The New Climate Debt: Carbon Trading Wrapped in a Green Bond Proposal

A new proposal by the International Emissions Trading Association (IETA) for "green sectoral bonds" would transform global climate finance from a public fiduciary duty, primarily funded by developed countries, to a new source of developing-country debt to private creditors—and a new source of profits for IETA members.

At the May 31–June 11 Bonn negotiations on climate change, International Emissions Trading Association (IETA) members will be trying to sell their new proposal on "green sectoral bonds."[1] Like a conventional bond, the "green sectoral bond" is a debt instrument issued for a specific purpose, in this case for investments to meet bond-stipulated greenhouse gas (GHG) reductions, and whose principal must be paid back with interest over an agreed time period.

Conventional bonds require collateral for bond repayment, such as physical assets that can be sold for cash, or in some cases abstract concepts, such as "the full faith and credit of the United States" for government issued bonds. The collateral of the "green sectoral bonds" would be developing country carbon emissions credits, which bond creditors and other investors can buy and sell as often as they wish. And, of course, developing countries would be required to pay back the bond principle with interest, if they wish to retrieve their carbon emissions collateral to trade for their own profit. The following brief analysis explains some of the features of this proposal in the context of the climate change negotiations

IETA brings together about 170 transnational financial, law, energy and manufacturing firms who believe that trading carbon emissions and their financial derivatives is the most effective way to induce emitters to invest directly in low greenhouse gas–emitting technology.[2] Given the IETA members' economic power, revolving door presence in government and lobbying clout, governments are likely to take the proposal seriously. Although not yet a formal IETA position, the green bonds proposal is far from modest. If implemented, the proposal would transform climate finance from a public fiduciary duty primarily funded by developed countries to a new source of developing country debt to private creditors and of profits for IETA members, particularly from trading the emissions credits.

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IETA's proposal in brief

A fundamental assumption of the proposal is that industrialized country governments are too indebted and incapable of creating new public finance to contribute to a fund that would enable developing countries to buy technology and take other measures to reduce their GHGs. Alternative sources of public finance, such as a financial transaction tax and/or a crackdown on corporate and wealthy individual tax evasion and tax arbitrage, are nowhere considered. Developing countries are invited to apply to issue "green sectoral bonds," under the supervision and only with the formal approval of a "bespoke new body" (1), the International Green Bond Board (IGBB), which would effectively supercede the Kyoto Protocol's Clean Development Mechanism Executive Board oversight of the issuing of developing country carbon emissions credits.

To attract "mainstream investors" that IETA members assume are needed to finance climate change mitigation, the bonds would be "fully commoditizable and tradeable" (4), meaning that the bonds could be divided and repackaged according to their credit ratings agency perceived risk in bond derivatives. The repackaged bonds could then be sold and bought by any party in any combination, whether on regulated exchanges or via largely unregulated over-the-counter (dark market) trades. For example, a AAA carbon bond from X country could be repackaged with an A-rated carbon bond from Y country whose GHG-reduction projects credit agencies regard as less likely to fulfill the terms of the bond contract. Furthermore, because the returns from bond derivatives trading, to say nothing of the mere interest payments on the original carbon bonds, will not satisfy IETA's "mainstream investors," the green sectoral bonds would come with a "stream of carbon credits" (4).

Per current practice, these carbon credits likewise would be fully commoditizable and tradeable by any qualified investor and in any combination, e.g., bundled into commodity index funds along with wheat, oil and other commodity futures contracts.

In sum, developing countries would take on debt to finance GHG reduction, while the value of the bonds and their carbon credits would be determined in the derivatives market over which few developing countries have any regulatory or financial influence. The draft IETA proposal does not foresee a need for measures to prevent and counter the well-documented gaming of the carbon trading system, including outright fraud.[3]

A chart, "Annual Climate Financing Figures and Estimates," envisions the demand for the new bonds and possible sources of institutional investor finance for the bonds. The "annual potential climate change financing shortfall" is estimated at $350 billion. Assets in institutional pension funds are estimated at $12 trillion. A three percent investment of that $12 trillion in green bonds would cover the estimated climate financing shortfall, in addition to generating huge fees for the bond dealers. The two largest U.S. pension funds, currently worth about a combined $239 billion, currently invest about 1–2 percent of their monies in commodities as part of a diversification strategy.[4] If the IETA proposal moves forward, the day may come when such investments will include carbon.

Pension funds were among the biggest investors in the investment bank commodity index funds that a U.S. Senate committee and the French government determined were major drivers in inducing price volatility in wheat and oil in 2007-2008, including the historic July to mid-November 2008 aggregated commodity price collapse.[5] Nevertheless, if carbon and green sectoral bond traders can convince pension funds and other large sources of investment capital that their investments are secure, those funds may invest in the bonds. The terms of collateral are key to the success of the IETA sales pitch to potential investors.

Collateralizing the green sectoral bond

To avoid the over-allocation of carbon credits, which lead to European emitter windfall profits and the European Emissions Trading Scheme failure to induce emitter investment in GHG reduction technology,[6] IETA proposes that the developing country bond "hosts" post verified GHG emissions as bond collateral. Most developing countries have opposed mandatory monitoring, reporting and verification of their GHG emissions. However, the IGBB approval of bond design would require that verification to release a portion of each developing country's Guaranteed Carbon Collateral Units (GCCU) per the value of the issued bond. The GCCUs would act as collateral for international financial institutions, such as the World Bank and International Monetary Fund, which would be the bond guarantors.

In the event of a green bond default, the IFIs would take the developing country GCCUs and sell them to help the IFIs pay the bond's creditors. The IFIs would return the GCCUs to the participating developing country, if the bond performed successfully to reduce GHGs and fulfilled the financial requirements of bond repayment within its maturation period, as specified by the IGBB. The allocation of the GCCUs to each developing country would result from a formula that would include the percentage of a country's verified emissions of global emissions and the "amount of overall reductions by Annex I [i.e., industrialized] countries with 2020 targets" (5). This latter factor is included to help determine the developed (Kyoto Protocol Annex I) countries' institutional demand for the green sectoral bonds, since the carbon offset credits resulting from bond projects are assumed to be bought largely by developed country firms to meet their GHG-reduction compliance requirements.

In the "significant paradigm shift" (3) called for by IETA, the onus of GHG-reduction performance is with the developing country governments, who will pay a "determined cash equivalent to [bond] holders" if the GHG reduction targets of the bond, as designed and approved by the IGBB, are not met. "For avoidance of doubt" about who is to benefit from the funds raised by the sale of a bond, the IETA proposal calls for private sector firms, as well as the public sector, to be able to access the bond generated funds for GHG abatement projects (5). But if private sector projects fail to fulfill the terms of the IGBB-stipulated bond contract, the developing country government, not the private sector firms, would pay the bond holders, if not cash, then commodities or other cash equivalents.

The IETA proposal in the context of the climate change negotiations

IETA would further the objectives of Copenhagen Accord proponents to replace the Kyoto Protocol with a non-binding agreement of voluntary pledges to reduce GHG emissions from self-selected baselines. The proposal would render the Protocol's Clean Development Mechanism for developing country climate finance moot by creating an IGBB to design and approve developing country bonds to meet mandatory GHG reductions not required of developed country members in the Copenhagen Accord. IETA's members would be upfront beneficiaries of bond and carbon emission trading and legal fees, as well as recipients of carbon trading credits. According to a U.S. Commodity Futures Trading Commission official, the nominal (initially contracted) value of the U.S. carbon emissions derivatives market could reach $2 trillion by 2017, assuming that the U.S. Congress passed legislation to require carbon trading as a means to comply with U.S. GHG caps."[7]

Many developing countries insisted in Copenhagen that a UN Framework Convention on Climate Change (UNFCCC)–controlled fund for mitigation and adaptation should provide grants, not loans, to developing countries. At the Bonn negotiations in June 2010, developed countries opposed the creation of a UNFCCC Finance Board to manage funds contributed by developed countries. The developed countries argued instead for individual country–based climate finance, which would be compatible with the IETA approach.[8]

Since the Copenhagen summit, many developing countries desperate for any form of climate finance have "associated" themselves with the Copenhagen Accord in order to access promised "up front" mitigation and adaptation monies in 2010–2012. The IETA proposal that developing countries should take on more debt, in the year after developing countries and economies in transition are struggling with extremely low currency reserves resulting from the economic crisis triggered by finance services deregulation,[9] might seem "Dead on Arrival." However, IETA has positioned its proposal as if there were no alternative for developing countries but to rely on the financial markets to raise mitigation funds.

On the first day of the Bonn negotiations, several developing country delegates told how they had been unable to access climate change adaptation monies from the Global Environment Facility (GEF), the UNFCCC financial mechanism administered by the World Bank. The United States, which had denied Bolivia, Venezuela, and Ecuador a few million dollars of bilateral climate change assistance due to their opposition to the Copenhagen Accord, expressed "amazement" that developing countries could not access the GEF.[10] The longer the delay in accessing the GEF or other publicly financed mechanisms for investment to reduce GHGs, the more attractive the IETA proposal for financing may become.

Caveats against criticism

This short critique of the green sectoral bond concept cannot do justice to the political sophistication of its complementarity with the Copenhagen Accord. But crudely, a "diplomatic" argument to developing countries for the IETA proposal could be: "This is the only way that you'll get climate finance because OECD countries will never acknowledge a climate debt, much less pay it, nor will they agree to a technology transfer agreement to supply you with cutting-edge low-carbon technology. If you want the $30 billion up front financing promised by the G-8, you'll support this 'green bond' proposal in Cancún."

Climate finance must not be made to depend on the highly volatile and destructive financial and carbon derivatives markets that are not and arguably cannot be regulated effectively,[11] at least in their present structure. Alternative proposals for climate finance, beyond a reiteration of demands for developed-country payments of a generalized climate debt to all developing countries, cannot begin too soon.

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