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Green, green shades of bonds

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Do ESG bonds fulfill their promises?

ESG bonds that are based on certain environmental and/or social projects by the issuer have been around since 2009, when they were first issued as Climate Awareness Bonds by the European Investment Bank.

In recent years, we have seen dynamic growth emerging. It started with green bonds, which were then complemented by social bonds, sustainability bonds (a combination of environmental and social projects), and sustainability-linked bonds.

The latter finance no particular projects, but the issuer aims to achieve certain environmental and/or social goals during the life of the bond. If the issuer fails to do so, the coupon is usually ratcheted up. These bonds are subject to an elevated level of risk of greenwashing or false labelling, given that it is the issuer who defines and sets the goals. This is basically a positive step if said goals are about carbon reduction, the reduction of waste, or socially measurable goals. However, one should keep a critical eye on such goals.

Shooting up issue volumes

The World Climate Conference in Paris in December 2015 led to regulatory measures as well as a significant increase in the volume of sustainable bond issues in the following years. ICMA Group (International Capital Market Association) has sketched out principles for the individual segments (green bonds, social bonds, sustainability bonds) that represent a market standard but are not obligatory for the issue of the respective bonds.

The ECB and the EU Commission have set further milestones by declaring their commitment to a sustainable capital market. The EU is planning to cover about a third of its bond programme with ESG bonds. The first issue in October 2021 was a sizeable one. The record volume of EUR 12bn created an order book of EUR 140bn.

No uniform standard

Despite the enormous growth rates, sustainable investments are still faced with the problem that they have no unified standard. A lack of transparency and consistency are points of criticism. The goal of the draft Regulation created by the European Commission in July 2021 (EUGBS – European Green Bond Standard) is to provide a regulatory framework and a point of orientation; however, it is not obligatory at this point. This standard is based on the EU Taxonomy, which defines in practical terms what is considered sustainable according to six central environmental goals.

Cumulative issue of ESG bonds on a quarterly basis (as of Q2, 2021)



But this is where it gets bumpy. Nuclear energy, for example, which accounts for a more or less substantial share of the energy mix in about half of the EU countries, is very controversial. While on the one hand the low carbon emissions and the safety of the energy supply are usually arguments on the pro side, others (like us in Austria) consider the unsolved question of final storage, the environmental contamination, and the complex depletion of radioactive materials like uranium as primary aspects on the con side, in addition to a possible reactor accident of course.

Nuclear energy and ESG bonds

Numerous utility companies (some of which actually count on the expansion of nuclear energy) have issued ESG bonds in order to strengthen their involvement in renewable energy as well. But this cannot be seen as transition or adaptation towards more sustainable activities. Instead, these companies like to put on a green (and largely carbon-neutral) hat.

2021 market share by ESG bond category

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Quelle: Erste Asset Management

Financial service providers have also experienced a boom with regard to the issue of ESG bonds in recent years. Often, we find that this includes refinancing transactions of projects declared as sustainable that have been on the books already and thus do not indicate any imminent change in the credit policy of a financial service provider. It seems that there is a lot of peer pressure in the sector to keep up to date and position oneself prominently on the ESG market.

CONCLUSION

For investments in our impact funds, which invest in ESG bonds, it is therefore crucial to closely scrutinise not only the framework of the bond, the implementation of the principles, and the independent (clean) audit opinion, but also the issuer. Investments will only go ahead if the issuer of ESG bonds achieves an EAM ESGenius Score that places them within the investible universe and does not violate any criteria of exclusion.

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