Climate Bonds INITIATIVE

Mobilizing Bond Markets for the Low Carbon Transition

An 8 point plan

We need a FAST transition; the emissions horse is about to bolt and we have yet to significantly deploy solutions that will allow us to rein it in.

The needed climate change solutions will require a lot of investment. The International Energy Agency (IEA) estimates that, worldwide, $1 trillion of investment in energy, transport and building sectors are required each year above business as usual[1]. According to the UN Environment Programme, if the sustainable management of natural resources such as forests, fisheries, agriculture and water is included, an average additional annual investment of $1.3 trillion is required out to 2050.

Public sector balance sheets are, to say the least, constrained. The bulk of the money is going to have to come from the private sector, in particular from the $75 trillion of assets under management by institutional investors.

This is possible to achieve. Investments in climate resilient infrastructure, from renewable energy to energy efficiency, typically involve high capital expenditure that creates secure and predictable long-term assets — very close to what pension funds and insurance investors are looking for.

Investment in these assets have so far focused on equity; but bonds are a great funding instrument for such high capex, long-life projects. On top of that we are, in the light of the crash of the past few years, entering the Age of Bonds. Institutional Investors have realised that high returns in equity can be illusory and have been busily shifting across to the bond market; that market is now worth $78 trillion[2] compared to $53 trillion for equities, the reverse of a few years ago.

Climate Bonds, asset-backed or ring-fenced bonds issued to raise finance for climate change solutions, have been developed as one means of tapping that market.

But funds are still not flowing; how do we get some action? Here are 8 steps:

1. To create deal flow, think big.

Investors say there are simply not enough big deals on offer — bond markets want deal flow lumps of half to one billion dollars and investors will only buy if there's going to be liquidity as a result of large volume issuance. Which means the bigger the opportunities the more investors will be interested.

In equities this is beginning to change, with landmark deals such as PensionDanmark's recent acquisition of a huge offshore wind farm from Dong energy. Bond opportunities remain few.

One of the big challenges is that both the renewable energy and energy efficiency markets are much more disaggregated than traditional energy sectors with many small projects. Bond investors need scale; those smaller projects need to be aggregated into larger offerings suitable for the appetite of the big investors.

Banks providing project finance are having to recapitalise, a process that is going to happen with even more vigour as new Basel III regulations come into force. That means they are curtailing their smaller business and project lending, and will squeeze even more in the future.

Other players, like utilities and governments, are similarly constrained in their financing capacity.

If banks and utilities are to be major players in growing the Climate Economy, we need them to change their focus. They need to be project developers and financiers, dealing with the upfront risks of setting up new energy infrastructure.

Once they've done that they should be flipping what will then be low-risk assets and loan portfolios into the calm waters of the institutional investor ocean, using equity and asset-backed security offerings, and aggregating smaller offerings to do so as well.

[1] World Energy Outlook 2011. www.iea.org

[2] Data compiled by the Bank for International Settlements (BIS) indicates that the size of the global debt securities market (domestic and international securities) was $78 trillion at Dec 2012. Governments account for 49% of this, financial organizations 39%, and non-financial corporations 12%. Prior to that BIS had said the bond market was worth $100 trillion. However, in Dec 2012 they published a paper saying they'd uncovered problems in their methodology that had led to double-counting, and had revised the global figure down some $20 trillion!

Governments may have to kick start this process. Connecticut and Pennsylvania, for example, are setting up warehouses to buy up energy efficiency loans and securitise them. The UK Government is working with financiers to set up a "Green Deal Warehouse". These aggregation facilities need to be big, and we need them everywhere. The same lesson applies with applies to wind farms.

But post-crash, the securitisation market is on life-support and the appetite for exposure to renewable energy assets is low. Apart from government getting the new regulatory environment right, to revive it we're going to have to take investors on a journey of understanding.

Bond investors need scale; those smaller projects need to be aggregated into larger offerings suitable for the appetite of the big investors.

The Climate Bonds Initiative has developed a mechanism for issuing "asset-linked" corporate climate bonds. These are fully backed by corporate treasuries but report on the performance of the underlying asset as part of the package. Institutional investors have expressed strong interest in this style of debt. Five of the world's largest insurers, for example, publicly called in December for more aggregation, and for standardisation of products as climate bonds[3].

The corporate climate bond market can then be developed with partial treasury guarantees, ensuring that investment grade ratings are maintained, until investor and market maturity allow the development of a fully asset-backed market.

2. Engineer investment grade offerings.

When institutional investors say "big deals" they mean *low risk* big deals.

For better or worse, the yield curve in the bond market is not going to change — the demand is for investment grade, although BBB, A and AA will do just fine.

As most people in the renewable energy field would appreciate, ratings agencies persist in over-estimating policy and resource risks for renewables, while under-estimating the carbon penalty risk for coal and oil companies.

Until there is a longer track record for at-scale renewable investments to counter perceptions of "novelty", major deals are likely to depend on various kinds of public sector support, from the nature of power purchase agreements (such as feed-in tariffs) and tax-breaks (common in the US), to low-cost loans to show how its done (as KfW Bank is providing for offshore wind farms in Germany) and regulatory support (in some markets just removing subsidies for fossil fuel energy is all that's needed).

What's needed is a grand pact between governments and institutional investors: government engineers a stream of large scale investment opportunities and does everything it can do make sure they are investment grade; in return institutional investors turn on the taps.

3. Be clever about public sector risk-sharing.

Public support doesn't always have to be fiscal. There are many options, from guarantees to knocking heads together to regulatory measures, all which can encourage institutional investors.

Insurance products could include:

> First loss and selective loan guarantees. Well known tools for development banks; a lot more could be done with them in renewable energy investing and other climate change solutions.

> Policy risk insurance (e.g. building on the under-utilised Multilateral Insurance Guarantee Agency).

> Currency risk insurance (like the scheme run by the Dutch Government for development finance).

But regulatory support can also work:

> The UK's Green Deal legislation collects energy efficiency loan repayments through the utility bill and ties those loans to the dwelling not the mobile dwellers. The legislation effectively de-risks investments by ensuring that default rates will be minimal (everyone pays their power bills). On the back of that loan portfolios can be built and securitised.

> In Germany the Covered Bond (Pfandbrief) market is worth nearly a trillion dollars. By extending that legislation to cover renewable energy assets German can hugely expand institutional investor access and participation in the renewables market and lower borrowing costs.

> In Japan the government is legislating to give preferential treatment renewable energy bonds over other unsecured debt. This tactic has worked for the Japanese nuclear utilities; it can work for renewables.

In summary, the mantra has to be leverage leverage leverage (of private finance), but can be regulatory leverage as much as financial.

4. Build green enabling institutions.

We know that the solutions have to involve new forms of private/ public risk sharing. We also know that the "understanding" gulf between Treasuries and investors is astoundingly large. Rapid change requires special purpose teams and institutions operating at the border between

[3] http://climatebonds.net/2011/12/insurers-worth-3-5tn-call-for-climate-bonds-and-support-standards/

investors and government and tasked with finding quick ways to achieve change.

Green Investment Units and Banks are needed where State banks are not strong.

Where they already exist they need to be greened. The European Investment Bank, for example, is the world's largest clean energy lender - but they have a dark side that uses cheap public money to build new coal-fired power stations. It's policy lunacy because it means the EU's bank is undercutting EU emissions reduction targets (let alone the world's). They should be switching that dark side money to the light side and then leveraging it, for example by offering guarantees for qualifying climate bonds. Same thing applies to all the development banks (ask the EBRD about their coal lending!)

While we're at it, can we cut back 100% project lending by development banks in favour of leveraging private finance? The EIB for example talks a lot about leverage but doesn't do that much; it's still lending 100% of funds willy-nilly. Time to better stretch that public sector balance sheet.

5. Give tax incentives for climate bonds.

This is not rocket science; it's been used for many years to support the oil and gas industry in the US for example. Just a matter of defining what your qualifying universe is and doing it.

Very little treasury loss can be a big boost to investment.

The Climate Bonds Standards and Certification Scheme (see point 7) is designed exactly to support this.

6. Build an economic recovery narrative.

The money is there, parked in cash, sitting out the crash.

Shifting the economy by building productive investments is a recipe for a long-term economic stimulus plan. And that's what it would be.

The economy needs a narrative to right itself. A green growth narrative does that, while addressing the single most substantial threat of our era.

Part of that narrative is signalling where we can expect to see the economy go. As we address climate change we will need to revamp our economies across every sector.

7. Use Climate Bond Standards as a screening and preferencing tool.

Climate Bonds offer a tool to help investors and policy-makers to rapidly scale-up finance and action for the transition to a low carbon economy.

There is growing appetite from the investment community for investment-grade bonds that are specifically targeted at financing the low-carbon economy. However, in order for the market to grow and for liquidity to develop investors need tools to help them monitor and verify the climate effectiveness of their investments.

There are many benefits to Climate Bond Standards:

> Governments need to be able to signal encouragement for and track private capital financial flows in investment-poor areas of the economy.

> Institutional Investors, particular public sector funds that dominate the rankings of largest funds in the world, need to be able to signal investment areas they are interested in and assure the public that institutional capital is being invested in their interest.

> The public needs to know that a vehicle for catalysing large-scale financial flows to ensure future environmental stability is available and that the financial sector is supporting this future.

A large and liquid Climate Bond market will stimulate innovation from banks, issuers and policy makers alike and will make an important contribution to bridging the financing gap that currently exists.

8. Make it easy for politicians.

This is where real work is needed. Investors are aware of the risk of climate change; organisations representing $20 trillion have been calling for change for years — without huge success.

That's because too many politicians are focused on the short-term, caught in the headlights of the fossil fuel lobby (just go to Washington DC and *feel* the number of coal and oil lobbyists around).

If concerned bond investors and business issuers are to see the policy settings needed to address climate change, they have to get better at packaging politically sellable solutions, not just making inchoate demands like protesters in the street.

That means working on and supporting industrial and investment plans that can address the challenge; that means showing how multiple sectors of the economy can be engaged in the task; and that means developing marketing campaigns to get those plans adopted and helping politicians see how they can successfully sell those plans to voters.

It's time to match the fossil fuel lobby.

By Sean Kidney, Chair, Climate Bonds Initiative