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CCD FACTSHEETS

Coordination SUD
Solidarité Urgence Développement

« CLIMATE » BONDS: A NEW FINANCIAL ELDORADO?

Bonds : an old-style financing method makes a comeback

Bonds are a fundraising tool commonly used by development banks, governments, local authorities and businesses.

> *« A bond is a transferable security representing a share of the long-term debt of a government, local authority or company. There are different types of bonds, but they all have one thing in common: payment of interest (a « coupon ») in consideration of the loan provided by the investor »* [1].

A bond operates like a loan. Bondholders therefore « lend » a certain amount to the issuer (government, local authority or business) at a fixed or variable periodic interest rate until the «maturity» date, i.e. the date when the loaned amount must be paid back in full. The interest rate offered on a bond depends on the risk associated with the issuer. A bond issued by a less solvent government will potentially yield more than a «safe» bond, but the risk of non-repayment on the maturity date is also higher.

The international bond market is now said to be worth around 100,000 billion dollars[2], more than the global gross domestic product (GDP) which is around 70,000 billion dollars per year.

Why so much fuss about this financing method and « climate » in particular ?

What's new is the «green» or «climate» stamp on these bonds, which have to meet a certain number of specific criteria ensuring that the projects they finance have positive effects in mitigating climate change. At first sight, this funding mechanism looks virtuous because it is based on high standards in terms of combating climate change and helps to steer private investors towards « climate-compatible » investments.

But the trend raises various questions:

Are all climate bonds the same ?

It is vital to ensure that the principles/standards that are developed enshrine respect for human rights and the environment. Starting with the development banks and especially the French Development Agency (AFD) which issued «climate-approved» bonds for the first time in September 2014.

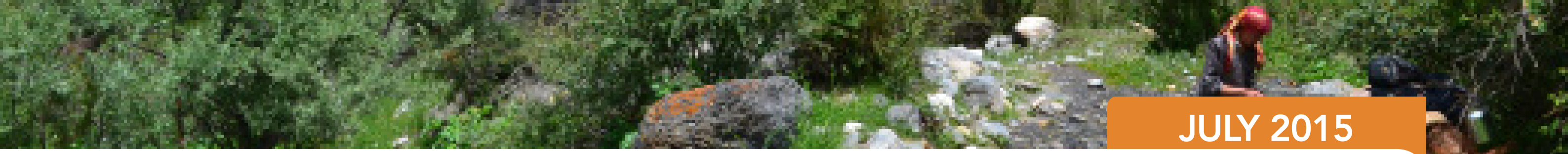
Does the bond tool genuinely advance the interests of the most vulnerable countries ?

Given the relatively modest returns expected, the investor in climate bonds is looking for limited risk. This means that only the least risky projects can be financed using this tool and yet, as the volume of grants[3] declines in France, how will more risky projects obtain funds (e.g. projects implemented in countries where the political situation is unstable)?

How can you guard against the risk of «greenwashing» ?

An investor may have as many climate bonds in his portfolio as classic bonds which may, for example, finance investment in projects with high emission levels. He could then claim the «greening» of his investments, without making the urgent and necessary transition towards a low-carbon economy and infrastructure.

1 Source : http://www.boursedeparis.fr/obligations
2 Source : http://www.lafinancepourtous.com/Actualites/100-000-milliards-de-dollars-de-dette-obligataire-mondiale
3 Which for example represented only 56% of French ODA in 2011, as against more than 80% for the other DAC countries (cf. Analysis of the French finance bill by the ODA committee of Coordination SUD: http://www.coordinationsud.org/wp-content/uploads/PLF-2014-Version-Finale.pdf)



Climate bonds : what are we talking about ?

What is a Climate Bond ? - Types of bonds involved[4]

The basic problem with «climate» bonds is that we only have the issuer's word for their climate-friendly nature. The challenge is to define and work out standards aimed at making clear what is covered by the terms green and climate and which categories of investment may be included.

In response to this need for clarification, the *Climate Bonds Initiative*[5] (CBI) is presently putting together a taxonomy on the notion of climate bonds. The CBI estimates that, of the 100,000 billion dollars on the bond market, 500 billion bonds[6] are potentially « climate-oriented » according to the typology it has developed. This underlines the fact that, despite strong growth in the green bond market, simply redirecting funds raised in a traditional manner could help to mobilize huge amounts of finance to combat climate change and its impacts.

The « climate » taxonomy[7] of the CBI thus contains a list of inclusions and exclusions of types of projects considered. In the energy field, for example, bonds aimed at financing uranium mining or projects based on fossil fuels such as gas, coal or oil are not counted amongst « climate-oriented » bonds.

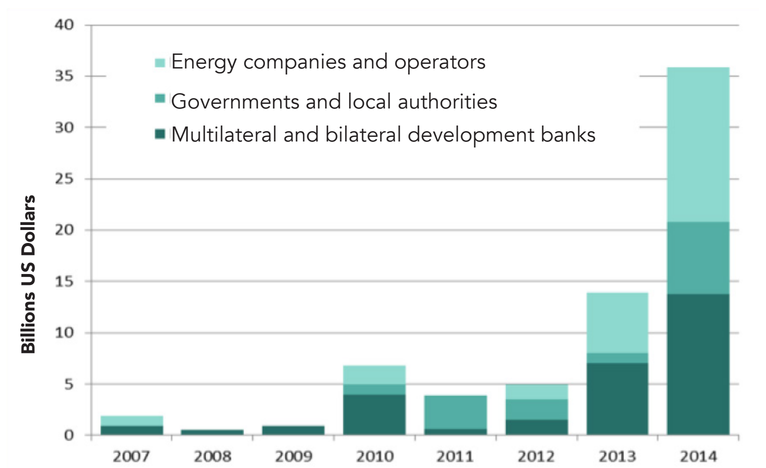
The CBI supports a process of setting standards to ensure that « climate » bonds are « green » and comply with a number of environmental and social principles known as the *Green Bond Principles*[8] (GBP). Put together by a consortium of investment banks, these principles are process guidelines calling for transparency in investments and promoting integrity as the green bond market grows and develops.

According to the CBI, the green bond market was worth 36 billion dollars in 2015 (re-evaluation by CBI).

Who is involved in developing Climate Bonds ?

At international level, China, the United States, United Kingdom, France and multilateral institutions are the main issuers of climate bonds.

More specifically, the Canfin-Grandjean report published in June 2015 identifies the following distribution:



Source : from Backgroung Report on Long Term Climate Finance de CICERO/CPI - BNEF (2014), CBI (2014a), CBI (2015), World Bank (2015)

Historically, the pioneers of the movement are the development banks and particularly multilateral institutions such as the World Bank, which are seeking to raise the profile of their activities in this field[9].

Local authorities (regional, district and town councils, etc.) are likely to develop this financing method to a large extent in the next few years and become a major stakeholder. This innovative mechanism enables them to diversify their funding sources against a background of dwindling budget allocations. In addition, this tool offers an opportunity for local authorities to increase the degree of independence of their financial management vis-à-vis central government.

Private scetor, which initially showed little interest, is stepping into the breach and issuing more and more « green » bonds. Taking up positions on this market is therefore part of a strategy to stand out in terms of ESG and non-price competitiveness.

Development banks are still the main players as regards this financing method but the massive recent influx of private companies into the climate bond market is gradually reversing the trend.

4 Source : http://www.climatebonds.net/files/files/-CB-HSBC-15July2014-A4-final.pdf
(Study commissioned by HSBC, illustrating the banking sector's interest in moving into this market)
5 Official website: http://www.climatebonds.net/
6 Source : http://www.climatebonds.net/bonds-climate-change-2014
7 The full taxonomy may be consulted at : http://www.climatebonds.net/standards/taxonomy
8 The principles are set out here : http://www.ceres.org/resources/reports/green-bond-principles-2014-voluntary-process-guidelines-for-issuing-green-bonds/at_download/file
9 AThe first World Bank green bond programme followed the launch of its « Strategic framework for development and climate change » in 2008. Since then, the World Bank has issued around 4 billion dollars in green bonds. de Green Bonds

Why is this financing method gaining ground ?

An instrument developed in response to the failure to raise conventional funds to invest in the ecological transition

Increased use of bonds as a means of financing the fight against climate change comes against a background of budget cutbacks and gradual disengagement of the State.

In fact, the bulk of climate finance comes from the private sector, but development banks could play a growing role as guarantors of finance from private sources[10]. Development banks therefore have a genuine interest in « climate-theming » bonds in order to scale up private funding flows towards low-carbon development, subject to compliance with high environmental and social standards. In addition, bearing in mind commitments made by States at earlier Conferences of the Parties (COP), which include raising 100 billion dollars per year by 2020, climate bonds represent a convenient tool.

Serious shortcomings in terms of regulation

Less than perfect existing standards

By way of example, in France in 2014, AFD issued 1 billion euros compared with the figures of 1.4 and 2.5 billion euros for EDF and GDF-Suez respectively. In all three cases, these climate bonds were labelled « green » by the rating agency Vigeo, supposedly ensuring compliance with a certain number of environmental and social criteria. Despite this, considerable criticism has been directed by CSOs at certain projects financed through green bonds issued by GDF-Suez (especially the Jirau mega-dam in Brazil[11]). Yet the GDF-Suez bonds had been labelled as « green » according to criteria set by the rating agency[12]. This tends to suggest that there are some shortcomings in existing standardization mechanisms. On top of this, Vigeo does not have predefined criteria but confines itself to checking and assessing the quality of the bonds issued on the basis of the issuers' own standards.

As we have seen earlier, work is being done on certification of these bonds, particularly by the CBI and GBP, but this is still incomplete and in need of improvement. The CBI uses a carbon-centred analysis based solely on the carbon balance sheet of the project to be funded. Climate compatibility should not, however, depend only on a binary emitter/non-emitter formula, but needs to take account of the impact on people and ecosystems as well as possible interdependencies with other sectors. This means that the analysis should consider environmental and social integrity as a whole, whereas the binary nature of climate labelling follows the rationale of simplifying investment decisions for buyers on the market.

Moreover, the standards are still inadequate to deal with matters of transparency/accountability or allocation of funds.

A voluntary approach to the labelling process that raises questions

Getting a second opinion from a rating agency is an increasingly common practice amongst the various issuers of climate bonds. It is not systematic, however, and mainly reflects the wishes of the issuers themselves. Nor is it exempt from conflicts of interests, given the existing interconnections between stakeholders. Over the period 2013-2014, the CBI calculated that only 61% of bond issues were the subject of a second opinion.

10 According to some estimates, climate finance represented between 340 and 650 billion dollars in 2014, with development banks accounting for only 69 billion dollars.

11 More information here : http://www.novethic.fr/gouvernance-dentreprise/entreprises-controversees/isr-rse/bresil-le-barrage-de-jirau-en-amazonie-est-il-si-vert-que-gdf-suez-le-dit-142951.html

12 Vigeo's second opinion on the GDF-Suez bonds : https://www.gdfsuez.com/wp-content/uploads/2014/05/gdf-suez-green-sustainability-bond-vigeos-seconde-opinion-april-2014.pdf

The Climate Bonds of the French Development Agency

Background

On 10 September 2014, AFD issued 1 billion euros in green bonds maturing in 10 years and paying 1.5%. This first attempt was so successful that it was oversubscribed[13]. It is worth noting nevertheless that bonds constitute a regular, long-standing means of financing for AFD. In 2013, bond issues accounted for 16.4 billion euros, or almost 2/3 of the agency's total funding. The « climate » label therefore seems to be a roundabout way of increasing the volume of funding generated through the bond market by jumping on the « climate » bandwagon.

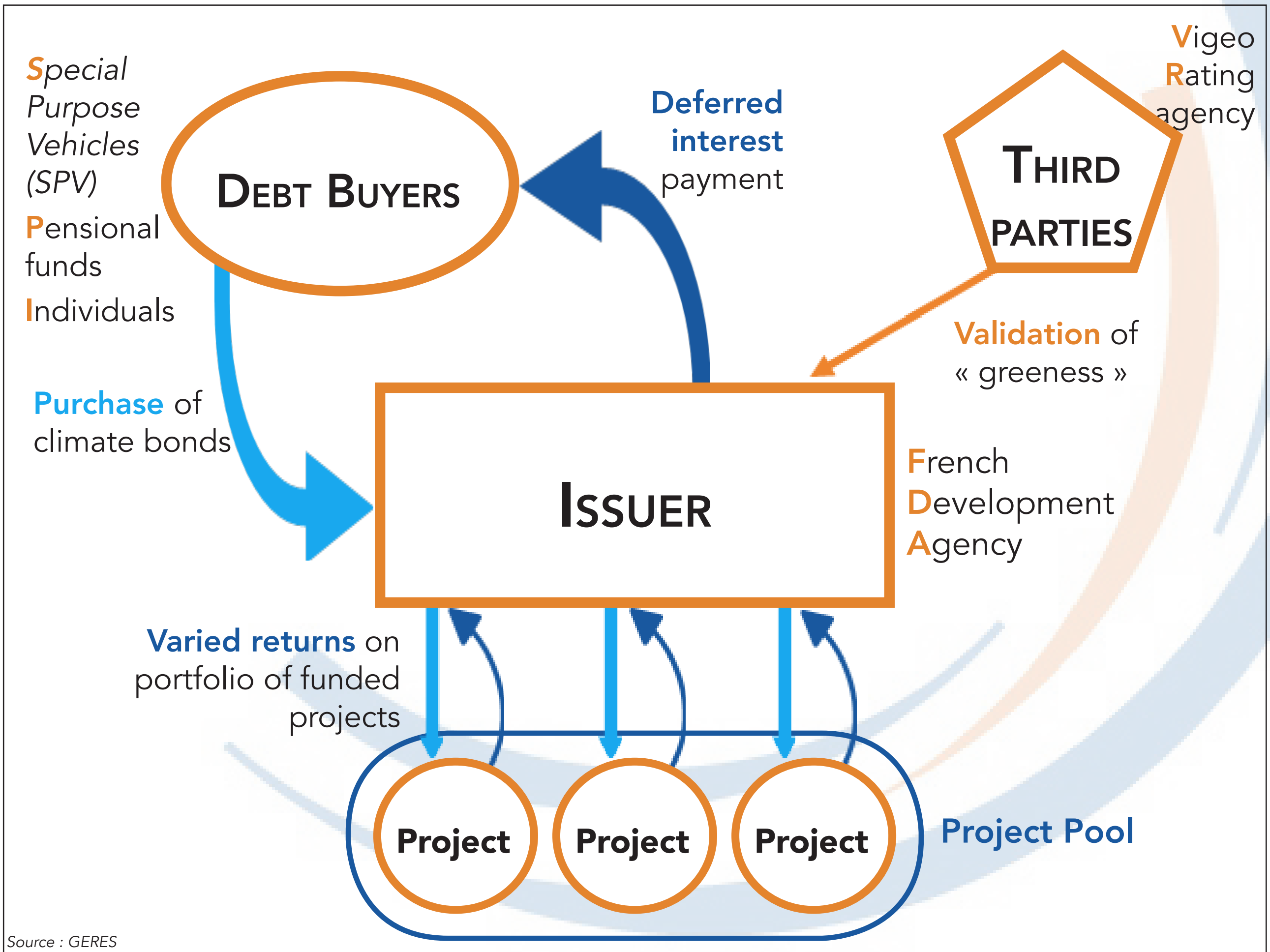
The bond issue was the subject of a second opinion given by Vigeo[14] which clarifies some elements. Four kinds of projects are involved: (i) Renewable energy generation; (ii) Low-carbon urban transport; (iii) Energy efficiency; and (iv) Biological sequestration.

The funding raised by means of this issue will be allocated to a pool of AFD projects. Each project will be the subject of an analysis based on project selection and evaluation criteria. In this connection, 12 criteria have been defined and divided into five categories reflecting the AFD strategy :

- ***Social responsibility :*** ensuring respect for human rights and high-quality employment and working conditions
- ***Environmental responsibility :*** controlling environmental impacts
- ***Local development and community well-being :*** contributing to the development of the area and the well-being of local communities
- ***Market behaviour :*** promoting responsible market practices and sustainable relationships with suppliers and beneficiaries
- ***Project governance :*** ensuring proper risk management and the project's fulfilment of its commitments

There will be further bond issues in the coming years to replenish the project *pool* on a regular basis.

Operation of AFD Climate Bonds (simplified)



Source : GERES

13 Source : http://www.afd.fr/webdav/shared/ELEMENTS_COMMUNS/AFD/Finances/CP-green-bond-vf-afd.pdf

14 Vigeo's second-party opinion on the AFD bonds : http://www.afd.fr/webdav/site/afd/shared/ELEMENTS_COMMUNS/AFD/Finances/Rapport-Vigeo_Second-party-Opinion_Climate-Bond-AFD-FR.PDF

Issues and constraints arising from the first AFD Climate bond issue

A lack of transparency related to the financialization of the fight against climate change

By definition, as bonds fund a portfolio of projects, the projects benefiting from such fundraising will only be known ex-post. Greater transparency is needed on the part of AFD regarding not just a selection of exemplary projects but the whole pool of projects it funds. When it comes to reporting, however, there is a problem with the status of AFD, which requires it to maintain banking secrecy. At present, the release of information concerning the projects it funds is subject to the borrower's prior authorization. As a result, reporting tends to be on an aggregate, sectoral basis, illustrated with examples of selected projects. AFD insists that it is impossible to make everything public let alone to commit to doing so at the time of issue.

Questions remain concerning certain types of project that could be funded, such as « Biofuels », « Electricity production », « Fuel replacement » and « Climate-smart farming practices », given that these cover a wide spectrum of practices that are sometimes antagonistic to the aim of low-carbon, resilient development.

What challenges does AFD faces in terms of « climate » reputation ?

AFD is looking to put its climate expertise to use on the green bond market, particularly because the latter comprises «green» investors wishing to invest in projects that deal in a practical way with environmental and social issues.

AFD justifies the use of this financial tool in the climate field because: (i) it primes the pump of private funding for the fight against climate change; (ii) it helps gradually to boost acceptance of high environmental and social standards; and (iii) it ensures the effectiveness of the investment via the notion of return on investment (as the project must be economically viable to generate profit).

Persistant methodological issues with AFD's cross-cutting climate framework

AFD is proud to «set an example» in terms of combating climate change. It means to try to influence its peers from this point of view and is working hard to standardize environmental and social safeguards for climate bonds.

The methodological framework for selection/labelling of projects financed through climate bonds nevertheless rests on the same basis as that applicable to AFD's overall approach to the matter of climate change. As a result, similar constraints and shortcomings can be seen, such as:

- Climate selectivity of projects still excessively focused on binary analysis (polluting/non-polluting) and carbon-centred (ex-ante carbon balance sheet of the projects to be funded) ;
- Climate-proofing of projects still insufficiently systematic in practice;
- Failure to take account of the specific challenges of adaptation;
- A lack of predefined exclusion criteria.

Towards segmentation of climate finance tools

1. Meeting the challenges of adaptation

These billions will first of all go towards funding projects to mitigate the effect of greenhouse gas emissions. Adaptation projects are not the core projects financed through climate bonds.

2. Different levels of risk and different needs depending on the countries concerned

The nature of this instrument means that the projects it funds mainly involve emerging countries. It is therefore important to increase both national and international additional public funding in the form of grants to the poorest countries so that projects can be funded even where the level of risk associated with the country means that there are few investors. The share of grants in official development aid is nevertheless decreasing sharply. The imbalance between «climate» funding flows and the level of vulnerabilities will therefore continue to get worse, particularly now that adaptation is the poor relation in climate finance.

Concerns of Non-governmental Organizations (NGOs) of Coordination SUD

French NGOs of Coordination SUD :

- Are worried about AFD's lack of transparency regarding the projects it funds and particularly the opacity surrounding the matter of « banking secrecy » that prevents AFD from releasing the comprehensive list of projects financed through climate bonds.
- Deplore the absence of an exclusion list of projects considered detrimental to the fight against climate change and to respect for fundamental human rights.
- Would like to see an improvement in the methodology used by AFD to select and characterize climate projects (which projects are included in « climate co-benefit » projects? What account is taken of the potential to reduce the vulnerability of a project's target beneficiaries and areas?).
- Would like to see a gradual shift in AFD funding, hitherto mainly focused on mitigation, towards funding climate change adaptation projects. To increase the level of grants for adaptation, AFD could consider taking advantage of the fact that climate bonds offer a useful way of financing mitigation.
- Are concerned that there may be a reduction in the range of financial tools, which would result in the exclusive use of market mechanisms to finance development. The financialization of development aid leads to a drive for returns on any investments made and is liable to be prejudicial to the poorest countries. This means that efforts to raise additional public funds in the form of grants to the most vulnerable countries must be pursued.

Coordination SUD is the French national platform of international solidarity NGOs. Founded in 1994, it brings together more than 160 NGOs active in the fields of humanitarian aid, development assistance, environmental protection, the defense of disadvantaged people's human rights and international solidarity education and advocacy.
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The Climate and Development Commission (CCD) of **Coordination SUD** works to influence the strategies of the development actors, to pass on good practices and to influence international negotiations. It brings together about 20 international solidarity NGOs : **4D, Acting for Life, Action Contre la Faim, Agronomes et Vétérinaires Sans Frontières, Association la Voûte Nubienne, ATD Quart-Monde, CARE France, Centre d'Actions et de Réalisations Internationales, CCFD - Terre Solidaire, Electriciens Sans Frontières, Fondation Energies pour le Monde, Groupe Energies Renouvelables, Environnement et Solidarités, Gevalor, GRDR, Gret, Initiative Développement, Institut de recherches et d'applications des méthodes de développement, Médecins du Monde, Oxfam France, Peuples Solidaires - ActionAid France, Planète Urgence, Secours Catholique-Caritas France.**

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