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Green bond issuers reinforce European Union's lead in sustainable finance

by Lee Wei Qi

- **Amidst worsening credit outlook, as shown by the NUS-CRI Forward PD, future demand for green bonds remains strong**
- **With the EU Green Bond Standard set to build further credibility within the green bond market, there is an increasing prevalence of relatively credit-worthy issuers**

Building upon United Nations' Sustainable Development Goals, the sustainable finance industry has witnessed significant headways in the past few years. While the NUS-CRI's Jul 2019 brief has previously covered green bonds, the green bond market experienced defining structural shifts in 2020. As green bonds continue to prove themselves as comparable alternatives, Covid-19 has emboldened the role of Environmental, Social, and Governance considerations in investment. Despite worsening credit outlook, it appears that capital flow towards the green bond market should hold steadfastly against the pandemic-induced downturn. Encouraged by European Union's (EU) leadership, the future demand for green bonds is expected to increase. At the same time, the EU Green Bond Standard will minimize greenwashing[1] and increase the creditworthiness of the marketplace. In doing so, investors and more credit-worthy corporates have greater propensity to participate.

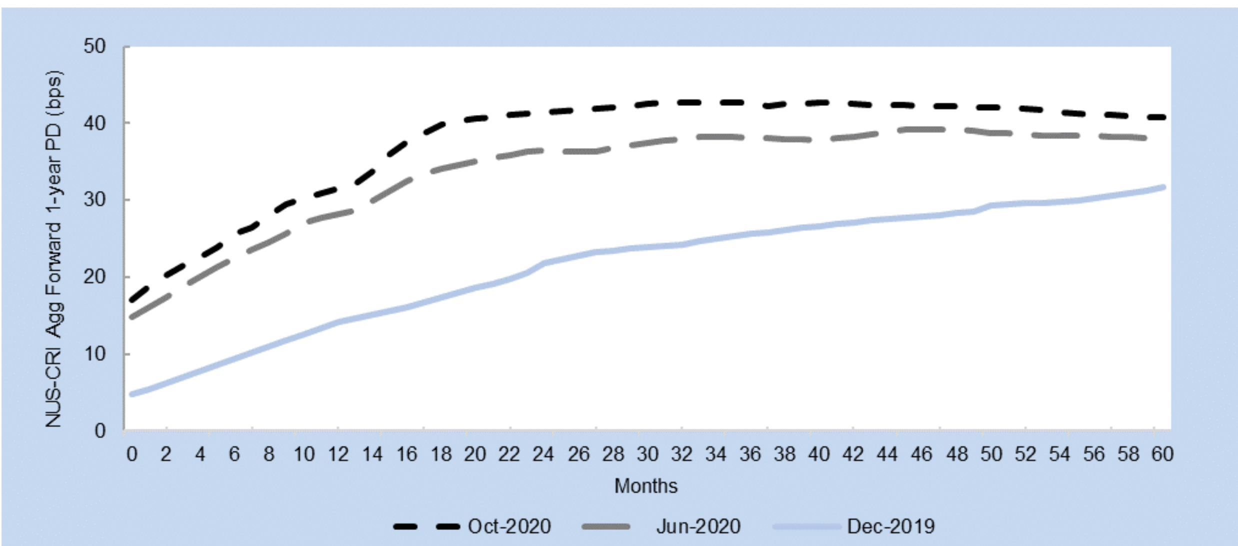

Figure 1: NUS-CRI Agg Forward 1-Year PD of global corporate green bond issuers[2] based on data feed as of Dec 2019, Jun 2020, and Oct 2020 *Source: NUS-CRI*

Covid-19 has resulted in an series of nation-wide lockdowns and travel bans. The prevailing macroeconomic uncertainties have inevitably resulted in credit strains on most corporates. As evident in

[1] One obstacle that hinders the development of the green bond market is greenwashing. The term refers to the channeling of capital raised from green bonds to projects without positive environmental impact.

[2] Jun 2019 marked the release of the EU Green Bond Standard Report by the Commission's Technical Expert Group on Sustainable Finance (TEG). Mar 2020 marked the release of the EU Taxonomy and the Usability Guide on the EU Green Bond Standard. As such, the brief seeks to differentiate itself from the Jul 2019 brief by covering the new corporate green bond issuers as of YTD 2020.

Figure 1, this year's corporate green bond issuers are not unaffected from the slowdown. Over 2020, the NUS-CRI Aggregate (Median) Forward 1-year Probability of Default (Forward PD[3]) term structure became increasingly elevated. Despite the deteriorating credit outlook, investors' appetite for green bonds is projected to be on the rise. The QoQ increase for non-green issuance from Q1 2020 to Q2 2020 was 30%. More importantly, the green bond market saw issuance up by 44% over the same period. Institutional initiatives toward a carbon-neutral economy have contributed to this observation. A critical player in sustainable finance is the EU. Leading with the European Green Deal Investment Plan, the EU has pledged EUR 1tn in support of sustainable causes over the next decade.

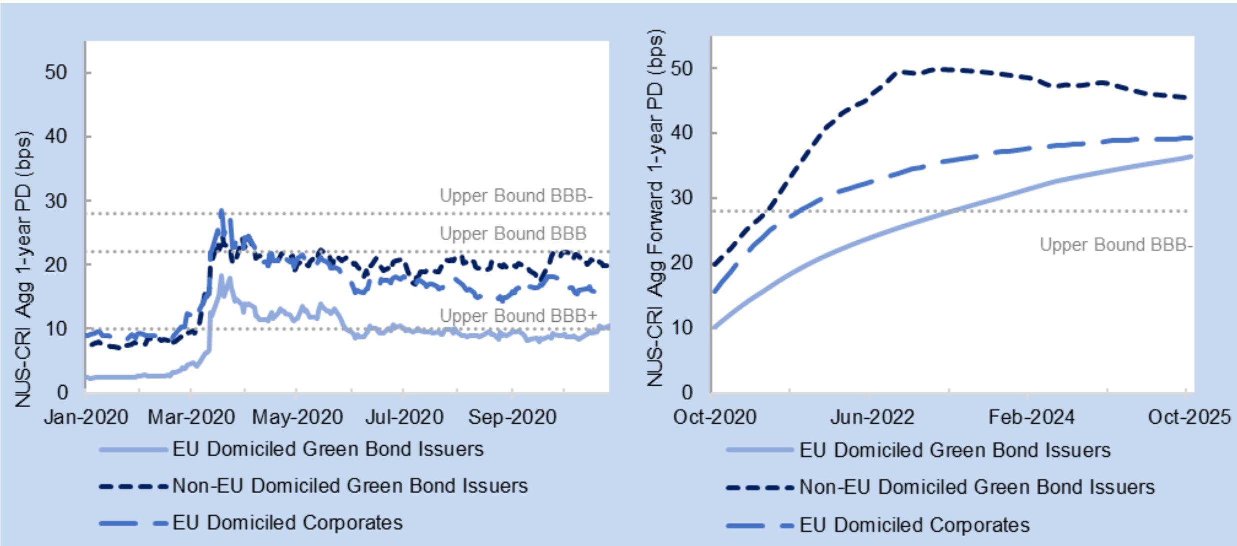

Figure 2a (LHS): NUS-CRI Aggregate 1-year PD of EU corporate green bond issuers, non-EU corporate green bond issuers, and EU domiciled corporates – excluding covered corporate green bond issuers, from Jan 2020 to Oct 2020 with reference to the PDiR2.0[4]. Figure 2b (RHS): Corresponding NUS-CRI Agg Forward 1-Year PD based on data feed as of Oct 2020 with reference to the PDiR2.0. *Source: NUS-CRI*

Notably, the EU Green Bond Standard serves to fortify the green bond market. Guided by the EU taxonomy, issuers are to publish their green bond frameworks with mandatory external verification, allocation disclosure, and impact reporting. Early adopters, which are prominently from the EU, are deterred away from greenwashing – an alleged activity by green bond issuers in pursuit of lower interest expense. Figure 2a illustrates that the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) for EU domiciled green bond issuers has been consistently lower than that of the non-EU green bond issuers and other EU corporates. In addition, the Forward PD in Figure 2b reveals that the non-EU domiciled green bond issuers and EU domiciled corporates have relatively elevated term structures compared to EU domiciled green bond issuers. Both indicators suggest that this year's EU domiciled green bond issuers are more credit-worthy.

A practical cost-benefit analysis of green bond issuance could account for why credit-worthy firms are more inclined to issue green bonds. The greater monitoring and reporting costs resulting from the EU Green Bond Standard offset the potential benefit of lower interest expenditure. Investment in sustainable projects redirect cash flows from potential expansion and/or dividends distribution. Relative to less credit-worthy firms with generally lower excess capital and higher cost of borrowing, credit-worthy companies stand to gain more from sustainable investments. Alligning with ESG values showcases the firm's corporate social

[3] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 1 year plus 6 months, conditional on the firm's survival in the next 6 months.
[4] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation of credit quality by mapping the NUS-CRI 1-year PDs to the S&P letter grades. Instead of relying solely on the reported default rates, the method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool.

responsibility. Corporate social performance is likely to contribute to better credit ratings as agencies start to increase emphasis on ESG during credit assessments. These benefits can outweigh the higher cost of green bond issuance for well-capitalised firms with greater financial scope.

The future of sustainable finance can benefit from the InvestEU Programme. The programme aims to direct private and public funding to an array of firms that align with EU's long-term priorities. This includes companies investing in green transition activities[5]. With the programme, the European Investment Bank Group, national banks, institutions, and other implementing partners are backed by an EU budget guarantee. By enhancing the risk-taking capabilities of the aforementioned stakeholders, EU hopes to de-risk ventures into private sustainable investments. This should empower more firms to undertake climate-positive projects and potentially increase future green issuances.

Apart from revitalising investors' demand and corporate green issuances, the European Central Bank (ECB) has purchased 20% of the eligible green corporate bonds under the EUR 2.8tn asset purchase programme. Within the sovereign green bond market, the German Treasury issued its first green bond with roaring success, receiving EUR 33bn worth of bids for a EUR 6bn debt issuance. Many members of the EU like Sweden and the Netherlands have also issued green bonds. Rising sovereign issuances and active purchase by the ECB have provided more liquidity within the green bond market. The new German Green Bond Programme seeks to issue green bonds across different maturities (2 to 30 years). These issuances will establish a representative green yield curve. The new green benchmark should enable green issuers to better price the corresponding fixed income instruments. Moreover, it should better guide retail and institutional investors with their sustainable investment decisions. All these policies reinforce the EU's strong mandate towards a carbon-neutral economy. The extensive, yet necessary, push from demand and supply has improved optimism towards the future of corporate and sovereign green bond markets.

[5] Green transition activities include renewable energy, energy storage, clean hydrogen and fuel cell, decarbonisation, carbon capture and storage, and circular economy technologies.

Credit News

Investors binge on convertible bonds as issuance soars

Nov 2. As a result of the pandemic induced downturn, affected firms flooded towards convertible bonds as an affordable means of capital raising. These issuances were well received by investors given the strong returns. Almost 30% of the USD 450bn convertible bonds outstanding were issued this year. Unlike traditional bonds, holders of convertibles stand to benefit from capital gain should the company's stock price rises above a specific threshold. A representative from Lombard commented that the optimal way to play the convertible market is to purchase out of the v-shaped recovery. (WSJ)

Money market funds brace for rules overhaul after Covid shock

Oct 30. US policymakers were confronted with an escalating crisis relating to the US money market funds. After the pandemic induced downturn, the Fed's intervention effectively provided a back-stop to the whole market. This mitigated a potentially fatal liquidity crunch. In the context of low-interest rates, the imposition of liquidity regulations has impacted the money market funds' ability to generate yield. This forced many big players into liquidating or converting their funds. Industry players are also advocating for a shift in focus to the wider credit market. As the access to liquidity becomes priceless in times of crisis, policymakers may find money market funds to be the center of an investor 'dash for cash'. (FT)

Vaccine bond sale raises USD 500mn to fund immunization programmes

Oct 30. A vaccine bond has raised USD 500mn to fund immunization programmes in developing countries. The deal attracted more than USD 1.5bn worth of bids for its three-year debt that yielded at 0.44%. The proceeds would be deployed for vaccine procurement in the context of COVID-19. To combat the pandemic, discussions are taking place to repurpose financial mechanisms previously deployed for other vaccines. Historically, IFFI has raised more than USD 6bn since 2006 and has provided USD 2.6bn in funding to Gavi, the UN-backed vaccines alliance. The finances raised by the IFFI on the capital markets allow for quick distribution of funds. (FT)

Corporate bond market wavers ahead of US election

Oct 30. The corporate bond markets are beginning to destabilize due to the upcoming US election as investors become more fearful of the rising COVID-19 cases and delays of further US stimulus. Last week, investors withdrew USD 2.5bn worth of funds from the US corporates bond market - the second largest withdrawal since March. In a sign of market uncertainty, two junk bond sales have been pulled. The default risk implied by credit default swaps has steadily risen over the last 2 weeks, implying greater hedging activity by portfolio managers. (FT)

Australia's banks stop funding coal as trading partners decarbonise

Oct 29. ANZ announced that it would cease lending to existing coal-fired plants and mines by 2030 to reduce the carbon footprint on its loan books. It will also boost lending to the renewables sector and introduce emission reduction goals for financing provided to its 100 largest customers. ANZ is the last of Australia's Big Four banks to commit to this cause as the company cuts back on its outstanding loans to the industry. ANZ has gradually reduced its exposure to the industry as its outstanding loans fell to AUD 500mn in September, down from AUD 1.7bn in 2015. This trend has led to Australian coal miners seeking more overseas funding. (FT)

Muni sales surge 22% past old record in rush to beat election (Bloomberg)

South Africa's Comair secures new debt as lenders back rescue (Bloomberg)

Aston Martin forced to pay 10.5% yield on USD 1bn bond deal (FT)

Regulatory Updates

Fed reduces loan minimum, easing terms for Main Street program

Oct 30. The US Federal Reserve (Fed) has made key adjustments to its Main Street Lending Program, including reducing the loan amount and adjusting fees to help expand access to the program. Since its launch over the summer, 400 loans totaling USD 3.7bn have been made. This is a fraction of the USD 600bn in loans available through the initiative. The Fed said it was lowering the minimum amount to USD 100,000 from USD 250,000 to provide greater access to small businesses. Only fewer than 100 banks have made loans through the program so far. One of the barriers that have caused this is that the terms set by the Treasury Department require banks to take most of the risk for losses on the loans. (Reuters)

ECB eyes more bond buys, cheap loans in December as pandemic hits

Oct 29. The European Central Bank (ECB) has committed to take new action in December to contain the growing fallout from the second wave of COVID-19 infections. This will likely be in the form of more bond purchases or cheaper credit for banks to encourage lending. The ECB's Pandemic Emergency Purchase Programme has exhausted nearly half of its EUR 1.35tn firepower and could be due for an expansion of the programme in the near future. The fresh COVID-19 restrictions are challenging the view that the Eurozone economy will grow back to its pre-crisis level by the end of 2022. (Reuters)

Colombia central bank holds rate, ending seven months of reductions (Reuters)

Central banks flexing their green muscle for climate fight (Reuters)

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