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FINANCE SECTOR HUB

# **Thematic Bonds 101:**

Macro Environment, Market Dynamics
and
Steps to Issuance

# Why Bonds 101?

- From Country Offices pre-COVID there was already demand for support on raising sustainable debt linked to green, blue, SDG uses of proceeds and accessing capital markets as well as a request for financial guidance. Post COVID this demand has accelerated.
- The macro environment is favorable for supporting these instruments issued into 2021 and beyond.
- Our goal is to help countries through the Finance Sector Hubs and Country Offices directly with Ministries of Finance as counterparties, in raising capital and widening fiscal space that is also linked to delivering on the SDGs.
- This deck lays out the background to thematic bonds: from market dynamics to supply and demand and typology
- The accompanying deck includes ***the roles and responsibilities*** and ***bond offering*** in terms of what is needed to issue a bond, and what UNDP can provide, i.e. the potential roles of the UNDP, and the steps to scoping which role or financial instrument makes most sense.

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I. Bond market macro indicators and enabling factors

II. Market supply and demand

III. Steps for issuing a bond

# Macroeconomic and Fixed Income Market Dynamics

Existing **macroeconomic and fixed income market dynamics** currently support these instruments on account of:

## Interest rates environment:

Central bank interest rates across most OECD countries are close to and in some cases below zero. This creates market demand particularly from institutional investors, pension funds for long dated lower yielding, relative to equities, financial instruments. By contrast, interest rates offered to emerging economies are very high especially post COVID.

## Quantum and adaptability:

Global debt markets are valued at over US$247 trillion. US debt markets are double the size of US equites. Unlike niche innovative finance mechanisms, sovereign and corporate debt including funds are familiar asset classes for capital markets. Financial institutions can relatively easily adapt or restructure existing debt instruments to support SDGs, or issue new debt in the form of green bonds. Green bonds $350bn of new sovereign and corporate green bond issuances forecast in 2020.

## Liquidity:

Bond markets offer investors liquidity often not available with impact investment or niche finance instruments.

## Creditworthiness:

Risk of debt instruments is ranked by rating agencies making them eligible for low risk investors such as pension funds. Credit guarantees like those from MIGA or DFC can help (i.e. through political risk insurance). The ability to protect principal (par value) whilst generating regular income (annuity payments) is another attractive feature of fixed income instruments for investors.

## Debt maturities extending:

Debt can be structured across short- to long-term maturities making fixed income suitable for funding longer dated projects supporting biodiversity and climate recovery such as reflooding peatlands, afforestation and fisheries recovery. Debt offers a flexible financing option, over equity, enabling variable coupons, principal holidays and mezzanine options.

## Contracts now including SDG use of proceeds:

Bond term sheets, which layout the basic terms and conditions of the investment, can include SDG use of proceeds from health to clean water to tourism and biodiversity through measurable indicators such as soil quality, along with the usual conditions such as amount raised, interest rate, payment dates and maturity dates.

# The market is supported by IMF rhetoric—countries can take action

- The IMF itself has lent only $100bn in emergency loans.  The World Bank has set aside $160bn to lend over 15 months — while estimating that low and middle-income countries will need between $175bn and $700bn a year.
- The only co-ordinated innovation has been a debt service suspension initiative (DSSI) by the G20. The DSSI allowed 73 of the world's poorest countries to postpone repayments due until June 2021 on official bilateral loans from G20 governments and their policy banks — though the debts must still be met in full, with repayments spread over four years.
  - Forty-six debtor countries took up the offer this year, deferring about $5bn in repayments.
- The US Federal Reserve and other advanced economy central banks have pumped trillions of dollars into financial markets, buoying up demand for risky assets. OECD has announced support for such measures so it is expected to continue:
  - Middle-income and some low-income countries were able to borrow $145bn by issuing dollar-denominated sovereign bonds between January and September
  - No country in sub-Saharan Africa, has issued international bonds since the crisis began.
- The IMF is responding with a new common debt framework to provide an ease of lending and borrowing to developing countries.
  - The common framework aims to address this by assessing whether a country's debts are sustainable, by signing it up to an IMF programme, and by involving both official bilateral creditors — governments and their policy banks — and commercial creditors — banks, bondholders, commodity traders and others.

# Enabling factors, why issue a Sovereign Green/ Blue/ SDG Bond now?

## IMF and OECD support available

- The emerging debt crisis has been accepted as inevitable if action is not taken, hence lenders like the IMF and OECD members are encouraging debt restructuring and issuances supported by developed nations. The common debt framework is one step towards this and enables bond issuers with better market access.

## Signaling and future resource mobilization

- Signaling of commitment to SDGs and green growth strategy
- Inter-ministerial collaboration to support efforts to implement green/sustainable growth strategy
- Improve government tracking of SDG and climate related expenditures

## New and Diverse Investors

- New socially responsible investors and asset managers with green investment mandates looking for opportunities
- Key benefits for emerging economies (offshore sovereign issuances or in local currency)

## Potential Pricing Advantages

- High demand and diversified investor base can drive better pricing

## Visibility

- Reinforce one’s reputation and sustainability agenda
- Signal a policy shift and commitment to more diversified economy

# Enabling factors at the macro level, why issue a sovereign Green/ Blue/ SDG Bond now?

## Market Creation

- Benchmark role to support local green bond market development (scale, liquidity, price discovery)
- Set good practice issuance and standards for other green bond issuers
- Position national financial centres as green hubs

## Capital Mobilization

- Connect green projects directly with investor demand (e.g. infrastructure investment)
- Finance financial incentives (e.g. tax reliefs, subsidies) to crowd-in private investment for low-carbon assets

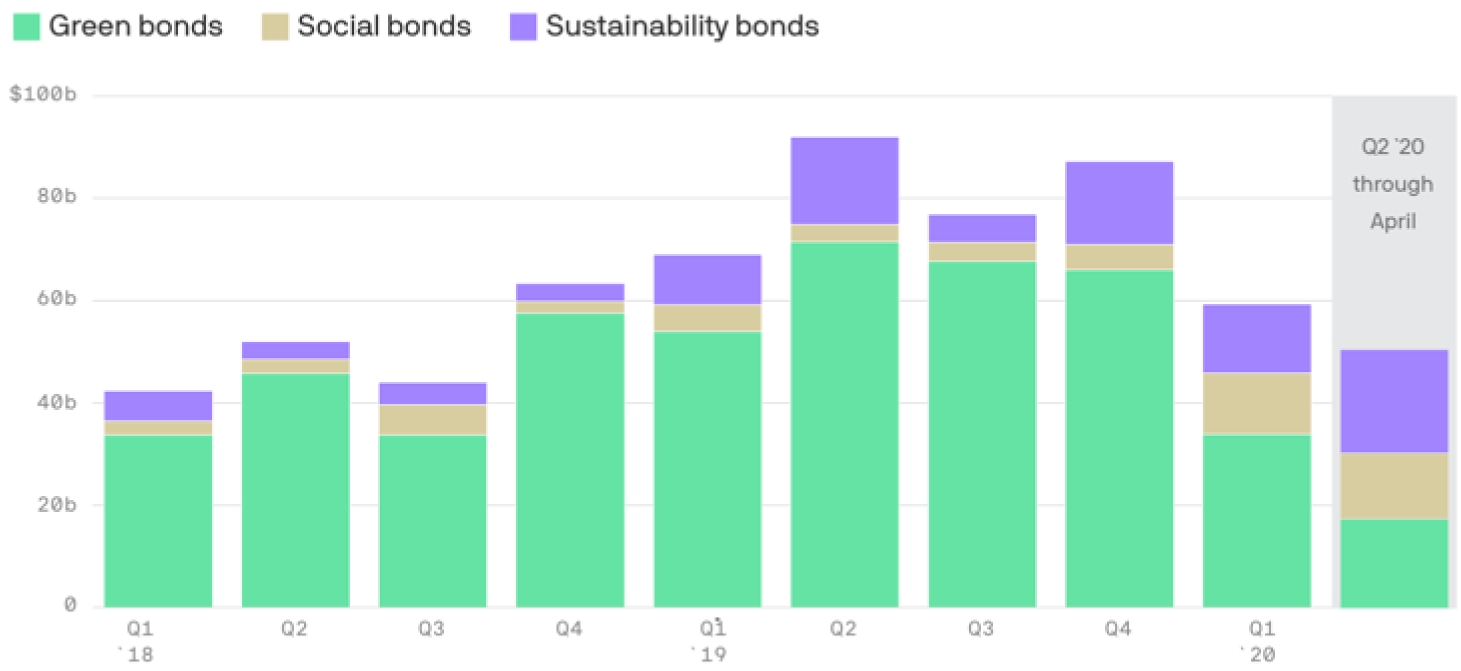
## International Leadership

- Display leadership in green finance and sustainability
- Connect green bond markets to facilitate foreign capital flows in emerging economies
- Drive bond market reform to help reduce cost of debt through a green bond market agenda, in underdeveloped capital markets

# In April, total issuance of ESG bonds — green, sustainability, and social bonds* — increased by 272% year over year and was double the total from March, reaching $48.5 billion

*Social Bonds that raise funds for social projects, i.e. in the past linked to social housing or job creation. Sustainability bonds: Sustainability Bonds are bonds where the proceeds will be exclusively applied to finance or re-finance a combination of both green and social projects. Now primarily issued by agencies, Supranationals, FIs  for healthcare and to preserve employment. Sustainability-linked bonds are corporate issuances linked to their own ESG

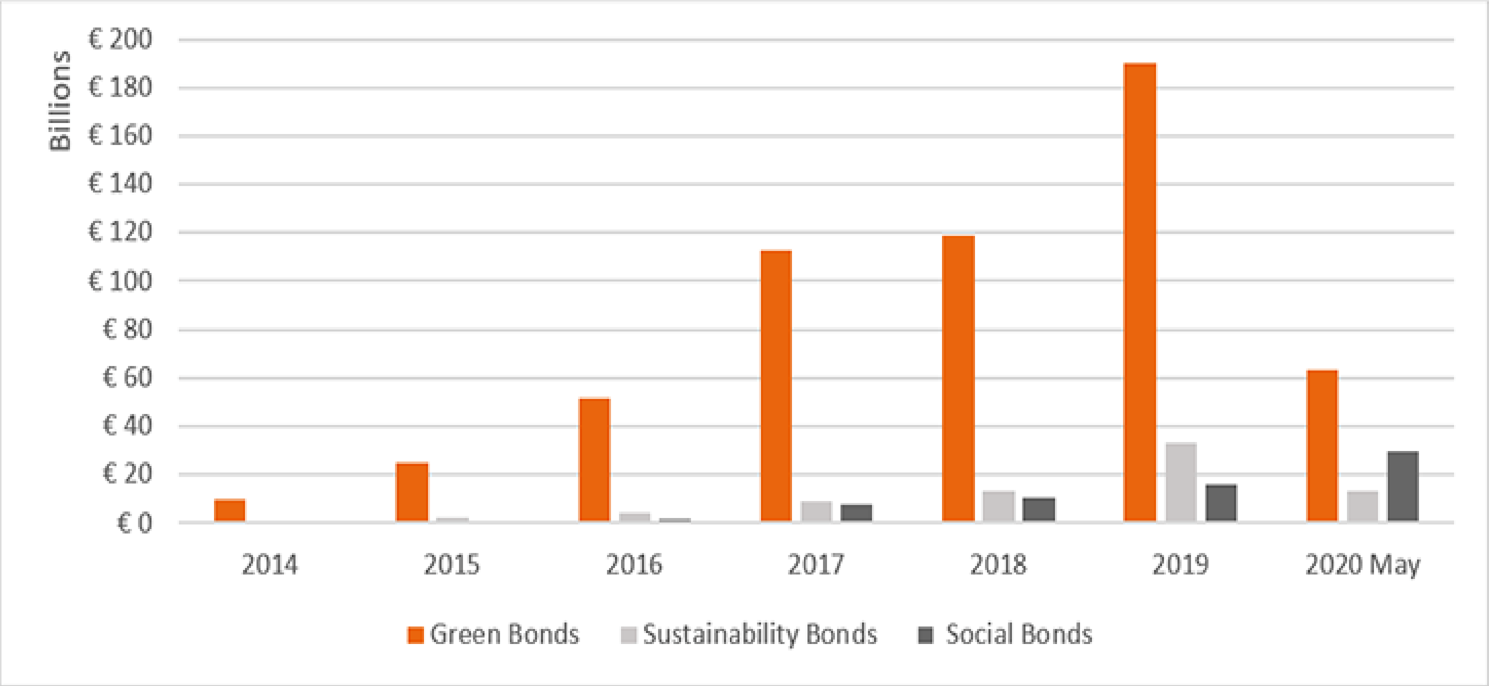
## Global sustainable bond issuance




Reproduced from Moody's, with April data from Refinitiv; Chart: Axios Visuals

In less than three months, the social bond market grew by a staggering 43% to EUR 66 billion with around EUR 20 billion raised in France, Spain, Italy, the Netherlands, Japan and Africa*

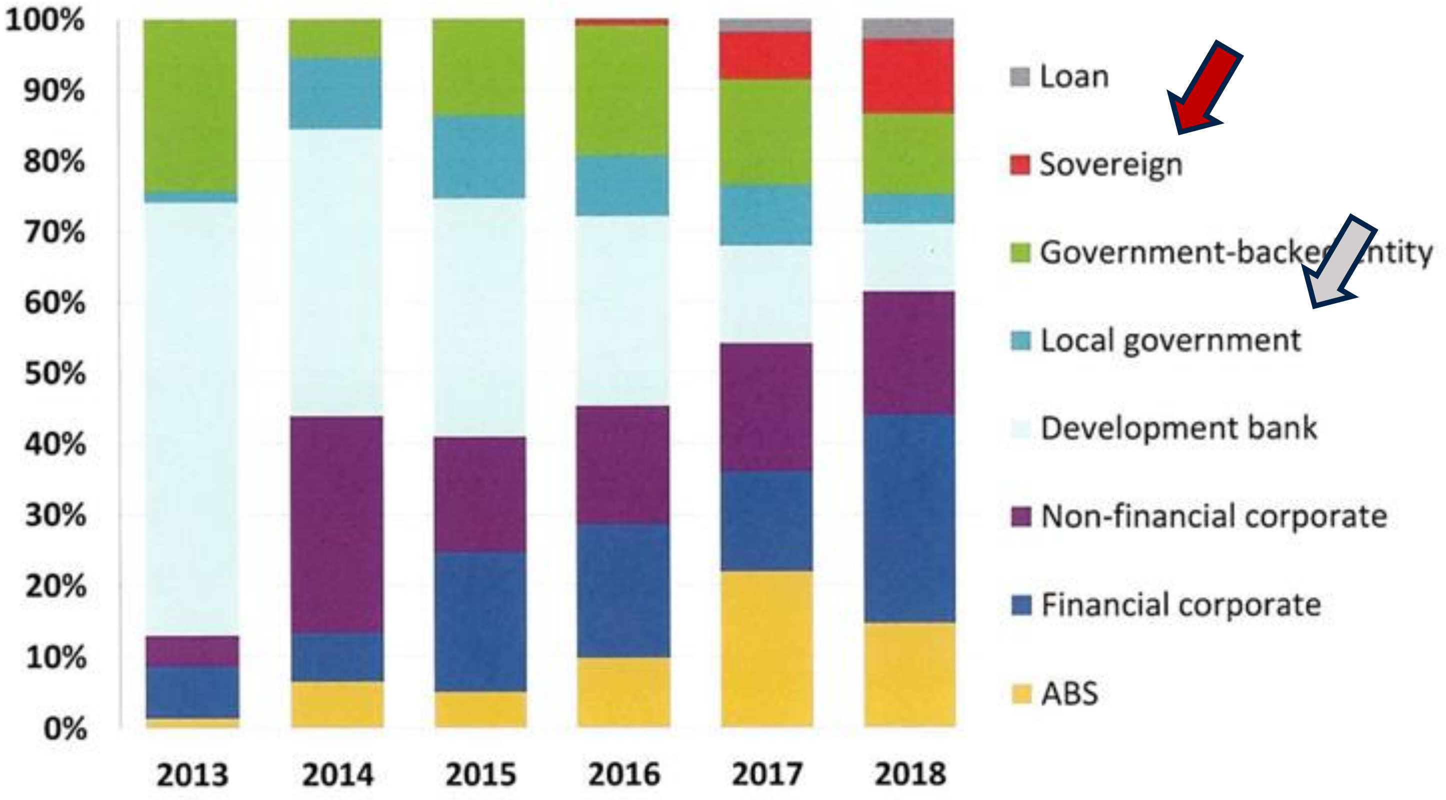
*AfDB issued EUR 3bn for the continent's COVID relief




Source: Bloomberg, 06/06/2020

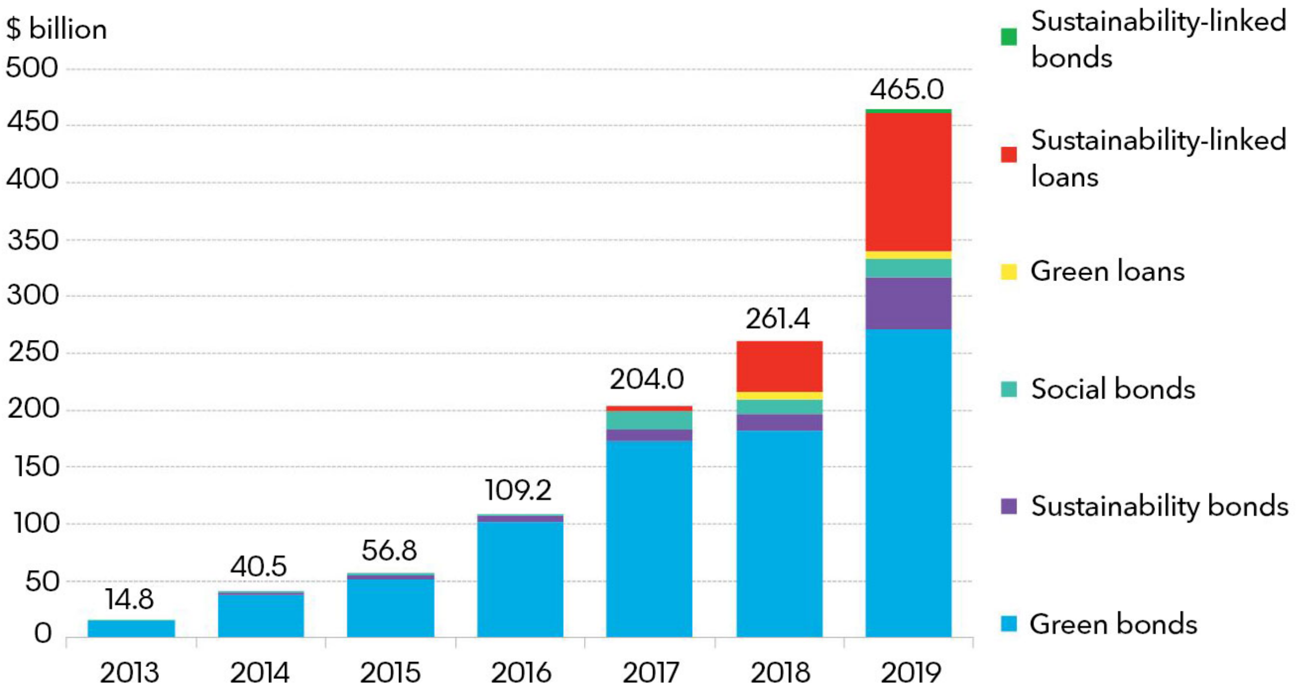
Sovereign /local govt sustainable bond issues on the rise: these are potential UNDP clients

Sustainable bond issuances by year and type of issuer



# The market was already booming pre-pandemic.

**Global sustainable debt annual issuance, 2013 - 2019**

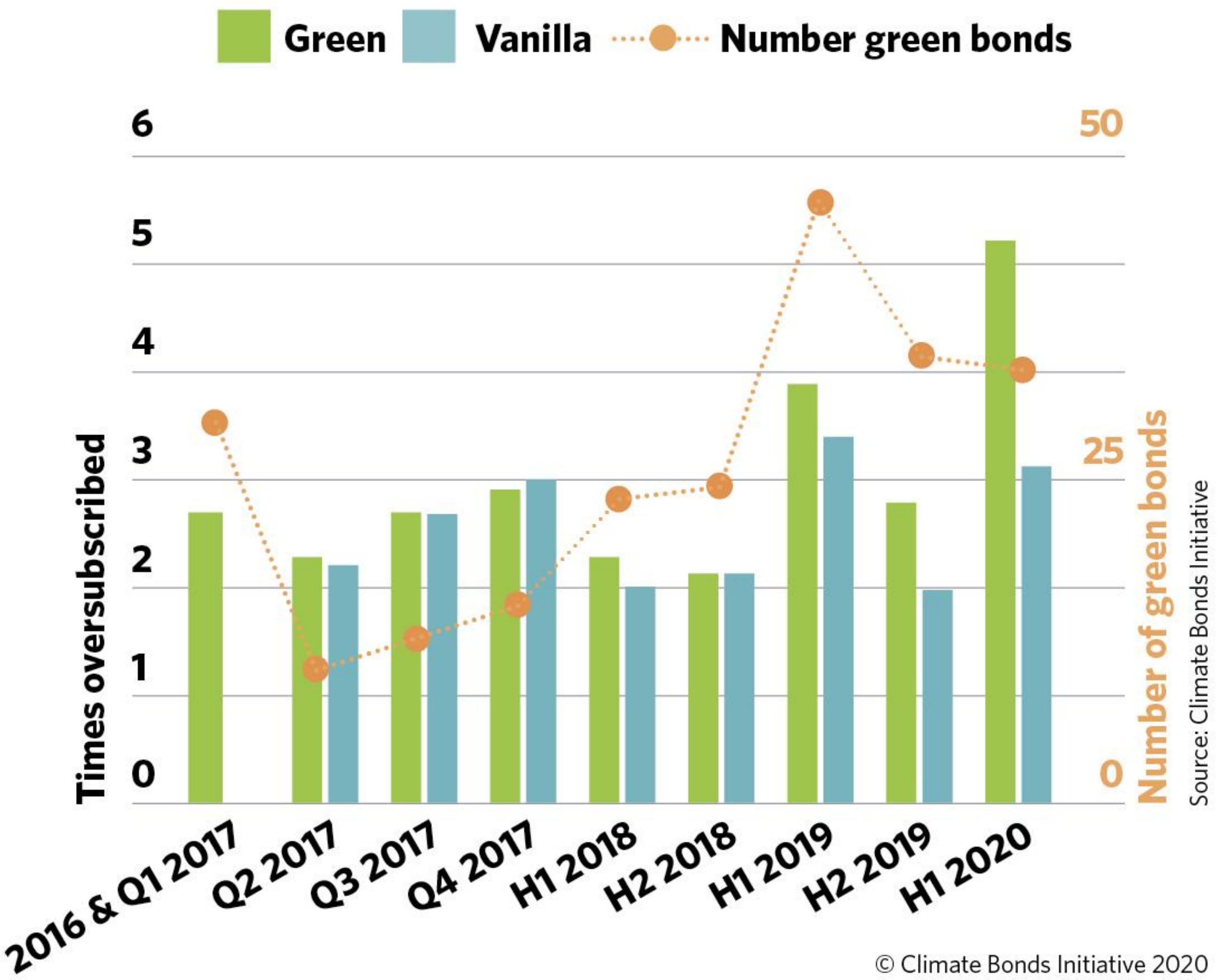



*Source: BloombergNEF, Bloomberg L.P.*

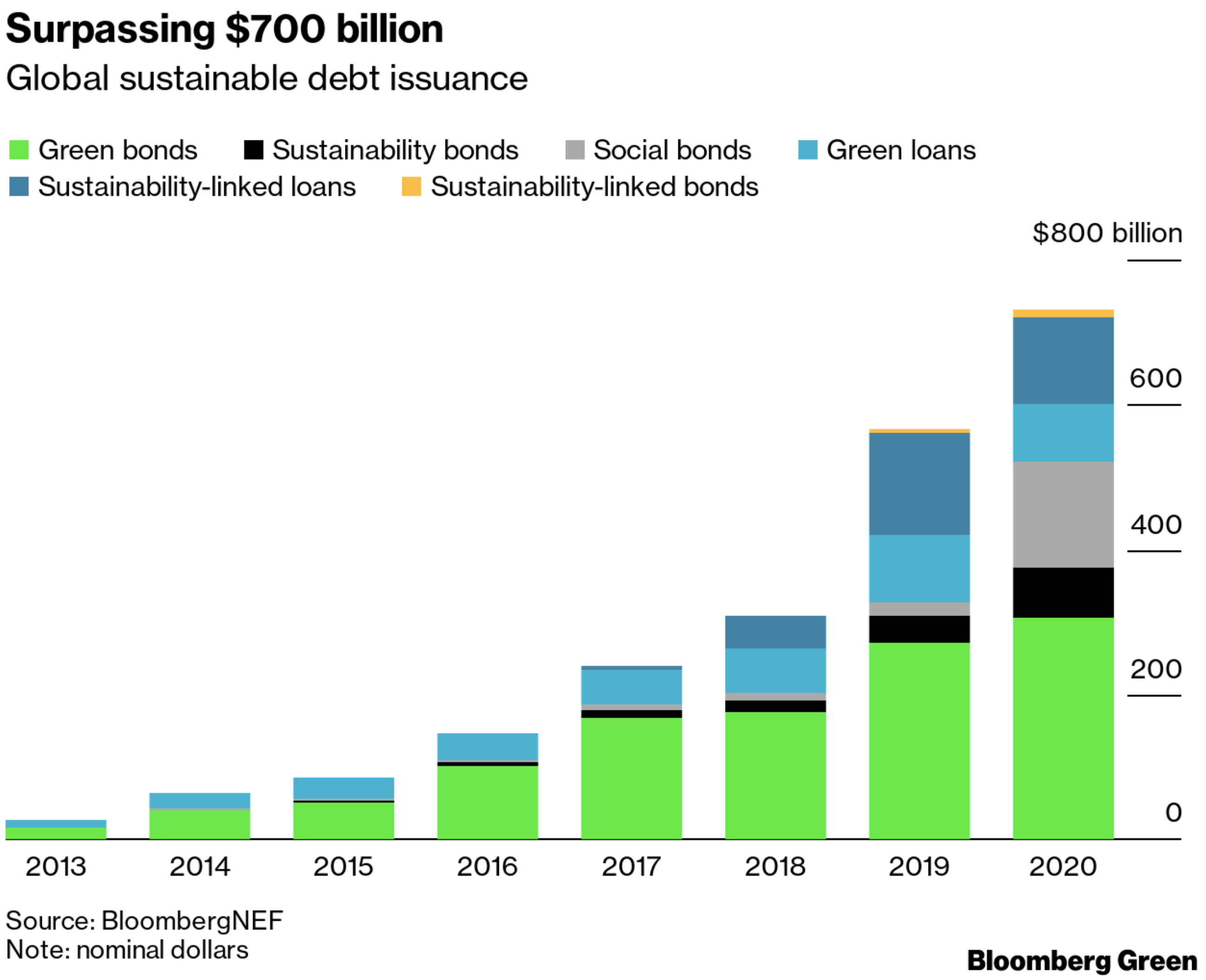
# With significant oversubscription at each issuance

## Average oversubscription of EUR bonds in sample

Climate Bonds INITIATIVE



2020 has seen over $700bn in global sustainable debt issued.
This will continue thanks to pandemic relief efforts, new commitments to emissions reductions and environmental preservation, and continued demand.



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Governments and supranational bodies such as the European Union and the African Development Bank issued almost all of 2020's social bonds to fund pandemic healthcare and relief efforts.

These were attractive not only because of the way the proceeds were going to be used, but also for their high credit ratings.

The EU's first social bond, issued in October, was 14 times oversubscribed.

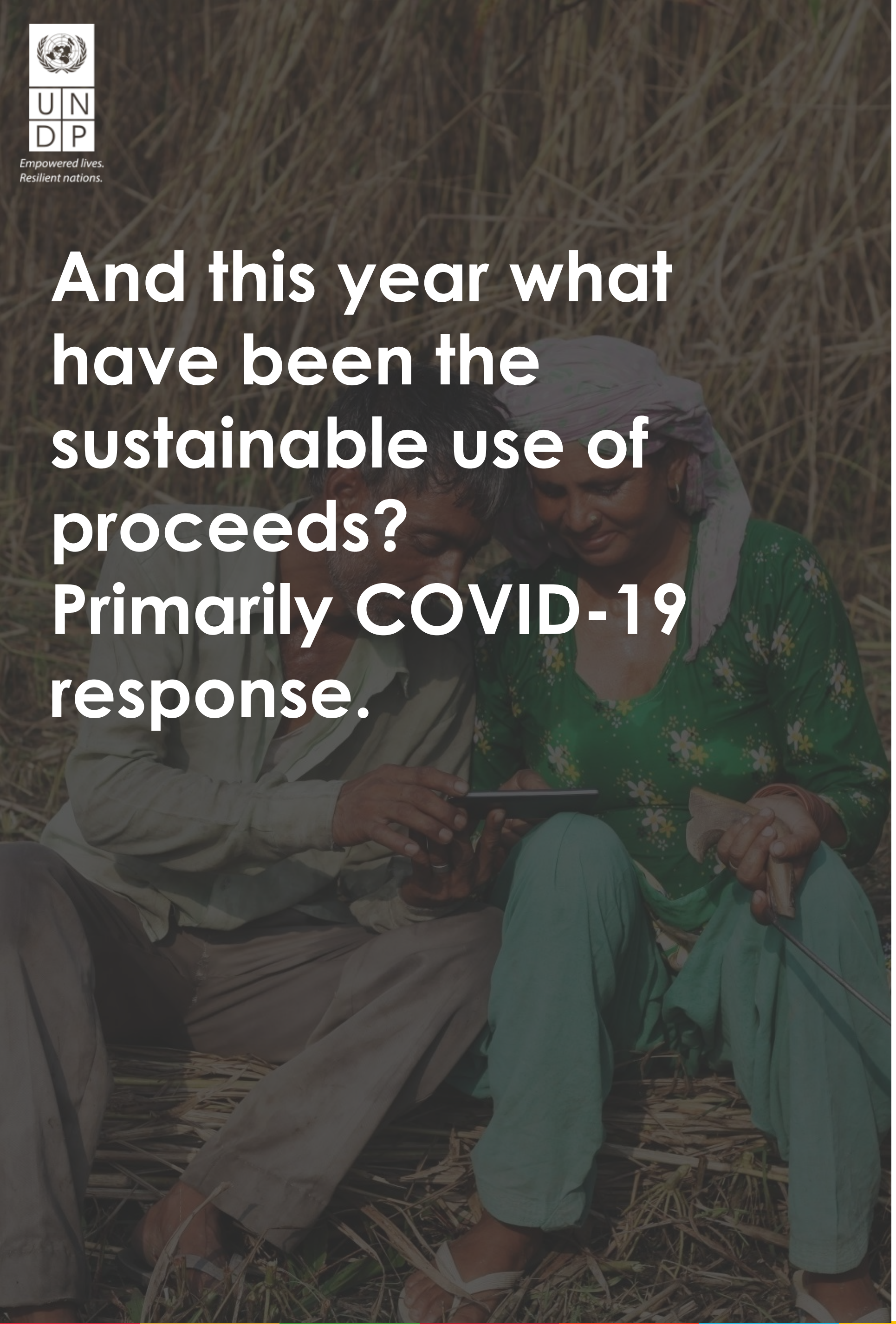
## Up, but Also Down

Sustainable debt issuance, 2019 to 2020

| Type of debt | 2019 | 2020 | Change ($) | Change (%) |
|---|---|---|---|---|
| Green bonds | $271.1B | $305.3B | $34.2B | 12.6% |
| Sustainability bonds | 37.9 | 68.7 | 30.8 | 81.1 |
| Social bonds | 18.0 | 147.7 | 129.7 | 720.3 |
| Green loans | 93.4 | 80.3 | -13.0 | -14.0 |
| Sustainability-linked loans | 140.1 | 119.5 | -20.6 | -14.7 |
| Sustainability-linked bonds | 5.0 | 10.6 | 5.6 | 112.5 |
| Total | 565.5 | 732.1 | 166.6 | 29.5 |

Source: BloombergNEF

**Bloomberg Green**



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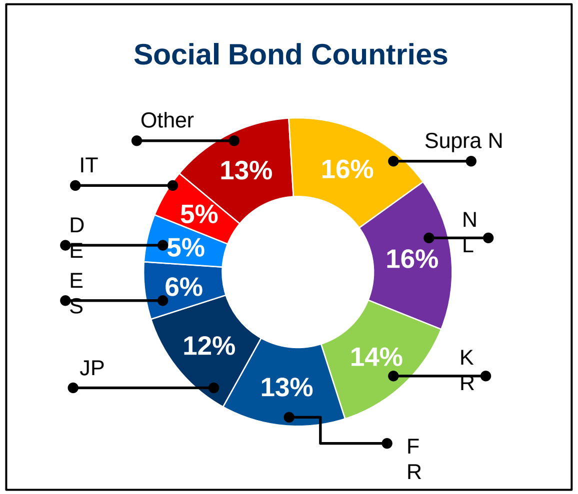
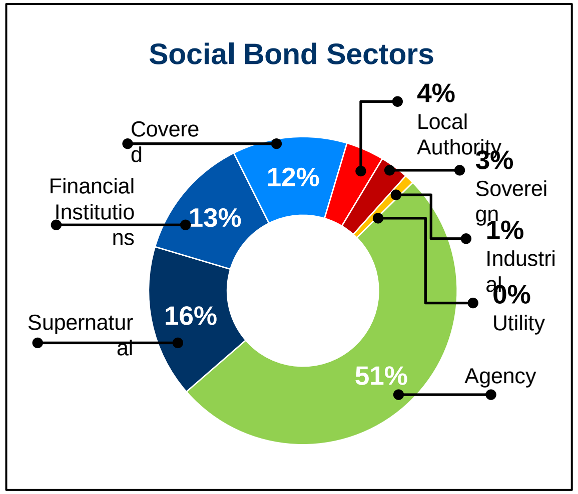
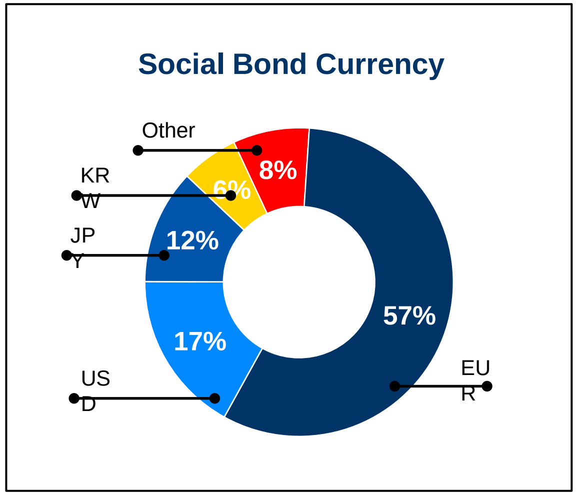
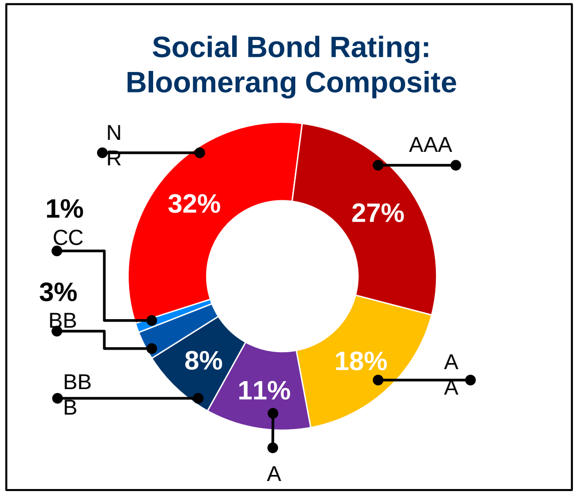
# And this year what have been the sustainable use of proceeds? Primarily COVID-19 response.

- With the new IMF framework this is expected to continue, with developed market funds seeking emerging market returns, securely and sustainably
- In the EU, the majority of the proceeds have been used to support MSMEs with a focus on the preservation of jobs.
- To fight Covid-19-related fluctuations in the French labour market, Unédic (the French unemployment insurance management body) launched the largest social bond to date, worth EUR 4 billion. In response to the challenges in the healthcare sector, other recently launched social bonds' proceeds targeted medical supplies and equipment, rehabilitation, medical-related infrastructure, and R&D for medicines and vaccines.
- They also help provide financial support to businesses so they can retain staff and maintain employment levels, and to fund the repurposing of factories to produce essential equipment.



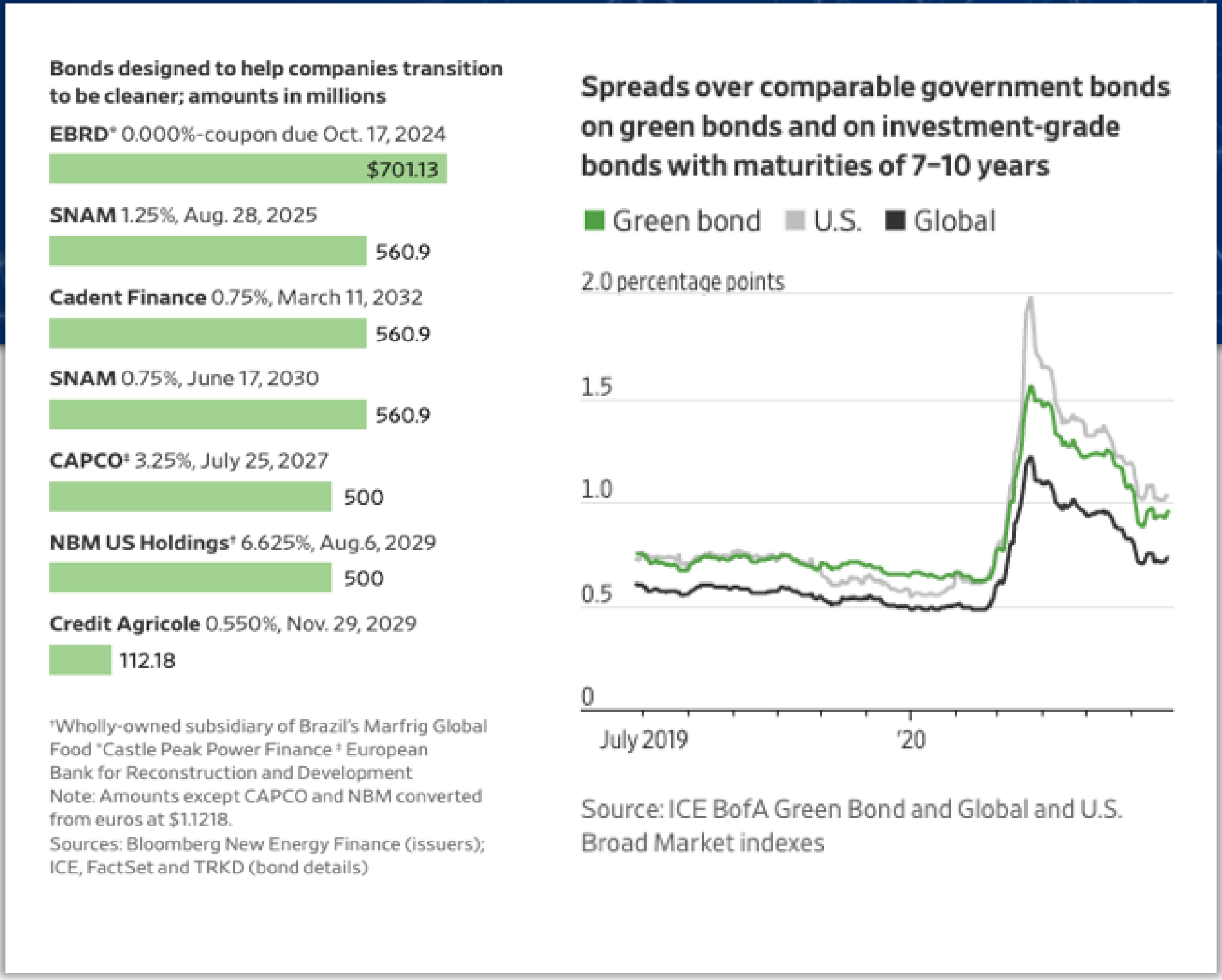




Source: Bloomberg 29/05/2020 – Total Social Bond market EUR 66 Billion

# Also on the rise: Transition Bonds

## Applying corporate strategy to countries making SDG transitions for example moving away from extractives in countries like **Gabon**?

- Transition bonds are emerging as a new asset class in the debt market, creating a link between fossil-fuel companies and ESG investing. Rather than being issued by companies that claim to have a high ESG scores, are designed for businesses that are still cleaning up their act.
- Seven transactions that have raised $3.5 billion so far vs $270bn green bond market
- What about applying this to countries in transition on various SDGs, or designating protected areas, etc.?



# IDENTIFYING THE RIGHT CANDIDATES FOR SDG BONDS: EXTERNAL DEBT VS COST OF DELIVERING SDGS

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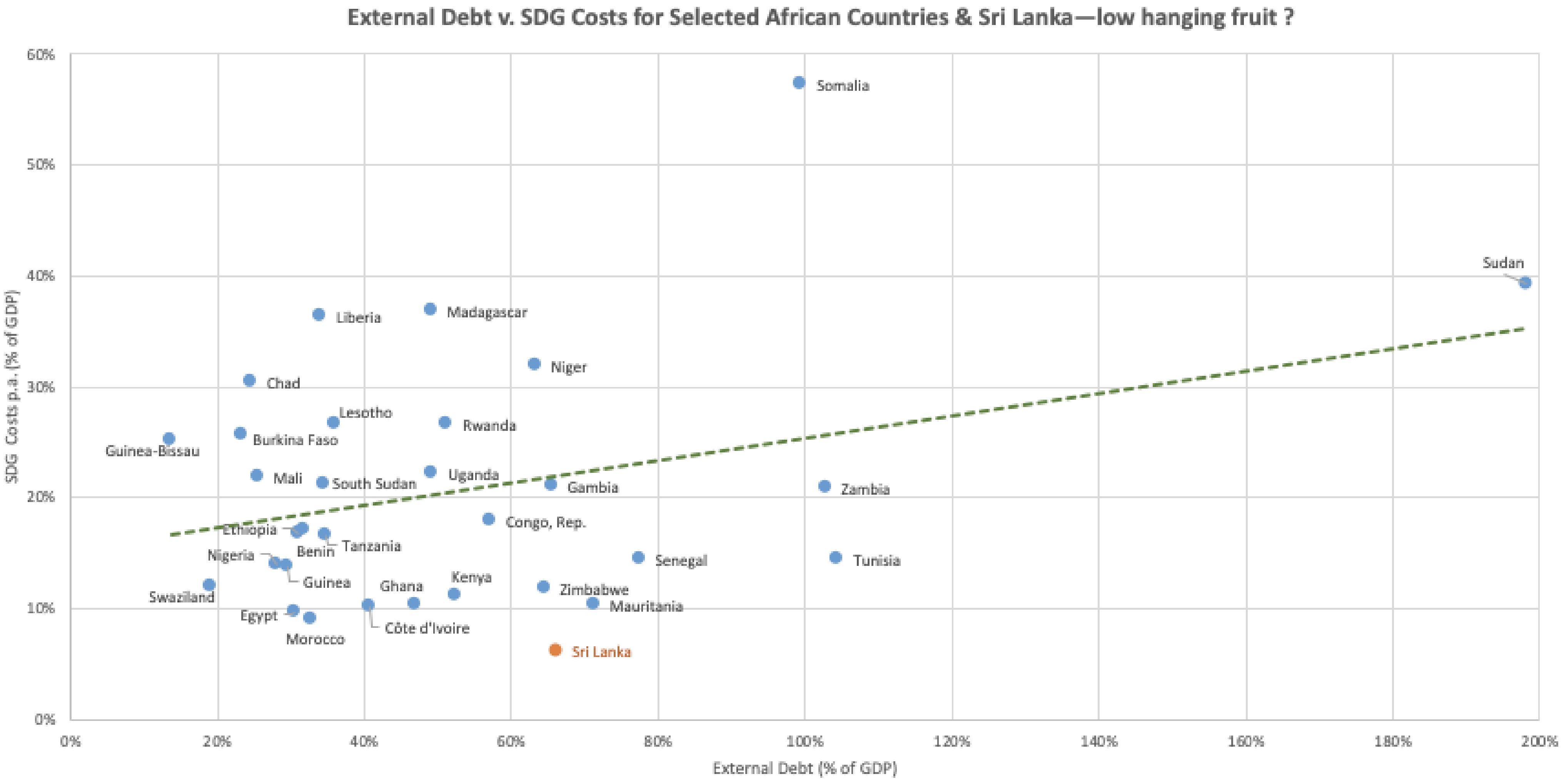


*Sources: Overseas Development Institute (ODI), IMF, UNDP Staff Estimates*

# Now that we have seen what the market looks like, who actually decides which bonds are 'Sustainable'?

For example, the green bond market has been dominated by the green bond principles and climate bonds (standards).
The veracity of the bonds—green, sustainable or social—are audited formally and informally by stock exchanges, second opinion providers, and index providers.
**For SDG bonds, there is no dominant arbiter—UNDP can fill this role through advisory and standards.**

| Voluntary Principles | Stock Exchanges | Second Opinions | Funds and Indices | Standards |
|---|---|---|---|---|
| The Green Bond Principles<br>The Social Bond Principles<br>The Sustainability-Linked Bond Principles<br>**Recommends external review** | London Stock Exchange<br>OSLO BØRS<br>**Require independent second opinion** | Center for International Climate Research | BARCLAYS<br>MSCI | Climate Bonds Initiative PARTNER<br>SDG Impact |

*The Social Bond Principles (ICMA) offer voluntary guidelines for issuing social bonds, similar to the Green Bond Principles for green bonds. https://www.icmagroup.org/green-social-and-sustainability-bonds/*

# How are SDG/Green/Climate Bonds Differentiated?

Climate Bond Certified

The Green Bond Principles 2017

## Special requirements for:

- Use of proceeds
- Process for Project Evaluation and Selection
- Management of Proceeds
- Reporting
- Adhering to Green Bond Principles
- And Verified (Climate Bond Certified)

# Steps for issuing bonds

# Seven Steps For Issuing Sovereign Green/SDG Bonds

01 Engage Governmental stakeholders

02 Establish a Green or SDG Bond Framework

03 Identify eligible budget Items

04 Arrange an Independent External Review

05 Issue the Green or SDG Bond

06 Monitor and Report

07 REPEAT!

# Seven Steps For Issuing Sovereign Green / SDG Bonds

Step 1:

**Engage Governmental Stakeholders**

### Set Goals

Set the goals for the green bond issuance: this may include financing low-carbon programmes, sending a policy signal, growing the domestic green bond market, promoting a green finance centre.

### Engage Ministries

Engage with several ministries: cross-collaboration among government is a central part of the sovereign green bond process, as they will be responsible for finding eligible projects.

### Get Buy In

Get early buy-in from the Ministry of Finance: this is essential given its budgetary and debt management responsibilities

### Expand Stakeholders

Expand the engagement to external stakeholders (e.g. Public-Private Green Bond Advisory Council, roundtables, bilateral dialogues) if useful to gather feedback and wider support

Step 2:

## Establish a Thematic Bond Framework

### Determine Sectors

Determine eligible sectors:

- Refer to science-based categorizations/taxonomy (such as the Climate Bonds Taxonomy)
- Consider sectors aligning with wider climate policies, in particular NDCs

### Determine Expenditures

Determine eligible types of expenditures:

- Direct investments or intangible assets (e.g. tax exemptions, subsidies)
- Inclusion of new and refinancing projects

### Set Monitoring

Set monitoring, tracking and reporting practices

### Amend Legislation

Amend existing legislation if needed for your framework to comply

# Seven Steps For Issuing Sovereign Green or SDG Bonds

Step 3:

**Identify Eligible Green Budget Items**

Step 4:

**Identify Eligible Green Budget Items**

## Assign Ministries and Identify Assets

**Assign key ministries to identify eligible assets** from their budgets

- Assets must be equal to or greater than the size of the bond
- Assets can be located overseas as part of cooperation and development activities
- SDG impact compliance

## Select Verifier

**Select and independent verifier** to assess the SDG or green credentials of the bond, in order to provide assurance to investors

- An independent review can take the form of a third-party certification against the Climate Bonds Standard, a second party opinion or a green rating
- The review may also include a post-issuance assessment, to ensure the pre-issuance claims have been followed through

Step 5:

**Issue the Bond**

**The usual steps for issuance of conventional sovereign bond apply.**

### Supporting materials produced to promote transaction can include:

- A green bond prospectus,
- An investor presentation or an FAQ

### Additional marketing material to promote issuance may be produced:

- Showcase of financed projects
- Main elements of the Green Bond Framework
- Alignment with governmental strategy

### After having issued, investor roadshow if needed

Distribution partners should have been preselected who take the bond to market

# Seven Steps For Issuing Sovereign Green or SDG Bonds

Step 6:
**Monitor and Report**

Step 7:
**Repeat**

## Produce a Report

**Produce a report** and update publicly available information on the bond at least annually

- The first reporting statement may take the form of a post-issuance review carried out by an external verifier
- The reporting should align with the expectations set in the green bond framework
- Sovereigns can set precedent on good reporting practices

## Repeat Issuance

Not all eligible expenditure may be included in a first green bond, an issuance can be further tapped or a new one carried out

A programmatic approach, i.e. ongoing issuance, allows for programmatic certification under the Climate Bonds Standard, i.e. just one pre- issuance verification on the total pool and post-issuance verification once a year if bonds are issued

Indo green sukuk now on its 4th issuance! s

# Differences in issuing Green / SDG Bonds vs Traditional Bonds

| Issuing a regular bond | Issuing a Green/SDG Bond – additional steps |
|---|---|
| •Get rated<br>•Get market intelligence on currency, tenor, size<br>•Decide on underwriters<br>•Register with local regulator<br>•Issue prospectus<br>•Comfort letter / due diligence<br>•Outreach through roadshows and sales | •Define Green/SDG Bond Framework or define how project meets green bond eligibility criteria<br>•Put in place project selection process and select eligible projects<br>•Set up accounts and process to earmark and allocate proceeds – ring fence the proceeds<br>•Get pre issuance external review<br>•Allocate proceeds to the project<br>•Align with SDG Bond Standards |
| Launch the bond into the market | |
| •Price and allocate bond to support secondary market performance<br>•Communication to the capital market<br>•Monitor secondary market | •Allocate proceeds to the projects<br>•Monitor the projects<br>•Publish impact report<br>•Post issuance audit if necessary |

# Get in touch

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