8.2.23

Bloomberg 8.2.23

Green Bonds Are Making Fewer and Fewer Promises to Investors

In art, green is created by mixing together the primary colors of blue and yellow. In finance, green is created by mixing together a hefty dose of promotion and lax bond documentation. The market for green bonds — or debt meant to finance renewable energy and other sustainability-related projects — has exploded in recent years. But the tide may now be turning for environmental, social and governance investing due to fresh regulatory scrutiny and political opposition. A new research paper from law professors Quinn Curtis, Mark Weidemaier and Mitu Gulati delivers a fresh line of criticism on a global market that's now worth trillions of dollars. It argues that bonds intended to promote green aims often fail to set out specific terms in their contracts that would allow investors to enforce the promises being made by the companies which sell them. And while the sometimes fuzzy pledges of green bonds are well-documented at this point — so much so that they've been given their own term of 'greenwashing' — the study goes beyond the usual parameters to examine the progression of the debt's enforceability over time. The result is a stark depiction of a market that isn't getting better about enforcing environmental accountability as it matures, but one that is instead getting better at avoiding it — at least when judged by legal documentation. "The market has evolved away from, not towards, enforceability," the researchers say. "Increasingly, investors receive detailed disclaimers making clear that issuers are not obliged to use proceeds in any particular way and that investors have no enforcement rights if the issuer does not use proceeds as expected."

The study looks at a sample of nearly 1,000 green bonds sold between 2012 and 2022. While almost all of this debt includes some language that the issuing company intends to use the proceeds from sale towards some ESG-related goal, they almost always lack enforceability.

"Even when the bond includes promissory language regarding the use of proceeds, the promise is effectively unenforceable," the academics write. "In a standard use-of-proceeds green bond, the issuer will promise to invest in projects meeting certain eligibility criteria. However, these criteria typically cover a vast range of vaguely-defined activities." "Ultimately, even if an investor identifies a breached promise — say, the issuer has failed to invest in any projects that could credibly pass as green — there will probably be no recourse. Not one bond in our sample expressly makes it an event of default for the issuer to fail to live up to its green promises. In consequence, the investor has no right to accelerate the debt and walk away from the investment," they say.

Instead, the sellers of green bonds have been packing contracts full of language intended to avoid accountability — for instance by explicitly stating that failure to fulfill green goals would not constitute an 'event of default' (the blue dotted line in the chart above) or disclaiming any duty to pursue green objectives (the solid red line in the same chart). Use of such language has been increasing over time and "what emerges is a clear trend away from enforceability," the researchers say. The lack of enforceability raises the question of just why investors accept it, particularly when green bonds may offer a lower return to investors resulting in an expensive "greenium" (or premium) for buying the debt. Discussions with market participants conducted by the researchers suggest a demand- driven market that has so far had little incentive to enforce ethics.

"Why not just buy a regular bond of the same issuer? The answer was that, in recent years, big investment funds have been instructed by the market either to offer dedicated green or ESG funds or funds with a portion of the assets in ESG-labeled investments," they write. "For some time, demand for such investments has outstripped supply, so that green bonds are in demand even when there is already a comparable vanilla bond by the same issuer available." Ultimately, the researchers say that neither buyers nor sellers of green bonds are incentivized to tighten up the terms of the debt, given that they both benefit from the market's growth. Issuing green bonds can allow companies to fund the pricey transition towards renewable energy at a lower cost, while investors get to enjoy an influx of new money from investors eager to do good in the world (or make returns):

"Green bonds lack enforcement because neither investors nor issuers have strong interests in seeing them enforced. Of course, issuers have no incentives to include more enforcement mechanisms in bond documents than investors demand. But why would green bond investors not seek strong enforcement of green promises? The answer is that green bond investors, while sophisticated, are intermediaries whose interests are not perfectly aligned with those of their beneficiaries. Investment funds care primarily about assets under management. If ESG is a hot sector, then funds will seek to capture those asset flows and the investment management fees that come with them."

Of course, green bonds could still help achieve ESG-related aims even without fully enforceable contracts, as sellers of the debt may be reluctant to take a reputational hit by falling down on their commitments. Still, the lack of enforceability in green bonds when 'normal' debt contracts often run to hundreds of pages of risk factors and specific terms around default, runs the risk of devaluing a space that's been identified as crucial to raising the the hundreds of trillions of dollars needed to effectively battle climate change. "If issuers wish to engage in aspirational cheap-talk about climate ambitions or green projects issuances without incurring liability, they are free to do so in press releases or on the issuer website," the researchers say. "Putting green promises in the bond document ought to mean something."