The case for sovereign climate bonds

How to combat climate change with fiscal policy

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Investment in a low-carbon future is a key priority for many governments across the developed and developing world, and also for central banks looking to diversify their investment portfolios. One proposal for turning this priority into action is through the creation of climate policy performance bonds – calling them 'sovereign climate bonds'.

The interest rates on these bonds would be linked to carbon dioxide reduction targets. Governments could set a rate of return on their bonds that pays investors more when the proportion of renewable energy over a year drops below a target percentage. Alternatively, the more a government reduces carbon dioxide emissions, the less interest it pays.

A vehicle for enhanced funding

Governments are well-placed to take the initiative and have the political and moral incentive to do so. Climate change threatens the lives of billions of people. If the global temperature rises by 1.5 degrees Celsius, 150m children's lives are threatened, while if it rises by four degrees this figure increases to 1.5bn. The World Bank estimates that air pollution causes one in every 10 deaths worldwide, killing four times as many people as HIV and six times as many as malaria.

November's meeting of the 'conference of the parties', the decision-making body of the United Nations Framework convention on climate change, in Marrakech, reinforced countries' commitments to keep the momentum and renew investment in a low-carbon future. Before that, the national determined contributions pledges signed by 196 nations at the Paris Agreement asked for $350bn in financing.

There is an urgent need to take action, especially as the financial challenges are increasing. But the collapse in carbon dioxide prices is weakening incentives for investment. National determined contributions are high-level blueprints, not action plans or investments. Now they need to be ordered so their impact is measurable. They could then be transformed quickly into investments, especially as low oil prices and the election of Donald Trump are threatening temperature rises exceeding the two-degrees scenario.

> ***"Sovereign climate bonds could allow long-term investors to hedge their climate risk and profit from opportunities linked to low-carbon markets.***

More importantly, governments have the financial means and incentives to do so. Since 2007, public sector debt has grown by $62tn, around 9% per year. Fixed-rate bonds (which includes so-called 'green bonds') are growing across the corporate sector. The government bond sector is a different story. There is a huge opportunity to re-orientate traditional government debt to help achieve carbon dioxide emission reductions. Governments could use debt to add credibility to their commitment of holding on to their policies.

Issuing a sovereign climate bond is a simple and effective way for governments to enhance their funding, provided they engage in reducing their own carbon dioxide emissions or increase renewable energy generation. Contrary to traditional 'green bonds' with a fixed coupon, there is a clear incentive for the issuer to reduce carbon dioxide by whatever means are available, especially through 'costless' measures such as adhering to reduction policies. The payoff formula ensures that the proceeds of such bonds will be appropriately invested rather than resulting in under- or over-investment in green projects.

New investable climate asset class

Imagine if Barack Obama's outgoing administration had issued sovereign climate bonds in 2015 following the previous meeting of the Conference of the Parties. The buyers of this debt would have been institutional or renewable investors hedging their risk of policy change. President-elect Trump would probably have considered an environmental policy change more carefully, as this would have resulted in billions of additional dollars to be paid to investors.

Many investors know they are over-exposed to climate change risks and under-exposed to the opportunities. Sovereign climate bonds could allow long-term investors, such as insurance or pension funds, to hedge their climate risk and eventually profit from opportunities linked to low-carbon markets.

Bonds for a new war

Many long-term investors, such as public pension funds or university endowments, have faced public pressure to divest from fossil fuels and invest in green products. However, they also have a duty to provide returns. Sovereign climate bonds would allow them to decarbonise their portfolios while supporting public policy and hedging against changing government policies.

On a case-by-case basis, scientists, rating agencies or other external auditors could provide additional guarantees on governments meeting, or failing to meet, their targets. The Bank of England issued the first sovereign bonds in 1694 to finance Britain's war against France. Now, more than 300 years later, we urgently need to issue a new form of sovereign bond to win the war against climate change and turn the promises of Paris into substantive action. ■

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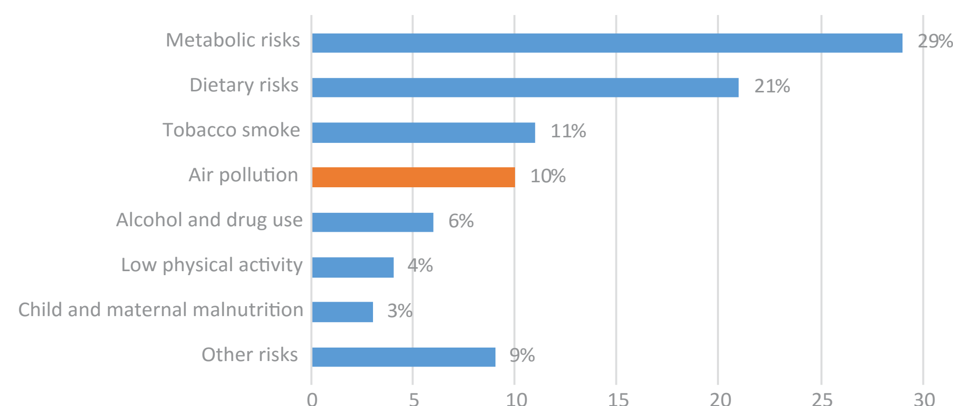
One in 10 deaths attributed to air pollution

Global attribution of deaths, by risk



Source: World Bank. Figures may not add up to 100 due to rounding.