SSA carbon exposures: JBIC New Year's Announcement

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Investors looking to align their SSA bond portfolios with net zero targets should have a closer look at news flow around benchmark-relevant SSA issuer Japan Bank of International Cooperation (JBIC). Going into the very year-end - 30 Dec specifically - JBIC announced a USD522mn loan into a facility (FIGI BBG014BCNC36) for Irkutsk Oil (IRK), a Russian upstream oil and gas operator, in order for IRK to equip a petrochemical plant in Eastern Siberia.[1] Total deal size is USD871mn with three European/US banks putting in the remainder. Deutsche Bank is reported to have led the transaction.[2] The end of year timing of the IRK facility announcement appears similar in style to JBIC's announcement of the 1.2GW Vung Ang II thermal coal expansion 29 Dec 2020.[3,4] In 2021, JBIC has also been engaged with the Barossa gas field development in Australia which is reported to be particularly carbon-intensive and problematic from an emissions perspective.[5]

We again recommend investors to review whether the risk-premiums (discussed below) of JBIC bonds offered in the market are proportionate to the potential carbon emission funding liabilities through the entity's balance sheet. We expect the carbon intensity of SSA portfolios to come under further scrutiny in 2022. Furthermore, with JBIC having roadshowed a green bond framework in Dec -21 and a deal just being announced (11 Jan)[6], we opine that potential investors should conduct a thorough due diligence on the climate strategy of the issuer as well as potential reputational risk factors associated with these investments.

Lastly, we discuss more generally on the topic of portfolio impact of providing loans to government outfits that subsidize activities to the detriment of other entities to which the investors has portfolio exposures. In the case of JBIC/IRK transaction, holders of equity or bonds in BASF, Dow, LG Chem, SABIC and similar companies, may want to take note.

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[1] "Buyer's Credit to Russian Limited Liability Company Irkutsk Oil Company", JBIC webpage, 30 Dec 2021.
[2] "Deutsche Bank AG supports $871mn credit facility to Irkutsk Oil Company", Deutsche Bank, 30 Dec 2021.
[3] "The Reformed SSA Trader: New Year's Exclusions" , AFII, 6 Jan/12 March 2021, provide more colour on that particular financing project and associate loan/bond transactions.
[4] To update our readers on the Vung Ang II project, it was reported that actual construction works at the site were set to commence in Dec -21, "Construction of Vung Ang II thermal power to start in December", Vietnam Inv. Review, 26 Oct 2021. In our view makes it is likely that actual fund disbursements from JBIC to the project will start in 2022.
[5] "Barossa gas contains so much CO_2 that most of it will have to be separated and vented" according to analysis by IEEFA, "Santos' Barossa gas field emissions create major risks for shareholders", IEEFA, 31 Mar 2021. Refer to "JBIC faces climate pressure over Australian LNG plans" Global Trade Review, 21 Apr 2021, for background on JBIC's involvement in the project.
[6] Neither IRK loan banks is party to the JBIC green bond issuance.

Market and loan segment background

JBIC is a repeat issuer in the SSA market, having more than USD40bn outstanding in dollar denominated bonds.

JBIC 10y USD bonds (cf. JBIC 1.25 01/31; US471048CL00) currently trade around 25bp over the US Treasury curve, with a single A rating. For comparison, KfW 0.75 09/30s (US500769JG03) trade 6bp over Treasuries with a AAA rating; AAPL 1.65 02/31s (US037833ED89) trade at 47bp over T with a split AAA/AA rating. JGB 10y CDS trades at 32bp meaning that an investor could buy Treasuries and sell CDS on the guarantor of JBIC to create a higher yielding trade. In our view, a spread/yield pick-up trade argument to invest in JBIC bonds is fairly weak.

Looking at the proposed green bond transaction, the IPT is ms+39bp for a 5yr. As a comparison, the JBIC 2.25 11/26 (4.8 years) appears to trade around z+38, indicating that the IPT is pretty much bang on fair value for the secondary curve.

Turning to the recent IRK transaction, for broad background on the petrochemical sector, its fixed income exposure and climate, refer to "Petrochemicals: Major credits, carbon risks, green bonds", AFII, 10 May 2021. The petrochemical sector is the single largest domain for growth in petroleum demand until 2030 according to projections by the IEA and there is a current supply glut in terms of plastics production capacity in Asia, the intended destination for the IRK plant's output,[7] which would make us wary on the fundamentals of the transaction.

Export credit agencies – potential pitfalls for SSA investors

JBIC is also an interesting case exemplifying how export credit agencies can impact the climate transition. These institutions are significant hard-currency issuers in the SSA space and have started coming into the spotlight as potential funders for activities that bond markets themselves are less keen on financing.[9]

In an ideal scenario, export credit agencies provide domestic companies with guarantees for payments of exports that the companies may not have capacity to enforce themselves, thus alleviating market friction costs. The export credit enables economic transactions that would otherwise not happen due to the transaction costs, and the agencies provide expertise in terms of the often complex process of exporting goods into another country. A foreign company in a poor country with less firm legal structures wants to buy solar panels at price X, but in order to sell those panels and apply margins for risk of non-payment etc, the home country company needs to put a surcharge of 50% on each panel to make it worthwhile. The export credit agency, however, knows how to deal with the foreign country and is able to give guarantees such that the home country company only needs to make a minimal surcharge, reducing the 50% market friction.

In less good cases, export credits become indistinguishable to government subsidies. For example, an agency provides subsidised cost of capital (sub-market rate loans) for purchasers of goods abroad conditional on them buying the agency's home country's exports. In practice, if a foreign

[7] "Surging Competition Forces Asia Plastics Makers to Stifle Output", Bloomberg, 9 Jan 2022. The article indicates that Asia capacity rose by 20% in 2021.

[9] See " Export credit agencies warned about their continued support for fossil fuel projects", IHS Markit, 13 May 2021, for a recent overview.

company funds at 10% in its home market but is offered a 5% loan from the export agency but with strings attached, then the foreign company is clearly incentivized to buy export agency home country goods, even if they are inferior or significantly more expensive. It might even be to the point that the foreign company would not do an investment, e.g. in a coal plant, if it met the market rate cost-of-capital, but instead goes ahead with the coal plant it because it gets subsidized capital from the export agency. Such work introduces market distortions and lead to suboptimal economic outcomes, as well as environmental hazardous products that would be impossible to fund in the public market.

Of course there are many shades of export financing in between the ‘good’ and the ‘bad’ cases and it may be hard to distinguish between the two. Add to this the game theory dimensions on international trade as well as the political economy implications of these government run institutions and one quickly runs into a fairly hard-to-digest analysis.

However, to simplify the investment decision, we believe bond investors should consider the basics along the lines of:

- Will my lending lead to increased GHG emissions and environmental degradation to the detriment of my stakeholders or in non-alignment with our stated climate policies?
- Is the investment policy that the money is being lent to in the interest of my stakeholders and/or other positions in my portfolio? For example, if the investor holds BASF, Dow, SABIC or LG Chem exposures in their portfolio, is it to the benefit of the total portfolio that JBIC subsidizes a competitor to which the investor does not have exposure?

We do not claim that these factors will be show-stoppers for investors: however, they should be weighed versus the potential financial benefits from the bond investment.

The Anthropocene Fixed Income Institute is a non-profit organization "to monitor, advocate for and influence the impact of the fixed income and bond markets in the age of human induced climate change." For more information about the Institute, please visit wwww.anthropocenefii.org or follow us using the hashtag #anthropocenefii.