Intelligence MEMOS

From: Glen Hodgson

To: Canada's Ministers of Finance

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Re: **Federal Green Bonds Could Build Capacity, Impose Order**

The green bond market was growing rapidly – to $257 billion globally in 2019 – until the pandemic hit in 2020. As the recovery unfolds, green bonds – fixed-income securities used to finance sustainable projects – appear poised to resume their trajectory, in Canada and abroad. But should the federal (and provincial) governments get into the action with their own green bond issues?

In a **recent C.D. Howe Institute paper**, I argue there are many good reasons for Ottawa to issue its own green bonds; chief among them is the setting of a benchmark price that can help build overall market capacity in Canada.

These bond instruments, whose proceeds are exclusively applied to finance or refinance eligible green projects, such as solar or wind power generation, are distinct from other types of fixed-income instruments. The criteria for qualifying as green bonds are going through a rapid evolution, shifting from voluntary standards and processes toward more mandatory practices, such as those now in place in the European Union.

In a perfect world, the price system, using efficient market-based policies such as carbon taxes, would address negative effects, such as greenhouse gas emissions. There would be no need for separate green bonds. But in the real world, where the public policy response is so far inadequate, issuing governments and businesses, and investors, are making use of green bonds to address the GHG problem.

The strongest evidence comes from abroad. The World Bank and European Investment Bank have been key issuers of green bonds from the outset and have been joined by many governments and private-sector issuers. The global market expanded by 51 percent in 2019, to $257 billion. The severe economic disruption caused by the pandemic affected the market's development, but it is reasonable to expect green bond markets to recover and grow rapidly as capital markets re-establish more normal conditions.

Canada also saw rapid green bond market growth until 2020. The Canadian market accelerated in 2019, growing by 63 percent to an estimated $9.25-billion by year's end. Canadian issues were led by the public sector at the outset, and an increasing number of commercial issuers have joined in. Export Development Canada (EDC) has acted as the de facto representative for the federal government, issuing green bonds in both US and Canadian dollars.

While nothing appears to be "broken" in the market, there are a number of advantages to direct federal green bond issuance, with few disadvantages.

Ottawa announced its intention to begin issuing green bonds in 2021-22 in its fall economic statement. This is welcome news, since the federal government is able to set the best possible price benchmark for Canadian dollar issues by other Canadian green bond issuers, notably in secondary markets. This will create a more liquid market for green bonds, which will reduce any premium paid on these assets when they are traded. The Bank of Canada could also accept green bonds as collateral, as the ECB has done with sustainability-linked bonds.

In addition, federal issuance would help restore and fuel growth in the Canadian green bond market for institutional and other investors, including foreign investors. The issues could fund green infrastructure projects and other public investments to improve climate resiliency and reduce GHG emissions.

Other policy decisions are going to be required for Ottawa's rollout of such a program. The financing terms for its initial issue and future issues should avoid crowding out other bond issuers. Moreover, the federal government will need to decide what specific green bond standards to adopt and how to manage its green bond issuance, certification and reporting. Joining other nations to establish a global standard would help. Investors would prefer to see one set of green bond standards and the federal standards and processes adopted could become a de facto benchmark for Canadian issuers.

The possible use of temporary tax incentives is another area for consideration, although we would suggest waiting to see how the market evolves, post-pandemic. And the federal role in transition finance for the oil and gas sectors and other emissions-intensive sectors should also be examined, where many of the same decision areas exist. Transition bonds can be used, for example, to finance investments in cleaner oil and gas technology.

Ultimately, the federal government should expect to engage all available economic and policy instruments to meet its commitment to reduce GHG emissions and reach net-zero emissions by 2050 within a well-performing economy. The decision to issue federal green bonds directly demonstrates its policy engagement. Defining the related financing structure, standards and conditions are key next steps.

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