Key Private Bank

Key Questions

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What Makes a Bond Green?

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Green bonds can provide a great opportunity for sustainability-focused investors to make an impact on environmental challenges without compromising risk/return objectives.

The green bond market has experienced remarkable growth over the past several years with the acceleration of both investor interest and demand for capital to fund environmentally-focused projects. The global emphasis on sustainability has propelled this trend and driven green bond investing — once a niche impact segment — into the mainstream.

The first green bond was issued by the World Bank and European Investment Bank in 2007-08. After a slow start, the market took off with the signing of the Paris Agreement in 2016. Since then, green bond issuance has exploded as a result of the growing focus on mitigating climate change. A total of $222 billion of green bonds were issued in 2020, boosting the cumulative issuance to over $1 trillion as of last December, a significant milestone.

At its core, a green bond is a fixed income security that specifically earmarks proceeds to fund projects that have a positive environmental and/or climate impact. Examples include projects focused on renewable energy, clean transportation, sustainable water management, pollution prevention, and green buildings.

Issuers label bonds as “green” based on guidance from market associations, stock exchanges, and regulators, although such guidelines are voluntary. While labelling criteria can vary, the Green Bond Principles (GBPs) developed by the International Capital Markets Association (IMCA) have become the accepted standard. The GBPs framework provides strict criteria for use of proceeds, project evaluation and selection, and reporting of environmental impact. In addition to following these guidelines, most issuers commission independent reviews by third parties — auditors or ESG (environmental, social, and governance) research firms — for a second opinion regarding the green label. This external assessment of alignment with the GBPs provides a benefit to investors and support for issuer quality.

While greenwashing, or providing misleading information regarding environmental benefits, can be an issue with self-labeling, third-party verification can help address this concern. Also, prudent fixed income managers often conduct their own due diligence on the green label before purchasing bonds to ensure that they meet their sustainability standards as well.

Asset flows into ESG funds reached records levels last year, and green bonds were a key element of positive flows into fixed income. Green bonds make up approximately 1.5% of total global fixed income assets; although it’s a small percentage now, it’s growing as supply and demand increase. Also, while this may be confusing to investors, a green label does not require the bond issuer to have a favorable ESG profile, as companies with weak ESG credentials can issue green bonds. One example is a poorly managed car company issuing a green bond to fund development of an electric vehicle. As a result, some ESG fixed income managers will only consider green bonds of issuers with strong ESG profiles.

As the market has grown, green bond issuance has broadened and diversified from both a sector and a regional perspective. Corporations are now the largest issuers of green bonds (40%), followed by development banks (16%) and government bank entities (15%). Financial organizations have recently begun to issue more and more green bonds to fund green purchases such as renewable energy loans. From a regional perspective, Europe is the leader (43%), followed by North America (24%) and Asia Pacific (22%).

In terms of performance, investors should expect that any individual green bond provides the same return as a comparable "non-green" bond as their only distinguishing factor is the green bond's underlying project or use of proceeds. And since proceeds are designed to make a measurable and positive impact on efforts to address environmental concerns, green bonds offer additional impact benefits without additional financial risk.

In aggregate, however, the green bond universe is not as diverse as the overall bond market in terms of sectors, maturities, geographies, and credit quality. For example, US treasuries and securitized products are key sectors in the overall bond market but do not exist in the green bond universe. This can make it a challenge for an investor seeking to build a diversified portfolio exclusively from green bonds. As a result, green bonds are often just one part of a broad fixed income portfolio.

Overall, the green bond market is thriving, with issuances regularly oversubscribed and demand increasing among mainstream investors. Assuming appropriate attention is given to due diligence, green bonds can provide a great opportunity for sustainability-focused fixed income investors to make an impact on environmental challenges without compromising risk/return objectives. They also serve as another tool for investors to align their values with their investment goals.

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