How green bonds are (not) supposed to work. The case of State Bank of India and potential Carmichael lending.

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A green bond market where issuers can directly finance what has been called "the world's most insane energy project"[1] and still claim credit for refinancing a dozen of windmills deserves to be questioned.

Unfortunately, green bond issuer State Bank of India (SBI) potentially giving a USD650mn loan to the oversized Carmichael coal mine project,[2] raises the question to acute relevance.

We opine the green bond investor-, issuer- and bank community as well as other parties in the market should actively engage and dissuade SBI from providing the loan.

If the loan deal goes through, we argue that any SBI bonds or loan facilities should be stripped of "green" status. The Carmichael loan looks to be similar in size to SBI's green funding, but with a CO2 footprint of at least 20x more than is saved through SBI's green projects. Removing the green status after a potential loan would at least to some extent mitigate the reputational damage to the market. Failing to do so would give green bond market doubters plenty of ammunition, for a long time.

On the flip side, a successful engagement could provide a strong narrative around the positive impact of green bonds and/or investor engagement to dissuade companies from toxic fossil projects. And we believe not extending the loan would likely be a fundamentally better trade for SBI, although it might brush a few political feathers.

This note explains our reasoning and follows up three earlier pieces laying out the exposures to this situation among global investors and counterparties.[3]

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[1] "The World's Most Insane Energy Project Moves Ahead", Rolling Stone Magazine, 14 Jun 2019.
[2] "SBI set to offer Rs 5000 cr loan to Adani coal project in Australia: Report", Business Standard, Nov 17 2020.
[3] "SBI (potential) Carmichael loan: Key financing transaction parties", Nov 2020.
"State Bank of India + Coal Mega-Mine? Not so fast please", Nov 2020.
"Global investors and the Carmichael mega-mine", Sep 2020.

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Background

The Carmichael mine in Queensland, Australia, is the world's best known and biggest new greenfield coal mine project. Slated to start producing coal in May 2021, numbers on the amount of thermal coal output range from 10Mtpa to 60Mtpa, with associated downstream CO2 emissions of 30-180Mtpa. Over time, Carmichael coal is likely to become a gigatonne CO2 source. Funding for Carmichael has dried up, and we saw BlackRock engage in parallel with Extinction Rebellion earlier this year to criticize Siemens for executing a USD15mn railway signalling project for the mine[4]. Funding has effectively dried up, with the key entity Adani Abbot Point failing to raise bond capital earlier this year. Naturally, ultimate owner Adani Group is looking for alternative ways to fund the project.

Enters State Bank of India as a potential saviour, now looking set to advance a USD650mn loan. It has been speculated that this is not driven by economic but political motives, as the Adani Group has close relationships with Prime Minister Modi[5], and SBI is government controlled through majority ownership. As Reuters report[6], coal financing seems like an atrophying business elsewhere, so it seems unlikely that the Adani project is a homerun financially. **The issue for the green bond market is that SBI through its 2018 green bond transaction (USD4.5% 09/2023) not only is a marquee EM issuer, it is also something as unusual as an EM financial institution issuer with the backing through various programs and funding facilities of other green bond issuers like the World Bank, EIB and KfW.** A number of prominent green asset owners are indirectly exposed to SBI through their investments in the IFC/Amundi EGO fund which in turn appears to be the largest investor in the green bond.

The involvement of SBI in Carmichael puts into question a basic assumption of ourselves and most investors, we believe. **Surely the general purpose of a green or climate dedicated bond or any investment must be to create incentives as well as actions for borrowers <u>in general</u> to mitigate climate change and CO2 emissions?** It is not only a question of whether the green bonds are directly financing sustainable activities, but rather whether the issuer is actually dedicated to sustainable activities or climate transition in general. This is usually referred to as the "intentionality" of the issuer/bond. The importance of this is for example exemplified in the IFC/Amundi EGO bond fund that explicitly states one of its three policy pillars in the prospectus:

"Exclusion policy at the issuer level, based on Issuers' ESG score, taking into account portfolio exposure to high ESG risk and carbon-intensive sectors and to projects associated with potentially significant environmental and social risks and impacts, and/or sector-exclusion"

We volunteer Carmichael as an example of a project associated with significant environmental impacts. As we will show below, on the issuer level, SBI engaging in Carmichael lending will eradicate its green funding's positive impact by several multiples.

[4] "BlackRock rebules Siemens on its environmental record", Financial Times, Feb 6 2020.
[5] "Modi's Rockefeller: Gautam Adani and the concentration of power in India", Financial Times, Nov 13 2020.
[6] "As more countries pledge zero emissions, coal finance evaporates", Reuters, Nov 24 2020.

The green bond contract: not asset-backed, not backing bad issuers?

Just to clarify some of the technical aspects: the general green bond is not asset backed and does not give the investor legal recourse over the issuer in terms of how the money from a bond sale is spent, or any ownership of the assets it was supposed to finance. There is even not always a requirement for a third-party verification of the use-of-proceeds, and definitely not with the precision that would be required under traditional financial accounting. Instead, **most investors we speak to – knowing that they have relatively weak leverage on the issuer from a formal standpoint – establish a trust that the issuer of the bond actually intends to mitigate negative environmental effects in general. Otherwise they do not invest.**

Is this trust naïve? No – as the name credit implies – some sort of trust is built into the general bond asset class. If you invest in a traditional bond, it is usually issued under general corporate purposes clauses, by which the investor understands that the company to some extent is trying to generate economic value in order to repay the bond. Analogously, we strongly believe green bond investors' understanding is that the issuer is trying to bring about environmental/climate improvements. This would explain the reticence vis-a-vis green bonds from the oil sector: yes, you might be bringing CO2 reduction through sun-powered flaring valves on oil rigs, but it does not really bring about the structural change investors seek for a credible climate transition. An oil company green bond proposition has historically been unlikely to reflect a true intention to align with Paris targets.

SBI: Coal funding impact >>> green funding impact

In the current case of State Bank of India, we see that on the one side the bank has financed renewables projects and brought positive effects, and on the other is considering giving a loan to the Carmichael mine build. To decide on intentionality of SBI, we could consider what is the weight of each side?

Starting on the green side, the bank itself states on page 66 of its Sustainability Report for 2020 that its **USD800mn of green funding contributes to CO2 reductions of 1.6 million tonnes of CO2 per year**. However, we first note that the green funding is refinancing of the underlying renewable energy assets: in case of the SBI funding being withdrawn, it is fair to assume that the underlying activities would be able to refinance through other sources. In the green bond market, this usually referred to as "additionality", and in the SBI green bond case we would consider it low. Renewable assets do not struggle to refinance in the current marketplace.

Turning to the other side and looking at the Carmichael mine project, the mine production rate is planned to be 10 million tonnes of thermal coal per annum (Mtpa), with some indications that it could be significantly more. **Even at the lowest level the associated Carmichael CO2 emissions would be approximately 30Mtpa CO2**. In terms of additionality, there are two points: first, the mine is being built right now, so funding is stronger in effect compared to refinancing an already existing asset. Secondly, as banks and international investors have withdrawn from providing funding to the Carmichael project, this potential loan is really operating as an enabler of the build to happen at all. Call SBI a potential coal-lender-of-last-resort. Consequently, we believe that is clear that the CO2 burden of Carmichael accruing to SBI from a fixed income funding perspective is very high.

Then, from a pure mathematical standpoint, one could argue a leverage ratio of 30/1.6 *(800/600) ~= 23x in terms of the negative impact of the USD650mn loan vis-à-vis the USD800mn of green funding to SBI. We would adjust this with an additionality factor that one could assume to be fairly high, say 2.5x. This lands us at a ratio of roughly 50:1 in terms of how much green you would need to fund, just in order to net out the negative effects of a dollar being redirected to a Carmichael loan. **So hypothetically, if an investor lends $49 to SBI in green funding, and SBI uses that involvement as credibility capital ("Look, XYZ is lending to us, so should you") to raise just $1 of general funding, the green lending could actually lead to net positive CO2 emissions!** We do not delve further into the issue of the green funding often being in much appreciated hard-currency format, there are additional dimensions in that as well.

We invite readers to challenge the exact numbers in these assumptions, but **we rest assured that SBI's potential Carmichael loan will effectively more than negate the positive effects they have from green projects on balance sheet.** Consequently, if they were to go ahead, we opine that SBI would be in breach of the intentionality principle and would feel comfortable, yet uncomfortable, to denote their green funding as '**greenwash**'.

A call to action

This is the time to engage. Syndicating banks need to advice SBI on this issue. Direct and indirect investors (asset managers and owners) need to engage. Green bond investors *not* engaged in SBI still need to engage if they agree there is reputational risk to the green bond market in general. Green bond issuers need to engage likewise. Green bond framework providers, legal advisers and consultants should engage. We could go on: you get the idea.

Anthropocene Fixed Income Institute – Previous publications

General articles

"SBI (potential) Carmichael loan: Key financing transaction parties", Nov 2020. Link
"State Bank of India + Coal Mega-Mine? Not so fast please", Nov 2020. Link
"Your AMs/PMs want to buy new Saudi Aramco bonds? Have them consider alternatives", Nov 2020. Link
"Final port of coal? The Brookfield Dalrymple IPO", Nov 2020.
"The bond market and the climate transition", joint with Stockholm Sustainable Finance Centre, Nov 2020. Link
"The ECB and Alberta's oil production tax holiday", Oct 2020. Link
"Reef Credit: An Indulgence", Oct 2020. Link
"Technical note: An ECB Rapid Decarbonization Plan", Oct 2020. Link
"Low carbon credit performance: A 2002Q3 Update", Oct 2020. Link
"Dalrymple of Queensland and the Mighty Greenwash", Sep 2020. Link
"Global investors and the Carmichael mega-mine", Sep 2020. Link
"Hard coal auction", Aug 2020. Link
"ESG in CDS indices: A practitioner approach", Aug 2020. Link
"Top coal, top ESG?", Aug 2020. Link

Academic/technical papers

"The Green Bond Risk Premium: A Twin-Bond ULFP Approach", SSRN working paper, Jul 2020. Link.
"Credit alpha and CO2 reduction: A portfolio manager approach", SSRN working paper, May 2017. Link.

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