Investing in green bonds with positive environmental impact potential

Atlanticomnium's Romain Miginiac,
fund manager of the
GAM Sustainable Climate Bond Fund[1],
believes that green bonds issued
by the European banking sector
are a compelling investment opportunity.

Green bonds offer strong visibility on use of proceeds and measurable impact

From a pure risk-return perspective, green bonds and their traditional non-green counterparts are virtually identical. Green bonds are typically issued in senior unsecured form (but can also be in subordinated and other forms of debt) and have the same credit risk, ratings and structure as non-green bonds. The key difference is the use of the proceeds (i.e., what the issuer is allowed to do with the cash raised). While non-green bonds are typically issued for 'general corporate purposes', proceeds from green bonds can only be used to finance projects with a positive environmental impact. Eligible categories of projects to be financed typically include but are not limited to, renewable energy, green buildings, sustainable transport and/or forestry. From an investor's perspective, this means visibility on how proceeds are employed and a direct link between issuance and impact.

An important aspect to consider is that while the proceeds are earmarked to finance these eligible projects, bondholders bear the credit risk of the issuer, and not of the underlying green project, thereby mitigating financial risk. Bondholders have no recourse to the green assets, and in the creditor hierarchy, green and non-green bonds rank *pari-passu*. In the case of default of the issuer, the process of recovery for green and non-green senior unsecured bondholders would be identical. In essence, green bonds are not securitisations, and the linkage between the issuance and impact is through the use of proceeds.

From a bondholder's perspective, we see this as positive, as bondholders benefit from visibility on the use of funds and have a direct link in terms of positive, tangible impact, without sacrificing credit quality.

[1] *GAM Star Fund plc - GAM Sustainable Climate Bond*

The fund is managed by Atlanticomnium S.A., an independent Geneva-based fund management company, which has specialized in credit investing since it was founded in 1976. The firm has managed assets for GAM since 1985. Atlanticomnium has a strong track record, through 35 years of experience investing in the bonds of financials. Moreover, Atlanticomnium has one of the longest track records in European financial bonds, with an established history of analyzing issuers, conducting close engagement and building deep relationships with issuers and regulators.

Fund managers, Gregoire Mivelaz, Patrick Smouha and Romain Miginiac have over 35 years' combined experience within the industry. The primary source of added value is the bottom-up credit selection ability of the managers and their expertise in financials. The managers are supported by an analyst team with in-depth knowledge of issuers' credit profiles.

For more information, please visit GAM.com.

Investing in green bonds with positive environmental impact potential

Furthermore, the multi-decade transformation of the European banking sector post the global financial crisis (GFC) in 2008, driven by regulation, has led the financial sector to become extremely resilient. Supporting the economy and impact projects requires strong issuers, and we believe that European banks have 'rock solid' fundamentals and credit quality. This is especially important as banks finance projects with high impact but higher risk of default, such as small and medium-sized enterprises (SMEs) or specific smaller green projects.

One of the only differences between green bonds from banks versus green bonds from other corporate issuers is that banks do not directly purchase green assets such as wind farms, but instead finance their clients involved in such green projects.

European banks' green bonds—Tremendous impact potential as banks green their lending books

Given the characteristics of green bonds issued by banks (lending rather than directly purchasing green assets), there is a natural question of why we favour banks from an impact perspective.

First, investors should consider the role of European banks in the economy. As financial intermediaries, banks play a pivotal role in financing both households and corporates. This is further reinforced by the dominance of bank lending in financing European corporates, estimated at a high 80%, given the lesser reliance on capital markets financing compared to the US, for example. This means that not only is non-bank financing not available to SMEs and individuals, but even larger corporates rely on bank financing. The impact potential from supporting SMEs is particularly compelling, as SMEs represent around two thirds of employment in the eurozone according to EU statistics. Bank financing acts as a catalyst to drive impact for SMEs, and indirectly drives positive social impact on top of environmental impact through financing green projects. As an example of this impact, Credit Agricole reported in its 2020 Green Bond Report (credit-agricole.com) financing of EUR 19 million to support Cap Sud's (French SME specialising in the installation and maintenance of solar power plants) expansion in France and abroad. Consequently, banks' role in the economy is primordial, and as such, banks shifting the flow of credit towards the green economy has tremendous positive environmental impact potential.

Moreover, although sustainable financing commitments have accelerated as banks have rolled out net zero targets, we believe that banks can and must do more to align their financing with net zero emissions, scale up green finance and withdraw from projects that fail to meet the goals of the Paris Agreement. We fully support the Institutional Investors Group on Climate Change's (IIGCC) expectations for the banking sector, which formalise clear areas for action for banks, including urging them to cease activities that cause emissions through deforestation, land-use change and fossil fuel financing.

The key catalyst for the banking industry to support the environmental transition is regulation. Since the GFC regulatory authorities have built an extremely positive track record in transforming the banking sector and with climate risk at the forefront of the regulatory agenda, the trend for the next decade(s) is clear. There are numerous ongoing regulatory initiatives (on top of issuer, investor and government-led initiatives) to tackle climate risk in banks' lending and investment portfolios – ranging from improving disclosures to stress tests. Climate stress tests are, in our view, the game changer, as they will in time influence banks' capital planning – we think either via capital surcharges for 'brown' financing (fossil fuel financing, for example) or capital add-ons for inadequate climate risk management.

Investing in green bonds with positive environmental impact potential

Regulation is already incentivising banks to ramp-up their green asset financing (for example Banco Santander looking to raise and facilitate EUR 220 billion of green financing over the next decade), also reflecting banks' role in financing the economy and a growing pipeline of green projects. For green bond investors this is clearly positive, supporting the growth of the market and providing new investment opportunities.

The second indirect implication of banks' 'greening' of lending books is engagement with existing clients. This is often overlooked, but we see this as a key lever of banks' capacity to effect change. Banks, as often the sole source of lending for SMEs and individuals and key financiers for large corporates, have a privileged relationship with their clients. Engagement between bankers and clients are often longstanding, typically on business development or financial matters to support bankers' credit risk assessment. With momentum on climate risk steadily increasing, the role of banks in green financing is pivotal and this will only intensify. Ultimately environmental criteria (and social and governance criteria) will influence underwriting decisions and loan pricing, which are trends already nascent.

What does this mean? As banks are 'penalised' by regulators (in terms of capital required) for lending to issuers with weak environmental credentials or to 'brown' industries, banks will put pressure on clients to implement and execute credible environmental strategies. For the laggards, this will mean either a higher cost of lending or even ending lending relationships. The impact potential is colossal given banks' role in the economy throughout each industry. Banks will drive change for the whole economy by pressuring clients to set credible environmental strategies. We estimate that the green bond market for European banks can easily reach EUR 200 billion or more by the end of 2023 (compared to circa EUR 80 billion currently), given the current pace of issuance. This is to be put in perspective of European banks' bonds outstanding of above EUR 1 trillion across currencies. It is important to note that as banks are mainly deposit funded (debt funding is only a minor portion), green projects financed by banks will be a large multiple of green bonds issued – with EU banks holding around EUR 17 trillion in loans, thus green projects financed will be in the EUR trillions. As an example, BBVA recently revised its 2025 green financing targets to EUR 200 billion (from EUR 100 billion); this is EUR 200 billion for one bank only.

Green bond investing compounds the importance of active management to generate meaningful impact

Despite our conviction on banks' green bonds as a powerful tool to support banks, the economy more broadly and an orderly transition meeting the targets set by the Paris Agreement, active management is also vital in issuer and bond selection.

Although significant progress has been made to harmonise the green bond market, there are no legal or regulatory requirements of what constitutes a green bond and issuers' obligations towards investors. As an investor, there needs to be a strong focus on selecting bonds that offer high potential impact and avoiding those issued without a genuine sustainability purpose is key.

Beyond traditional credit analysis to screen for strong issuers (arguably only strong issuers have the capacity to effect change), in-depth extra-financial analysis is essential to identify high quality green bonds. As part of the GAM Sustainable Climate bond fund, there are three key pillars of analysis to screen for high quality green bonds:

- Analysis of issuers' ESG profiles: issuers with strong ESG credentials (with a special focus on the "E") are more likely to have a have a clear

Investing in green bonds with positive environmental impact potential

and credible environmental strategy and have strategic reasons to issue green bonds. The issuance of green bonds should be aligned with a credible and ambitious environmental strategy, for example to support the pipeline of green assets.

- Analysis of the green bond framework: the green bond framework, the "green prospectus" sets out all the processes and governance surrounding the allocation of proceeds to green assets or projects. High quality processes and governance ensures confidence surrounding the impact of funds deployed. Issuers such uphold high standards (such as the ICMA green bond principles as a minimum) and provide transparent reporting to investors on allocation of funds and impact.

- Analysis of impact: Issuers provide post-issuance reporting on allocation and reporting, including estimates of the positive environmental impact of green assets or projects financed. The difficulty lies in the wide range of methodologies and assumptions used to calculate these which varies significantly issuer by issuer. Using comparable methodologies can help assess the positive impact between issuers.

Screening for best-in-class green bonds requires in-depth analysis at all levels

Best-in-class Green Bonds Characteristics	Key pillars of analysis
Genuine Issuance Purpose	**Issuer ESG Quality** • Robust ESG Profile • Credible climate Strategy • Alignment of green bond issurance with climate strategy
Visibility on use of proceeds	**Green Bond Framework** • Complies at least with ICMA Green Bond Standard • High quality green prospectus • Transparent allocation and impact reporting
Meaningful climate impact	**Impact analysis** • Comparable data used to assess impact • Meaningful impact from financing of green assets

Source: Atlanticomnium.

Investing in green bonds with positive environmental impact potential

Combining the financial and extra-financial analysis required to identify and select high quality green bonds, clearly active management has a strong value-add when investing in green bonds. Moreover, engagement with issuers should be a top priority, at each step of the analysis – both to enhance internal analysis and to voice our views to issuers towards upholding the highest standards in the green bond market.

Green bonds from European financials offers attractive opportunities

Green bonds from European financials can offer attractive returns for investors. Beyond the positive environmental impact, they provide strong yield and spread pick-up for investors compared to the euro-investment grade (IG) market. As banks and insurers issue green bonds across the capital structure in both senior and subordinated format, this provides the ability to generate higher yields – around or even above 1% in EUR, compared to circa 0.4% on corporate IG bonds. This is without compromising on credit risk or interest rate risk – with an average bond rating of BBB+ (similar to the IG index) and duration of 5 or below (compared to 5.3 on the index). Therefore, a positive environmental impact can be compatible with attractive income yields.

The question of 'greenium' is another key topic for green bond investors – are we sacrificing yield or spread to buy green bonds instead of non-green bonds? While there is an observed 'greenium', in the order of 0-10bps (0-0.1%) – is this an actual yield/spread foregone? There is an argument that the greenium arises from excess demand for green bonds, and investors accepting a somewhat lower return in exchange for the environmental benefits of the bonds. However, it seems that the 'greenium' could rather be explained by more traditional risk/return considerations. For example, green bonds tend to be more liquid than non-green bonds, especially in times of market shocks. Moreover, green bonds also tend to be less volatile than non-green bonds. Analysis on the subject is based on a limited timeframe and is at its infancy, however, there seems to be financial reasoning explaining the 'greenium'. This would point to the fact that green bonds are more 'robust' structures.

Overall, we see green bonds from European banks as a powerful instrument for investors to generate meaningful positive environmental impact alongside attractive income. Climate change is one of the biggest risks for the global economy looking ahead, thus incorporating climate risk as a core part of the investment process ensures robust forward-looking risk management, and by extension protecting bondholders' returns.

Romain Miginiac, CFA
Fund Manager & Head of Research, Atlanticomnium

Romain Miginiac is co-fund manager of GAM Sustainable Climate Bond fund and Head of Research and at Atlanticomnium S.A. Prior to joining Atlanticomnium SA in September 2018, Mr Miginiac was with Aberdeen Standard Investments where he spent the last two years as a credit analyst covering European financial institutions. Prior to that, he held positions with KPMG and UBS in financial services audit and wealth management respectively. Romain holds a bachelor's degree in economics from the University of Geneva and a master's degree in finance from ESADE Business School. Romain is a CFA Charterholder and have passed the CFA UK's Certificate in ESG investing. He is based in Geneva.