Green bonds

Fostering development of the Polish market

instrat

Instrat Policy Note 01/2023
executive summary

Stanisław Stefaniak
Anna Padiasek

Warszawa, June 2023

Recommended citation:

S. Stefaniak, A. Padiasek, *Green bonds. Fostering development of the Polish market*, Instrat Policy Note 01/2023 executive summary

Authors:
Stanisław Stefaniak, Anna Padiasek

Contact:
Stanisław Stefaniak,
Program Zrównoważone Finanse
stanislaw.stefaniak@instrat.pl

Cover: Anna Olczak.

Publication with the support of European Climate Foundation (ECF).

Available at:
www.instrat.pl/green-bonds

Usual caveats apply.

Instrat Policy Note 01/2023

Warszawa, czerwiec 2023

Fundacja Instrat
ul. Hoża 51
00-681 Warszawa

Executive summary of main findings and conclusions

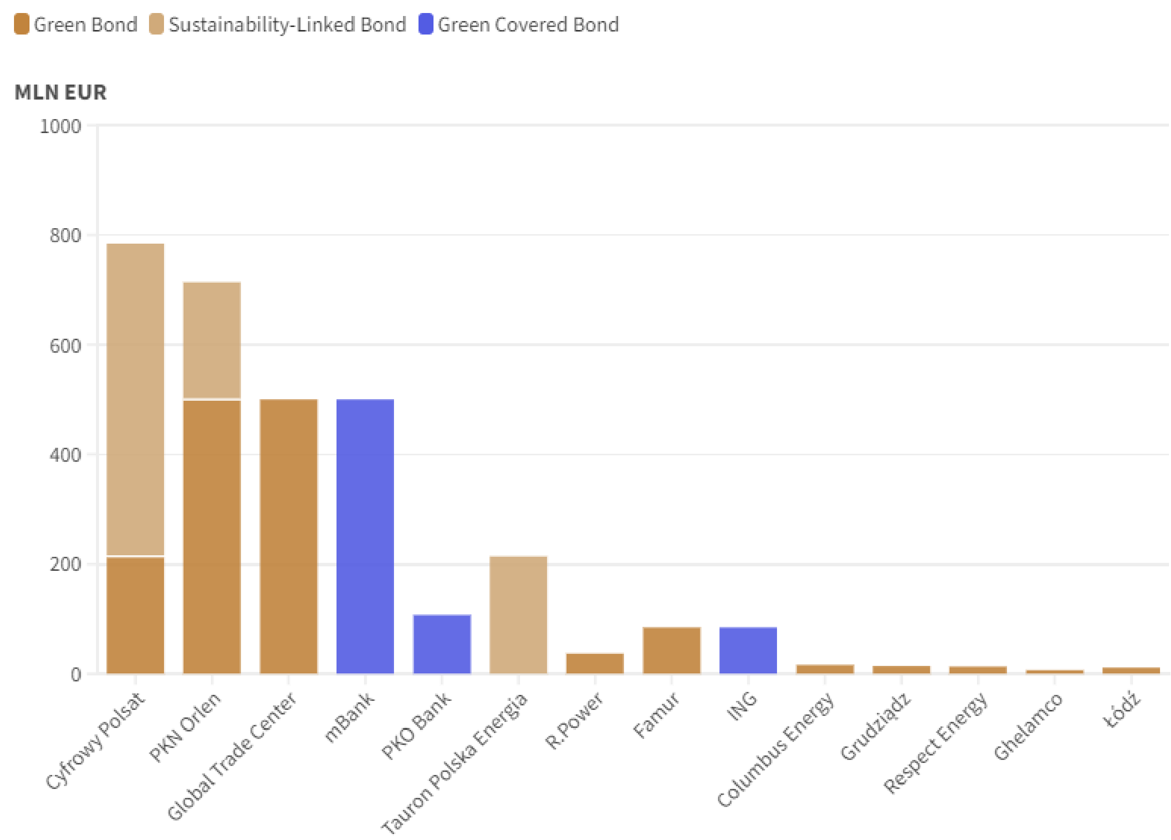
Growth of the green bond market

- Supporting the development of the green bond market is based on the assumption that a liquid and deep market for such instruments will make it easier to connect issuers looking for financing for pro-environmental projects with investors willing to provide funds for these activities on preferential terms, including a greenium. The wider the base of end investors that issuers can reach, the greater the chances of obtaining greenium.

- Though Poland was the first country to issue treasury green bonds in 2016, the Polish corporate and municipal green bond market is still underdeveloped. So far, only 14 issuers have issued sustainable debt for a total amount of approximately PLN 14 billion.

- Green bonds are defined mainly in relation to voluntary market and regulatory standards. In order for a bond to be considered green, the issuer must obtain external certification and report their expenses. However, regulatory standards are emerging - e.g. the EU standard of green bonds and transformation bonds designed by the national legislator.

Figure 1. Issuance of sustainable corporate and municipal bonds in Poland



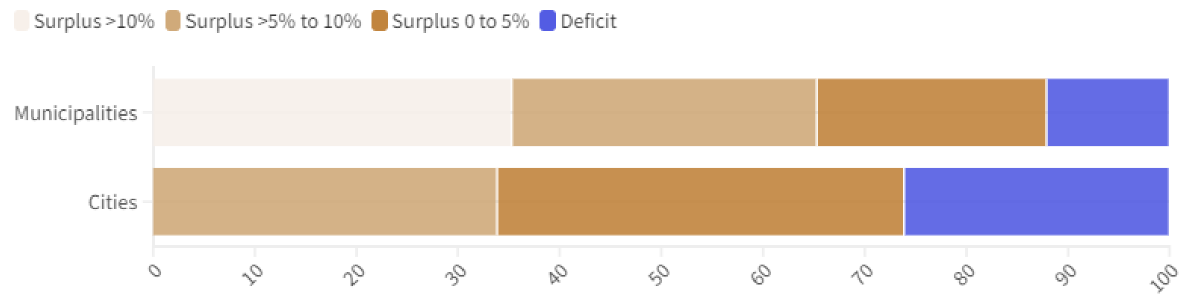
Source: Instrat, based on NBP (2022) and Smoleńska (2023).

Municipal green bonds

- Local government units (LGUs) are important potential issuers of green bonds due to the fact that they carry out many investments in climate-relevant areas related to their own activities, such as public transport, heating, infrastructure or nature protection.

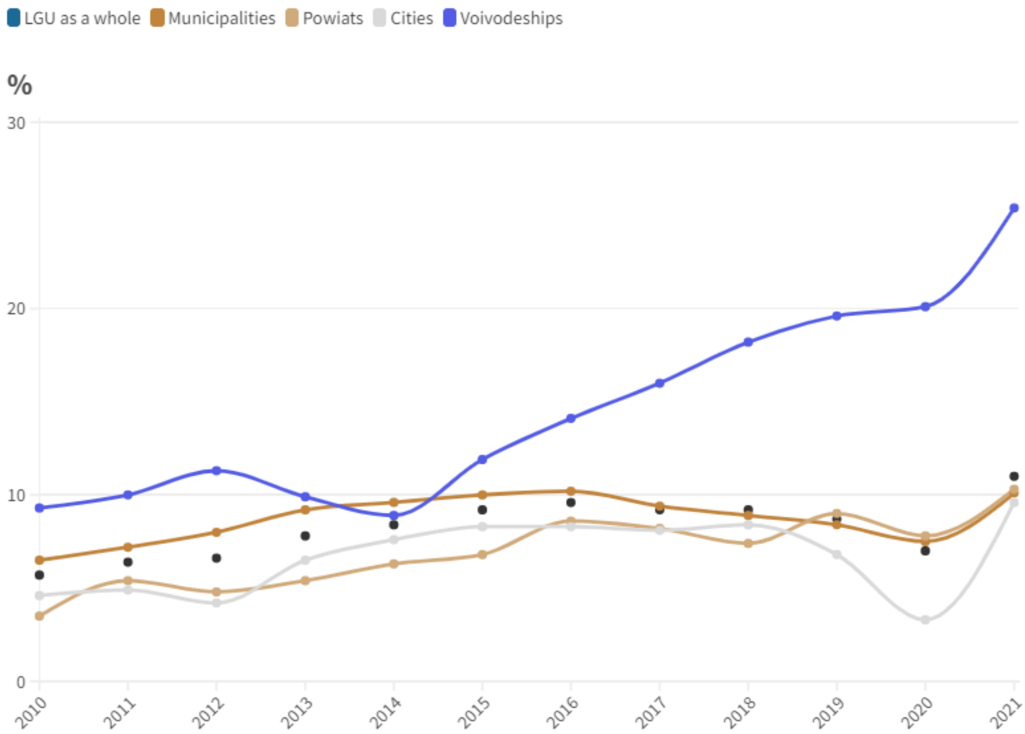
- Local governments generally have a large potential to increase debt to finance investments, as measured by their operating surplus. Incurring liabilities is necessary to finance investment expenditures of local governments, e.g. in the form of own contribution to projects co-financed from EU funds. Thus, the effectiveness of obtaining EU funds indirectly depends on the possibility of increasing debt

Figure 2. Share of LGUs with a deficit and the ratio of operating surplus to income by size



Source: Instrat, based on KRRIO (2022).

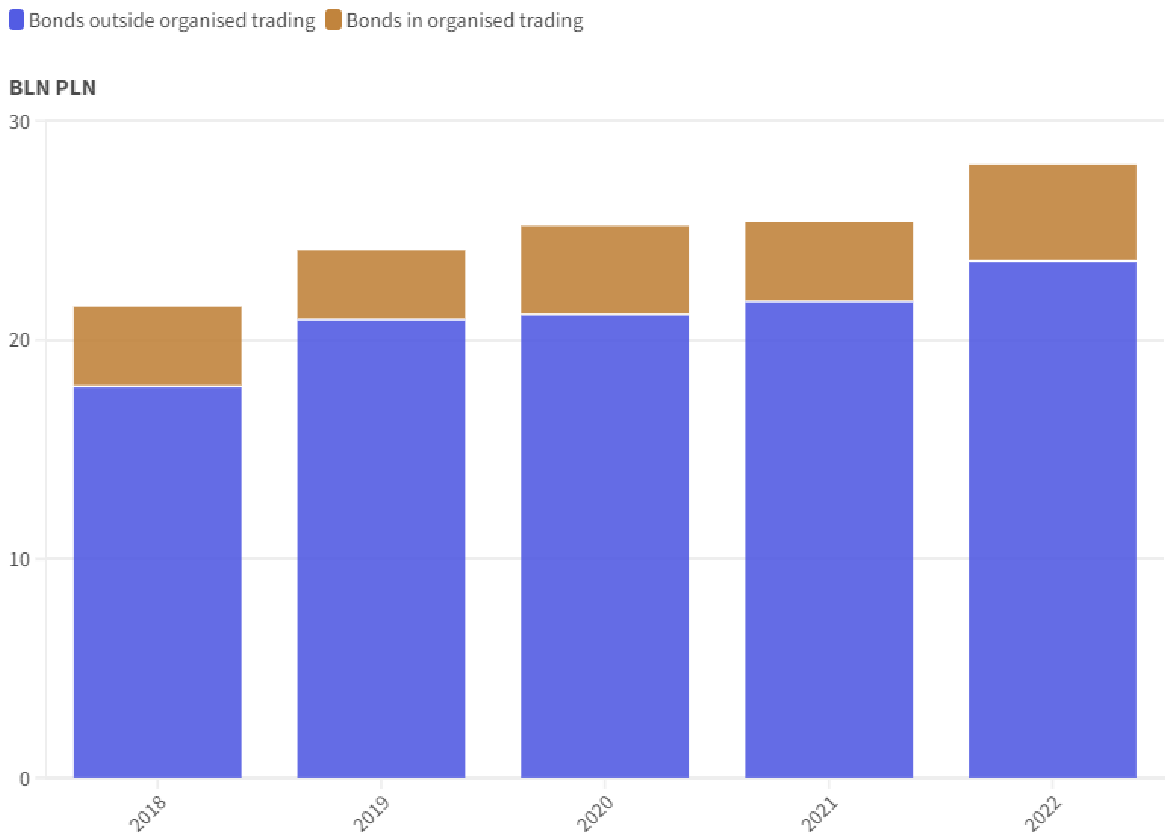
Figure 3. Operating surplus of local government units as a percentage of their revenues



Source: MIiR (2022)

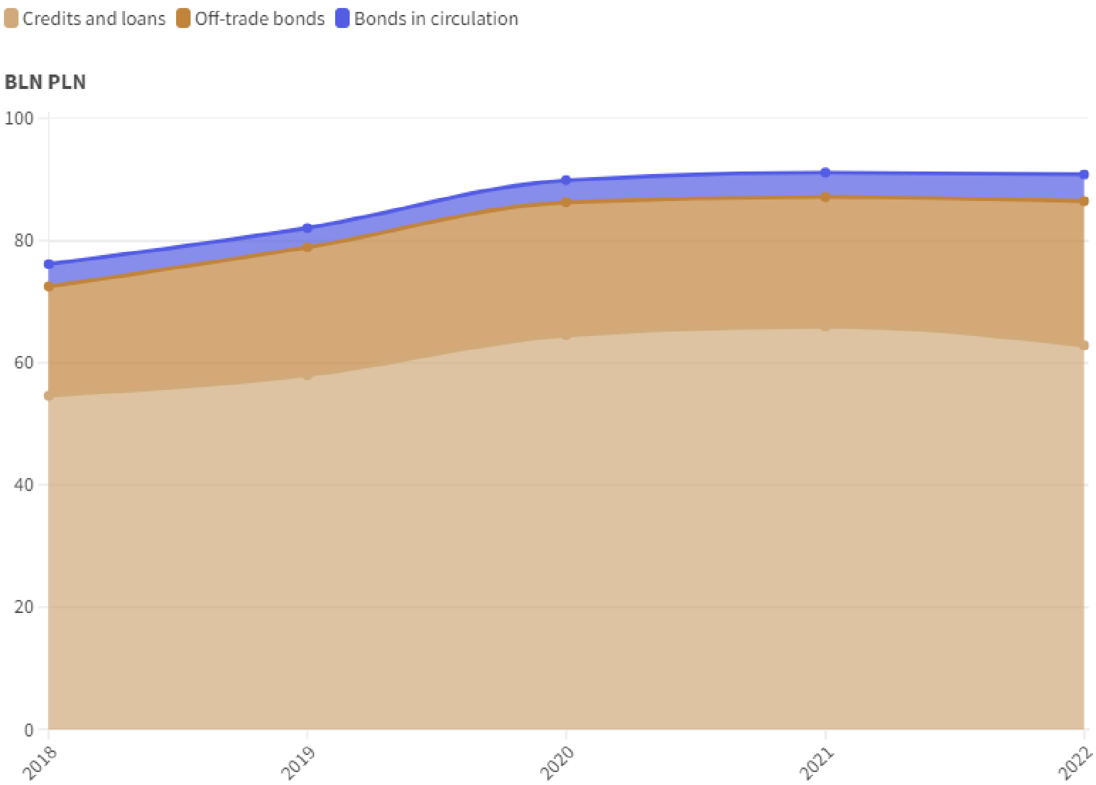
- Currently, the debt of local governments due to bonds is approx. PLN 30 billion, which constitutes one third of the total debt of local government units. However, only 15% of the bonds issued by local governments (4.4% of the total debt) are introduced to organised trading. Most bonds are taken up by banks and held until maturity, thus being the equivalent of a bank loan. Although banks can sell municipal bonds to other investors on the over-the-counter market, this rarely happens in practice, and the sector continues to represent approximately 78% of municipal bond holders. Moreover, trading in bonds on the secondary market is not very liquid. This means that the investor base in municipal bonds is not very diversified, and local governments obtain financing mainly from the banking market.

Figure 4. The value of liabilities of LGUs due to bonds in and outside organised trading]



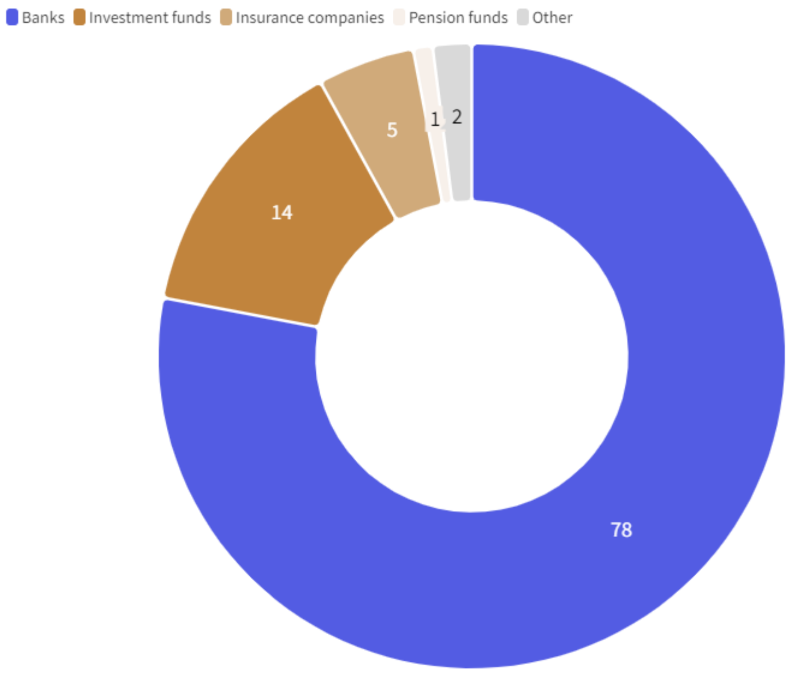
Source: Instrat, based on NBP and Ministry of Finance data.

Figure 5. Liabilities of LGUs by type of debt instrument



Source: Instrat, based on NBP and Ministry of Finance data

Figure 6. Structure of local government bond holders



Source: Fitch Ratings (2022)

- The main barrier to the issue of bonds are the additional unit costs and labour costs associated with the issue of bonds in general and the issue of green bonds in particular. The issue of green bonds involves the costs of hiring advisors, external certification of compliance with the green bond standard and reporting the use of the funds obtained. The implementation of the issue of green bonds is also connected with the requirements as to the competence of local government employees in relation to the identification of projects that can be financed in this way and knowledge of relevant standards (e.g. EU Taxonomy).

- To overcome the indicated barriers, we propose the creation of a Local Government Green Bonds Agency, which would aggregate projects of individual local government units that can be financed with green bonds and issue and service green debt, distributing the obtained funds between individual local government units. Aggregation of projects would reduce fixed costs in the value of the issue and centralise competences in the field of green bond issues in one entity.

- Greater creditworthiness of the Agency, whose liabilities would be jointly and severally guaranteed by participating local government units or the State Treasury, would also allow for lowering interest costs and unifying financial conditions for local governments. Larger issue amounts and the possibility of issuing in foreign currencies would enable the Agency to reach a wider group of investors, including foreign ones. This would increase the chances of reaching entities willing to finance green projects, and thus, of obtaining a greenium bonus.

- Similar solutions already exist in many European countries (Scandinavia, France, the United Kingdom). International experience shows that the costs of financing through such entities are 30 to 200 basis points lower than those that local governments could obtain on their own on market terms.

Corporate bonds

- Corporate bonds are not a significant source of external financing for Polish enterprises, the base of which are mainly loans and other banking products. Organised trading in corporate bonds is dominated by bonds issued by large energy companies and banks.

- For corporate issuers, the main barrier is also the high unit costs associated with the issue of green bonds. A tool to reduce them may be fiscal incentives, which are a form of subsidising the costs of financing green investments.

- Currently, tax incentives related to the issue of green bonds operate mainly in countries outside the European Union. These incentives may take the form of relief for the issuer (the possibility of deducting eligible issue costs) or relief for the investor (exclusion
- or reduction of taxation of interest income from green bonds). In each case, however, the reliefs are to translate into lower interest costs of implementing a given project. Due to the more direct impact of reliefs for the issuer on its financing costs, we recommend introducing reliefs in this form.
- At the same time, due to the growing importance of business decarbonisation plans in the context of access to sustainable finance, their dissemination among companies should be supported. In this regard, we recommend educational activities addressed to entrepreneurs, tax reliefs for costs related to energy audits or calculation of the carbon footprint, and making the granting of public funds dependent on the applicant's acceptance and implementation of a decarbonisation plan.

Proposed solutions for the municipal bonds market

Creation of the Local Government Green Bonds Agency

We propose the creation of a Local Government Green Bonds Agency responsible for aggregating environmental investments that individual local governments would like to finance with the use of debt financing and issuing green bonds for the account of participating local government units. This institutional solution will make it possible to obtain more external debt financing for LGUs at a lower cost, thanks to the centralization of fixed costs related to the issue of bonds.

Institutions that enable joint financing of local government projects have been successfully operating for decades in countries such as Denmark, Sweden and the Netherlands. Over the last decade, similar institutions have also been established in France and the United Kingdom. Most of them operate in a similar operating model, in which a separate entity performing the SPV function is created (with public or private law status). This entity incurs liabilities on its own behalf, but on behalf of participating LGUs. The debts of this entity are guaranteed by the participating local governments or the State Treasury (as in the case of Finland's Munifin). The mark-up on SPV operating costs is estimated in European countries at 7-15 basis points of the value of obtained financing.

Lower costs of obtaining financing will be associated with an increase in the creditworthiness of the central entity compared to individual local government units. The Agency's creditworthiness can be strengthened in two ways: by guaranteeing its liabilities by local government units that are its members or by guaranteeing them directly by the State Treasury. A possible State Treasury guarantee would not however create incentives for local government units to incur excessive debt (moral hazard) due to the possibility of influencing the level of debt of local government units through legal mechanisms (such as IWZ). In addition, the debt of local governments already benefits to some extent from the implied state guarantee, due to the lack of a bankruptcy procedure for local government units and the lack of signals that local governments are abusing it.

Cyclic emissions through the Agency would allow for additional economies of scale related to the centralization of issuance activities:

1. Lower costs of obtaining debt compared to market conditions that can be obtained by individual local government units, resulting from the greater creditworthiness of the Agency, whose debts will be guaranteed by participating local government units or the State Treasury. Lower financing costs will be particularly important for LGUs in a worse

financial condition. The agency would therefore standardise credit conditions for local governments and eliminate the differences in the cost of debt.

2. Removal of the costs of preparing the issue for individual local governments (preparation of documentation, roadshow, external advisors, certification of compliance with the green bond standard), which would be borne mainly by the Agency. The fixed costs of preparing the issue, which would have to be borne by each LGU, will be covered by the Agency only once.
3. Obtaining financing for investments whose low value would make individual green bond issues of individual local government units unprofitable.
4. Developing competencies in identifying and planning projects that could be financed with green bonds, as well as in reporting the use of funds. As in the case of the costs of the issue itself, the costs resulting from the need to ensure its "greenness" (selection of the appropriate regulatory standard, reporting on the implementation of the goal) will mostly be transferred to a central, specialised entity and will be borne only by it. Thus, the Agency will also become a green competence centre for local governments, able to perform advisory and consulting functions at the stages preceding the issue process itself.
5. The creation of a centralised entity, engaging in issues of large denominations, will also allow for issues in foreign currencies, addressed to foreign investors. In such a situation, centralisation will make it possible to reduce the costs of managing the exchange rate risk. Access to foreign markets also means access to more investors willing to provide a greenium premium.

Similar proposals, assuming joint incurring liabilities by local government units, appeared as postulates in expert comments (Dmuchowski, 2020), as well as proposals in some strategic documents and in isolation from the issue of support for the green finance market. For example, the National Strategy for Regional Development 2030 of 2019, developed by the Ministry of Development, provided for the creation of regional development funds (RFR) "with competence in the field of repayable assistance, financial instruments, bond issues, capital support", also assuming their cooperation in obtaining funds from BGK (national development bank) (MIiR, 2019). According to some proposals, the role of the Agency could be performed by one of the existing entities that also deal with financing local governments, such as BGK, PFR or NFOŚiGW. Such a solution is not excluded, but it seems that it would be more optimal to establish a separate entity that would only be tasked with issuing debt for the account of local governments.

Regulatory relief for green debts of local governments

One of the barriers limiting the willingness of local governments to use external debt financing, even on favourable terms, is the limit resulting from the Individual Debt Ratio (Article 243(3) of the Public Finance Act). This regulation has a number of consequences that distort the motivations of local governments and their practices in the area of debt management. Setting the debt limit results, among others, in the use by local government units of alternative forms of financing not covered by the limit, incurring liabilities with a longer repayment horizon in order to minimise debt servicing costs in individual periods, and de facto outsourcing of local government tasks to municipal companies whose debt is not included in the ratio.

Municipal debt from the issue of green bonds - both issued by the Local Government Green Bonds Agency in accordance with our proposal, and individually by individual local government units - should not be included in the individual debt limit of individual local government units (at least up to the specified upper limit). This would correspond to the currently applicable solution, according to which the debt incurred to finance own contribution to investments financed from European funds is excluded from IWZ limits.

CIted works

KRRIO, 2022, *Sprawozdania z działalności regionalnych izb obrachunkowych i wykonania budżetu przez jednostki samorządu terytorialnego w 2021 roku*, https://rio.gov.pl/download/attachment/109/sprawozdanie_za_2021_r.pdf.

NBP, 2022, Rozwój systemu finansowego w Polsce w 2021 r., https://nbp.pl/wp-content/uploads/2022/11/rozwoj2021-1.pdf

MIiR, 2022, *Raport Inwestycje w Polsce. Okres I kw. 2020 R. – I kw. 2022.* https://www.ewaluacja.gov.pl/media/111456/DSR_Raport_Inwestycje_I2020-I2022-web.pdf.

Smoleńska, 2023, *Aktualny stan rynku zielonych obligacji w Polsce*, presentation given on 27.04.2023 r. at Polish Ministry of Finance Sustainable Platform's Working Group on Green Bonds Platformy

Fitch Ratings, 2022, Przegląd rynku nieskarbowych instrumentów dłużnych , 5(417), 31.05.2022, https://www.fitchratings.com/research/pl/international-public-finance/rating-rynek-may-2022-15-06-2022

Full publication in Polish can be found under this link