Summary

The green bond market is relatively young. Although it has, within the space of a decade, grown exponentially (from being non-existent to having a global value of around USD 300 billion at the end of 2017), it can still be considered a niche product. The value of green bonds equates to less than one per cent of the total value of all issued bonds.

At the same time, we know that the prevailing financing need to meet the target from the Climate Summit in Paris – to keep the temperature increase to well below 2 degrees – is tremendous. Some reports claim that the need is USD 93,000 billion for the period until 2030. Green bonds have been indicated, on numerous occasions and by various institutions, as an important source of financing to manage the transition. To enable this, the conclusion is that measures must be taken to make green bonds more attractive to both investors and issuers.

To date, the value in owning or issuing green bonds has mainly had a signalling nature. A party issuing or buying a green bond wants to convey its desire to be part of the transition towards a more sustainable world. In financial terms, however, that value has been limited, or even negative.

A green bond has characteristics that differ from those of a traditional bond, however. A green bond features an element of influence that is absent in a traditional bond, in that the issuer has to report back to the investor on how the issue amount was used, hence paving the way for a dialogue. Conditions are thus created for an ongoing dialogue between the issuer and investors. A number of issuers have also described how introducing a green bond has opened the door for an internal dialogue between different entities at the issuer, mainly between the environmental side and the finance side. These new dialogues have, in themselves, brought up sustainability issues in a positive way.

At the same time, thus far green bonds have not entailed a lower financing cost for the issuer, or lower risk for the investor. It can even be said that, due to extra costs for certification and reporting back, green bonds are a more expensive financing source than regular bonds from the same issuer (albeit only marginally, seen in relation to the sizes of issues). Also, liquidity on the secondary market has been poorer for green bonds so far.

Besides the signalling value, it is difficult to find purely financial reasons for issuing or owning green bonds. It can also be added that regulations in the form of definitions and measurability are sometimes perceived as ambiguous.

The overarching remit of the inquiry has been to identify ways in which a green bond market could be promoted. It has thus not been the remit of the inquiry to judge whether green bonds are an effective financial instrument, or assess whether or not the green bond market should be promoted.

If the objective is to increase growth in green bonds and hence make them an important source of financing for a decided sustainable transition, measures are needed. These can be divided into three categories.

- Improving the existing market based on existing green bonds. The green bond market has nonetheless grown from being non-existent to amounting to around USD 300 billion in the space of ten years.
- Attempting to create green bonds that have partially new characteristics, mainly a lower credit risk, and hence offer a lower financing cost.
- Attempting, in different ways, to eliminate some of the additional expenses and obstacles that undoubtedly prevent a number of issuers from issuing green bonds, even if they fulfil the set requirements.

In the opinion of the inquiry, there is not **one single** solution to all the challenges; rather, it is a matter of assessing an extensive arsenal of areas in which the green bond market could be promoted.

All proposals will, in one way or another, require changes to regulations and mandates in order to be implemented.

At the same time, the ambition is for it to be practically feasible to implement the proposals presented by the inquiry in the relatively near future.

Limitation

The inquiry has chosen to make frequent references to the climate risk. The reason is that there is a clear link between Sweden's commitment in the Climate Agreement and the stipulations of the climate policy framework – that Sweden shall reduce emissions of greenhouse gases into the atmosphere by 85% by 2045, compared to emissions in 1990. Green bonds have also been explicitly indicated as an important source for financing the commitments in place under the 2015 Paris Climate Agreement. The benefit is also that climate impact is relatively easier to measure compared with other sustainability areas. Furthermore, there is reason to believe that a model for how the climate transition is to occur can most probably be duplicated for other areas of sustainability.

It is also essential that the proposals submitted do not require subsidies. When subsidies are used, all systems run a risk of exposure to short-term changes. Besides the shocks and imperfections subsidies can have on the functioning of a market, in some cases they can also contravene EU rules regarding prohibited state aid. Driving developments towards greater sustainability requires the game rules, like the issue itself, to be long-term. This applies not least to the field of bonds, which in themselves constitute a long-term commitment by both investors and issuers.

Some of the commissioner's proposals for promotion

Below are some proposals in the area that could contribute to creating a larger green bond market in Sweden, thus contributing to financing a transition towards a more sustainable society. The proposals are motivated by a conviction that, over time, sustainable investments have a lower credit risk and hence a lower financing cost, which could also help achieve more effective capital allocation in the longer term.

The first two proposals in this context concern extending the green bond market without altering the bond itself. They are discussed in

Chapter 8. Another category of promotion focuses on attempting to create a green bond which has a lower credit risk, and which would hence entail a lower financing cost for the issuer. Some of these proposals, which are discussed in Chapter 6, are summarised here. Chapter 6 also contains a third area of promotion that concerns the need to reduce thresholds, improve information and training, and contribute to a better-functioning secondary market. As is the case for all new phenomena, not least in the financial sector, there is reason to create clear regulations in a broad sense.

Issuing a Swedish green sovereign bond

Although, at the end of 2016, Poland was the first state to issue a green bond, it was only when France issued a green bond at the beginning of 2017 of a full EUR 7 billion that the discussion and desire for states to issue green bonds took off.

The desire to see states issuing green bonds should be seen in light of, for instance, the fact that sovereign bonds generally have better liquidity and represent around 20% of the total value of issued bonds worldwide.

The single most important promotive action, and that which would have the greatest impact, would be if the Swedish state were to issue green bonds.

At the same time, several countries, including Sweden, have restrictions on state borrowing, which complicates the issuance of green bonds. Commonly, under the law, borrowing must always occur at the lowest possible cost. Because issuing a green bond is associated with "extra costs" in the form of certification and back-reporting, it is easy to dismiss green bonds as a source of financing solely on those grounds. Furthermore, many claim that it is difficult, if not impossible, to earmark money for certain projects.

As mentioned above, the green bond market is also smaller, which is a drawback in that the secondary market is poorer than for traditional bonds.

The conclusion is that it is easy to argue on a number of points that issuing a Swedish green sovereign bond is not feasible, or even desirable, given current regulations and the requirement for the cost of central government debt management to be minimised in the long term with due consideration for risk. On the other hand, France basically has the same regulations as Sweden, and a green bond was issued there that was oversubscribed threefold.

Therefore, the inquiry cannot see why this would not be possible in Sweden too. However, a number of questions and circumstances must be analysed in more detail, including the budgetary framework and the fact that the borrowing need in Sweden currently differs from that in France.

Issuing a green sovereign bond must, in all likelihood, be based on the following:

- In time, green bonds will account for a substantial share of the bond market, and the extra costs associated with an issue today must be seen as an investment in the learning curve towards eventually obtaining a new source of financing. In this context, it can be mentioned that the additional cost of issuing the French sovereign bond equals 0.0004% of the issued amount.
- A green sovereign bond could be a means of communicating Sweden's target to reduce emissions of greenhouse gases by 85% by 2045. That bond could, quite simply, be linked to a number of investments that have the purpose of realising the set targets.
- From the point of view of society, it is also important that the state plays an active role in facilitating financing a sustainable transition. Looking at the longer-term perspective, there is reason to believe that the marginal expenses arising in the short term are offset many times over by the long-term benefits reaped by society. The dilemma with today's stock and bond market is that it tends to look to the short-term perspective, and in that perspective sustainability is more by chance than the effect of conscious choice. If the time horizon is changed, the conclusion could be completely different.
- Issuing a green bond would also broaden the future investor base for Swedish sovereign bonds, considering that demand for the green bond in France had a partially different spread in terms of both geography and investor categories. There are therefore strong market-related reasons for the state to engage in the green bond market.

At the same time, most agree that, without manifest state commitment, it will probably not be possible for green bonds to be the financing source that many desire and indeed demand. The opinion of the inquiry is – at least in the short-term perspective – that it is only states that can supply markets with the volumes needed.

It ought to be possible to use the structure of the French green bond as a model for a Swedish equivalent. If that were done, the arguments about it not being possible to earmark money in a budget would not hold water, and indeed neither would the argument that a green bond would hold investors back from traditional bonds.

State-owned companies

If a government and parliament wish to develop the Swedish green bond market, encouraging the state-owned companies to issue green bonds ought to be a reasonable option. Sustainability has long been high on the ownership agenda of such companies – quite simply, pioneering and setting a good example. It is set forth in the state's ownership policy that "Companies with state ownership shall act in an exemplary manner within the area of sustainable enterprise and otherwise act in such a way as to enjoy the confidence of the general public." Adding to this is the fact that the state, e.g. through board nominations for such companies and, in some cases, the possibility of issuing owners' instructions, has a relatively good opportunity to influence how the companies act in this respect.

A number of the state-owned companies are active on the corporate bond market. Here too, however, the conditions must be such that green bonds stand out as the most attractive financing option in the long term.

Real estate financing and covered bonds

One way of relating the risk in a green bond would be to link the bond to specific objects or holdings. One example of this is green commercial real estate. It is clear today that an absolute condition of a growing number of tenants is that they would only consider moving into a certified green building. One effect of this is that the vacancy level of green buildings is lower, and hence so too the financial risk. Investors who hold a green real estate bond backed by green real estate can thus reduce their required return. In turn, this gives a lower financing cost for the owner of the property. There is thus an incentive for property owners, when constructing new buildings, to focus more on green properties because, all else equal, they will give a more favourable cost of financing.

At 30 June 2017, the total value of bond financing of commercial real estate amounted to around SEK 230 billion.

Equivalent rationale can be applied to financing homes. Market participants have already defined the criteria for a "green home". In order to stimulate the issuance of green covered bonds, issuers must have access to the information they need to be able to identify the objects that fulfil their criteria. The Swedish covered bond market amounts to around SEK 2,100 billion and is an important market in many respects.

Here too, there is an opportunity to steer the future production of homes and real estate in a more sustainable direction. Estimations show that around half of the climate impact occurs during the production of a property – a factor that goes unnoticed in the current certification systems for green properties.

Pay for delivery

Sweden's greenhouse gas emissions shall, under Swedish law, decrease by 85% by 2045 compared with the emission level in 1990. Sweden emits just over 53 million tonnes a year today. At the same time, there is a carbon dioxide tax of around SEK 1,040 per tonne. Put simply, it could be said that society has estimated the cost of our annual emissions at around SEK 62 billion. If the emissions cease, the cost for society would be reduced by an equivalent amount, i.e. reduced emissions create a gain for society in relation to the situation today.

It is often said that measuring sustainability is difficult. For carbon dioxide, however, the task is much simpler.

Considering how very small incentives can steer a capital market, and primarily a bond market, it would be an interesting model to have a system in which a small part of the gain for society is paid back to the issuer of a green bond, provided that the bond was delivered as promised.

If a company carries out an investment with the purpose of permanently reducing CO2 emissions, and finances it by issuing a green bond, and can subsequently demonstrate that emissions have been reduced, it ought to be possible for the state to give back part of the gain to society that this achieved.

Such a system would lead to increasing interest in green bond issuance, because it gives a lower financing cost. The buyer of a green bond can also point out what the effect of the investment has been from a climate perspective.

Bonds are highly suited to this type of structure because small incentives have a leverage effect through the fundamental characteristics of the bond. This is particularly the case in the current situation of record-low interest rates.

Copy the Singapore model

As mentioned above, green bonds are associated with certain additional costs in connection with issues and back-reporting. However, in this context it is not a case of large amounts considering issue volumes, around SEK 120,000–400,000 in external costs, although marginal issuers could be pushed out. To resolve this, in Singapore it has been decided to let the state cover the extra cost involved in issuing a green bond. The gain for society if several investments are rendered sustainable would probably exceed this cost to the state many times over. An equivalent structure in Sweden would, given the current issue volume, be well below SEK 100 million. Put simply, it is a well-justified expense in light of the positive, albeit sometimes difficult to measure, effects for society. It would be a matter of an initiative that is limited in time until the green bond market has reached a predetermined size compared with the current level of just over SEK 100 billion.

Functioning secondary market with clear rules

One of several shortcomings of green bonds is said to be the lack of clear rules regarding what a green bond is, and the absence of a well-functioning secondary market. It is of course important that investors, large- and small-scale, 'know' that the capital generated by the green bond is used as intended. In order for the green bond market to grow and hence become an important financing source for a sustainable transition, there must also be an advanced and well-functioning secondary market for such bonds. Because green bonds are still a niche product, trading volumes in these bonds are much smaller than in traditional bonds.

On the stock market, it is the trading venue that formulates the requirements that must be fulfilled for a company's shares to be admitted to trading. Similarly, it would be natural for a stock exchange to set clear requirements in terms of what defines a green bond. It would ease the sometimes confused discussion about what a green bond is and is not, hence improving the conditions for effective self-regulation. In the past, self-regulation has also proven favourable when the game rules for a trading venue are developed. Changes occur rapidly, placing great demands on flexibility and adaptability, and in the view of the inquiry self-regulation is usually better apt to deal with this than legislation. On a trading venue there are also sanctioning possibilities if an issuer fails to fulfil the regulations.

At the same time, it should be emphasised that the current definitions of a green bond appear to have worked satisfactorily to date.

Measure and report

The old saying 'what gets measured gets done' often holds up. It also has a bearing for green bonds.

The pressure on investors to report their climate risk has increased markedly in recent years. The idea is of course for savers and investors to be given insight into how the capital is invested, and to provide the opportunity to make selections from a sustainability point of view.

In France, a law regarding energy transition has been adopted. Article 173 thereof makes it compulsory for pension funds and asset managers, as of the 2017 financial year, to report the climate risk and how it is managed. The law itself will undoubtedly lead to sustainability issues attracting greater attention, and being reported more relevantly. Article 173 is based on the concept of 'comply or explain'.

In Sweden, there are no overarching regulations regarding how climate risk and other sustainability matters are to be reported in asset management. Parts of the market have prepared guidelines, but there are no overarching, comprehensive regulations like in France.

The requirements regarding and desire for reporting are understandable. The more comprehensive they are, the better.

This also creates a desire among investors to have access to information that enables relevant reporting. In light thereof it would be desirable if a green bond issue also reports, as far as possible, the concrete effects of the stated investments.

No Swedish law on green bonds

The inquiry has a mandate to propose the legislative amendments that are deemed necessary, but has arrived at the conclusion that the self-regulation of the market functions well, and that there is no immediate legislative need to promote green bonds. It is possible that Swedish national statutory provisions would even serve as an obstacle on a global market. If a statutory provision is to be introduced at all, it should in that case be at minimum EU level.

Adding to this conclusion is that an array of EU-based regulations prepared in the wake of financial crises around 2010 are under national implementation in the member states, starting to apply during 2017–2019. A number of the issues pointed out by the inquiry will be addressed through such entry into force.

Another reason to wait with proposals for legislative reforms is that the European Commission has announced a reform package, an initiative, to promote investments within the framework of the capital markets union in March 2018. The package is planned to include proposals regarding green bonds.

The inquiry has therefore found, in its contacts with the European Commission, that now is not the right time to put Swedish legislative bills forward. It is therefore the opinion of the inquiry that the analytical work performed and the conclusions drawn by the inquiry can constitute a solid basis for Swedish standpoints in the forthcoming negotiations in the European Council.

In the event of any change in circumstances, the inquiry has appended an outline of the legislative approach that would be preferable for a Swedish green bonds act (Chapter 6).