



Strategic sustainability in investments for Corporate Treasurers: Understanding green bond financing



Introduction

The concept of green bonds dates back to 2007, when the European Investment Bank and the World Bank pioneered this type of instrument as a way of raising funds for projects tackling climate- and environment- friendly projects. Since then, multilateral development banks have continued to issue green bonds, mostly in relatively small sizes.

More recently, however, the market has seen an influx of new issues – and in 2014 alone, the market tripled in size. The recent growth has been spurred in part by a greater focus around the world on climate change, resource efficiency and green issues in general.

For corporate treasurers, the rise of green and sustainable bonds presents some interesting opportunities. Historically, sustainability has not sat within the domain of treasury – but in the last few years, treasurers have taken on more responsibility at the strategic level. This has included finding ways for their organisations to act responsibly from an environmental, social or governance (ESG) perspective.

In practice, most companies issue debt for investments that are within their growth strategy or needed to finance operations. Where green bonds are concerned, the challenge for treasurers is to understand how this can play to their benefit.

The Rise of Green Financing

Aila Aho, Head of Sustainable Financing, Nordea, Wholesale Banking

Green motivations mean different things to different people. A professional asset manager, for example, may have a specific green bond fund. The fund may target investors who want to limit or allocate their investment funds to purposes that correspond to their responsibility profile, or that do not carry certain environmental risks. Pension funds, in contrast, have very long-term liabilities and therefore need to consider trends which have a long-term impact on economies, such as climate change.

Signatories to the Principles for Responsible Investment (PRI), a partnership with the UN and investors, integrate sustainability into their asset valuation, thereby contributing to the development of a more sustainable global financial system. These signatories already represent management of over \$59 trillion of global assets.

Meanwhile, impact investors take evaluation to the next level, striving to change the behaviour of their investment targets. This could mean dropping projects that investors claim are a costly and risky use of shareholders' funds, such as arctic drilling, or better management of environmental risks, i.e. initiate improvements that they believe would increase the long term value of their investment.

While motivations can vary, the common denominator is that all these investors consider environmental issues to be relevant to their asset selection. Indeed, most institutional investors are now seeking both environmental resilience and financial performance in their investments. These are not mutually exclusive goals: good ESG performance may indicate a well-managed company that is less likely to encounter unpleasant surprises. Equally, environmental excellence is no substitute for the requirement to meet financial criteria.

Nordea Asset Management has a family of funds called STARS that uses positive selection to invest in quality companies with well-managed ESG profiles that generate long-term economic value. The treasury units of multilateral banks – and large corporates with high sustainability profiles – may also use ESG criteria to manage part of their excess funds. In some cases, they are willing to trade off liquidity, or relative return, to see the funds used for purposes with a positive impact on environment or society.



Understanding Green Financing

Any company eligible for the bond market can issue conventional bonds – and conventional bonds of a pure play company, such as a renewable energy company, are often regarded as green by investors. However, a green bond or loan also reflects other objectives.

Green financing differs from conventional financing in a few key areas:

- **Sharing information.** The main practical difference is that the company needs to share information beyond the financials, that specify the assets and projects that will utilise green funding and show how its operations will have environmental benefits and/ or a positive social impact. Green Bond Principles (GBP) are a set of standards agreed among issuers, investors and banks to strengthen the integrity of the emerging green bond market. The focus is on ensuring adequate transparency so that investors can decide if bonds fit their requirements.
- **Tracking the use of funds.** It is also important to track the use of funds until – and after – they have been spent. This may involve quantifying the positive impacts. For example, a company may be able to quantify how much carbon emissions were saved by producing energy with renewable sources.
- **Outside opinion.** In practice, investors like to see an outside opinion in order to verify compliance with the GBP and, in some cases, the ESG quality of the issuer itself. Establishing these working and reporting streams does entail some work and cost – but it is not as burdensome as people unfamiliar with the green financing space might think. The amount of work also depends on the information already available elsewhere in the company.
- **Ratings.** Where ratings are concerned, the credit credentials of green bonds are the same as other bonds, as green bonds are repaid from the same cash flow as conventional bonds. However, some individual investors may give additional weight for good green issuers.

Quantifying the benefits

The area of green financing includes a broad range of investment opportunities, including renewable energy, energy savings, sustainable real estate, water management, sustainable forestry and public transportation. As mentioned above, the benefits of these opportunities should ideally be measurable or quantifiable in some way. For example, all new buildings are energy efficient – but obtaining a LEED gold or platinum certificate makes it simpler to prove that above average standards have been met.

Primarily, this information comes from issuers themselves. Ideally, information should be validated by an external second opinion provider or auditor. Professional ESG rating providers are useful when evaluating the overall ESG quality, and many of them provide green bond second opinions.

In some sectors, such as real estate, there are widely used certification standards. However, in general the industry is at an early stage of developing common standards.

Pricing

Academic evidence is beginning to emerge that environmental risks are an element of pricing – so it is important to make this element clear, both in terms of actual operations and in investor communications. Some studies are also showing that debt instruments for issuers with good ESG ratings tend to react less in situations of market disturbance.

Investors like less volatility, so issuers should make sure that investors are aware of an instrument's quality credentials – particularly if the ESG metrics are good. At times, the good demand can drive tighter pricing of the premium for green bonds.



Leveraging the Opportunities

In the last few years, the issuer base for green bonds has widened to include commercial banks, corporates and municipalities in Europe and the US. Large Indian and Chinese banks have also entered the market, and in 2015 green bonds issuance reached a high of \$40 billion. Nevertheless, new green bond funds are also emerging and demand for green bonds currently outweighs supply – and this wider investor group is something of an untapped resource.

Despite the growing demand for ESG investments, corporate treasurers sometimes hesitate to act. In some cases, treasurers may be unaware of how relevant non-financial factors have become in the investment equation. In other cases, the treasury team may operate quite separately to other activities in the group, missing opportunities to engage with this newer investor group.

Corporate sustainability responsibility tends to take place in another department that manages and publishes a potential issuer's information – such as GRI reports, which include information relating to areas such as energy efficiency. The finance manager may not be aware of these, or may simply not see how to benefit from sustainability achievements or information through treasury activities. Tight resources can also be a consideration: there is an expectation that doing something new will take up valuable time.

In order to overcome these challenges, treasurers need to increase their general awareness about sustainability and investor demand. Internal teamwork across the organisation and top management attention can be a great support, while examples from other treasurers or investors can provide a boost. In the end, however, it is up to market intermediaries – ie banks – to bring the right investors and issuers together.

"I'm pleased that Skanska was one of the first corporates in green financing back in 2014, and while the market is continuing to enjoy a healthy growth, it's important to recognize that green financing must undertake a broader sustainable purpose within corporations in order to successfully and truly underpin the meaning of "sustainability"."

Pär Lageryd, Head of Treasury, Skanska Financial Services AB



The Role of Technology in Green Financing

Andre Chanavat, Senior Product Manager, Thomson Reuters

With so much momentum in the market, almost every large institutional investor has a department with green motivations. However, those green motivations can differ significantly – which is driving the creation of diverse financial products tailored around different sustainability themes. This area is continuing to grow: our database currently shows \$92 billion of outstanding debt labelled as green bonds.

A number of our customers are now incorporating ESG criteria into their funds. Last year, for example, Thomson Reuters collaborated on a fossil free fund project with Australian fund Future Super. The fund undertakes a negative screening process to avoid investment in negative and harmful activities, and a positive screening process to identify investments in positive and beneficial activities.

Whatever the goals of a particular fund or investor, technology is playing a key role in helping companies achieve their green financing objectives.

Leveraging ESG data

Many customers are using our ESG data to help them understand companies' risks and opportunities in more detail. Green motivations are not just an exercise in philanthropy, or about being prepared to sacrifice returns in order to do good. The goal is rather to gain a better understanding of a company, looking beyond the income statement.

With the quality of ESG data improving all the time, it provides additional information which is not readily exploited in the market. It also gives more forward looking details, compared to fundamental and technical sources, and can help investors make better stock decisions. ESG data can also give our customers a window into the culture and performance of a company. This includes internal factors, such as staff retention and operational efficiency, and external considerations, such as the extent to which companies work with their communities. By indicating how well a company can execute on its ESG vision and strategy, our data also gives our customers a competitive edge.

Our comprehensive ESG database incorporates data from over 5,000 publicly listed companies. In addition, our officers and directors database provides information on over 1.8 million officers and directors for public companies, and over 1.1 million for private companies. This information is increasingly important to investors focusing on compensation or board diversity as part of their ESG agenda.





Mitigating downside risk with ESG analysis & Multi-factor ratings

More and more investors are taking the issue of ESG in the investment process more seriously. Factoring in ESG performance and risks is important to investors now more than ever because of: the changing regulatory landscape globally and the hidden risks that lead to major corporate scandals like the recent example of Volkswagen. However, it requires high quality data and access to methodologies to assure the data is cleaned and verified to invest confidently. What's more, ESG scoring is becoming the industry standard for evaluating corporate social responsibility with some types of models ranking different companies in a way which implies a degree of precision that is simply not attainable at this point.

When it comes to scoring, it is possible for investors to purchase ESG ratings from rating providers, but for many customers looking to build their portfolios, there is a preference to create their own bespoke ESG rating for stock pick allocation purposes, based on their own risk appetite, values and goals. Furthermore, for many customers, the task of sifting through data on thousands of companies can be a significant challenge when it comes to scoring.

Our new multi-factor ratings capability via Eikon, our intuitive desktop solution for financial and market analysis, is a capability that enables customers to choose the ESG variables that matter to them from a list of over 400 metrics – ranging from hazardous waste to policy board diversity. Customers can now get the whole picture on company performance, risks associated and value drivers as well as attribute their own weights to their chosen variables, based on which the system will provide a custom score. This score can then be applied to the relevant portfolio or list, helping customers to analyse individual companies based on high quality data.

Indeed, as green financing develops, more companies are looking to focus more narrowly on specific areas – such as a financial product based on carbon neutral, or focusing on diversity and inclusion. Another example is the rise of social impact bonds, whereby the coupon paid to investors can vary depending on whether certain quantitative goals have been fulfilled.

In-Depth ESG Content...





Taking advantage of AI in ESG data

A further development is the recent use of artificial intelligence (AI) or cognitive computing in ESG data. This has recently been developed by TruValue Labs, who are focusing on real-time ESG data. They use sophisticated cognitive computing techniques to capture over a million data points from across the internet (in real time) and filter all that information into only the ESG events that matter most for over 7000 publicly listed companies.

This type of output can potentially act as an early warning indicator or at a minimum the ability to get alerted on key ESG events across a portfolio of stocks. For customers who wish to mitigate reputational risks that might be associated with holding a certain stock. While this might also be applicable to portfolio managers and investors more generally, reputational risk can be a particular concern for fund managers who are offering sustainable funds.

Conclusion

Green financing is here to stay. At this stage, asset managers tend to be more focused on this area than corporate treasurers. Nevertheless, treasurers are slowly adapting to the new climate – and awareness is growing of how sustainability can help to shape their long-term investment strategies.

As this area develops, technology is playing an increasingly important role in helping market participants to monitor risks and undertake analysis, while focusing more narrowly on specific areas of sustainability. By providing a robust suite of tools and capabilities, Thomson Reuters is empowering customers to make effective decisions – whatever their ESG priorities.





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