Climate Bonds INITIATIVE

NOVEMBER 2011

Climate Bond Standard Public Consultation Report

Introduction

This report is an explanatory appendix to the 'Climate Bond Standard – Version 1.0 – Prototype'.

The aim is to explain the changes in the released draft following a consultation process on a first draft and to invite further comment and suggestions on outstanding issues.

The Prototype will be reviewed after a six-month period, and re-released, with any agreed changes, as the final Standard.

The Consultation Process

The first draft of the Climate Bond Standard – Version 1.0 – Prototype was opened for public consultation on the website of the Climate Bonds Initiative on March 15th 2011 for a 30 day period. Comments were received through the website and in email form from various sources.

Revisions to the Standard text was then carried out by the Climate Bonds Initiative based on consultations with the expert **Industry Working Group** including representatives from:

- Standard & Poor's
- Aviva Investors
- IFC (a part of the World Bank Group)
- KPMG
- PwC
- Calvert Funds Management
- Environmental Capital Group
- Climate Strategy & Partners
- Enviromarkets
- DNV

The members of the **Climate Bond Standards Board** – the California State Teachers' Retirement System; the Natural Resources Defense Council; the California State Treasurers' Office; the Investor Group on Climate Change; the Carbon Disclosure Project; and the Ceres Investor Network on Climate Risk – were also consulted on the draft text in the lead up to final approval and public release.

Finally, Shearman & Sterling LLP provided extensive and invaluable support on drafting, industry practice and related matters.

Public Consultation Results

Comments were invited for general opinion on the purpose of the standard and for each of its 16 clauses across the objectives of Low Carbon Efficacy, Climate Integrity, and Financial Accountability. Table 1 provides an overview of the Standard structure in the 1st Draft under consultation.

Table 1: Overview of Standard structure – 1st Draft for public consultation

Purpose	Standard for corporate bonds associated to wind energy investments		
Introduction	Working definition of a 'Low Carbon Economy' – *describing the low carbon economy framework from which eligible projects or assets may be derived from* Process of Inclusion and Standard Expansion – *describing the research and development process by which set eligibility criteria for particular projects or assets or to be derived.*		
Objective	Low Carbon Efficacy *listing eligible assets and providing for the association and tracking of these with bonds*	Climate Integrity *upholding the integrity and spirit of climate bonds by asking for disclosure on ESG and maintaining the low carbon nature of funds under management*	Financial Accountability *ensuring the funds tracked are accountable in supporting low carbon investments through ring-fencing or other means*
Clauses	1. Coverage 2. Project Nomination and Traceability 3. Grandfathering	4. Environmental and Social Integrity 5. Project Holding 6. Contamination 7. Dilution 8. Use of Released Funds from a Climate Bond	4. Bond Issuance Integrity 10. Settlement Period 11. Management of Pooled Funds 12. Ring-Fenced Cost Centres 13. Management of Surplus Funds 14. Verification 15. Certification 16. Non-Compliance

The comments received fall into three different categories

General comments on the Standard purpose, its role in the market and structure

All respondents welcomed the introduction of the Standard as a tool to help catalyse investment in the low carbon economy. Some comments reflected the need for a better accuracy in the explanation of what the Standard is aiming to achieve. For example, some interpreted the aims of the Standard for financing of new green assets and as such would require 'additionality' tests of some sort. The aim to support re-financing of existing assets was not apparent.

In addition, the explanation of the Standard's role in relation to the Low Carbon Economy was commented on. This ranged from the need for verification of emissions avoided from business as usual by assets financed by Standard compliant bonds or the inclusion of elements under the low carbon economy framework such as biodiversity and ecosystem services. In general, the use of the Standard as a straightforward binary tool to determine eligible investments for a low carbon economy rather than a investment tool based on carbon accounting was not apparent to respondents.

Furthermore, the coverage of the Standard for corporate bonds related to wind energy investments was not apparent. Respondents were not sure as to which clauses were common to all bonds and investment types and which specifically for corporate bonds or wind related investments.

Comments regarding the text, meanings and potential consequences of specific clauses

Many comments were made on specific clauses most notably[1]:

[1] Note these clauses refer to 1st Draft of the Standard that went under public consultation on March 15th. Headings and numbers of clauses have been altered in the 2nd Draft

2. Project nomination and traceability: the clause designed to link the bonds to underlying low carbon assets. Respondents suggested some complex bonds may rely on multiple sources of revenue not only from specified projects or some multiple bonds may be linked to one project, and that reconciling value of bonds with eligible projects when necessary may be too onerous.

4. Environmental and social integrity: the clause designed to promote disclosure by issuers of compliance if any to national laws and ESG standards in the given area. Responses ranged from the need to avoid hoodwinking issuers into complying with other standards to those who supported the definition of best practices by naming certain standards.

6. Contamination: the clause designed to forbid funds from bonds to be used for activities inconsistent with a low carbon economy. Responses focused on greater clarity around the compliance requirements for this clause

7. Dilution: the clause designed for bonds that may be associated with a mix of low carbon and other assets. Responses reflected the remit of the Standard over non low carbon assets and potential thresholds for mixed-bond compliance

10. Settlement Period: the clause designed to ensure the funds from bond issuance are assigned promptly to associated low carbon projects. Many respondents deemed the 1 year timeframe for the settlement period to be too restrictive.

Comments on other clauses included requests to expand the eligible projects rapidly (1. Coverage); clarification on dealing with retrospective issuances (3. Grandfathering); the restrictive nature of requiring associated portfolios to be replenished if assets are divested (5. Project Holding) and of placing constraints on the use of funds released by a bond issuance (8. Use of Funds released by a Climate Bonds). There were also comments and suggestions related to reporting and verification requirements at issuance and through the management of the funds (clauses 11, 14, 15, 16).

OTHER COMMENTS

Respondents highlighted omissions that should be included such as information on dispute resolution or an alert system to notify bondholders of non-compliant bonds.

Comments were made on the ability of verifiers to clearly interpret and act on the text in completing audits of applicant bonds particularly in relation to the disclosure clauses and whether verifiers must also be qualified to verify compliance with disclosed ESG standards or good practices in financial services (clauses 4, 9). Verifiers also needed better guidance on how to comment against the management of funds raised through the bond in relation to the associated projects and the maintenance of the portfolio as a low carbon portfolio (clauses 6,7,8,11,12). Other responses stressed the importance of minimising process overload and disruption to the ordinary business of issuers.

Approach to Revised Draft

The comments led to the adoption of three main objectives in the drafting of the Revised Draft. These were:

- To more accurately communicate the aims and objectives of the Standard and its role in the market
- To simplify the standard structure to better reflect how the Standard will operate in the market
- To clarify text in the clauses and refine or exclude clauses which may be impractical or need further work before inclusion.

COMMUNICATING AIMS AND OBJECTIVES

The previous Standard structure was based on the objectives of:

- Low Carbon Efficacy – promoting the low carbon efficacy of bond investments
- Climate Integrity – upholding the integrity of climate bonds mark in terms of supporting ESG or forbidding investments in areas inconsistent with a low carbon economy such as fossil fuel generation
- Financial Accountability – ensuring that funds and accounts can be monitored and verified to be supporting the specific low carbon investment it claims to support.

Given the elements of confusion or misunderstanding in some of the consultation responses on how the Standard operates and achieves these aims, it was important to more clearly set out the aim of the Standard itself and what it is trying to achieve.

The Revised Draft adopts a single overarching aim for the Standard itself. It is articulated as follows:

"The Climate Bond Standard aims to provide assurance that funds raised using a Climate Bond are being used in ways consistent with delivering a low carbon economy."

The new aim succinctly communicates what the purpose of the Standard is and frames the relevance of the following text. The previous objectives are either incorporated within the overall aim or are more relevant to particular clauses rather than the Standard itself.

The following sub-sections in the Introduction elaborate on the role the Standard will adopt in the market.

The *Working Definition of the Low Carbon Economy* sets out the framework for which low carbon investments will be eligible as a Climate Bond. This section has been simplified in the Revised Draft.

The sub-section on *Process of Inclusion and Standard Expansion* has been deleted and text merged with the italic text under the previous section for simplification.

A new section has been added '*Application of the Climate Bond Standard*' to communicate how the Standard is intended to be applied in capital markets. The section articulates the belief that additional deal flow can be generated for low carbon purposes by allowing for certification of three types of bonds:

- Corporate bonds .
- Portfolio Bonds issued by securitization vehicles comprised of individual loans to finance physical assets or equity investments in physical assets.
- Project development bonds

The clarification of the types of bond structures the Standard aims to certify is as a result of a need to better communicate how it is envisaged corporate bond certification would work and also as a result of feedback indicating that many provisions were also relevant to project development bonds e.g. for wind farm development and construction. This has therefore led to an expansion of the initial scope of the Standard to not only focus on corporate bond-types but also project development bonds.

We believe these changes to the overall aim and application of the Standard better articulates what the Standard is trying to achieve and the purpose for the clauses to follow.

STRUCTURE

The structure of the Standard clauses has been changed significantly. Through consultations it has been possible to identify elements of the Standard that should be general requirements for the Climate Bond asset class and those which are specific to wind investments and corporate bonds respectively. The structural changes are summarised in Table 2 below:

Table 2: Comparative Structures of Climate Bond Standard – 1st and Revised Drafts

	1st Draft	Revised Draft
Purpose	Standard for corporate bonds associated to wind energy investments	General Standard for all Climate Bonds (to be expanded over time)
Introduction	Including: ▪ defining the 'Low Carbon Economy' framework for eligible projects under the Standard ▪ describing the Process of Inclusion and Standard Expanision	Including: ▪ defining the 'Low Carbon Economy' framework for eligible projects under the Standard ▪ the intended scope of 'Application of the Standard' for particular bond types and structures in the market
Part 1	Low Carbon Efficacy	General Requirements
	Listing eligible assets and providing for the association and tracking of these with bonds	Listing general requirements applicable to all Climate Bonds such as asset linking, use of proceeds, verification and certification requirements and encouraging disclosure on ESG.
Part 2	Climate Integrity	Low Carbon Contribution
	Upholding the integrity and spirit of climate bonds by asking for disclosure on ESG and maintaining the low carbon nature of funds under management	Listing the eligible low carbon projects or assets for investment and referencing any developed technical criteria that may apply to them This section will be expanded over time to include a wider range of eligible low carbon investment areas.
Part 3	Financial Accountability	Bond Structures
	Ensuring the funds tracked are accountable in supporting low carbon investments through ring-fencing or other means	Providing specific clauses for certain bond types. Version 1 covers project development bonds, corporate bonds, and portfolio bonds and will be expanded over time to include other bond types.

The structure changes allows the market to better understand the role of Standard, identify the place that each clause has in promoting investment, and how additions of eligible low carbon areas and bond types can be added over time.

Definitions

Many phrases in the text required further definition to allow better accuracy and understanding.

- Low Carbon Economy: Many respondents were either concerned at the vagueness of the working definition of the Low Carbon Economy in the 1st draft and the role it played in defining what eligible low carbon assets may be applicable to Climate Bonds. We have therefore added text that clearly refers to investments that support climate change mitigation and adaptation. We have also referred to scientific consensus related to limiting global average temperature increase to 2°C by 2050.
- 'Nominated Projects': For greater understanding, this phrase has been defined further by the *physical assets or loans to finance physical assets* associated with a Climate Bond. We believe it is important that to assure the low carbon claims of bond issuers, the specific physical assets can be traced.
- Contamination: This has been defined as the use of intended Climate Bond funds for activities inconsistent with the delivery of a Low Carbon Economy. We have deleted references to other activities which would bring the Climate Bonds into disrepute. We invite further comment as to whether such investments are self evident, and thereby self-regulating, or whether a negative list or climate benign list of investments is required.
- Wind Energy: We have changed the previous context of defining eligible projects from a resource-based definition i.e. *any asset which uses wind to harness energy*, to a more defined structure which lists eligible assets such as wind farms, wholly dedicated wind manufacturing facilities; or wholly dedicated transmission infrastructure. We invite further comment on this definition.

MERGING, ADDITION AND EXCLUSION OF CLAUSES

In accordance to the newly adopted structure of the Standard the clauses have been reallocated to the three sections. This is detailed in Table 3.

Particular clauses have been split or compliance requirements reallocated to better reflect the placing and purpose of each clause under each section. [2]

Deleted clauses from the 1st draft include:

- 3. Grandfathering – it was recognised that any retrospective bond issuances would need to comply with the Climate Bond Standard in any case.
- 9. Bond Issuance Integrity – it was recognised that requiring adherence to good financial practices in order to uphold the good name of the certification mark would lead to confusion of the purpose of the Standard as related solely to assurance on the low carbon claims of the bond rather than and financial or credit rating.

Some clauses from the 1st draft have been excluded and noted for future consideration and agreement. If eventually these clauses are added to the Standard these would only apply to new issuances after their addition. They are listed in the Annex of this document and include:

- 7. Dilution: where mixed bonds are provided for, was excluded due to the complex nature of such certification at this early stage of the scheme.
- 8. Use of Funds Released by Climate Bond had previously featured to promote the re-investment by banks into additional low carbon areas once a bond has been issued. For corporate bonds this was a particularly strict requirement and a Corporate Bond Overhang clause is under consideration in order to ensure that the use of Climate Bonds for re-financing also can catalyse additional investment.
- Penalties: Whether a penalty regime for bonds which move out of compliance in order to discourage the abuse of the Climate Bonds Mark by prospective issuers and to protect bondholders is required will need to be considered including its form and how it is implemented.

New clauses which have been included in the Revised Draft are[3]:

- 3. Use of Proceeds – This clause originated from compliance requirements in the Project Holding clause where it was required to hold underlying assets to the market value of the bond at the time of issuance. This was in order to defend against bond issuances which use low carbon claims to raise more than is required to finance the underlying assets in order to finance other related activities. It is inserted in the General Requirements section to underline the application of this principle to all Climate Bonds – that bonds are issued solely for delivering finance for low carbon assets.
- 9. Technical criteria – This clause is a placeholder for technical criteria to be developed for eligible projects and assets listed in clause 8.
- 12. Confidentiality – With particular corporate or portfolio type bonds linked to a number of assets or loans, such disclosure of underlying information may be subject to confidentiality agreements between interested parties. This clause aims to provide for the conformity with such agreements while allowing a fair and transparent verification to take place.

Significant editing has occurred on the following clauses:

- 1. Project Nomination – There is now a requirement for issuers to avoid double-counting. Requirements on disclosing fraction of investments to value of assets was deleted and issues on reconciling value of bonds to underlying assets is dealt with separately.
- 3. Non-Contamination – In the italic text it is clarified in what instances contamination may occur and how issuers must ensure against the use of funds with activities inconsistent with the delivery of a low carbon economy as described in the Definitions section. For the compliance requirements, there is a common 1 year grace period to allow temporary management of funds, to be extended on request to the Climate Bond Standards Board for example in the case of force majeure. In addition, it clarifies that systems for fund management must be in place for verification and that only funds equal to the amount raised by the climate bond are subject to the requirements of non-contamination.

[2]

[3] Clause numbers refer to the Revised Draft November 2011

- 4. Environmental and Social Integrity – This clause has been clarified for verifiers and issuers to be clear about the requirements in this case. In the first instance, it should be stated that linked assets are in compliance with local and national environmental and social regulations. In the second instance, the Climate Bond Standard encourages adherence to other relevant Standards, for example the Equator Principles. This clause allows for compliant issuers to disclose this information readily to prospective investors.
- 5. Verification – It is clarified that investigations into alleged breach of compliance may only be initiated by interested parties to the certified Climate Bond. Additions were also included to allow for public disclosure of verification reports subject to approval by interested parties.
- 7. Non-compliance – while the text outlines the consequences for the issuer if the bond is to become non-compliant with the Standard it clarifies that loss of certification is not linked to a default on the financial obligations of the issuer.
- 8. Eligible Physical Assets – as referred to in the Definitions section, the eligible wind activities have been clarified to specify the construction and development of wind farms; wholly dedicated manufacturing facilities and transmission infrastructure.
- 11. Project Holding – the text previously suggested that mark-to-market valuation changes of underlying assets would require the bond issuer to add, during the term of the Climate Bond, more assets to the linked pool or portfolio. The new language explicitly refers to the nominal market value of assets at the time of issuance of the bond and how this must be maintained in the linked portfolio except in cases of market devaluation.
- 13. Settlement Period – After consultation, it was deemed to preserve the 1-year settlement period of funds subject to extension through a request to the Climate Bond Standards Board. Issuers are also required to provide an investment schedule to verifiers at the time of issuance.

Clauses which were merged due to duplication or for simplification include:

- 11. Management of Pooled Funds into Ring-Fenced Cost Centre
- 13. Management of Surplus Funds into Settlement Period

Table 3: Allocation of clauses in Climate Bond Standard – 1st Draft and Revised Draft

	1st Draft	Revised Draft (Previous related clauses)
Part 1	Low Carbon Efficacy 1. Coverage 2. Project Nomination and Traceability 3. Grandfathering	General Requirements 1. Project Nomination (2. Project Nomination & Traceability) 2. Use of Proceeds (5. Project Holding) 3. Non-Contamination (6. Contamination) 4. Environmental and Social Integrity (4.) 5. Verification (14.) 6. Certification (15.) 7. Non-Compliance (16.)
Part 2	Climate Integrity 4. Environmental and Social Integrity 5. Project Holding 6. Contamination 7. Dilution 8. Use of Released Funds from a Climate Bond	Low Carbon Contribution 8. Eligible physical assets (1. Coverage) 9. Technical criteria
Part 3	Financial Accountability 9. Bond Issuance Integrity 10. Settlement Period 11. Management of Pooled Funds 12. Ring-Fenced Cost Centres 13. Management of Surplus Funds 14. Verification 15. Certification 16. Non-Compliance	Bond Structure Corporate Bond 10. Traceability (2. Project Nomination & Traceability) 11. Project Holding (5.) 12. Confidentiality (new) 13. Settlement Period (10.) 14. Ring Fenced Cost Centre (12.) Portfolio Bond As for clauses 10. 11. 12. 13 above Project Development Bonds No additional clauses required

Next steps

The released Climate Bond Standard – Version 1 – Prototype is currently open for certification in a working trial period of six months. This period is designed to allow for further improvements to be made, subject to identified solutions, as the market adopts the Standard. It allows an extended period of consultation on existing text while also allowing for consideration of additional clauses by stakeholders.

Further details on comments and suggestions during the working trial period is available on http://standards.climatebonds.net.