THE "WHY" FOR A SOVEREIGN SLB

Q&A: AZUCENA ARBELECHE

Uruguay is preparing its first issue of a sovereign sustainability-linked bond, as it pushes forward on a goal of reducing carbon emissions. The note, says the country's finance minister, will provide an incentive: reach the target, and it will pay less interest.

BY CHARLES NEWBERY

Sustainable finance is gaining in Latin America and the Caribbean, as more companies and sovereigns take advantage of growing investor demand for these instruments in a bid to combat climate change. Globally, the combined sale of green, social and sustainability, sustainability-linked (SLB) and transition bonds shot up a year-on-year 59% in the first half of 2021, according to the Climate Bonds Initiative, a global non-profit organization.

Chile has been a leader in Latin America in green bond issues, and other countries are following suit. Uruguay, which has already decarbonized most of its power generation, is one of them. The country's government is designing the first sovereign SLB. It will be linked to environmental indicators, most likely a reduction in carbon emissions. Meet the target, and Uruguay will pay less in interest as a reward. Miss it, and the sovereign will pay more.

LatinFinance recently spoke with Uruguayan Minister of Economy and Finance Azucena Arbeleche to discuss the design of the SLB and how the country aims to meet the target.

The interview was edited for length and clarity.

LatinFinance: Uruguay is designing its first climate bond. What is the driver behind this?

Azucena Arbeleche: First of all, to put this in context I think we have to bear in mind that Uruguay is at a turning point when it comes to fighting the COVID-19 pandemic, and an economic recovery is underway. Our goal is for this recovery to be inclusive and sustainable. That is to say, that we can combine growth and the creation of jobs with an improvement of the population's living conditions. This goes hand in hand with investments that have a positive, measurable and verifiable impact on social and environmental indicators.

LF: Can you provide us any specifics on the bond?

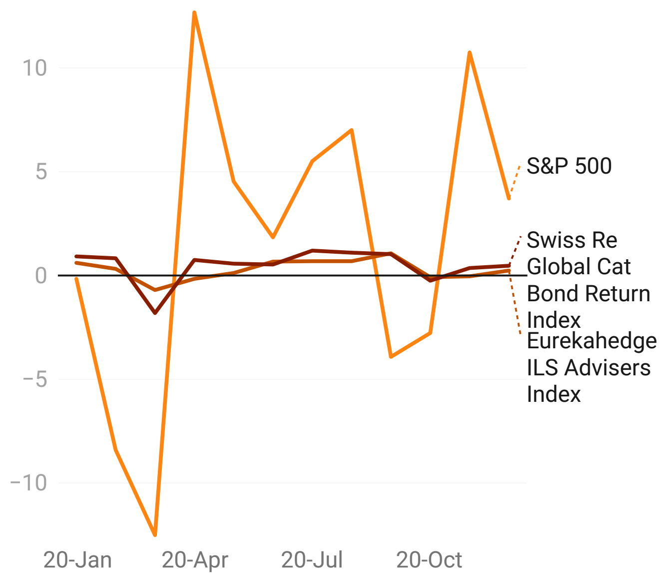
AA: It is still a work in progress. I can say that are working together with the Ministry of Industry, the Ministry of Livestock and the Ministry of Environment on its design. It will be linked to our compliance with indicators for the reduction of greenhouse gases. The idea is that the payment of interest on this bond will be linked to environmental indicators, and this payment of interest will be contingent on reaching the goals in the performance indicators.

LF: Is this proposed bond a new trend for sovereign issuers?

AA: So far, advanced and emerging countries have issued a little more than 20 environmental bonds. All these bonds have been thematic bonds like green bonds for which the use of proceeds is for specific projects, such as for renewable energy, clean transportation or biodiversity protection. In Uruguay, we are exploring an alternative model called the sustainability-linked bond, where the bond is oriented toward the achievement of environmental objectives rather than using the proceeds for green projects. Corporations have done this, but no sovereign has.

High Intensity, Low Frequency, Steady Returns

Monthly returns of ILS indexes x S&P 500, 2020, in %



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LF: What indicator could you use to measure the country's progress?

AA: This is something that is still being evaluated. We have not defined the particular indicator, but it will be part of the international commitments that Uruguay has taken on for the Paris Agreement. Uruguay already has an advanced system for measuring, reporting, verifying, and monitoring greenhouse gas emissions. This allows us to make do frequent and transparent monitoring of how the intensity of gases evolves in the economy. This is a very important element when considering the development of a bond indexed to these environmental indicators.

LF: Why are you exploring SLB as an alternative versus a green bond?

AA: One reason is that a sustainability-linked bond issuance involves a national effort. When interest payments are tied to certain indicators, those indicators are the result of the entire country's actions. On the investor side, we have also seen a rise in demand for environmental, social and governance [ESG] issues. Responsible investment funds want to explicitly know what will be done with their funds. With the bond we are designing, Uruguay will have a fiduciary mandate to take care of the environment and reduce carbon dioxide emissions. What is interesting with this bond is that the incentives of the investor and the issuer will be brought together for the fulfillment of a certain indicator.

LF: If you don't meet your target, what will happen?

AA: The idea is that if the target is met, we will pay less. We will set a certain base rate of interest and we will be penalized if we do not reach the objectives. But if we reach the target, we will be rewarded.

LF: What benefits could the SLB bring to Uruguay?

AA: First of all, there is demand. We have held preliminary meetings with investors in both the United States and Europe, and so far we have found good receptivity for this instrument. In terms of the benefits, I think there are three. The first is that as Uruguay advances in these environmental factors, it will also have a greater weight in ESG indexes, and this will help us to have a more liquid secondary market. A second benefit that the deal will increase the visibility of the national environmental strategy. This demonstrates our commitment to move forward. When you prioritize environmental issues, this becomes an extremely important letter of introduction to the country. Issuing a bond linked to environmental indicators shows the importance that Uruguay is putting on the environment. This visibility can also help us access more international climate finance, such as donations or non-reimbursable public financing. The third benefit is in the economic and social development for everyone today and for future generations.

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becomes an extremely important letter of introduction to the country."

– Azucena Arbeleche

LF: Could this attract foreign direct investment to Uruguay?

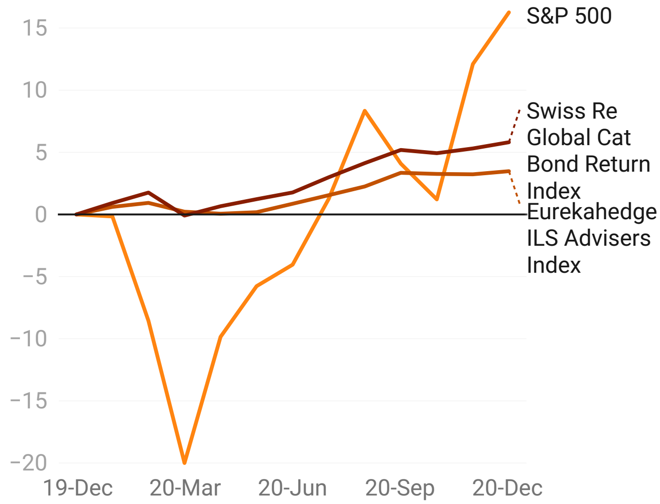
AA: Yes. More people and investors are becoming aware of environmental challenges, and so whoever makes a foreign direct investment in our country or puts their money in a bond in our country will be looking at the environmental issues. This type of bond requires a response not only from the entire government, but it also requires a strategy and an effort from the entire private sector and the entire nation. In this sense, this bond issuance can have an important demonstration effect for this private sector to join.

LF: Uruguay has been reducing its carbon emissions by increasing the share of renewable power generation capacity. What progress has been made so far?

AA: Uruguay has made great strides in recent years in the use of renewable energy. We have almost completely decarbonized electric energy. More than a third of our electric energy is produced from wind.

Few Thrills with ILS in a Catastrophic Year

Cumulative returns of ILS indexes x S&P 500, 2020, in %



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LF: What else can be done to reduce emissions in the near and long term?

AA: What challenges do we face next? There is a high level of carbon dioxide emissions that we have associated with transport and mobility. So, we have to develop new renewable energy sources and promote investment in the use of clean energy and technology that reduces pollution, and we also have to provide economic incentives for consumers and companies to pursue these environmental goals. For example, we are proposing a tax on carbon dioxide emissions in gasoline, which is something that is happening internationally. The Ministry of Industry is also leading the country's second energy transition, which involves converting transport and mobility to run on electricity and to develop sources of green hydrogen. The Ministry of Livestock is also executing a climate-smart livestock production project to protect native forests and promote reforestation. The central bank aims to improve the role of the financial system to mobilize capital for investments that are green and low in carbon.

LF: Do you plan to provide incentives to encourage a reduction in carbon emissions?

AA: I would say that macroeconomic policy is a fundamental tool to achieve climate goals. Subsidies, regulatory changes, incentives, public spending and taxes can all be brought into alignment to achieve these goals. We are optimistic about the long-term benefits of a climate-neutral economy, but clearly we cannot ignore that this has fiscal and transition costs. These costs are assumable, but we are talking about considerable amounts when it comes to designing this transition and being fair to future generations in terms of the environment and costs. That is why it is so important that private initiatives are involved and that development banks and international organizations also get involved. I think we all agree that it is time to take a concrete step to implement these changes and that the government, the multilaterals and the private sector all have to be on the same side.

LF: Thank you.