RBC Capital Markets

# Green-tinted LENSES

The global green-bond market appears to be entering a phase of rapid growth, and could reach US$100 billion of issuance in 2015. Australia's contribution is small so far, but participants at the Green Bond Conference in Sydney in March – hosted by KangaNews and RBC Capital Markets (RBCCM) – say the challenges the local market is working through are no different from those playing out on the international stage.

BY LAURENCE DAVISON

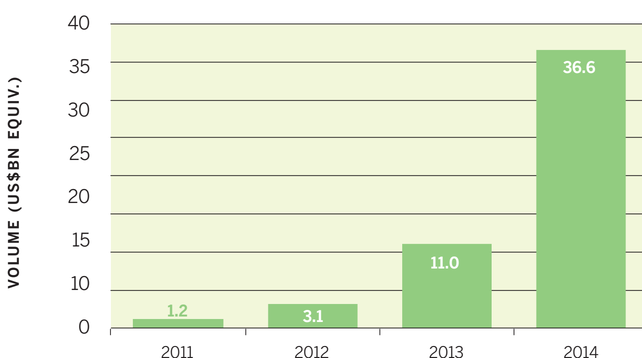
On March 17 2015, KangaNews and RBCCM hosted their first Green Bond Conference in Sydney. In attendance were the bulk of Australia's most significant green-bond investors, every issuer to have placed a green deal in the Australian market to date and a clutch of other potential issuing entities.

The event was well timed, as the green-bond market globally is experiencing unprecedented growth (see chart on this page). "Public and private investment in green infrastructure is increasing at a rapid rate," confirms Gavin Ezekowitz, head of RBCCM's global markets business in Sydney. "We have seen the green-bond market expand to more than US$37 billion in 2014 from just US$3 billion of issuance in 2012."

Australia's adoption of green bonds has been a little slower, but signs are that demand is emerging at a brisk pace. The first domestic Australian dollar transaction priced in April 2014, and two more transactions came to market in the year following (see chart on this page).

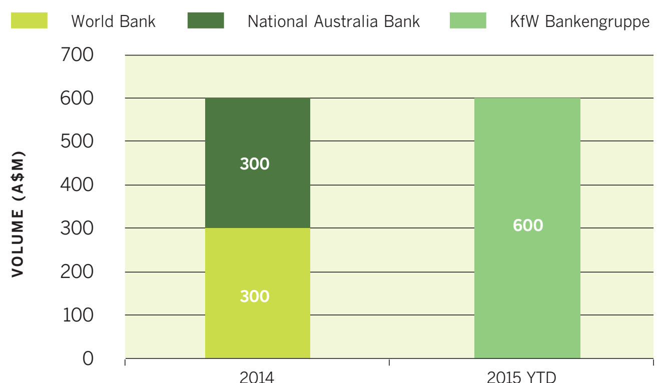
Assisted by the momentum of the Sydney event, KfW Bankengruppe debuted in the green Kangaroo market barely a week after the conference finished, with RBCCM as one of the lead managers. The German agency priced a A$600 million (US$460.7 million) deal – double the size of the two previous Australian-market transactions.

**GLOBAL GREEN-BOND ISSUANCE**

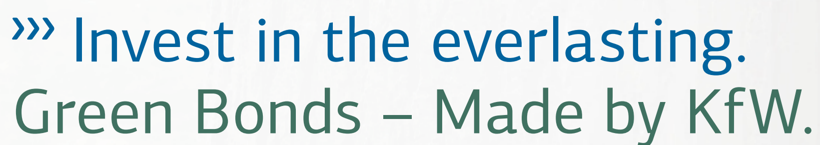



SOURCE: CLIMATE BONDS INITIATIVE MARCH 17 2015

**AUSTRALIAN DOLLAR GREEN-BOND ISSUANCE**




SOURCE: KANGANEWS APRIL 15 2015

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**GAVIN EZEKOWITZ** RBC CAPITAL MARKETS

## SIZE AND SCOPE

Sean Kidney, chief executive at the Climate Bonds Initiative in London, is one of the green-bond market's leading advocates. He points out that issuance has tripled in each of the past two full years. And he uses this as one piece of evidence that 2015 could be a US$100 billion year for global issuance. Indeed, Kidney claims there is a "good shot that this could be a US$1 trillion market by 2020".

The US$100 billion figure is not simply an upside estimate. Kidney explains that this is the volume of capital Western governments at the 2009 Copenhagen summit pledged to make available for climate-change mitigation. For Kidney, being able to demonstrate the ability of the capital markets to generate this scale of investment would present a major challenge to the public sector. He says: "We want to be able to go to the UN climate conference in Paris at the end of this year and tell delegates that while governments have been figuring out how to get US$100 billion, the bond markets have already delivered it."

Behind the emergence of the green-bond product is a growing awareness, on the part of both issuers and investors, that if climate change is not tackled the bulk of their mandates will become increasingly difficult to achieve.

Development banks in the supranational, sovereign and agency (SSA) sector have been the pioneers of green bonds on the issuer side – and continue to provide the largest share of volume even as bank and corporate borrowers emerge (see chart on p18). SSA issuers say green funding makes sense because climate-change mitigation is critical to their lending mandates in both a direct and indirect manner.

Ben Powell, Washington-based head of funding at International Finance Corporation, explains: "Many of the development goals towards which we are working would be eradicated in a world with 4 degree climate change. The existence of green bonds as a vehicle to motivate capital and raise awareness is a fundamental reason for us to be involved in the market."

The nightmare scenario of upper-range climate change outcomes is also driving investor behaviour. Bill Hartnett, head of sustainability at Local Government Super in Sydney, says his firm is aware that investors "are not neutral agents" in this context. He adds that achieving current investment goals in a 4 degree climate-change world would be virtually impossible.

## INVESTOR ATTRACTION

Not all the investor money for green bonds – either in Australia or globally – is coming from rigidly defined socially responsible investment (SRI) mandates. According to Kidney, this sector is estimated to have assets under management of around US$13 trillion globally. SRI investors are becoming more active in the bond market, having been underweight the asset class prior to the financial crisis.

However, Kidney adds: "This is not a market driven by strong, dedicated, green-bond mandates. There are only a few dedicated green-bond funds, and we actually counsel against them because we are a little worried that they may not always be able to get the best pricing outcomes if they are very restricted. What we are more interested in is switching from existing funds."

Even so, diversification of investors is a key benefit to green-bond issuance – for both SSAs and other entities. Kidney says the primary reason issuers bring green bonds to market at present is for investor diversification. He uses the example of Toyota, which priced a US$1.75 billion green bond in March 2015 and attracted three completely new names to its register.

Australia's first domestic green-bond issuer – National Australia Bank (NAB), which priced a A$300 million transaction in late 2014 – observed the same phenomenon. David Jenkins, director, capital financing solutions at NAB in Sydney, reveals: "The deal's distribution was certainly diversified relative to a normal NAB senior-unsecured benchmark."

However, European Investment Bank (EIB), which has been in the green-bond market since its inception, sees the product as much less clearly differentiated from the supranational's main

"At the moment, it's easiest for the market to return to SSA issuers: their green credentials are pretty much unimpeachable and therefore their issuance doesn't run the risk of shedding demand on the basis of different interpretations of green on the investor side."

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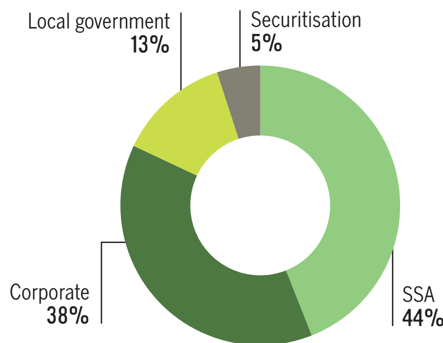
**GREEN BONDS BY ISSUER TYPE, 2014**




SOURCE: CLIMATE BONDS INITIATIVE MARCH 17 2015

funding programme. "At the margin, we see new investors in the EIB programme coming into green bonds. But 'pure' SRI money is still relatively a very small universe," comments Sandeep Dhawan, Luxembourg-based head of funding, Americas, Asia and Pacific capital markets at EIB.

One consequence of the existence of a focused SRI investor base alongside demand for green bonds from mainstream funds is that issuers can and do vary their allocation strategies. These range from explicit favouritism towards SRI accounts all the way to complete ambivalence about allocations between specialist mandates and mainstream investors (see box on p20).

## DEFINITION AND VERIFICATION

At the same time issuers are considering to which end investors they would like to allocate green product, so investors themselves are reaching different conclusions about the nature of green product. The biggest issues are defining what is legitimately green for mandate purposes, and how – if at all – these green credentials need to be verified both ahead of and subsequent to issue.

Very little of this discussion relates to the structure and format of green bonds. The product itself is deliberately designed to be as vanilla as possible. Green bonds are issued off standard documentation and generally in senior-unsecured format.

While their proceeds are ring fenced for lending to qualifying projects, the inherent credit risk is of the issuer and not the underlying assets. There is some interest in creating a project-finance market for green investments, but it is in its early stages even in global markets (see box on p22).

There is a specific risk of so-called 'green default'. This occurs when green-bond proceeds are not invested in accordance with green standards or – more commonly – when an issuer cannot find green assets in which to invest, for instance if it divests green assets during the life of the bond.

It is this area for which the concept of verification becomes relevant. The concept is fairly straightforward: the issuer employs a third party to verify the green credentials of its portfolio, and to ensure it funds sufficient green assets to justify the scale of issuance. The verification agent can, if requested, also return to the issuer after deal completion for update checks.

Verification tends to be conducted in line with a set of agreed standards, most commonly the Green Bond Principles developed in 2014 with guidance from issuers, investors and environmental groups. These are not prescriptive, but instead form a guideline framework against which proposed issuance can be judged.

"From our perspective, the Green Bond Principles represent flexibility for a growing market," comments Mark Robinson, Sydney-based manager, sustainability services at DNV GL Business Assurance (DNV) – which offers verification services. "New technologies, structures and purposes may not easily fit into a standardised format, so having the ability to wrap a set of principles around any specific proposed bond is really useful. The advantage is the ability to establish new frameworks."

The issuers for which verification or certification are most relevant are those with large, mixed-asset portfolios which are not overwhelmingly green, and those exploring funding for non-mainstream assets. NAB is one such case – and Jenkins says NAB's decision to seek certification to the Climate Bond Standards was a "vital means of adding to investor comfort with its deal", especially given the lack of Australian green bond issuance as NAB began working on its own green bond.

"Many of the development goals towards which we are working would be eradicated in a world with 4 degree climate change. The existence of green bonds as a vehicle to motivate capital and raise awareness is a fundamental reason for us to be involved in the market."

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# *INVESTOR TARGETING:* TO SRI OR NOT TO SRI

Australia's third-ever green-bond transaction showed the benefits of welcoming all investors – not just socially responsible investment (SRI) specialists – into books. Some issuers, however, have reasons for favouring niche mandates.

For its Kangaroo green-bond debut, KfW Bankengruppe (KfW) deployed a different execution approach from that used by Australia's only other green-bond issuer from the supranational, sovereign and agency (SSA) sector.

Where World Bank – which debuted in the green Kangaroo market with a A$300 million (US$230.3 million) transaction in April last year – focused exclusively on SRI-mandated investors, KfW was more willing to accept bids from non-SRI accounts.

RBC Capital Markets (RBCCM) was a lead on both transactions – joined by J.P. Morgan and Nomura on the KfW debut. Enrico Massi, head of debt capital markets at RBCCM, says KfW's broader book is the main reason for its larger deal size.

This strategy helped KfW to price A$600 million in its five-year green bond on March 26 – double the volume of any previous Australian dollar deal in this format (see chart on p14).

"Our sense is that the 'pure' SRI market in Australian dollars is supportive of individual transaction sizes of A$300-400 million – which is the volume achieved by World Bank and, subsequently, by National Australia Bank [NAB]," Massi tells *KangaNews*. "KfW's transaction had a mix of both SRI investors and others, which again is in line with what we see as capacity in this growing sector of the market."

KfW itself did not anticipate the level of demand it received. "We started with a minimum size of A$300 million and were pleasantly surprised on the upside," reveals Caroline Flick, manager, new issues at KfW in Frankfurt. "On the back of a well-diversified and granular order book we were able to price a A$600 million deal, ending up oversubscribed."

### Different approaches

KfW's trade was placed with 28 accounts according to official deal statistics, with 64 per cent sold offshore – of which 30 per cent went to Europe. This compares with the 15 investors which participated in the World Bank trade. World Bank saw an Australian flavour to its book, as 77 per cent of its green bond sold to domestic accounts.

The KfW approach appears to be in line with the bulk of supranational, sovereign and agency green-bond issuers. European Investment Bank (EIB) is perhaps the strongest advocate of investor ambivalence. Sandeep Dhawan, head of funding, Americas, Asia and Pacific capital markets at EIB, explains: "We see green bonds as bonds with a very specific use of proceeds. For us, this means any bond we do could potentially be classified be a green bond – and, therefore, any investor is welcome to buy that bond. So we don't specifically

"OUR GREEN BONDS TARGET INVESTORS WITH A DESIRE TO BE ACTIVE IN THE CLIMATE-CHANGE MITIGATION SPACE. THEREFORE, WHENEVER WE ISSUE A GREEN BOND WE GARNER A MAJORITY OF DEDICATED SRI INVESTORS."

**DORIS HERRERA-POL** WORLD BANK

He explains: "Verification on use of proceeds was very important. As a bank issuer, we needed to be beyond reproach. It was critical to us that we could not be perceived to be 'greenwashing'."

On the buy side, the diverse nature of SRI mandates adds some value to having a relatively standardised green-bond product. According to Matthew McCrum, Sydney-based director, investments at Omega Global Investors: "One area where standardisation can help is with the reporting we have to do to our clients. The expectations of an Australian superannuation fund versus a US retail client can be very different."

### VERIFICATION DILEMMA

However, the use of verification is not as clear cut as it might seem. A critical aspect of the green-bond market is that the product should price in line with an issuer's existing senior-unsecured curve. Issuers are naturally reluctant to pay a premium for green funding, while investors equally do

"We don't want to see verification become like a credit rating – concentrated with a small number of providers and thus more expensive. The cost would likely end up having to be borne by investors."

**NICK FOOTNER** UNISUPER MANAGEMENT

discriminate between investor types in our green bonds."

International Finance Corporation's approach is similar in concept, says Ben Powell, the supranational's head of funding. However, he adds that because green bonds have the added advantage of tending to attract new investors in practice, the SRI accounts may find themselves better allocated in oversubscribed deals.

"Our allocation decisions are driven by what we believe is good investor relations," Powell comments. "If a new investor comes into our programme – via green bonds or otherwise – we want to build a long-term relationship with that investor. Giving them a poor allocation in their first deal is not the best way of starting this relationship."

By contrast, World Bank is keen to maximise the component of its green-bond books which cares about the climate-friendly use of proceeds. Doris Herrera-Pol, World Bank's director and global head of capital markets, says the issuer does not demand 100 per cent SRI participation but it does expect at least a comfortable majority of books to be placed with investors which value the climate-specific focus of green bonds.

She explains: "Our green bonds target investors with a desire to be active in the climate-change mitigation space. Therefore, whenever we issue a green bond we garner a majority – if not 100 per cent – of dedicated SRI investors. For every other investor, there are regular World Bank bonds."

Australia's only domestic green-bond issuer to date – NAB – also favours the diversification provided by SRI specialists. However, David Jenkins, director, capital-markets solutions at the bank, says the relatively small size of this market in Australia means pragmatism is necessary to complete successful deals.

"There is a limited number of dedicated SRI investors with specific mandates for green bonds," Jenkins points out. "We focused very hard on the key investors in this space within Australia, but the deal featured a mix of relative-value investors and middle-market names as well as SRI and environmentally focused accounts."

### Investor preferences

Other than a general preference for not being scaled, mainstream investors seem generally to favour transactions which have the best expectations of liquidity. Massi confirms that SRI investors did not object to the presence of mainstream accounts in the KfW green Kangaroo book.

The specialist mandates were rewarded with full allocations – in line with KfW's preference to maximise the SRI component of its book – but according to Massi this plan was not disclosed ahead of time.

Indeed, there is one obvious reason why broader books might be the preferred outcome for all investor types. "Liquidity in green lines is a topic that tends to be mentioned by both SRI and non-SRI accounts," Massi reveals. "For instance, some non-SRI investors have suggested that green Kangaroo bonds should offer a degree of illiquidity premium over 'normal' Kangaroos."

Flick confirms that relative liquidity of the new asset class tends to be high on investor agendas in the green-bond arena. "Liquidity in green bonds was definitely a topic during our March investor meetings in Australia," she tells *KangaNews*. "However, given the size of our green Kangaroo bond and the granularity of its order book we are quite optimistic on secondary liquidity."

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**CAROLINE FLICK** KFW BANKENGRUPPE

not wish to receive less margin for the asset class – especially as it may also be less liquid than mainstream bonds given the smaller volume on issue.

Verification could scupper the market's prospects, if it becomes a significant cost factor which has to be borne by issuers or investors. Nick Footner, manager, fixed interest and cash at UniSuper Management in Melbourne, argues that verification may not in fact be required in some cases – though he says it is undoubtedly valued in others.

"Verification seems to be a reasonably cost-effective process at the moment, but we don't want to see it become like a credit rating – concentrated with a small number of providers and thus more expensive. The cost would likely end up having to be borne by investors," Footner says.

SSA issuers in particular also say demands for verification in all cases are not appropriate in their sector, given development banks' books tend to be overwhelmingly made up of sustainable lending already.

Dhawan says EIB has committed to lending a minimum 25 per cent of its €60-70 billion (US$64-74 billion) annual programme to climate-action projects. And he adds: "It's mistaken to paint the whole green-bond issuer universe with one brush. Multilateral development banks have a key role, and they are fulfilling it – but making it procedurally overly cumbersome to issue green bonds can scarcely be helpful. This won't stop our efforts on green lending but it might, at the margin, reduce interest in issuing in this format."

### STANDARDISATION FEARS

Cost and resources are not the only issues, either. In fact, there appears to be greater concern about verification and green-bond standards in general potentially trying to apply a commoditised formula to diverse markets.

"Standardisation *per se* is not something we can push very aggressively – certainly not for the time being and possibly not ever," argues Doris Herrera-Pol, director and global head

# BEYOND THE BOND: PROJECT RISK IN GREEN FINANCE

Green-bond proceeds are ring fenced for suitable on-lending, but their fundamental credit risk is at the issuer level. Some borrowers would like to see further development of an investable market for project credit risk in green format.

"The one issue on which I think the market needs to move forward, and on which it is having some difficulty, is getting investors to buy project risk," says Sandeep Dhawan, European Investment Bank's head of funding, Americas, Asia and Pacific capital markets.

Introducing project risk likely entails greater credit diversification. Dhawan continues: "At the moment what is getting bought is triple-A risk. Even a coupon with returns tied to project outcomes has difficulty finding a home. We have been searching extensively to find a critical mass of investors who might have appetite for this kind of risk."

International Finance Corporation (IFC) is taking an innovative approach to the issue, according to its head of funding, Ben Powell. He says that the supranational is pitching a "managed co-lending" programme to key investors.

This involves a pre-agreed portfolio of IFC loans, to which the investor commits a volume over time. IFC remains the lender of record, but investment is coordinated with the partner. However, Powell comments: "It's very easy for an IFC bond to fit into a portfolio. The challenge is to make an unrated portfolio of IFC loans also fit. This is what we have created and are looking to sell to institutional investors."

Another option would be green securitisation. Green asset-backed securities made up 5 per cent of the total market in 2014 according to Climate Bonds Initiative data – close to US$2 billion equivalent in total – and the concept is clearly relevant to some issuers.

David Jenkins, director, capital-markets solutions at National Australia Bank (NAB), says the bank has had discussions about the prospects for investors to directly debt-fund assets in future. NAB's debut green bond funded renewable-energy assets which were already on its balance sheet, and the bonds carried NAB risk. Jenkins says a green securitisation would in theory be the simplest way to for investors to directly debt fund these types of assets.

Developing a direct financing market is proving challenging globally, however. This suggests its emergence in a smaller bond market – which is also newer to green bonds – like Australia is an even more distant prospect.

Local Government Super's head of sustainability, Bill Hartnett, points out two key hurdles for bond investors – one which applies across asset classes, and one which is specific to the green market.

"Super funds are constrained by liquidity, which would be an issue for us when taking project risk. But a bigger challenge is policy certainty. It's not a case that there isn't enough money, though: what we need is for policy makers to understand that we need certainty around long-term investments," Hartnett explains.

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**SANDEEP DHAWAN** EUROPEAN INVESTMENT BANK

of capital markets at World Bank in Washington. "Every type of issuer, be they public or private sector, company, bank or development bank, has different projects. It would be very difficult to come up with a single definition of 'green'."

Investors tend to agree that demands around verification could prove counterproductive, at least while the market is at its current stage of development. Their preference tends to be for a *laissez-faire* approach unless and until issuance is less obviously or quantifiably green.

"When it comes to seeking standards or standardisation, my view is very much that we shouldn't 'let perfect be the enemy of very good'," says Hartnett. "We are in favour of promoting the development of an investment-grade product with green benefits, and to date the bulk of issuance we have seen has been from supranational-type entities. The type of lending these issuers do is demonstrably to low-carbon, climate-change mitigation projects – in which case I don't think there is any need to get too hung up on standards."

Meanwhile, Footner argues that standardisation around a rigid set of principles also runs the risk of disqualifying some of the diverse range of mandates which exist for green asset classes.

He explains: "Every investor will have a slightly different perspective on what is green. We have a sustainability focus rather than a climate-change focus, for instance. So if there was an attempt to devise a set of standards which was based purely around climate change, it could rule out other projects in which we might otherwise be interested."

## DIVERSITY TO GROW

However, most participants also say their real concern is making sure the fledgling green-bond market does not founder on the rocks of concerns about standardisation

"We all need to be aware of capacity issues in the SRI investor space. There is definitely increasing appetite out there, but it is important to manage the supply-demand equation in order to foster this growth sustainably."

**ENRICO MASSI** RBC CAPITAL MARKETS

so soon after setting sail. For now, an SSA-based market should have sufficient credibility at the issuer level to make the need for verification little more than a belt-and-braces issue. When issuance diversifies, verification should step up.

"We don't want to force the market to lose momentum," Hartnett confirms. "But we are already seeing a wider range of issuers looking at bringing green bonds to market. In this light I think it is important to take a horses-for-courses approach. There are a variety of ways to get the required level of understanding of what it is in which we are investing, and for some issuers a focus on accreditation is certainly one of those ways."

The point is not lost even on verification advocates – including Robinson from DNV. He agrees verification may not be warranted in all cases – a simple refinancing, for instance, or other straightforward programmes. His view, though, is that market growth will only spell more demand for verification – especially as the range of green-bond issuers diversifies.

Kidney from the Climate Bonds Initiative suggests issues around verification cost could be reversed for non-SSA issuers. "Standardisation has a role to play if we can reduce the cost of transactions by affirming eligibility criteria," he argues. "Our feedback is that this is something investors want – not because they don't trust development banks, but because they want to move beyond development banks and see the market grow."

## AUSTRALIAN AVENUES

For now, the likelihood is that the Australian market will retain its natural preference for development-bank issuers. "At the moment, it's easiest for the market to return to SSA issuers: their green credentials are pretty much unimpeachable and therefore their issuance doesn't run the risk of shedding demand on the basis of different interpretations of green on the investor side," comments McCrum.

It may in fact be in the Australian market's favour that it operates on a smaller scale than core funding jurisdictions globally. For example, Powell explains IFC's green issuance is driven by projects, rather than being part of an ongoing, generic funding task.

The supranational is therefore more likely to seriously explore an Australian dollar debut when it needs to top up its green funding portfolio at a time when Kangaroo economics are favourable. The fact that any future issue may not need to be of global benchmark volume adds a degree of flexibility.

Banks should also have opportunities to issue, though in this case investor expectations around verification of use of proceeds are likely to be enhanced. Jenkins at NAB says the bank could have gone offshore for its green-bond debut, but wanted to help develop the local option. "As an issuer we took a long-term view of the process – we certainly didn't do it as a one off," he affirms. "We are cognisant of what we have on our balance sheet and see an opportunity to bring further deals to market in future"

Corporate prospects are rather more mixed. Two Australian corporates – Stockland and Hallett Hill Wind Farm – have issued green bonds, but selected the euro and US private placement markets respectively for their debuts. Footner says the same issues which exist in the mainstream Australian corporate market also apply to green product.

"The reality is I don't think we are very likely to see a triple-B rated corporate issuer place green bonds in the domestic market in the near future," he suggests. "This is a function of the corporate market here. It's hard enough to complete a normal deal for this kind of issuer and investor limits – ours included – are simply not as big in this part of the market."

The most important factor may be maintaining discipline around deal flow. "There are a lot of issuers interested in the Australian green-bond market," says Enrico Massi, RBCCM's Sydney-based head of capital markets. "But we all need to be aware of capacity issues in the SRI investor space. There is definitely increasing appetite out there, but it is important to manage the supply-demand equation in order to foster this growth sustainably." •

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**SEAN KIDNEY** CLIMATE BONDS INITIATIVE