

CLIMATE CHANGE

GREEN FINANCING

Green bonds have been growing in popularity, a trend that could be bolstered by the widespread attention given to Pope Francis's environment encyclical and the looming global climate talks in Paris. But what exactly is a green bond? Who determines for investors if something qualifies? And what role might the United Nations play in answering those questions? Daniel Rossetto of Climate Mundial, whose work includes advising clients on such investments, takes a closer look at the state of green bonds.

Potential Role for UN in Setting Standards for Green Bonds Ahead of Paris Talks

DANIEL ROSSETTO, CLIMATE MUNDIAL LIMITED

I. Introduction

Green bonds are a new and exciting industry forming around the need to finance climate-friendly investments as we move into a world where sustainable development is an ever-increasing priority.

According to Christiana Figueres, executive secretary of the United Nations Framework Convention on Climate Change, the green bond market was worth \$35 billion in 2014 and is estimated to reach \$100 billion by the end of this year. While not much of this capital is yet

flowing into less developed countries, the potential increase in this area does exist.

At the same time, the market faces an existential threat, arising from its reluctance by the industry to define what constitutes an eligible use of proceeds—leading to concerns from some quarters of these specialized bonds being little more than “green wash”—merely claiming to be environmentally friendly—and not doing much to change the course of business-as-usual practices.

In parallel, governments of the world are grappling with the terms of a new global climate agreement to be finalized in Paris later this year.

North-South Finance. One of the critical elements in determining whether a deal will be possible is if developed countries can follow through on a promise to less developed nations to contribute \$100 billion a year in so-called north-south climate finance—money flowing from the rich nations to developing parts of the world—from 2020.

This laudable climate finance target, however, faces an enormous battle if it is to be funded mainly through public treasuries.

Daniel Rossetto is managing director of Climate Mundial, a dedicated climate finance and carbon markets advisory firm based in London.

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The battle will arise because developed country governments, almost universally, are struggling to deal with unsustainable budget deficits. The problem is so acute that many countries are now reliant on their central banks, through quantitative easing programs, to maintain the solvency of public institutions.

We were reminded in May of how difficult the task of raising \$100 billion a year will be. The UN Green Climate Fund, following a lengthy period of uncertainty, announced that it had become operational with contribution agreements of \$5.47 billion now in place.

While this is an encouraging signal, the contributions so far amount to a one-off advancement of capital that is just over 5 percent of the required annual amount.

Could it be, therefore, that these two parallel areas of endeavor could actually help each other to achieve a sustainable way forward? I certainly think so, and I would like to spend a few moments to explain how this is so. Let us start by looking more deeply at green bonds.

What Are Green Bonds? The concept of a green bond is very sound. You allow an entity—for example, a corporation—to issue a debt-based security for sale to the institutional investment market to raise money to finance—or refinance—a portfolio of investment projects capable of delivering a real and measurable environmental benefit.

Issuers enjoy the benefits of green bonds as they attract more interest from investors and, perhaps, a lower cost of capital in time leading to competitiveness gains. There is also the promise of recognition that their business activities are making a positive impact.

Investors gain a financial return from purchasing the debt securities, but through green bonds they can simultaneously obtain more detailed information about an issuer's business activities, as well as boost its own support for environmentally sustainable business practices.

Even more important, if green or climate-themed bonds lead to new and additional forms of sustainable development, as we would hope, the communities and countries the investments serve will benefit from cleaner energy, less pollution, a more climate-resilient future, and so on. On the surface, this industry looks absolutely fantastic.

Potential Risks. As it happens with almost anything, if everything appears great there must be a catch—and green bonds are no exception.

There is a significant risk in the background. This is not the kind of normal risk profile one might expect of fixed income investments—say for example, the credit quality of the issuer and the risk of their default. It is an even more serious risk that is orders of magnitude more difficult to see and harder, if not impossible, for industry participants to manage on their own.

What would happen, for example, if an issuer were accused of issuing a self-labeled green bond, but the investment projects it implemented did nothing to change

the business-as-usual level of environmental impact? In other words, the issuer did nothing to change the normal course of business and simply labeled its bond as green because it sounded nice?

This is not to say that green bonds are, in fact, a green wash. It is merely a recognition that we, in the public domain, simply do not have enough detail about how green bond eligibility was determined and whether anyone can prove that the use of proceeds constitute a genuine departure from business-as-usual practice.

Would the issuer and underwriters be able to survive the reputational impact if this claim were to be made by a third party, such as an organized environmental lobby group, in a very public way and they were not able to produce a strong enough argument to counter that claim?

Would an investor be within its rights to claim the qualities of the bond may have been misrepresented at the time of sale?

The 'Green Bond Principles.' The reality with green bonds today is there is no single and legitimate authority setting eligibility requirements; authorizing the labeling of bonds; and establishing protocols for ongoing measurement, verification and reporting related to green elements of the bonds and their use of proceeds.

Indeed, in a 2014 report, Bloomberg New Energy Finance concluded that most green bonds being issued in the market were, in fact, self-labeled.

Perhaps fully aware of the absence of such an authority, and with the interests of the whole industry in mind, a group of issuers, underwriters and investors, under the auspices of the International Capital Markets Association (ICMA), established a program in early 2014 to develop the so-called Green Bond Principles.

The principles are an important step, and a step in the right direction, though they remain largely silent on the all-important technical details on items such as eligibility—often referred to in the sector as trying to define “What is green?”—that could help to mitigate the risks mentioned earlier.

To illustrate this, in the case of a bond themed around climate mitigation, the Green Bond Principles do not offer sufficient guidance to would-be issuers as to how to develop a baseline of greenhouse gas emissions, or how to measure and verify investment performance against that baseline.

Other leading voices in the market, such as the Climate Bonds Initiative, are developing their own sets of green bond standards, though questions remain about the universal acceptance of those standards across the public and private sectors—or the public in general.

Indeed, at the first annual meeting of the Green Bond Principles in London this March, there was healthy debate on these topics but no firm conclusions were possible.

Perhaps the most notable aspect of the event was nobody from any of the United Nations institutions, namely the Climate Change Secretariat, the UN Framework Convention on Climate Change Standing Commit-

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tee on Finance, or the Green Climate Fund, was in attendance.

UN Climate Talks. Two key facts regarding the United Nations appear to have escaped the attention of mainstream participants in the green bond market.

The first is it is the UN that has carriage of the international effort to identify and oversee the \$100 billion in north-south climate finance a year needed to allow developed countries to meet their commitments ahead of the Paris climate summit this December.

As mentioned earlier in this paper, the task of raising \$100 billion a year through public treasuries is gargantuan and occurs at precisely the moment when developed country governments have least financial capacity to raise such funds. According to the Green Climate Fund's Executive Director H ela Cheikhrouhou in an e-mailed statement to Bloomberg News in April, "Climate finance and the Green Climate Fund are a decisive building block of the Paris universal climate agreement."

This implies that developed country governments really do need to demonstrate exactly how they will deliver \$100 billion a year in north-south climate finance.

Only this will allow creation of the level of trust that will facilitate agreement on other crucial elements such as mitigation targets and the use of market mechanisms such as emissions trading.

The Private Sector. Therefore, if climate finance is this integral to a robust UN climate deal in Paris, then developed country governments will certainly need the private sector. This area is clearly, therefore, one in which the green bond industry can help deliver a deal in Paris.

The second fact is that the United Nations Climate Change Secretariat has over 10 years and 7,500 plus projects' worth of experience in administering international systems for approving, measuring and verifying carbon reduction benefits—on a project-by-project and programmatic basis—through its sustainable development mechanisms function.

Even more appealing, the projects accredited with the UN are generally located in less developed countries, meaning that investors seeking strong development benefits from their capital allocations will likely be attracted. This kind of investment would be north-south in nature, providing additional much needed capital for low carbon development.

As a global standard-setting body in the area of climate change mitigation, the UN really has no peer. Perhaps the only real criticism that could be made of the UN's processes for determining eligibility, establishing

baselines, allowing for stakeholder consultation, assessing additionality, or measuring and verifying carbon reduction benefits, is that they are too complex.

With that said, concrete initiatives are in place within the UN to simplify the process—such as the introduction of standardized baselines for whole countries and regions—while not compromising the environmental integrity of its methods. As a consequence, this should not really represent a barrier.

It is also difficult not to be attracted to the legitimacy of a brand such as the UN in an international context where some form of leadership is needed on answering the question of "What is green?" Certainly the UN should be in the best position to answer the question of "What is a climate mitigation benefit?" And we can build from there.

It follows, therefore, that the UN and its institutions ought to be able to provide the very guidance and legitimacy the green bond industry seems to so desperately need.

Paris Expectations. What can we expect from the Paris climate deal? The United Nations climate summit, referred to as COP-21, to be held in Paris later this year is an important moment for business as much as it is for governments and their citizens across the world.

The business community is still nursing the scars of having believed too strongly that a similar UN conference held in Copenhagen in 2009 would deliver a concrete, legally binding agreement to tackle climate change, which could become a basis on which to invest in climate-resilient projects and companies.

It is therefore with some reservation that the private sector observes the buildup to this year's event in Paris. The basis of any great deal is that the parties first recognize that they need something.

Then the parties identify others that have what they need and are willing to offer that to the other. The negotiators must finally then be willing to sit down and agree the terms to allow prosperous cooperation to take place that is in everyone's interests. There is an unquestionable alignment of interest here between both governments and business.

Via the UN there appears to be a solution, provided both sides are willing to work together and engineer an outcome. With the Paris climate summit fast approaching, this may all be arriving at just the right time.

The 2014 Bloomberg New Energy Finance report on green bonds is available at <http://about.bnef.com/white-papers/green-bonds-market-outlook-2014/content/uploads/sites/4/2014/06/2014-06-02-Green-bonds-market-outlook-2014.pdf>.