ARDEA
Investment
Management

Sustainable Finance Consultation

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About Ardea Investment Management

Founded in 2008, Ardea Investment Management is one of Australia's largest fixed income fund managers. Ardea is entrusted with managing over $25bn on behalf of superannuation funds, insurance companies, government entities and wholesale and retail investors both here in Australia and globally.

As stewards of capital, Ardea has a duty to ensure that we are operating and investing sustainably. Given our investment focus on sovereign bond markets, Ardea sees climate change as the sustainability risk of most concern. Ardea is committed to use its knowledge and to effect change in government bond markets arising from the realisation of risks related to climate change.

Scope of comments

The Federal Treasury's Sustainable Finance Strategy consultation paper raises both foundational issues and priorities to underpin the development of Australia's sustainable finance markets. In this submission, our comments are confined to the following two priorities:

- Identifying and responding to potential systemic financial risks, and
- Issuing Australian sovereign green bonds.

Priority 6: Identifying and responding to potential systemic financial risks

As an active owner and participant in the Australian government fixed income market, Ardea views a well-functioning government bond market as an essential component of a modern economy and financial system. For investors, it is a core allocation in well-diversified investment and superannuation portfolios given its low-risk, predictable returns, and high liquidity. Government bonds are also critical for the functioning of monetary policy, as a secure asset held for prudential regulatory purposes, and for use as a risk-free rate when pricing a wide range of other asset classes.

The central role that government bonds play means that divestment and allocation away from the asset class is of limited usefulness. Ardea considers it incumbent on all investors to actively engage with governments and more broadly as stewardship can support the development of informed and practical pathways to net zero in a manner that is fair and just for all.

It is therefore critical to identify and respond to system-wide financial risks, such as climate change and the sustainability of governments' fiscal burdens. Fiscal sustainability is particularly important to ensure governments have the flexibility to respond to changes in economic conditions and buffer its citizenry against adverse shocks.

The fiscal consequences of climate change should be highlighted, given that Australia's ageing demographics will already place a large burden on public finances in the coming decades. Climate change will have an impact on the medium and long-term fiscal sustainability of government budgets, however the global and long-term nature of the problem, the interconnection with biodiversity loss, and its complexity makes its amplitude and timing much more uncertain.

Many in the investing community claim that climate change is not being factored into government bond markets; therefore, sovereign bond yields are not fully reflecting the impact of climate change and a country's effort to transition to a low-carbon economy in line with the 2015 Paris Agreement.

Findings from a shared research project between the University of Technology, Sydney, Fortlake Asset Management and Ardea, have challenged this narrative and found that carbon dioxide emissions, natural resources rents, and renewable energy consumption, as measures of transition risk, significantly impact government bond yields and spreads. Accordingly, governments that perform poorly in managing climate change transition may encounter difficulty finding investors to buy their sovereign debt.

By contrast, countries with lower carbon emissions incur a lower borrowing cost. Advanced countries reducing their earnings from natural resource rents and increasing renewable energy consumption are associated with lower borrowing costs. This differs from the effects in developing countries and accordingly, the necessity to support developing countries to meet climate change targets also emerges. The research findings are published here.

In many asset classes in investment markets, including government bonds, transition risks have materialised much faster than physical risks. The physical risk of climate change is currently impacting GDP levels globally. Over the medium to longer term, the physical impacts of more frequent natural disasters will impact the credit ratings of Governments by ratings agencies. This research has identified that advanced economies that perform poorly in managing their climate transition may encounter:

- increased sovereign borrowing costs,
- liquidity constraints,
- reduced capacity to effectively manage climate transition, and
- the inability to finance economic recovery from severe climate shocks or natural disasters.

Given the threat climate change poses to the global economy and the fast materialisation of transition risk, these environmental factors are most likely to be material determinants of sovereign bond markets. Further, we believe that environmental risks (and, in particular, climate change) will become increasingly important over time.

Priority 9: Issuing Australian sovereign green bonds

The Australian government's budget night announcement to issue sovereign green bonds remains a welcome initiative.

Globally, there is a long way to go to 'greening' sovereign debt with approximately 5% of all government issuance labelled as sustainable (be that green, social, sustainable, sustainability-linked or transition)[1]. This is important to acknowledge given the additional expenditure that will be required to achieve net-zero emissions in line with the planet's time horizon – finance that will need to be mobilised by both public and private sectors. The Australian Government has both the political mandate and the potential to provide the

[1] 2022 Market Snapshot: And 5 big directions for sustainable finance in 2023 | Climate Bonds Initiative

long-term capital needed to finance the low-carbon transition.

We would note the attractiveness of the “greenium”, or the higher price, investors are willing to pay for green (and other sustainability-related bonds), compared with debt. This is a clear benefit to issuers with the practical upshot that green projects also become more financially attractive to government issuers.

Green bonds continue to attract higher investor demand than their equivalents in the primary market with demand for green investments far outstripping available supply. Green bonds also typically tighten in the immediate secondary market as the higher demand translates into relatively tighter pricing.

We consider the presence of the greenium in government bond markets to be structurally persistent given:

- An increased emphasis on responsible investment overall,
- Heightened pressure on governments to set climate change objectives,
- Increased number of corporates committing to their own net zero targets, and
- Investors are willing to pay for greater transparency and enhanced reporting, including impact indicators like emissions avoided.

Whilst the demand for green bonds is likely to remain strong, Ardea would encourage Treasury to also review the other sustainability labels available when issuing sovereign debt. Notwithstanding the imperatives of acting on climate change, Ardea has observed an insufficient global pipeline of available and standardised green projects which is impacting the increased issuance of green sovereign bonds. In the Australian federal system, the States also have responsibility for much of the infrastructure assets and green projects that would traditionally underpin a green bond.

Capital raised through green bonds must be used exclusively to finance or refinance projects with clear environmental benefits through the “use of proceeds” approach. This use of proceeds approach is shared across green, social, and sustainable bond labels and allows for a broader, more diversified project pipeline to be considered for inclusion. Again, state governments, like Western Australia and South Australia, have incorporated both green and social projects in their recent bond issuance.

A more recent evolution in sustainable finance is transition bonds which could play an important role for a resource dependent country like Australia. As the name suggests, transition bonds are used to fund the process of transitioning to lower carbon emissions. These bonds could include projects that would not normally qualify for green bonds, supporting the government in its efforts to decarbonise the economy in a way that is as fair and inclusive as possible.

The reporting requirements are more onerous with the need for science-based measures on the path to delivering net zero, an expectation of annual impact reporting and the need for independent assurance or auditing on the tracking of transition projects.

One potential form of transition bond, the sustainability-linked bond, involves the issuer committing to make sustainability improvements, such as reducing emissions, within a predefined timeline. Sustainability-linked bonds are structurally linked to the issuer’s achievement of climate or broader sustainability goals through a covenant linked to the coupon of a bond. In this case, progress, or lack thereof, towards the selected goal results in a decrease or increase in the instrument’s coupon.

Ardea is very supportive of Australia joining other sovereigns through the issuance of a credible green or sustainable bond program with clear objectives to finance programs that support a just transition. We are an active participant in global green government bond markets as well as in the Australian sub-sovereign green bond market. Indeed, a practical way that Ardea has integrated Environmental, Social, and Governance (ESG) into the investment process has been to use our highly active trading style as well as our active ownership approach to stewardship to advance the development and growth of the sovereign green bond market globally.

By creating more opportunities for trading and enhancing price discovery, our aim is to contribute to advancing the development and growth of the green bond market globally which, in turn, has encouraged governments to issue more green bonds and contributes to a reduction in sustainability risk for issuers, and therefore economies overall. This has direct implications for the sustainability of the government bond market in aggregate and therefore all investors in government bond strategies.