

Green bonds need a ‘big-tent’ approach

Aaron Franklin, a capital markets lawyer at Latham & Watkins, has submitted this article in response to an earlier piece about Green bonds written by IFR editor-at-large Keith Mullin.

Keith Mullin wrote in the April 9 edition of IFR that it is not appropriate to label as “Green” bonds used to finance acquisitions or bond redemptions because, regardless of the underlying businesses, such financings do not create a new positive impact on climate and environmental protection (ie, “additionality”).

He states that calling acquisition finance green is “an example of vested interests pumping the market to create a buzz of self-serving publicity while losing sight of the fundamentals”. He argues that “in the absence of additionality, isn’t the green designation just bogus?” and suggests it is “overtly misleading” to label a bond “Green” if it does not finance new green investments. I disagree for the below reasons.

As a starting point, this argument would imply that the Green bond market is, in general, “bogus” because the Green bond market is not, in general, limited to bonds financing new green activity. Such a limitation is not found in the listing requirements of the London, Luxembourg or Oslo Green bond stock exchange segments or in the criteria for the Barclays MSCI or the S&P Dow Jones Green Bond indices.

This limitation would be incongruent with the Green Bond Principles and Moody’s Green bond assessment criteria, each of which explicitly include bonds used to refinance existing projects and therefore are not limited to bonds financing new green activity.

This limitation would be inconsistent with the publicly available database maintained by the Climate Bond Initiative and would cast doubt on the validity of many “pure-play” Green bonds and the second opinions issued in support thereof. The market

understands and accepts that not all Green bonds are tied to new investment and offering disclosure addresses this point. It is hard to see how this state of affairs can be considered “overtly misleading”.

Setting aside the question of what is customary in the Green bond market, it is unclear what good could come from constricting the definition of Green bond. For the sake of the discussion, we can assume that bonds that finance new investment lead to a net gain in green activity, however defined.

This assumption is highly problematic because bonds that refinance existing debt (either in standalone refinancings or acquisitions) are vital to the continued existence of green companies. This assumption is also problematic as applied to green acquisition finance because acquisitions shape the incentives that lead to early-stage investors taking a risk on new green businesses.

They like the idea of a profitable exit and there is no telling how many fewer green businesses we would have without this possibility. Even if you assume that a bond that finances new green activity is better than a bond that only finances a green business, both types of bond should be considered Green bonds.

Firstly, this ‘big-tent’ approach to Green bonds leads to more deals that include promises of good environmental and social behaviour, more attention to environmental impact and more focus from the investment community on these topics. Even pure-play issuers have frequently obtained second opinions that promised additional reporting and transparency. Issuers and underwriting banks take seriously the risk of being targeted with accusations of “green washing”; when issuers label their bonds as green, they have reputational, contractual and securities law-based incentives to keep their promises.

Secondly, a constricted definition excludes issuers at later stages of development and investors focused on such businesses. These issuers may not be looking to grow through new investment but rather to maintain their existing operations and their bonds may present a different risk/return profile. A greater variety of investment opportunities will engage a broader pool of investors and more investor interest in bonds that are tied to environmental promises is a good thing.

In contrast, the exclusive-club approach advocated by Mr. Mullin would warn off issuers interested in emphasizing their ESG strategies and in making environmental topics more central to their operations. That would mean fewer issuers, banks and investors focusing on solving environmental issues. Nor is it likely that this approach would lead to greater investment in bonds that finance new activity. Deals get done when they make business sense, not when they qualify for a green label. The only thing at stake is whether the issuer is going to emphasize and stand behind its green activities, which should be encouraged.

The lack of an additionality limitation in the Green bond market might be because of “vested interests” having “lost sight of the fundamentals” but the more plausible explanation is that the focus for most investors is investing in a green business. At least for now, the priority may not be to claim responsibility for unique pieces of green infrastructure. This may be disappointing to those that would prefer if investors had different priorities but it would be quixotic to argue that investors’ preferences should be otherwise.

Markets exist where buyers and sellers overlap. In this case, green investors who want to invest in green businesses and businesses that want to emphasise and finance their green activity. Those are positive forces and should be supported by the norms and rules of the Green bond market.