Is Green Always Good?
A closer look at green bonds

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Executive Summary

- Investments in sustainable, green and ESG products have ballooned in recent years as evidence increasingly demonstrates the benefits of considering qualitative factors in investment decisions.

- As green bonds have expanded from mostly supranationals and other government-related entities into corporate issuers, some investors have touted green bonds as the next distinct asset class based on exponential growth rates and diversification benefits. Corporate green bonds – the fastest growing segment of the green bond market – are critical to continued growth.

- Contrary to popular belief, green bonds have been shown to trade at a premium to comparable “plain vanilla” bonds, while carrying additional downside risk for investors. The added risk combined with higher pricing has created headwinds for increasing mainstream interest in the asset class and corporate green bonds in particular.

- Green bond investors have an opportunity to increase companies’ focus on the benefits of environmental risk and opportunity management throughout organizations. As more corporations enter the green bond market, investors should focus on integrating, not separating environmental analysis. This approach will maximize the environmental benefits while minimizing investment risk.

Gordon Gekko, the cutthroat financier in the 1980s movie Wall Street, opined “greed, for lack of a better word, is good. Greed is right. Greed works.” Gekko utilized the concept of greed to justify his unbridled pursuit of profits at any cost. Fortunately, investors have evolved since the Gekko days and are beginning to realize that considering qualitative factors can lead to higher returns. Studies have demonstrated the financial benefits of integrating environmental, social and governance (ESG) factors into investment decisions. Investments in sustainable, green and ESG products have skyrocketed in the past few years (up over 60% in just two years, according to the Global Sustainable Investment Alliance).

One of these products, green bonds, has even been touted as a potential distinct asset class given its current growth trajectory. While green bonds began in 2007 as the exclusive instruments of high quality, supranational government-related entities, in recent years corporate issuers have driven growth. Corporate green bonds are the fastest-growing segment of this market, rising from 17 percent of total green bond issuance in 2013 to 33
percent by 2015 (see Exhibit 1). The majority of corporate green bond issuers have been high quality investment grade issuers (like French utility EDF and Apple), but a few high yield issues have tested the market.

**Exhibit 1**

![Corporate and muni bonds make up a growing proportion of issuance](chart)

Source: Climate Bond Initiative, Bonds and Climate Change: The State of the Market in 2016

**Corporate Green Bonds Carry More Risk**

In fixed income investments, potential gains pale in comparison to potential losses. Investors need to weigh a relatively small, capped upside against the possibility of default and a total loss of capital – making risk and cash flow analysis critical components in bond purchases. When analyzing corporate green bonds, investors need to know that green bonds are repaid with general corporate funds (unless asset-backed), not from dedicated cash flows from the environmentally-friendly projects.

Conventional wisdom dictates that a company’s green bond pricing should be similar to its traditional bonds given that both have the same recourse against cash flows. However, early evidence refutes this notion. Barclay’s reported that green bonds command a 17 basis point price premium over comparable bonds, likely driven by strong demand by green funds.¹ Apple’s $1.5 billion green bond issued in February 2016 trades anywhere from 8-20 basis points richer than comparable issues (see Exhibit 2).

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Climate Bond Initiative has called green bonds standard bonds with a bonus feature of green,\(^2\) but this bonus does not come without a price. Investors in corporate green bonds bear increased downside risk versus equivalent “plain vanilla” corporate bonds. Unlike their traditional counterparts, socially conscious investors appear willing to pay more despite greater underlying risk in green bonds. If a green bond issuer disappoints its mission-driven investment base with a less-than expected environmental impact or weak reporting on use of proceeds, the price of those bonds will likely fall despite the fact that corporate cash flows and creditworthiness may be unaffected. For example, if Apple reports that it plans to cease its efforts to install solar capacity, the company’s overall cash flows would not see a measurable impact near-term. Apple’s traditional bond holders would not consider this a reason to sell and decrease the price of Apple bonds, but green bond holders may be driven to sell on principle alone. The only Apple bond that would suffer downside pricing in this scenario would be the green bond – if the bonus feature disappears, so would the bonus premium.

While high demand from socially conscious investors explains some of the price difference, part of the green price premium could be explained by alternative views on relative value. For example, a socially responsible investor would compare Apple’s green bond pricing and risk to a relatively small pool of renewable energy projects and other green investment opportunities. In this case, Apple’s investment grade rating and financial profile might be significantly more attractive and worth a premium price. A traditional investor would view

\(^2\)https://www.climatebonds.net/market/explaining-green-bonds
the Apple green bonds as higher risk and more expensive relative to a broad comparable universe of all investment grade corporate bonds and other Apple bonds. This difference in relative value determination, coupled with low supply, results in higher premiums for green bonds.

**Shades of Green**

Green bond investors have been calling for more stringent, mandatory standards (like the Green Bond Principles) and labelling bonds with “shades of green” to enable investors to differentiate between impact levels of green bonds. For example, IFC’s recent innovative deforestation bond that pays either cash or carbon credit coupons would be considered much greener than Apple’s bond. For traditional corporate bond investors, shades of green won’t make a difference if the bonds are repaid from the same cash flows as conventional bonds. The only shade of green mainstream corporate investors care about is the color of bills used to repay the bond. Organizing corporate green bonds by grades of environmental-worthiness will only increase the downside risk and premium paid by green investors for the higher-ranked bonds. Certain investors might have a mandate requiring the purchase of bonds rated only the most impactful shade of green. Dividing an already relatively small supply of green bonds into smaller subgroups would drive an increasing share of investor dollars after a shrinking pool of investable options and would significantly raise the prices of high quality green bonds.

**Integrate, Don’t Separate**

Corporate green bonds broaden the investor base for companies while making it easier for socially responsible and impact investors to directly express support for environmentally-friendly projects, but they do not necessarily encourage green behavior throughout an entire organization. Notably, Toyota Financial Services has issued asset-backed green bonds to fund financing for vehicles with higher fuel efficiency than its standard fleet – yet the parent company continues to profit from sales of large SUVs and trucks that contribute to increasing carbon emissions worldwide.

Socially conscious investors could capitalize on their status as a new group of investors in certain corporations (like Apple and Toyota) by calling upon management teams to integrate environmental awareness throughout organizations – not just through selected projects. Environmental responsibility at a corporate level involves many variables - including water usage, energy efficiency, carbon intensity and waste management. Managing these variables lowers cost, improves productivity and should be an integral part
of any effective corporate management team’s goals. These elements should be a focal point for all investors, not just socially responsible and impact investors.

**Solutions**

To more effectively engage mainstream investors in green bonds and integrate environmental concerns into corporate management, fixed income investors should focus on four areas:

- **Relative value enhancement.** For traditional investors to buy more green bonds, relative value (from their perspective) needs to be more attractive. Corporations can accomplish this by either lowering the risk or increasing the premium paid. For example, a corporation could issue green bonds as a senior secured note (lower risk), higher in the capital structure than a “plain vanilla” bond.

- **Covenant language.** Corporate bonds contain detailed incurrence and maintenance covenants that require compliance by the issuer. Incurrence (or negative) covenants, place limitations on a company’s ability to raise additional debt or sell assets, for example. Incurrence covenants are only tested when triggered by a specific event, such as issuing debt or acquiring an asset. Corporate loans, on the other hand, often include maintenance covenants that are tested quarterly or annually. Maintenance covenants are used to monitor the financial health of a company and maintain company financial ratios at specified levels. For example, a maintenance covenant might require leverage to remain below 1.0x. While maintenance covenants are not typically included in high yield bonds – and definitely not included in investment grade issues - if several large fixed income investors collaborated, standardized maintenance covenant language could be negotiated in bonds that would require reporting of specific environmental metrics and goals.

- **Bond ratings.** Ratings agencies like S&P and Moody’s contribute to the segregation of environmental issues by failing to include long-term environmental risks and opportunities in ratings. Ratings agencies are typically slow to react to rapidly-changing market conditions, with prices on bonds moving up or down long before the rating changes. Despite this, ratings agencies can play a valuable role in drawing corporate and investor focus to specific long-term issues like climate change. Most credit ratings are designed to apply over a three to five year period and do not include consideration of long-term risks like the impact of climate change, changes in environmental policies, and rising energy costs that may occur beyond that period. While this approach may make sense for short-term bonds, buy-and-hold investors (like many buyers of green bonds) may be underestimating environmental risk. Rating agencies could publish both short-term (one to five years) and long-term (20+ years) ratings to appeal to different types of investors and maximize their value-added through long-term risk management.
• **Hold management teams accountable.** Although fixed income investors are not shareholders, they can still influence management teams. All fixed income investors (not just socially responsible and impact investors) should question management teams on handling of long-term risks like climate change, encourage more disclosure on pertinent metrics, and commit to being long-term holders of companies that integrate environmental management into everyday operations.

## Conclusion

If Gordon Gekko could speak to today’s enlightened investors, he might change his words to “Green is good. Green works.” Green and greed need to be woven together to create sustainable, long-term corporate profits and environmental benefits. To enable the green bond market to continue its remarkable growth and galvanize capital needed to fund environmentally-friendly projects, traditional investors need to be incented to buy – not just socially responsible and impact investors. Low supply, higher pricing and potentially further subdivisions into shades of green could make green bonds a less effective method of driving corporate preparations for climate change. Both socially responsible and traditional investors should be encouraging the integration of environmental responsibility at all companies and rewarding those who succeed with an overall lower cost of capital.