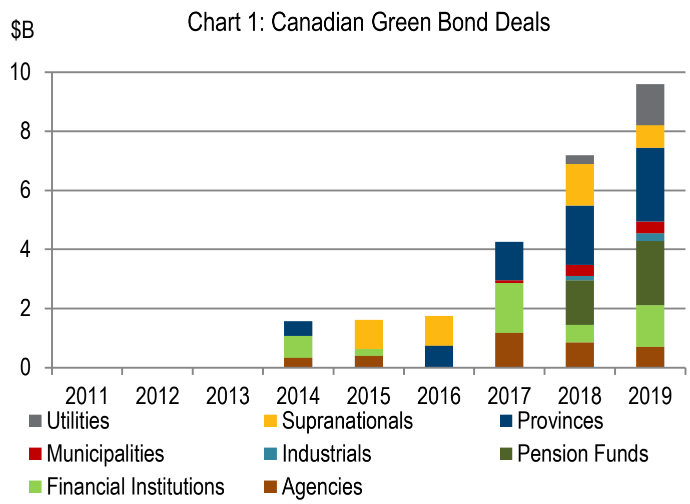
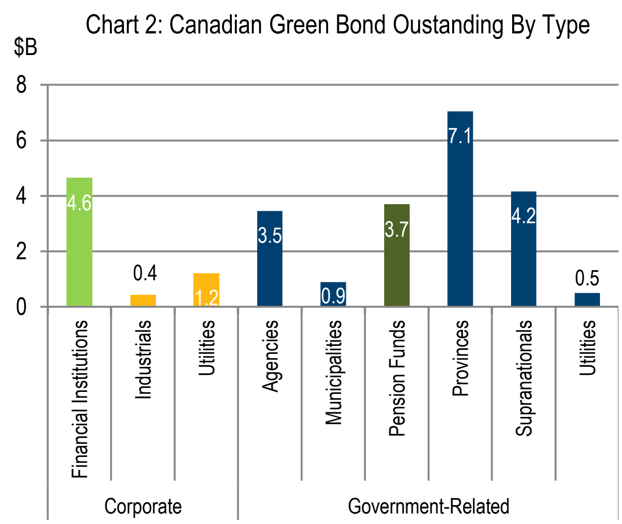
Canada Green Bond Update: Focus on SDG-linked and Transition Bonds

The Canadian financial sector has taken the lead

Issuance of Green Bonds by Canadian-based and supranational organizations has reached $9.6B this year, surpassing the $7.2B mark of 2018 (chart 1). While the governments of Ontario and Québec were the single largest block of issuers in 2018, the financial sector, including financial institutions and pension funds, have taken the lead in 2019. Two deals raising a total of $1.4B were completed this year by Canadian banks (RBC and Scotiabank). This compares to a single $600M deal in 2018 done by Manulife. In 2019, CPPIB issued two green bonds: a euro medium term note ($1.5B) and a private placement ($665M). Interestingly, all green bonds issued by the financial sector in 2019 were denominated in foreign currency (euros and U.S. dollars). Combining banks and pension funds, the financial sector now forms the largest block of issuers in Canada ($8.3B outstanding in Canadian dollars equivalent, chart 2). Domestically, provincial issuance rose from $2.0B in 2018 to $2.5B in 2019. There was no significant increase in municipal and agency green bonds.



Notes: In Canadian dollars. Canadian-based issuers and supranational organizations. Including deals in Canadian, U.S. dollars and Euros. As of December 4th 2019. Classifications by Bloomberg (BCLASS 1 and 2) and LBS.
Source: Bloomberg Finance L.P. and LBS Econ. Res. and Strategy.



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Thematic bonds making their entry

Various thematic bonds enlarging the universe of responsible investment appeared in Canada during 2019 (see table 1). Beyond traditional Green Bonds, the Climate Bonds Initiative (CBI) also developed standards for two types of bonds: 1- Social bonds aiming at fostering positive social outcomes and 2- sustainable bonds combining environmental and social use of proceeds. The categories of projects eligible for funding under the social bond framework are broad and include water infrastructure, affordable housing, food security, etc. CIBC issued in 2019 the first-ever Canadian social bond, geared towards fostering gender-equality and women leadership.

Table 1: Thematic Bonds

Issuer Name	Settlement Date	Maturity	Curr	Amount Outstanding ($M)	Bloomberg Classification	Market Issue	Use of Proceeds
Toronto-Dominion Bank	12-Sep-17	11-Sep-20	USD	1,216	Banking	Global	General Corporate Purposes Green Bond/Loan
Canadian Imperial Bank of Commerce	14-Sep-18	14-Sep-21	CAD	1,000	Banking	Canadian	Social Bond/Loan
Brookfield Renewable Partners ULC	20-Sep-18	15-Jan-29	CAD	300	Electric	Canadian	General Corporate Purposes Green Bond/Loan
Concordia University	08-Feb-19	10-Feb-39	CAD	25	Other Industrial	Canadian	Project Finance Refinance Sustainability Bond/Loan
National Bank of Canada	20-Feb-19	20-Feb-31	EUR	60	Banking	Euro MTN	Sustainability Bond/Loan
National Bank of Canada	01-Apr-19	01-Apr-34	EUR	75	Banking	Euro MTN	Refinance Sustainability Bond/Loan
Sun Life Financial Inc	13-Aug-19	13-Aug-29	CAD	750	Life	Canadian	Sustainability Bond/Loan
National Bank of Canada	09-Oct-19	07-Oct-22	USD	1,000	Banking	Private Placement	Refinance Bail-in Sustainability Bond/Loan
National Bank of Canada	09-Oct-19	07-Oct-22	USD	1,000	Banking	Euro-Dollar	Refinance Bail-in Sustainability Bond/Loan
Bank of Montreal	21-Oct-19	01-Nov-22	USD	656	Banking	Domestic MTN	Sustainability Bond/Loan

Source: Bloomberg Finance L.P.

The rationale behind transition bonds

The universe of thematic bonds continues to evolve at a rapid pace. In the following section, we focus on two kinds of thematic bonds that increasingly generate interest among market participants: transition bonds and SDG-linked bonds.

Companies looking into issuing Green Bonds have to meet certain criteria (see our primer on Green Bonds). Chief among those, proceeds need to be allocated to projects providing clear environmental benefits. Those usually fall under specific categories: renewable, efficiency, pollution prevention and control, aquatic biodiversity conservation and clear transportation, among others. Oil and gas, mining and some transportation companies would usually not qualify themselves to issue under the GBP or would receive a lighter shade of green (the rating code for green bonds) from second party opinion providers. This might lead to the following quandary: is the main goal of sustainable finance to attract capital for green projects or to *maximize* greenhouse gas emission reduction? If it is the latter, then the data suggests that oil and gas production is where maximum efficiency can be achieved. Indeed, in 2017, 27% of all Co2 emissions in Canada came from oil and gas production (Charts 3A and 3B). This was closely followed by the transportation industry, including motor vehicles, airplanes and ships, with 24% of total emissions (Chart 3C).

This brings us to the concept of transition bonds. As defined by Ryan Riordan at the Institute for Sustainable Finance, proceeds from transition bonds are used to “fund a firm’s transition towards a reduced environmental impact or to reduce their carbon emissions”. Importantly, the use of proceeds do not have to finance a project classified as “green” by current GBP, but rather to help transition a project towards a smaller environmental footprint and/or sustainable activities. Put differently, according Global Capital Bonds, funding large emitters to transition towards a low-carbon economy represents a *different theory of change* than funding clean projects. The article refers to the example of the Spanish oil producer Repsol’s transition bond (see below) delivering carbon cuts 30 times larger than ABN Amro’s Green Bonds which fund energy efficient homes.

In contrast to green, social and sustainable bonds, no generally recognized guidelines exist for transition bonds. Axa Investment Managers has published some guidelines that are akin to the green bond framework. Those were recently used in a private EUR100M transition placement issued by Credit Agricole in late November. This is the first transition bond offered by a commercial bank. Corporate Knights and the Council for Clean Capitalism in Canada have also released a preliminary Clean Transition Bonds Guideline, including a taxonomy. Despite the absence of clear and universally recognized principles, several companies globally have already issued under this thematic and provide a snapshot of what this market could look like in the future.

Chart 3A: Greenhouse Gas Emissions By Economic Sector (2017)

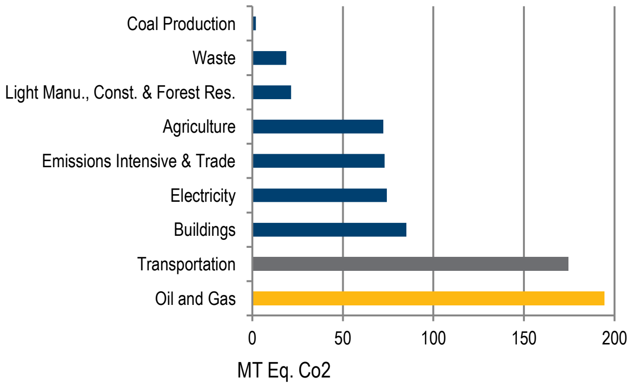


Chart 3B: Oil and Gas

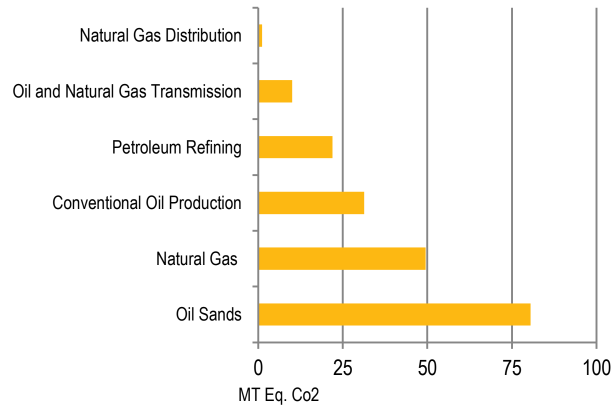
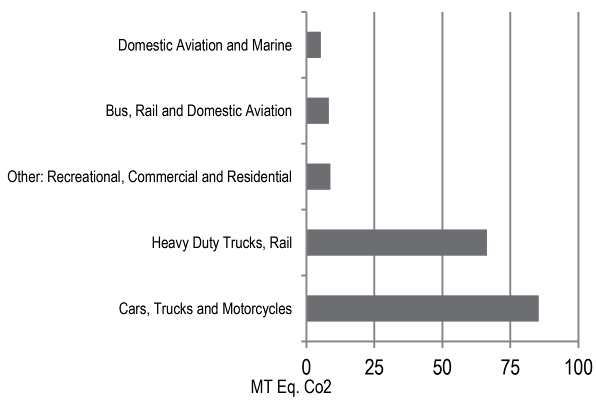


Chart 3C: Transportation



Source: Environment Canada.

Repsol

In 2017, Repsol became the first Oil & Gas Company to issue a green bond: EUR500M maturing in 2022. The second party opinion, required to certify a green bond, was provided by Vigeo. The latter confirmed that Repsol's deal was aligned with the GBP and therefore made a positive contribution to their sustainable development. According to Repsol's Green Bond Framework, the proceeds of this transaction are to be used to reduce the company's GHG emissions by about 1.2 million equivalent tons of Co2 by 2020. Eligible projects include energy efficiency and low emission technology. At the time, the deal brought controversy, and most of the index providers did not include the bond in their Green benchmark. However, the transaction was not considered as "greenwashing" by organizations such as the Climate Bonds Initiative (CBI) and was praised for its high level of disclosure and transparency.[1]

[1] According to the OECD and KPMG, greenwashing refers to a situation where proceeds are not used for their intended purposes or an issuer is not able to prove that proceeds have funded projects with positive environmental impacts. Issuers accused of greenwashing face reputation risk.

Marfrig

In June 2019, the Brasilian company Marfrig, one of the biggest beef producers in the world, issued a US$500M sustainable transition bond. Even though the deal was structured under a sustainable framework, investors perceived the issue as a transition bond and received ample demand from investors. It was also seen as a clear step towards reducing the company's environmental footprint while still evolving in an industry that usually does not qualify to issue green bonds. The use of proceeds has to go towards reducing the environmental footprint of Marfrig's suppliers and contractors operating in the Amazons. It remains to be seen whether it is possible to efficiently monitor those approximately 10,000 suppliers of livestock across the Amazons.

Sustainable Development Goals (SDG)-linked Note

Enel

Enel issued a total of EUR3.5B Green Bond in 2017. This Italian energy company innovated in 2019 by issuing a EUR1.4B SDG-linked bond. An SDG-linked note includes SDG covenants in its structure. The bond's coupon will often be conditional on respecting those covenants.

In Enel's case, the covenant is tied to the United Nations SDG goal number 7: Affordable Clean Energy. For instance, the company has to produce 55% or more of its energy from renewable sources in 2021. If it fails, the covenant stipulates that investors will receive a one-time coupon step-up of 25 basis points. The progress towards achieving this SDG target, including measurements and metrics, is to be externally verified in order to provide transparency.

Another particularity of this bond is that the proceeds will be allocated for general business purposes rather than by project, as it is usually done. More than a classic thematic structured model as developed by the International Capital Market Association (Green, Social and Sustainable), the focus is to align corporate action across the whole business with the United Nations SDGs. Initially, the deal brought controversy. Indeed, some investors believed that the general purpose structure could eventually breach the principles of transparency and eligibility by allowing the proceeds to be allocated for any purposes. Although the deal was deemed somewhat controversial, orders reached US$4B and 70% of the allocations were made to funds with explicit ESG strategies.

World Bank

Another type of SDG-linked bond was issued by the World Bank for US$3.52M in Hong Kong and Singapore in late 2018. The deal was structured whereas bonds' returns are linked to the performance of the Solactive Sustainable Development Goals World MV Index. Securities included in the index are based on Vigeo Eiris' SDG scores. Proceeds from this SDG-linked bond are to be allocated to projects that primarily advance the World Bank's goal of eliminating extreme poverty around the globe.

Conclusion

Thematic bonds are increasingly popular worldwide and were widely adopted by the financial sector this year. The global market has seen the advent of new thematic bonds related to companies wishing to transition from polluting sources of energy towards environmental-friendly operations. Investors generally reacted positively as expressed by the strong demand for those products. This warm reception from investors is tied to the fact that large emitters have significant potential to reduce Co2 emissions with transition and SDG-linked funding strategies. Developing a precise taxonomy seems to be the next step towards clearly identifying sustainable-transition deals.

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