Bonds that build back better

Some might argue that building a sustainable economy is a technological problem. It isn't. The world is sufficiently stocked with greenhouse gas-reducing technologies such as renewable fuels, carbon capture and energy storage. What it lacks is capital.

USD 60 trillion. This is how large the sustainable fixed income market could be by the end of this decade if world leaders are serious about net zero. That is equivalent to approximately one third of all global government bonds outstanding.

It's a surge in growth that would transform fixed income investing. In as little as five years, climate-aligned, green, sustainability-linked and social bonds could be investment staples for investors worldwide. It is a future in which the mitigation of climate change, the protection of biodiversity and the promotion of social cohesion will be possible through fixed income investments.

These are the findings of new research undertaken on behalf of **Pictet Asset Management** by the **Institute of International Finance** (IIF).

Our research looked at several climate capital scenarios that could plausibly unfold over the next five to 10 years. Under the most bullish of our three main scenarios, annual issuance of bonds that are labelled as having environmental, governance and social (ESG) objectives could climb from the current USD1 trillion to as high as USD4.5 trillion by 2025. Green bonds – securities the fund specific environmental projects – are expected to represent the biggest single market, followed by sustainability-linked bonds, instruments whose coupons are tied to corporate environmental targets.

The research also lays bare the critical importance of climate capital in the developing world. Emerging market sovereign and corporate bond markets could see annual issuance of ESG-labelled bonds reaching some USD2 trillion.

Yet these forecasts cover just one part of the sustainable bond universe. It does not take into account climate-aligned bonds - securities that don't carry an ESG label but are issued by companies that contribute directly to the clean energy transition. Sold by firms that operate in green industries such as clean energy, water recycling and carbon capture, these bonds have also attracted the attention of investors.

Recent estimates from the Climate Bonds Initiative, an environmental consultancy, suggest some USD900 billion in new climate-aligned bonds were sold in 2021 alone. To account for this growth, the IIF also devised projections for climate-aligned fixed income, basing estimates on the various energy transition scenarios set out by the Network of Central Banks and Supervisors for Greening the Financial System.

Using this methodology, IIF's research forecasts that, combined, the ESG-labelled and climate-aligned bonds markets could grow to USD32 trillion in 2030 under current climate policies and to as much as USD60 trillion under a more ambitious net zero path.

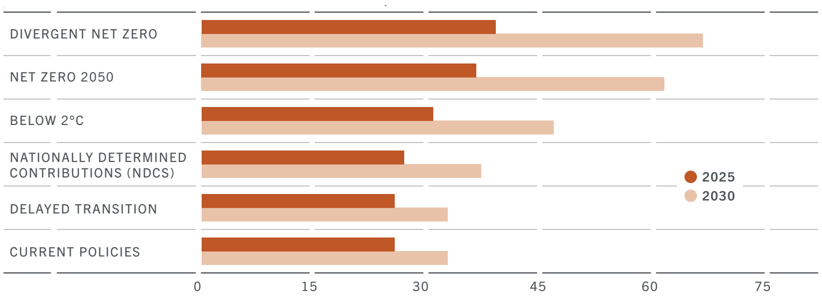
Nevertheless, for all its dynamism, ESG and climate-aligned fixed income is not yet guaranteed to evolve into the mainstream. There are some difficult obstacles to navigate. Progress towards greater harmonisation across sustainable finance taxonomies and ESG disclosures is essential. Without this, the ESG-labelled market in particular will struggle to achieve critical mass. Currently, the labelling and certification of sustainable bonds differs considerably from one country to another, while efforts to harmonise disclosure requirements haven't met with much success.

Another pre-requisite is greater transparency on how ESG rating agencies - which pronounce judgement on bond issuers' sustainability credentials as well as use of proceeds - collect, analyse and calculate sovereign and corporate ESG metrics.

Investors also need to be convinced that such bonds are as liquid and stable as their conventional counterparts. Here, the bar is high. Due to their complexity, ESG securities tend to be costly to analyse, requiring far greater scrutiny than their conventional counterparts. Nor do they fit neatly into the portfolio construction frameworks investors favour.

Still, if the world is serious about financing the transition, none of this appears insurmountable. The bond market could be the difference between decarbonisation success and failure.

Estimated size of climate-aligned bond market under different climate scenarios, USD trillion



Source: IIF, forecast covering period 31.12.2025 and 31.12.2030

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ESG bonds characteristics

KEY
✔✔✔✔ 500+ USD, BILLION
✔✔✔ 100-499 USD, BILLION
✔✔ 50-99 USD, BILLION
✔ 0-49 USD, BILLION

		KEY CHARACTERISTICS OF ESG-LABELLED BONDS				
		ACTIVITY-LEVEL			ENTITY-LEVEL	HYBRID
		GREEN BONDS	SOCIAL BONDS	SUSTAINABILITY BONDS	SUSTAINABILITY-LINKED BONDS	TRANSITION BONDS
USE-OF-PROCEEDS		✔	✔	✔	✔	✔
KPI-LINKED (GENERAL-PURPOSE)		✗	✗	✗	✗	✗
INTERNATIONAL PRINCIPLES/GUIDELINES		ICMA GBP	ICMA SBP	ICMA SBG	ICMA SLBP	N.A
SIZE OF THE MARKET		✔✔✔✔	✔✔✔	✔✔✔	✔✔	✔
SECTORAL TAKEUP/ POTENTIAL	SOVEREIGNS	✔✔✔	✔	✔		
	SUPRANATIONALS	✔✔	✔✔✔	✔		✔
	GOVERNMENT-RELATED (EX. SOVEREIGNS)	✔✔✔	✔✔✔	✔✔		
	FINANCIALS	✔✔✔	✔✔	✔✔	✔	✔
	NON-FINANCIAL CORPORATES	✔✔✔	✔	✔✔	✔✔	✔
	HEAVY EMITTERS	✔✔✔	✔	✔	✔	

Source: IIF, as of December 2021

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