Should you pay more for green bonds?

Is it really worth paying a premium to issuers of green bonds over conventional bonds? And which factors might catalyse this 'greenium' in the future?

Supporting the energy transition to a low carbon world has become a priority of governments and corporations globally. Estimates by the International Energy Agency (IEA) point to a $4 trillion annual investment worldwide needed in clean energy to reach net zero emissions by 2030.[1]

With the spotlight on sustainable finance to provide solutions that will accelerate the energy transition, green bonds have emerged as one type of investment that can help finance a radical transformation of the energy mix. And any discussion about green bonds results in talk of the 'greenium'.

'Greenium' is shorthand for 'green premium'. When applied to fixed income investments, like bonds, the 'greenium' describes the difference between the yield of a 'green bond' – the 'yield' being a measure of the income returned, or earned, on the investment – and the yield of a conventional, non-green bond from a similar issuer.

What this amounts to is lower borrowing costs for issuers of green bonds, and higher costs for their investors. It is, essentially, the way that 'price' is assessed in the green bond market.

Why has the greenium become a talking point?

Conversations about the greenium have arguably come about as a result of the rising popularity for ESG investing more broadly over the past five years.[2]

Many investors want to have a positive impact on environmental factors, particularly on climate action1, and, in the search for integrity, a number of funds have been converting to green labels. Stocks have traditionally led this revolution, but there has been an increase in demand for green bonds of late too.[3]

Some have observed that the increase in dedicated green bond mandates means a growing number of investors have become forced buyers of a concentrated number of deals, pushing the prices up regardless of the financial characteristics of the offering.

Yet others argue that a greenium is justified in some cases because the green label can be a proxy for good management, increased disclosure, and a clear, long-term business strategy at an issuer – essentially, the G the ESG (environmental, social and governance). And if these are things that an investor ultimately wants from their green investment, then paying the premium makes a lot of sense.

Either way, the gap has been narrowing between what investors are willing to pay for green bonds versus more traditional bonds. In Europe, which boasts the most developed green bond market, the greenium has shrunk from over 9 basis points (bps) in 2020 to between 1 and 2 bps in 2022.[4]

How does this differ across sectors?

The return of inflation, high commodity prices and higher interest rates have meant issuers of both green and conventional bonds have withdrawn somewhat this year.[5]

Research has found that the risk-averse environment that has caused a wider yield differential – the 'credit spread' – should benefit green bonds, which are often more robust than conventional bonds under such conditions.[6]

It equates this positive assessment to the more defensive profile displayed by the green bond universe, their popular 'impact' characteristics – financing projects that contribute positively to the environmental and energy transition, such as the development and storage of renewable energy – and also their investor base, which is believed to have a longer investment horizon.

Scaled according to the issuing sector, the research says the greenium tends to be lower in sectors where conventional bonds are expected to be in a minority and replaced by green bonds.[5] These sectors include utilities and financials.

However, cyclical sectors displayed a higher greenium – the consumer goods sector, for instance, is still at a very early stage in the green bond market. Car manufacturers and their suppliers, meanwhile, are issuing on a recurring basis to finance the production of cleaner vehicles.

But it's in sustainability linked bonds (SLBs) where the largest growth in issuance volumes have been seen in recent years[5] – and where there's the most potential for competition with green bonds.

What are SLBs?

With green bond investments, the use of proceeds might be linked to environmental projects – say, renewable energy installations. But with an SLB, the coupon payment itself is actually linked to the sustainability performance of the issuer – lower greenhouse gas emissions, for instance.

The issuer of an SLB can therefore use the proceeds for general purposes and is not required to track the projects funded by the issuance. This flexibility afforded to the issuer makes SLBs highly attractive. And sectors that issue large amounts of SLBs relative to green bonds will widen the greenium – such as the consumer goods, pharmaceutical and technology sectors.

Does the future look bright for the greenium?

The growth of green bonds shows investors are seizing the opportunity to drive the energy transition. And the emergence of SLBs as competition for green bonds, a positive interest rate environment and updated credit ratings (including downgrades) for indices, and the overall bond universe, may all be contributing factors that catalyse the greenium in the months ahead.

Moreover, the renewed focus on 'greenwashing' – SFDR came into force in Europe last year, while the SEC has proposed similar rules in the US – and closer regulatory scrutiny, may result in a more robust greenium for select issuers.

However, 'greenness' is not an exact science – that's why it's important to be judicious. Thankfully, there are some asset managers that are more selective than others. While many do the minimum of analysis, others stipulate that the environmental impacts of a green bond project must also be sufficiently clear and ambitious to ensure significant progress can be made towards reaching the stated objective.

FOOTNOTES

1 Source: IEA, Net Zero by 2050, May 2021, https://www.iea.org/reports/net-zero-by-2050

2 Source : https://www.im.natixis.com/intl/research/esg-investing-survey-insight-report

3 Source : Climate Bonds Initiative, 2022, https://www.climatebonds.net/resources/press-releases/2022/08/h1-market-report-green-and-other-labelled-bond-volumes-reach-4178bn

4 Source : https://www.afme.eu/Publications/Data-Research/Details/ESG-Finance-Report-Q1-2022---European-Sustainable-Finance

5 Source : https://home.cib.natixis.com/articles/green-and-sustainable-bond-market-update-2q-2022

6 Source: Mirova, 2021