Investors are attracted to green bonds because they orient capital towards environment-friendly business activity, say experts at Insight Investment. But it is important to remember that they require the same thorough analysis as the rest of the fixed income universe.

Interest in green bonds, issued by supranational entities and corporations to finance activities focused on the environment, is booming. Supply and demand have grown substantially as investors and governments acknowledge the need to finance projects focused on environmental development and energy transition. Green bonds have become an important tool to raise funding that supports such progress, and so we believe it is important to assess how the asset class can contribute to investment portfolios.

The supply of green bonds has expanded quickly. The European Investment Bank issued the first green bond in 2007, and Bank of America issued the first corporate benchmark-standard green bond in 2013. Issuance has risen from less than US$2B in 2011 to US$90B in 2016 and over US$52B in the first half of 2017. Nearly US$250B in financing has been raised in total, mostly by multilateral entities like the World Bank. Demand from institutional investors has increased to match supply.

QUESTIONS TO ASK

We believe that, like investing in fixed income more broadly, investing in green bonds requires in-depth analysis and careful consideration. There are several factors to consider.

1. Lack of scale: Corporate issuance of green bonds has been lower than expected, with only 198 corporate issues of benchmark size (at least US$200M), worth US$127B in total in various currencies. Of the corporate green bonds issued, 77 are U.S. dollar-denominated (worth US$43B) and 67 euro-denominated (worth €39B). As the two most important investment currencies for corporate issuance, these 144 bonds represent the investable universe.

2. Lack of diversification: Financials and utilities have issued 82 and 62 bonds, respectively, of all corporate green bonds issued. Banks raise money to reorient loan books towards commercial and residential energy efficiency projects, and utilities for developing renewable energy power generation. Of the firms that have issued green bonds, more than a dozen issuers have gone on to issue more green bonds after their first.
3. **Variable credit quality:** Issuers of green bonds are just as susceptible to weakness as issuers across the fixed income universe. In fact, it has been argued that companies facing difficulties might decide to issue green bonds as they are more likely to be bought than conventional issues. There have been high-profile defaults: Abengoa and TerraForm Power issued 10 green bonds between them, raising more than US$5B from investors. Investors have seen the value of their investments fall significantly.

4. **Questionable standards:** Green bonds may be issued to finance specific projects focused on the environment, but issuers may themselves fail to uphold best practices when it comes to other sustainability factors. This may raise questions as to the rationale for investing in a specific green bond. Some energy companies, for example, have issued green bonds despite being large fossil fuel emitters, exposing the lack of standardization that is critical for more widespread adoption of green bonds.

Of the approximately 60 investment-grade corporate issuers of green bonds, some do not provide key information on carbon reduction targets and strategy. At least 10 investment grade issuers have either declined or ignored requests for environmental information from the CDP® initiative, an industry standard for reporting detailed and comparable environment-related information. If companies are not transparent with regard to their operations, a key objective of green finance is undermined.

**THE FUTURE**

We believe investors should only take exposure to green bonds where in-depth analysis justifies the investment rationale of a specific issue. It is worth noting that an issuer’s green bonds will often be structured in a similar way to their non-green bonds.

It encourages investors to recognize that they have an important, positive role to play in supporting environmentally friendly projects. Over time, we believe many of the problems identified above are likely to dissipate, and green bonds may improve in terms of their quality and appeal.

However, we believe more issuance from a wider variety of companies and sectors is required before an allocation focused on green bonds, as if it were a separate asset class, would be justified. Investing now in a portfolio focused on green bonds, where the opportunities are limited, could increase the potential risks to investors.

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1Source: Bloomberg. 2Source: Ibid. 3Source: Ibid. 4CDP, formerly the Carbon Disclosure Project, is a not-for-profit charity that runs the global disclosure system that enables companies, cities, states and regions to measure and manage their environmental impacts. 5Source: *Putting Principles Into Practice*, 2016 Responsible Investment Report, Insight Investment.