Blue bonds and climate finance in island economies

September 2023

The need for Climate Finance in island economies

According to the Economic Vulnerability Index, islands are the most economically vulnerable of all groups of developing countries, especially when it comes to climate change. The growing frequency and intensity of some climate events have an enormous impact on the economic development of islands. In the Caribbean alone, the damage caused by climate-related hazards is estimated at US$12.6 billion per year. Being at the frontline of climate change impacts, islands need capital to carry out the necessary climate change mitigation and adaptation investments, such as in resilient infrastructure.

As explored in [KPMG's Net zero readiness: Islands,] access to climate financing has proven to be a challenge for many island economies, particularly in the Caribbean. This challenge arises from their small size, limited resources, and remoteness. The unique circumstances of Caribbean islands include a lack of adequately developed domestic public or private finance and limited eligibility for international aid or debt relief, which often comprises a substantial portion of climate finance.

While available estimates vary, these factors contribute to a climate finance gap of between US$78 and US$127 billion annually between now and 2030 in the Americas and the Caribbean, the largest financing gap globally in absolute terms (see graph below). An alternative estimate by the IMF suggests **yearly climate investment needs of more than $100 billion in the Caribbean alone, equaling one third of its annual economic output.**

As a result, Caribbean islands and island economies, more generally, spend a disproportionate amount of their public finances on debt servicing rather than on climate mitigation or adaptation, further locking them into cycles of unsustainable debt levels while the impacts of climate change are intensifying.

This situation leaves island economies in precarious situations unless they leverage new sources of climate finance – which have largely been overlooked until now.

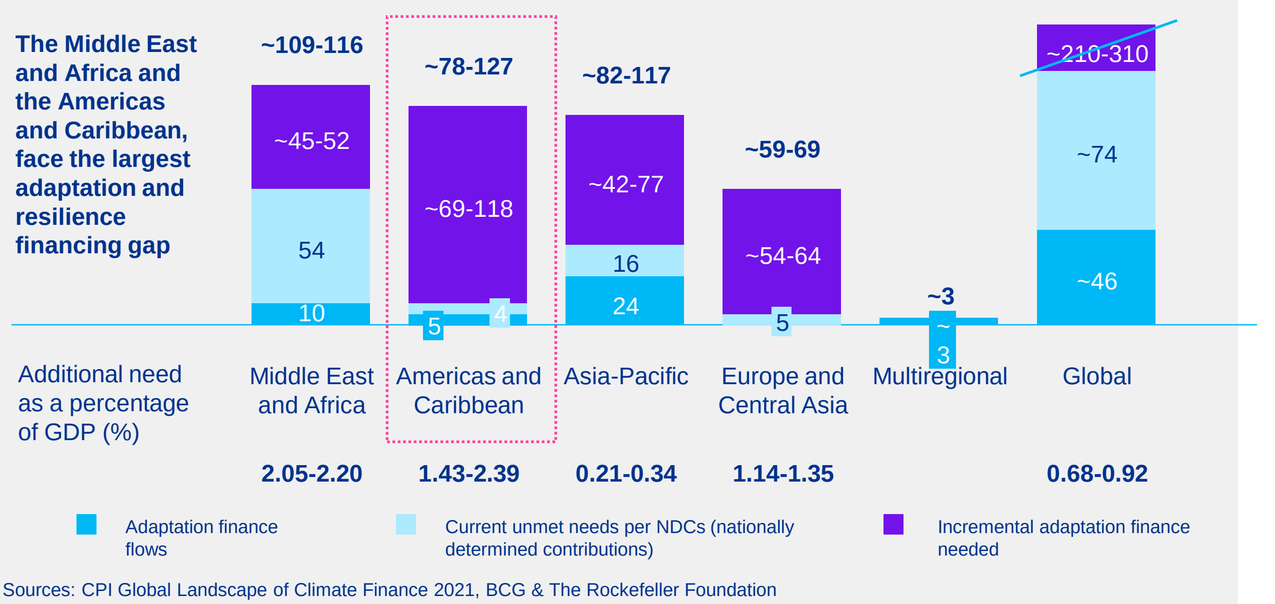
Climate finance has evolved rapidly, and an increased reliance on international partnerships, multilateral development banks, and other mechanisms could help address the unique challenges islands face against climate change.

New innovative financing instruments are emerging, such as impact finance or blended finance tools, green, social, or sustainability-linked loans or debt instruments, or carbon offsetting mechanisms, all aiming to mobilize the vast amounts of private sector capital currently in search of "sustainable investments". These could play an important role in supporting islands in their sustainable development agendas.

After introducing recent climate finance commitments in islands, this publication focuses on some specific opportunities blue bonds represent for islands in leveraging the full potential of the blue economy.

Adaptation and resilience financing gaps, per regions

Financing gap, US$ billions



Sources: CPI Global Landscape of Climate Finance 2021, BCG & The Rockefeller Foundation

Small island economies now find themselves at a pivotal point when investors' interests and policymakers' commitments to climate finance align.

The Bridgetown Agenda

As local governments increasingly recognize the need to drive financial resources towards climate action and the Sustainable Development Goals (SDGs), climate finance commitments have multiplied in island economies.

Most recently, the Barbados Prime Minister, the Hon. Mia Amor Mottley, presented the Bridgetown Agenda, an unprecedented policy proposal to reform the global financial architecture, addressing how high-income countries financially support lower-income countries adapting to climate change, especially Small Island Developing States (SIDS). According to Prime Minister Mottley, low-income countries should not be forced to sacrifice their development goals in favor of climate spending. The Bridgetown Agenda sets out three ways to change how development finance works and channels financial resources toward climate action:

Expanding multilateral lending

by US$1 trillion for climate resilience in climate-vulnerable countries

Changing loan repayment terms,

including debt deferment clauses or triggers in the case of emergency, and the need for liquidity following catastrophic weather-related events

Activating private sector capital for climate mitigation

and funding reconstruction after climate disasters through new multilateral mechanisms.

These three pillars aim to facilitate the expansion of climate finance, to increase investment in the energy, public health, education, transport, and agricultural sectors, as well as funding for enhancing climate resilience and sustainability.

The Bridgetown Agenda was presented at the COP27, generating considerable interest, with some of the G7 key public figures supporting the plan, such as French President Emmanuel Macron and IMF managing director Kristalina Georgieva. The Bridgetown Agenda sparked additional proposals for innovative financing mechanisms at COP27, such as:

- The establishment of a **Loss and Damage Fund** to compensate countries most vulnerable to climate change but that have contributed little to it. With details to be formulated at COP28 in December 2023, the Fund will allow countries with high carbon emissions to financially compensate countries experiencing the impacts of climate change, with a notable focus on vulnerable communities.

- A **Global Climate Mitigation Trust** hosted by the IMF and backed by Special Drawing Rights, donor guarantees (or similar instruments) that invest borrowed funds based on the size and pace of climate change mitigated, with the potential to leverage private finance.

Considering their unique development and climate-related challenges, small island economies have the potential to play a leadership role in setting the climate finance agenda.

Other key climate finance developments in the Caribbean in past years

- The establishment of the Caribbean Community Climate Change Centre (CCCCC) in 2002 has played a central role in coordinating climate finance activities in the region.
- The creation of the Green Climate Fund (GCF) in 2010, a global fund that provides financial resources to developing countries to support their efforts to mitigate and adapt to climate change. The Caribbean has received GCF funding, with projects focusing on renewable energy, climate-smart agriculture, and coastal resilience
- The adoption of the CARICOM Climate Change Resilience Framework in 2018 provides a comprehensive strategy for addressing the impacts of climate change in the region.
- The establishment of the Caribbean Climate-Smart Accelerator in 2018 aims to mobilize US$8 billion in climate finance over the next decade to support climate-resilient development in the Caribbean.
- The implementation of several other initiatives to promote climate finance in the region, such as the Caribbean Catastrophe Risk Insurance Facility (CCRIF) and the Inter-American Development Bank's Climate Investment Funds (CIFs).
- The publication of a Carbon Credit Trading Bill was issued by the Bahamian Government in 2022. The Bill will establish a regulatory framework for the trading of carbon credits in on from within The Bahamas.

Sustainable debt markets and tools: introduction

Among innovative climate financing tools, sustainable bonds, also called Green, Social, Sustainability, and Sustainability linked (GSSS) bonds or GSSSB, have gained momentum in the Caribbean and other regions.

GSSS bonds represent but a fraction of the overall bond market. However, they have shown rapid growth, with an average annual growth rate of 80%, meaning that the market size has almost doubled from one year to the next since 2014.

While 2022 showed a contraction in issuance amounts, with the total market going from 1.6 trillion to 1.3 trillion, 2023 is showing signs of being another record year for GSSS.

GSSS bond activity remains concentrated in developed markets, with China traditionally being a strong player. Yet, issuers in developing countries have shown the greatest appetite for innovative instruments.

Green bonds
Raise capital for projects with dedicated environmental benefits

First issued in **2007**

Social bonds
Raise capital for projects with dedicated social benefits

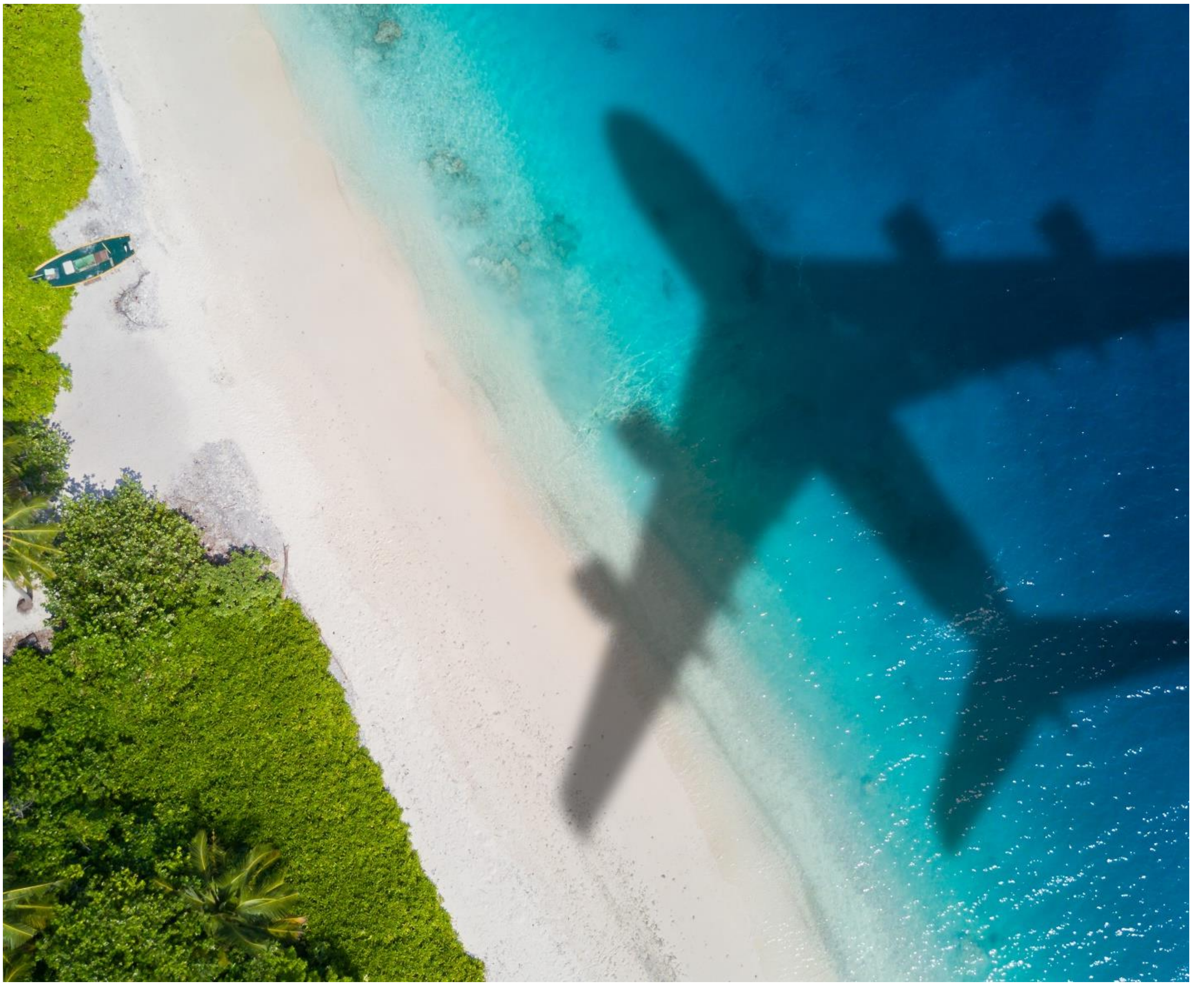
First issued in **2010**

Sustainability bonds
Raise capital for projects with a mix of social and environmental benefits

First issued in **2012**

Blue bonds
Raise capital for projects with marine or ocean-based benefits

First issued in **2018**



Blue Bonds : recent history and development

Among GSSS, Blue bonds are a relatively new debt instrument issued to support investments in healthy oceans and "blue economies". Blue bonds today are where green bonds were 10 years ago.

Blue bonds first gained attention in October 2018 after Seychelles launched a US$15 million 10-year bond designed and implemented with the support of the World Bank Group and the Global Environment Facility.

This process aimed to support the expansion of marine protected areas by 30%, improve governance for priority fisheries, and develop the country's blue economy.

Since then, the supply of blue bonds from both public administrations and private companies has kept growing, as has the interest of investors in using their capital to support initiatives seeking to preserve marine ecosystems.

What are blue bonds?

Blue bonds can be issued by companies, financial institutions, and governments.

Blue bonds are financial instruments that can be issued by companies, financial institutions, and governments. They function similarly to traditional bonds but with an added focus on protecting and conserving marine ecosystems. Just like green bonds, blue bonds operate as debt instruments, providing capital to issuers who repay the borrowed amount with interest over a specified period.

However, the issuance of blue bonds entails adhering to specific criteria and best practices, including principles related to the use of funds, genuine commitment, and transparent management. These stipulations ensure that interested parties respect guidelines for the responsible utilization of blue bond proceeds.

A simplified structure of recent blue bond issuances is as follows:

Enabling Funding (impact, philanthropy)

Transaction Structuring [credit enhancement - insurance, dev. banks]

Marine Spatial Planning (MSP) (goals & roles established with all stakeholders to protect oceans)

Conservation Protection (Endowment Trust to manage payments to fund conservation work e.g. mangroves, coral, wastewater, fish habitat)

Sustainable oceans, and local economies

In the past two years alone, there have been 12 issuances of blue bonds, totaling a value of US$2.9 billion.

In 2021, Barbados unveiled a blue bond facility totaling US$150 million. The structure is co-guaranteed by the global environmental organization The Nature Conservancy ("TNC") for US$50 million and the Inter-American Development Bank for the remaining US$100 million. This dual-currency blended finance deal was arranged jointly by CIBC First Caribbean and Credit Suisse and includes key features listed below.

Barbados is not the first Caribbean country to issue a blue bond: in November 2021, Belize issued a blue bond.

Key Features of the Barbados Blue Bond:

- An extension of the debt profile to 2037
- US$50 million toward marine conservation
- Capitalization of an endowment to fund marine conservation with the aim to protect 30% of Barbados' ocean
- Inclusion of a climate clause in the case of a natural disaster, that would permit the deferral of debt payments for two years
- A unique 'pandemic clause' to allow the government to defer debt payments (for up to two years at a time and twice if necessary), in the event of another global pandemic like COVID-19.

This represented the world's largest debt restructuring for marine conservation with a sum of US$553 million, a reduction in total debt by US$250 million, and debt service savings of approximately US$200 million.

This external commercial debt was refinanced and replaced with a US$364 million loan financed by Credit Suisse and the US International Finance Development Corporation in conjunction with TNC.

The key transaction components were similar to the Barbados blue bond, with the exception of the pandemic clause.

Recent public and private Blue Bond issuances globally

2018

Republic of Seychelles

In October 2018, Seychelles became the first country to issue a blue bond, raising US$15 million from international investors to support sustainable marine and fisheries projects.

Republic of Palau

In November 2018, the Republic of Palau issued a blue bond worth US$15 million to support the establishment of a marine sanctuary and the expansion of the country's sustainable fishing industry

2019

World Bank

Issuance of a Sustainable Development Bond worth US$10 million to address marine plastic waste by Morgan Stanley.

Nordic Investment Bank

Issuance of 5-year bond worth SEK 2 billion for wastewater treatment, prevention of water pollution and water-related climate change adaptation in the region.

2020

Mowi

Issuance of 5-year senior unsecured bond worth €200M, the first for a seafood company, to help it achieve goals of producing more food from the ocean while respecting the environment and helping local communities flourish.

Portugal

In September 2020, Portugal became the first European country to issue a blue bond, raising €500 million to finance sustainable marine and ocean projects.

2021

Fiji

In June 2021, Fiji announced plans to issue a US$50 million blue bond to support its climate resilience efforts, including the protection of marine ecosystems.

Republic of Seychelles

Issuance of blue bonds worth US$25 million to support sustainable marine projects, including fisheries management, marine conservation, and renewable energy.

While debt restructuring for nature conservation and climate adaptation is not new, it plays a significant role in the island economies, where economies face similar challenges, including:

- Vulnerability to the impacts of climate change, such as rising sea levels, biodiversity erosion, and more frequent extreme weather events such as hurricanes and tropical storms
- Economic dependency on tourism and maritime trades, such as fishing
- High cost of international trade due to transport costs and high dependency on foreign imports
- Limited access to reduced interest rates from international finance institutions due to the use of gross national income (GNI) metrics.

These transactions can be beneficial from a treasury perspective, reducing countries' debt stock and creating a budget capacity for necessary conservation programs that have historically lacked funding. In the case of Belize, it allowed the government to buy back all of its Eurobonds at a discount, facilitating a decrease in the country's debt ratio of 12%.

Based on the limited number of issuances, it seems that blue bonds could also help countries secure debt at a lower cost. In Barbados, the government was paying 8% for its domestic bonds and 6.6% for its Eurobonds, with the blue bonds enabling savings amounting to approximately 200 basis points. Similarly, in Seychelles, the blue bonds reduced the effective interest rate from 6.5% to 2.3%. In the case of Belize, the interest rate on the blue bond was similar to that of the original bond, mainly reflecting the nature of the transaction, which was a restructuring of the debt.

The Blue Bond Guidance: Setting the Global Standards

One major challenge around blue bonds, similar to other sustainable financial products, has been the lack of globally agreed-upon finance taxonomies.

However, with the aim of addressing this issue, 2022 saw the publication of the consultative draft of the Blue Bond Guidance, developed by the UNGC, the International Finance Corporation, the Asian Development Bank, the United Nations Environment Program Finance Initiative and the International Capital Markets Association (ICMA). The Blue Bond Guidance, one of the most significant outcomes of the UN Ocean Conference, provides the steps governments, financial institutions, or companies should follow in issuing blue bonds aligned with existing voluntary standards for sustainable finance. The Blue Bond guidance clarifies what constitutes eligible "blue" investments under international standards.

Notably, the Blue Bond Guidance is intended to act as an overlay to existing sustainable finance frameworks (e.g., the European Union's Sustainable Blue Economy Finance Principles), instead of developing an entirely new set of principles for issuers and investors to follow.

Also in 2022, the Asian Development Bank (ADB) launched the world's first Blue Bond Incubator, supported by ADB's Asia Pacific Climate Finance Fund (ACliFF), to scale up and accelerates sovereign and corporate blue bond issuances, signaling further support for innovative financing mechanisms by international development banks. The Incubator's first partner is the Fiji Ministry of Economy which requested ADB's support to develop and issue its first blue bond.

Country	Issue date	Amount (USDM's)	Tenor (Yrs.)	Domestic Bonds	Blue Bonds	Estimated Savings
Seychelles	2016 & 2018	21 +15	20	6.5%	2.3%	400bps
Barbados	2022	150	15	8 % domestic 6.6 % Eurobonds	4.9%	200 bps

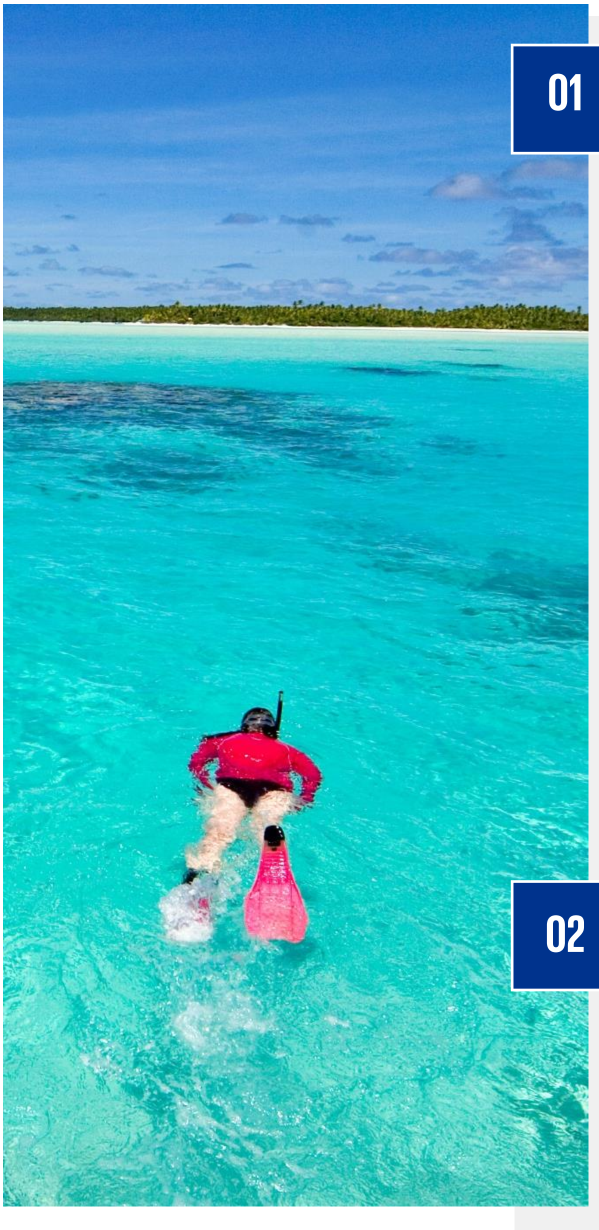
With high investor demand for thematic bonds and sustainable investments on the rise, blue bonds represent one potential source of large-scale financing for island economies to protect their oceans while promoting economic development.

Creating a sustainable financing model for Islands via Blue Bonds

As we assess the current position of Barbados and other island economies, the importance of a sustainable financing model is key to increasing resilience to climate change and other development challenges. Various projects undertaken by local and municipal governments on islands, particularly in sectors like water, transport, and infrastructure, are highly suitable for the issuance of blue bonds or other Green, Social, and Sustainable Bond (GSSB) options.

In issuing blue bonds, islands should consider **5 key principles:**

While climate finance presents significant opportunities for sustainable development in island economies, blue bonds alone are far from sufficient to meet the entire financing needs of these economies. Significant transformations are required to enable the issuance of these bonds on a large scale and ensure their effectiveness.



01

Demonstrate fiscal prudence

As detailed previously, over the last few years, many small island economies have developed a high level of debt and several economic metrics that have warranted higher risk being placed on their debt issuances. This increased risk has been reflected in external ratings from agencies as well as higher interest rates attached to the bonds.

As observed with the Barbados and Belize blue bonds, fiscal prudence was exercised by refinancing the more expensive debt with favorable terms that lowered interest rates and extended the repayment term.

The fiscal space this created provides several benefits:

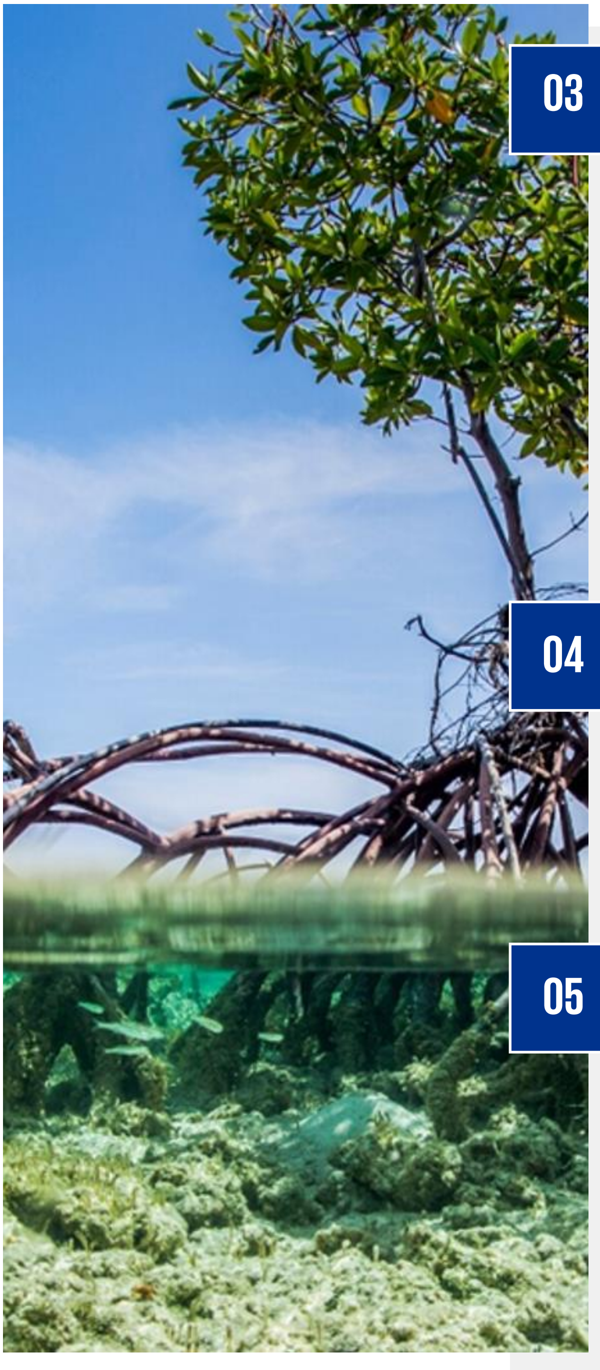
- Lower debt servicing requirements,
- More headroom since debt to GDP is lowered in some instances,
- More cash flow to channel into the sustainability or conservation funds associated with the bonds, and
- A mechanism to maintain contributions in the “Resilience Funds” over the long term.

02

Adhere to Blue Bond Guidance

By using the Blue Bond guidance in their issuance, islands can improve their credit perception, raising their profile in the international capital markets and promoting confidence among investors.

This entails issuers developing clear roadmaps that outline their objectives for their ocean economy.



03

Partner with international guarantors

The Barbados and Belize blue bond structures were guaranteed by both the TNC and multilateral organizations. In each instance, the guarantors possessed exceptionally robust financial ratings. For instance, the Barbados blue bond received a Triple-A rating.

This arrangement resulted in situations where the demand for bonds exceeded the supply, thanks to the reliability of the guarantors. The positive publicity associated with the issuance and credibility of financial partners also played a crucial role in attracting a broader range of investors to the region.

04

Establish Conservation Endowment Fund

The goal of the foregoing structure is to set up a long-term mechanism such that funds will be available for conservation policy and project implementation. This structure ensures that resilience funding is maintained.

05

Tie Blue Bonds to overarching blue economy strategy

Issuers implementing robust ocean economy plans will likely leverage greater interest from the private sector. This means blue bonds should have clearly defined sustainability goals directed at achieving SDG 14 and utilize Key Performance Indicators (KPIs) to enable the measurement of said objectives.

Clearly defined policy programs, objectives, and KPIs lowers the risk for investors and increase the opportunity for investments in the blue bond economy.

With more governments actively setting emission reduction, nature conservation, or other sustainability objectives and targets, blue bonds can help ensure sufficient financial resources are channeled to their achievement.

Who might Blue Bonds help?

Blue Bonds can represent a powerful sustainable finance tool for island economies, more specifically for:

- Any party wishing to refinance existing debt and finance marine conservation projects. Additionally, blue bonds might fund water supply & sanitation, ocean-friendly products, sustainable shipping, fisheries, aquaculture, fishing, sustainable tourism, and offshore wind.
- New investors: in addition to impact investors and philanthropists, this structure appeals to ESG-linked institutional investors (such as insurance companies, fixed-income investors, pension funds, and other such entities)

How KPMG can help

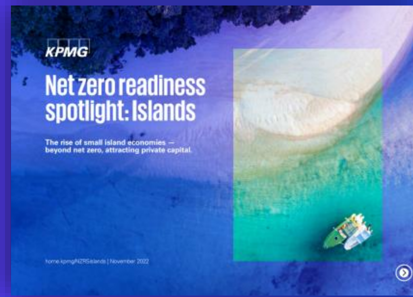
Member firms' experience in advising clients on both financing and sustainability strategies helps give KPMG's global network a level of capability few can match.

KPMG can support you throughout the life of a blue bond, from preparation and strategic thinking to execution and reporting, as well as stakeholder management.

Key services include:

- Setting up a Blue Economy Strategy
- Financing option review
- Design for sustainability bond framework, including blue bonds
- Execution
- Monitoring and reporting
- Third-party independent assurance
- Ongoing stakeholder management

Other Climate Change and Sustainable Finance Thought Leadership



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