LEADERSHIP FROM LENDERS: THE CASE FOR EUROPEAN BANKS' GREEN BONDS TO SUPPORT THE ENVIRONMENTAL TRANSITION

Executive Summary

Green bonds from European banks can provide investors with a positive environmental impact while benefiting from the very strong credit quality.

Given European banks' dominant role in financing corporates and individuals the greening of the banking sector is crucial in supporting the environmental transition.

Investing in green bonds from banks is a great opportunity to support banks in reaching increasingly ambitious green financing targets.

Regulation is acting as a catalyst for banks to ramp up green financing, but equally importantly is leading banks to pressure existing clients to implement credible environmental strategies – a big driver to "green" the whole economy.

Active management is paramount to ensure investing in high quality green bonds and avoiding those without a genuine sustainability purpose. This requires in-depth analysis at the issuer, bond and project level.

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1. European banks have followed the global trend in ramping up the issuance of green bonds

Global green bond issuance continues to rise, having exceeded the USD 1 trillion mark on a cumulative basis with close to USD 300 billion in 2020 only. The strong momentum has been supported by increasingly ambitious environmental strategies being set by issuers, pressure from legislators and regulators to tackle climate risk and ultimately met with strong demand from investors.

European banks have definitely been an active player in the green bond space, with the market having reached USD 100 billion in the first six months of 2021, driven by a record USD 33 billion in the first half of 2021 alone (as of 30.06.2021, source ATL, BBG). Banks have been issuing green bonds at a faster pace than European corporates, with banks green bonds accounting for 35% of the market, compared to 28% for the broad corporate index (Barclays Bloomberg Euro-Aggregate Corporate Index, as of 30.06.2021). Banks have been deploying environmental strategies in line with net zero by 2050, often supported by quantitative targets on green/sustainable financing.

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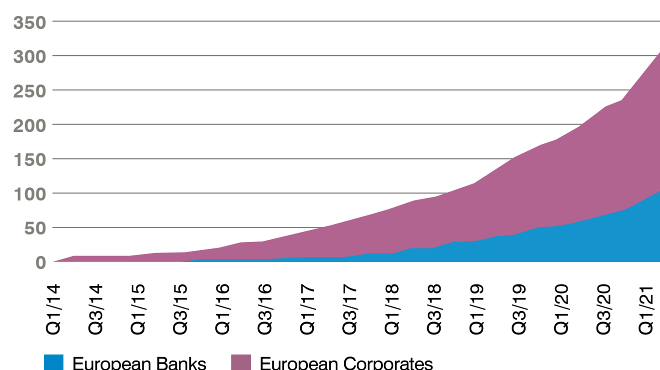
The recently formed Net Zero Banking Alliance, comprising global banks with a total of USD 30 trillion in assets, is a strong commitment from the banking sector to set credible net zero strategies, aligned with the Paris agreement (temperature rise of less than 2 degrees and preferably 1.5C by the end of the century). The issuance of green bonds has therefore been a natural tool to support the pipeline of green assets.

Chart 1: Issuance of green bonds by European banks has accelerated ($bn – Cumulative)



Source: Bloomberg, Atlanticomnium, data as of 30.06.2021.

Before delving into the details of why we see green bonds as being a powerful tool for investors seeking to generate both a meaningful environmental impact and attractive returns, it is important to understand the mechanics of green bonds.

From a pure risk-return perspective, green and non-green bonds are virtually identical. Green bonds are typically issued in senior unsecured (can also be in subordinated and other formats), have the same credit risk, ratings and structure as non-green bonds. The key difference is the use of the proceeds (what the issuer is allowed to do with the cash raised). While non-green bonds are typically issued for "general corporate purposes", the proceeds from green bonds can only be used to finance assets or projects with a positive environmental impact. Eligible categories of assets or projects to be financed typically include renewable energy, green buildings, sustainable transport, forestry, etc. all with a positive climate impact. From an investors' perspective, this means visibility on how the cash raised is used and a direct linkage between the issuance of bonds and climate impact.

An important aspect to keep in mind is that while the proceeds are earmarked to finance these eligible assets, **bondholders bear the credit risk of the issuer, and not of the underlying green projects** or assets. Bondholders have no recourse to the green assets, and in the creditor hierarchy, green and non-green bonds rank pari-passu. In case of default of the issuer, the recovery for green and non-green senior unsecured bondholders would be identical. **In essence, green bonds are not securitisations, and the linkage between the issuance and impact is through the use of proceeds.**

From a bondholders' perspective, we see this as positive, **benefitting from visibility on the use of funds and a tangible impact, without sacrificing credit quality**. Green bonds from carefully selected European banks provide investors with positive impact while benefitting from rock solid credit quality. This is especially important as banks finance projects with high impact but higher risk of default, such as SMEs or specific smaller green projects – here investors benefit from the high impact but avoid the higher default risk of individual projects.

Green bond from banks are no different from green bonds from corporate issuers. The only slight difference is that banks do not directly buy green assets such as wind farms, but instead finance their clients involved in such green projects. For example, banks will offer financing for renewable energy projects or mortgages on green buildings.

SUSTAINABILITY WITH CREDIBILITY

Unfortunately, despite the introduction of green bond principles and market-led initiatives, there are no legal requirements for what constitutes a green bond and greenwashing exists in the market. As the green bond market grows we believe it is critical that the owners of these investments actively ensure that proceeds flow to genuinely green projects.

That is why GAM builds several layers of analysis into its green bond assessment framework.

Our framework is based on the ICMA Green Bond Principles and undertakes three layers of analysis. We check not only the profile of the issuer to ensure they have a clear and credible environmental strategy, we also analyse the bond's processes and governance for allocating proceeds to ensure they flow to credible green assets or projects and, at asset-level, we assess whether there is meaningful positive environmental impact, aligned with Paris Agreement targets, using third-party quantitative data.

The latter layer especially is easier said than done.

When reporting on the net emissions saved from a solar farm in Spain, for example, some methodologies will express the 'tons of emissions saved' compared to electricity produced by say a coal-fired power station. This gets a big number but, in our opinion, a disingenuous one. Hence we have chosen a methodology that would describe 'tons of emissions saved' compared specifically to the equivalent electricity generation based on the average energy mix in Spain, and also reflective of emissions produced from the manufacture of the solar farm's technology. A smaller but more realistic number.

To make our impact reporting as high-quality as possible we are working with specialist data provider Carbone 4 to calculate environmental KPIs at the fund level, with the full methodology and assumptions available on request to investors.

It means we can say with confidence that EUR 10 million invested in our Sustainable Climate Bond Strategy would fund power solutions and technology projects helping to reduce emissions equivalent to a car travelling 212 times around the Earth, or 10,000 European houses refurbished.

2. European banks' green bonds – greening the behemoth to support the environmental transition

Given the characteristics of green bonds issued by banks (lending rather than directly buying green assets), there is a natural question of why we favour these from an impact perspective.

Firstly, investors should consider the role of European banks in the economy. As financial intermediaries, banks play a pivotal role in financing both households and corporates. This is further reinforced by the dominance of bank lending in financing European corporates, estimated at a high 80%, given the lesser reliance on capital markets financing, compared to the US for example. This means that not only non-bank financing is not available to SMEs and individuals, but even larger corporates rely on bank financing. The impact potential from supporting SMEs is particularly compelling, as SMEs represent around two thirds of employment in the EU (Source: Statistics on small and medium-sized enterprises - Statistics Explained (europa.eu)). Bank financing acts as a catalyst to drive impact for SMEs, and indirectly drives positive social impact on top of environmental impact through financing green projects. To illustrate this impact, Credit Agricole reports in its 2020 Green Bond Report (PowerPoint Presentation (credit-agricole.com)) financing of EUR 19 million to support Cap Sud's (French SME specialised in the installation and maintenance of solar power plants) expansion in France and abroad. Consequently, banks' role in the economy is primordial and as such banks shifting the flow of credit towards the "green" economy has tremendous positive environmental impact potential.

Moreover, we believe that banks can and must do more to align their financing with net zero emissions, scale up green finance and withdraw from projects that fail to meet the goals of the Paris Agreement. We fully support the IIGCC's expectations for the banking sector, which lay out clear areas for action for banks, including urging them to cease activities that cause emissions through deforestation, land-use change, and fossil fuel financing.

As discussed in our recent article on banks' ESG (Banks and ESG: from governance (G) to environmental (E) | GAM), the key catalyst for the banking industry to support the environmental transition is regulation. Since the GFC regulator's track record in transforming the banking sector has been outstanding, and with climate risk at the forefront of the regulatory agenda – the trend for the next decade(s) is clear. There are numerous ongoing regulatory initiatives (on top of issuer, investor, government-led initiatives) to tackle climate risk in banks' lending and investment portfolios – ranging from improving disclosures, to stress tests. Climate stress tests are, in our view, the game changer, as it will in time influence banks' capital planning – we think either via capital surcharges for "brown" financing or capital add-ons for inadequate climate risk management.

This is already incentivising banks to ramp-up their green asset financing (for example Banco Santander looking to raise and facilitate EUR 220 billion of green financing over the next decade), also reflecting banks' role in financing the economy and a growing pipeline of green projects. As green bond investors this is clearly positive, supporting the growth of the market and providing new investment opportunities.

The second indirect of banks' "greening" of lending books is engagement with existing clients. This is often overlooked, but we see this as a key lever of banks' capacity to effect change. Banks, as often the sole source of lending for SMEs and individuals and key financiers for large corporates, have a privileged relationship with their clients. Engagement between bankers and clients have been longstanding, typically on business development or financial matters to support bankers' credit risk assessment. With momentum on climate risk gaining momentum, these are already being incorporated into discussions and these will only intensify. Ultimately environmental criteria (and other ESG criteria) will influence underwriting decisions and loan pricing, a trend already nascent.

What does this mean? As banks are "penalised" by regulators (in terms of capital required) for lending to issuers with weak environmental credentials or to "brown" industries, banks will put pressure on clients to implement and execute on credible environmental strategies. For the laggards this will mean either a higher cost of lending or even ending lending relationships. The impact potential is colossal given banks' role in the economy throughout each industry. Banks will drive change for the whole economy by pressuring clients to set credible environmental strategies. We estimate that the green bond market for European banks can easily reach €200bn or more in the next 24-36 months (compared to c€80bn currently), given the current pace of issuance. This is to be put in perspective of European banks' bonds outstanding of above EUR 1 trillion across currencies. Important to note that as banks are mainly deposit funded (debt funding is only a minor portion), green assets financed by banks will be a large multiple of green bonds issued – with EU banks holding around EUR 17 trillion in loans, thus green assets financed will be in the EUR trillions. As an example, BBVA recently revised its 2025 green financing targets to EUR 200 billion (from EUR 100 billion); this is EUR 200 billion for one bank only.

3. Green bond investing compounds the importance of active management to generate meaningful impact

Despite our conviction on banks' green bonds as a powerful tool to support banks, the economy more broadly and an orderly transition meeting the targets set by the Paris agreement, active management is also vital in issuer and bond selection.

Although significant progress has been made to harmonise the green bond market, there are no legal or regulatory requirements of what constitutes a green bond and issuers' obligations towards investors. As an investor, there needs to be a strong focus on selecting bonds that offer high potential impact and avoid those issued without a genuine sustainability purpose.

Beyond traditional credit analysis to screen for strong issuers (arguably only strong issuers have the capacity to effect change), in-depth extra-financial analysis is essential to identify high quality green bonds. There are three key pillars of analysis to screen for high quality green bonds:

- **Analysis of issuers' ESG profile:** issuers with strong ESG credentials (with a special focus on the "E") are more likely to have a have a clear and credible environmental strategy and have strategic reasons to issue green bonds. The issuance of green bonds should be aligned with a credible and ambitious environmental strategy, for example to support the pipeline of green assets.
- **Analysis of the green bond framework:** the green bond framework, the "green prospectus" sets out all the processes and governance surrounding the allocation of proceeds to green assets or projects. High quality processes and governance ensures confidence surrounding the impact of funds deployed. Issuers such uphold high standards (such as the ICMA green bond principles as a minimum) and provide transparent reporting to investors on allocation of funds and impact.
- **Analysis of impact:** Issuers provide post-issuance reporting on allocation and reporting, including estimates of the positive environmental impact of green assets or projects financed. The difficulty lies in the wide range of methodologies and assumptions used to calculate these which varies significantly issuer by issuer. Using comparable methodologies can help assess the positive impact between issuers.

Screening for best-in-class green bonds requires in-depth analysis at all levels

Best-in-class Green Bonds Characteristics	Key pillars of analysis
Genuine Issuance Purpose	**Issuer ESG Quality** • Robust ESG Profile • Credible climate Stragegy • Alignment of green bond issuance with climate strategy
Visibility on use of proceeds	**Green Bond Framework** • Complies at least with ICMA Green Bond Standard • High quality green prospectus • Transparent allocation and impact reporting
Meaningful climate impact	**Impact analysis** • Comparable data used to assess impact • Meaningful impact from financing of green assets

Source: Atlanticomnium.

Adding up both the financial and extra-financial analysis required to identify high quality green bonds, clearly active management has a strong value-add when investing in green bonds. Moreover, engagement with issuers should be a top priority, at each step of the analysis – both to enhance internal analysis and to voice our views to issuers towards upholding the highest standards in the green bond market.

Overall, we see green bonds from European banks as a powerful instrument for investors to generate meaningful positive environmental impact. Climate change is one of the biggest risks for the global economy looking ahead, thus incorporating climate risk as a core part of the investment process ensures robust forward-looking risk management, and by extension protecting bondholders' returns.

For more information, please visit GAM.com

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