Green Bonds & Beyond: A Sustainable Path in Fixed Income

Arnab Choudhury
Executive Vice President & Group Head, Debt Capital Markets
SBI Capital Markets Ltd.

The global market for "sustainable" fixed-income securities is estimated at over $1 trillion and growing. It includes corporate, municipal, sovereign, and securitized bonds issued to finance businesses, infrastructure and projects designed to have positive environmental and social impact.

Types of Sustainable Bonds.

There are several ways to generate positive impact in investment grade credit. One is by investing in corporate green bonds, which include bonds issued by companies whose sole or primary business is related to sustainable development, such as renewable energy, energy efficiency or wastewater treatment businesses. Green bonds also include those issued by businesses seeking to improve their sustainability profiles, for example a utility financing the replacement of fossil fuels with renewable energy to generate electricity, a coffee company building out an organic farming value chain and providing education and loans to farmers, or a food and beverage company increasing its suite of healthy products. These bonds are typically used to fund specific projects but are supported by the balance sheet and cash flows of the parent company.

A second credit sector offering opportunity for positive impact with low credit risk is the taxable municipal bond sector. This includes bonds issued to build schools, hospitals, and critical infrastructure, with a focus on underserved communities. In some cases, these bonds are backed by the full faith and credit of the municipalities. Lastly, sovereign governments, government backed entities and development banks issue green and social bonds to finance sustainable development in specific countries around the world.

Measuring Impact

Active sustainable fixed-income managers evaluate impact through an analysis of each bond's "use of proceeds" (the specific projects being financed by the bonds) and by monitoring impact KPIs (key performance indicators). Use of proceeds is typically spelled out clearly in bond offering documents, and KPIs align with the use of proceeds. For example, the impact attributed to bonds issued to build renewable generation may be measured in tons of carbon emissions avoided or megawatts of renewable capacity added. Impact KPIs for bonds issued to finance affordable housing and community development may include number of affordable housing units built, number of affordable mortgages guaranteed, community facilities built, or jobs created. Because use of proceeds tends to be clear and transparent, active managers can target investments in particular sustainability themes, such as affordable housing, financial inclusion, and climate change; they can also target specific United Nations Sustainable Development Goals (UN SDGs) and report on progress on impact KPIs.

We believe that the growing focus on sustainability could inspire financial innovation that widens and diversifies the universe of economically attractive securities. As the potential for competitive returns on investment for funding sustainable objectives becomes apparent to more market participants, we expect to see novel markets and financing structures that may improve the risk/return profiles of many traditional fixed income portfolios. We see three sustainability trends with potentially substantial implications for fixed income markets:

1. **Global shift toward green industrial policies**
   As awareness of the risks of climate change intersects with national security concerns in an uncertain geopolitical environment, governments are intensifying their push to fast-track domestic low-carbon energy transitions. Notable legislation such as the US Inflation Reduction Act, REPowerEU, and the EU Green Deal Industrial Plan are steppingstones in this transition. These initiatives seek to fuel private investment in climate technology and infrastructure projects, using public funds and financial incentives as catalysts. Their aim is to build robust, homegrown manufacturing and financing capabilities within their borders that connect environmental stewardship to economic and energy security.

   By enhancing the economic appeal of private-sector projects, these new policies are attracting private capital via a variety of project-based debt-financing structures. As a result, opportunities abound for fixed income investment, for projects geared toward transforming existing infrastructure to support electrification, reduce carbon emissions, and enhance climate resilience. Encouraging more widespread private-sector lending in these areas could also result in new types of securitizations connected to sustainable projects.

   With policy changes potentially expanding the issuance of debt to finance the energy transition, how might fixed income markets react to rising supply? We predict that two dynamics may counterbalance the resulting upward pressure on yields and spreads. **First**, although the supply of sustainable debt may be growing, so is demand for that debt. **Second**, governments' vested interest in the success of green projects suggests that, on balance, these projects should have lower credit risk than markets currently perceive. Over time, we expect that these qualities will be able to support tighter credit spreads.

2. **Emergence of sustainable financing innovation**
   Market participants appear increasingly willing to think creatively about scaling up sustainable funding in ways that acknowledge governments' fiscal limitations (particularly in emerging markets) and private investors' risk-adjusted return requirements. Tackling these financing challenges could broaden the fixed income opportunity set, as potential recipients of this financing, such as sovereign and quasi-sovereign entities, primarily access public capital markets via fixed income issuance. We suspect these issuers would welcome innovation that expands their market access.

   Because fixed income markets are diverse and allow for a variety of structures and issuer types, they are fertile ground for innovation in sustainable finance. Novel financing approaches may include:

- Public/private partnerships that direct sustainable financing to emerging markets, including to create local capabilities for originating and securitizing sustainable project debt
- Reinsurance solutions with payouts linked to borrowers' successful climate mitigation or resilience measures
- Financing structures like blue bonds or natural-capital-backed debt, which not only reward stewardship but also can help quantify the economic value of critical but hard-to-price public goods

   Because these new structures may have low correlations with traditional fixed income securities, they might also unlock new opportunities to improve portfolios' risk/return characteristics.

3. **Asset managers' role in this evolving ecosystem**
   We envision diversified asset managers playing a pivotal role in the evolution of sustainable fixed income markets, helping ensure that the resulting financial innovations meet investors' financial objectives while contributing to sustainable outcomes. Asset managers can support the development of sustainable fixed income markets in three main ways:
   - Impact measurement and management. Managers can offer vital quality control as new markets and security types emerge. By looking beyond labels and leveraging industry- and country-specific knowledge, they can assess whether new issuances support measurable, additive sustainable objectives.
   - Product development. By bridging the gap between financing needs and sources of capital, managers can ensure that new sustainable financing structures match the investment objectives, risk tolerance, and return requirements of a diverse set of investors, thereby expanding the market for sustainable investment solutions.
   - Convening ability. Financing sustainable outcomes is a complex, multidisciplinary challenge. It requires collaboration between investors, scientists, policymakers, standard setters, and nongovernmental agencies on a global scale. Large asset managers who interact extensively with these diverse stakeholder groups are in a prime position to help shape sustainable fixed income markets in ways that deliver financial benefits to investors and support sustainable outcomes.

Closing thoughts

The potential to generate attractive returns by investing in securities that support sustainability objectives — from mitigating climate-related financial risks to expanding internet access or financial services or health care for billions of people — is growing. It is clear to us that fixed income markets hold the key to financing enduring progress on these objectives. We also believe sustainability will drive financial innovation, influence policymaking, and reshape the fixed income investment landscape. The evolution we have witnessed in green policy, blossoming interest in sustainable financing innovation, and accelerating pace of disclosure and standardization all signal a profound transformation. We believe our role is to leverage our expertise and networks to ensure that the growth of sustainable finance produces better investment outcome for our clients and underpins a sustainable future.