So what's next?
How to grow green bond markets around the world

Public sector agenda for stimulating private market development in green bonds

The rapid growth of the green bond market over the last year has proven that there is strong investor demand for financially competitive green bonds.

However, while the growth rates of the green bond market are impressive, and volumes are starting to be significant, the market is still tiny compared to the overall $100 trillion bond market.

To address the climate change challenge we need continuing rapid growth in the market, especially in emerging markets. This is where the vast majority of investment needed to transition the world to a low carbon and climate resilient economy will be.

Many of these countries are also now reforming their capital markets, creating exciting opportunities to make sure reforms facilitate the growth of a labelled *green* bond market.

In 2015 we've seen several labelled green bonds from emerging economies, notably India. This is a great development; now we need to speed up the process to ensure that the rapid expansion of infrastructure and growth in these countries is low carbon and climate resilient. The scale of the opportunity is immense: in India alone, the government has set a target of 165 gigawatts of new renewable energy capacity by 2022. According to Yes Bank, $70bn of debt investment is needed to achieve this goal – ample opportunity for green bonds.

There is a role for the public sector to create and develop a market for green bonds to tap into investor demand and ensure the market meets its potential.

The public sector and different market actors - including investors, commercial banks and bond issuers - can work together to enable market creation. The main market development tool used so far has been green bond issuance by multilateral and national development banks. This has been essential to establish models and provide market liquidity.

But such issuance is only one of the options in the public sector toolkit.

10-point Agenda for the Public Sector

Issuer base

1. Strategic issuance from public entities

Public issuance can provide initial market deal flow and liquidity, engaging investors and educating them about the asset class. International development bank issuance kick-started the green bond market. More recently we've seen the impact of German development bank KfW issuance in kick-starting a German green bond market.

In addition to domestic and multilateral development banks, potential public demonstration issuers include green banks and municipalities.

Green Bond Market Development Committees

One collaborative model being implemented to create and develop green bond markets is the Green Bond Market Development Committee. These Committees representing various stakeholders are currently being organized in Mexico, Brazil, Turkey, India, China, Canada and California. We expect to see many more in the coming year.

Global cooperation between the Committees will allow ideas and policy proposals to be shared and activities to be synchronized. The Climate Bonds Initiative is actively supporting the Committees.

2. Strengthening planning and pipeline transparency of green projects

This allows potential green bond issuers, investors and regulators to plan ahead. It gives these actors reason to develop improved expertise in the relevant investment areas.

Investor base

3. Improving the risk-return profile of green bonds: credit enhancement

Credit enhancement should be selective, and aim to make green bonds fit institutional investors' credit requirements.

Relevant credit enhancement tools include partial guarantees, subordinate debt and insurance.

For example, in 2014, a green credit enhancement program was launched by the US-government guaranteed Overseas Private Investment Corporation (OPIC). Multiple green project bonds have been issued under this program. Other agencies have similar schemes.

Of course, credit enhancements need to be tailored to the context of particular markets. That takes work, some trial and error and good initial analysis, such as the work done by the Climate Policy Initiative, comparing the fiscal efficiency of different support mechanisms for renewable energy development in India.

4. Tax incentives

Tax credit bonds are being used to encourage the development of bond markets in various countries around the world, including, for example, the municipal bond market in the US and the infrastructure bond market in India.

Specific green tax incentives are also used. The Obama Administration has put in place a number of tax credit schemes that support green investments. China is now examining opportunities to introduce tax incentives specifically for green bonds.

There is also an opportunity for policymakers to tweak tax codes to encourage longer dated investments more generally. This would benefit low carbon investments and green bonds, as many of them are longer term.

Tax incentives can be designed to accrue to issuers or investors.

5. Boosting demand: domestic fund mandates

Governments regularly provide guidance to public pension funds, sovereign wealth funds and the like about investment filters that will support a sustainable economy. The same can apply to green investments, including green bonds. For example, Norway's sovereign wealth fund, one of the largest in the world, now includes green bonds in its fixed income portfolios through its environmental mandate.

Green sukuk (Islamic bonds)

There has been lots of talk of investor interest in green sukuk. The market needs to be kick-started with issuance by government-associated entities, such as energy utilities or sovereigns. We're hopeful that this will happen before next year's State of the Market report.

6. Boosting demand and convening power: central banks

Central banks can use their balance sheets to purchase green bonds, including through quantitative easing, liquidity-providing operations and other mechanisms. They can also play a coordinating role in bringing together policymakers and advancing the green bond policy research agenda. How China's central bank has advanced the green bond agenda in 2015 sets an example (see p13).

Market structure

7. Market integrity: Supporting standards development

The public sector can support efforts to establish common green definitions, standards, verification, certification and enforcement processes for the green bond market. One example is green bonds only qualifying for market incentives, such as tax incentives, if they comply with standards.

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8. Market creation and development: aggregation of small-scale green assets

Facilitating aggregation of green assets is crucial, as many low carbon investments are small-scale – for example rooftop solar PV. Supporting the growth of a securitisation market for low carbon assets is one way the public sector can do this. This includes encouraging deal flow of green loans suitable for subsequent securitisation; supporting financial warehousing of loans and providing credit enhancement for securitisation issuance. These supports can be made conditional on loans using standardized contracts. This would speed up the standardization process for low-carbon assets such as energy efficiency loans.

9. Financial regulatory measures are important

Regulatory measures can provide opportunities for positive incentives for green bonds. One example is the preferential risk weighting for green bonds in banks' capital ratio requirements being considered by China's central bank.

But it is also crucial to ensure that other regulatory changes do not have unintended negative consequences for low carbon and climate resilient investments. This has been the case with Basel III and Solvency II, which has disincentivised the longer-term investments needed in renewable energy and other low carbon sectors.

10. International financial cooperation

International collaboration is crucial to avoid fragmenting the global green bond market with incentives e.g. having different tax incentives in different European countries. Liquidity benefits arise from such international cooperation on policy support, as it allows the creation of a global green bond market. An example here would be mutual recognition of standards for green bonds between governments. Of course ideas-sharing is also useful.

For more details on each action area see the Climate Bonds Initiative website.

The Climate Bonds Initiative will publish an extended strategic policy guide for green bonds in October 2015.