Diversity in the environmental asset class is suffering from high minimum issuance sizes and monitoring costs. Green striping could be the solution

Environmentally-minded finance has been popular over the past few years, headlined by the rise of green bonds. The idea behind environmental finance is that investors back companies in environmentally-friendly businesses, such as wind farms, or that they back particular environmentally-sustainable projects, such as construction of energy efficient buildings. In either case, investors typically like to know that 100% of their funds are used for environmental purposes. When it comes to green bonds, this means that the entire amount of the proceeds is to be allocated either to green companies or for green projects.

This article presents a vision for how the green bond market could expand beyond this all-or-nothing approach to allow for so-called green striped bonds. Such an instrument could help to extend the pool of issuers able to participate in the green bond market, connecting them to more investors and diversifying environmental investment options.

Green Bonds are a small fraction of the global bond market but are growing rapidly. Approximately $11 billion in green bonds were issued in 2011; approximately $44-48 billion in green bonds have been issued so far in 2016, depending on which source you read. The rapid acceleration in issuances has spurred the financial community to develop the infrastructure to keep up with the demand. Indices have been developed by Barclays MSCI or the S&P Dow Jones and dedicated segments established on the London, Luxembourg and Oslo stock exchange segments. A consortium of investment banks, issuers and investors established the Green Bond Principles, which provide procedural guidelines for the market, and Moody’s has created assessment criteria to help inform the market on whether an issuance is sufficiently green.

Green bonds were initially only issued by multilateral development banks and have since expanded to commercial banks, municipalities/governments and large corporate issuers. But only a small handful of these green bonds have been sub-investment grade, or high-yield. It seems unlikely that the forces driving investment grade companies to focus on environmental sustainability are not affecting high-yield issuers. To understand this lack of diversity among green bonds, it is helpful to look at why environmentally-focused bonds have expanded so rapidly since 2011.

How green bonds solved a problem

The debt capital markets have existed for centuries and environmentalism for decades so why is it only during the past few years that issuance of environmentally-focused bonds has accelerated? Bonds offer the same benefits to environmental issuers, such as stable capital with flexible terms. Furthermore, interested investors could always invest directly in, for example, recycling companies, or other companies that pursued environmental aims; adding a label does not add much.

The primary constraint on environmentally-focused debt was that bonds have to be rather large to be attractive to investors. Investors require bonds to be issued in sufficient amounts to improve the likelihood of at least some ability to trade the bonds later on. Bond investors like the flexibility to sell their positions if necessary and, as a rule of thumb, like to see at least $200 million equivalent in liquidity.

This minimum liquidity problem reduces the number of companies able to issue environmentally-focused bonds, even among those companies that are investing heavily in environmentally-sustainable projects. There are only so many companies able to issue at least $200 million or so of bonds entirely for environmental purposes. If your environmental borrowing needs do not allow you to issue bonds above the minimum liquidity threshold, you will need to either use non-bond finance or raise conventional bond funding and forego the green credential.

Another important constraint on environmentally-focused bonds was that they required researching and monitoring of the environmental quality of an investment. Many investors do not have the resources or expertise to review in detail each investment and ensure on-going compliance with environmental criteria. Before green bonds became a widely-known type of asset, companies had little reason to help investors overcome these constraints by labelling their bonds as green and undertaking to use their financing in an environmentally-sustainable manner. This resource constraint problem further limited the investors who could participate.

To overcome these obstacles, certain multilateral development banks developed green bonds in 2007. The innovation at the heart of green bonds is that the banks would issue bonds with a promise to investors that they would loan the bond proceeds to so-called eligible green projects to be identified later.

Relying on the promise from the bank on how the funds would be deployed in the future, investors became comfortable that by purchasing green bonds they were fulfilling their environmental investment mandate or preference. Market practice

The issuer would adhere to the norms of the green bond market as if it had issued a standalone green bond

For the uninitiated, green bonds are debt instruments with similar characteristics to traditional bonds that issuers use to implement, emphasise, and finance their environmental responsibility strategies.

An issuer labels the bond as green when marketing the bond to help investors identify the purpose of the bond and states how the bond’s proceeds will be used. For example, an electricity utility might issue a green bond to finance investment in renewable energy production. The meaning of green is unregulated in most markets, save China (which has national green bond standards in place), and remains a contested topic. For most issuers, green bond financing is not materially less expensive than conventional financing and the benefit to issuing a green bond comes from the positive effect it has on investor relations.
has since developed whereby banks will, in some cases, obtain a second-party opinion confirming that their green project criteria were environmentally sound and report to a certain extent on the future lending of the proceeds. Questions remain on the extent to which ultimate borrowers fulfil their agreement to deploy the funds in an environmentally-sustainable manner.

This model works well in some respects. First, it helped to overcome the minimum liquidity problem because banks were able to issue large bonds and then in the future lend the proceeds to projects of various sizes. Unlike bonds, loans of this nature are unlikely to need to meet minimum size amounts. Second, this model helped to overcome the resource constraint problem by shifting the diligence burden from the investors to the banks. Instead of reviewing the details of a planned hydroelectric power station, investors could review a brief statement on how the bank will select investments. For example, in the past the World Bank has stated that it would use green bond proceeds to fund projects related to “(a) mitigation of climate change including investments in low-carbon and clean energy generation facilities, such as energy efficiency and renewable energy programs and projects, or (b) adaptation to climate change, including investments in climate-resilient growth.”

The heavy lifting of reviewing the business plan, checking the environmental reports and monitoring progress fell to the bank, which had the resources and expertise to perform these functions.

The bank-issuer model for green bonds has been tremendously successful but has not proved as useful for non-investment grade companies or investors that seek to invest in higher yielding bonds. This is likely because a bond issued by a bank (or municipality/large corporate adopting the same model) is almost always rated investment grade and suitable primarily for investors seeking low risk, low return options. This makes sense, especially for commercial banks, which would not be able to on-lend the proceeds at a profit if the interest rate on the original green bond was already high. Non-investment grade companies, on the other hand, are far less likely to be able to issue sufficiently large bonds purely for environmental purposes because these companies are likely smaller and more leveraged. If the green bond market requires that the entire issuance is dedicated to green bonds, a large portion of these companies will be shut out, along with the investors who would be otherwise interested in investing in their bonds.

### Diversifying the market

Green striped bonds could allow more bond-issuing companies and more investors to participate in the green bond market by helping to resolve the minimum liquidity problem. Green stripes that would be too small as standalone green bonds would be part of a sufficiently large bond and any bond-issuing company could choose to commit a stated fraction of a bond’s proceeds to environmental purposes. That could include non-bank issuers that would use the proceeds themselves and leveraged companies that issue higher yielding bonds, resulting in bond financing tied to environmentally friendly activity becoming available to more companies. By allowing a more diverse set of issuers to participate, investors could have more options across a range of criteria, including yield/coupon, size and type of business, green aspect and place of operations. The greater the variety of choices available to investors, the more investors will be able to find attractive investments in environmental finance.

Green striped bonds would also provide a way for investors to overcome the resource constraint problem in identifying and monitoring environmental investment opportunities. Issuers would have an incentive to commit to use a certain portion of the proceeds for environmental purposes – being able to label their bond as green striped. Investors could rely on that commitment in the same manner that they rely on the commitment from banks to loan proceeds in the future to eligible green projects. Rather than being forced to choose between 100% green bonds and 100% conventional investments, investors could choose investments that blended conventional and green in one.

The status quo green bond market has had a fantastic run of growth since 2011 and the predominant bank-issuer model has been instrumental in that success. But however well the status quo green bond market serves the needs of its participants, there are other companies and investors waiting outside. Green striping could be one way to start opening the doors and further realise the lofty ambitions animating the green bond market.

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