CLIMATE ECONOMICS UPDATE

Lessons from Brazil's first sovereign ESG bond

- **Brazil's first sovereign ESG bond arrived last month amid much fanfare, but the reality is that any "ESG premium" looked fairly limited to us. And we think ESG bond premia, in general, will likely remain low.**
- Brazil's government issued its 7-year US dollar "sustainability bond" at a yield of 6.5%. That was the tightest new issue spread over US Treasuries for Brazilian debt in nearly a decade and near the spreads Mexico's more highly-rated, investment-grade debt attracts. **This *Update* addresses three questions around this issue.**
- **1) Does this strong pricing indicate an ESG premium?** The ESG premium (the price investors are willing to pay for ESG bonds over conventional ones) can't be observed as Brazil did not issue "twin" conventional bonds in the way Germany does. Many have heralded the low yield of this bond as evidence of a healthy ESG premium; but we think it probably also reflects improved sentiment towards Brazil's finances in general. After all, broader measures of risk premia had already fallen to low levels. (See Chart 1). What's more, the issue came amid strong demand for bonds generally, with a huge rally in global bonds last month. **Most estimates placed this ESG premium at 10-20bp – we suspect it was at the lower end of that range.**
- **2) Is an ESG premium justified?** In equilibrium (i.e., when supply and demand balance) the premium ought to just equal the additional cost of issuing an ESG bonds over conventional ones. After all, if issuers received a premium above that cost, supply ought to rise until that gap vanishes (in a competitive market). As regulations are clarified and harmonised, we expect these costs – and the premium – to largely disappear.
- **But in the interim, the ESG premium varies from bond to bond depending on supply-demand balances.** So, while Germany's sovereign ESG bonds appear to trade with an ESG premium of 1-2bp (see Chart 2), the more limited supply of Brazil's sovereign ESG bonds helps to explain the slightly larger premium there.
- **3) Will this ESG premium persist?** One key factor will be how the bond's proceeds are used – investors will presumably be looking for signs of a strong sustainability angle to any spending. If the funds are used for other purposes, the ESG premium would most likely fade. For Brazil's government, there is no *direct* punishment for using the proceeds for other purposes (bondholders would take the hit via a fall in the price of their bond). But Brazil's government would most likely struggle to attract any ESG premia on *future* bonds if they lose their credibility with this one. **So in this respect, compliance could become self-policing.**
- For ESG premia *in general* over the coming years, we set out our thoughts in this Focus. In short, we expect relative demand for ESG bonds vis-à-vis conventional bonds to increase as regulations improve and help alleviate concerns over greenwashing; but we also anticipate a surge in relative supply, which we think will prevent ESG premia from rising much. **So we expect ESG premia – which have, in general, fallen a long way from the levels observed a couple of years ago – to remain at low levels over the coming years.**

Chart 1: Stripped Spread Of Brazil JPM EMBI Index & Brazil 5-Year USD Credit Default Swap Premia (bp)

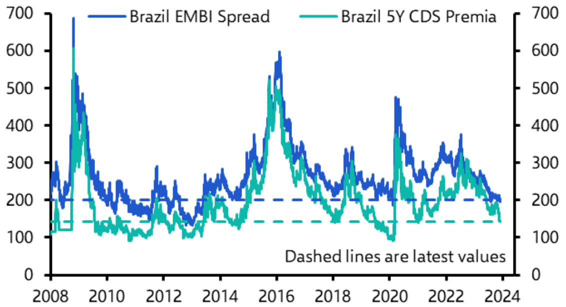
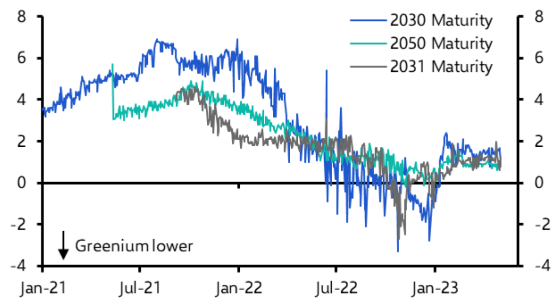


Chart 2: Selected German Conventional Bund Yields Less The Yields Of Their "Green" Twins (bp)



Sources: Refinitiv, CBI, Capital Economics

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