Green bonds are helping investors take action against climate change

By Carolina Minio-Paluello

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Climate change is one of the most pressing sustainability challenges investors are facing today. It presents a systemic risk that is very difficult for investors to diversify away. The physical risks associated with a rise in global temperatures, and the transition risks created by shifting towards a low-carbon economy are already having wide-reaching consequences for society, for the global economy, and for investment portfolios.

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In response, we believe it is now mission-critical for the investment process to adapt and innovate to mitigate climate risk, and to take advantage of the many opportunities a transition to a low-carbon economy will create. Green bonds are an increasingly important instrument for investors to use to avoid carbon emissions and increase the resilience of their portfolios to the transition to a low-carbon economy.

As the market for these bonds has grown, it provides a much more diverse and liquid opportunity set. Furthermore, because the use of the assets is clearly ring-fenced for climate-friendly projects, the outcome of the investment can be more easily measured in terms of carbon emissions avoided. Climate bonds represent a small, but growing segment of the fixed income market. We believe they will continue to grow in prominence as the transition to a low-carbon economy unfolds.

We believe companies who manage their carbon intensity relatively well, or who issue climate-aligned bonds, are more likely to be better positioned in this changing environment. As the world transitions to a low-carbon economy, companies that are proactive in managing their exposure to climate risk will be more resilient as they are better positioned to adapt to new regulations, innovation, or a shift in consumer appetite.

Growth of the green bond market

Green bonds represent a fast-growing market that offers investors the chance to use their capital to finance climate change solutions. The green bond market has experienced a remarkable decade of growth in response to the increasing prevalence of climate change. The value and purpose of these products in an investment portfolio has never been clearer. Since the first of these products was launched by the World Bank in 2007, there has been a cumulative issuance of more than $521bn. The size and diversity of the market today makes it possible to design an investment strategy that is well diversified in terms of credit rating, duration, region and sector.

The first labelled climate bonds were issued by the European Investment Bank (EIB) in 2007, followed by the first labelled green bond issued in November 2008 by the World Bank. The green bond was created after a report from the Intergovernmental Panel for Climate Change (IPCC) outlined the undeniable link between human activity and global warming. The report prompted a collection of Swedish pension funds to consider how financing could be used to address this growing threat, leading to the creation of the green bond.

Green bonds have been very well received by investors. Strong issuance across the range of issue types and sectors has been matched by strong demand from investors. The World Bank has remained a major issuer of green bonds and estimates to have raised more than $13bn through 150 bonds since 2008. The market has evolved a great deal since its inception, although the original purpose of connecting capital to green assets remains central to the concept.

With tight pricing, oversubscription and upsizing of deals being common in the primary market, and with the secondary market strong on the bid side, there is clearly scope for continued growth. The repeat issuance from a multitude of issuers and increased reliance on the secondary market is further evidence of the increasing demand for green bonds. The OECD recently estimated that annual green bond issuance could reach between $620bn and $720bn by 2035, and that the green bond market alone is likely to be worth between $4.7tn and $5.6tn by 2035, marking it as a mainstream asset class.

Climate change mitigation costs

A major driver of demand for green bonds has been, and will continue to be, the attention around the issue of climate change, which is heightened by well-publicised investigations such as the recent IPCC report. The costs associated with mitigating climate change are substantial. The Paris Agreement – which aims to limit global warming to well below 2°C compared to pre-industrial levels by the end of this century – sets out $100bn per annum for both adaptation and mitigation, and by 2030 the cost of adaptation alone is expected to total $300bn per year. The green bond market has been used as a tool to address this gap, by ensuring positive environmental and social change, while also raising capital.

Alongside the increase in size, there has been an increase in diversification of issuance. Originally, the majority of impact bond issuance was by governments and supranationals, but now corporate issuance constitutes half of the overall market.

For example, US mortgage agency Fannie Mae issued $20.1bn in green bonds in 2018, making it the largest issuer in the world. Fannie Mae estimates this has resulted in a number of positive environmental impacts, including reducing greenhouse gas emissions from properties by 287,000 metric tonnes, saving annually 4.3 billion kBtu of source energy, and properties are projected to save approximately 5.9 billion gallons of water annually.

Amsterdam’s Schipol airport has also emerged as a dominant issuer in the private sector. Schiphol aims to allocate the funds of the green bonds towards the funding of green buildings and clean transportation in accordance with Royal Schiphol Group’s Green Bond Framework. The ambition is to become the world’s most sustainable airport and management have stated the goals of being a zero waste airport by 2030 and a climate neutral airport by 2040. The airport raised €500m through issuance of green bonds in 2018.

For us, identifying companies that are well positioned for the transition to a low-carbon economy is a key aspect of delivering sustainable investment returns in the future. Climate change, as a systemic risk, is something investors can no longer afford to ignore. Green bonds have an important role to play in this environment.

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