Headline: ‘Green’ bonds for the fight against climate change

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PARIS—Climate change is already wreaking havoc throughout the developing world. Vietnam, for example, has reported that natural disasters, some of them exacerbated by climate change, have caused annual losses equivalent to 2 percent of its GDP. In agriculture-dependent countries like Ethiopia, longer droughts and more frequent flooding are threatening livelihoods and food supplies.

As the international community gears up for the United Nations Climate Change Conference in Paris in December, identifying and streamlining sources of financing for the fight against climate change must be a top priority. Development banks like the French Development Agency (AFD), where I am CEO, are well placed to contribute.

For starters, development banks can finance projects that benefit both development and the environment. Global warming is now a vital factor to consider when planning any development project. For example, the effects of climate change can pose critical risks to infrastructure—agricultural irrigation, public transportation, or nearly anything else. Meanwhile, rising incomes—a goal of any development effort—nearly always means increased consumption of natural resources and energy, resulting in more emissions and further warming.

Such interlocking relationships between global warming and development explain why the French government requires that at least 50 percent of the funding provided by the AFD be directed toward development projects that also have a positive impact on the environment. Examples include wind farms in Ethiopia, better forest management in Madagascar, nationwide climate plans in Indonesia and Vietnam, and clean urban transport in Colombia.

Development banks can also play an important role in designing financial tools that allow private investors to contribute to the fight against climate change. But today’s funding challenge is no longer just about quantity. Though potential sources for climate-friendly development financing now include pension funds, insurance companies, foundations, and sovereign wealth funds, what is often missing are mechanisms to ensure that investments are channeled into well-targeted and effective projects.

One solution is “green” (or “climate”) bonds. These instruments have all the characteristics of conventional bonds, but they are backed by investments that contribute to sustainable development or the fight against climate change.

Until recently, only a few organizations or governments, including the World Bank, the American state of Massachusetts, and the French region of Île de France, issued green bonds, and generally the amounts involved were modest. But in the past two years, other players have entered the market, and volumes have skyrocketed. In 2014, emissions of green bonds exceeded the total in all previous years combined.

Indeed, demand is outstripping supply. The latest bond offers were all oversubscribed—and the trend is likely to continue. The insurance industry has committed to double its green investments, to $84 billion, by the end of 2015. And in September, three major pension funds from North America and Europe announced plans to increase their holdings in low-carbon investments by more than $31 billion by 2020.

As the market for these bonds expands, they must be better labeled and certified. Today, harmonized standards do not exist. The quality of the assets backing the bonds depends solely on issuers' goodwill and technical skills. Specific guidelines and rating methods need to be developed. In this context, the recent decision by a coalition of institutional investors to measure and disclose the carbon footprint of at least $500 billion in investments is a step forward.

Last September, the AFD issued 1 billion euros ($1.2 billion) in climate bonds, with one goal being to contribute to the development of concrete quality standards. With the help of a major agency that rates corporate social responsibility, we were able to provide investors with solid information—and an accountability process—about the portfolio's direct impact on greenhouse-gas emissions. Indeed, the projects financed by these bonds were required to meet stringent criteria, including a prior analysis of their carbon footprint, proof of a clear and significant impact on climate change, and a design that is aligned with the broader strategies being pursued by local actors and countries.

Climate bonds have the potential to empower countries and institutions as they move toward meeting enforceable commitments to reduce carbon dioxide emissions. However, if they are to be effective, they will require clear guidelines and a reliable framework for assessment. As leaders from countries and institutions from around the world prepare to meet in Paris in December, getting the financing right should be a top priority.

Anne Paugam is chief executive officer of France's development financing institution Agence Française de Développement. France will host COP21 in December 2015 in Paris.