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Government Offices of Sweden
Ministry of Finance
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Inquiry concerning *Promoting the Market for Green Bonds* (SOU 2017:115)

(Fi 2008/00116)

One of the main proposals in the inquiry *Promoting the Market for Green Bonds* is that the Swedish government should issue green bonds. As the public authority responsible for central government borrowing and debt management, the Swedish National Debt Office focuses in its consultation response on that proposal as presented in Chapter 8.

The proposal entails that the Debt Office would issue green government bonds within the framework of the ongoing financing of deficits in the central government budget and maturing loans. It therefore concerns borrowing for already decided upon and approved expenditures in the budget, not financing new green investments. The money raised through the green bond must correspond to the amount of budget expenditures classified as green, although the funds are not earmarked for specific green projects.

The Debt Office's views in brief

- The Debt Office sees no room to currently introduce green government bonds within the management of central government debt. Given the current limited borrowing requirement, introducing a new debt instrument would lead to higher long-term funding costs for the government. Consequently, it is not consistent with efficient management of government debt.

- Even long-term, the structural borrowing requirement – and with that the capacity to issue new instruments – would be limited since the surplus target within the fiscal policy framework implies that new expenditures primarily should be funded through taxes and fees, not with higher government debt.

- Should the borrowing requirement nonetheless be large over a period of time, the Debt Office may consider green government bonds as a compliment to traditional bonds. A green bond could then be issued provided it is perceived to contribute to long-term cost minimisation or lower risk.

- The alternative solution proposed by the inquiry, to label a traditional sovereign bond "green," is only possible if the same preconditions as for the traditional bonds prevail. For example, there has to be sufficient green expenditures to achieve the volume required to ensure liquidity during the life of the bond.

- The Debt Office opposes the proposal to further investigate reduced capital requirements and resolution fees in order to promote the issuance of green bonds.

Basic aspects for the Debt Office's consultation response

One of the Debt Office's principle tasks is to borrow money on behalf of the central government for the financing of budget deficits and the refinancing of maturing loans. The Debt Office borrows by issuing various types of sovereign debt instruments, primarily bonds. Most of the borrowing is done in nominal government bonds with various maturities. The Debt Office also issues inflation-linked bonds and bonds in foreign currencies as a supplement.

The objective of borrowing and government debt management is, according to the Budget Act, to minimise long-term costs while taking risks into account. The Debt Office's primary contribution to cost minimisation is to make the Swedish government bond market attractive to as many investors as possible. The strategy is to be transparent and predictable in order to reduce investors' risk. Other things equal, that would make investors willing to pay more for the bonds. Another important strategy to make the market more attractive is to promote liquidity, i.e. facilitating turnover in large sizes without moving the price.

The Debt Office is the sole issuer of government bonds in kronor and therefore needs to have a long-term commitment based on transparency and predictability. Hence, the Debt Office cannot have an opportunistic approach to funding, searching for the best market conditions at every single time of execution. In the international capital market, however, the Debt Office has the possibility to take advantage of favourable market conditions.

As mentioned, the Debt Office uses different types of debt instruments. Having access to several markets and a broad investor base contributes to building up long-term funding capability. However, when the borrowing requirement is limited, the Debt Office has to focus its borrowing to nominal government bonds to preserve that market. Nominal government bonds are the Debt Office's most important source of funding, as it is deemed to provide the best prerequisites for achieving the objective of long-term cost minimisation. This is due, among other reasons, to the fact that the investor base is large, demand is high and stable, and market liquidity is relatively good. The Debt Office's goal is therefore to continuously issue nominal government bonds and keep the supply on a stable level.

A prerequisite for the inquiry to be able to submit a proposal of green government bonds was that it would be compatible with the design and structure of the Budget Act and effective management of government debt. The inquiry comes to the conclusion that this is largely the case, although there are certain obstacles such as the borrowing requirement and the liquidity for Swedish government bonds. In order to minimise the liquidity problem, the inquiry proposes a solution in which a traditional government bond is labelled as "green" as an alternative to issue a special green bond.

In the consultation response the Debt Office comments both on the issuance of a special green government bond alongside the current borrowing, and the alternative solution to label a traditional government bond as "green." The Debt Office also submits its views on some of the other proposed measures for promoting the green bond market. As an introduction of the response, the Debt Office notes that the removal of the earmarking requirement has made it possible for the central government to issue green bonds.

The abolition of earmarking paves the way for green government bonds

An important feature of green bonds is that the money borrowed is to be clearly linked to the green projects that are financed, meaning that the money is earmarked. For many states, including Sweden, this connection is difficult to achieve. This is simply due to the fact that the Budget Act is based on a principle of separation between financing (irrespective of if it is loans or tax revenues) and how the funds are utilised.

In order to make it possible for central governments to issue green bonds, the requirement for earmarking has been removed in the Green Bond Principles. This means that Sweden would be able to issue sovereign green bonds in a manner similar to what France has done.[1] Decisions concerning expenditures and investments are then made in the customary manner – based on socio-economic calculations and within the budget process. Of the expenditures decided upon, some are then classified as green and the government can issue green bonds in the amount corresponding to the total green spending.

However, it does not need to be exactly the same proceeds that are borrowed with the green bonds that go to the green spending. Therefore, in practice there is no difference from a perspective of sustainability between investing in a green and a traditional government bond, except that the investor in the green bond receives reports concerning the green projects.

In order to define the bonds as green, the government must establish a framework for the type of expenditures that can be classified as green, have the framework validated, earmark or identify green expenditures in the budget, report how the proceeds from the issuance of the bonds have been allocated, and present the impacts that have been achieved in terms of environmental and climate change issues.

Special green government bonds are not justified at present

The Debt Office cannot see that a special green government bond alongside traditional government bonds would contribute to an effective management of government debt at present. Even though the interest rate at the time of the issuance may be favourable, as there is a strong demand for green government bonds at the moment, the risk of higher long-term costs for the government's borrowing carries more weight. This is because a new

[1] Other states, such as Poland and Fiji, have also issued green bonds. However, the inquiry particularly highlights France as a comparison since their budget process is considered to resemble the Swedish one.

debt instrument, combined with today's limited funding needs, would impair the liquidity in traditional government bonds.

Possible lower interest rates due to a strong demand for green bonds…

The inquiry has found that at present there are no provable definitive cost benefits with green bonds, as compared with traditional bonds, since the liquidity for green bonds is inferior (p. 252). However, government issuance may contribute to better liquidity and thus reduce interest rates (increase prices), provided a large supply and a long-term commitment.

For the government, it is reasonable to believe that individual bonds would be beneficially priced when executed, as demand for Swedish government green bonds could be expected to be strong. The experience with France's first green bond was that demand exceeded the offered volume by more than three times and the bond was priced in line with the corresponding traditional government bond (p. 392-393).

The actual selling costs for the bonds depend on whether issuance method is syndication or standard auctions. If syndication is used, as in France, assistance from one or more banks is necessary, which increases the costs compared to traditional government bonds.[2]

Irrespective of the selling method, the central government would incur costs in order to set up a framework, retain independent auditors, invest in resources for reporting and follow-ups etcetera. Even though these costs could be placed outside debt management and thus be financed by other appropriations, this would nevertheless entail additional costs compared with traditional borrowing.

…but increased risk for overall higher long-term funding costs

Like bonds in foreign currencies, green bonds could contribute to a broader investor base, thus strengthening the government's capability to borrow. At present however – with a limited funding need – a new debt instrument would instead have a negative impact on the government's capability to borrow, because an increased fragmentation of borrowing is likely to impair the liquidity of the traditional government bond market. With reduced liquidity, the bonds become less attractive, leading to increased funding costs.

The Swedish government differs from many other countries in that it has had large surpluses, and thus a very small borrowing requirement, in recent years. As a consequence, the supply of government bonds has fallen sharply, reducing liquidity in the market. The

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[2] The Debt Office pays SEK 14.2 million a year in primary dealer commissions collectively for all government bonds issued in Swedish kronor. The fees are conditioned on the dealers fulfilling the requirements imposed on them to inter alia participate in the primary market and continuously quote prices in the secondary market. In a syndication, there are no corresponding requirements on the lead manager banks. A 10-year syndicated bond of SEK 10 billion would cost, according to what is standard, SEK 17.5 million (standardised fees according to EIB's EARNs programme: 2 years 0.075 %; 3 years 0.100%; 5 years 0.125 %; 7 years 0.150 %; 10 years 0.175%; 15 years 0.200 %).

Riksbank's decision to purchase government bonds, for monetary policy purposes, combined with new regulations have contributed to further intensifying the problem.[3]

In its assessment of the government's borrowing and debt management in 2013–2017, the Swedish National Financial Management Authority (ESV) writes that the liquidity situation in the government bond market is so serious that the question of additional measures must be posed.[4] Such a measure would be to allow the Debt Office to borrow in excess of the government funding needs.[5] However, the ESV is of the opinion that a measure that should precede overfunding is to reduce issuance in other debt instruments than nominal government bonds. With a particularly low government debt, it is probably not possible nor effective to have too many instruments, ESV writes. In light of this, it is not appropriate to introduce a new instrument such as a green bond.

Altogether, a special green government bond cannot currently be justified in terms of costs or risk. If, however, the motive was something else – for instance, to promote the green bond market – the Riksdag (the Swedish Parliament) would have to give the government a special mandate to borrow on terms and conditions that do not strictly follow the Budget Act, or else amend the law, according to the Debt Office's understanding.

During period of large funding needs a green government bond could be considered

The structural borrowing requirement will probably be limited also in the longer term, as the surplus target within Sweden's fiscal policy framework means that new expenditures are financed primarily by taxes and fees, not by increased government debt. Should the funding need during a period anyhow be large, the Debt Office could consider issuing green bonds as a complement to traditional government bonds. Assuming long-term cost minimisation or lower risk, green bonds could be an option for the Debt Office.

Green labelling of traditional government bond requires same conditions

The inquiry writes that a solution to the liquidity problem would be to replace a traditional ten-year benchmark with a corresponding green bond. In such case, there would not be any new bond with a new maturity that takes resources away from the existing bonds, according to the inquiry. What this means in practice is that the Debt Office would issue a new traditional government bond with a green label in the customary manner through outright and switch auctions. This would then be the sole ten-year Swedish government bond.

The Debt Office has made the assessment and arrived at the conclusion that this solution is only possible if the same preconditions exist as for traditional government bonds:

- There must be a sufficient amount of "green spending" in the budget the year that the bond is introduced, in order to reach a sufficiently large volume to ensure the

[3] See the inquiry relating to Central Government Debt Policy (SOU 2014:8) for an in-depth discussion concerning the importance of liquid markets for sovereign debt instruments.
[4] Evaluation of the central government's borrowing and debt management 2013-2017, p. 73
[5] According to proposals presented in the inquiry relating to Central Government Debt Policy (SOU 2014:8)

liquidity of the bond. This would involve a minimum of SEK 20 billion in the months immediately subsequent to the introduction, and thereafter roughly the same amount during the first year.

- There must be a sufficiently large amount of "green spending" in the budget in the following year and until the bond matures, so that the Debt Office would be able to
  - issue the bond in outright and switch auctions
  - meet the repo demand of the bond.

- There must be a sufficient number of investors in the green bond who are prepared to switch to a new ten-year benchmark at the next introduction, even if the new bond is not green. An important principle for ensuring liquidity in the market is that the Debt Office can quickly build up the volume of new bond through switches from outstanding bonds. If it is not possible to use switches, it will be difficult and/or very expensive to attain a sufficiently large volume.

The amount of expenditures in the budget that would be classified as green is difficult to estimate. According to the inquiry's recommendation, the Swedish green government bonds should primarily finance expenditures in the current year's budget and, with limitations, the previous year's budget and, if proceeds remain, the expenditures in the future budgets. The allocation of the proceeds should not be put off to a later date as that could generate a discussion about what the funds are used for until they are allocated (p. 403).

As to the possibility of carrying out switches (third point above), the Debt Office means that there is a high risk that some of the investors who purchased the green-labelled bond would not be willing to switch to a non-green version. In such a situation, the switches could not be fully executed, or would be very costly to the government.

Altogether, the Debt Office doubts that the above preconditions can be fulfilled. Should a green-labelled traditional bond be considered, this issue needs to be further investigated. If the preconditions are not fulfilled, the green-labelled bond cannot have the same characteristics as the traditional bond. The green bond must then be regarded as a new debt instrument and thus as a supplement to, rather than a substitute for, a traditional government bond. That would inter alia cause the liquidity problems mentioned above.

It is also worth noting that with the alternative option of green-labelled government bonds, no new green yield curve would be created that otherwise would serve as a reference and an incentive for other issuers. Thus, one of the market-promoting impacts that the inquiry indicates would not occur.

Central government involvement in green projects – alternative solutions

In Chapter 8.3, the inquiry discusses the possibilities for the central government to involve in green projects in other ways than by allowing the Debt Office to issue green bonds. The inquiry discusses among other things. whether the government can use green bonds within the framework of alternative funding solutions in order to facilitate the implementation of public investments of particular interest. The discussion primarily concerns what is referred to as the Public Private Partnership (PPP) structure. The Debt Office is very critical to PPP since it always implies higher funding costs for the government.[6]

In this context, the Debt Office would like to point out that neither alternative financing solutions nor green bonds create new money. Nor does it lead to that any party other than the government ultimately pays for the investments. Expenditures which wholly or in part are to be paid by the government should be dealt with within the ordinary budget process and prioritised vis-à-vis other expenditures.

Debt Office rejects reduction of capital requirements and resolution fees

The inquiry has come to the conclusion that there are grounds for further investigation of the possibility of reducing capital requirements and resolution fees to promote green bond issuance (section 6.7.2). The Debt Office strongly advises against using regulations meant for risk management in the financial system for the purpose of promoting certain asset types or investments. Capital requirements should reflect financial risks and have the objective of safeguarding financial stability. Lowering the protections and thereby weakening financial stability, for the purpose of subsidising a particular form of financing, results in increased risks with potentially very high costs for the society.

The Swedish legislator and Swedish public authorities have chosen to introduce requirements that are more stringent than the minimum requirements of the EU's legal framework, as it was deemed necessary in order to maintain financial stability in Sweden. As long as the risks underlying this assessment are not decreased, a reduction in the target for the resolution fund, the annual resolution fees or the institutions' capital requirements, would risk increasing both the probability and the costs of a financial crisis.

In this matter, the Debt Office's Director General Hans Lindblad has made the requisite decisions, after a presentation by Linda Wik, analyst. Maria Norström, Johan Bergström, James McConnell, Åsa Andersson, Ann-Christine Hagelin and Heidi Marks also participated in the preparation.

Hans Lindblad, approving the response

Linda Wik, presenter

[6] See for example a presentation (only available in Swedish) by the Debt Office Director General Hans Lindblad (https://www.riksgalden.se/sv/omriksgalden/Pressrum/Nyheter-och-pressmeddelanden/nyheter/2018/riksgalden-diskuterade-finansiering-av-infrastruktur/) and a report by the UK's National Audit Office (https://www.nao.org.uk/report/pfi-and-pf2/).