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Bond markets have a role to play in helping the environment

By Mike Scott

"We are currently on the road to catastrophic climate change. We all need to take action." As an introduction to a conversation about the role of bond markets in boosting investment in clean technology, these words are a stark reminder of what is at stake.

But Sean Kidney, founder of the London-based Climate Bonds Initiative, stresses the importance of understanding the case for developing a market in debt products that help to reduce greenhouse gas emissions.

He adds that the above is not his judgment but that of Fatih Birol, chief economist at the International Energy Agency.

"The technology, the capital, the capability and the policy understanding to tackle climate change is there," he adds. "But there is a failure of leadership and a lack of investment. It is frightening just how clear the science is and just how opaque the discussion is – the discordance is extraordinary."

So where do the bond markets come in? The IEA says $500bn per year must be invested in clean energy between 2010 and 2035.

Yet according to the UN Environment Programme, global investment in renewable power and fuels was $211bn in 2010. "The gap between the level of capital investment required and the actual level of investment is creating a clean energy investment gap," UNEP says.

The challenge is one of timeframe, according to Mr Kidney. "For many – although not all – clean energy technologies, over three, five or even 15 years, the investments do not yet make economic sense. But over 40 years it becomes economic."

The bond market is almost twice the size of the equity market, he adds, meaning much of the funding for climate solutions should come from this source.

However, because many of the areas that need investment involve new technology or business models – and therefore higher risk – they are currently more suited to equity investment than bond funding. In addition, "the world has had a love affair with equity investment for the last 20-30 years. There has been a shift towards the bond market in the last five years, but the renewable energy sector has not caught up with that."

As a result, "the bond markets are extraordinarily absent from current investment in climate change solutions. At the moment we don't see a lot of opportunities for the bond market to invest in renewables. We need to create them."

To do that, the Climate Bonds Initiative argues, there must be deal flow, with projects being aggregated into larger offerings that suit institutional investors.

This requires a change in the perception of the risk of climate solutions. The process is starting to happen naturally as the technologies mature and investors gain experience in the sector, but governments need to speed up the process by measures such as public sector risk-sharing, tax incentives for climate bonds and tying in climate bonds to a narrative of economic recovery, Mr Kidney adds.

This all looks a long way off. President Obama felt it necessary to state that climate change is not a hoax during his re-election campaign, while in the same week that scientists revealed Arctic sea ice had hit a record low, the UK prime minister appointed an environment minister who refused to confirm whether he accepted the science of climate change.

"Whatever the competence of the relevant minister, appointing someone who avoids embracing a core government position can only introduce uncertainty about the government's future position," Mr Kidney says. "Investors are weighing up political risk all the time as the renewables market is primarily driven by government policy. Investors will think 'these guys don't seem to be 100 per cent committed to their policies' and probably look elsewhere."

However, it would be wrong to say there is no climate bond market at the moment – existing climate bonds just are not classified as such. In a report earlier this year, the Climate Bonds Initiative and HSBC's Climate Change Centre of Excellence said the market was broader and deeper than expected.

The report claimed that since the Kyoto protocol came into force in 2005, there has been $174bn of climate-related bond investment, most of it in railways and low-carbon energy.

It identified seven areas where investors can put their money to take advantage of the increasing opportunities climate change creates – energy, transport, building and industry, climate finance, water, waste and pollution controls, agriculture and forestry.

Nick Robins, head of the Climate Change Centre of Excellence says: "This reframing of the investable universe could help to overcome a perception among investors that climate-themed bonds are a niche market."

The market will be boosted by the introduction of climate bond standards, which the Initiative developed last year with bodies including the California State Teachers'

Retirement System (CalSTRS) Jack Ehnes, chief executive of CalSTRS, says: "We are looking for investment-grade returns that also address climate change. The Climate Bond Standard will allow us to know that investment opportunities put before us will be the right ones to build a low carbon economy."

For a lot of investors who want to invest in climate change solutions, due diligence is a problem, Mr Kidney says.

"Climate is not a credit theme, it is a crosscutting social, environmental and policy theme. We want to commoditise the due diligence and make it really easy and cheap to identify opportunities. I believe that will significantly increase flows into the sector."

Over time, certified bonds will be listed on platforms such as Bloomberg and investors will be able to build a portfolio around them. But the key role of climate bonds will not be to finance more low-carbon projects, although there will be a place for that. Rather, he says: "We need to expand the climate bond market to allow an exit path for banks and equity issuers who can then reinvest the money into new projects.

"We have evidence of buyside demand – some of the world's biggest insurers called for more climate bonds at the Durban climate conference last year. Now we have to push through the supply."

The Initiative has certified its first bond, a $300m-$500m issue linked to a pool of wind energy loans from a large regional bank that is waiting for market conditions to improve before it brings the bond to market.

"Slowly but surely we are getting product out there, but there are already plenty of opportunities in the existing bond market," Mr Kidney concludes. "If you have a choice between two bonds with the same yield, why would you not buy the one that helps to tackle climate change?"