

In March 2022, the Republic of Chile placed the first-ever Sovereign Sustainability-Linked Bond (SSLB). This \$2 billion 20 year SSLB was more than 4 times oversubscribed - a remarkable achievement given the sovereign bond market's volatility and uncertainty.

Green Policy Performance Bonds, Sustainability-Linked bonds (SLBs), and, most noteworthy, Sovereign Sustainability-Linked Bonds (SSLBs) form a subset of green bonds however, they differ from green bonds, social bonds, or sustainability bonds in several crucial ways:

- First, the funds raised are not tied to a specific project, but a corporate or national objective. Liberating the proceeds from a specific project frees the issuer to deliver sustainability improvements using a wide range of means.
- Second, SSLBs and SLBs are issued with specific sustainability performance targets (SPTs), which contain key performance indicators (KPIs), for example: "A 20% reduction in scope 1 & 2 emissions by 2030".
- Third, if the SPT is missed the bond is subject to a 'step-up' clause, meaning the bond interest increases.



The concept of policy performance bonds began in 2005 as part of Z/Yen's London Accord discussions on using finance to 'save the planet'. Professor Mainelli drew inspiration from the world's first known inflation-indexed bonds issued by the Massachusetts Bay Company in 1780. These bonds were invented to deal with severe wartime inflation and discontent among soldiers about the decline in the purchasing power of their pay. The bonds were a promise that the commonwealth would tackle inflation, backed by financial penalties should it fail to do so. Policy performance bonds are similar in concept but, instead of inflation, they focus on policies that deliver carbon emission reductions.

The concept was formally presented by Z/Yen at the World Bank Government Borrowers' Forum in Ljubljana in May 2009, was included in the City of London's submission to COP15 in Copenhagen, was promoted by the French government in the run-up to COP21 in 2015, and has been the subject of many papers and journal articles, most notably a 2017 French booklet, *"L'Innovation Financière Au Service Du Climat: Les Obligations Á Impact Environnemental"*, by Abdeldjellil Bouzidi & Michael Mainelli. SLBs began being issued by corporates in 2018, starting with French companies such as Danone and Louis Dreyfus.

However, the original idea of 'policy performance bonds' was directed at governments as a means of delivering on their climate change pledges (though they are equally suited to corporate issuers). In its simplest form, interest payments are linked to the actual greenhouse gas emissions of the issuing country. An investor in this bond receives an excess return if the issuing country's emissions are above the government's published target.

For organisations and individuals seeking to invest in a low-carbon future, uncertainty about

government commitment manifests itself in three specific risks:

- Government carbon emission targets being missed;
- Fossil fuel prices remaining low;
- Carbon (emissions) prices remaining low.

Missed targets, low fossil fuel prices, and low carbon prices reduce the profitability of low carbon projects and cause losses to investors. SSLBs act as a hedge against policy risk and can help attract both domestic and foreign direct investment in low carbon projects as they de-risk government policy risk. Policy risk affects investment, for example when the worsening economic environment leads governments to talk about ‘temporary’ easing of carbon reduction commitments, or there is a period of low fossil fuel prices, or when lobbying for special treatment of existing infrastructure looks strong.

In the case of Chile, with the issuance of the world’s first SSLB, the country aims to embed green and financial incentives across several political cycles, while mitigating some of the limitations of existing sovereign green, social and sustainability instruments.

“Another interesting, and sometimes misunderstood, feature of Chile’s SSLB is its long maturity of 20 years. The Sustainability Performance Targets will be verified in 2030 and 2032 and the potential step-up would be paid until 2042. This automatically ties several governments and administrations to the structure and climate actions. It is really a huge step that is, in our view, a game-changer.”

Patricio Sepúlveda, Head of DMO at the Ministry of Finance (Chile)

We expect innovative countries, committed to targets such as net-zero carbon emissions by 2050, to start issuing SSLBs following Chile’s lead. Numerous countries are currently considering SSLBs. Based on the corporate SLBs market development, from \$11bn in 2020 to \$110bn one could imagine that SSLBs will represent 10% of the green government issuance in a few years and, as a result, SSLBs issuers will be under pressure to exhibit higher standards to differentiate their offerings.

In the current economic environment of rising inflation and interest rates, SSLBs could even be more attractive than classic debt. If SPTs and KPIs are bold enough, the lower cost of funding should be a persuasive argument to convince governments to issue such instruments.

This document is a *precis* of **“Sovereign Sustainability-Linked Bonds: Chile Sets A High Bar”**, the supplement to the ninth edition of the Global Green Finance Index. The full text can be found at: <https://tinyurl.com/2p9am8v8>

