GREENIUM—a drop in the yield and spread ocean

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The "Sustainability", "ESG", or "Impact" benefits of investing in green bonds are well known – visibility on where bond proceeds are invested (projects that have a positive environmental impact) and a measurable impact (for example tons of CO2e avoided). These benefits are of course only valid when buying green bonds from issuers with robust and credible sustainability strategies (at the company level, not only green bond level), in particular around climate.

But how about financial returns? After all, green bonds investors also have return objectives, whether private individuals saving for their retirement, pension funds that need to pay benefits to retirees, etc. The concept of "greenium" is often mentioned as a headwind for the green bond market, as a sacrifice of yield that erodes returns over time. Ultimately, looking at the greenium compared to other return enhancing parts of the market, especially through subordinated green bonds of financials (banks and insurers), reflects a very limited impact on returns. Clearly any greenium means a lower return like for like, but how material is the greenium on expected returns?

Greenium

Starting with the basics, the concept of greenium. The greenium is the difference in yield or spread between a green and non-green bond of the same issuer, with the same maturity, same seniority and structure. Green bonds tend to have a slightly lower yield or spread compared to a similar non-green bond – the "greenium". The greenium exists purely because of a supply/demand imbalance, with demand for green bonds largely outweighing current issuance.

The differential or "greenium" is currently around 5bps (0.05%) when looking at the EUR investment grade corporate market, which can be seen as a proxy for the difference in annual performance between green and non-green bonds. This means a theoretical sacrifice of 0.05% per year of performance. Clearly not zero, however compared to the 3.8% annualized total return since June 1998[1] on EUR IG Corporate bonds this impact is arguably marginal.

The greenium is also not a static number. The greemium can vary by sector, geography, issuer, seniority, and most importantly can significantly vary through time. And in some case green bonds can offer higher yields than non-green bonds, a negative "greenium". Taking BNP as an example to illustrate how the greenium may fluctuate through time, the bank's green senior non-preferred bond maturing in 2024 currently has a greenium of roughly zero, which has varied between 8bps (0.08%) and -2bps (-0.02%). The current nil greenium or even 2bps average greenium implies an immaterial give-up in future performance for green bondholders. At the other end of the spectrum, Iberdrola's green corporate hybrids for example currently exhibit a very high greenium, in the range of 20-50bps.

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[1] *EUR IG Corporate annualized total return from 30/06/1998 until 19/05/2022*

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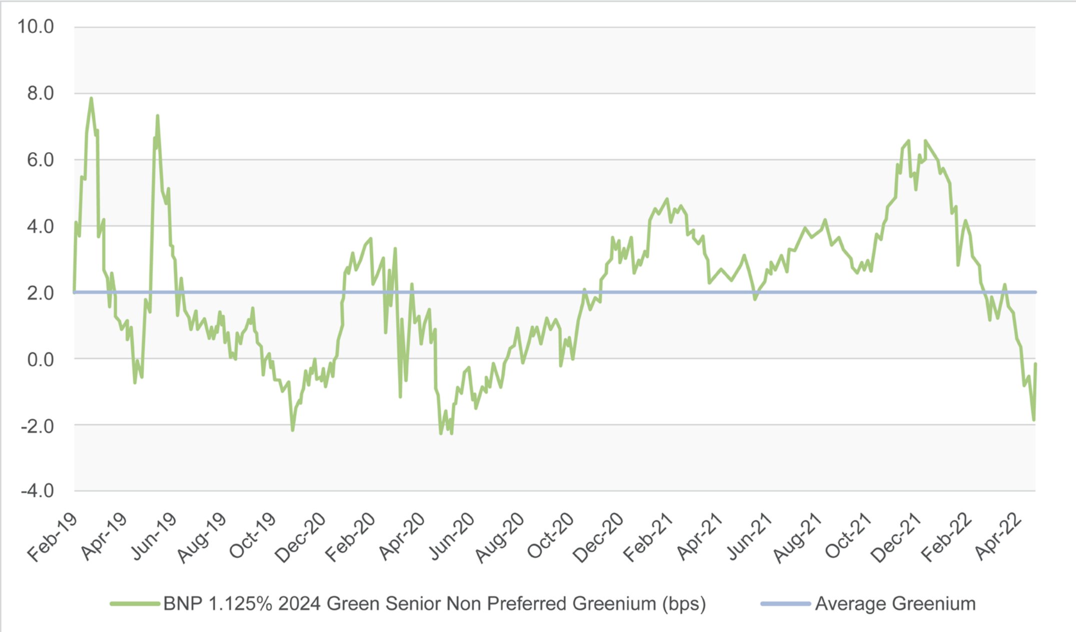
Chart 1: Illustrating the greenium—BNP's senior non-preferred 2024 bond has a historically marginal greenium



Green financials subordinated debt to the rescue

Based on current market conditions, the potential negative impact from the greenium on future returns is limited. On the other hand, pockets of the green bond market offer the ability for investors to enhance yields and spreads. Subordinated debt of financials provides a sizeable pick-up in yield/spread, in a magnitude that relegates the greenium to the equivalent of a drop in the ocean. And that without going down in ratings or extending duration.

Beyond our conviction on European financials from a fundamental perspective and sustainability perspective (as financiers of the transition), financials offer the ability for green bond investors to invest in a range of different green bonds. As issuers of subordinated debt for regulatory purposes, European banks and insurers have been increasingly "greening" their capital structure – essentially issuing green subordinated debt. Banks and insurers have issued close to $10bn USD equivalent in subordinated green bonds in 2021 (out of $50bn of financials green bonds issued), close to double 2020 levels. We expect the trend to continue, with rapid growth of the green subordinated debt market over the coming quarters and years.

For investors, subordinated debt of financials provides an attractive way to enhance yield on risk-adjusted basis. Looking at Investment Grade rated EUR Tier 2 bonds from banks and insurers, spreads of currently c270bps are around 100bps higher than EUR Investment Grade Corporate Non-financials for the same rating and same duration. This means that with the same credit risk and duration risk investors can capture an additional 1% per year of potential returns. As this spread pick-up is based on non-green bonds, fitting the greenium into this equation does not materially alter the attractiveness of Tier 2 – 5bps of greenium compared to 100bps of yield/spread enhancement.

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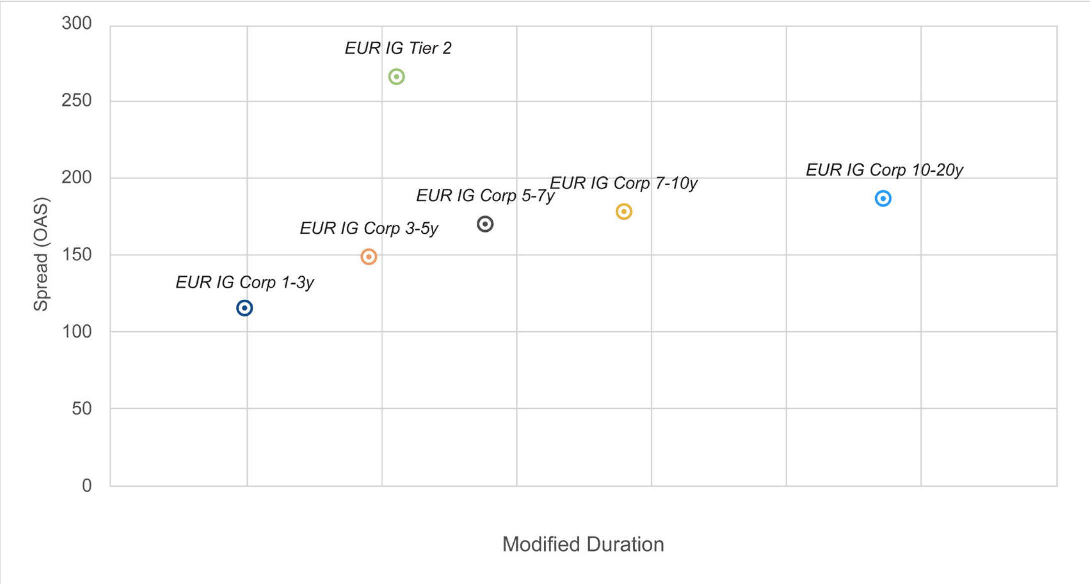
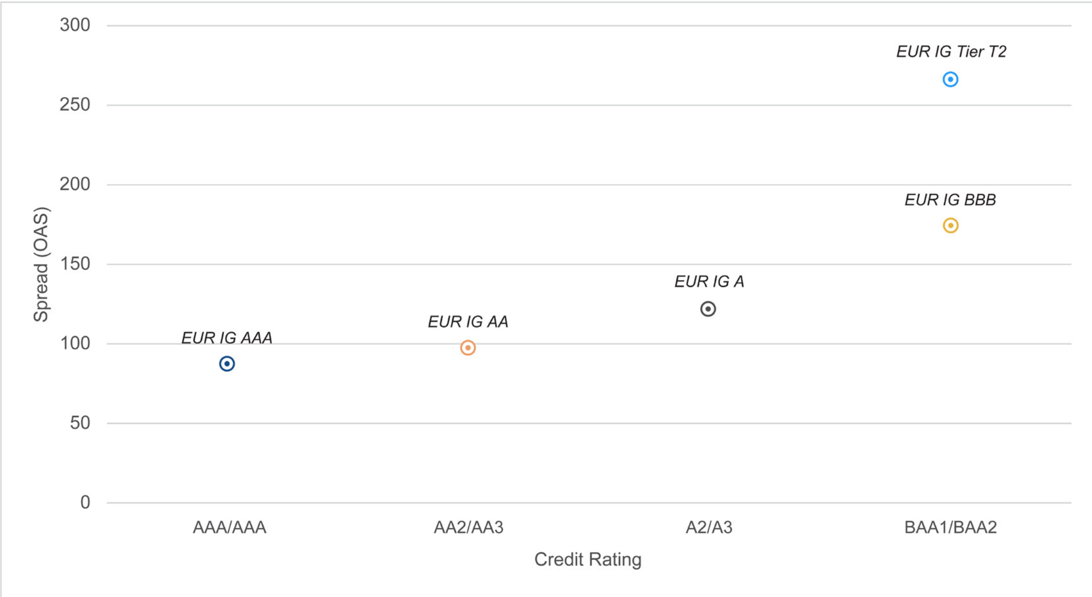
Chart 2: Subordinated debt of financials provides higher risk spreads/yields compared to non-financial investment grade





Over the past decade, the high income captured as a result of higher spreads and yields has led to a significant outperformance of Investment grade Tier 2 compared to investment grade corporates. Over three, five and ten years, Tier 2s have outperformed the EUR investment grade bond market by at least around 1% per year, and by close to 3% per year over the past decade.

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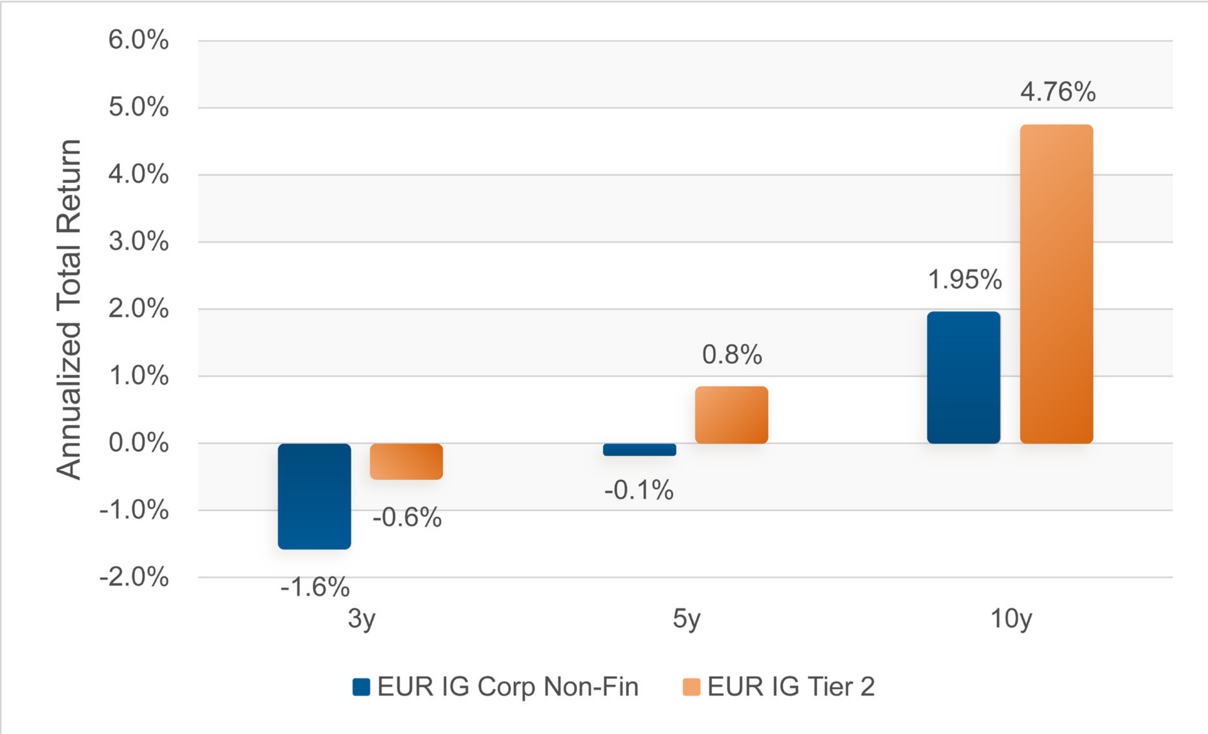
Chart 3: Over the longer term, high spreads and yields have driven significant outperformance of sub debt corporates.



While the analysis refers to non-green bonds (green bonds currently make up a very limited portion of both indices), including a potential greenium of around 5bps would not have made a material difference. To illustrate this, the ten-year annualized total return of the EUR IG Tier 2 index after applying a static 5bps greenium would have been 4.71% compared to 4.76% without a greenium, compared to 1.95% on EUR IG non-financial corporate bonds.

Overall, we view the greenium in the market as a marginal drag on returns, especially in the context of active management. Areas of the green bond market, such as Tier 2 subordinated debt from banks and insurers provide a significant pick-up in yield and spread without compromising on credit or interest rate risk. The magnitude of the greenium is dwarfed by a high spread pick-up for subordination.

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