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#RecoveryPlan #Social #Economy
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European Recovery Plan: Time for Green and Social Bonds!

Exceptional circumstances, exceptional measures... but also exceptional financing. On May 27, the European Commission proposed a €750 billion plan to boost the EU economy and support countries most affected by the pandemic. These €750 billion would be borrowed on the financial market.

A large portion (at least 30%) of this recovery plan will finance environmental efforts and the fight against climate change provided for in the Green deal; another part will finance investments in the healthcare sector, and more broadly in the social sector as a result of COVID-19's social impact.

Europe Jacques Delors suggests that the European Commission issue a significant part of this debt in the form of "Green Bonds" for an amount of up to €100 billion over 5 years, and another in "Social Bonds" for a potential amount of €50 billion over 5 years.

01.

Green bonds: a booming market

"Green Bonds" are debt securities on the financial market whose proceeds are used to finance "green" projects or activities, i.e. in support of the environment, the fight against climate change, biodiversity preservation, the circular economy, etc.

Green Bond issuers must indicate this 'earmarking' prior to issue and publish a follow-up of the projects and activities financed in order to ensure that they have met their targets.

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Initiated in 2007 by a European Investment Bank (EIB) bond issue, this market segment was created by private and public players (major European and American banks, EIB and the World Bank) under the aegis of the International Capital Markets Association (ICMA).
A set of specifications ("Green Bonds Principles") were defined in order to be able to use the "Green Bonds" label, which deals with the allocation of funding transparency vis-à-vis the market both upstream and throughout the life of the loan. The Green Bonds Council (which brings together financial institutions as well as NGOs), defines and updates these "Green Bonds Principles".

To reach a volume of $278 billion in 2019 (around €250 billion) – 40% of which was EU-based – the market has clearly experienced strong growth in recent times.

The brief history of this still special market was marked, in 2O17, by the issue of a €7 billion government bond by France for a period of 22 years (22-year maturity), which spurred robust subscription demand. This issuance, which is on the same line of credit as the additional €18 billion France borrowed in less than 3 years, offered the market the first sovereign benchmark of a major country, giving it greater depth and liquidity and paving the way for other sovereign borrowers, including those of emerging and developing countries.

The market is currently mature and diversified, with borrowers from 24 countries mainly composed of multilateral or national public banks, private banks, non-financial companies from the energy or transport sectors, as well as regional authorities, cities, and some states. Loans take on various forms (some of which are asset-based securities) but are all earmarked for "green" funding.
Green Bonds have higher transaction costs than conventional bonds since they must include a system for tracking, monitoring and reporting on stated targets.

Nevertheless, this is offset, for most issuers, by lower interest rates than for conventional bonds given the strong demand from institutional investors (insurance companies, pension funds, sovereign wealth funds, asset managers, etc.) for this type of products. It has also been recently noted that Green Bond prices hold up better than those of conventional bonds in times of crisis, such as since March 2020.

02.
Social bonds: a smaller but fast-growing market in 2020

Social Bonds are a market-based instrument for mobilising private capital for public goods and objectives related to public or social utility. The proceeds of these loans are used exclusively for social causes. As with Green Bonds, transparency beforehand is required from issuers concerning what the loan will finance, as well as regular transparency during the term of the loan with respect to the implementation of the project it is financing.

The first Social Bond was issued in 2006 to increase the supply of vaccines to the world's most disadvantaged countries and have since been typically used to finance health investments.

Up until the recent flux, this market has stayed considerably smaller than the Green Bond market, with issues amounting to $13 billion in 2019.

It should be noted, however, that since the start of 2020, while the amount of bond issues in the world was lower than in 2019, Social Bonds have yielded significant activity due to the health crisis: by mid-June 2020, issue volumes reached $27 billion.

Two examples of recent issues: in March, the International

Finance Corporation, a subsidiary of the World Bank, issued a three-year $1 billion social bond to "support the private sector and employment in developing countries affected by COVID-19"; a few days later, the African Development Bank issued a three-year "Fight COVID-19 Social Bond" to mitigate the economic and social impact of the pandemic on the living standards of Africans. Finally, in France, Unedic borrowed €10 billion in just a few months.

03. The Commission should issue Green Bonds to finance the "green" portion of the Recovery Plan

To demonstrate the seriousness of its "green" plans and to ensure transparency in their implementation… As mentioned above, the Green Bond market requires issuers to be highly transparent prior to issue, as well as during the project's implementation, which includes project monitoring for the duration of the loan. Issuing on this market will therefore require the Commission to be highly transparent on the green portion of its recovery plan, which will be part of the green deal, and will therefore help to ensure its realisation.

To support the development of this market, which is far too narrow, by responding to high demand… The Green Bond market only makes up 3% to 4% of the global bond market. This is not due to a lack of interest on the part of capital providers (long-term institutional investors) who, on the contrary, complain of being unable to find sufficient "Green Papers". With investment objectives for their funds often including these products (a minimum of 25% of their portfolio, for example), meeting these criteria are difficult to achieve. When a borrower of conventional bonds enters the Green Bond market, non-traditional capital providers interested in "Green Papers" are mobilized.

The European Commission is a sovereign borrower with an excellent credit rating (AAA or AA). It is therefore capable of issuing a sizeable loan, which it can reissue several times. It can therein create a flagship loan, as France did in 2017 and the years following. This loan may be the subject of an active secondary market and will therefore become a key element – a "benchmark" – useful for the development of this market.

The Commission could aim to borrow €100 billion over 5 years, a much higher annual volume than a country like France (€25 billion from 2017 to 2020). That being said, France's borrowing capacity is limited not by the market, but rather by the amount of its budget lines earmarked for "green" financing. This will not be the case for the Commission given the scale of its "Green deal" financing.

To facilitate its work in regulating green finance… By borrowing on this market and complying with transparency obligations, the Commission will in practice improve its knowledge of green finance and this will help it in its regulatory work, such as the development of green labels, reporting obligations and taxonomy. The latter has just been the subject of a political agreement in principle between the EU Council and the European Parliament, which the Commission will implement on the basis of expert advice.

… and without having to borrow at a higher cost: As previously stated, despite additional transparency and monitoring costs of projects financed by a Green Bond, borrowers in this market have slightly lower rates to pay, effectively offsetting additional costs. The same would apply to the European Commission.

04.

The Commission should also issue Social Bonds to finance the social portion of its recovery plan, particularly in the healthcare sector

These obligations could in particular finance the SURE programme, a mechanism proposed by the Commission - for the time being temporary - aiming at contributing to the financing of national short-time working schemes (which have been heavily used during the crisis) in Member States which request it.

The requirement of ex-ante **transparency** and implementation of funds monitoring **serves the same interest;**

The Commission's contribution to market development will likely be even greater given that, as the leading sovereign borrower of Social Bonds, it would give significant publicity to the Social Bonds market. This is noteworthy since the Social Bonds market is considerably less known to investors than the Green Bonds market. In light of recent developments in this market following the health crisis, the Commission would likely be able to borrow €10 billion initially (over 1 year), and subsequently borrow €50 billion (over five years) if market growth remains steady.

It is also likely that this loan will not cost the Commission more than a conventional bond issue: if well calibrated, not only will socially-driven investors be attracted, but traditional institutional investors will also be enticed for reasons relating to their image and reputation, which is logical in the wake of the health and social crisis.

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