
IIGCC POSITIONING PAPER ON GREEN BONDS

Statement by the Institutional Investors Group on Climate Change (IIGCC)

IIGCC represents institutional investors with over €6.5trn of assets under management who collectively recognise both the threat of climate risk to their investments and the investment opportunities being created by a low-carbon economy. To that end, IIGCC seeks to be actively involved with governments in finding financing solutions to satisfy long-term energy infrastructure needs. While we welcome renewed vigour to move toward a low-carbon economy, we want to use this opportunity to promote the development of new structures and products which are aligned to our needs. This may allow us to provide the scale of capital at the pace required to renew and upgrade our ageing infrastructure.

As institutional investors we have a fiduciary duty to our beneficiaries which means we seek to maximise long-term risk adjusted returns from our diversified portfolio of investments. This paper sets out the characteristics of green bonds necessary for them to be attractive and appropriate investments for us and our beneficiaries. We also explain our reservations about committing unconditional support to green bonds initiatives at this stage.

Scope of existing green bond proposals

Currently in the UK, the coalition government has committed to create a Green Investment Bank (GIB) which may be allowed to issue green bonds in 2015/16 as a means to raise capital. While we support the creation of the GIB and other similar European initiatives in principle, we are concerned that institutional investor appetite for green bonds at this time may be overstated. The many public documents commenting on the design of the GIB state that investors, in particular pension schemes, would allocate significant capital to the purchase of such green bonds¹. We believe that these statements do not adequately reflect how institutional investors make investment decisions and allocate capital and do not address certain investor's misgivings about the generic use of the term 'green bond'.

What are 'green' bonds?

A key part of the issue is how we define the characteristics of a green bond. Without standard definitions we need, at minimum, answers to the following questions before being able to evaluate a green bond and consider any allocation:

- How are the coupon payments and principle repayment calculated and hence how will the bond be valued? (for example is the coupon payment dependant on the carbon price²?)
- What are the assets backing the cash flow? (If this is debt securitisation, asset backed or similar we will need to fully understand the structure and gather an independent view on the appropriate credit rating)
- What is the capital structure (including the covenants in the bond documentation)? What is the credit risk of the issuing institution, is it explicitly government backed?

¹ See appendix for a list of relevant public documents.

² Some investors view carbon as a commodity and are restricted by legislation from investing in it.

- What is the size of the issue? What is its duration? What is the likely liquidity of the bond? Will the issuer support a market in these instruments? Is a yield curve to be created or will the issuer re-issue the same maturities over time?
- Will the bonds finance projects with clear and transparent environmental benefits?

Before an investment is made, institutional investors will de-compose any bond into its constituent parts and calculate the price of the bond compared to the price of the unbundled investments. Additionally, any investments backing the bond cashflows will be analysed individually and alternative methods of accessing investments directly via equity or infrastructure will be assessed independently for comparison. Without definitive answers to these questions we will struggle to evaluate these bonds and invest (or mandate our investment managers to invest) in them.

How we allocate capital

Institutional investors such as pension funds make investment decisions based on meeting their liabilities in order to pay current and future retirees. Prior to committing to any specific investment, assets need to be allocated to an asset class. As pension schemes, we have a number of asset classes or in some cases risk classes to which we can allocate. Typically these tend to include listed equity, fixed income (with sub categories of government, corporate, inflation linked), property, private equity and infrastructure such that the pension scheme assets are diversified by risk and return. These asset/risk classes are each defined by characteristics and associated benchmarks including expected returns and volatility as well as minimum liquidity requirements. To allocate to any of these asset/risk classes a prospective asset needs to fit within the underlying characteristic. Hence a green bond would need to conform to either a liquid, government (or government guaranteed) bond class or the higher returns of a well-rated corporate bond class. Inflation-linked bonds provide liability matching and the best alignment and are always well received.

Asset allocation challenges of green bonds

In addition to assigning each investment to an asset class, reductions in liquidity, which could arise if the bond issuance size is small by institutional investors standards, would need to be compensated by higher yields. If the bonds are illiquid, pension schemes struggle to place them within existing asset allocations and the amount of funding available would fall far short of the amount required especially as many investors are limited to buying maximum of 10% of any issue. In short, we have a fiduciary duty to invest in the most commercially competitive bonds after considering price, credit risk and liquidity.

While we have a preference for investing in sustainable long-term assets, it is unlikely that we would apply any premium to the “green” label. However, just because institutional investors are unable to attach added value to green bonds it does not mean that others, including retail investors, will not be attracted to these bonds particularly if they are structured with tax benefits.

Conclusion – our exposure to green bonds so far

To date we have struggled to source green bonds which have the required level of returns and liquidity to meet our requirements. While the multilateral development banks and institutions have ventured into green bond issuance, European investors have been unable to purchase them in scale due to the lower yield profile of early attempts compared to existing bonds, along with the reduced liquidity and short tenor.

Although we are unable to support the green bond initiative unequivocally at this stage, we are keen to be involved. However green bonds are only ever likely to form a small part of our bond allocation. The amount of funding we would be able to supply would be far greater if we take this timely opportunity to help shape the investment framework to drive new forms of public-private investments.

References

Public documents that discuss pension scheme allocations to green bonds

“Unlocking investment to deliver Britain’s low carbon future”, **Report by the Green Investment Bank Commission:**

“If green bonds were to finance all the investment needed to support the low carbon transition over the next five years (£265 billion, according to E3G), pension funds and insurance companies would have to allocate up to 5% of their total bond investment (1.7% overall assets) to them”. p.20

“The Green Investment Bank”, **House of Commons Environmental Audit Committee Report** p16-18

“Financing the future: a green investment bank to power the economic recovery”, **The Aldersgate Group**

“Carbon capital: financing the low carbon economy”, **Barclays and Accenture**

About IIGCC

The Institutional Investors Group on Climate Change (IIGCC) is a forum for collaboration on climate change for European investors. IIGCC’s ambition is to provide European investors with a voice on climate change and engage with policymakers, companies and investors on addressing long-term risks and opportunities associated with climate change. The group currently has over 70 members, including many of the largest pension funds and asset managers in Europe, representing assets of over €6.5trillion.

In detail, the IIGCC’s objectives are:

- To encourage the adoption of public policy solutions that ensure an orderly and efficient move to a low carbon economy as well as measures for adaptation which are consistent with long-term investment objectives.
- To encourage a pro-active approach on climate change amongst asset owners and asset managers in order to preserve and enhance long-term investment values.
- To improve climate-related disclosure, reporting and management of climate related risks and opportunities across different asset classes.

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IIGCC Members, April 2011

Amundi
AP1 (First Swedish National Pension Fund)
AP2 (Second Swedish National Pension Fund)
AP3 (Third Swedish National Pension Fund)
AP4 (Fourth Swedish National Pension)
APG Asset Management
ATP
Aviva Investors
Baptist Union of Great Britain
BBC Pension Trust
Bedfordshire Pension Fund
BlackRock
BMS World Mission
BNP Paribas Investment Partners
BT Pension Scheme
CB Richard Ellis
CCLA
Central Finance Board of the Methodist Church
Church of Sweden
Climate Change Capital
Co-operative Asset Management
Corporation of London Pension Fund
Earth Capital Partners
Environment Agency Pension Fund
Environmental Technologies Fund
Ethos Foundation
F & C Management Ltd
Generation Investment Management LLP
Greater Manchester Pension Fund
Global Energy Efficiency and Renewable Energy Fund
Grosvenor Investment Limited
Henderson Global Investors
Hermes
HgCapital
HSBC Investments
Hudson Clean Energy Partners

Impax Asset Management
Insight Investment
Invicta Capital
Joseph Rowntree Charitable Trust
Kent County Council Pension Fund
Kleinwort Benson Investors
London Borough of Hounslow Pension Fund
London Borough of Islington Pension Fund
London Borough of Newham Pension Fund
London Pensions Fund Authority
Merseyside Pension Fund
Nordea Investment Funds
Northern Trust
Osmosis Investment Management
PGGM Investments
PKA
Platina Partners
PRUPIM
Railpen Investments
Robeco
Sampension
Sarasin & Partners LLP
Schroders
Scottish Widows Investment Partnership
South Yorkshire Pensions Authority
The Church of England Pensions Board
The Church Commissioners for England
The Church in Wales
The Roman Catholic Diocese of Portsmouth
The Roman Catholic Diocese of Plymouth
The Roman Catholic Diocese of Salford
The United Reformed Church
Universities Superannuation Scheme
West Midlands Metropolitan Authorities Pension Fund
West Yorkshire Pension Fund
William Leech Charitable Trust