BLOG POST

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Green Bonds: Challenges, Opportunities, and Their Precarious Place in a Sustainable Future

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According to the International Capital Markets Association (ICMA) [1], green bonds are “any type of bond instrument where the proceeds or an equivalent amount will be exclusively applied to finance or refinance, in part or in full, new and/or existing eligible Green ProjectsThe first green bond was issued by the World Bank in November, 2008 to raise funds from fixed-income investors to support lending for climate-focused projects. The issuing of green bonds aims to accelerate green financing by supporting profitable enterprises, and to contribute to protecting the environment through financial means. But the question remains- can green bonds truly be effective in promoting green financing and sustainability?

Green bonds have experienced a 49% growth in the five years preceding 2021[2] . In 2021, the green bond market reached over half a trillion dollars (USD 517.4 billion) in value, the highest figure since the market's inception with 10 consecutive years of growth[4]. Investors expect global green investment to reach USD1 trillion by the end of 2022.

Green bonds are an indispensable tool for raising investors’ awareness of environmental challenges and promoting climate action by   prompting more investors to spotlight green projects instead of oil companies’ equities and options.. Most investors repeatedly lend into oil equities as they can produce significant capital gains from share price appreciation and attractive dividend income during periods of high oil and gas prices [4] (DiLallo, 2021). However, investors are progressively realising that climate change will negatively affect returns on assets such as stocks and bonds [5] (Nordea, 2021). Simultaneously, green bonds can act as a strategy to hedge against the risks brought by climate change while achieving at least similar returns on their investment, according to the World Bank [6]. The growth in green bonds and green finance also indirectly disincentivise high carbon-emitting projects (ibid.).

However, green bonds must align with 4 core components for them to prove effective.
First, the utilisation of the proceeds of the bond should be for eligible Green Projects only. These projects can include renewable energy, energy efficiency, pollution prevention and control, environmentally sustainable management of living natural resources and land use, sustainable water and wastewater management etc. Next, the process for project evaluation and selection must be lucid. The bond issuer must clearly demonstrate the environmental sustainability objectives of the eligible Green Projects to investors, relevance of their project within the eligible Green Projects categories, and complementary information on processes by which the issuer identifies and manages perceived social and environmental risks associated with their project. Third, the management of proceeds must be done appropriately. The net proceeds of the Green Bond, or an amount equal to these net proceeds, should be credited to a sub-account, moved to a sub-portfolio or otherwise tracked by the issuer in an appropriate manner. It should also be attested by the issuer in a formal internal process linked to their lending and investment operations for eligible Green Projects. Last, reporting of the use of proceeds must be transparent. Issuers should create and maintain readily-available, up-to-date information on the use of proceeds. This should be renewed annually until full allocation and on a timely basis in the case of material developments.

But, have green bonds truly been effective in mitigating environmental challenges? Admittedly, the growing market of green bonds continually faces various obstacles. There are three pressing issues which threaten the credibility of the market: green washing, lack of investor protection, and costs. Greenwashing is an environmental challenge plaguing various industries; issuers of green bonds performatively utilise proceeds to enhance their reputation rather than investing in a project intended to address an environmental issue. The growing demand from investors for sustainability-oriented projects and the rapid expansion of the market has attracted actors who have leveraged the lack of international legal standards for green bonds. To exemplify, Hong Kong Airport Authority secured USD$1 billion for the expansion of the Hong Kong International Airport through the issuance of a green bond in early 2022. However, such a project is set to damage the habitat of the endangered Chinese white dolphins that inhabit Hong Kong's pristine waters [9]. Issuers have no legal standards to adhere to, which puts the market in danger of being flooded with greenwashed bonds.

Issuers report the use of proceeds at two stages: before issuance in order to sell the bonds, and post-issuance about their specific use [10]. The market has grown at a pace faster than one that policy-makers have been able to dictate the rules of the sector. In the first stage, issuers can employ any convenient criteria to label their bond as 'green'. In the second stage, a study by the Climate Bond Initiative concluded that a mere 38% of bonds engage in post-issuance reporting [11]. Thus, investors often have limited means of measuring the impact of their investment and of ensuring that their investment is faithfully directed towards a green project. This hinders their capability to seek penalties in the case of a 'green default'- an instance when the issuer does not satisfy the predetermined green criteria. Unless contractually specified, investors cannot take the issuer court in the case of a misallocation of proceeds.

Finally, the lack of universal standards has led to issuers having to attend to a flurry of NGOs, second-party reviewers,third-party certificators, auditors, and consultants in order to guarantee the project sustainability to investors. These obstacles entail transaction costs absent in standard bonds, which may render green bonds uncompetitive and thereby less attractive to investors- despite their urgent necessity in tackling the climate crisis.

Evidently, the lack of universal legal standards for green bonds and the rights and duties of issuers and investors creates a plethora of challenges in this rising market. Institutions, policy-makers, legislators and leaders ought to formally dictate these standards in order to maximise the efficiency and reputation of this essential market.

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