Konrad Adenauer Stiftung

CLIMATE REPORT 2017

PRIVATE SECTOR AND CLIMATE FINANCE IN THE G20 COUNTRIES

ABOUT THE REPORT

The G20 countries comprise two thirds of the global population as well as more than three quarters of the world's economic output, trade and CO_2 emissions. Climate change is on the G20 agenda as a central future issue, also as an economic and fiscal challenge because corresponding investments from the private sector are a prerequisite for the fulfilment of the Paris climate protection goals. Our latest Climate Report, which continues the series from 2007, 2011 and 2014, provides answers to the question of how far the private sector plays a role in climate financing in the G20 countries.

EUROPEAN UNION

Green bonds – vanilla bonds with their proceeds earmarked for green initiatives – can potentially deliver significant financial flows for climate change action. Collectively, the EU and China are the largest issuers of green bonds. Despite this attribute, the growth of the green bond market in Europe is still inhibited by definitional and standardisation issues. However, policy support for green bonds is strong in the EU which suggests that there is potential for the scaling up of the market.

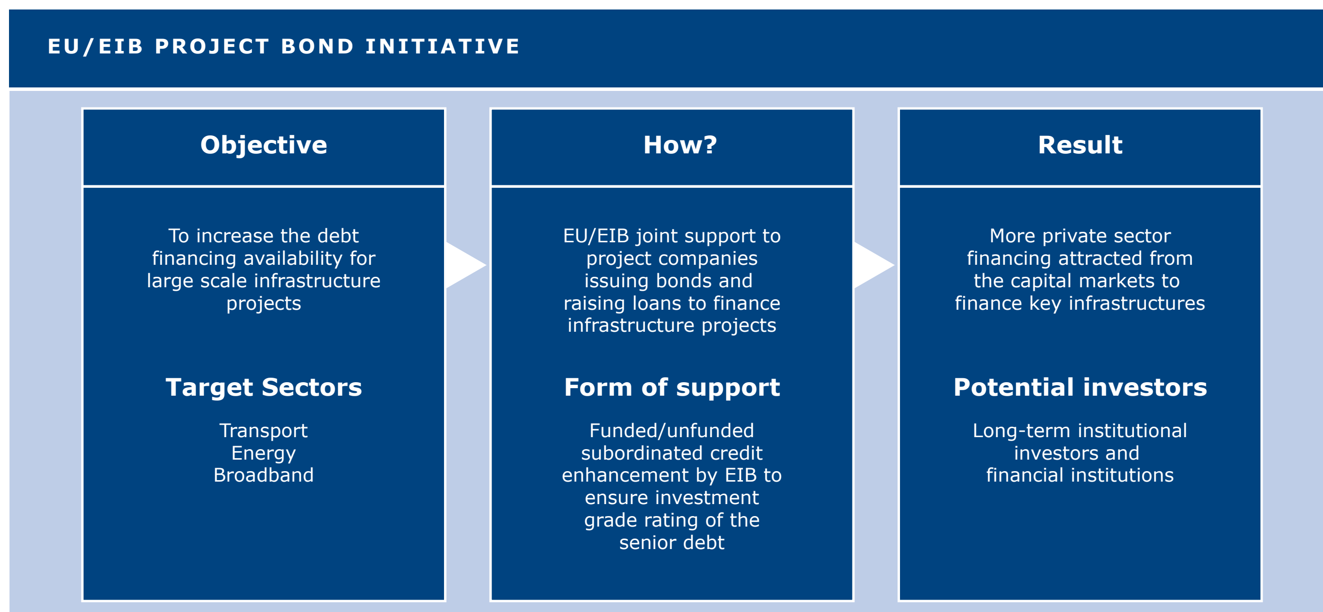
There is still no common standard for green bonds in the EU. © Source: ilolab, AdobeStock

BACKGROUND

Given the significant investment needs to realign the global economy with a low carbon climate resilient future, financial flows will be required from all sources, including both public (government) and private (commercial) actors. According to the International Energy Agency (IEA), aiming to limit temperature increase to two degrees Celsius, investment in low-carbon power generation would need to increase by a factor of three while energy efficiency would need to increase by a factor of eight – a cumulative investment of 53 trillion US dollars by 2035. This represents, between 780 billion and 2.3 trillion US dollars by 2020 and 2035, respectively, in annual low-carbon infrastructure investment, and cumulative investment of 53 trillion US dollars by 2035.

Financial innovation and the development of new green investment products will be vital in meeting the infrastructure financing gap. Green bonds – "plain vanilla bonds" with proceeds used for green initiatives – are an example of a promising financial innovation that enables proactive climate investment strategies. The green bond market has grown substantially in recent years. In 2015, the amount of labelled green bonds increased to 42 billion US dollars from 37 billion in 2014. As per July 2016, the labelled green market stood at 118 billion US dollars while the unlabelled climate-aligned bonds equalled 576 billion US dollars. Despite this booming growth, green bonds remain only a small fraction of the total bond market, approximately 0.1 percent.

Standards ensure that the proceeds from green bonds are used for green projects with measurable green benefits. Although



Source: Barrett 2012

there is no internationally accepted standard of green, the Green Bond Principles provide voluntary guidance and external environmental reviews are becoming best practice. However, these practices vary by issuer and by region, raising a risk of "green-washing" that could deter some investors. "Green-washing" in the context of green bonds refers to bonds labelled as green but the proceeds are allocated to projects that possess little or questionable environmental integrity. Approximately 40 percent of green bond issuances are self-labelled green, i.e. the issuer does not use an independent external review but determines what is green with no external environmental quality checks.

THE GREEN BOND MARKET IN THE EU

Some green bond thought leaders have suggested that the European market be standardised through the implementation of a European Green Bonds Standard. Standardisation is a critical issue in all green bond markets, including the EU. It may be more advisable for European actors (supported by the G7 or G20) to first increase transparency on green bond definitions as it must be recognized that one standard does not fit issuers and investors in all regions. A comparison of external reviewers and implied definitions in green bond funds, indices, and securities market listings could guide issuers and investors alike in green bond decisions.

Kidney and Sonerud (2015) also suggest that EU policy makers could support the expansion of green asset backed securities (ABS) which are defined as green bonds backed by pools of loans or other revenue generating assets. Green ABS make it easier for banks to make green investments as banks can get loans to green projects off their balance sheets. The Climate Bonds Initiative states that there is policy support for securitization in the European Commission and the European Central Bank. Lastly, ABS can further support the Europe 2020 project bond initiative by the European Investment Bank (EIB) which targets increased reliance on bond financing at the project level.

EXPERIENCES AND CHALLENGES IN THE GREEN BOND MARKET

This risk-return of green bonds must be more attractive to institutional investors than the risk-return of vanilla bonds. The public sector can also play a role in de-risking green bonds to attract a broader investor pool. There are various instruments that can be used by the public sector to provide credit enhancement including guarantees, sub-ordinated debt or equity, insurance and political risk insurance. The World Bank and the IFC were pioneers in creating the green bond market, issuing 8.1 million US dollars and 3.4 million as per July 2016, respectively. The strong credit ratings (AAA) of development institutions allow them to introduce green bonds to institutional investors without significant levels of credit risk making them more attractive, particularly in emerging economies.

For issuers, there is a general lack of awareness of the additional requirements and transaction costs in issuing a green bond versus a traditional bond. The voluntary Green Bond Principles are interpreted in different ways by different issuers. There are many external review providers with different approaches. Some issuers already have a strong capacity for environmental impact reporting, e.g. multilateral development banks, whereas others are just starting to consider the environmental impacts of their operations and products. Increased transparency and guidance on steps to issue a green bond could support increased issuance, especially by corporations.

For investors, transparency on environmental impacts can help guide financial decisions. The Task Force on Climate-Related Financial Disclosures convened by the Financial Stability Board recommends disclosure of potential impacts of climate risk for companies and financial organisations. This provides strong impetus for financial decision-makers and companies to seek information on climate risk. A useful framework for green bond assessment is the Shades of Green approach used by CICERO,

an external reviewer, which allows for a transparent comparison of green bonds as to how well they support a low carbon climate resilient future. A broader application of such an approach across the green bond market could raise the level of publically available climate risk information to a broad set of investors.

CONCLUSION

Globally, European and Chinese issuers make up the largest portion of the climate aligned bond market. In Europe, France and the UK are the biggest issuers. Despite the growth of the Green Bond market in Europe, capacity building and awareness raising is still needed to diversify the pool of actors. Such initiatives could be directed at institutional investors and potential issuers to elaborate on potential green project types and climate risk while attracting actors who are not familiar with green bonds. Political groups including the G7 and G20 could further strengthen the case for such initiatives.

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