CAN GREEN BONDS HELP US MANAGE CLIMATE RISK?*

This autumn, Affirmative Investment Management (AIM) participated in the annual Ny-Ålesund Symposium, which focused on climate risks. It was timed just ahead of the release of the 2018 UN Intergovernmental Panel on Climate Change (IPCC) report on the impacts of global warming of 1.5°C above pre-industrial levels. The 53 delegates at this high-level convention in the High Arctic comprised climate researchers, investors, green bond issuers and policy-makers, coming together to discuss how the financial system can collectively navigate climate risks.

All investments have an impact, whether positive or negative, socially and/or environmentally. Similarly, climate events, such as floods and droughts, have a financial impact. The Symposium posed the question: how prepared is the financial system for assessing and managing climate risks? One emerging solution gaining traction is the fast-growing green bond market. It originated in 2008 and has grown to approximately $400 billion outstanding today, but it's still well below the $1 trillion of green finance required annually.

Are green bonds an effective tool for managing climate risk? Green bonds - self-labelled bonds with a defined use of proceeds towards low-carbon and/or environmental activities and sectors - are one of the major success stories in terms of financial innovation supporting green finance flows in recent years. There are many reasons why this fast-growing, emerging asset class can be an effective tool in helping manage climate risks.

First, green bond frameworks tend to finance low-carbon assets. Approximately 40% of total green bond issuance went towards energy projects, such as renewable energy generation, and 87% of the LO-Funds Global Climate Bond fund (winner of Environmental Finance magazine's Green Bond Fund of the Year) was in mitigation-focused activities in 2017. In AIM's analysis, we do find that there are fewer proceeds in the green bond market dedicated to addressing physical risk through funding adaptation-focused activities than mitigation-focused activities.

Second, the choice of an issuer to issue a green bond can also be a signal that it is seeking to address transition risk. This signal only holds if the green bond framework is aligned with the broader entity-wide transition, i.e. it is not used as a tool to grant the issuer social licence to continue counterproductive strategies. This is one of the reasons why AIM verifies green bonds on a combined framework and issuer basis. Third, enhanced disclosure relating to green bond issuance promotes greater transparency and engagement between issuers and investors on climate-related matters. Within the green bond market, disclosure remains heavily focused on carbon-related data, where

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it is relevant. Increasingly, AIM seeks to encourage greater disclosure relating to physical risks.

In summary, our view is that green bonds can be an effective tool to manage climate risks, providing that issuers and investors focus on both climate change mitigation and adaptation and show alignment of green bonds with issuer low-carbon transition plans. The failure to assess issuer responsibility leaves green bonds vulnerable to climate risks - i.e. green bonds issued by an issuer unable to carry out their expected strategies or meet their forecasts in a 2-degree scenario, as global policy and consumer demands shift, may render their ‘business as usual’ less profitable or assets vulnerable to event risks.