The big push for green bonds

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The creation of an environmental bond market has been frustratingly slow – but interest is building. **Mark Nicholls** reports

Set to underpin a fixed income revolution?

There is no shortage of bold predictions for the potential size of the market for environmental bonds – and no shortage of factors that should drive issuance in the months and years to come. But much of the discussion at the Environmental Bonds 2012 conference last week was around challenges and barriers that are, for the time being, keeping a lid on the market.

Some $16 billion of environmental bonds have been issued to date. The majority of these are from multilateral lenders such as the World Bank and the European Investment Bank (EIB). These bonds carry the same credit risk and pay the same coupon as the issuer's conventional paper, but the proceeds are ring-fenced for environmental investments.

Meanwhile, towards the riskier end of the credit spectrum, a handful of asset-backed bonds have been issued against renewable energy projects, while up to $130 billion of corporate bonds have been issued by companies that derive at least 25% of their revenue from the clean energy sector.

But these figures are dwarfed by the overall size of the bond market and, indeed, by the scale of capital required to fund low-carbon infrastructure – at a time when the availability of project finance from the bank market is drying up.

A lot of people … are frustrated that green bond issuance has failed to take off materially at this point

And, on the demand side, institutional investors are hungry for long-term assets with predictable yields and, t the same time, are paying growing attention to environmental, social and governance (ESG) considerations in their investments – which should mean that green bonds find willing buyers.

However, environmental bond issuance has been relatively muted to date.

"A lot of people … are frustrated that green bond issuance has failed to take off materially at this point," Colin Purdie, manager of the Sustainable Future Corporate Bond Fund at Aviva Investors, told the conference in London on Wednesday.

He argued that asset-backed green bonds have been too complex and difficult to analyse. “We need to ensure that structures are simplified,” he said. On the corporate side, he partly blamed a continuing view within investment bank syndicate desks and among ‘mainstream’ bond fund managers that environmental bonds remain a niche product for “treehuggers” managing ethical or socially responsible funds.

“That is probably the hardest thing to address,” he said.

Mark Wells, a managing director in BNP Paribas’s specialised product group, worked on the €200 million Andromeda project bond, sold at the end of 2010, which was backed by solar farms in Italy developed by SunPower.

He reeled off a list of challenges faced in trying to launch asset-backed renewable energy bonds. These include the relatively small size of the underlying transactions and the fact that renewable energy “is not a core asset class” for “virtually all” bond investors, meaning they need to be incentivised to look at the sector. And “they need to be shown that there’s a decent pipeline” of deals to justify the investment they would have to make.

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There is also a mismatch between the credit quality of the structures – often at single-B – and where investor demand is, typically for single-A or above.

“There’s lots of liquidity [in the bond market], but the question is, at what rating level does that liquidity come in?” The solution, he said, involves “de-risking” the senior level of debt, perhaps by adding some sort of credit enhancement (such as a guarantee by an export credit agency, as with the Andromeda deal) or by reducing the leverage involved.

He added that, while sponsors are unlikely to want to put more equity into transactions, the entry into the sector of mezzanine funds – which offer capital somewhere between debt and equity – could help to unlock fixed income investments.

Michael Eckhart, the New York-based global head of environmental finance at Citi, proposed the creation of a “global OPIC”, to help support renewable energy bonds, borrowing characteristics of the US Overseas Private Investment Corporation and mortgage agency Fannie Mae.

Such a body would help local banks to offload loans written to renewable energy projects – assuming they followed specified terms – to international banks, by offering to underwrite bonds issued against those loans.

Michael Eckhart, Citi: calling for a "Global OPIC"

But not everyone expressed frustration. “Some say we’re going slow – we’re going exactly as planned,” said Christopher Flensborg, head of sustainable products at Swedish bank SEB – the most active arranger of environmental bonds for the multilateral banks.

“Like every new product, it’s important to get the foundations right from the beginning.” While he acknowledged a need for more corporate issuance of green bonds – “to expand [the market] across the credit curve”, he said it is important to build consensus around standards and definitions, or risk confusing and deterring investors.

“One fear that we see is that there are five or six or seven different solutions, and investors say, ‘it’s too complicated’,” said Flensborg.

Peter Munro, head of investor relations at the European Investment Bank, said that interest in the bank’s green bonds is growing, expanding from “pockets of demand” among Nordic pension funds and Japanese retail investors. “It’s getting ever broader,” he said, citing enquiries from “mainstream accounts” and efforts by State Street Global Advisors to attract investment from conventional US investors.

“What’s interesting is that mainstream accounts are saying, if you can bring sufficiently liquid size, we’ll consider it – [and] that’s the next thing on our agenda,” he said, without elaborating.

The Green Deal Finance Company should be a major source of green bonds

Purdie at Aviva said that, if environmental bonds bonds were issued above a sufficient size – above £250 million ($395 million) or so – they would be included in fixed income benchmark indexes, which would require passive index-tracking funds to buy them, and would at least force active fund managers to make a deliberate decision not to buy them – and risk drifting away from the benchmark against which their performance is judged.

“This is a vital next step” for the market, he said.

Such large-scale issues are on the agenda. In the UK, a company set up to facilitate a major UK energy efficiency programme could issue a £400 million-500 million bond within the next couple of years.

Jon Williams, a partner at consultancy firm PwC said the “Green Deal Finance Company should be a major source of green bonds”, issuing potentially £20 billion ($32 billion) over the next decade.

James Cameron, Climate Change Capital: about addressing "twin systemic risks"

The Green Deal is a UK government initiative designed to help UK consumers and companies install energy efficiency equipment by allowing the cost of improvements to be paid for from savings in energy bills, provided those savings exceed the cost of the work.

“The idea is to take the receivables from a pay-as-you-save structure, to aggregate them, to warehouse them on a bank’s balance sheet,” said Williams, “and then when you get to about £500 million, start launching those as asset-backed bonds.”

But what would really transform the environmental bond market would be if a sovereign issuer was to step up to the plate – although conference speakers detected strong resistance from conservative finance ministries.

“It requires large institutional investors to go to government, and say very directly to [UK finance minister] George Osborne, the Treasury, we can deliver capital at scale for a whole series of environmental objectives,” said James Cameron, executive vice-chairman of environmental asset manager Climate Change Capital.

“This is about how to build instruments that address the twin systemic risks – the environmental and the economic,” he said.