INTERVIEW

WALKING THE TALK – TRANSITIONING BROWN INDUSTRIES TO GREEN

Manuel Adamini
Head of Investor Engagement, Climate Bonds Initiative

Picture credit: Walter Kallenbach

Manuel Adamini is Head of Investor Engagement at the Climate Bonds Initiative. He is an expert in institutional responsible investing, with a deep understanding of climate-related investment risks and opportunities, including green/climate bonds. Manuel is a frequent speaker at conferences and has contributed to numerous international publications.

Until early 2015, he served as Head of Responsible Investing at Dutch EUR 55 bn asset manager ACTIAM for seven years. Earlier in his career, Manuel worked with Fortis, at the time a major international bank-assurance company. He initiated and implemented a climate strategy for carbon neutrality on a global scope, including the scaling up of business opportunities like carbon banking and green banking and insurance.

Climate Bonds Initiative is an investor-focused not-for-profit, promoting large-scale investment in climate change solutions. Climate Bonds undertakes advocacy and outreach to inform and stimulate the market, provides policy models, government advice, market data and administers an international Standard & Certification Scheme for best practice in green bond/loan issuance. More information on our website here.

I - DELINEATING THE TRANSITION CONCEPT

Q1. Climate Bonds Initiative has been a vocal supporter of the inclusion of brown industries in sustainable finance. Why is this topic so instrumental?

The green bond market has grown from zero to around $750 billion outstanding in about a decade. This is a global phenomenon. But it doesn't change the equation yet.

We need to urgently finance and deploy measures to mitigate emissions and to adapt to climate impacts already in the system. The IPCC SR15 report points to the speed and scale required. We face a climate finance gap of around $2.5trillion per year, add SDG goals with their critical contribution to climate resilience, then we're looking at $5-7trillion. Achieving the milestone of $1 trillion in annual green investment early in the 2020s will help change global perception of these numbers from headline style goals to achievable, investment reality. Steps to address climate change need to happen at every level of the economy, and we need to bring other actors, especially non-financial corporates, along the transition path – first towards low carbon, then to zero carbon. The responsibility to facilitate and catalyse such transition rests squarely with the financial sector, including institutional investors.

With the climate emergency demanding that we spend our money wisely, issuers' funding propositions must relate to strictly verifiable climate-relevant projects and assets. Those need to come out of the vital few sectors that make up the bulk of global emissions. While per-sector contributions can vary significantly across countries and regions and are sensitive to sector boundary definitions, the big five tend to be: energy, buildings, transport, energy-intensive manufacturing and materials, and agriculture/land-use (change).

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Past green bonds issuance and use of proceeds has been heavily biased toward the first two of those sectors (with the caveat that energy largely refers to renewables investments by power utilities). Transport has been catching up over the past two years, but this primarily covers public transport. Manufacturing and materials as well as agriculture have been notably absent - the latter partly because it can be hard to make investible anyway, and in debt capital markets even more so.

Green bond markets to date have yet to land here: they have largely overflown some of the vital sectors. This must change. Repeat issuers lament the scarcity of projects. Investors complain about lack of supply of bonds. We need to activate those segments of the market that have remained absent but offer huge emissions reductions potential as well as nice yield . It's easy to do some mapping: we're talking cement and concrete, metals and mining, and private transport. This doesn't sound particularly green – yet we can't achieve our green targets without reductions in these sectors, and that's exactly the point. We even need to look at oil, petrochemicals and gas - though we can't see a Paris-Agreement aligned pathway here yet, as we simply can't ignore scope 3 emissions across the value chain.

Q2. Could you present your recently launched partnership with Credit Suisse to promote the Sustainable Transition Bonds market?

Investor appetite for debt-based issuance that reflects the transition towards sustainability is growing, however investors will need to see a broader range of issuers, expanded uses of proceeds (UoP) and a wider credit spectrum in order to enhance yield and sector diversification within their own 'sustainable' portfolios. There is also a strong desire to align their investments with the UN Sustainable Development Goals (SDGs).

At the same time, more and more issuers across industry sectors are looking to incorporate sustainability into their core operations and invest in shifting their business models to better address the climate change challenge. They are also looking at wider impacts across their value and supply chains, including packaging, waste and biodiversity loss. Both Credit Suisse and the Climate Bonds Initiative see the need for an inclusive, open and rigorous process to develop a framework that will underpin a scalable and robust sustainable transition bond market, which will unite the ambitions of these investors and issuers.

The partnership intends to build on the European Union's work on a sustainable taxonomy, as well as other emerging green market standards and the UN Sustainable Development Goals. It will undertake the initial groundwork, conceptualization and broad market engagement to develop options for a sustainable transition bond market that can support key industry transition pathways.

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The aim is to accommodate prospective issuers and investors whose strategic objective is to transition towards low carbon and sustainable business models. It's not an exclusive partnership. We will be working with many actors on this issue, from UN organisations and NGOs to investors and other banks.

Q3. Apart from the various possible end goals of a completed transition – e.g. climate scenarios alignment, carbon intensity emission halving, carbon net neutrality – the question of the strategic transition levers has been little covered. How would you define the transition at corporate level from a business model transformation and change management perspective?

We can spend every dollar only once. Given runaway climate change, we cannot afford wrong investments, locking us into future emissions. We have to carefully set gatekeepers and markers when admitting brownish sectors to the green game. I want to see issuers committed to strategic change: green intentions turning into tangible and verifiably climate-relevant measures that relate to companies' core business activities. Green capital expenditure compared to traditional capex may be small for a start. However, it should be a credible indicator of more to come: a reorientation toward a 2ºC - or rather 1.5ºC - global warming pathway.

So how can prospective issuers make sure they're credible? According to the Financial Stability Board Task Force on Climate-related Financial Disclosures (TCFD) framework, companies need to provide evidence to investors as to how they intend to manage anticipated financial impacts of climate-related risks and opportunities on their cash flows, and from there on to income statements and balance sheets. Companies need to demonstrate that they understand: what a transition to a low carbon business model may look like; what key mitigation and adaptation issues have to be addressed; what strategies need to be developed in response; what governance frameworks (incl. senior management capabilities and incentives) need to be put in place; what capital expenditure is necessary; and what funding is to be attracted to deploy such capital expenditure. Only then should one focus on what role green bonds play within that funding mix. Credible green bonds are a means to supporting the journey from brown to green – never an end in themselves.

And then going to back to my earlier point, it's not a one-way street. The finance sector and institutional investors, on behalf of their millions and millions of beneficiaries have a responsibility here. A responsibility not just to be advocates, but to be active supporters of and partners in a process that helps key sectors and corporations to move decisively on the path towards zero carbon business models. Ultimately that's where we have to end up as investors, corporations, shareholders, beneficiaries.

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Q4. Do you think that the concept of transition needs to be framed differently from a sector to another? Should we differentiate air or maritime transportation, cattle-farming and oil & gas from less substitutable industries such as cement or aluminum?

I expect the market's (and investors') demand to evolve towards more nuance across sectors. For some sectors, lower-carbon alternatives may (for the foreseeable future) seem out of reach. In such cases, the transition discussion has to cover both aggressive improvements for the status quo as well as substitution and phasing-out. For other sectors, lower-carbon alternatives may well be technically available, but economically challenging. In many cases, a voluntary sectoral approach may have to be married with an (inevitable) policy and/or regulatory response. In all cases, we have to ensure that we don't lock ourselves in to further fossil-fuel based paths.

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II - KPI-LINKED FINANCING INSTRUMENTS – AN APPROPRIATE TOOL TO SUPPORT TRANSITION?

UoP financing relates to the intrinsic features of assets regardless of the broader context of the issuer. By contrast, transition introduces the notions of interim period and pathways. While focusing at the early stages on the definition of transition Use-of-Proceeds, the debate is slightly shifted towards KPI-linked instruments. The simplest idea being to tie the coupon to the achievement of KPIs.

Q5. The overall climate performance of emitting companies, roughly reflected by their Scope 1 to 3 GHG emissions, can be improved through various levers and not only diversification towards pure green activities. Feedstock changes, energy efficiency or circularity can be for instance very instrumental. Thereby, don't you think that KPI-linked instruments, which are more holistic and forward-looking, are the right format to address the transition challenge?

We have to remind ourselves what this climate finance market is all about. It's about channeling money into ambitious and verifiably climate-relevant investments at scale, at speed. The type of instrument used to accomplish that goal should only be of a secondary order.

That said, it is important that the cornerstone of the success of the green bond market as is, notably transparency around use of proceeds, not be undermined. While it can be hard to assess whether or not an investment would have occurred anyway with a UoP bond, the closeness to the asset or project allows for a clear assessment of its existence and its climate relevance.

With KPI-linked instruments, we have to find a way to assess whether such KPIs confidently show that climate-relevant investments are indeed being made and remain in place.

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If that is the case, then KPIs may actually offer some extra benefit: they can show that the investments are core-business related, and not isolated . However, the market presently lacks both the tools and the understanding to make that assessment.

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Q6. Do you think that KPI-linked financing instruments could also become a credible answer from capital markets to address the TCFD risk angle and prepare for the future climate change stress testing that will use resilience-oriented indicators?

This is a possibility, indeed. However, the burden of proof will be on issuers to show that the employed KPIs are core-business related. TCFD, if used with care and sincerity, can be a great tool to evidence this. Investors understand and support the TCFD framework, but will have to ensure that they command the necessary in-depth sector- and company insight to assess and challenge the reporting presented to them.

Q7. Through KPI-linked instruments, issuers put skin in the game with regards to their sustainability or climate targets, which is much appreciated by ESG investors. Do you think Green Bonds will evolve in that direction? And include a more formal stake in respecting engagements with a results or performance-based dimension? The introduction of a more forward-looking perspective?

Again, the devil is in the detail. How much skin issuers really put in the game can only be assessed if the extent of KPI-linked coupon hikes or discounts is disclosed – which is not always the case, esp. with loans. Even if disclosed, such numbers only become meaningful if investors can judge

a) how ambitiously the KPI has been set
b) how material that KPI is to the core business of the company
c) how material a potential coupon adjustment would be compared to average funding (or refinancing) costs and total funding outstanding
d) whether the company may simply call and refinance the bond if a coupon hike were to happen.

At present, we have doubts as to whether investors can actually make those assessments.

Q8. The labels battle is fierce. We saw Climate Action, SDG, Sustainable Transition bonds. We will also have the EU GBS standard. How can actors, especially investors, navigate this landscape? What "names" do you recommend and in what cases?

We don't care that much about the name. As long as money flows into ambitious and verifiably climate-relevant investments at scale, at speed, I'm happy. I am concerned, though, that ever more labels may reduce the market's clarity and hence its credibility and attractiveness. A proliferation and multiplicity of labels and marketing is not what's needed from the financial sector. Verifiable and measurable climate impacts from investment is what civil society wants and rightfully, expects from us as actors, stakeholders and fiduciaries in meeting this crisis.

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III - PRICING INTEGRATION AND MORAL HAZARD

Q9. Several investors highlight that they like the "skin in the game" dimension of such product. However, one can consider that it creates some misalignment of interests: when an issuer fails in its climate targets, investors financially win. Is it an issue? Is it different from any risk-reward pricing mechanism, where in this case the underlying risk is climate-related?

This is a very big question. It essentially asks to provide an answer to a persistent, decade-old global financial market failure, being the accurate pricing of climate (or environmental, or all extra-financial, for that matter) risk.
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> *To the extent that KPI-linked products help the market better price [climate] risk, it is surely worth the try. This market is young and still learning, and all innovation hence welcome.*

Q10. Do you believe that, to avoid multiple debt curves (vanilla, transition bonds) and more importantly adverse arbitraging, issuers should tie all of their non-UoP earmarked issuances to their KPI once they have started to issue some?

It seems a bit rushed to me to advise to convert all outstanding instruments into one new product... However, if over time climate-related risk (and opportunities) disclosure improves, and thus climate risk (and opportunities) pricing with it, then the underlying question will become irrelevant.

If market pricing gets climate risk right, then there will only be one curve, and if that correct pricing is based on good reporting, then it will be based on pertinent KPIs.

For this to happen, though, we need regulatory pressure from supervisory bodies and central banks. I'm thrilled to see continued leadership from the Bank of England and the NGFS on these matters.

There are additional measures that Central Banks and Financial Regulators (CBFR) can take and at Climate Bonds we strongly believe that they now have a role to 'tilt the playing field' as part of their evolving systemic responses to climate change. Our latest report puts some of these options forward.

Overall though, it's up to each and every actor in the market to now respond to the climate emergency and keep responding. Transition strategies are one area where the financial sector can deliver outcomes. Together with your readers we want to work on this outcome.

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