

Forests into fixed income

Despite being relatively new to the fixed income market, green bonds offer responsible investors a good opportunity to invest sustainably. Nina Röhrbein reports

First issued by the World Bank in December 2008, green bonds have become an attractive alternative investment for responsible investors trying to integrate climate change into their portfolios. Issued primarily by supranational and multilateral development banks, green bonds have similar financial characteristics to traditional bonds, but offer investors the opportunity to finance environmentally beneficial projects or initiatives.

There is now around \$12bn (€8.8bn) in green bonds across multiple issuers, maturities and currencies, according to Chris McKnett, responsible for ESG Investing at State Street Global Advisors. In 2010, around \$3.5bn of green bonds were issued, according to Initiative for Responsible Investment at Harvard University.

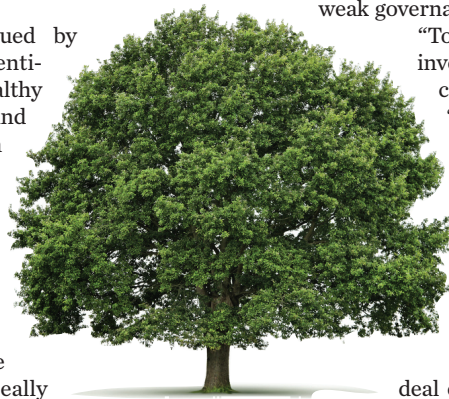
“Given the secular trends of macro de-risking, efforts to mitigate and adapt to climate change and the dual policy imperatives of sustaining economic recovery and spurring employment growth, the green bond market is poised to grow rapidly,” says McKnett. “Green bonds could provide an estimated €1.4trn of capital for low-carbon technology in Europe between 2011 and 2020, according to a report by Accenture and Barclay’s Capital in February 2011. Much of green infrastructure investment will likely be financed via the bond markets, with green bonds expected to play a major role.”

Forest bonds, a sub-set of green bonds, could be key to get private investment in forest conservation. Andrew Mitchell, executive director of tropical forest think-tank the Global Canopy Programme, says: “Natural capital is misvalued in two ways: first, in terms of what it supplies us with, and second, because the cost of destroying that natural capital is not included in the price of goods we buy. Nowhere is this more apparent than with forests because the damage-costs of the destruction of forests, including emissions from clearing and burning them are as great as those from the entire global transport sector.”

The amount of money required to halve deforestation by 2020 stands at €20-40bn per year, estimates Mitchell, a tiny fraction of the €115trn global bond market. But governments have, so far, committed only €5.3bn to solve this problem, which is why engaging the private sector is essential. “It would be a big win if we can jump-start forest bonds while waiting for the international community to catch up with the climate negotiations,” says Mitchell.

Forest bonds would be issued by governments or sub-national entities – buyers would include wealthy family offices, impact investors and large institutional investors such as pension funds interested in uncorrelated green assets.

“But it is a very young market and their fiduciary responsibility means that pension funds will have to look very carefully at this,” says Mitchell. “A forest bond must become something that is rock solid, ideally



Assessing the ecological risks of government bonds

The UN Environmental Programme Finance Initiative (UNEP FI), together with international sustainability research organisation Global Footprint Network and leading financial institutions, has launched a project that includes ecological risk in the assessment of long-term government bond risk.

The project aims to investigate the linkages between ecological risk and country-level risk in sovereign bonds, and to develop a methodology exploring how credit rating agencies, investors and financial information providers can integrate ecological data into their respective models. In particular, the analysis will look at the risks to countries whose populations and/or industries require more resources than is domestically available and which are hence reliant on ecological services from abroad.

“Natural resources are important to investment decisions because the trading flow of natural resources is underlying most economic systems,” says Gemma Cranston, lead scientist at the Global Footprint Network. “Many countries with large natural endowments are depleting their resources. At the same time, resource prices are constantly rising and with the global economic crisis this is going to be a real problem for sovereign governments. We want to assess the valuation of their sovereign bonds and whether or not they are going to be a riskier investment for investors.”

The project looks at the flow of natural resources in a given country and the consumption patterns of its residents. Its starting point is the

ecological footprint, in other words the demand for natural resources and biocapacity.

Carbon makes up a large part of the ecological footprint. It includes the availability of forests to sequester emissions as well as the assessment of carbon emissions within individual states. The carbon from a producing country is transferred to the importer country, such that the footprint is inclusive of production and imports of a country and excludes its exports.

“One good example is the relationship between China and the US,” says Cranston. “China brings in a lot of raw materials, manufactures them into products and then exports them to big players like the US, while at the same time buying up US debt. However, due to our planet’s finite resources this inextricable interdependency of producers and consumers is not going to be sustainable in the long term.

“Our goal is to get the ecological risk assessment adopted by investors and a credit rating agency to make governments integrate their biocapacity into their daily decision-making practices,” she says. “We want to shift their current paradigm of thinking – which is based on economic growth – to look at a more holistic form of wealth creation.”

The first results of the project are expected in six months. Then, after a dialogue with financial institutions, another six months of research will focus on the integration of the results into the financial decision-making of portfolio managers and credit-rating agencies. The new framework will be road-tested from November 2012.

an AAA-rated instrument. That way they will scale and we need them to scale because of the amount of money required to finance this transition in our economy.”

“We believe the global bond market can be tapped for funds to protect forests,” says Sean Kidney, chair at international network The Climate Bonds Initiative. “And if forest bonds to protect rainforests have an investment grade rating, pension funds will buy them.”

But there are two major barriers to forest bonds: creditworthiness and regulatory risk, particularly in countries with institutionally weak governance.

“To get their money back, most investors have been looking at the carbon market,” says Mitchell.

“But the carbon market requires an approved compliance mechanism to operate at scale and we do not have that yet. The Reducing Emissions from Deforestation and Forest Degradation (REDD+) mechanism is the most advanced of any of the mitigation mechanisms that are under discussion, but a great deal of uncertainty remains about the

outcome of the Kyoto negotiations.” Kidney adds: “Revenue from REED+ is likely to be too volatile to support bonds.”

However, these issues could be solved through a new kind of forest bond – regional development forest bonds underpinned by cash flows from a range of activities relevant to avoiding deforestation. These would recognise the multiple values of forests, from the returns of sustainable timber and carbon revenues to other sources of revenue such as environmental taxes. They would be based on a blended cash flow model comprising carbon, agriculture, forestry and subsidies.

“We suggest multinational banks and richer countries focus on providing credit enhancements to get these forest bonds to investment grade,” says Kidney. “By financing investments that boost the local economy and address issues such as unemployment or small landholder sustainability we hope to reduce external pressures on forests as well.”

The Global Canopy Programme, together with The Climate Bonds Initiative and WWF, is currently researching this model. It is expected to be launched in 2012 or 2013, and would be greatly enhanced if governments created an advanced market commitment (AMC) mechanism for forest carbon.