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FEBRUARY 5, 2021

Investment Grade Fixed Income | Responsible Investing

Green bond standards advance, bringing greater clarity for issuers, investors

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This blog is the second of a two-part series on green bonds. It examines the need for greater clarity, standardization and guidance around the green bond label, benefiting issuers and investors alike.

Boston - The green bond market, which grew to $1 trillion by year-end 2020, plays an increasingly important role in financing assets needed for the transition to a low-carbon future. However, the lack of uniform and detailed green bond standards has confused issuers and investors alike, and hampered growth of the market. In recent years, many standard-setting organizations — mainly in Europe — are seeking to address this issue.

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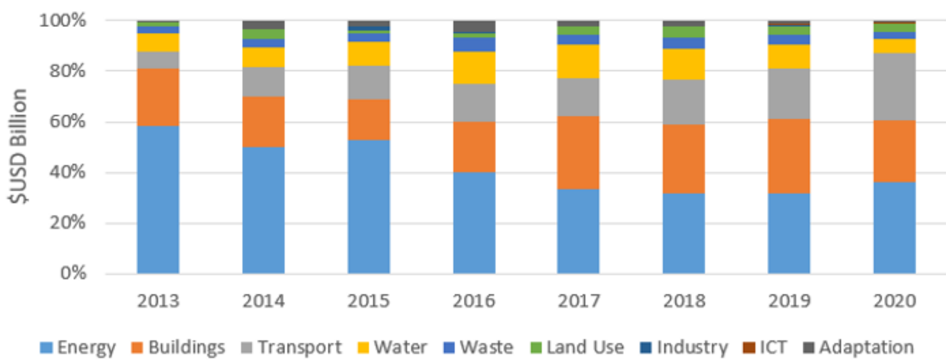
Over the past decade, the variety of issuers and projects supported by green bonds has increased. Despite the expansion of the market, however, during the last four years, the collective focus on green categories that address climate-change mitigation (such as energy, buildings, and transport) has grown — likely due to increasing adoption of science-based carbon targets at national and organizational levels. (Figure 1.)

Figure 1: Green bond issuance by use of proceeds



Source: Climate Bonds Initiative (CBI).

Standardization: Confidence and clarity for the market

While use-of-proceeds bonds have generally coalesced around the guidelines laid out in the International Capital Market Association's (ICMA's) Green Bond Principles,[1] certain corners of green finance continue to grapple with uncertainty. Some issuers remain doubtful as to whether their projects have sufficient impact to qualify in the green financing market and so, may consider less common vehicles, such as sustainability-linked bonds. Others fear their perception among ESG investors as a non-green entity may disqualify them from participation.

Some noticeable progress was made in 2020 in terms of guidance and frameworks from leading industry groups in the area of transition finance, where companies in higher carbon-emitting industries and businesses look to pursue a greener path. In September, Climate Bonds Initiative (CBI)[2] and Credit Suisse published "Financing Credible Transitions," a framework that sought to define ambitious goals and bring additional clarity to potential entrants to the transition bond market.

In December, ICMA released its Handbook for Climate Transition Finance, which although it did not provide a definitive framework for defining transition bonds as some had hoped, still delivered issuer-level recommendations on the disclosure necessary to generate trust from investors regarding transitions.

For investors, concerns generally center on whether they have adequate information to make well-informed decisions. Greater standardization of green bond qualifications is expected to provide, in the words of Credit Suisse and CBI, "confidence for investors, credibility for issuers and clarity for bankers." This, in turn, would likely promote greater market growth.

EU green bond taxonomy

In Europe, the European Union (EU) is taking steps to issue a green taxonomy that is set to underpin the EU Green Bond Standard and will serve as a significant benchmark for a bond's alignment with six key environmental objectives. In November 2020, the European Commission published drafts of final criteria for classifying economic activities as sustainable for two of those objectives — climate-change mitigation and climate adaptation. Criteria for other environmental objectives is slated for later in 2021. When finalized, the EU taxonomy will provide significant guidance to investors and issuers worldwide on sustainable finance classifications and supportive metrics.

China raises its standards

China, a dominant player among emerging markets in green bond issuance, has made significant headway in raising its green bond qualification standards. This may in part be driven by the country's recent net-zero 2060 commitment.

In May 2020, the People's Bank of China, China's central bank, proposed plans to remove "clean utilization of fossil fuel" projects (such as supercritical coal-fired power plants and projects that aim to remove impurities from coal) from its list of programs eligible to be funded by green bonds. The Bank's plans also impose uniform standards for issuers across China's disparate jurisdictions that are overseen by different regulators, including the NDRC and China Securities Regulatory Commission. While China's state planner, the NDRC, still does not mandate that all money raised from green bonds support sustainable assets (it allows for 50% of proceeds to be used for general working capital — a nonstarter for many green bond investors should Chinese issuers take advantage of this leniency), these standards should continue to improve.

While the role of standard-setting organizations is vital, investors also have a role to play. They need to tell issuers what information they deem most critical and what they regard as market best practices. As engagement with issuers, consultants and banks continues, we expect to see greater market growth and comprehensive green bond standards formalized.

Bottom line: The green bond market is critical to financing the global transition to cleaner energy and alignment with science-based targets. Standardizing green bond classifications and providing clarity around sustainable finance instruments will help support market growth.

1. ICMA's suite of guidance for sustainable finance instruments — The Green Bond Principles, The Social Bond Principles, The Sustainability Bond Guidelines, The Sustainability-Linked Principles and Climate Transition Finance — has been instrumental in creating a shared understanding of sustainable finance instruments. However, more technical guidance will be necessary to provide heavy-emitting issuers with a roadmap to accessing sustainable capital.

2. Climate Bonds Initiative (CBI) Green Bond Market Summary H1 2020, August 2020. To be classified as "green" by the CBI, 100%

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