Green bonds: an investors' perspective

September 2016

a novethic study

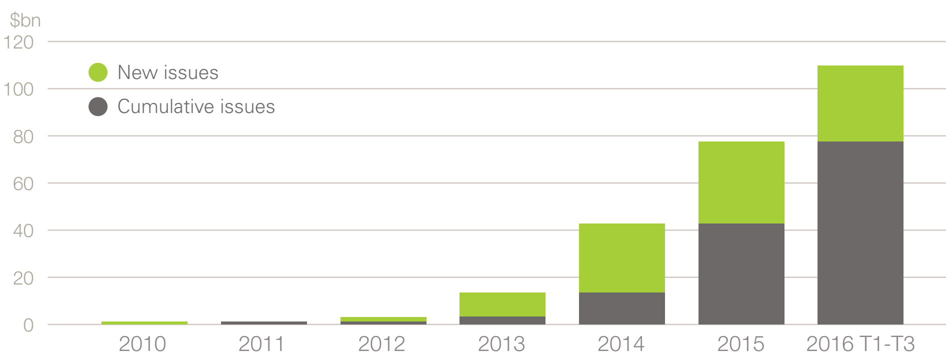
The green bond market is driven by a rapid growth of investor demand. In order to better understand investors expectations, the Novethic research centre questioned a representative sample of seventeen investors who are among the most active in green financing and responsible investment. In total, they manage assets of €4,300 billion, with €2,700 billion invested in fixed income, thereof €7.7 billion specifically in green bonds. 40% are institutional investors (insurance companies, pension funds, public institutions and banks) that have invested €2.4 billion in green bonds. The remaining €5.4 billion is in the hands of asset managers. 95% of the green bonds held by the investors in our sample are in mainstream bond funds, the outstanding 5% in dedicated green bond funds. Seven asset managers currently offer such green bond funds. Over the past twelve months, they have registered inflows of €400 million.

A **growing** but still small **market**

All studies show that 2016 has been a year of robust growth for the green bond market, with about $120 billion outsanding as of September 2016. Nevertheless, investors still find the offer to be too limited for several reasons:

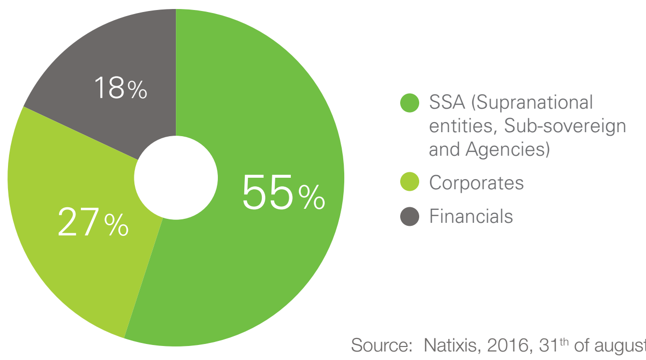
- Most of the bonds issued in China, which account for about half the volume issued in 2016, are restricted to domestic investors;
- Green bonds issued by municipalities in the United States have limited appeal to European investors because only US-based investors profit from a tax benefit;
- Some green bonds issuances are too small for big investment funds. Thus in reality, investors in our sample only have access to $100 billion worth of green bonds, of which only about a sum of $30 billion have been issued since the beginning of 2016. Moreover, a significant share of the $70 billion in bonds outstanding from previous years are held by buy and hold portfolio managers. This restricts secondary market liquidity.

Green bond market (excl ABS, Muni, China Onshore)



Source: Natixis, 2016, 31th of august

Green Bond market by type of issuer

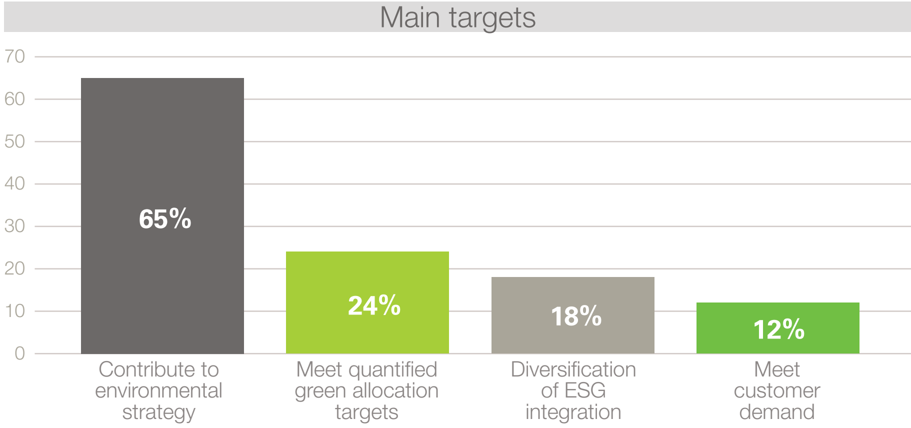


Source: Natixis, 2016, 31th of august

Investors face another difficulty, too. About half the bonds are issued by supranational banks and government agencies which currently offer very low spreads. Corporates issuances, which currently better meet investors' credit requirements, accounted for only about $10 billion of the bonds issued in 2016. This makes it hard for investors to be demanding with regard to green bonds' environmental characteristics. Thus only the smallest funds, and in particular those dedicated to green bonds, can be truly selective. In the meantime, some large funds have set ambitious green objectives. Against the background of the limited offer, they are obliged to buy what currently is traded on the market. Consequently, they are forced to postpone their quality requirements until the offer increases.

Advantages of green bonds

An investment tool for **low-carbon strategies**



Source: Novethic

Investors see green bonds as a practical way to channel their investments to projects in line with their environmental policies and commitments. These investments lend credibility to their quantified green investment targets. Some even specify the amounts to be invested in green bonds. They enable investors to track environmental proceeds. For asset managers specialised in responsible investing, green bonds are also a persuasive way to show the relevance of environmental analysis in fixed income management.

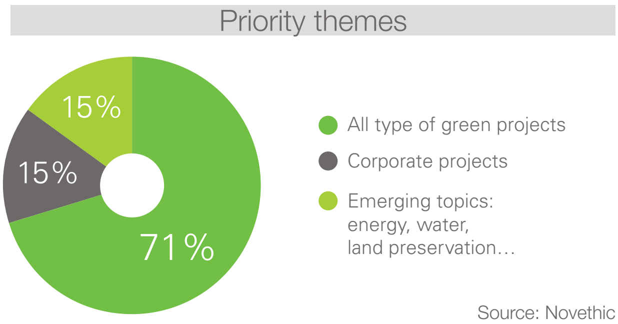
Green bonds are **bonds** first and foremost

Source: Novethic

Investors appreciate the fact that green bonds have the same financial characteristics as plain vanilla bonds. Some of them hope they will eventually have more favourable financial characteristics over the long term. They also believe green bonds can help reduce portfolio exposure to climate risk, notably in high carbon exposure specific sectors. Others, however, worry about the pernicious effects that the limited size of the green bond market could have on their short-term performance.

Strong desire for a **larger market**

The market is still considered too small, so the majority of investors adapt to all the themes currently available on the market. However, in addition to wanting more corporates in the market, some investors would like to see more issuances from emerging themes such as water, land preservation, and pollution management. And while most investors say they focus on bonds issued in OECD countries, one-third is also interested in emerging market issuers.

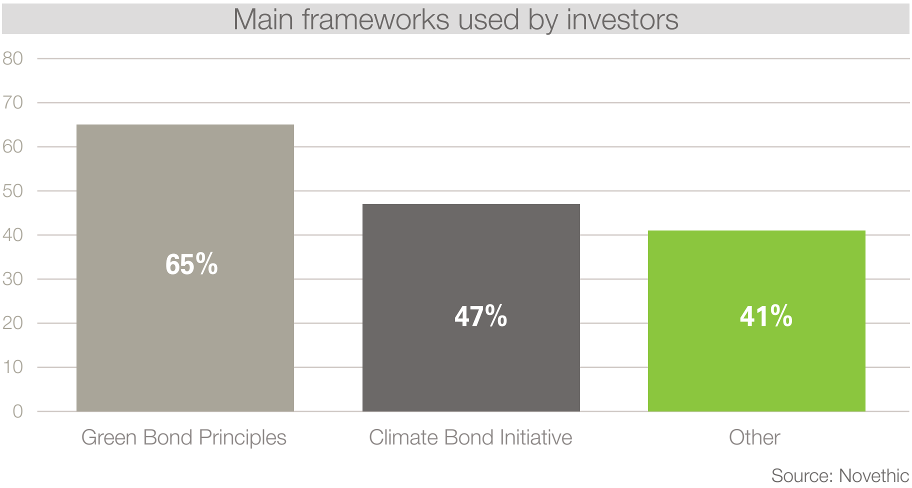


Source: Novethic

Pure players

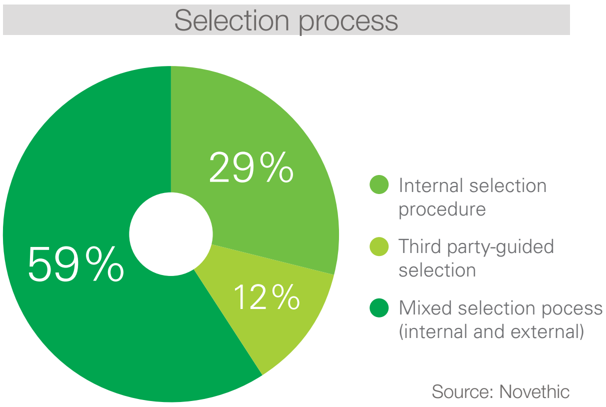
Figures provided by the Climate Bonds Initiative (CBI) show that in addition to the labelled green bond market, about $600 billion in bonds have been issued by companies that have climate-aligned activities but that have not labelled their bond issuances as green. Consequently, even though bonds are in line with the CBI taxonomy, they do not meet the transparency standards promoted by the Green Bonds Principles. This shows the need to urge issuers that carry out low-carbon infrastructure projects and other environmental activities to indicate they are issuing green bonds. While this entails a commitment and additional effort on the issuer side, it will greatly accelerate the diversification of the offering that investors are eagerly awaiting.

Methodological framework



One particularity of the green bond market is the existence of a transparency standard from the outset. Today, the Green Bond Principles (GBP) enjoy broad support from investors as well as from a growing share of issuers. They are a prerequisite for two out of three investors. Moreover, half the sample group referred to the CBI taxonomy, which provides a detailed framework of eligible activities. Others prefer to develop their own screening based on a green allocation aiming at aligning portfolio with a 2°C scenario.

Multiple **intermediaries**



There are already many specialised intermediaries in the green bond market in addition to the financial experts. They fall into three main categories:

- Second opinions are a third party evaluation of an issuance which often follow a specific and systematized framework: they offer an external review and assessment on the environmental and in some cases the social and governance proceeds of bonds before they are issued;
- Third-party assurance: they audit ex post the actual use of proceeds to green eligible projects that were indicated when the green bonds were issued;
- Environmental impact assessment specialists: they assist both issuers and investors through their reporting on environmental impact.

Although second opinion services are already widely used – they have been involved in 73% of the volume issued on the market – investors do not regard them as a must have. The variety of methodologies contributes to this attitude, but they do offer the benefit of providing detailed and structured information. In most cases, investors also do their own in-house analyses when selecting green bonds. For some, this can involve a very thorough environmental or ESG analysis. Post-investment audits, which are done for slightly more than half the market, seem more useful to investors because they guarantee that the funds are allocated to green projects. A lot is happening in this market segment, and the arrival of major credit rating agencies, led by Moody's and S&P, should accelerate developments.

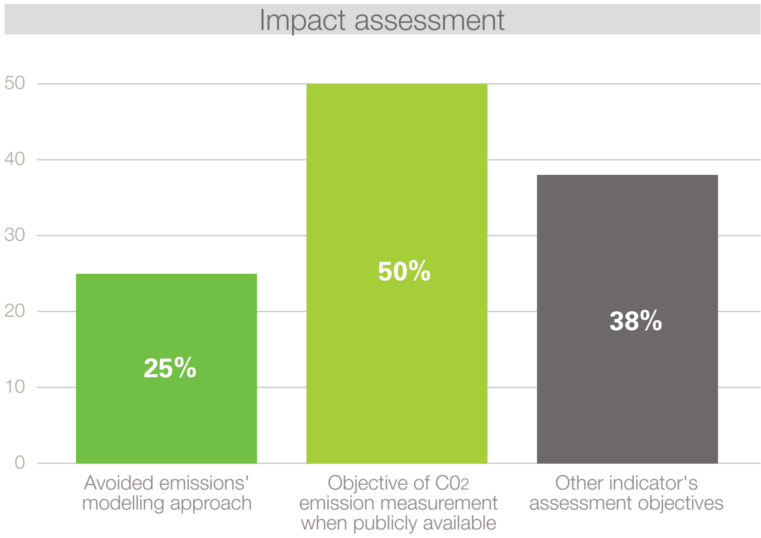
Energy transition certification, a guarantee of green bond funds' quality

The French Label for the Energy and Ecological Transition (TEEC), launched in early 2016 by the French government, has a specific methodology for green bond funds. It is not only based directly on the Climate Bonds Initiative (CBI) taxonomy, but the programme also promotes environmental impact reporting for each portfolio as a whole. Two green bond funds have already received TEEC certification, one managed by Mirova and the other by Humanis. Simultaneously, all type of issuers are awaited on the GB market, including governments like France's. The major financial institutions with climate commitments are looking for investments that can lend credibility to the green portion of their investments and facilitate the reporting required by Article 173 of the French Energy Transition Law.

Label
TRANSITION ÉNERGÉTIQUE
ET ÉCOLOGIQUE
POUR LE CLIMAT
pour les investisseurs qui s'engagent
Ministère de l'Environnement, de l'Énergie et de la Mer

Impact measurement

Environmental **impact indicators**



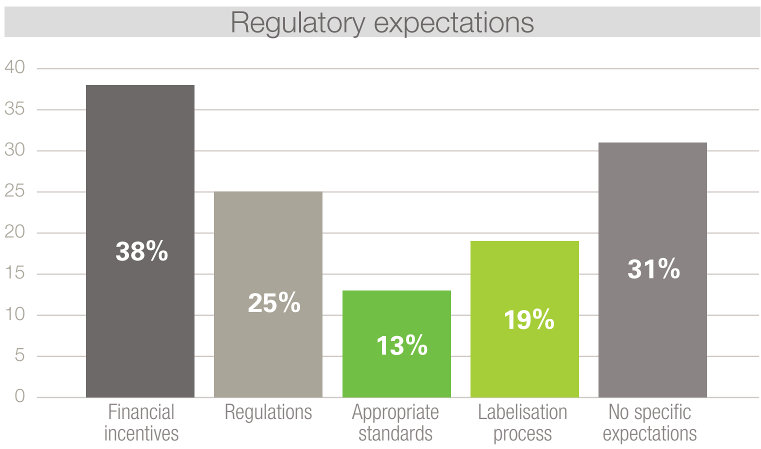
Source: Novethic

Investors want reliable environmental impact indicators, but know that they are not yet fully developed. For the time being, they are following three courses of action:

- One-quarter of the sample group, who are among the most active in responsible investment, are already working on this issue within their funds. They are focusing efforts on the volume of avoided CO2 emissions. They make it a selection criterion if the data exists; otherwise they use data from modelling according to the nature of the projects financed.
- Half the investors make impact measurement a priority and a mandatory objective, and they expect issuers to provide these data on an annual basis and as rapidly as possible.
- One-fifth of the investors prefer to wait for more refined impact assessment methods and a more developed market to use them as tools for guiding and monitoring their green bond investments.

On the whole, there is strong demand for impact reporting. The green bond funds managers want more data on certain bond issues. While almost all agree that emphasis should be placed on carbon impact, three out of five investors call for targeting other, related areas of monitoring such as production of renewable energies, water, biodiversity and pollution, or social impacts such as the contribution to the creation of decent jobs. Given the current lack of quantitative data, qualitative approaches tend to be used.

Market **outlook**



Source: Novethic

The green bond market is growing, and expectations along with it. A significant share of investors are hoping for a wider range of issuers (52%) and for an improvement in green bond quality (41%). In particular, they want more offerings related to energy efficiency, and they express increasing interest in the areas of water and land preservation, as well as in the Chinese market and in emerging economies. Investors see the structuring of the market by the Green Bond Principles as a positive sign, but about four out of ten also think that tax incentives for issuers or regulatory requirements would encourage a larger offering of green bonds. They are also in favour of stimulating the market through certification initiatives, which would increase the visibility of green bonds and clarify their characteristics.

Acknowledgements

The Novethic research centre wishes to thank all the investors who took the time to respond: ABN AMRO IS, Actiam, Allianz GI, Amundi AM, AXA Group, AXA IM, BNP Cardif, BNP Paribas IP, Caisse des Dépôts, Candriam IG, Crédit Agricole SA, CNP Assurances, Humanis, Ircantec, Mirova, NN IP, and Raiffeisen CM. It also expresses its gratitude to the Climate Bonds Initiative team*, the Sustainable Banking division of Crédit Agricole CIB, and the Natixis SRI research department for their market data and their expert perspectives on the green bond market.

*Novethic joined the Climate Bonds Partnership Program in September 2016.

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Survey conducted by Dominique Blanc, Novethic Head of Research,
with the assistance of Marguerite Bonnin during summer 2016.