THK BLENDED FINANCE PLATFORM

Workstream 3: GSS Bonds and Biodiversity

Roundtable 1: Developing a blueprint for sustainability bonds to encourage and facilitate issuance in emerging and frontier markets (EFMs)

THK Blended Finance Platform

The THK Blended Finance community was established in 2018 on the sidelines of the World Bank Annual Meeting in Bali to respond to the need for a united multilateral framework for advancing blended finance. The THK Roadmap on Blended Finance, launched in 2018, produced a set of common values to underpin blended finance operations, and later the THK response to the Covid-19 crisis. In 2021, the THK began a new chapter with the establishment of the THK Blended Finance Platform.

THK is a unique platform for international dialogue on blended finance that convenes a variety of stakeholders from all over the world. The vision of the Platform is to become a policy interface between global actors in blended finance ensuring the development of innovative blended finance solutions produced by actors in the global blended finance ecosystem. The THK Platform aims to integrate the existing blended finance work of its members into four work streams and actively engage with international fora such as G20 and G7.

The THK Blended Finance Platform is conducting its work along three workstreams:

- **Workstream 1, 'Transparency and Impact'**;
- **Workstream 2, 'Blended Finance Strategies in Developing Countries'**; and
- **Workstream 3, 'Green, Social and Sustainability (GSS) Bonds and Biodiversity'**.

→ For more information on the THK, visit The THK Website.

Background: The Challenge

THK Workstream 3: 'Green, Social and Sustainability (GSS) Bonds and Biodiversity

Today, **most GSS Bonds are issued by developed markets**, and the share of GSS Bonds issued by EFMs is still relatively low and regionally skewed towards Asia. As highlighted in a recent OECD stocktake report on Green, Social and Sustainability Bonds, while green, social and sustainability (GSS) bonds are gaining traction as a tool to mobilise finance for the SDGs, there is still a fundamental need to develop the capacity of issuers in emerging and frontiers markets (EFMs). In addition, ongoing consultations to inform accompanying guidance for donors on the issuance of green, social and sustainable bonds (GSS) indicate that a reciprocal structural transformation is required to improve market access for EFM issuers.

There is substantial analysis on GSS bonds (see 'Key Resources for Further Reading on the Issuance of Sustainability Bonds'), however, limited attention has been paid to the particular constraints facing GSS issuances in EFMs.

In light of this challenge, the THK Working Group 3 on 'Green, Social and Sustainability (GSS) Bonds and Biodiversity' endeavours to develop a **blueprint** for issuing sustainability bonds in emerging and frontier markets.

The working group uses the term sustainability bond to refer to green, social and sustainable **(GSS), use-of-proceeds bonds** – whereby the capital raised must be put towards sectors and practices meeting green, social or sustainable criteria – as well as **sustainability-linked bonds (SLBs)**, which commit the issuer to sustainability commitments independent from the issuance of the bond itself.

This first roundtable on GSS bonds brought together professionals across the full spectrum of expertise required to overcome the challenges involved in issuing sustainability bonds in EFMs, both on the issuer and investor side. Experts included issuers, investors, representatives from rating agencies as well as donors and DFIs.

This brief elaborates on the key issues and takeaways raised with reference to select case studies and proposes a set of recommendations for stakeholders.

About this Brief

Brief Structure:

Record of the WS-3: Roundtable 1, 30 November 2021

Key Issues Raised

Investor demand: growing with further room for growth

Investor demand for GSS bonds has soared in recent years, including in emerging markets – albeit from a low base. ***Despite the strain on the pandemic on financial markets, the size of the GSS bond market almost doubled in 2020, with USD 700 billion worth of issuances***.

Although it is growing, the market constitutes only a fraction of the global bond market. Representing ***only 1% of total assets outstanding and around 2% of new issuances***, it is still considered a niche sector. The GSS bond market thus represents a huge untapped potential. Indeed, GSS bonds offer an alternative and additional source of financing for achieving the sustainable development goals (SDGs).

Standards: how high should the bar be?

It is vital to safeguard the integrity of GSS bonds. A consistent taxonomy and approach are needed to ensure that GSS bonds are veritably impactful projects. Indeed, ***no product can be considered green, social or sustainable in the absence of certification by a verifier*** when it reaches the market.

Pre-issuance, high standards are enforced through green, social and sustainability frameworks. Post-issuance, monitoring and reporting must also be carried out to ensure that commitments are being met.

In the case of use-of-proceeds, green, social and sustainable (GSS) bonds:

- The framework in use will specify the intended assets and products the proceeds of the bond will be used for, including a justification for their GSS status. It will also establish the reporting requirements post-issuance, and the policies, methodologies and strategies in place to monitor and evaluate findings.

In the case of sustainability-linked bonds (SLBs) (performance-based):

- It is crucial to critically assess the value of the key performance indicators (KPIs) for the bond. Is it telling the main story? For instance, while a coal producing company may issue a gender bond with clear gender equality outcomes, this would not be addressing the principal detriment of the company's activities on the environment and society.
- Credit rating agencies (and anyone else) should likewise place greater scrutiny on the validity and impact of KPIs for SLBs.

Ensuring equity behind the standards:

High standards can, however, form a barrier to potential EFM issuers entering the GSS bond market and, therefore, to investment in the most impactful geographies, sectors and populations. Indeed, ***tensions can sometimes emerge between environmental, social and governance (ESG) standards and achievement of the Sustainable Development Goals (SDGs)***, due to the higher risk investment in the SDGs often incurs.

From a rating agency perspective, what is considered green is (or ought to be) dependent on context. What is a feasible, low-carbon option in Norway may not be a veritable, feasible and equitable green action in Ghana, for instance. ***Rating agencies must consider the realities – environmental, economic, regulatory or otherwise – EFM issuers operate in***, and endeavour to not penalise them for falling short of standards designed for developed country contexts.

Country ownership and context:

In addition to complying with high ESG standards, ***GSS bonds – in terms of use of process – and SLBs – in terms of organisation-level commitments – must be aligned with national, regional and local development priorities, and be informed by local expertise, in order to create a meaningful impact***.

EFM issuers, and other local stakeholders such as civil society organisations, are best placed to identify the most pressing challenges and the most appropriate strategies to overcome them. GSS bond issuance should, therefore, be structured in a manner that promotes local knowledge leadership and innovation. For instance, GSS needs, requirements and risks in the Small Island Developing States (SIDS), are distinct from those of other developing countries (notably the threat of rising sea levels).

Country ownership of prioritisation and choice of underlying investments must simultaneously be ***balanced with greater harmonisation of industry standards*** and definitions, as the proliferation of standards, frameworks and definitions only serves to further confuse an already crowded space.

Bankability:

Many participants raised the lack of a pipeline of eligible, bankable products and projects for investors as a major barrier to capital reaching GSS projects. However, the term bankability is used to connote a wide variety of factors affecting whether or not a project or bond issuance can go ahead.

Further exploration of what bankability *means*, and for whom, is therefore essential if we are to overcome this structural mis-match between available resources and the areas where they are most needed.

Capacity-Building:

Participants generally pointed to ***significant capacity constraints as a major limiting factor on the issuance of GSS bonds in EFM***, as opposed to a lack of will. EFM GSS bond issuances could be greatly enhanced through the provision of technical assistance (TA). This could be in the field of developing frameworks, pipelines of bankable projects, reporting and monitoring and strong yet adapted financial structuring.

Donors and DFIs have a crucial role to play in TA. However, given the important role played by banks in reaching MSMEs through lending, they too can be crucial TA providers.

In the case of supporting EFM issuers (including smaller banks, corporates and MSMEs) to comply with GSS and ESG standards through capacity-building, roundtable participants suggested a ***'plug and play' model*** that would mitigate the time and resource intensity of developing GSS frameworks for individual issuers, by allowing them to repurpose existing frameworks. EFM issuers would be protected from bearing the costs of developing them from the ground up. ***Continuing to share experiences and learnings will be essential to supporting and accelerating EFM issuances of GSS bonds***.

Developing local capital markets & local currency issuance:

As well as supporting EFM issuers to issue bonds on well-established stock exchanges such as London, New York, Luxembourg or Hong Kong, interventions pointed to the ***need to develop local capital markets***, notably as a means of reaching MSMEs, which represent the backbone of many EFM economies. Banks are the most likely to reach MSMEs through lending.

In addition to issuing in EFM markets, ***local currency issuance emerged as another important theme***. Participants suggested diversifying currency and currency risk in order to ensure broader market participation.

Incentive systems:

There is a need for greater risk mitigation and transfer by actors such as development finance institutions (DFIs), who are able and willing to take on more risks. This includes political risk mitigation and credit enhancement.

Regulation is also needed to make traditional or 'vanilla' investments less appealing relative to investing in GSS bonds.

As above, structural barriers to EFM issuers receiving higher ESG/ GSS ratings may disincentivise GSS bond issuance, which also incur high initial costs (cost of green frameworks, monitoring, reporting and evaluation).

Some participants also pointed to mitigating macroeconomic conditions. For instance, in a market currently flooded with liquidity, the 'greenium' – an oft-cited premium for green bonds in particular – has weakened and lost its persuasive power.

Data quality & availability:

The lack of data volume and quality on key issues of investor interest was identified as another fundamental obstacle for investors. Without sufficient data, investors are unable to commit their capital to green, social and sustainable ends, both for lack of knowing whether it will be a profitable investment, as well as whether it will satisfy the investor's targets and commitments. Indeed, data is a crucial issue for trust and transparency.

Asymmetric information:

Some participants identified dedicated risk capital as a remedy to this dearth of data, as it would enable market-builders, notably development finance institutions (DFIs) and multilateral development banks (MDBs) to test and build local capital markets, which would in turn improve data availability and transparency.

Asymmetries in access to information could potentially be addressed through blended finance operations by engaging local capital markets and blending with funding from institutional investors. This may require a particular structured finance approach: local capital, participating at higher risk, via guarantees or asymmetric risk sharing.

For more on transparency, please see this roundtable brief on Transparency and Impact, produced by the THK Working Group 1: 'How can DFIs balance granular impact reporting and commercial confidentiality?'.

Other structural barriers to EFM issuers entering the market:

In addition to the need for technical assistance and capacity-building, and the high costs associated with GSS and ESG frameworks, roundtable participants pointed to certain structural and regulatory barriers to EFM issuers entering into bond markets.

- **Lack of risk capital:**

  Several participants pointed to a lack of risk capital as a significant bottleneck for investing in higher-risk geographies and sectors.

- **Liquidity:**

  It is important to acknowledge the impact of BASEL II and III; when looking at the regulation, one of the main challenges we face is de-risking ESG as a credit risk factor versus a secondary opinion.

- **Debt sustainability:**

  GSS bond issuances can be hindered by a lack of debt capacity and sustainability in instances where EFM governments are unable to meet their financial obligations.

- **Maturity mis-match:**

  GSS bonds with longer maturities have the potential to be an antidote to maturity mismatch, whereby short-term funding is inadequate for long-term assets.

There is also a mis-match between issuer and investor needs: institutional investors require SLBs and long-term debt.

Key Takeaways

The following key calls-to-action were drawn from the roundtable discussion:

1. **develop strong standards for measurement and monitoring** how funds are used for GSS purposes or whether performance metrics are achieved, whilst enabling EFM issuers' access to markets
2. mobilise **technical and financial support** for bond origination
3. optimise the use of **risk capital or concessional finance** for credit enhancement and **targeted debt relief**
4. optimise the inclusion of GSS bonds in **debt restructurings**
5. **manage currency risk** for locally issued bonds
6. **aggregate GSS assets** to create investment opportunities at scale
7. **support GSS lending by local banks** which serve SME clients.

Examples of EFM issuances

Belize Debt-for-Nature Swap

The roundtable benefitted from welcoming key stakeholders in the issuance of the Belize Debt-for-Nature Swap blue bond, which was discussed extensively.

As part of its Blue Bonds for Ocean Conservation program, The Nature Conservancy (TNC) issued a USD 364 million blue bond in November 2021, passing on the proceeds to the Belize government in the form of a blue loan. The US Development Finance Corporation provided political risk insurance to enhance repayment prospects for the new debt, which helped enable an investment grade rating for the TNC blue bond.

The government, in turn, used the loan to repurchase, at 55 cent on the dollar, a portion of its USD 550 million Eurobonds due to mature in 2034. This will help to reduce debt service costs and improve long-term debt sustainability.

A portion of the financing, USD 23.5 million, is placed into an endowment that sets aside funding for marine conservation accessible from 2041, contributing to the protection of Belize's marine ecosystems. The government will also establish a Conservation Fund that will be capitalized by the government of Belize through payments of approximately USD 4 million over 20 years. This fund will support marine and coastal conservation projects. In addition, TNC and Belize agreed to numerous conservation commitments and milestones.

Source: Credit Suisse finances The Nature Conservancy's Blue Bond for marine conservation for Belize (credit-suisse.com)

Benin's launch of its inaugural SDG bond

In July 2021, the Republic of Benin became the first African country to issue an SDG (Sustainable Development Goals) bond. The government of Benin prepared a comprehensive SDG framework, with a second party opinion provided by Vigéo Eiris.

The framework is based on and outlines :

- the identification of the most pressing SDG targets (49 ones identified) based on a costing analysis, in collaboration with the IMF, the UNDP, and GIZ
- a sophisticated process to evaluate project eligibility based on their contributions to the SDGs
- a commitment of the Republic to the preservation and enhancement of its architectural and natural heritage treasures
- a comprehensive list of theme-based and sectoral exclusions with a particular focus on conservation of biodiversity
- a partnership with the United Nations Sustainable Development Solutions Network (SDSN) to monitor and evaluate the progress made in achieving the SDGs.

The EUR 500 million 12.5 year bond was sold at a coupon of 4.95%, approximately 20bp above Benin's yield curve. The safeguards and mechanisms to ensure transparency of the use of proceeds as well as the impact are said to have led to this favourable pricing.
Source: Republic of Benin's trailblazing €500m 12,5-Y inaugural issuance under its new SDG Bond Framework | Our Center of Expertise (natixis.com)

Recommendations for stakeholders

INVESTORS

- Demanding transparency from their investees and conducting proper due diligence
- Developing meaningful KPIs in the case of SLBs
- Supporting technical assistance

DONORS

- Knowledge-sharing and technical assistance
- De-risking GSS bond issuances
- Helping to create proper financial structures
- Providing direction for private sector: regulation, policy landscape

DFIs

- Risk transfer and mitigation
- Technical assistance
- Market-building, pioneers

RATING AGENCIES:

- Leading the way in establishing robust yet equitable standards

EFM ISSUERS:

- Supporting development of pipeline of bankable projects on issuer side
- Highlighting the need to mobilise and scale GSS bond issuances in EFMs
- Encourage G20 Guidance on how MDBs and DFIs can be effective and catalytic[1]
- Engaging with regulators

THK WORKSTREAM3:

- When approaching the blueprint, we must think critically about the different parts of the economy it is trying to reach

[1] G20 Argentina, *Scaling Development Finance for Our Common Future* (2018): https://www.g20-insights.org/wp-content/uploads/2018/07/TF9-9.2-T-20-Brief-GDP-Center-DFIs-1-1.pdf

Next steps… get in touch!

We are always looking for new perspectives, insights and case studies, as well as to build new relationships that will inform and enrich our research. In preparation of the **THK blueprint for sustainability bonds to encourage and facilitate issuance in emerging and frontier markets (EFMs)**, the working group will conduct further targeted bilateral and smaller-group discussions with key stakeholders involved, starting in **January-February 2022**.

To get in touch, please contact the Co-Chairs at following address:

Workstream Co-Chairs

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KEY RESOURCES FOR FURTHER READING ON THE ISSUANCE OF SUSTAINABILITY BONDS

- European Green Bond Standard: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/european-green-bond-standard_en
- ICMA Green Bond Principles (GBP): https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/green-bond-principles-gbp/
- ICMA Social Bond Principles (SBP): https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/social-bond-principles-sbp/
- ICMA Sustainability-Linked Bond Principles (SLBP): https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/sustainability-linked-bond-principles-slbp/
- International Platform on Sustainable Finance (https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/international-platform-sustainable-finance_en)
- OECD Blended Finance materials on guarantees and risk transfer mechanisms
- CBI 2021 'Sovereign Green, Social and Sustainability Bonds Survey' report?: https://www.climatebonds.net/resources/reports/sovereign-green-social-and-sustainability-bond-survey
- Environmental Finance, Sustainable Bonds Insight 2021?: https://www.environmental-finance.com/assets/files/research/sustainable-bonds-insight-2021.pdf