GAM EXPLAINS:
GREEN BONDS

MARKETING MATERIAL FOR PROFESSIONAL INVESTORS ONLY

GREEN BONDS

What are green bonds?
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WHAT ARE GREEN BONDS?

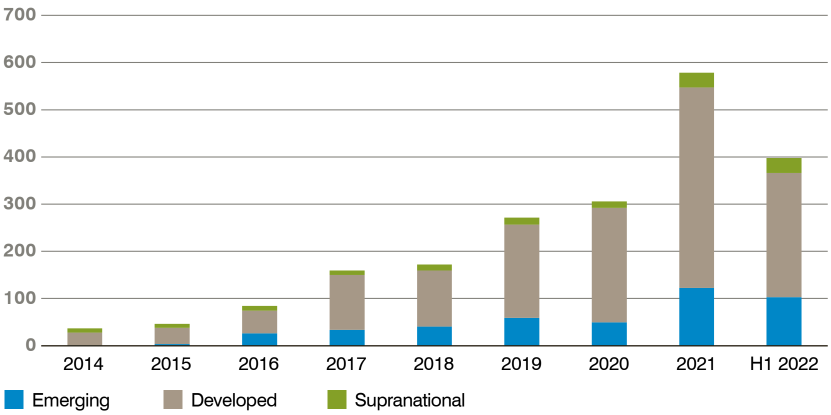
Green bonds are debt securities where the proceeds raised may only be used for specific projects that aim to generate a positive environmental impact, such as renewable energy or forestry.

Green bonds are typically issued in senior unsecured format and have the same characteristics and ratings as non-green bonds – therefore identical from a credit standpoint. The sole difference is the use of the proceeds (what the issuer is allowed to do with the cash raised), which, in the case of green bonds, can only be used to finance 'green' assets or projects.

While there is no legal or regulatory framework for green bonds, these typically comply on a voluntary basis with the International Capital Market Association's (ICMA) Green Bond Principles, which set out minimum requirements. These requirements encompass several areas, covering the governance and processes surrounding the green bond, such as the selection process for green assets, reporting or third-party verification.

Green bonds have gained significant traction over the past years, as issuance volumes reached the half trillion mark in 2021, and more than USD 2 trillion of green bonds have been issued to date. The success of green bonds is underpinned by the clear 'sustainability' feature – as investors benefit from visibility on where the proceeds are allocated and are able to measure the impact.

Figure 1: Green bond issuance volumes reached half a trillion USD for the first time in 2021



Source: Climate Bonds Initiative, as at 30 June 2022.

ICMA Green Bond Definition

Green Bonds are any type of bond instrument where the proceeds or an equivalent amount will be exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible green projects and which are aligned with the four core components of the Green Bond Principles[1]:

- **Use of proceeds:** The cornerstone of a green bond is the use of the proceeds of the bond for eligible green projects, which should provide clear environmental benefits.
- **Process for project evaluation and selection:** The issuer should communicate the environmental sustainability objectives of the eligible green projects; the process by which it determines how the projects fit within the eligible green projects categories; as well as how it identifies and manages risks associated with the projects.
- **Management of proceeds:** The net proceeds of the green bond should be credited to a sub-account, moved to a sub-portfolio or otherwise appropriately tracked by the issuer and attested to by the issuer in a formal internal process linked to the issuer's lending and investment operations for eligible green projects.
- **Reporting:** Issuers should make, and keep, readily available up to date information on the use of proceeds.

Source: ICMA Green Bond Principles
[1] Green-Bond-Principles_June-2022-280622.pdf (icmagroup.org)

While green bonds are the largest proportion of issues[2], there are four key types of bonds that dominate the sustainable debt market – green, sustainability, social and sustainability-linked bonds.

Additional types of sustainable bonds

What is the difference between different sustainable bond types? While green, sustainability and social bonds share very similar characteristics, sustainability-linked bonds (SLBs) are very different.

- **Social bonds** are similar to green bonds. However, the proceeds of the bonds are earmarked for projects with a positive social impact rather than environmental impact. This includes, for example, social housing or education projects aimed at tackling issues such as poverty or inequality.[3]
- **Sustainable bonds** are a mix between green and social bonds, where proceeds are earmarked for both green and social projects.[4]
- **SLBs**, a relative newcomer in sustainable debt markets, are a fairly different animal. There are typically no restrictions on the use of proceeds from SLBs, which are “for general corporate purposes”. However, the sustainable element comes from the ESG targets that are embedded in the bonds – which can relate to climate targets, gender diversity targets etc. SLBs contain a mechanism where failing to achieve these targets would result in a financial penalty for the issuer, typically a coupon step-up (for example, the coupon rate of the bond increasing by 0.25%).[5]

A key concern for investors is the uncertainty surrounding which projects are financed. Pre-issuance, investors typically do not know exactly which projects are financed, and rely on the issuer’s green bond framework – a green prospectus that sets out the governance and processes surrounding the green bonds. This document includes everything from project selection criteria and limits on the proportion of re-financing, to processes in case projects no longer comply as ‘green’, to reporting.

WHY IT MATTERS TO INVESTORS

Taking a step back, a key headwind to achieving the Paris Agreement targets is the current climate financing gap. While climate financing flows have increased significantly over the past decade, doubling to circa USD 850 billion per annum[6], these still fall short of the estimated circa USD 4 trillion plus required per annum by 2030.

Green bonds allow investors to play a direct role in supporting the transition of the economy by directing capital towards specific ‘green projects’. As the use of proceeds of green bonds is specifically earmarked for projects contributing to a specific environmental impact, which can contribute directly to climate change mitigation and adaptation or other environmental outcomes.

[2] Source: cbi_susdebtsum_highlq32022_final.pdf (climatebonds.net)
[3] https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/social-bond-principles-sbp/
[4] https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/sustainability-bond-guidelines-sbg/
[5] https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/sustainability-linked-bond-principles-slbp/
[6] Source : Global Landscape of Climate Finance: A Decade of Data - CPI (climatepolicyinitiative.org)

Another important aspect for investors is the ability to access a wide range of projects without taking on the specific credit risk from these projects. While the proceeds of green bonds are earmarked to finance green assets, bondholders bear the credit risk of the issuer, with no recourse to the green assets. In the case of a default of the issuer, the recovery for green and non-green senior unsecured bondholders would be identical. Investors get the best of both worlds: the sustainability and impact features of private markets, while having the ability to invest in high quality issuers. An example is European banks, where green projects financed may include smaller loans to support SMEs in their transition that typically come with limited liquidity and high credit risk. However, buying the green bond of a strong bank offers the impact of the bond with the credit quality and liquidity of the issuer.

Green bonds can represent an excellent tool for investors looking to generate a positive environmental impact within liquid markets, or those seeking to build Paris-aligned portfolios.

THREE TOP TAKEAWAYS

1- Proceeds of green bonds can be governed by robust frameworks and offer transparent reporting

Green bonds can offer robust frameworks, which provides confidence on the impact of the projects financed. Below are examples of good practice that supports a robust green bond market:

- Project selection criteria: ING's green bond framework sets out detailed eligibility criteria for green projects in the areas of renewable energy and green buildings. The issuer strives to align projects to the EU taxonomy and has mandated a third party to assess the EU taxonomy alignment of its selection criteria.
- Governance: BBVA's Sustainable Funding Working Group reviews and approves projects that fit the criteria set out in its green bond framework. Final approval for projects to be allocated to green bonds is then taken by the Standards Working Group (that includes senior representatives from sustainable finance). Projects are periodically monitored with a policy to replace those that no longer comply with criteria.
- Tracking of bond proceeds: The proceeds from AXA's green bonds are monitored and tracked by the group's internal systems to ensure these are allocated to eligible green projects. Pending full allocation of proceeds, AXA will invest these in cash or liquidity instruments, aligned with its responsible investment policy.
- Reporting: Banco Santander provides granular reporting of the proceeds of its green bonds, including a detailed overview of the allocation, split by type of renewable, country, as well as case studies. Moreover, the group provides reporting on the impact of the green projects financed, estimated based on the pro-rata of the bank's share of financing and disclosing the calculation methodology. PwC has assessed the environmental impact indicators as part of its assurance of Santander's green bond reporting.

What is GAM doing?

GAM sees climate change as a top priority, reflected in our group's commitment to decarbonise its asset base.

In 2021, GAM launched the Sustainable Climate Bond strategy, a high conviction strategy that focuses on green and other types of sustainable bonds from the European financial sector. It aims to deliver a positive environmental impact alongside attractive financial returns for investors.

The bias towards European financials is based on a conviction that the sector has a pivotal role to play in the transition. The European banking sector has tremendous impact potential as it finances the bulk of the economy (around 80% of corporates in Europe). Momentum on banks' own environmental strategies is increasing rapidly due to regulation and their own efforts, and banks are increasingly ramping up green financing and pressuring clients to align their activities to net zero.

The strategy was awarded 'Green bond fund of the Year' in Environmental Finance's 2023 Bond Awards and the 'Award for Impact Reporting' in the Environmental Finance Impact Awards 2022.

In September 2021, GAM also joined the Climate Bonds Initiative (CBI), an investor-focused not-for-profit, promoting large-scale investment for climate action. GAM was also invited by the CBI to join their Transitions Investors Advisory Council to develop guidance on credible transitions for both the use of proceeds and entity-level assessment for green bonds.

2- Green bonds offer allocation to a broad range of green projects

While green bonds are typically associated with renewable energy, their scope and remit goes far beyond. The three largest use of proceeds categories in green bonds are energy, transport and buildings – around 80% of the total. These sectors represent a large proportion of global greenhouse gas (GHG) emissions worldwide. Even categories such as energy include a very granular sub-set of projects, beyond renewable energy generation – for example infrastructure such as transmission lines to connect renewable energy supply.

The remaining c20% of the market is split between a wide range of project types, including waste, water, land use etc. Biodiversity has been a growing theme in the green bond market, with allocation to forestry projects, and we have even seen green bonds dedicated to sustainable agriculture for example. Moreover, sustainability bonds for example support both green and social projects, hence can deliver on a wider range of positive outcomes. Social projects can include affordable basic infrastructure (access to water), access to essential services (healthcare, education) or even targeted employment generation (supporting SMEs).

Within the green and sustainability bond market, we believe that the European financial sector offers a unique opportunity, supporting a global and inclusive transition. While the European financial sector is a single sector and geographic area, the impact offered is perhaps the broadest available in the green bond market. The breadth of impact is three-dimensional in terms of geography, sector and stakeholders. While green bonds are typically issued by large corporates, proceeds from green bonds from banks will be channeled to a wide range of stakeholders including SMEs or individuals – a unique opportunity in the green bond market.

3- Greenium concerns are often overstated

The concept of a "greenium", the differential in yield for a green compared to a non-green bond, remains highly topical. While the greenium exists and on average green bonds have a yield of roughly 5 bps (0.05%) below that of non-green bonds, this single number hides very high dispersion.

The greenium of 5 bps typically observed is a relatively immaterial number, especially at a time when EUR investment grade (IG) corporate bonds offer yields north of 4%. Moreover, the greenium is not a static number and varies both in time and across issuers, tenor, currency etc.

As an example, looking at the greenium on two of BNP's senior bonds, this has ranged between -11 to 11 bps since 2019 with an average of 1 bp.

As the example above highlights, the greenium can be negative – in which case green bonds offer a higher yield compared to non-green bonds. This is the case, for example, currently on several green bonds issued by ABN Amro that offer circa 30 bps (0.3%) pick-up in yield to non-green bonds. Note that while the greenium is the difference in yield, this does not imply that the differential is due to the fact that the bond is green and is driven by a wide range of different factors.

Bottom line, we do not see greeniums as a material driver of returns and given the dispersion of greeniums, this is purely an extra consideration when managing green bond portfolios.

WHAT TO LOOK OUT FOR

While we see green bonds as a great tool to bridge the climate financing gap, not all green bonds are born equal, and active management is key. While it could be argued the issuer's ESG strategy is irrelevant as green bonds finance green projects with a positive impact, we see issuers' sustainability credentials as one of the key factors when assessing green bonds. More specifically, the issuance of green bonds should be a tool for issuers to deliver on their climate strategy, therefore a strong rationale for issuance is necessary. As an example, BBVA has set a EUR 300 billion sustainable financing target (cumulative from 2018 to 2025), hence the issuance of green bonds is a natural tool for the bank to support the pipeline of green assets.

We welcome the EU green bond standards and expect to see inaugural green bond issues under these standards in 2023.

For more insights from GAM, please visit 'Our Thinking' page here.

GAM's purpose is to protect and enhance our clients' financial future. By attracting and empowering the brightest minds to think beyond the obvious, we strive to provide investment leadership, innovation and a positive impact on society and the environment.

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For more information, please visit GAM.com

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