Insight INVESTMENT

# GREEN BUILDINGS, GREEN BONDS AND GREENWASHING

## INVESTIGATING WHAT MAKES PROPERTIES GREEN – AND THE ROLE OF GREEN PROPERTY BONDS IN RESPONSIBLE INVESTORS' PORTFOLIOS

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BNY MELLON | INVESTMENT MANAGEMENT

# EXECUTIVE SUMMARY

1. Buildings are a significant emitter of greenhouse gas emissions, contributing 38% to total global emissions

2. Green property bonds could help drive positive change in this area and represent 40% of the green bond market over the long term

3. Beware greenwashing by misunderstanding the purpose and scope of green building classifications

4. Engagement is crucial: a green building certificate alone is not enough to prevent greenwashing

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Green property bonds look set to play an increasingly important role in financing sustainable building property developments – meaning analysis of certification standards will need to play a central role for investors.

ANNABEL JENNINGS, ESG ANALYST

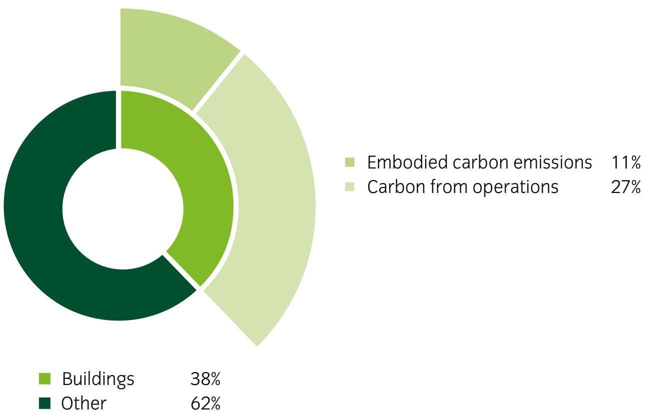
# GREEN BUILDINGS:
# A KEY CONSIDERATION FOR RESPONSIBLE INVESTORS

As investors prioritise sustainability-driven investments, new fronts in the battle against excess $CO_2$ emissions are commencing.

While emissions from energy production remain a primary focus, other sources of greenhouse gases are growing in prominence, in particular from buildings.

Currently, about 38% of overall global GHG emissions originate from buildings[1], with 27% of emissions deriving from the operations of building[2] and the remaining 11% the result of embodied carbon, the GHG emissions associated with building materials and construction (see Figure 1).

**Figure 1: Buildings account for a significant proportion of global GHG emissions (% of total GHG emissions)[2]**




The environmental externalities produced by buildings go beyond emissions. The building industry's utilization of water and other natural resources as inputs into the construction and operation of buildings also produces high environmental costs.

Given the significance of the environmental outlays associated with buildings, regulatory authorities in several jurisdictions are unsurprisingly seeking to reduce the size of the building sector's environmental footprint. For example, as part of its net-zero commitments, the European Union is aiming to reduce the industry's emissions by 60%[3].

The imposition of such targets helps to align buildings with a net-zero future. Consequently, access to appropriate financing mechanisms to aid the transition will become increasingly imperative. Green financing represents such a mechanism.

[1] New report: the building and construction sector can reach net zero carbon emissions by 2050, September 23, 2019, World Green Building Council.
[2] Sector by sector: where do global greenhouse gas emissions come from?, September 18, 2020, Our World in Data.
[3] Greenhouse gas emissions from energy use in buildings in Europe, December 14, 2021, European Environment Agency.

# GREEN FINANCING:
# RESPONSIBLE INVESTORS CANNOT IGNORE GREEN PROPERTY BONDS

Green financing typically involves raising capital to finance, or refinance, environmental projects. For the building sector, this means issuers can use the proceeds of green financing to enhance the sustainability of existing properties, or invest in newer, more efficient buildings, thus creating the capacity to rotate from existing, less sustainable developments.

## THE IMPORTANCE OF GREEN PROPERTY BONDS FOR INVESTORS

As awareness of sustainability focussed property developments has increased, demand for green finance has surged, and the supply of green bonds with 'use of proceeds' frameworks targeting green buildings has grown significantly[4]. According to the Climate Bonds Initiative, green bonds linked to buildings could represent 40% of the green bond market over the long term.[5] By monetary value, issuance of green bonds linked to green buildings approached US$166bn during 2021[6] (see Figure 2), while the cumulative value of green property bonds issued since 2014 amounts to US$512bn (see Figure 3), over 27% of total issuance.

Clearly, the growth in the market for green property bonds has exploded in a relatively short timeframe, reflecting the momentum of the sustainable fixed income investing more broadly. However, such surging growth poses one potentially significant issue for fixed income investors: the trajectory of green property bond issuance means the sector will soon account for a sizeable proportion of the green bond market. For investors, obtaining clarity on the destination and use of a given green property bond's financing is central to maximising the potentially positive environmental effects that could accrue from providing finance to the sector.

Figure 2: Use of proceeds bonds issued by sector (total US$bn)[6]

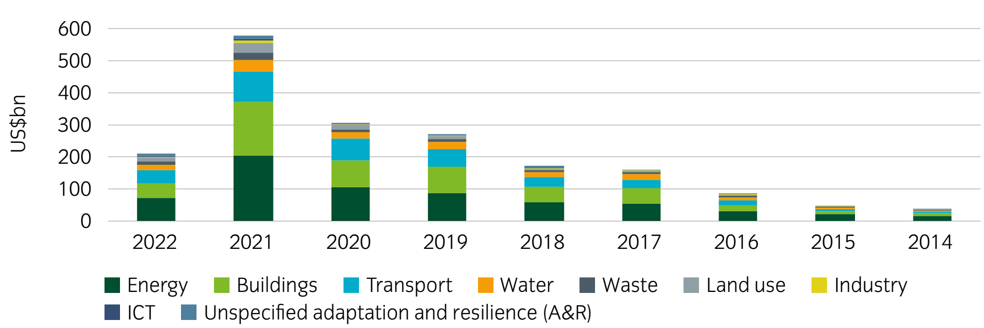
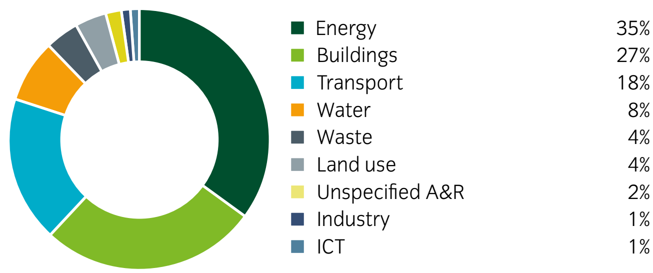



Figure 3: Use of proceeds bonds outstanding (cumulative value by sector, US$bn)[6]




[4] A green bond is a bond where the issuer specifies that the capital (proceeds) it receives from investors will be used to finance activities which have a positive environmental impact.
[5] The Building Criteria: Climate Bonds Standard, Climate Bonds Initiative.
[6] Source: Climate Bonds Initiative interactive data platform, as of June 30, 2022.

# DEFINING 'GREEN' IS CRUCIAL

In our view, for investors seeking transparency regarding a green bond's use of proceeds, understanding the underlying characteristics of a 'green building' is vital. According to the World Green Building Council a green building is "a building that in its design, construction, or operation, reduces or eliminates negative impacts, and can create positive impacts, on our climate and natural environment"[7].

It identifies several features that distinguish a building as 'green', including:

- Efficient use of energy, water and other resources
- Use of renewable energy, such as solar energy
- Pollution and waste reduction measures, and the enabling of re-use and recycling
- Good indoor environmental air quality
- Use of materials that are non-toxic, ethical and sustainable
- Consideration of the environment in design, construction and operation
- Consideration of the quality of life of occupants in design, construction and operation
- A design that enables adaptation to a changing environment.

## BEWARE GREENWASHING

Given the apparent receptiveness of investors to green bonds, considerable commercial benefits can accrue from marketing a project as green, potentially incentivizing 'greenwashing' – exaggerated claims regarding the environmental sustainability. Consequently, several industry certification standards have arisen, designed to effectively mobilize capital to suitable investments and assure investors about any bond's use of proceeds.

However, the relative opacity and multiplicity of the certification standards poses a risk for investors. The sheer number of attributes qualifying a building and any related bond issue as 'green' may lead to greenwashing. Likewise, whether the level of certification targeted by a specific bond issue is wholly appropriate for a green label is open to question, given the variety of companies involved in different building types.

## BEWARE THE DIVERGENCE OF CERTIFICATION STANDARDS

In addition, each certification scheme uses a different methodology to certify whether a bond issue related to a real estate development can be considered as 'green'. Thus, depending on the certification scheme utilized, two ostensibly green buildings may possess divergent features.

Moreover, the criteria listed above are often decided at the point of a building's construction, which means the greenest buildings are generally purpose built as such. By contrast, improvements made to a property through a process of refurbishment may struggle to attract the highest certification due to legacy issues.

## INDEPENDENT ANALYSIS IS A MUST

Therefore, an appropriate assessment of the sustainable credentials of any green financed building or project, requires an analysis of each standard's specific screening criteria and its application to different construction projects. Only by comparing each green building standard can investors fully understand if a certification level can produce a meaningfully positive environmental impact.

[7] About Green Building, World Green Building Council.

## UNDERSTANDING WHAT DRIVES A GREEN BUILDING CLASSIFICATION IS A NECESSARY STEP

There are a variety of classification schemes used to validate a proposed project's sustainability. Among the most prominent are the global Building Research Establishment Environment Assessment Method (BREEAM) standard and the US Leadership in Energy and Environmental Design (LEED) designation.

Some commonality exists across both standards: LEED and BREEAM assess a building's environmental impact holistically by considering (amongst many other characteristics) water use, the types of materials utilized in construction and land use.

However, there are significant differences in measurement, scope and application (see Figure 4). For example, 35% of the credits for every LEED assessment relate to climate change, 20% to a building's impact on human health and 10% to biodiversity. Meanwhile, the BREEAM standard utilizes a much more fluid scoring system; the weighting applied to each area of assessment depends on the project in question.

Additionally, developers can choose to comply with or discard specific areas of a BREEAM assessment to build a performance total, a fact not immediately evident within a headline BREEAM score.

Figure 4: Overview of BREEAM and LEED standards

| Category | BREEAM | LEED |
|---|---|---|
| Purpose | Used for new, refurbished and extension of existing buildings | A certification system for residential and commercial buildings |
| Rating Levels | • Pass<br>• Good<br>• Very Good<br>• Excellent<br>• Outstanding | • Certified<br>• Silver<br>• Gold<br>• Platinum |
| Areas of assessment | Management<br>Energy<br>Land use and ecology<br>Pollution<br>Transport<br>Materials<br>Water<br>Waste<br>Health and wellbeing<br>Innovation | Energy and atmosphere<br>Sustainable sites<br>Location and transportation<br>Materials and resources<br>Water efficiency<br>Indoor environmental quality<br>Innovation in design<br>Regional priority |

Given such differences, we believe any green bond focusing on green buildings requires close scrutiny to ensure any classification meets an investor's expectations. Identifying the appropriateness of each rating threshold within a certification scheme adds another layer of complexity to any appraisal of green bond issue.

Insight's framework for assessing green and other use-of-proceeds bonds aims to highlight whether we believe such a bond fulfils sustainability expectations – with a dark green rating highlighting a bond as best in class, a light green rating highlighting a bond as meeting sustainability expectations, and a red rating highlighting a bond as falling short – meaning that while it might be appropriate for investment from a financial perspective, portfolios with sustainability strategies may be prohibited from investing.

### Digging deeper: understanding BREEAM and LEED standards

Insight has analyzed the BREEAM, LEED and EPC standards for green property bonds and considered how different classifications might contribute to our assessment of a related green bond (see Figure 5).

We believe the higher-rated BREEAM, LEED and EPC certification levels represent the most desirable qualifying thresholds for a bond issue to receive a light green or dark green rating (our two highest ratings) in our impact bond assessment framework. We encourage issuers to pursue the highest green building certification standards.

However, we believe that some of the lower-rated certification levels from BREEAM, LEED and EPC are not appropriate for green bonds because they provide insufficiently positive environmental or social benefits, contrasting with the impression conveyed by the label 'green'.

Figure 5: How Insight views appropriate certification levels for green bonds – BREEAM and LEED[8]


## ENGAGEMENT IS KEY: A GREEN BUILDING CERTIFICATE ALONE IS NOT ENOUGH

Scrutinizing the nuances that underlie each certification standard provides a sound basis for investors to understand the attributes of a building, but to truly understand the positive environmental impact delivered by a green bond, further engagement with issuers can be enlightening.

Examining why issuers have selected a specific green building certification scheme, and their rationale for aiming for a certain classification, are a natural starting point for investigation. Likewise, establishing what percentage of a given company's portfolio possesses green building certifications, its net zero targets, and the issuer's specific plans to manage and mitigate ESG risks associated with buildings, are all legitimate areas of enquiry.

[8] Source: Insight Investment, July 2022. For illustrative purposes only. Insight's impact bond assessment framework takes multiple factors into account before assigning a rating.

Pertinent questions might include:

- Why have they selected the specific green building certification?
- What percentage of the company's portfolio has a green building certification? What is the percentage breakdown for different ratings? What is the percentage breakdown of ratings in the portfolio of buildings linked to the green bond?
- Will the green bond's proceeds be used for capital or operational expenditure? Will proceeds be used just for the green capital expenditure?
- Do they have policies in place to encourage tenants to use buildings in an environmentally friendly manner?
- Do they have a target to achieve net-zero emissions by 2050? If so, how will they ensure all buildings in the relevant portfolio are aligned?

While the list above is not exhaustive it represents a starting point for investigating an issuer's rationale for issuing a green property bond and serves to mitigate the risk of investing in a greenwashed bond issue.

## CONCLUSION

As regulatory authorities globally increase their focus on reaching climate targets, reducing the environmental impact of buildings will become a crucial lever in meeting that aim. As a result, green property bonds look set to play an increasingly important role in financing sustainable building property developments, and we believe effective certification standards will only increase in prominence.

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