Beyond the labelled bond market – redirecting capital flows towards climate-aligned activities

The identification of climate-aligned bond issuers and the transition of refinancing offers to the labelled market benefit both issuers and investors while supporting low-carbon economic development paths. BY CEDRIC RIMAUD, CLIFFORD LEE, YULANDA CHUNG

THE ESG-themed bond market continues to rapidly evolve, develop and grow across the world, with the pace of change picking up in Asia in recent years. Assessing bonds and issuers along climate-aligned business activities and assets can serve to further this growth, with banks such as DBS focused on working with issuers and investors to accelerate the development of the market and bring about real change in promoting climate and societal well-being.

As testament to the fast-developing landscape, more than US$1.7 trillion of green, social and sustainability bonds have been issued globally as at end-2020, according to the Climate Bonds Initiative (CBI). Green bonds alone surpassed US$1 trillion in issuance in November 2020. Many corporate issuers are also actively seeking the help of sustainability specialists to evaluate the opportunity of raising financing with strong environmental, social and governance (ESG) credentials.

In the traditional bond market some investment opportunities already exist that can redirect capital flows towards "climate-aligned" activities, even though they do not carry an explicit label. Many companies are operating in attractive sectors, which investors would find readily investable.

Why do we need bonds and loans with extra financial characteristics?

Private capital is urgently needed to finance low-carbon investments. The Paris Agreement and subsequent support for sustainable investment by organisations like the Principles for Responsible Investment (PRI) have encouraged institutional investors to include broader ESG considerations in their investment decisions and begin the long process to decarbonise their portfolios.

Clear definitions of green and social categories have enabled market guidelines to emerge, minimising the risk of "greenwashing", or the risk of investment of projects being mislabelled and financed without proper transparency and disclosure standards.

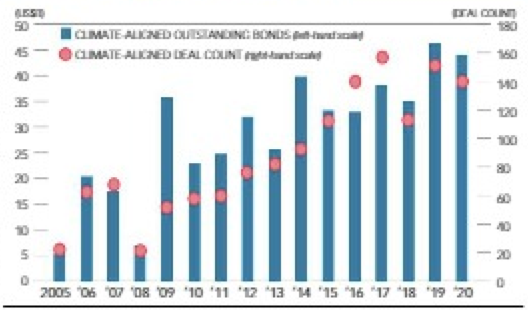
In a vein similar to how we may declare our vaccination status in pursuing different economic activities in future, investors will expect issuers to declare if money raised in capital markets will be used for green projects, as in a green labelled bond, or to propel improvements in broader ESG objectives, as in a sustainability linked issuance. Thus, companies should seize the golden opportunity of leveraging their climate aligned business to tap into the sustainable finance market as the pool of capital for labelled investments is set to grow much further.

What is the size of the "hidden" climate-aligned bond market?

In a report just published with the support of DBS Bank, CBI identified a universe of US$913.2 billion of unlabelled, but "climate-aligned" bonds, or about half the total size of the existing US$1.7 trillion market of labelled instruments.

The methodology adopted for this research comprised the screening of issuers and analysis of their revenue stream from a global pool of public and private companies. Issuers that derive at least 75 per cent of their revenues from climate-aligned activities are classified as "strongly-aligned" issuers, and those with 95 per cent of their revenues as "fully-aligned" issuers.

Climate-aligned bond market



Source: CFA

In this pool of capital, 420 issuers from 45 countries have issued traditional bonds that, according to CBI could be characterised as "climate aligned", with an equal split between developed and emerging markets, while supranational institutions only represent 1 per cent.

In Asia-Pacific, US$437 billion of bonds were issued by 183 climate-aligned issuers. Most of them were issued by companies from China, making up 36 per cent of the world's total and 74 per cent of the regional number. Europe ranked second, with 121 issuers having issued US$321billion of climate-aligned debt. North America was third, with 65 issuers and a total volume of US$120 billion. Latin America was fourth, with 49 issuers and US$27 billion in volume.

Climate-aligned bonds have grown in size

The main industry sectors for these bonds were transport, followed by energy, water, ICT (information, communication and telecoms), waste, land use & agriculture and buildings. Globally, there is a large number of transport climate-aligned companies.

In Asia-Pacific, they represent 75 per cent of bonds issued, more than the 40 per cent they account for in Europe. Large issuers include China Railway Corp, India Railway Finance and Korea Rail Network Authority. The energy sector represents a 21 per cent share in Asia, on par with Europe (24 per cent). Among the top issuers are Korea Electric Power Corp, China National Nuclear Corp and China Three Gorges.

Should investors be interested in un-labelled bonds that meet green objectives?

There are substantial opportunities to scale up the labelled bond universe: companies that are active in aligning with the objectives of lowering carbon emissions and transitioning towards net zero could refinance their maturing liabilities via the labelled bond market and benefit from the extra visibility offered by such instruments.

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Refinancing from vanilla to green

CBI found that more than 40 per cent of the existing universe of climate-aligned bonds will mature in 2024 for a volume of around US$372 billion. The most obvious opportunities come from the transport and energy-related sectors.

Large-sized bonds represent the larger share of the climate-aligned universe, with benchmark sizes of US$500 million to US$1 billion representing about 30 per cent of the total volume, primarily in the energy and railway sectors, while another 20 per cent falls in the US$250-500 million size bucket.

Investors should also take some comfort from the fact that these issuers are of good quality. Almost 90 per cent of the emerging markets' climate-aligned universe has been rated by international rating agencies.

Roughly 3 per cent of the universe is in local rating, while 9 per cent is non-rated. Most of the climate-aligned universe is investment grade, in both international and local ratings, with 81 per cent of issuance at least BBB-rated. AA takes almost half of the market, followed by BBB at 31 per cent and BB at 9 per cent. Some climate-aligned issuers have already issued labelled green bonds, but there remains further scope for climate-aligned issuers to label their debt.

To achieve a low-carbon transition, we need to see a significant shift of mindsets and behaviour among policymakers, issuers and investors.

Increasing capital flows towards investments that address climate factors and contribute to reaching national emissions targets must be among the priorities for both policymakers and finance sector stakeholders, especially in emerging economies.

The identification of climate aligned bond issuers and the transition of refinancing offers to the labelled market have a benefit greater than the individual issuance itself. Expanding green and sustainable debt markets, increasing the depth and diversity green bonds, loans and sukuk benefits both issuers and investors while supporting low-carbon economic development paths.

Investors have an opportunity to make choices that respond directly to their ESG mandates, as well as protect their portfolios against adverse risks coming from climate change. A closer focus on climate aligned corporations offers another pathway to help achieve these goals.

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