

The rise of green bonds: potential prospects and limitations

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Abstract:

Since 2009, the issue of climate change has fuelled a global economic competition focused on the green energy markets. So-called “green” bonds, issued to finance projects with a positive effect on the climate and on the broader environment, have become emblematic of this new green energy market, which is impacting all energy-dependent economic sectors, led by the real estate, mobility/transport and industrial sectors. These green bonds have the potential to accelerate investments given their capacity to harness market funding rapidly and on a massive scale. However, their rise is limited by two factors. The first limiting factor, of a technical nature, is the need to define which investments are “green” in order to avoid greenwashing, with its abuses and windfall effects. The second limiting factor, of an economic nature, is whether green bonds (which are designed for large-scale and infrastructure projects) can meet the demand of the green economy (which is primarily local in France and the rest of Europe). More broadly, the issue at hand is the choice of a banking model (between the Anglo-Saxon capital market-based model and the Continental model based on bank financing, notably via universal banking) for matching “green” financing, jobs and coherence on a local and regional level.

A need for a massive shift in financial flows

The estimate of \$500bn, put forward by the International Energy Agency (IEA), is often cited to assess the global financing needs for the energy transition alone between now and 2035, not including other areas (water, sanitation, waste, agriculture, etc.¹). In France, a €50bn investment plan is in the works to “prepare the growth model of the future”, including €15bn directly connected to the ecological transition. These substantial amounts show the reality of the ongoing energy transition, in other words, the global trend under way since 2009 whereby investors are focused on renewable energies and energy efficiency (which have become profitable and viable) rather than fossil energies (whose margins have deteriorated with the falling price of oil). This trend chiefly involves the energy sector, with knock-on effects for all sectors with high energy dependence: real estate, transport, agriculture and industry.

⁽¹⁾ DG Trésor and Commissioner General for Sustainable Development, “White Paper on Financial Ecological Transition”, 2013.

Public investments will not be enough to cover these needs. The private banking/financial sector is thus a key contributor – even more so for the French banking sector, whose universal banking model enables it to assist all types of clients through its various activities: retail (lending), corporate banking, finance leasing, factoring, asset management and insurance, as well as capital market activities.

Among financial responses to the green energy question, many experts consider green bonds to be the preferred instrument because they can tap the markets for sizeable amounts of money and can therefore finance large-scale energy transition projects. In 2012, \$2.6bn in green bonds was issued worldwide. In 2015, the total amount of green bond issuance surged to \$41.8bn. Issuance came to around \$75bn at end 2016 and is set to be around \$100bn by end 2017. Estimates for 2020 stand at \$160bn. At end 2016, the European Commission projected that an additional \$177bn would have to be invested per annum from 2021 to achieve the climate and energy goals set for 2030.² In January 2017, France positioned itself as the leader in climate action by issuing a sovereign green bond. This debt issue set records due to its maturity (22 years) and its size (€7bn). In addition to providing useful funds, green bonds convey a reputation of expertise and innovation that governments and banks use to their advantage when competing on the climate finance market. By issuing a sovereign green bond in early 2017, France has shown its determination to play a leading role in this new market.

The current limitations of green bonds

In light of the demand for green investments, there appear to be no obstacles to the development of green bonds. Of course, they are not a one-size-fits-all instrument, and they currently suffer two limitations of a practical nature: 1) their “green credentials” are not sufficiently well defined, and 2) there is a lack of ecological projects in the pipeline. In practice, a green bond is a “classic” bond issued by banks like any other financial product, except that the bond proceeds are used solely to finance projects related to the ecological transition.

The first limitation of green bonds lies in the definition of their “green credentials” for using the proceeds. This definition is provided in the prospectus for investors. For this purpose, the French government launched the TEEC label (for *Transition Énergétique et Écologique pour le Climat*, Energy and Ecological Transition for the Climate) in 2015. The TEEC label represents significant progress for green bond issuance. Internationally, the Climate Bonds Initiative catalogues the projects that fulfil the Green Bond Principles (its climate criteria). Progress on this point was crucial: according to a 2016 report by the European Commission, 85% of Clean Development Mechanism (CDM) projects under the Kyoto Protocol do not clearly comply with their purported emissions reduction targets.³ However, this process does not seem suitable for financing small-scale projects – such as those involving SMEs, small local authorities or individuals, and financed by local bank networks – because it is too burdensome and probably too costly to set up.

⁽²⁾ European Commission report on green bonds, 2 December 2016

⁽³⁾ Öko-Institut, SEI and INFRAS, “How Additional is the Clean Development Mechanism?” Report to the European Commission, Berlin, March 2016.

Therefore, the challenge is to ensure a correlation between project-related green credentials such as the TEEC label, the Green Bond Principles and regional green labels (e.g. AB Bio for organic food and BBC Rénovation for energy-efficient buildings). This would enable green bond proceeds to be used, when appropriate, not only to refinance projects, but also for local clients that have a complementary fit with the projects of large firms, in a value chain approach.

The second limitation of green bonds is connected to their capacity to drive the green economy's growth on a local level so that it delivers on its promise to create new jobs. The fact that SMEs are the major source of job creations in our economies – especially in France⁴ and elsewhere in Europe – raises the challenge for green bond issuers to build a method that makes SMEs, on their own scale, eligible for green investments.

As of end 2013, salaried employment in France represented slightly less than 24 million people, including some 8 million working for the public sector, 6 million for businesses of fewer than 20 employees, 8 million for businesses with 20 to 500 employees, and 2 million for large companies. Companies' operating accounts show that the additional turnover required for the creation of one new job is €50,000 in a VSE (very small enterprise), €150,000 in an SME, €250,000 in a mid-tier firm and €350,000 in a large firm.⁵

These figures show that VSEs and SMEs are now, more than ever, efficient drivers for job creation, as it takes seven times less turnover to create one job in a VSE than in a large firm.

Adapting the range of financial instruments to the broad spectrum of needs

This situation is even more obvious in the sectors of the green economy. In France, €37bn is invested annually in the green economy, two-thirds (i.e. €21bn p.a.) of which at the local level via artisans and SMEs working in sectors such as the thermal renovation of buildings. In fact, this is why it is difficult to structure these sectors. The *Entreprises et Environnement* ("Companies and Environment") prize, awarded by the Ministry for the Ecological and Solidarity-Based Transition, demonstrates the major structural role that VSEs/SMEs play in meeting the economic challenges of the energy transition, as 70% of the businesses competing for the prize are VSEs or SMEs.

Since the 2009 UN Climate Change Conference held in Copenhagen, the international dimension of climate talks has given emphasis to market-based tools such as green bonds, in addition to traditional bank loans, which are often more localised. These market-based instruments are prioritised in order to mobilise substantial funds rapidly for international efforts (e.g. within the scope of the G20, OECD or FSB). This financing mode is suitable for large-scale stakeholders with the resources to invest in these often complex, and thus costly, financial arrangements. As a result, establishing a pragmatic and effective link between

⁽⁴⁾ "In 2012, there were 3.5 million SMEs in France, accounting for 99.9% of all businesses, 48.3% of workers (FTE), 35.5% of turnover and 43.9% of value added", according to the website finances.gouv.fr

⁽⁵⁾ Gilles Lecointre, "Les PME, plus que jamais le premier moteur de l'emploi", *La Tribune*, 21 May 2015: <https://www.latribune.fr/opinions/tribunes/les-pme-plus-que-jamais-le-premier-moteur-de-l-emploi-477835.html>

green growth and job creations requires the financing effort for regional stakeholders and local banks to be conceived proportionally to their size, and to adjust financing instruments accordingly (notably adapting them to the profiles of family-owned businesses).

Thus, an imbalance is arising in France – and the rest of Europe – between the functioning of financial markets for the energy transition and the needs of most stakeholders (households and businesses). At European level, the European Financial Services Round Table (EFR) recently criticised the High-Level Expert Group on Sustainable Finance (HLEG), established by the European Commission to incorporate sustainability criteria into EU financial sector regulations, for failing to include representatives of the banking sector; the EFR noted that no representatives of the major European banks were present in the HLEG.

The impetus given to major projects funded with innovative instruments such as green bonds paves the way for French banks to demonstrate their expertise in this new market for climate protection. Given the wide spectrum of needs – for large firms, mid-tier firms, SMEs, VSEs and households – this impetus can probably be supplemented by resorting to a full range of financial instruments, targeting everything from crucial local projects to international ones, in order to provide effective solutions required by the urgency of the transition. More than ever before, coordination is needed between the public authorities, banks and businesses so that green bonds and other available financial instruments can provide funding for the needs of currently underserved small businesses and households.