UNIVERSITÉ DE ROUEN

PARTIEL – **Octobre 2019 (Session October 2019)**

4 HEURES / 4 HOURS

Cours:

Economics

NOM DU PROFESSEUR

Marc SIMON

Allowed documents : Yes

Internet : No

Barème / Scoring : 100%

After having read the following article, please discuss in a structured and argued manner the following sentence: " Is Green Investment a way to show the path to ecological consciousness?"

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SUJET / SUBJECT :

How green are green bonds? Ratings can help investors know. September 8, 2019 The Conversation, Florian Kessel

Since the Industrial Revolution, humans have invested in machines and other technologies to help them increase productivity and improve their lives. Unfortunately, one of the side effects of many of these advances is that we're now grievously damaging the planet.

We're now reconsidering our relationship to the environment, as demonstrated by Greta Thunberg and the Fridays for Future movement, but an even bigger revolution is what's required. The International Energy Agency (IEA) estimates that cumulated costs of approximately 50 trillion USD are needed until the end of 2035 to significantly lower our CO_2 emissions and reach the goals of the 2015 Paris Agreement.

Are green bonds part of the solution?

The necessary investments in energy efficiency and CO_2 and carbon-emission savings are large, but the financial market has already begun to promote investments in sustainable projects. One possible solution are "green bonds", which are earmarked for climate and environmental projects. Green bonds are not new: in 2007 a "climate awareness bond" was issued by the European Investment Bank. However, the number and the volume of green bonds has massively increased since the first issue. As of today, 14 international stock exchanges have launched a dedicated green bond section.

The advantage of green bonds is that companies can focus on sustainable projects and investors can support them. Research shows that green bonds may even enjoy a negative premium compared to their "brown" peers and thus can be financed less expensively.

While it sounds straightforward, the main issue lies in the general character of the bonds. A green bond has the sustainable aspect, but no other differences from conventional ones. Bonds represent a form of debt financing from investors to borrowers, but the borrower can be various, and all companies can be potential issuers. Currently, most of the issuers are sovereigns and development banks, but also companies, such as Apple, release green bonds. Theoretically, it would be possible that firms from pollution-intensive industries issue ostensibly "green" bonds. As the cash from the bond goes directly into the hands of the firm, it is important to define the use of proceeds. The International Capital Market Association (ICAM) developed Green Bond Principles which are voluntary process guidelines.

Labeling and greenwashing

The voluntary process shows that there are currently no hard definitions what is a green bond or what is a sustainable investment. The market is not standardized; therefore it can be very hard to define what is green and what is not. Market standards and certifications could be one important aspect to increase the popularity of this segment while building the investors' trust. The European Commission is currently working on an Action Plan on Financing Sustainable Growth to set a comprehensive strategy to further connect finance with sustainability.

Bonds that are issued in the green segment of big stock exchanges, such as the London Stock Exchange, need to have a green label which must be certified by an agency. An independent party has to confirm the green character of the bond. From the investor's side, besides regular reporting, a label might be a good guaranty that their money is invested in sustainable projects. The question that now arises is who has the competencies to issue green labels. A third party that is certifying the green character of the investment might just give labels to greenwash conventional bonds. If there is not enough transparency in the green labels and green labeling agencies start a market competition, the quality might be affected. The agency with the easiest requirements might win the battle and low standards would be established.

The race for the pole position

Besides the certification of the green bond character from a third party, investors want to know more about the sustainable character of a company. It can be very difficult to assess and compare the sustainability level of a company. Similar problems can be found in the past. More than 100 years ago, people who invested in railroad bonds were not able to calculate the probability of default. They asked John Moody whether he could rank the probability of default, and from this the credit-rating market arose. However, the market is associated with several issues, from regulatory aspects to agency problems. It is quite likely that the "green labelling" or "sustainable rating" market will have similar issues. The question is whether and how we can learn from the past.

The market for green and sustainable finance is rapidly growing, and a number of environmental, social, and governance" (ESG) rating agencies have established themselves. Their business model is similar to that of established firms such as Moody's or Standard & Poor's, but their analytical approach can vary. Some companies have a background in collecting data and they mainly use the market ones, such as Bloomberg or MSCI. Others, such as Sustainalytics, are ESG-exclusive data providers, have an approach similar to classical rating agencies and provide unique methodologies to assess the ESG quality of a firm. Finally, there are also other companies that focus on specific targets among the three aspects of ESG.

ESG ratings and classical credit ratings also have in common the possible risk for the rated company. If the firm receives a poor ESG rating, investors might refrain from buying equity, and sales could also fall. BP and Volkswagen are good examples of what happens if your ESG score is suddenly lowered.

Who are the new players on the market?

Regulators and investors have to start thinking now whether and how they want to establish green-label institutions and agencies as new players in the financial market before they become too important to be regulated. Alternative concepts to the business model of classical rating agencies already exist. It might be possible that ESG criteria are not rated by individual analysts but rather from a group of (independent) experts. Impaakt, for example, just started an alternative service using a crowd-based approach.The big question is what will be the standard definition of ESG criteria in the future. For example, if an oil company is labelled as "ecological" because it has a reduced energy consumption, does this really mean that it is ecological? ESG investing should be transparent and therefore it is important that ESG ratings methodology behind follow a holistic approach based on regulated methodologies.

Advice: Owing to the fact that you only have 2 hours, it is strongly recommended to focus on the major aspects and matrices presented during the course.