proceeds**, to assess environmental impact which the issuer claims. As green bonds are essentially regular bonds with earmarked allocation of proceeds, analysis of the underlying projects that will be financed is important.

The proceeds of the issuance of the green bond have to make a positive contribution to one of the environmental objectives as defined by the EU. In addition to creating a positive contribution to one of the objectives, the bond cannot finance activities that do significant harm to any of the other five:

Figure 3 | Economic activities that are considered environmentally sustainable for investment purposes

1. Climate change mitigation
2. Climate change adaptation
3. Sustainable use and protection of water and marine resources
4. Transition to a circular economy, waste prevention and recycling
5. Pollution prevention and control
6. Protection of healthy ecosystems

Source: EU Strategy on Sustainable Finance

The third step is to scrutinize the **impact reporting** provided by the issuer. Reporting on the use of proceeds and the positive contribution to the environmental objective is required at least annually. Optionally, the issuer would have looked for external assurance on the reported impact (ex post). This assurance could be given by an auditor as part of the audit of the financial statements.

If we find that the issuer does not disburse bond proceeds as described in the offering documents, we will re-assess the eligibility of the bond for investment. If the proceeds are used towards existing activities that have no positive impact, it is likely that the bond will no longer be eligible.

Based on the circumstances, we can even decide for the issuing company to become a candidate for engagement, to further discuss the governance around their financing process. This could eventually have consequences for the investment recommendation for the entity.

As a fourth step, we consider the issuer's **environmental strategy**, to determine whether its philosophy and approach reflects comprehensive thinking about environmental sustainability. This step is designed to prevent investments into an entity that is not making significant steps towards becoming more sustainable. In this step, we consider the wider strategy of the company, country or government related entity. The absence of a coherent strategy or expansion plans in thermal coal, for instance, will lead to a 'no pass' in this step.

And, fifthly, we look at the issuer's **conduct**, to ensure it is not embroiled in any controversies and that it adheres to international norms, including respect for human and labor rights. We screen the issuer to ensure none of its actions violate the UN Global Compact and that it is not subject to international sanctions.

The performance of green bonds

A green premium

Several studies were published in early 2020 on the premium on green bonds relative to non-green issuance. A study from HSBC (*Green Bond Insights*, January 2020), covering 200 bonds, shows that the average new issuance premium for green bonds versus outstanding debt has been 5bps since 2014. The new issuance premium for non-green bonds was 12bps on average. In early 2020, premiums were lower for both green (-1bps) and non-green bonds (7bps), but the difference remained stable. In fact, the data dating back to 2014 shows that this difference in premium between green and non-green bonds generally was still intact one month after issuance.

For the secondary market, this study found that sub-sovereigns trade at the largest premium (on average, the yield is -3bps lower). Sovereigns and corporate bonds trade within a very narrow range to non-green bonds. For the vast majority of individual bonds, the premiums versus non-green curves ranged from +5bps (green bonds being cheap) to -5bps. Similarly, a study from Goldman Sachs (*Bonds Go Green*, February 2020) concluded that while new-issuance premiums are declining over time, the performance difference between green and non-green bonds has been negligible over the past three years.

Robeco's green bond investment strategy

Robeco's investments in green bonds have kept track with the development of the market. Inaugural investments were made in 2013, and initially these were small. Allocations to green bonds increased significantly during 2014-2019, as issuance volumes rose and the profile of issuers became more diversified. Green, social and sustainable bond investments are now an integral part of most Robeco fixed income funds.

For example, green bonds are a core part of the investment universe of the RobecoSAM SDG Credit fund range; the Robeco Institutional Sustainable Core Euro Bonds fund has a target of 30% to be invested in green bonds; and the Robeco Euro Government Bond fund has an 11% allocation to green bonds.

As of the end of March 2020, Robeco's investments in green bonds totaled approximately EUR 1.7 billion.

Conclusion

The opportunities presented by green bonds remain attractive, in spite of the recent global financial market turmoil. Green bond issuance has reached a healthy momentum over recent years, and the market now provides an effective tool for investors to meet a range of objectives, including impact, diversification and financial return.

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