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What is a green bond?

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08 November 2016

The rise of green bonds and the Green Bond Principles

Market origins and recent developments

A snapshot of international guidelines

The green bond market is underpinned by voluntary guidelines and standards, as well as more recently by rules and regulations in some jurisdictions such as China, India and France. At the core, there are the Green Bond Principles (GBP).

Globally, the most widely accepted guidelines for green bonds are the Green Bond Principles (GBP). These are voluntary guidelines elaborated by key market participants under the coordination of the International Capital Markets Association (ICMA) acting as secretariat. The GBP, updated most recently in June 2016, have achieved broad market acceptance as well as growing recognition by policy makers and regulators.

This is complemented by the work of the Climate Bonds Initiative (CBI), as well as by the work of multilateral and other development finance and government institutions. In addition, a number of private and academic organisations provide assurance on alignment with the GBP and/or on Climate Bonds certification, as well as on the eligibility of environmental projects. Some are also developing different types of green ratings.

Green bonds came of age in the past few years, as the environmental risks and opportunities facing capital markets converged with policy imperatives. As the consensus built regarding the implications of climate change, and with it concern about linkage to investment performance, so too did the need for investments with transparency regarding their environmental impact. For similar reasons, investors' wider environmental, social and governance (ESG) integration has gained momentum – good company for green bonds.
The Paris Agreement entered in effect on 4 November 2016. To paraphrase the UNFCCC, it "for the first time" brings nations together behind a widely shared cause - "to undertake ambitious efforts to combat climate change and adapt to its effects". With such ambition come the "nationally determined contributions" (NDCs). "This includes requirements that all Parties report regularly on their emissions and on their implementation efforts." In the new vernacular, "emissions" are an "impact" that has reached the strategic agenda of capital markets.
Looking ahead, markets and the authorities are therefore both faced by an imperative to generate and apply improved information about environmental impact. Investors are already facing pressure to disclose GHG footprints – witness Article 173 of new French Energy Transition Law.
The financial system is also recognising that climate change is entering the important realm of "materiality". This has been a driver of the work by the Financial Stability Board's Taskforce on Climate-related Financial Disclosure (TCFD). Issuers already face obligations for ESG disclosure, for example in the EU, and markets anticipate a need for growing issuer transparency on environmental performance and impact, and growing pressure to reduce environmental footprints.
With financial materiality come risk and opportunity. Either way, there is value in transparency regarding the environmental credentials of investment.
Green bonds governed by the Green Bond Principles (GBP) offer a simple proposition and relevant contribution to the new order: proceeds are used purely for assets or activities with environmental benefits. Crucially, for those adhering to the GBP, green bond reporting on the underlying assets "should include ... expected impact".
The proof is in the pudding: A green bond market which saw issuance of only $3 billion in 2012, amounted to well over $60 billion in the first nine months of 2016. Growth, internationalisation and diversification continue.
Most green investment remains financed through equity and bank credit. Potential for scaling-up issuance in the green bond market is tremendous. An OECD analysis, examining the potential for the bond markets to finance a 2°C scenario, estimates that bond issuance for low-carbon investments in renewable energy, energy efficiency and low-emission vehicles alone has the potential to scale to around $700 billion per annum in four markets by 2030 (China, Japan, the EU, and US), provided governments adopt supportive policies .
It seems no accident that issuance gained momentum after the GBP were launched in January 2014 – the market was looking for a shared framework for green bond issuance. The GBP met the challenge, by building a market consensus and addressing imperatives for environmental disclosure and accountability.

Peter Munro, Director, Green Bond Principles Secretariat, ICMA

Today no less than 200 GBP members and observers worldwide are driving the evolution. The trajectory is carefully curated by an Executive Committee, and benefits from technical innovation harnessed and spurred by an array of working groups, housed under the ICMA umbrella.

The basic features and merits of green bonds have become more widely understood: Green bonds under the GBP provide clearly segregated cash flows, and so demonstrate environmental purpose through transparency on use of proceeds. The GBP recommend that such bonds report on impact, and such bonds often provide high impact solutions that may be elusive with conventional bonds. Data on the overall environmental performance of issuers remains patchy, whereas green bonds call for greater clarity. In this way, green bonds provide valuable data for the re-balancing of investment portfolios, especially as decarbonisation gains momentum.

The GBP recently issued more detailed guidance on green project categories, which remains broad, leaving room for innovation and crowding-in relevant green initiatives. However, the GBP states that it will not provide detailed advice on what is green, leaving this to either investors themselves or to other parties with specialist expertise.

There is also improved guidance on impact reporting, with a reporting template of practical value for markets. Also, the GBP launched a resource centre, which not only simplifies reporting on GBP-alignment, but also eases comparisons among green bonds.

The GBP are referenced in a growing array of official sector guidelines and rules, in countries including Brazil, China, France and India. As the G20 September 2016 Communique noted, such "voluntary principles" warrant attention.

Green bonds are a product that is helping markets to adjust to the future. A future that will entail far greater environmental rigour, and more profound investment implications, as the materiality of environmental risk and opportunity crystallises.

As greater clarity emerges on environmental imperatives and norms, it is likely that skills and reputations acquired in the green bond market will put market participants in good stead.

Defining green bonds

Green bonds raise funds to finance or re-finance projects with environmentally sustainable benefits. A segregated use of proceeds for green purposes distinguishes green bonds from regular bonds. Green definitions for projects associated with green bonds and adequate disclosure further distinguish green bonds.

There are a range of other taxonomies addressing green project definitions. The GBP currently provide guidance on eligible green project types through high-level project categories. Further assessment of this landscape is part of the 2016-17 work plan of a GBP Working Group on Eligible Green Projects. In view of differing national environmental priorities, definitions can vary internationally. However, there are also international definitions, such as those under the Climate Bonds Standard issued by the Climate Bonds Initiative (CBI), or the wide variety of definitions or green technical standards for specific sectors, such as BREEAM for buildings.

In the absence of global acceptance in capital markets as to what is a green project, the majority of issuers commission external reviews of their green bond investment frameworks or issuance, for the benefit of investors.

Most bonds that are termed "labelled green bonds" are subject to an external review. As of June 2016, $118 billion of labelled green bonds were outstanding (CBI/HSBC, 2016).

Beyond this labelled green bond market, there are unlabelled bonds - identified as supporting green projects but that are not specifically labelled as green. This market for unlabelled bonds was valued at $576 billion as of June 2016 (CBI/HSBC, 2016); for instance, bonds from "pure-play" wind energy companies.

The GBP recommends that the term "green bonds" be used only for GBP-aligned bonds, while the wider universe should be referred to as climate or environmental themed bonds.

Rationale for green bonds

An estimated $6-7 trillion in annual investment will be needed globally over the next 15 years to meet the demand for green investment, to facilitate the global transition to an environmentally sustainable and low-carbon economy[1]. For instance, according to the IEA, for a 2°C scenario, investment would need to increase by a factor of three for "low-carbon" power generation, and by a factor of eight for energy efficiency.

Currently, most green debt investment is financed through bank credit. However, the bond market, which provides about 1/3 of total financing for corporates globally[2], has yet to play a comparable role in green financing. The OECD estimated that labelled green bonds issued globally in 2015 represented less than 1% of total US bond issuance alone and less than 0.2% of debt securities issued globally. Thus, the potential for scaling-up the green bond market is tremendous.

The green bond market can offer a range of important benefits – here are a few of highlights:

a. Capacity to scale up and provide a major source of green financing.

b. Enabling more long-term green financing by addressing potential maturity constraints for alternative products
c. Clarifying corporate environmental strategy and performance and generating reporting capacity that may serve growing obligations environmental disclosure.
d. Potential for risk/return enhancement for investment – building on evidence found in academic research on ESG investment
e. Facilitating the "greening" of traditionally brown sectors- the aforementioned benefits can function as an incentive for issuers become greener.

Market evolution - GBP initiatives

The GBP continues to respond proactively to change in the market, leveraging its role as the leading global forum for market development.

Among the GBP initiatives is a series of working groups, which support the annual update of the GBP. The GBP Working Group agendas for 2016-17 have just been announced. The working groups address (1) Indices and databases, (2) impact reporting, (3) green project eligibility, and (4) social bonds. The working groups are broadening their interaction with stakeholders, thus taking into account insights that can add value to market development.

The GBP also continues to respond to an array of consultations on green bonds, notably from the official sector and trade associations, and this work is led by a New Markets Taskforce.

Such initiatives demonstrate that the GBP aims to be responsive and to keep pace with market evolution and the wider context.

Peter Munro is director of the Green Bond Principles Secretariat, ICMA. This article includes personal opinions and certain elements may not represent the ICMA view.
The article, in particular the "Analysis" section, draws extensively on a paper co-authored by ICMA (Nicholas Pfaff, Secretary to the Green Bond Principles) for the G20 Green Finance Study Group report: "Green Bonds: Country Experiences, Barriers and Options".