In the race for the Democratic Party nomination in the 1984 US Presidential election, Senator Gary Hart was the up-and-coming man: good-looking, bouffant-haired, cowboy boot wearing, and full of "new ideas". His candidature was eventually punctured when his rival, Walter Mondale, borrowed a line from a Wendy's hamburger commercial, asking Hart during a TV debate "Where's the beef?"

Some 30 years later, green bonds look and sound new and attractive, they appeal to idealistic investors and those with sustainability mandates, and they have momentum on their side: Bloomberg New Energy Finance is predicting that this year will see a record $37bn of green bonds issued, up from $14bn in 2013.

But green bonds have their critics too: are they actually driving new funding into sustainable solutions or are they just the favoured greenwashing wheeze of the day? Or, to put it another way, where's the beef?

I will start with the case for the defence. But first, a definition: green bond is an umbrella term that encompasses several different types of security, including the following: bonds issued by development or commercial banks to finance a ring-fenced pool of loans that will be made to climate-related projects; bonds issued on the back of securitising a pool of existing loans to solar customers or other clean energy users; bonds issued by utilities or other industrial companies to fund just the climate-related portion of their capital spend; and project bonds, secured directly on the revenues of new or existing clean energy projects. My colleagues have been working hard to present details of all these types of green bonds under the SRCH @GREEN function on the Bloomberg Terminal.

Large issues in recent months have included $1.7bn of 1.375% bonds due 2020 from utility GDF Suez, $1bn of 2.5% bonds due 2024 from real estate company Unibail-Rodamco, and – earlier this month – $1.3bn of 1.375% bonds due 2024 from development bank Agence Francaise de Developpement, or AFD. Most recently, on 22 September, Abengoa of Spain said it planned to issue $642m of five-year green bonds to fund projects in "renewable energy, water, power transmission, energy efficiency, bioenergy and waste-to-energy".

The market has grown rapidly over the past 24 months for a number of reasons. One of them is investors' urgent need for yield at a time of record-low interest rates. Among the institutions hungry for yield are an increasing number with an environment, social and governance, or ESG, mandate. Green bonds provide them with a convenient mechanism to ensure that their funds are not used to finance the drilling of oil in the Arctic, the supply of weapons to a conflict zone, or a plethora of other ESG-incompatible activities.

The case for enthusiasm

Here are four arguments in favour of green bonds. They might be abbreviated to "inform, supply, demand and build". The first argument is that their emergence is helping to inform investors, inside and outside the core group of ESG-focused financiers, on the climate challenge and the difference between climate-friendly and climate-unfriendly activities. If institutions decide that, given a choice between two bonds with identical coupons, risk and term – one a green bond tied to climate-friendly activities and the other a "brown" bond linked to activities that are at best neutral to climate – they would buy the former, then they are simultaneously greening their portfolios and gaining knowledge on sustainability.

Second, supporters claim that this very choice above is beginning to steer organisations to prioritise climate-friendly investment because it can be more easily financed. All of the green bond issuers to date have reported strong demand.
Some of the biggest green bond issues have been by utilities such as GDF Suez and Iberdrola, and in March 2014, Toyota issued a $1.8bn bond in the form of an auto-loan asset-backed security with cash flows tied to repayments of outstanding loans for the company’s green cars such as the Prius. These companies have noticed that green equals investor appetite.

The French development agency told Bloomberg New Energy Finance that it hopes that rising green bond issuance, of which its recent $1.3bn issue represents a part, would help to “redirect the flows” of capital in the financial system towards environmentally-friendly activities.

Argument three in favour of green bonds is that they open up a new supply of finance. If they did not exist, sustainability-oriented investors could put money in specialist clean energy stocks, but equity represents only a part of the capital needs of the low-carbon transition. In the fixed income part of their portfolios, they would have to fish in the very small pool of bonds issued by “pure-play” renewable energy or sustainability technology companies, or simply try to avoid non-specialist bonds from the worst issuers. The availability of green bonds gives them active choice among a much expanded choice of investments.

Perhaps more importantly, green bonds may open up a significant new source of finance by providing a simple label enabling more climate-friendly investing by the non-specialist fixed-income investor. He or she inhabits a market worth an estimated $80 trillion. Normally, his or her money goes into government bonds, or municipal bonds, or corporate bonds, or perhaps credit derivatives. If a fraction of that starts to move into green investment, it could make a big difference to the world’s efforts to combat climate change. It could also parallel what is happening on stock markets, where yieldcos on both sides of the Atlantic are enabling equity investors to back relatively low-risk pools of operating renewable energy assets.

Argument four is the view that green bonds lay the tarmac for a road that will ultimately see institutions pumping money directly into clean energy projects. This is the “build” argument. Christopher Flensborg, the SEB banker dubbed the “father of the green bond”, made this point in an interview in our Clean Energy & Carbon Brief in July. He said: “To make a difference on these issues, you need to have the financial infrastructure in place to facilitate the transition. If we raise awareness and build the infrastructure, encouraging investors to move along the curve, they will end up financing projects, and that is where you will get the additionality.”

So far, direct institutional purchasing of project bonds is only a very small piece of the overall green bond market. In 2013, they made up $3bn of the $14bn total issued, thanks partly to a $1bn bond from Warren Buffett’s Berkshire Hathaway Energy to finance the Solar Star PV project. In the first five months of 2014, project bonds (as defined by Bloomberg New Energy Finance) made up none of the $16.6bn total. However Flensborg’s hope is that in the future, project bonds will become more and more common. They might finance the construction of some projects but, more typically, would enable projects to be refinanced so that developers’ and banks’ capital could be recycled into new undertakings.

Green bond market still small compared to other fixed income areas

![Green bond market still small compared to other fixed income areas](image)

Source: Bloomberg New Energy Finance

The case for caution

That is the case that green bonds are real beef, not just sizzle. However, there are also reasons to take a breath rather than being swept along in the charge of green bonds. Here are three. Let’s call them "impact, additionality and quality control".

Starting with impact, at the moment, $37bn-a-year of green bonds may sound like an impressive number but it is puny in comparison to the overall bond market. If little of that proves to be new money, rather than money that would have been deployed anyway, then current levels of green bond issuance will make very little impact on the build-out of clean energy infrastructure or the reduction in carbon emissions. To have real impact, green bonds would have to grow to a market worth hundreds of billions of dollars per year.

One thing that could stand in the way of that further growth is that there is as yet no yield advantage for companies and banks to issue green bonds. If Utility X decides to raise new bond finance, it can either issue six-year conventional bonds at, say, 1.4%, or it can issue a green bond at – you have guessed it – 1.4%.

A yield advantage may continue to prove elusive. Green bonds, like conventional bonds, are secured on the
balance sheet of the issuing organisation, so they carry exactly the same risk. If investor demand pushed up the price of Utility X's green bonds, with the result that the yield fell to 1.3%, then other investors might see an arbitrage and buy the conventional bonds until the yields were more or less the same again.

Sean Kidney, chief executive of the Climate Bonds Initiative and a firm supporter of green bonds, does not expect a consistent yield differential to emerge in the near future that would encourage organisations to issue green rather than brown bonds. But he says he is starting to see signs of a different advantage, duration. Some issuers have been able to find ready purchasers for green bonds with a longer duration (say, 20 years rather than 10 years), where they might have struggled to find such enthusiastic purchasers of an equivalent conventional bond.

If he is right, investor appetite could spur on the growth of green bonds to a point in a few years' time when they start to make a real difference to the cost of finance for climate-related projects. At the moment, the jury is out.

That takes us onto the second issue, additionality. The European Investment Bank, for example, says it invested EUR 6.4bn in renewable energy in 2013, plus EUR 2.2bn in energy efficiency. It issued a lot of conventional bonds, but it also issued EUR 1.4bn of its green variety, dubbed Climate Awareness Bonds. If it had issued no green bonds at all, and had just relied on conventional bonds, would its investment in renewable energy and efficiency have been any lower? Perhaps, perhaps not.

The same question could be asked about the green bond issues of utilities such as EDF and Iberdrola. Most European utilities have been cutting back their capital spending on renewable power in recent years, or are planning to do so. It is far from clear whether their green bond issues are resulting in more investment in clean energy than otherwise would have occurred.

Green bond fans might retort that at least the issuance of utilities such as EDF and Iberdrola. Most European utilities have been cutting back their capital spending on renewable power in recent years, or are planning to do so. It is far from clear whether their green bond issues are resulting in more investment in clean energy than otherwise would have occurred.

As a result, some green bonds are greener than others. If the market continues to grow rapidly, we are likely to see green bonds issued not just by banks with substantial lending programmes to clean energy or by utilities that invest heavily in the area, but perhaps by industrial companies to back investment in water treatment or infrastructure companies looking to finance flood defence building, and even by fossil-fuel companies to back desulphurisation or carbon capture projects. What happens when someone issues a green bond to fund an ultra-super-critical coal plant, on the argument that it is cleaner than the existing coal plant?

If the promoters of the market are not careful, the concept of the green bond could become diluted to the point where investors have difficulty distinguishing what is genuinely making an impact on safeguarding the climate and what is not. That could one day carry big dangers for investors. Any fund or individual that had invested in a broad array of green bonds in, say, 2014 in the belief that they were providing exposure to new energy, not old, might find in a few years’ time that some of those bonds were actually secured on the balance sheets of fossil-intensive companies.

If the volume issued multiplies from $37bn to $150bn or $250bn, it will be big enough for green bond indices to be launched and investors to buy exchange-traded funds. It would then be particularly important that quality control is strong on the underlying securities in those indices.

Carefully crafted, and widely accepted, standards for green bonds are essential to the development of a healthy market. Agence Francaise de Developpement said this month that its decision to issue a $1.3bn green bond was made partly because it wanted to contribute to the standards process. Its own filter for projects to qualify for loans using the proceeds of its green bond issue is that they have to result in a reduction in emissions of at least 10 kilotons per year of CO2 compared to the status quo.

It looks like it is going to take a good few years to establish an agreed system to rate the "shade" of a green bond. The challenge will be to make sure that such a rating does not add to the cost of issuance, to the point that organisations are dissuaded from issuing green bonds and stick to the brown variant.

So, in summary, are they burger or sizzle? There is already definitely some beef to green bonds – such as their role in informing investors about climate issues and making it easier for them to influence corporate priorities.

However, so far, the beef is dwarfed by the bun. As the green bond market grows, its supporters will have to be
vigilant to ensure that its impact on the bigger goal –
decarbonisation – becomes more obvious. Given
progress towards a simple, cheap rating system,
sustained interest by issuers and asset owners, a
supportive policy environment, green bonds could
perhaps turn out to be the real filet mignon.

Bloomberg New Energy Finance is holding a Green
Bond Lunch to discuss latest developments in the
market in London on Wednesday, 1 October. Anyone
interested should contact Greg Kay at
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