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CEFC Expert Review
The Treasury
Langton Crescent
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<u>Funding the CEFC with Green Bonds</u>

Dear Sir/Madam

Thank you for the opportunity to contribute to the Expert Review on the establishment of the Australian Clean Energy Finance Corporation (CEFC).

State Street is a leading financial services provider serving some of the world's most sophisticated institutions, such as pension funds, mutual funds, endowments and sovereign wealth funds. State Street offers services that span the investment spectrum, including investment management, research and trading and investment servicing. As of 30 June 2011 State Street had USD 22 trillion in assets under custody and administration and USD 1.9 trillion in assets under management, as well as operations in 27 countries and a network which spans more than 100 geographic markets.

State Street Global Advisors (SSgA), the investment management arm of State Street is one of the world's largest managers of Environmental, Social and Governance (ESG) products with over USD 122 billion in ESG assets. With over USD 359 billion in fixed income assets, SSgA is also one of the world's largest managers of fixed income.

SSgA launched the High Quality Green Bond Strategy in October 2011 to meet the growing needs of our clients for investment in high quality products that are environmentally beneficial. We would like to see a greater number of Green bonds to invest in and believe Green bonds will grow as an investment class given the global need to transition to a low carbon economy and the benefits of the product to our clients. It is against this background that we are commenting on the consultation.

We suggest the Expert Review consider recommending that Green bonds be issued by the Australian government to provide some or all of the seed funding of AUD 10 billion for the CEFC. In addition to providing a funding alternative to conventional Australian government bonds and revenues from the carbon tax, the issuance of Green bonds would have broader benefits for climate mitigation and adaptation efforts in Australia and elsewhere. Our detailed comments follow below.

What are Green bonds?

Green bonds offer investors the opportunity to participate directly in the financing of environmentally beneficial projects or initiatives which typically help mitigate or adapt to climate change. Green bonds may also include any bonds whose proceeds may be used principally to finance projects or initiatives designed or intended to fund or support environmentally beneficial projects, such as, development of clean sustainable or renewable energy sources, commercial and industry energy efficiency or conservation of natural resources. Bonds used to finance coal fired power and nuclear power are often ineligible for Green bond portfolios, though definitions vary in the absence of clear industry standards around the green label.

Green bonds have similar financial characteristics as the conventional bonds of the same issuing entity. However, the capital raised by Green bond issues are specifically allocated to fund environmentally beneficial development projects. The rating of the Green bond is the issuer itself (e.g. the Australian government). The coupon payments of the bond do not depend on the cash flows from the underlying projects funded. As such, the purchaser of the bond does not make a judgment on, or bear any risk relating to, the underlying environmental projects the issuer invests in. Such an arms length investment in environmental technologies is often more appropriate for large institutional investors than "bets" on individual technologies through the direct funding of companies such as start up ventures. Green bonds would therefore not pull funding away from companies but add to the overall pool of funds available to fund environmental projects.

Prospects for Green bonds

Green bonds are a relatively new but emerging asset class. In 2008 the World Bank issued the first Green bond. There is now approximately USD 12 billion in Green bonds outstanding across multiple issuers, maturities and currencies. Multilateral development banks (MDBs) – also commonly referred to as supranationals – and Multilateral Financial Institutions (MFIs) are the largest issuers of Green bonds. In the past two years alone, the Green bond market from these issuers has grown from USD 1 billion to more than USD 5 billion outstanding. Issuance by individual governments, such as Australia, is a potential next step.

Given the trend of de-risking by investors, efforts to mitigate and adapt to climate change and the dual policy imperatives of sustaining economic recovery and spurring employment growth, we believe the Green bond market has the potential to grow rapidly. It is also estimated that the move to a low-carbon economy could require as much as USD 1 trillion a year in new investment flows for the next 20 years to limit global temperature increases to 2 degrees Celsius. Much of that will be in the form of income-generating infrastructure investment that is well suited to debt finance, with Green bonds expected to play a major role.

Who buys Green bonds?

Clients choose Green bonds in order to obtain social returns in addition to financial returns comparable to conventional bonds. As such, Green bonds satisfy investors' financial and environmental interests. Institutional investors such as some major pension funds, insurance companies, foundations and sustainable and responsible investment managers, particularly those from Europe and the US, currently make up the bulk of investors in Green bonds. These entities seek exposure to investment products which assist in environmentally beneficial projects but need to balance their fiduciary duty with this objective. Green bonds provide a solution to this dilemma as the risks and returns are on par with conventional bonds from the same issuers. Investing in Green bonds could also replace part of an existing allocation to conventional bonds such as sovereign or other government bond allocation. There also appears to be strong retail interest in Green bonds which suggests the investment base will broaden once the asset class grows. Products for retail investors in Japan have, for example, been very successful.

Liquidity

One of the questions raised about Green bonds is their liquidity relative to standard (non Green) bonds. Lack of liquidity in Green bonds may be perceived as a risk as the government considers issuing Green bonds. In general, however, the liquidity for Green bonds is not that different from standard bonds of similar size from the same or comparable issuer. In other words, the relative difference in liquidity is not a function of the Green characteristics of the bond (e.g. use of proceeds towards low carbon projects) but rather a function of their generally smaller size than standard bonds.

In addition, most outstanding Green bonds are purchased in private placements and constitute part of investor's buy-and hold strategies (i.e. investors such as pension funds want to buy and hold the assets rather than sell them for short term profit). At present we expect that the bid-ask spread for Green bonds in the secondary market to be slightly wider than benchmark issues from the same issuer. In addition, the market itself is currently very small, decreasing secondary trading volumes. It should be noted that bonds issued by supranationals and MFIs are, however, among the most liquid fixed income securities available, and issuers maintain buyback provisions as a liquidity backstop. We believe that the slight difference in liquidity will reduce as the asset class grows and a broader range of investors invest in the asset.

Green bonds and the CEFC

Section 2 of Appendix A of the consultation paper notes that the CEFC will fund two streams of projects: a renewable energy and enabling technology stream and an energy efficiency and low emissions technology stream. We understand the AUD 10 billion in seed funding for the CEFC will come in part from Carbon Tax proceeds. Australian Commonwealth Treasury Bonds may fund the rest of the CEFC. If bonds is a funding source we propose that instead of issuing regular Treasury Bonds, the Australian government consider issuing a Green bond of equal standing.

The two streams of projects that the CEFC will fund are the sorts of projects often funded by the proceeds of Green bonds. Our understanding is that marginal changes to the information memorandum issued by the Australian government would be required. The funds would, however, need to be ring fenced and properly accounted for to demonstrate they are being utilized for the purposes intended. This can easily be done as shown by others that have issued Green bonds.

Relationship to other initiatives

The consultation asked about the relationship of the CEFC to other environmental initiatives being pursued by the government. We note the government's establishment of the Australian Renewable Energy Agency (ARENA) which will be part of the resources, energy and tourism portfolio. It might be possible to fund ARENA with Green bonds as we understand the intention is that ARENA will independently administer AUD 3.2 billion in existing Federal Government grants for research and development into renewable energy technologies and initiatives to bring them to market.

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The Clean Technology Innovation Program (CTIP) to be administered by the innovation, industry, science and research portfolio could be another destination of funds from Green bonds. We understand the CTIP will provide grants of AUD 200 million to support business investment in renewable energy, low emissions technology and energy efficiency and that the grants could support manufacturers to develop new clean technology products.

Advantages of a Green bond program

The issuance of green bonds would have benefits beyond environmental initiatives. The issuance of Green bonds on the heels of the recently announced price on carbon and carbon tax would add to Australia's global environmental credentials. If Australia is one of the first governments to issue Green bonds it will also gain a first mover advantage in attracting investors into this asset class. Australian issuance may encourage other governments to do the same, expanding the asset class and indirectly promoting funding for the global transition to a low carbon economy.

The creation of a Green bond market by Australia could also attract a new set of funds and investors to Australia, such as large US and European pension and insurance funds. An Australian Commonwealth Green bond issue would broaden the universe of securities that these investors could utilise to achieve their bond and ESG allocations. The establishment of a new asset class and the attraction of new funds would also support the goal of attracting further international portfolio investment to Australia and building Australia as a financial centre.

Thank you again for the opportunity to comment on the consultation paper. Feel free to contact us should you have any questions about the above. We would be happy to assist in any way we can with questions you might have on the nature and issuance of Green bonds and how they might apply to the CEFC or other environmental initiatives.

Yours sincerely

Lochiel Crafter
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