Led By Green Bonds, The Sustainable Debt Market Looks To Surge Ahead

February 13, 2020

Key Takeaways

- We expect global issuance in sustainable debt to surpass $400 billion in 2020, driven by further innovation and growth in green-labeled bonds and other sustainable debt instruments.
- New instruments, such as sustainability-linked loans and bonds, might expand and diversify the way investors contribute to sustainability objectives.
- Europe will cement its leadership in sustainable finance, pushed by unprecedented political and regulatory actions.
- Positive credit conditions should support growth in green-labeled issuance in 2020, and beyond then, we believe the market is likely to remain resilient to worsening credit conditions due to its strong market fundamentals and the predominance of investment-grade issuers.
- Further innovation may be needed to accelerate the allocation of financing to environmental objectives beyond the energy transition.

PRIMARY CREDIT ANALYSTS

Noemie De La Gorce
London
+ 44 20 7176 9836
Noemie.delagorce
@spglobal.com

Francesca Sacchi
Milan
(39) 02-72111-272
francesca.sacchi
@spglobal.com

SECONDARY CONTACTS

Maurice Bryson
London
maurice.bryson
@spglobal.com

Michael Wilkins
London
(44) 20-7176-3528
mike.wilkins
@spglobal.com

RESEARCH ASSISTANT

Reshma Thomas
Mumbai

Issuance in sustainable debt has doubled in 2019, and S&P Global Ratings expects it to surpass $400 billion in 2020. Primary among this issuance have been green bonds, which we expect will remain the main type of sustainable debt instrument. However, we also expect the sustainable debt market to continue to diversify and innovate, as investors look for alternative ways to contribute to sustainability objectives.

And the market shows few signs of abating. In S&P Global Ratings' view, the strong market fundamentals along with persisting positive credit conditions in the private sector are likely to support further green issuance growth in the next year. Issuance in the labeled green bond market could grow close to $300 billion in 2020, after achieving a record $238 billion in 2019, according to the Climate Bonds Initiative (CBI). While it still represents a minor part of global issuance, this share is increasing -- to about 3.5% from less than 1.0% five years ago. We expect this growth to be a long-term phenomenon, with sovereign and regulatory interventions, particularly in Europe, acting as a catalyst for private issuance. On the other hand, we believe this growth is insufficient to bridge the existing financing gap between available sustainable debt and investments needed to transition to a low-carbon and climate-resilient economy, which the U.N. estimates to at least

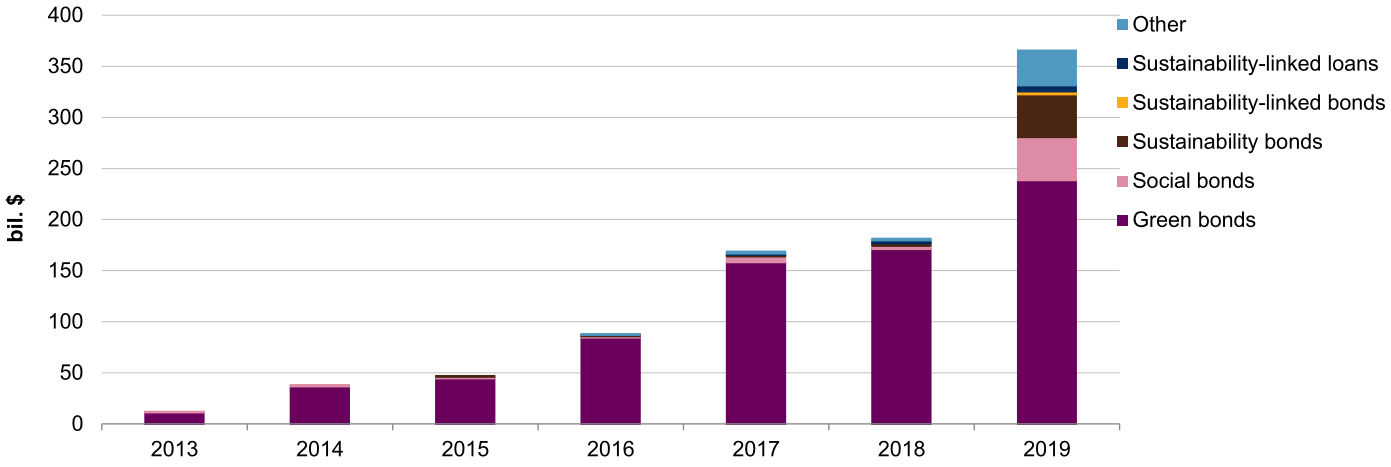
$60 trillion by 2050.

We Expect The Sustainable Debt Market To Diversify Further In 2020

Green bonds have been -- and still remain -- the dominant sustainable debt instrument. However, other sustainable debt instruments, including social bonds, sustainability bonds, and sustainability-linked loans and bonds, are emerging. Social bonds are defined by the International Capital Market Associations as bonds whose proceeds fund new and existing projects with positive social outcomes such as improving food security and access to education, health care, and financing. Sustainability bonds target both environmental and social benefits, and sustainability-linked loans provide incentives for borrowers to set and achieve sustainability performance targets (see "Why Linking Loans To Sustainability Performance Is Taking Off," published Sept. 3, 2019, on RatingsDirect). Last year also saw the world's first sustainability-linked bonds, which give issuers incentives to reach a predetermined target. Non-green-bond issuance increased to about 35% of the total sustainable debt market in 2019 from 6% in 2018 according to the CBI (see chart 1).

Chart 1

Sustainable Debt Surpassed $350 Billion In 2019
Annual Issuance In Sustainable Debt By Instrument Type



Source: Climate Bonds Initiative, S&P Global Ratings.

We believe investor appetite for other sustainable debt instruments will complement the continued expansion of the green bond market. In our view, this wave of innovation might expand the pool of investable sustainable financing, reducing the gap between growing investor demand for sustainable financing products and still-limited supply. Also, we believe these new instruments may help investors to diversify their contribution to sustainability objectives:

- Instruments such as sustainability-linked loans and bonds give companies incentives to advance their sustainability agenda by directly linking their cost of funding to the achievements of specific environmental, social, and governance (ESG) targets. Therefore, some investors see these instruments as a potential stronger driver of change than green bonds, which do not have

a similar incentive mechanism. Some investors also see these as more powerful than green bonds to embed sustainability into the company's strategy because the environmental and social objectives apply to the whole company instead of a specific transaction.

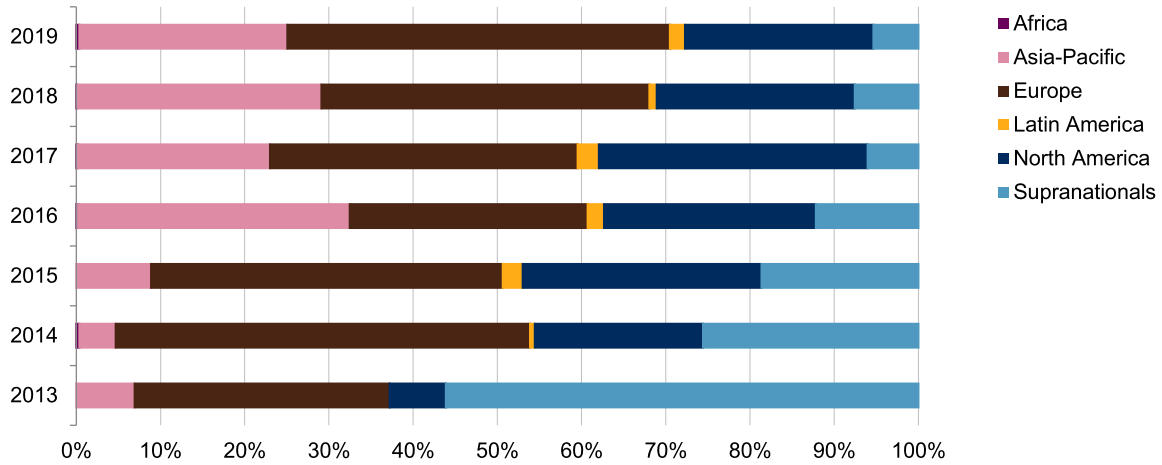
- On the other hand, sustainability-linked loans and bonds do not rely on the use-of-proceeds principle, the way green, social, and sustainability bonds do. An issuer could raise the proceeds for general corporate purposes without tracking, auditing, or regularly reporting on the allocation of proceeds to eligible projects. Because of this relatively lower level of governance and transparency, some investors might be concerned with "ESG-washing," whereby the proceeds of the sustainability-linked bond or loan would finance measures other than the ESG objectives the issuer is committed to.

We expect issuance of green bond-labeled instruments to reach about $300 billion in 2020. Growth in annual green bond issuance rebounded to 39%, after a temporary slowdown in 2018. We believe this strong growth partially reflects the surge in absolute fixed-income issuance globally, up 17% in 2019, after a 6% decline in 2018 (see "Credit Trends: Global Financing Conditions: Bond Issuance Is Expected To Grow 3.8% In 2020," published Jan. 30, 2020). In our view, this growth also reflects the strengthening of some key market components, including a regulatory and political push in Europe and a rise in private financing.

Europe will consolidate its leadership in green-labeled issuance. In 2019, the region represented close to half of new issuance (see chart 2), reflecting its unique regulatory and political push for green and sustainable finance. The European Commission recently announced its European Green Deal to become, in its own words, the first "carbon-neutral continent" by 2050 (see "EU Green Deal: Greener Growth Doesn't Necessarily Mean Lower Growth," published Feb. 10, 2020). In 2019, the EU also agreed upon a green taxonomy, which defines activities compatible with a 2050 net-zero economy, activities that contribute to a net-zero economy but are not currently operating at that level, and technologies that enable those activities. We believe this constitutes one of the most important developments in the sector in recent years, by creating a standardized taxonomy for defining eligible projects and helping to dissipate fears of greenwashing (see "The EU Green Taxonomy: What’s In A Name?", published Sept. 11, 2019). Since the spectacular rise in Chinese debt issues in 2016, issuance from emerging markets has slowed and stabilized, to represent about 25% of the total in 2019. In particular, green-labeled issuance from Chinese banks decreased to about US$15 billion from US$20 billion a year before, amid trade tensions with the U.S. In the financial services sector, green issuance from European banks surpassed that of Chinese banks for the first time in 2019, with French banks such as SocGen and Credit Agricole leading the way.

Chart 2

Europe Has Been Leading Green-Labeled Issuance Over The Past Three Years
Green Bond Issuance By Region

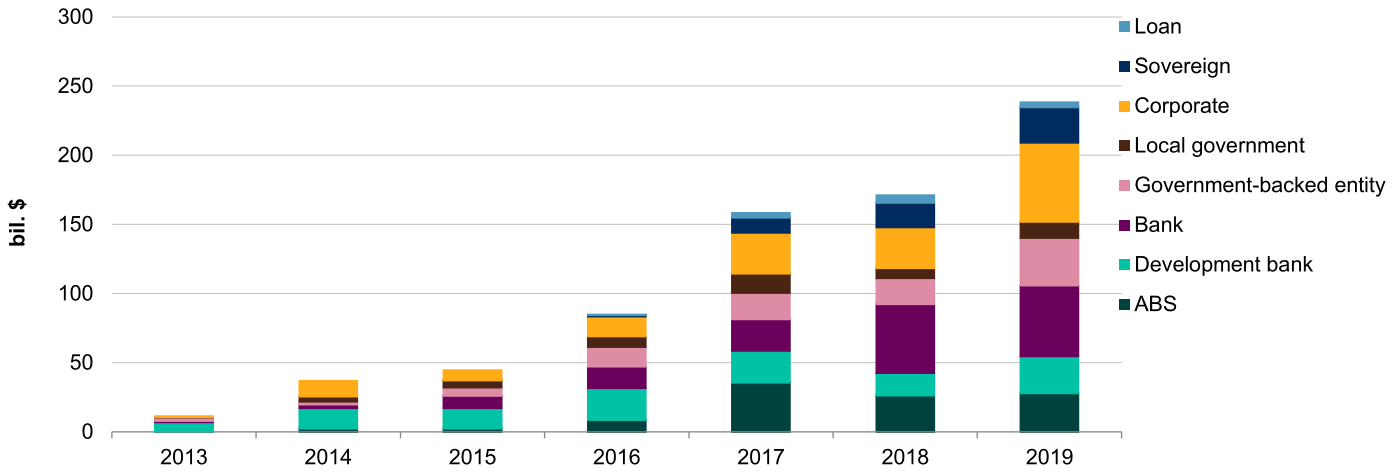


Source: Climate Bonds Initiative.

We expect the private sector to keep on propelling growth, especially if easing monetary policies continue to support favorable credit conditions. Banks and companies represented 45% of new green-labeled issuance in 2019 compared to 1% in 2013 (see chart 3). Corporate issuance almost doubled in 2019, the largest increase compared with other issuer types. New issuers included the Italian-owned solar producer Ergon Peru S.A.C, Japanese material manufacturer Daiken Corp., and U.S. real estate company Host Hotels & Resorts. Banks also played an important role with US$50 billion of issuance last year, in line with 2018. The sector saw new entrants, especially from Southern Europe, including the midsize Italian UBI Banca and the leading Spanish bank Santander. It also saw some market developments in Europe, such as the issuance of senior nonpreferred green notes among some Spanish and Swedish banks, which we believe could help banks comply with their European Minimum Requirement for own funds and Eligible Liabilities requirements while meeting some environmental objectives. European banks also continued to use green covered bonds, which represented about one quarter of their green bond issuance in 2019. We also anticipate insurance companies will tap the green bond market in the coming years, although more slowly than banks, as they seek to demonstrate their commitment to a greener economy in their investment policies. Insurers tapping the green bond market for the first time in 2019 included the French CNP, the Italian Generali, and Swiss Life.

Chart 3

Corporates And Banks Are Driving Growth In Green-Labeled Issuance
Annual Green-Labeled Issuance By Issuer Type

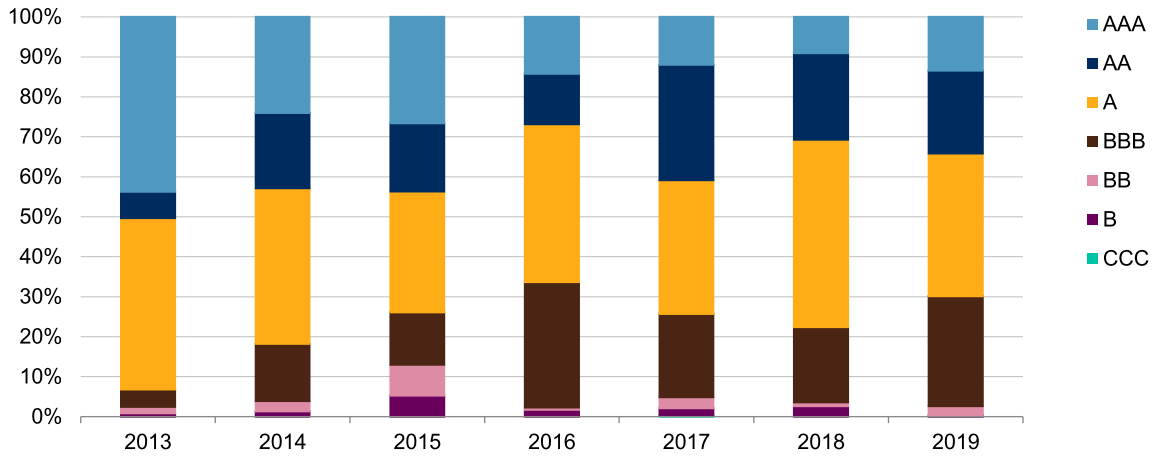


Source: Climate Bonds Initiative.

The relative diversification of credit ratings on green-labeled issuers illustrates the growing contribution of the private sector to the green bond market over the past seven years. The proportion of 'AAA' rated entities has declined to 13% in 2019 from 44%, which we believe partially mirrors the relative decline in issuance from development banks. That said, investment-grade entities continue to dominate the market (see chart 4), which could support its resilience to potentially worse credit conditions beyond 2020.

Chart 4

The Green-Labeled Market Remains Dominated By Investment-Grade Issuers
Green-Labeled Issuer By Ratings Category In 2019



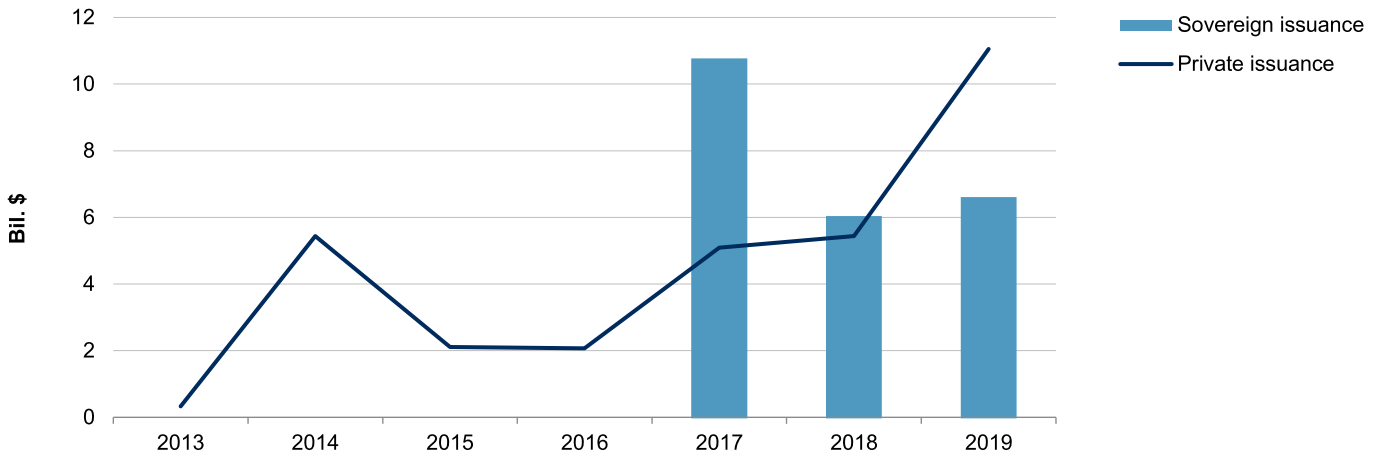
Note: Our sample only includes public issuance rated by S&P Global Ratings. Source: Capital IQ.

We believe public and multilateral issuers will continue to play a role in expanding green financing to less mature technologies and markets, for example by providing hedging and credit enhancement mechanisms to reduce risks for private-sector funders (so-called "blended finance"). In some cases, we believe sovereign issuance could act as a catalyst for private green-labeled issuance. In the case of France, the largest sovereign issuer, private issuance from banks and corporates in 2019 surpassed the amount of sovereign issuance for the first time since the government started issuing sovereign green bonds. The country saw a record number of new private entrants to the green bond market and the largest amount of green bond issuance to date (see chart 5). Green-labeled issuance continued to expand to new sovereign issuers in 2019, including the Chilean, Dutch, and Hong-Kong governments.

Chart 5

Private Green Bond Issuance In France Surpassed Sovereign For The First Time In 2019

Annual Sovereign And Private Green-Labeled Issuance In France

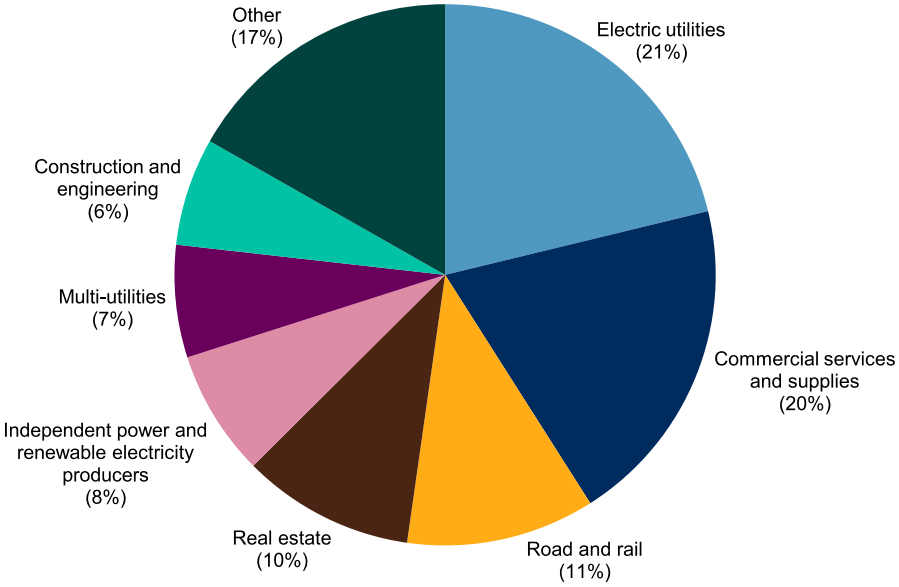


Source: Climate Bonds Initiative.

We expect a majority of the proceeds to remain allocated to the energy transition. In 2019, 80% of the proceeds were allocated to renewable energy, energy efficiency of buildings, and clean transport initiatives. While new sectors entered the market among corporate issuers, it has remained dominated by utilities, real estate, and transportation companies (see chart 6). In our view, this is because those technologies create a direct and immediate revenue stream for investors, compared to less mature technologies in sectors such as agriculture and forestry (see "Could Agriculture And Forestry Be The New Frontier For Green Bonds?", published Dec. 4, 2019). However, this concentration of green financing contrasts with the conclusions from the 1.5 degree Celsius report by the Intergovernmental Panel on Climate Change, which highlighted the need for all sectors of the economy to contribute to climate change mitigation. Also, adaptation financing remains marginal, despite the urgent need to mobilize financing to deal with loss and damage from climate change in the developing world.

Chart 6

Utilities Remain The Primary Sector Of Green-Labeled Issuance Among Corporate Issuers
Corporate Green-Labeled Issuance By Industry In 2019



Note: Our sample only includes public issuance rated by S&P Global Ratings. Source: Capital IQ.

Looking Ahead

The sustainable finance landscape is growing and evolving rapidly, with new financing instruments complementing green-labeled bonds. This will be supported by Europe's unprecedented political push in favor of sustainable finance and green growth, which could eventually percolate to other regions. In that context, enhancing transparency and standardization will remain critical to avoid ESG-washing, solidify investors' confidence, and ensure the credibility of sustainable finance among all stakeholders.

Related Research

- EU Green Deal: Greener Growth Doesn't Necessarily Mean Lower Growth, Feb. 10, 2020
- Sustainable Finance: Equity Content And Sustainability-Linked Hybrids, Feb. 10, 2020
- Credit Trends: Global Financing Conditions: Bond Issuance Is Expected To Grow 3.8% In 2020, Jan. 30, 2020
- COP25: There's Still Life In The Sputtering Climate Change Talks, Dec. 18, 2019
- Could Agriculture And Forestry Be The New Frontier For Green Bonds?, Dec. 4, 2019

- Delays In Addressing Global Warming And The Longer-Term Ratings Implications, Dec. 3, 2019
- Sink Or Swim: The Importance Of Adaptation Projects Rises With Climate Risks, Dec. 3, 2019
- The EU Green Taxonomy: What's In A Name?, Sept. 11, 2019
- Why Linking Loans To Sustainability Performance Is Taking Off, Sept. 3, 2019
- Green Finance: Modest 2018 Growth Masks Strong Market Fundamentals For 2019, Jan. 29, 2019

This report does not constitute a rating action.