Green bonds are flourishing and this could be just the beginning

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- Growing environmental concerns have helped the green bond market expand rapidly in recent years
- Green bonds can offer investors positive environmental impact, financial returns and diversification
- The market would benefit from further harmonisation

Despite the US administration's headline-grabbing decision to pull out of the Paris Climate Accord, the accord's key pledge to maintain global temperatures 'well below' 2°C above pre-industrial levels remains firmly in place.

Since it was founded at the 2015 UN Climate Change Conference – also known as COP 21 – to help countries transition towards a low-carbon economy, the agreement has kick-started a wave of regulatory change, increasing investment awareness of environmental issues. Green bonds, which were developed to finance projects specifically targeting a positive environmental impact, benefitted from this global commitment.

What is driving growth in the green bond market?

Over the last few years, rising awareness of climate change and the need to transition toward a low-carbon economy has driven both bond issuers and investors alike towards green bonds.

On one side, green bonds enable companies to emphasise their climate-friendly projects, sending a signal of concern and engagement around environmental topics. It also widens their investor base as green bond issuances usually experience stronger demand than standard bonds. And on the other side, many international investors committed to disclose their investments carbon footprint by signing the 2016 Montreal Carbon Pledge, including AXA Group. In this context, the opportunity provided by green bonds to invest in projects targeting environmental benefits, without taking on additional risk, was particularly appealing.

Now, regulatory pressures are also mounting to ensure that asset managers report on environmental issues and more broadly take into account Environment, Social, Governance (ESG) criteria. This regulatory incentive has enabled ESG investment to gain momentum over recent years, and has progressively helped investors more broadly to understand the potential materiality of ESG risks to the financial stability of an issuer.

So the green bond market has certainly benefitted from these initiatives and regulations, but this growth would not have been possible without well established actors such as the Green Bond Principles or the Climate Bond Initiative. These organisations have developed progressively since the first green bond issuance in 2007 and steadily released guidance and standards, which now help issuers and investors enter this market.

The overall investment universe has grown from a relatively small $36bn in 2015, to approximately $200bn today[1]. The capital expenditure needed to make the global transition towards a low-carbon economy is huge, which is helping to support the ongoing momentum. Indeed more than $40bn[1] worth of green bonds have been issued so far this year. And as the green bond market grows, it becomes more and more attractive for investors.

What are the benefits of green bonds? Impact and diversity without additional cost

Green bond issuers are expected to clearly identify the projects that they will finance upfront, and provide reports that monitor each projects' environmental benefit. This transparency of proceeds is a key feature of green bonds as it enables investors to assess the positive impact of their investment and to measure their performance beyond just financial returns.

Nonetheless, the benefits of the green bond market go beyond transparency and environmental KPIs. As the overall market has expanded, so too has the diversity of issuers, regions and sectors available to investors. Many sovereign issuers have emerged over the past year, with France and Poland opening the way in 2017, Belgium and Indonesia in 2018, and many more to come.

In the meantime, different seniority tranches are appearing such as corporate hybrids, financial covered or senior non-preferred debts, hence adding depth and value to the market. This is progressively transforming the green bond market from a niche asset class to a credible alternative to the traditional global bond universe. An attractive alternative in our view, as studies show that this market provided a slightly better risk-adjusted return than the global broad market over the past few years[2].

Indeed, investors might have been concerned that their positive environmental impact may mean sacrificing returns. This raises the question of green bond valuations. Market pricing typically reflects the financial risk of an issuer, and the risk of an individual green bond remains at the issuer level – just like a standard bond. This is why we do not see any difference on issuance price or financial performance between a green and a plain vanilla bond. We believe that this allows investors to include green bonds in their portfolio without taking on additional risk or paying a higher price.

What are the hurdles? Harmonisation of market practices is still needed

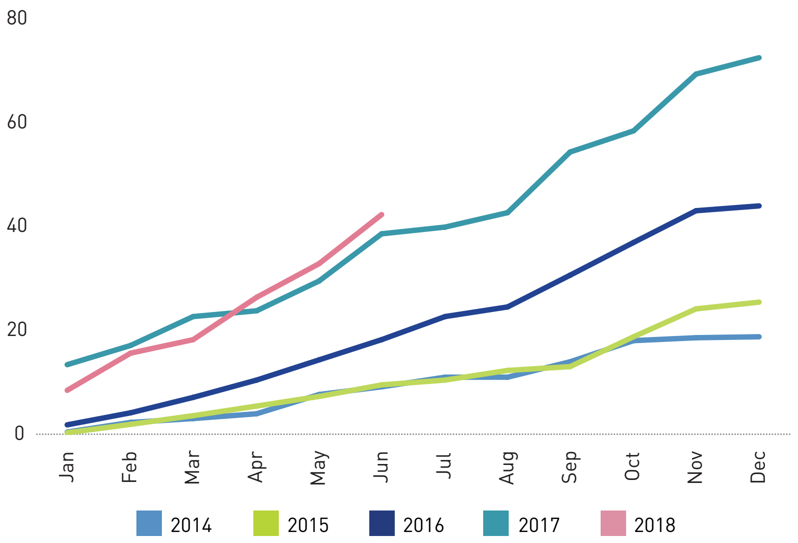
However, as with all new products, green bonds are not without their challenges. The number of green bond issuers is still relatively low compared to the standard bond market. If we expect more issuers to adopt this form of financing, we believe there needs to be some sort of incentive to entice firms to issue green bonds, such as mitigating the cost that they bear when doing so, which can include the costs of reporting and auditing data. Meanwhile, from the investor side, even if new environmental KPIs arise, we would welcome more harmonisation in terms of measurement methodology.

Additionally, with no compulsory international taxonomy for what constitutes a green bond, nor common regulation, there is the potential for issuers to make misleading claims about how environmentally responsible they are, often referred to as 'green washing'. In this context, strong analytical capabilities are still required to distinguish between green bonds and regulators could help make this market more accessible.

Europe is pushing forward in developing a common standard for green bonds, which could definitely boost the instrument further. Yet, as of now, a lot remains to be done to get there and investors will have to continue to cope with this blurred line differentiating what's green and what's not. That is why at AXA IM, we invested in internal qualitative analysis capabilities to ensure all green bonds we invest in are respecting a high level of environmental standards and impact, and have developed our own green bond framework to ensure we invest only in high-quality and truly impactful green bonds.

Figure 1: The green bond market continues to grow

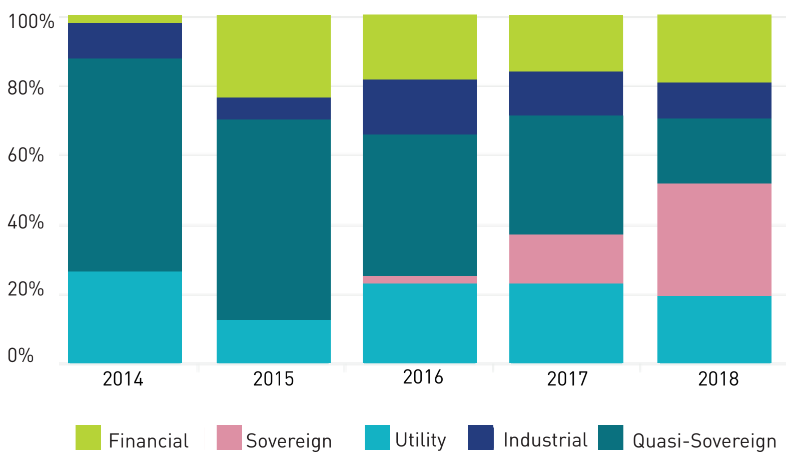
Green bond issuance in billions of US dollars



Source: Merrill Lynch Green Bond Index as at 29/06/2018

Figure 2: Sovereign issuers are steadily coming to the green bonds market

Yearly green bond issuance by sector



Source: Merrill Lynch Green Bond Index as at 29/06/2018

What does the future hold for green bonds?

The levels of investment required for the world to transition to a low-carbon economy is substantial. The Global Commission on the Economy and Climate estimates a figure of €90bn[3] in infrastructure over the next 15 years. At AXA IM, we believe that new issuers will continue to come to market, as the need for change is not focussed on one or two industries but has a vast social and environmental reach.

In this context, as investor awareness increases and regulations around environment reporting evolve, the rapid growth we have experienced over the past couple of years could be just the beginning.

Sources:

1. Merrill Lynch Green Bond Index as at 29/06/2018
2. AXA IM, Bloomberg, Merrill Lynch (ML) as of 29/06/18. Based on analysis of annualised return and volatility metrics of the ML Global Broad Index, ML Global Credit Index and Global Green Index from 31/12/2015 – 30/06/2018.
3. Report from the Global Commission on the Economy and Climate: http://www.worldbank.org/content/dam/Worldbank/document/WEurope/2014/IMF-global-commission-economy-climate.pdf

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