***portfolio institutional*: Do you invest in green bonds, Henrietta?**

Henrietta Gourlay: Not currently. My biggest concern is that the proceeds could be used for other projects, particularly if it is a large multi-national which has other financing requirements.

I am not convinced that the covenants are strong enough to make sure that this does not happen. Until that is resolved I am cynical, but there are ways around it. Private-public collaboration is one and the government setting standards is another.

PI: Is this a common concern among the investors you speak with, Sarah?

Sarah Mitchell: It is a question we are asked and is a question we should be asked. That is why the green bond segment of fixed income lends itself well to active management.

We apply our standard philosophy and process to valuing a bond, but the first step is identifying if it is truly green.

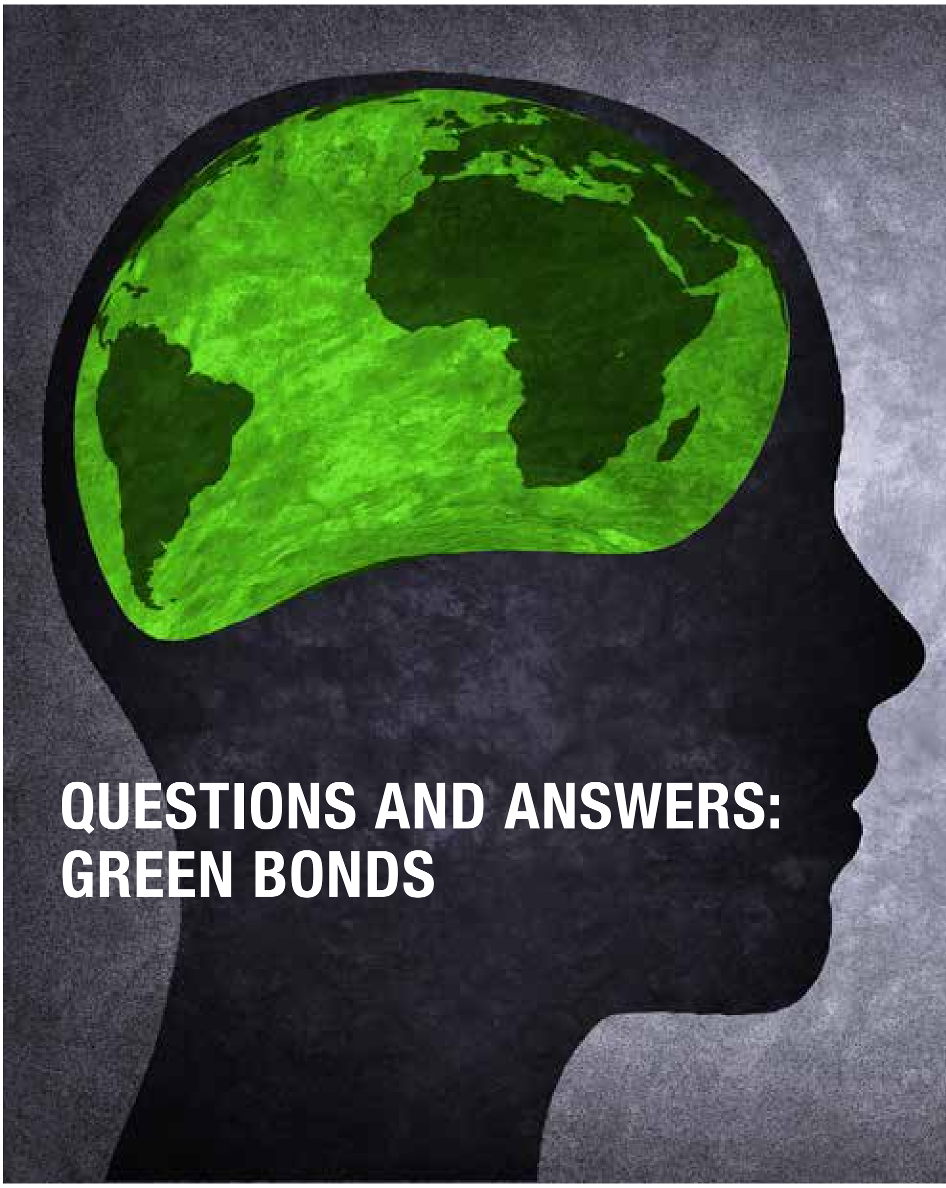
We try to make it as structured a framework as possible. We have a database for all the bonds we are considering where we look at the quality of reporting, use of proceeds and who is giving us a second opinion.

There is need for improvement and standardisation here. At the moment, you are trawling through PDFs, everyone's reporting is different and quality varies significantly. There is scope for a product or someone automating this stage of the process.

Graeme Anderson: Traditionally, when a new market arises it comes at a premium for investors. A new market usually has to work hard at convincing investors that its structures, controls and covenants are appropriate.

The green bond market is a victim of its own success. There are enough investors wanting the badge of investing in green bonds that they will invest in anything labelled green or sustainable.

As a consequence this market has started the wrong way round. Investors are desperate for a product and in many cases companies are simply issuing to meet that demand, rather than developing sensible projects and convincing investors to fund them. In my view, that is where a lot of the frustration with green bonds comes from. The market is not having to work very hard to persuade investors that they should be investing in it, which is actually slowing the development of the market.



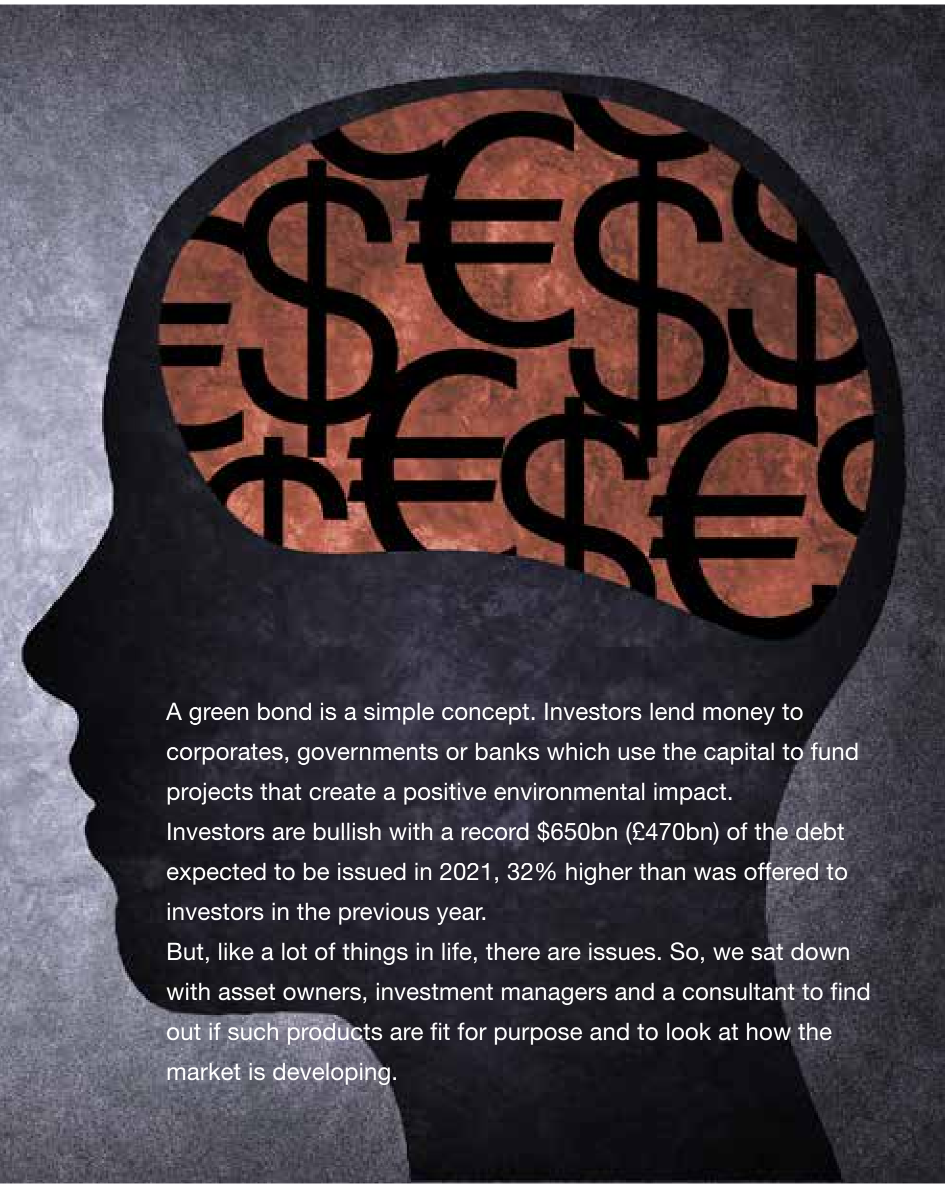
Scott Freedman: These are the same questions we ask issuers. It goes back to that active approach. Rather than buying anything with a label, we start by looking at the issuer's ESG credentials.

We are not going to invest in the green bond of an issuer who scores poorly here. We want senior management buy-in to the transition. That, along with more consistency of standardisation, will help, but it is the accountability point that everyone would like to see addressed.

On the question of how strong the covenants are, we continuously verify a bond's proceeds.

PI: Henrietta, has what you have heard eased any of your concerns?

Gourlay: It has. The underlying issue is, are there cross default provisions because if a company gets into financial distress,



A green bond is a simple concept. Investors lend money to corporates, governments or banks which use the capital to fund projects that create a positive environmental impact.

Investors are bullish with a record $650bn (£470bn) of the debt expected to be issued in 2021, 32% higher than was offered to investors in the previous year.

But, like a lot of things in life, there are issues. So, we sat down with asset owners, investment managers and a consultant to find out if such products are fit for purpose and to look at how the market is developing.

they need to get money from somewhere. If they have a bucket of money that has been allocated to a green project but could save the company from default, I suspect it would get used for that.

To Scott's point, if a company has good ESG credentials, then that is what you can go for. In pensions, the Task Force on Climate-related Financial Disclosures (TCFD) is about an organisation's approach to climate, so you can assess if a company is genuine.

PI: In general, are asset owners interested in green bonds, Joe?

Joe Dabrowski: There is still a long way to go on ESG reporting to get us to a place where assessments can be done in a more comparable way. Green bonds are unique in needing that work.

Asset owners are interested in green bonds. Our members have expressed an interest in climate-related investing and are keen for the UK to issue a sovereign green bond.

The Green Bond Principles are helpful in giving structure to some of the questions Henrietta identified. Is the bond doing what it is supposed to do? Is it traceable? Is it ring-fenced for the purposes you purchased it for?

It is a juvenile market. There will be some horror stories to come out, but we are heading in the right direction and the appetite is there. More generally, the appetite for gilts, certainly amongst mature defined benefit schemes, always outstrips supply. There is definitely client-side demand.

Joshua Palmer: The key part of our research is how asset managers are understanding the use of proceeds of these bonds, how they might perform going forward and their positioning in a default scenario.

This is a source of competitive advantage. Asset managers who understand the green bond market will be leaders going forward and it is an extra lens we look at our portfolios through.

PI: Are green bonds making an impact in the fight against climate change?

Anderson: It is working in the sense that it provides a focus for companies, but again the market has started the wrong way round. There is so much interest from capital markets, and they are responding to the challenge. Investment banks' origination teams across the globe are looking at all their clients for any activity they can attach a green bond to. Active management is absolutely the best way to deal with that. It helps you identify the box-ticking issuers.

Gourlay: Part of the problem with addressing climate change is the cost of producing equipment or improving manufacturing processes. Companies need capital, and green bonds provide that, but we are not there with scale yet.

Dabrowski: We are not in a place where we can say financing is flowing in such a way that you can demonstrate a measurable impact. We are some way off that. The financing is coming through and is going towards more projects, but that will have to be more precise, measurable and accurate.

If you think about the wider reporting landscape, when companies start to report on TCFD, those metrics will flow up and

THE PANEL

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Pensions & Lifetime Savings Association

Scott Freedman
Credit analyst & portfolio manager, fixed income
Newton Investment Management

Joshua Palmer
Head of fixed income ESG research
Willis Towers Watson

we will get a holistic picture of what is going where and how that is being impactful.

This is a couple of years away but is heading in the right direction. The flows of capital are, on the whole, going towards the right places.

Freedman: There might be some interesting green projects that an issuer has to offer, but if they are not large enough to parcel up into a liquid bond that is not the issuer's fault.

To an extent, it can skew towards best-in-class, because maybe some green bond issuers are further along the journey in terms of renewables, for example.

There is a big piece in the middle where it is about determining how green a project is and then drilling down deeper into that. What it is doing is focusing companies to think about the future and maybe they can ultimately go down that avenue.

The other side of it is standardisation and how investors look at that. At least it helps focus all stakeholders – and that is ultimately what we are on the road to achieving more of.

PI: What is needed to get high polluters to issue green debt?

Mitchell: We are seeing some of the less green industries issuing, obviously not at the oil and gas end of the spectrum. In the second half of last year, for example, several automakers came to the green bond market. Whilst they are in traditionally un-climate friendly sectors, green bonds worked quite well for them because they are funding their electrification efforts.

Market forces will have a big part to play. ESG is becoming a larger part of the conversation, so using green bonds as a tool to think about environmentally beneficial projects will be looked on favourably by investors.

There is also the benefit of diversification of your investor base. There is pressure on more traditional sources of funding with plans divesting from oil and gas and the EU considering bringing environmental factors or green asset weightings into their calculations of capital.

For those with dynamic management teams looking to the future in how they transition, green bonds are a neat vehicle that also bring benefits.

As long as we analyse the ESG credentials of the issuer, and if those bonds really are funding green projects, you can often get the biggest impact from non-green sectors or emerging market issuers.

It is moving in the right direction and market forces are there to help. But it is early days.

Freedman: We are seeing more diversification into different sectors and geographies as the green bond market matures. The transition piece is more about mainstream capital, and society will benefit most from transitioning away from the less green sectors.

What the Green Bond Framework has done is set the precedent for other innovations in ESG-labelled bonds. It is those hard to transition sectors, such as oil and gas, for example, that might go down the sustainability-linked bond route.

There is a debate about whether a sector should be demonised for where it is today or is an energy-intensive transition required? It is about broad stakeholder appreciation, engagement and trying to appreciate where we are and the challenge we face. This is where frameworks can help issuers and investors to scale these types of instruments in a credible and speedy way.

PI: Joe, are asset owners interested in the heavy polluting industries?

Dabrowski: Asset owners will look favourably on those who seem to be committed to the transition and are walking the walk, with a sceptical eye on those who are not properly engaging in any form of transition.

There are some important things for asset owners to consider. What are the credentials of the issuer? How do you verify the use of the proceeds?

There will be a hearts and minds piece from an issuer who has a murky reputation for how they are moving forward and there will be a hard sell needed for sectors that may be more challenging, like oil and gas. But where there is a transition with a heavy green tinge people will be more comfortable.

One of the big questions is, will we be talking about green bonds in five years' time? And will it just be bonds? Because the direction of regulatory travel is making it difficult to finance things that are not aligned with the Paris targets.

We will see this become less niche and more mainstream as we have with responsible investment generally over the past five to 10 years. We are on that journey with this type of instrument.

Anderson: A lot of asset owners think they are doing the right thing by screening sectors, but screening can get in the way of a positive transition. More engagement by an active asset manager to understand what can be done to support companies' transitions would be valuable. It is part of the journey.

The green bond market is a victim of its own success.

Graeme Anderson, TwentyFour Asset Management

Gourlay: There is a potential can of worms with green bonds. If you take electric cars, for example, they need lithium and copper, which you need to get from somewhere. So, can a mine issue a green bond to produce lithium more efficiently?

If you are screening certain stocks out then you are not allowing that part of the market to access capital, which means they will continue to be inefficient.

Palmer: Some exclusions make sense in certain mandates, but we would still expect managers to be properly integrating ESG. In addition, a key tool can be engagement. As we build a 1.5-degree portfolio it is important that managers can find companies on that pathway, and they might not necessarily be green issuers.

We are also moving towards more positive selection strategies. In areas where there is concentrated risk, like US high yield, we can find companies that through investing in low carbon technologies are ahead of the transition. They will be leaders going forward and there will be step-downs in the yields on their bonds.

Anderson: The whole ESG market is full of dichotomies between companies that are transitioning and companies that need support to transition but struggle because they are in a screened sector. This needs active management as box-ticking gives confused results.

I think it's important to recognise we will not always make decisions that are 100% feel-good. That is impossible. Asset owners have to understand that sometimes funding a poor ESG performer's transition to a greener approach is the only way they are going to make progress.

PI: Will the government's proposed green gilt encourage greater corporate issuance?

Mitchell: Yes. Historically, we have seen sovereign green issuance galvanise the corporate market. It provides a safe asset and they can issue in a much larger size than corporates, so it immediately provides scale, all things that help grow the corporate market.

The policy level is more important here. Green projects need capital from corporates, so issuing a green bond on its own helps, but it needs to be part of a wider agenda.

Freedman: I sit on the Investment Association's working group looking at the structure of the forthcoming green gilt. This is an opportunity for the UK to lead in terms of where green bonds go next.

There are expected to be social benefits. It is not just looking at the green element, but the jobs you create, and the other positive social impacts that can be reported on.

Our advice is to not just refinance three-year old projects. Have a robust mechanism, such as an audit committee, for example, to vet and monitor the projects.

Clear and concise frameworks for reporting give the private sector that scalability. This is being used by the government, so it makes sense to ensure that our corporate green bonds are launched in alignment with this framework. That enables scaling up domestically. We have seen that when sovereigns issue green bonds, the private sector quickly follows.

Anderson: The private sector does not necessarily need the government to lead the way. It can do that itself.

I can see the need for sovereign green bonds in emerging markets, but for G7 governments to get lower funding costs for green bonds is complete nonsense. They should be making investments sustainable anyway – that is why they were voted in.

Sovereign green bonds cause other problems too. The Green Bond Index's yield is pretty low. More than half of the index consists of sovereign issuance, which partially crowds out the private sector. This is not as clear cut as some people think.

Dabrowski: In the climate transition, emerging markets will need financing to lift people out of poverty and address the wider impacts of climate change. It is natural for green bonds to be in less mature financial systems.

Closer to home, there is still a lot of work to be done on the financing. It is an interesting philosophical question as to where that comes from. Past industrial revolutions have often been driven by large government intervention with corporates building on the back of it.

The demand side is high and issuance from the UK government is low. There is not a big appetite to issue lots of gilts. They have not wanted to do that for CPI gilts and they have kept RPI index levels static for some time.

They will come in, there will be some noise, it will be substantial, but not big enough to crowd everybody else out. There is probably more of a risk of that from the EU.

PI: Will green bonds play a role in repairing the economy post-Covid?

Gourlay: There will be demand because there is a lot of regulatory change. In Europe, there is the Sustainable Finance Disclosure Regulation and there is going to be a lot of pressure on investors to look for green investments. Hopefully, green bonds will help with the recovery.

Mitchell: It comes back to individual governments. There has been a massive stimulus, so there is an opportunity to divert some of it to environmental spending.

Green bonds lend themselves well to big-ticket government projects, such as infrastructure, so there is a role for them.

Dabrowski: It is worth noting that the EU is directing 30% of bond insurance towards Coronavirus recovery funds. We have to be careful about what some of this is being used for. It feels that some elements of the Coronavirus recovery might be better placed in a social bond.

Freedman: Investment banks have an important role to play. They should not see labelled bonds as an opportunity to enhance their relationship with companies. It comes back to the point of making sure that projects are credibly done rather than just playing this methodology. Making sure that it is credible will improve reputational risk and grow the market properly.

On the crowding out point, sovereigns have issued a lot of this debt. We do not necessarily focus on the Green Bond index. There is a lot more to choose from now in terms of idea generation in green-bond issuance. It is becoming more prevalent in different sectors and is moving into sub-investment grade too.

The opportunity set is improving.

> **The growth rate of different ESG-labelled bonds will be higher than green bonds.**
>
> Scott Freedman, Newton Investment Management

Demand is strong and there will be a lot more supply.

Gourlay: It is important to have top-down guidance from government in how proceeds are used. In infrastructure you want to make sure that they will put in proper standards and are not just greenwashing. The International Finance Corporation sets building standards in emerging economies to stop people building in the wrong places. You have to look long term at this.

PI: Do green bonds improve engagement between investors and corporates?

Mitchell: We have better dialogue with green bond issuers. It gives bondholders more information than we have had before to start the dialogue and hold issuers to account.

We also focused before launching our fund on engaging with non-issuers of green bonds to understand why people are not issuing.

Even on that side, we have better response rates. It is hard to disentangle this between the general shift to engagement on ESG, but it is a good tool for engagement.

Freedman: Engagement is important in all areas within fixed income. When an issuer launches a green bond, there is more alignment in terms of a willingness to talk. Clearly, they have a story to tell so they are open to that dialogue. That is an opportunity to ask questions about the issuer, not just the project. We are not a shareholder, but we absolutely can engage.

On the reporting side, it is interesting that the Sustainability Accounting Standards Board has joined together with the Global Reporting Initiative. Having two powerful bodies working together to align different taxonomy material risks, and how that should translate into corporate disclosure means that, hopefully, we will get some assistance on the reporting element.

Dabrowski: On the reporting point, from an asset owner perspective there is a lot changing. Asset owners have to keep an eye on this, whether it is for their reporting or how their intermediary reports.

> **Green projects need capital from corporates, so issuing a green bond on its own helps, but it needs to be part of a wider agenda.**
>
> Henrietta Gourlay, Grosvenor Estate Family Office

It would be helpful to bear in mind, certainly in the UK, that most engagement is at the larger end of the market. When you get down to the billion-pound schemes and below, there is less direct engagement and more engagement through consultants and proxies.

PI: Are performance-related returns being written into green bond agreements?

Palmer: We are seeing the emergence of KPI-linked debt and sustainability-linked bonds, which is a good step in the right direction. The proceeds can be used more generally, which is positive because we can engage on broader ESG issues.

We have not only seen carbon reduction terms written into bond covenants, but also board diversity and other social and workers' rights issues.

This is a signal that investors are starting to recognise the value of ESG within companies and what it means for performance and returns, which is positive. That will drive the transition going forward.

Anderson: Engagement is not just for equity. As fixed income investors we are engaging successfully.

Company financing is generally a repeated game, so they have to come back to us and listen to what we have to say.

As an example, TwentyFour is a large investor in the European asset-backed securities (ABS) sector. We engage a lot on the structure of new deals, whether it be collateralised loan obligations (CLOs) or any other mainstream asset-backed security. In that engagement we are pushing hard, and reasonably successfully, to make those assets greener and more sustainable.

That is a market you are not considering when thinking about corporate bonds. You are just thinking about companies, but there are loans underneath those structures that you can influence as a fixed income manager. Even in that sector, we are finding that we can have quite a bit of success.

PI: Will the EU introducing standards on what a green bond should be remove concerns over greenwashing?

Dabrowski: It will help. There is some way to go on regulation and taxonomy. More broadly, the direction is set that it is going to become harder to greenwash products.

There are probably a couple of other things worth bearing in mind. As asset owners have legislative responsibilities to report on what they are doing to savers, regulators and government, the way they will think about these things will become slightly different and much more eagle eyed, shall we say? That poses a risk to people wishing to persist with greenwashing.

We are still in a period where there could be a gold rush and we will need to work through that. People need to be careful, certainly at the smaller end where there might not be as much access to expertise. It would be easy to buy something believing that you are doing the right thing only to find that it was a mistake because you rushed into it. As the direction is set, it will be difficult to do that in the future.

Anderson: We can look at the Sustainable Finance Disclosure Regulation (SFDR) as an example of how EU standards might work. These rules are flexible in that they understand there is not one solution.

There is no question in my mind that some investors are gaming the SFDR system already, but, overall, what those regulations do is up everybody's focus on ESG, on sustainability, on green bonds. It just raises the whole tide. So, if the EU comes out with regulatory standards for green bond issuance, it will take us another step forward on our journey. We should be positive about that.

Freedman: The EU has done a lot of work on the taxonomy, which is powerful, but there is a debate around that taxonomy, and how specific it is as a starting point. We are not getting as much of the transition piece in there as we would like to have.

We want to avoid investors and issuers who are just trading methodologies. That is why it has been confusing to start with a taxonomy, because there will be revisions to it. They will probably grandfather existing green bonds that can be eligible, even though the taxonomy terms could change.

It comes back to the greenium point as well. If you are just chasing taxonomy-compliant issues or issuers in a small subset of the universe, it is going to be a land grab where things can get overly expensive from an investment perspective. It is a challenge that is not easy to solve, but we would prefer the taxonomy to be broader in terms of what it is trying to bring in.

Dabrowski: We might see good progress at COP26, but it is also a case that investors might be able to shop around or that for a time there will be differences in global standards. So, there is quite a lot of opportunity for friction, which needs to be overcome longer term.

> **KPI linkage is quite powerful. We will see more and more of it.**
>
> Joshua Palmer, Willis Towers Watson

Palmer: Greater disclosure and transparency are needed, but regulation only works up to a point. What matters is getting under the skin of a company. What is its strategy for dealing with various ESG issues? What actions has it taken towards that goal?

Nothing is going to get past having dialogue with companies to understand what their thinking in regards to this. That will solve the greenwashing issue, not just regulation.

PI: How much demand is there for other types of sustainably labelled debt, such as blue bonds, ocean bonds or social bonds?

Freedman: The first sustainability-linked bond was launched in 2020 and we will probably see at least $100bn issued this year. Setting precedents in terms of frameworks helps speed new innovations to market.

It is bad to have too many of these innovations, as it creates more complexity. I do not know what more we need that we do not already have. We have the use of proceeds bonds, which are green, then you have the social side. The sustainability-linked bond is the other part of it, where you have a key performance indicator focused on the issuer instead of funding a certain project. That is quite powerful, because you get senior buy-in when management are facing a step up in the coupon if they do not meet certain criteria by certain dates.

Ultimately, from an investor perspective, it is the mainstream capital in the transition piece that enables greater diversification across sectors. We are already seeing in sub-investment grade bonds quite a few issuers going down the sustainability-linked bond route.

Again, there are concerns about greenwashing. We have seen some gaming around covenants in US high yield. Covenants set in a sustainability-linked bond do not kick in until after other covenants have. We are seeing issues around that. It should be ironed out, and again, it is about doing it credibly to be able to scale up.

Having senior management buy-in is powerful. How governments go down this route will be testing, because they have to commit to certain KPIs. But what happens when you have a change of government?

> **It is a juvenile market. There will be some horror stories to come out, but we are heading in the right direction and the appetite is there.**
>
> Joe Dabrowski, PLSA

I am, however, quite optimistic about it. Again, it is about hoping that it is done in a proper and effective way.

Mitchell: Having too many different types of instrument and standards muddies the water and makes assessments more difficult. There is a place for different structures, such as sustainability-linked bonds, but they need to be brought under the same umbrella.

For the market to grow and achieve diversification and scale there needs to be as little fragmentation as possible.

Palmer: One of the biggest challenges investors have is demonstrating ESG performance. This is a great step towards that. If you can see carbon emissions coming down while you continue to be paid your coupons or there is progress on board diversity, for example, this is an actual KPI quantitative stat that you can show your stakeholders.

KPI linkage is quite powerful. We will see more and more of it.

> **There is a place for different structures, such as sustainability-linked bonds, but they need to be brought under the same umbrella.**
>
> Sarah Mitchell, Mondrian Investment Partners

PI: What are you expecting to see in the green bond market during the next 12 months?

Freedman: The growth rate of different ESG-labelled bonds will be higher than green bonds. We are going to see more social bonds issued as well as sustainability-linked bonds, which will chime with investors because it is not just about emissions, but also various other ESG factors.

We will see the first oil and gas sustainability-linked bond issued. It could be quite divisive in terms of: does it work? How will it be done? That will be an interesting one to watch.

Anderson: We will see continued growth. There was around $750bn issued last year and by May this year $500bn was issued. So, we can take it as read that the market continues to grow and wrestle with the problems and opportunities that we have been discussing. It is a market that is here to stay.

Gourlay: Should we expect a rush of issuance with concerns about inflation? The Fed said they are not going to raise rates, but yields are so low companies are never going to get cheaper financing. I am sure that is going to encourage companies to issue more debt and if they have to do it by labelling it green, sustainable or blue that is what they will do.

Anderson: Maybe, though because of the response from central banks to the pandemic we had a big rush of corporate issuance last year. This year there is less pressure for corporates to issue because they have done a lot of their funding.

What might happen is that companies who have not traditionally issued corporate bonds will issue green bonds.

We are custodians of asset owners' money. We have to be cognizant that we do not get sucked into equity risk with fixed income money. That is a risk in a green bond, social bond world.

Dabrowski: One trend worth watching is that given the political and regulatory changes, the sleeping giant of the US waking up to this market and wrestling with the EU in terms of where it wants to be as a leader in this space or if some of the more conservative opinions are still digging in.

Anderson: You are right. We have a US team who are seeing issuers talking about ESG and providing more information. We are already seeing evidence of the US starting to move. And once the US starts to move, it will move quickly.

Mitchell: I would agree. We have launched a green bond fund, with demand currently focussed in Europe for this product. However, Mondrian has a client base that is US centric and have had much more interest from the US than we thought we would, which we found interesting.

We expect more growth in the green bond market, more diversification and the US is a market to watch from an issuer's perspective.