Sustainability bonds: hype or long-lasting development?

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I. Green bonds: are they relevant for eastern Europe?

Green bonds seem like a massive opportunity for the eastern Europe region

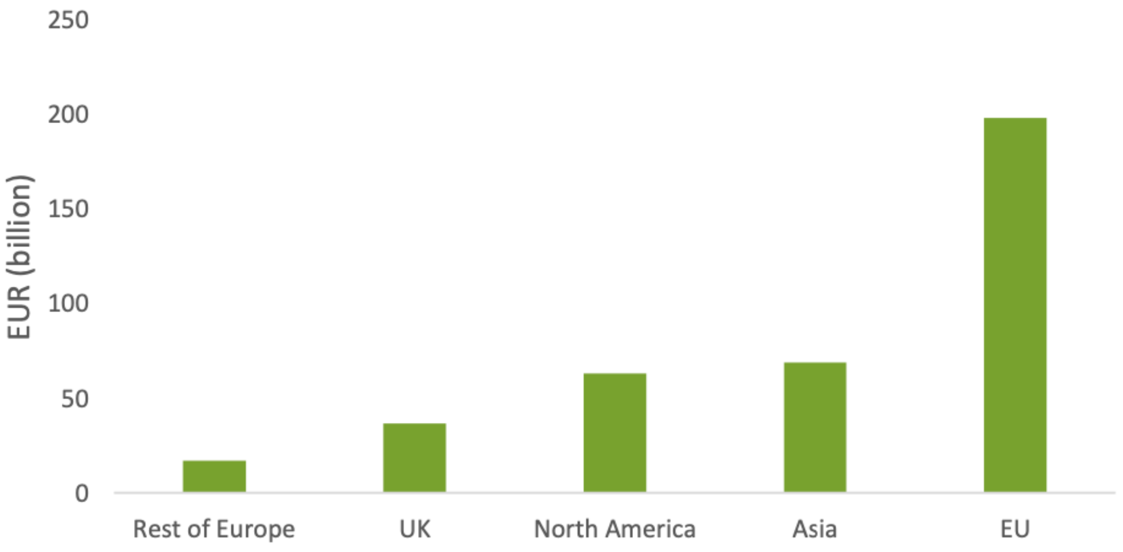
Simply put, a green bond is a plain-vanilla bond with some additional transparency about the use of proceeds.

The so-called **'issuer recourse'** structure is the most common green bond format. By definition offers the same credit risk as a plain-vanilla bond.

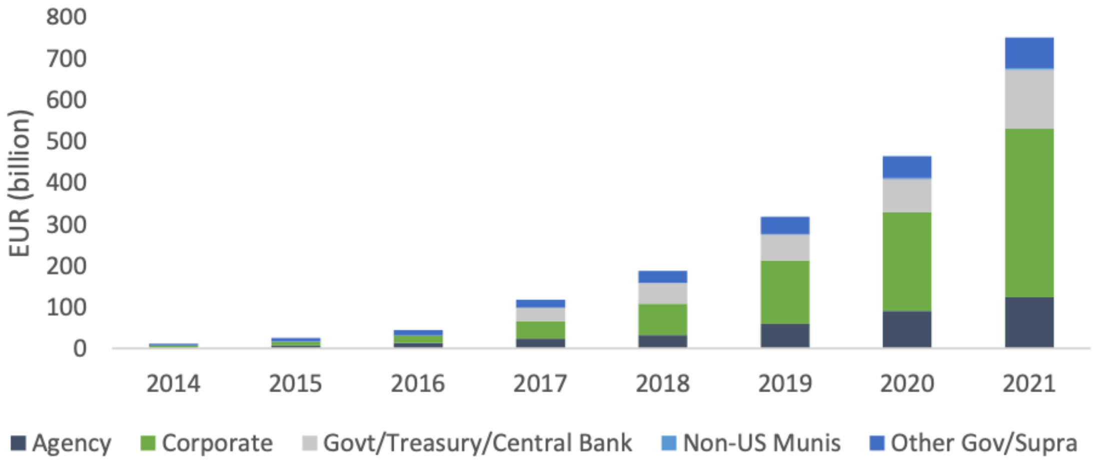
Some implications:

- The quality and credibility of the use of proceeds at different stages in the bond's life is an essential non-financial attribute of the bond for investors and asset owners, e.g. large pension funds.
- Emerging or frontier markets with poor corporate governance and transparency are not well placed to tap into this instrument

Green bond issuance in 2021



European green bonds outstanding by issuer type



Source: AFME ESG Finance Report, 2021.

Alternative structures may not be more suitable for the EECCA region

- Asset-based bond structures offer a more direct attribution of the desired project (impact) to the proceeds raised
- These structures normally depend on the ability of the issuer to create legally distinct SPVs, and on the investor's ability to assess credit risk within such structures.
- These structures are appealing in theory, though difficult to implement, especially in the underdeveloped capital markets in the region

Types of Green Bonds

Type	Use of Proceeds	Debt Recourse	Example
"Use of Proceeds" Bond	Earmarked for green projects	To the issuer: same credit rating applies as issuer's other bonds	European Investment Bank (EIB) "Climate Awareness Bond" (backed by EIB); Barclays Green Bond
"Use of Proceeds" Revenue Bond or Asset Backed Securities (ABS)	Earmarked for or refinances green projects	Revenue streams from the issuers through fees, taxes, etc. are collateral for the debt	Hawaii State (backed by fee on electricity bills of the state utilities)
Project Bond	Ring-fenced for the specific underlying green project(s)	To the project's assets and balance sheet	Invenergy Wind Farm (backed by Invenergy Campo Palomas wind farm)
Securitisation (ABS) Bond	Earmarked for green projects	To a group of projects that have been categorised together (e.g. solar leases or green mortgages)	Tesla Energy (backed by residential solar leases); Obvion (backed by green mortgages)
Covered Bond	Earmarked for eligible projects included in the covered pool	To the issuer and, if the issuer is unable to repay the bond, to the covered pool	Berlin Hyp green Pfandbrief; Sparebank 1 Bolligkredit green covered bond
Loan	Earmarked for eligible projects or secured on eligible assets	To the borrower(s) in the case of unsecured loans. Recourse to the collateral in the case of secured loans but may also feature limited recourse to the borrower(s)	MEP Werke, Ivanhoe Cambridge and Natixis Assurances (DUO), OVG
Other Debt Instruments	Earmarked for eligible projects	Depends on the structure of the debt instrument	Convertible Bonds or Notes, Schuldschein, Commercial Paper, Sukuk, Debentures

Source: Climate Bonds Initiative

Meanwhile the market is becoming more regulated

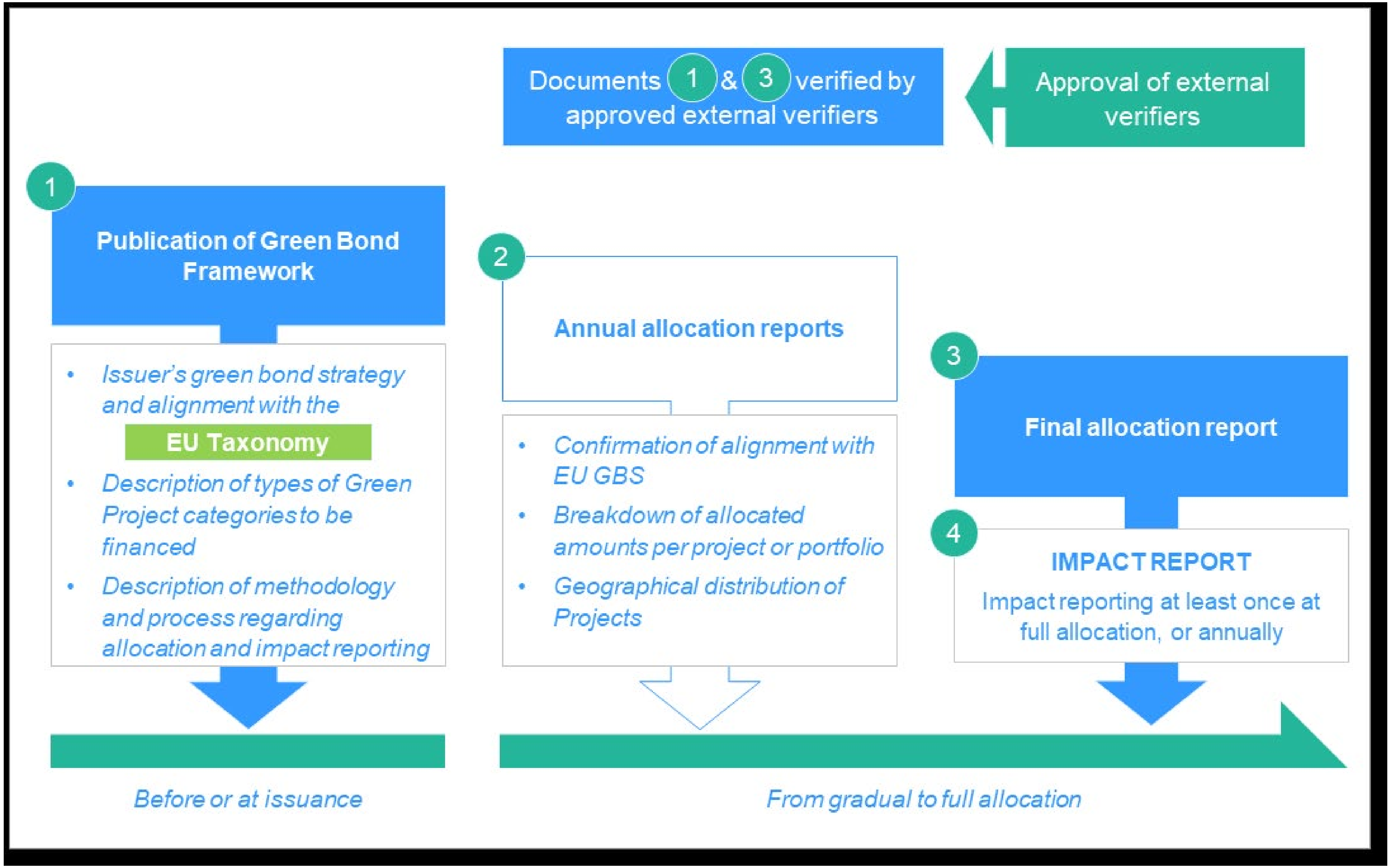
EU Green Bond standard proposal (June 2021) aims for a new regime of transparency and supervision:

A voluntary standard (weaker private standards remain an option):

- Use of proceeds only for projects that are in line with the EU taxonomy of sustainable activities. Issuers will need to provide additional information at the time of issuance, and subsequently through regular reporting.
- only external reviewers accredited and supervised by the EU capital markets supervisor (ESMA) will be allowed to verify an EU green bond

- ➢ Still not clear whether this will be the new industry benchmark though markets likely to move in this direction anyway
- ➢ Non-EU markets would need to demonstrate taxonomy alignment and rigorous verification standards or providers

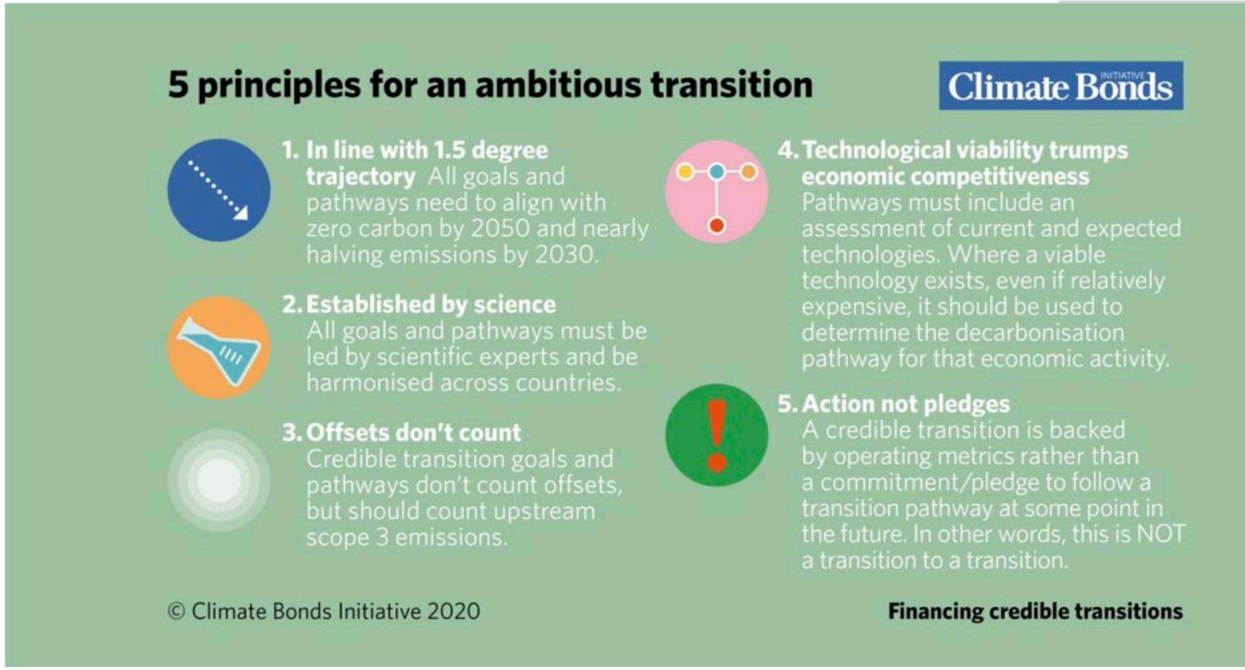
Main stages of verification under the EU Green Bond Standard



Alternative bond structures

In addition, there are a variety of other 'sustainable' bond structures, though these have not been firmly established in the markets:

- **Transition bonds**: which widen the use of proceeds from narrow 'green' (taxonomy-aligned) to 'green transition' (based on an agreed sectoral pathway).
  - E.g. **EBRD Green Transition Bond Programme** – proceeds refinance the Bank's project portfolio that matches certain exclusion and inclusion criteria.



➢**Sustainability-linked bonds**: proceeds of SLBs are usually not allocated to specific projects, assets or activities but used for general purposes. The issuing entity makes commitments regarding future sustainability outcomes, often in the form of company level key performance indicators (KPIs). In some cases, the cost of capital (coupon) is linked to achievement of those KPIs of the company.

- E.g. in 2019-20 Italian utility ENEL issued five sustainability-linked bonds, for a total of ca. EUR 4.5 billion equivalent. This was based on two KPIs: reduction of GHG emssions (scope 1) and share of RES in installed capacity

II. Green bonds in the EECCA region

OECD project ‘Greening debt capital markets in the EECCA countries’

- Funded by EU4 Environment
- Covers six Eastern Partnership (EaP) countries plus Kazakhstan
- Ca. 50 meetings in total with private, public sector and IFIs between Aug and Dec. 2021.
- To assess the potential role of green bond markets in financing:
  1. Capital market development in light of introduction of green bonds
  2. Barriers to scaling up green bonds
  3. Role for governments and regulators
- Summary report expected for Q3 2022

- ➢ In total only 7 green bonds were issued in 4 countries
- ➢ Three of the 7 transactions were sizable issues in international markets no cross-listing
- ➢ Significant support from IFI anchor investors in local issues in particular
- ➢ No transactions in Moldova, Belarus and Azerbaijan

Three out of seven countries have upgraded their green finance regulatory framework

- **Georgia**: 2019 roadmap for sustainable finance, ESG disclosure and reporting principles and first stock take in 2021. Taxonomy implementation and risk management principles for bank to be implemented.

- **Kazakhstan**. Split rules between the main exchange (KASE) and the Astana International Financial Center (AIFC). AIFC most advanced with a core taxonomy, green bond rules including for reporting, and technical support for potential issuers through the Green Finance Center.

- **Ukraine**. Green bonds recognised in capital markets law (July 2021) and detailed rules on the use of proceeds; NBU roadmap which contains plans for disclosure rules and sustainable financing.

Two transactions underline the trade-offs

Georgia Global Utilities (GGU). July 2020 issue over USD 250 million on the Irish stock exchange. Used to refinance outstanding debt backing renewable energy and water assets of the firm.

- Second party opinion found the issuer's green bond framework to be aligned with the ICMA Green Bond Principles. Report acknowledged the scope to address risks in flood-prone areas, and the potential to expand renewable energy generation, in particular from wind and hydropower:
- Yet, the proceeds of the bonds were partially used to refinance outstanding debt, underlining the problems in a relatively small emerging market to create a portfolio of green assets at the time of issuance or shortly thereafter.
- Proceeds were dedicated to a portfolio of companies in which GGU invests. Unclear whether this was associated with additional investment expenditure, or just used for working capital.

Ameriabank. November 2020 USD 50 m., 5 years maturity, senior unsecured notes at 3.05% coupon.

- Dutch FMO development agency the sole ('anchor') investor – in effect a private placement.
- Proceeds allocated to well-defined projects in renewable energy, energy distribution, energy efficiency and transport.
- Listed on local exchange, though in the least liquid segment.
- Second issue (in both AMD and USD) in Feb. 2022 as a public offering

III. How governments and regulators could foster green bonds in the EECCA region

Even though green bonds are popular in Europe, in EECCA key actors will need to see benefits more clearly

Perspective of the issuer: green bonds should offer long-term finance at limited additional transaction costs. Instrument needs to be seen as liquid at both primary issuance and in subsequent trading.

… of the investor: seeks ‘attribution’ (discipline the use of proceeds) and ‘impact’ (measurable outcomes). Both aspects difficult in poor corporate governance. Even in developed markets the link between green bond project characteristics and the reduction in the issuer’s carbon footprint is tenuous (BIS, 2020).

… of the regulator: new instrument should not fragment already small and illiquid markets. Greenwashing would discredit the market more broadly.

… of governments: will this really mobilize additional capital inflows

Policy options

- Development of the regular market is a precondition
- Upgrade of green finance frameworks: clear but straightforward taxonomies and disclosure rules
- On this basis develop a portfolio of projects within banks, suitable for subsequent bond market refinancing
- Engagement of IFIs, whole role as anchor investor will likely remain essential
- In liquid government bond markets: sovereign and sub-sovereign issues
- Cross-listing of green bonds issued in foreign markets on the local exchanges
- Ukraine reconstruction bonds?