AB FIXED INCOME INSIGHTS

BUYER BEWARE: HOW GREEN IS YOUR BOND?

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Just a few years ago, relatively few investors were actively considering green bonds and other socially responsible investments. Since then, the market for such securities has grown, creating new opportunities for fixed-income investors—and new challenges, too.

This month, MTR Corp, operator of Hong Kong’s Mass Transit Railway, issued its first green bond—a US$600 million, 10-year transaction intended to finance activities linked to low-carbon transport, energy efficiency, sustainability and other environment-related issues.

At the same time Moody’s Investors Service said that the three months to September 30 had been the strongest quarter yet for issuance of green bonds globally, with more than US$26 billion sold. The credit ratings agency added that total issuance for 2016 was likely to exceed US$80 billion.

That would be about twice the US$42 billion recorded for 2015 and would continue the steady growth that the market has seen since 2012 (Display). Capitalization of the global green bond market today is estimated to be well over US$100 billion.

If this ambitious goal is to be met, the demand for climate-related projects—and the bonds to finance them—is going to be huge.

The markets for environmentally and socially impactful investments are gaining critical mass for more grass-roots reasons, too, as consumers and retail investors demand that business behaves more ethically, and bond-issuing banks and corporates take note and respond.

Consequently, institutional investors are increasingly aware that they must engage with the trend, if only to understand it before committing their clients’ money to it.

One of the key questions they will need to address is: what exactly constitutes a green bond?

SHADES OF GREY

The potential difficulties around this were highlighted in March 2015 when the Massachusetts State College Building Authority (MSCBA) in the US sold what were described as green bonds on behalf of Salem State University near Boston.

There was some controversy over the fact that the proceeds from the issue were to fund a 725-space car park—hardly, on the face of it, an environmentally-friendly development.

According to the MSCBA, however, the project offered a number of environmental benefits, such as electric-car charging stations and the freeing up of land to reduce sprawl and make the campus more pedestrian-friendly, while also creating scope for the construction of new buildings.

Evidently, the “greenness” of green bonds can be a grey area. In Brazil, for example, the use of green bonds to finance an apparently eco-friendly hydropower plant was questioned when environmental groups claimed that the project could endanger fish species and lead to more deforestation.

In Mexico, the opposite happened when Mexico City Airport Trust successfully financed a new airport using US$2 billion of green bonds. Airports are usually considered to be carbon-emission hot spots: in this case, however, the new facility is planned to be 100% carbon neutral.

Such nuances apply not only to individual issuers but at country level, too. China, for example, has so far this year...
issued more green bonds than any other country, and yet its framework for green bond issuance considers clean coal to be an eligible “green” project—a use of proceeds inconsistent with many green investors’ objectives.

How should investors deal with such discrepancies and uncertainties?

A DIVERSITY OF VIEWS

As the market has grown, a number of organisations have produced guidelines or other standards intended to introduce consistency across jurisdictions in the way that green bonds are defined.

They include the International Capital Markets Association, which has developed guiding principles for issuers under four headings: use of proceeds, process for project evaluation and selection, management of proceeds and reporting.

The Climate Bond Initiative (CBI), a not-for-profit organisation, provides certification for green bond issuers based on its own criteria, while the two leading credit ratings agencies—Moody’s and Standard & Poor’s (S&P)—have introduced their own methodologies.

As might be expected, there are differences of approach between these adjudicators. CBI, for example, won’t certify a bond unless 100% of the proceeds are to be used for “green” purposes, while Moody’s methodology factors in the proportion of the bond proceeds to be used in that way.

S&P applies a slightly different philosophy: instead of assessing bonds by how closely they comply with green bond principles, it focuses instead on attempting to evaluate the overall impact of the bond from a “green” perspective.

Because of the differences between them, these approaches may confuse as much as help investors. Ultimately, investors face the challenge of deciding for themselves whether a green bond has all the right green credentials as well as credit characteristics.

This means that, when sizing up an offer of green bonds, investors need to know what questions to ask.

HOW TO KICK THE TYRES

In our view, there is no substitute for independent research when assessing a green bond (or, indeed, any other security). Here are some of the key things we do and suggest other investors do, too:

+ Be happy with the underlying credit: the borrower’s ability and willingness to pay, not its green credentials, should be the final arbiter of whether or not the bond is put into a portfolio
+ If possible, meet issuers face-to-face before buying their bonds to assess what they mean by “green bonds” and whether their interpretation is acceptable
+ Give preference to green bonds that have an individual verifier (such as CBI, Moody’s, S&P etc.) but take into account any particular idiosyncrasy of approach that the verifier might have
+ Review all green bond holdings to ensure that the issuers have applied the proceeds of their issues as they said they would. This information should be reported annually; if any issuer fails to do so, investors should ask them why not.

These are not the only considerations for green-bond investors (others, for example, are related to portfolio construction and allocation, and how green bonds should be priced) but they are among the most important for anyone entering this increasingly interesting and sophisticated market.