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2017: The year for sovereign green bonds?

Recent issuances highlight the potential opportunities for global investors

2017: The year for sovereign green bonds?

Green bonds allow sovereign issuers to diversify their investor base, support investment in sustainable infrastructure projects, and help with conservation and environmental challenges at a low cost of funding. However, to date there have been only two sovereign green bond issuances. **Tallat Hussain** and **Mindy Hauman** of global law firm White & Case discuss steps sovereigns can take to start accessing the green bond market.

It's been almost 10 years since the World Bank issued the very first green bond and, in that short period, the market's depth and volume has expanded to such a degree that green issuances are now considered mainstream.

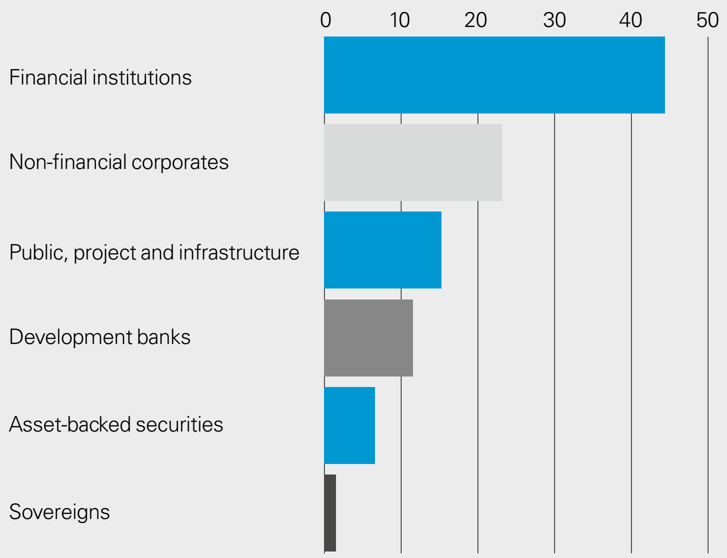
Green bonds started in the supranational space, so logic suggests that they should have now spread to the sovereign space. Instead, corporate and financial issuers made the market popular with investors and brought principles and increased standardisation to the market. Surprisingly, even though some sovereigns have laid foundations for entering the market, they have been slow to issue. However, they are now beginning to realise that green bonds offer easy access to a large and diverse funding pool, which provides a low-cost injection of much-needed capital to finance infrastructure projects and provide funding programmes that enable sovereigns to meet international environmental obligations, as well as their stewardship responsibilities to citizens.

A number of factors are influencing sovereigns' growing interest in issuing green bonds: their commitments under the Paris Agreement; the need for infrastructure finance; and the focus on power production,

2008

The year in which the World Bank issued its first green bond

2016 issuance by type of issuer

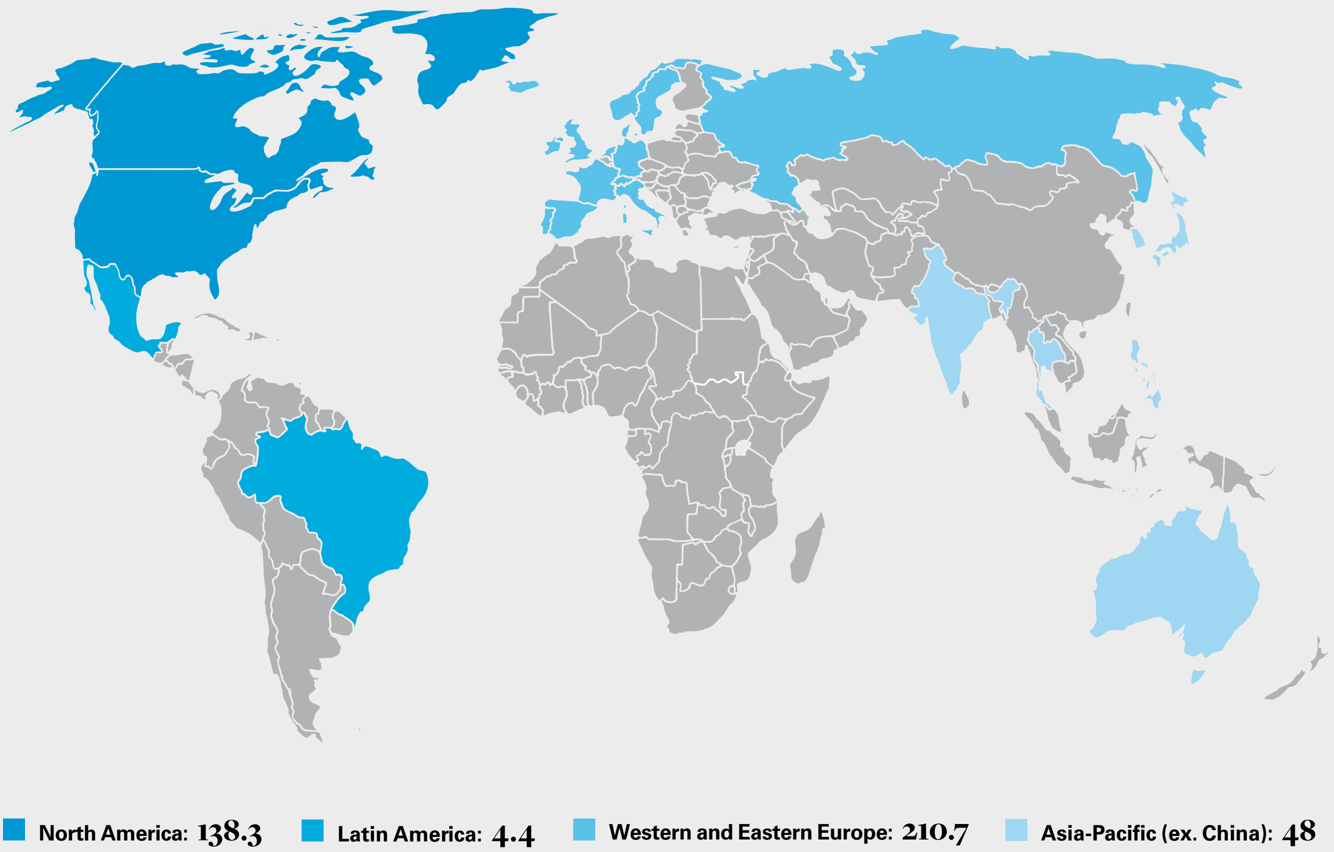


Source: *Financial Times*

> **Sovereigns are increasingly realising that green bonds provide an opportunity to tap into new pools of capital and meet their international environmental obligations**

Green bond issuances by region (US$bn)

Source: Climate Bonds Initiative



climate change adaptation and sustainable development. There are now sovereign green frameworks that capture the unique status of a sovereign in being able to set subsidies and other incentives that can stimulate the market.

> **“From a credit perspective, sovereign green bonds are often indistinguishable from other bonds**

What makes a bond green?
Sovereign green bonds are akin to mainstream sovereign bonds in many ways. Pricing and transaction costs are similar, and they are listed, traded and regulated in the same way as other bonds. Like conventional sovereign bonds, green equivalents are based on the creditworthiness of the issuer and are risk-weighted and credit-rated using the same methodology.

From a credit perspective, sovereign green bonds are often indistinguishable from other bonds. As there is no standard international definition of what constitutes a green bond, investors usually look to the Use of Proceeds section of a typical green bond prospectus to assess whether or not a given bond is ‘green enough’ for them. Today, the majority of issuances by corporates and financial institutions are based on the International Capital Market Association’s (ICMA) Green Bond Principles. However, the majority of supranationals and sovereigns tend to have their own, more bespoke standards to cater to their unique circumstances and needs.

In terms of reporting, most standards suggest an independent third party verify and report on the transparency of a green bond. The issuer will need to engage a third-party verifier to check that the projects or assets to be financed are eligible and that there are internal processes to track how the bond proceeds are being used. The verifier will also produce, at least annually, reports confirming that this is still the case. Issuers find that costs for verification fall into two categories: internal and external. Internal costs are based on the issuer establishing the required internal processes and controls for selecting projects and assets, allocating and managing proceeds, and producing regular reports. External costs are typically associated with the verifier's assurance of procedures and reports. There may be other costs depending on the type of bond and the certification sought, but the external cost is mainly determined by commercial negotiations between issuer and verifier.

Incentivising sovereigns
Most countries, whether economically developed or developing, have a need for infrastructure—and "green infrastructure" such as urban transport, water services or clean power compete with other government projects for funding. A large portion of these projects could be financed through green financing initiatives that tap into investors looking for exposure to green assets.

The Better Growth, Better Climate 2016 report by the New Climate Economy estimated that from 2015 to 2030 global demand for new, climate-resilient infrastructure could surpass US$90 trillion, and green bonds will be a key tool to drive this growth.

The strong creditworthiness of many sovereigns, along with their ability to make very large-scale issuances, makes them attractive to investors. Further, sovereigns are in the unique position of being able to create policy which directly and indirectly drives the direction of the market. For example, tax incentives and other sweeteners can be introduced to make these debt instruments more attractive to investors. Commitment to legislation and investment will play a critical role in encouraging green finance within the jurisdiction and will send an important signal to global markets.

€7bn
The value of France's 22-year term sovereign green bond, issued in early 2017

Sovereign green bond pioneers
To date, only two sovereigns have issued green bonds. Their diverse journeys demonstrate the flexibility, ease and wealth of opportunity green finance represents.

Poland was the first mover. It identified a number of sustainable projects including renewable energy, clean transportation, landfill rehabilitation and afforestation that required financing.

Poland generates more than 80 percent of its electricity from coal, demonstrating that even nations with a heavy reliance on fossil fuels can successfully issue green bonds. It also shows that it is possible to balance a nation's economic needs with its environmental obligations. The Polish government has shown its commitment to diversifying the country's energy mix and a more sustainable future and, as this issue has confirmed, investors value green ambitions.

The issuance also helped dispel the misconception that sovereign green bonds are more complicated to issue than conventional sovereign bonds. Poland's bond took only a few months to devise, and future issuances may take less time now that the framework is in place.

France kicked off 2017 with a record-breaking €7 billion issuance with a 22-year term. The coupon was set at 1.75 percent, in line with conventional bonds with a similar maturity, the proceeds of which will go towards funding renewable energy tax credits and other "green eligible expenditure", as France pursues its climate and energy policy.

France's inaugural green bond has added a strong impetus and much-needed liquidity to the market. Moreover, it was oversubscribed by more than three times, which should serve as ample encouragement to other sovereigns considering entering the market.

Sub-sovereign innovators
In some cases, it may be easier to start small rather than lead with a sovereign issue. Sub- and quasi-sovereign issuers have been comparatively prolific and diverse in terms of geography, economic development and project type, further demonstrating the versatility of green bonds and their ability to be tailored to local circumstances.

There are a variety of reasons for issuing at a sub-sovereign level. For example, Sweden, which is considered among the greenest nations, has not yet issued a sovereign green bond because the strength of its economy is such that its government does not require debt finance at the sovereign level. However, Sweden's second-largest city, Gothenburg, required funds to aid in its modernisation after the decline of its local shipping economy, so in 2013, it issued the world's first sub-sovereign green bond.

Most European sub- and quasi-sovereign green bonds issued to date comply with the ICMA's Green Bond Principles—partly for credibility. Recent issuers around the world have followed a similar trend, including the state-owned Brazilian Development Bank (BNDES); the New York Metropolitan Transport Authority; DC Water's Clean River Project; the municipal government of Queensland, Australia; and Mexico City.

In accordance with their published frameworks, each issuer earmarked

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proceeds of the green bonds to local green projects which were most appropriately dealt with at the local, rather than national, level.

Sub-sovereigns have enticed investors by offering income tax relief on interest payments. Incidentally, this has led to competitive pricing, as holding green bonds offers continued tax benefits and, as a result, they are in short supply in the secondary market.

The road to issuance: Green frameworks

While only two sovereigns to date have issued a green bond, many have created, or are in the process of creating, legislative frameworks that will facilitate green issuance in the future. This is a crucial first step, in particular for emerging economies with less-developed capital markets. It also fosters development of green finance initiatives by private institutions in a jurisdiction and sends important signals to the market and the citizens of a jurisdiction.

Some countries have fully embraced green bond frameworks. For China and India, it is a matter of when, not if, they will issue a sovereign green bond. Both countries have been extremely vocal in their support and commitment to the Paris Agreement, and both have worked with international bodies to develop frameworks aligned with the global green bond market while addressing their unique circumstances.

Despite only entering the market in 2015, by the end of 2016 China was the world's biggest issuer of green bonds, spurred by the development and implementation of official green bond guidelines and policy initiatives. Going over and above the production of a framework, the country has created a mandatory regulatory regime to more effectively address its specific national targets.

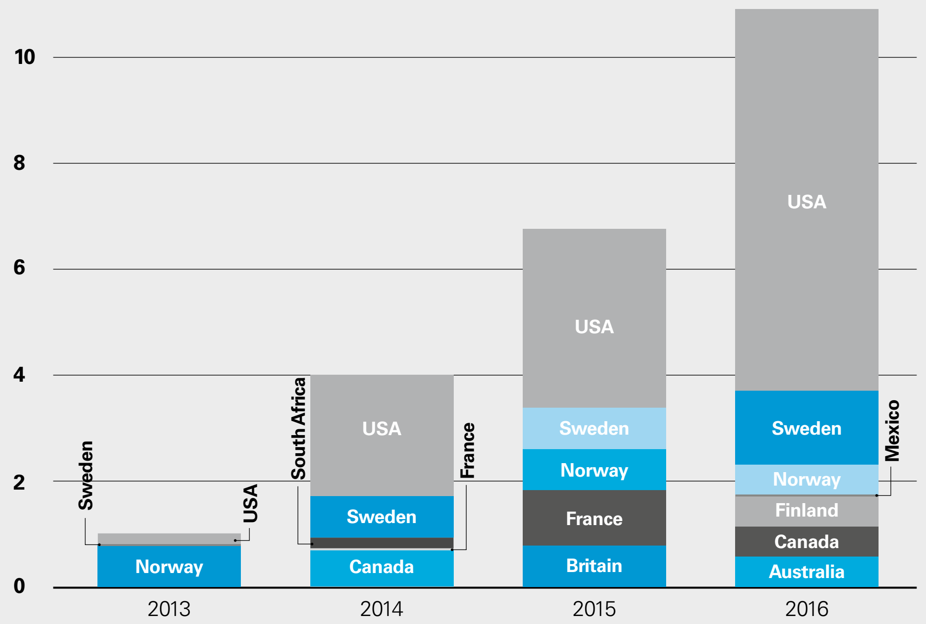
An issue with China-labelled green bonds is that projects that would not qualify for green funding in the international market may qualify in China. For example, 'clean' coal and the infrastructure that carries fossil fuels as well as renewable energy all qualify according to the Chinese standards. While on the face of it, this lack of international uniformity may be cause for investor uncertainty and concern, it has not proven problematic nor prevented Chinese banks from issuing green bonds on an unprecedented scale.

As it stands, the Chinese market is being entirely driven by commercial banks; there have been no Chinese sovereign or quasi-sovereign green issuances to date, although rumours suggest this will change very soon. The government has shown a deep commitment at almost every level and frequently speaks in public forums about its commitment to green finance.

Elsewhere, the Securities and Exchange Board of India has introduced listing mechanisms that will encourage and facilitate future green issuances. The country is planning numerous large-scale projects, such as the installation of solar panels on

> **"The strong creditworthiness of many sovereigns, along with their ability to make very large-scale issuances, makes them attractive to investors that many corporate issuers are unable to access**

Green city bonds issuance (2013–2016)



Source: Climate Bonds Initiative

the roofs and grounds of Indian railway stations. These initiatives are driven in part by the government's ambitious target of producing 165 gigawatts of new renewable energy by 2022. Despite being one of the most heavily polluting countries in the world, India, like Poland, has the potential to use green bonds to simultaneously draw international investment and clean up its infrastructure.

At the end of 2016, India ranked seventh internationally for total issuance and is a global leader in the external certification of green bonds. India is nearly as vocal and committed as China in encouraging such environmental finance.

Natural resource-rich sovereigns

For some natural resource-rich sovereigns, such as Indonesia and Brazil, issuance should be a natural and logical progression. These countries are prime examples of sovereigns with extremely rich natural resources which require protection and preservation and extensive infrastructure plans that could be financed using green methods. Many of their infrastructure projects are inherently green, so the introduction of green mechanisms has simply supported what was already in place.

After recognising the gap in funding required to reach national commitments under the Paris Agreement, the Brazilian Federation of Banks and the Brazilian Business Council for Sustainable Development in 2016 published guidelines for issuing Brazilian green bonds. The guidelines outline the country's market potential as well as issuance models. There have already been many high-profile quasi-sovereign and corporate green bond issuances, such as those by BNDES and eucalyptus pulp producer Fibria Celulose, and this trend is expected to continue.

Meanwhile, the Financial Services Authority of Indonesia, Otoritas Jasa Keuangan, will launch a regulatory framework later this year. A fundamental consideration in addition to complying with the Green Bond Principles will be compliance with Shari'ah law. These

> **"Sovereign and supranational green bond sales have been heavily oversubscribed**

often go hand in hand and, as such, 2017 may well see a new green product in the market: a green sukuk—the Islamic equivalent of a green bond.

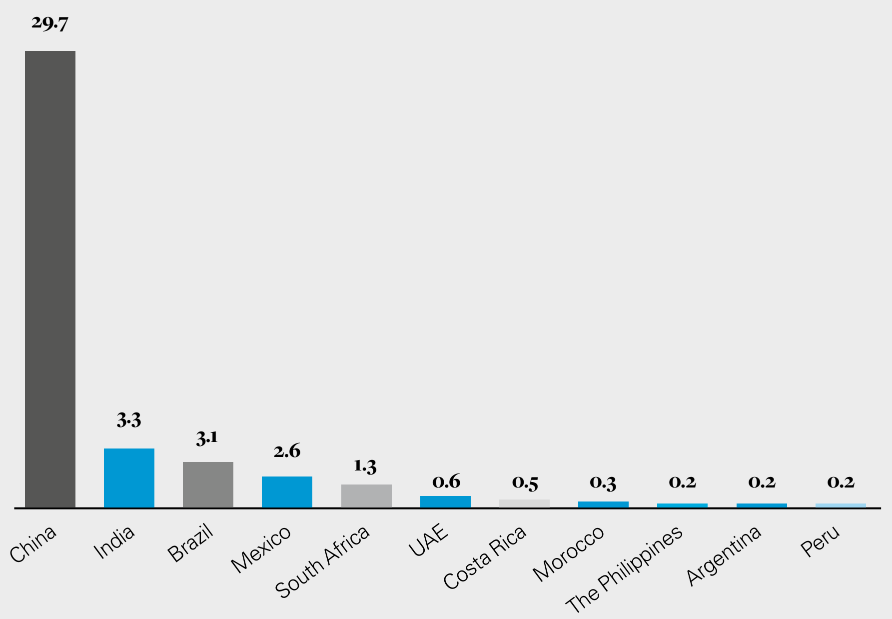
Africa's first movers

Compelled by access to cheap long-term money from a wide pool of investors, emerging market sovereigns like Nigeria are beginning to weigh up this financing option. A green label conveys higher standards of disclosure and transparency required by the Green Bond Principles. This credibility unlocks access to a much wider pool of investors who invest in higher-rated debt instruments than most emerging markets issuers can offer.

A legislative framework is now in place, and a Nigerian sovereign green issuance is expected in the near future. One of the keys to success will be winning investors' confidence by complying with the evolving Green Bond Principles. The rest of sub-Saharan Africa will be watching the country's progress intently.

Like Nigeria, Morocco is at the forefront of developing Africa's green bond market. The Moroccan Capital Market Association (AMMC) has produced guidelines explaining the concept of green bonds as well as practical instructions for issuance. For securities to be listed as green bonds in Morocco, the AMMC requires certain additional elements over and above

Emerging markets green bond issuance to Q1 2017



Source: Climate Bonds Initiative

those for plain vanilla issuances. Further, the AMMC itself will not make a value judgement on the 'greenness' of the use of proceeds, rather it requires a second opinion to verify the bond's legitimacy. Morocco has numerous upcoming projects that will be eligible for green financing, particularly in the solar energy space.

Investor incentives

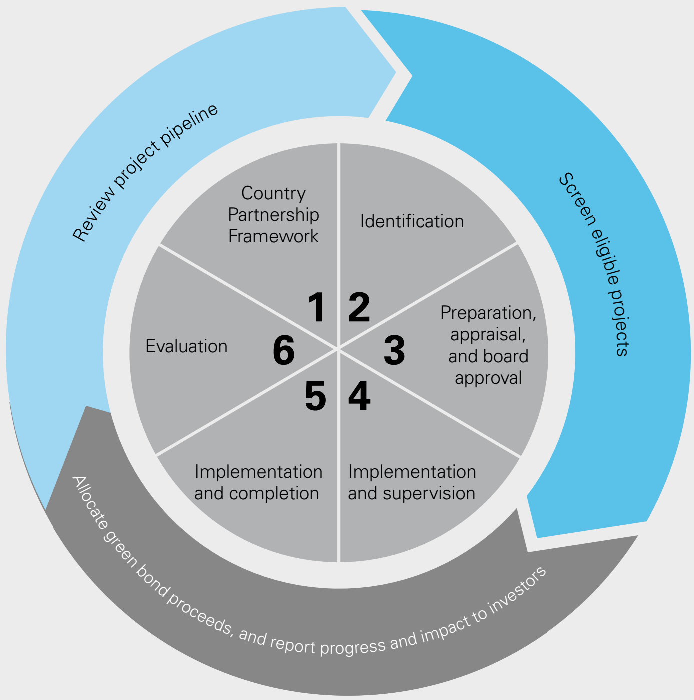
Sovereigns are in the unique position of being able to stimulate the market in a particular direction by creating policy that encourages market participants to act in a certain way.

One clear example is through the provision of tax incentives or subsidies. Though not directly facilitating government issuance, such incentives are a catalyst for private sector participation, which will be necessary for nations to effectively develop green infrastructure and economies.

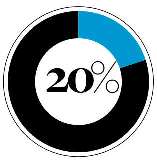
The Singaporean government, for example, is putting in place a Green Bond Grant regime which recognises the small additional financial burden of making a bond green, and nullifies this disparity through a subsidy. The subsidy is linked to the mandatory independent assessment and verification, which will be covered up to a cap of SGD100,000. Eliminating this disparity will make green bonds even more attractive for issuers.

Another form of incentive is tax credits, which investors receive in lieu of an interest payment on their investment. The US Clean Renewable Energy Bonds and Qualified Energy Conservation Bonds programmes are such examples and facilitate the issuance of bonds for the purposes of clean energy and energy conservation. Some 70 percent of the coupon is a tax credit or a subsidy from the federal government. Such policies will help to entice investors, who cite a lack of green investments in the market as being the main hindrance to market development. This paucity of supply has also meant that, to date, sovereign and supranational green bond sales have been heavily oversubscribed, a boon for issuers.

Green bond process implementation guidelines



Source: World Bank



The carbon dioxide emission reduction pledged by Nigeria by 2030 under the Paris Agreement

The case for going green

Almost every sovereign is party to the Paris Agreement and is committed to reducing carbon dioxide emissions to some degree.

Green bonds are one of the most readily accessible and economical options available to nations that must raise large amounts of capital to meet such environmental targets and the infrastructure projects that underpin them.

Government infrastructure projects are often inherently green, so in many instances putting these instruments in place is confirmation of what already exists. In most cases, sovereigns can issue green bonds regardless of their level of economic development and for an array of purposes.

Investor appetite for these bonds outstrips global supply, and even more so in the sovereign space. By capitalising on this demand, sovereigns can raise green finance to modernise their infrastructure and invest in sustainable, future-proof energy sources to become more competitive on the world stage and meet their domestic and international obligations. Emerging market sovereigns in particular should not miss the opportunity to be at the forefront of this movement, while the initiative is still for the taking.

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