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Beyond transparency: unlocking the full potential of green bonds

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Executive summary

'Green' or 'climate' bonds are a new asset class that has received increasing attention over the past few years. It is often seen as a financial instrument that may help overcome the low-carbon investment challenge. This report explores the current and potential contribution of green bonds to the low-carbon transition and different ways to enhance it. The analysis begins by taking stock of the current status of the green bond market, identifying key roles that the market plays for different stakeholders and pin-pointing two key challenges to be addressed. The first challenge – namely the question of environmental integrity of green bonds – explores the stakes related to definitions and procedures and identifies possible approaches to deal with it. Next, the second challenge focuses on how, beyond increasing transparency, both market-driven and public support measures may help increase the tangible financial contribution of green bonds to the low-carbon transition. The report then concludes with a number of possible steps for policymakers and financial stakeholders to overcome the current limitations of green bonds.

GREEN BONDS HELP TO IMPROVE THE TRANSPARENCY OF INFORMATION AND MATCH MARKET ACTORS

Currently, the green bond market unlocks a number of benefits by increasing the transparency of information available to investors on underlying assets and companies. Notably, green bonds can help investors implement their long-term climate strategies and enable responsible investors to have alternatives to broaden their delete portfolios. In turn, green bonds can help bond issuers communicate their sustainability strategies, create internal synergies between financial and sustainability departments, and expand and improve relationships of borrowers with debt providers. Finally, green bonds can support the implementation of national climate policies – through improved awareness and more efficient capital allocation, especially in the perspective of redirecting capital towards low-carbon and climate resilient projects (Table 1).

While these benefits alone may justify the existence of the green bond market, its tangible contribution to the low-carbon transition has so far been limited. Most notably, the green bond market does not appear to directly stimulate a net increase in green investments – or the financing and refinance of low-carbon projects – through a lower cost of capital. Moreover, the spontaneous bottom-up manner of the development of green bonds raises reputational and legal risks related to environmental integrity, which increasingly threaten the very survival of this nascent market. In order to realize its potential, the green bond market will therefore have to overcome two main challenges. First, it has to avoid implosion – due to the lack of investor confidence – by ensuring the environmental integrity of green bonds. Second, the impact of green bonds needs to be enhanced by growing the pipeline of underlying low-carbon projects and potentially bringing them tangible financial benefits.

FIRST CHALLENGE: STRENGTHENING THE ENVIRONMENTAL INTEGRITY THROUGH THE STANDARDIZATION OF PROCEDURE AND CLARIFICATION OF EXPECTATIONS

The first challenge of environmental integrity is in fact twofold. First, there is a question of defining 'greenness', which ultimately depends on the objectives of the use of green bonds. At the very minimum, the market actors will need to explicitly lay out the objectives of standards in order to provide a clear definition of 'greenness'. The lack of explicit and shared objectives for the green

TABLE 1. CURRENT BENEFITS OF GREEN BONDS

Actor	Benefits
Issuers	• Helping issuers communicate the sustainability strategy • Improving relationships with debt providers and broadening the 'investor base' • Creating internal synergies between financial and sustainability departments
Investors	• Helping investors to develop better-informed investment strategies • Facilitating the smooth implementation of long-term climate strategies • Helping responsible investors broaden their restricted investment portfolios
Policymakers	• Indirectly supporting the implementation of the low-carbon transition by better matching green issuers and investors

bond market is a source of misunderstanding that could eventually harm the market through accusations of green-washing and potentially higher transaction costs. Governments could facilitate this process by clarifying investment priorities that are coherent with long-term climate and sustainable development strategies and/or endorsing standards that are aligned with them. While governments' intervention can help structuring the market, it is clear that a diversity of approaches and financial products are necessary to support the low-carbon transition. This may ultimately support continued heterogeneity in the green bond standards – without necessarily leading to a questioning of the environmental impact of underlying assets.

Second, there is a question of the reliability of information, which is linked to monitoring and evaluation procedures. While the market-driven approaches have already made significant progress in this area, more needs to be done to ensure the environmental integrity of green bonds. As a next step, the market actors could reinforce the monitoring and reporting procedures – e.g. through existing market-driven forums such as the Green Bond Principles. In instances where the market fails to do so, governments may step in to provide guidance or implement top-down regulations. However, it is important that proponents of the standards – both private and public – strike a balance between stringency of procedures and the resulting transaction costs.

Overall, the process of reinforcing the green bond market can be compared to the one occurring at the international level on climate change: the 2015 Paris Agreement brings common understanding of the objectives and definitions as well as common reporting processes leaving different actors – states, local authorities, civil society, etc. – to define the best strategies and actions adapted to their own circumstances. The same approach could be applied to the green bond market: common procedures and reporting frameworks under the Green Bond Principles could be coupled with market- and/or public-driven development of standards (Table 2).

SECOND CHALLENGE: PROVIDING TANGIBLE BENEFITS TO INCREASE GREEN BONDS' IMPACT AND GROW THE PIPELINE OF PROJECTS

Concerning the second challenge of increasing the impact, the green bond market can help stimulate green investments by reducing the cost of capital for green projects. Evidence suggests that this does not currently occur in practice and thus limits the market contribution

TABLE 2. POTENTIAL NEXT STEPS TO SAFEGUARD THE GREEN BOND MARKET

Challenge	Potential next steps
The 'expectation gap' regarding the definition of 'greenness'	**For the market players and/or governments:** • Clearly lay out the objectives of different standards in order to define 'greenness' **For governments:** • Clarify investment areas compatible with – and potentially that are priority under – long-term national sustainable development pathways; • Publicly endorse standards that are aligned with long-term decarbonization strategies
Transparency risk related to monitoring and evaluation procedures	**For market players and/or governments:** • Further market convergence around the enhanced transparency frameworks; • Reinforce the global efforts around standardizing practices – through Green Bond Principles for example – while keeping additional transaction costs in check **For governments:** • Support the issuance of green bonds by public institutions to expand the market and potentially prove the relevance of more complex green bonds; • Create green bond labels aligned with long-term decarbonization pathways • Mandate similar disclosure requirements for all asset-linked bonds

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to the 'repackaging' or labeling of bonds that would most likely have been issued and fully subscribed as traditional products. Overcoming this limitation could be achieved by furthering the access of smaller and riskier projects to the bond market through securitization instruments that have already begun to emerge. Moreover, it is hypothetically possible that the green bond market could support a process of decreasing the cost of debt for underlying projects through a 'green premium'. This can be achieved if a sufficiently large 'committed demand' from institutional investors develops over time, although this perspective remains largely theoretical due to fiduciary duty limitations.

In this light, governments may provide targeted public support schemes to reduce the cost of capital for those green bonds that finance priority areas in line with long-term climate and sustainability objectives. These measures may include various forms of subsidies, tax breaks, changes in prudential regulation and public guarantees. Implementing such measures will, however, require robust evaluation and reporting in order to avoid free-riding and to maximize the efficiency of public support. Moreover, governments will need to weigh the use of public funds to support green bonds against more conventional climate policies that could improve the economics and bankability of underlying projects such as, for example, renewable energy subsidies. Ultimately, green bond support priorities will depend on national circumstances and sustainable development priorities.

THE STRINGENCY OF SELECTION OF GREEN BONDS ELIGIBLE FOR POTENTIAL PUBLIC SUPPORT WILL DEPEND ON THE NATIONAL POLICY OBJECTIVES

If national governments or other public entities decide to provide direct support for the green bond market, they will need to establish monitoring and evaluation procedures to better target this support and to avoid free-riding. Depending on the policy objectives, three levels of evaluation stringency can be distinguished:

- 'Coherence checks' that make sure that investment projects behind green bonds are aligned with the credible national climate and sustainable development strategies or more broadly, commonly-agreed decarbonization pathways.
- 'Average additionality' of the contribution of green bond issuance to national policy objectives through, for example, the development of positive lists of project types that are underrepresented or underfunded and therefore require additional support.
- 'Project-by-project' ex-ante evaluation of underlying activities and assets coupled with ex-post quantification of mitigation outcomes to maximize the 'environmental impact leverage' ratio per dollar of public support provided, e.g. the amount of GHG emissions reduced per dollar invested.

A BROADER DIALOGUE AMONG PUBLIC AND PRIVATE MARKET ACTORS IS NECESSARY

While the priorities for next steps discussed above can be debated, one recommendation appears crystal-clear: whatever measures private and public actors decide to implement to safeguard and support the market, a broader dialogue between policymakers and market stakeholders is critical while barely existing today. Such a dialogue should aim to strengthen the green bond market by aligning it with long-term sustainable development priorities and unlocking its full potential to deliver environmental benefits and ensure the quality of the improved transparency. This report lays out some ideas on the way of framing current and forthcoming processes around green bonds and should thus be seen as a discussion paper that calls for feedback and reaction from all kinds of stakeholders.