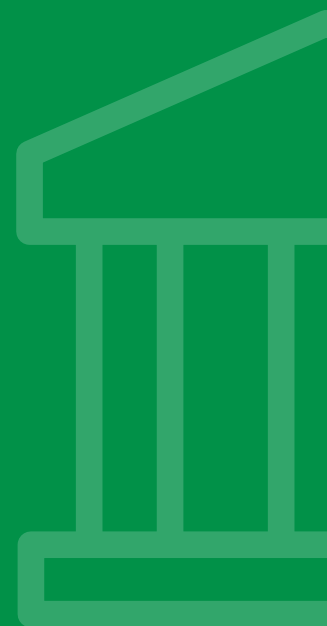




Developing the Thematic Bond Market in Latin America and the Caribbean:

Brazil's First Sustainable Bond by a Public Financial Institution

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Developing the Thematic Bond Market in Latin America and the Caribbean: Brazil's First Sustainable Bond by a Public Financial Institution

On December 23, 2020, the Banco de Desenvolvimento de Minas Gerais (BDMG)¹ issued a sustainable bond to support projects with measurable environmental and social benefits, such as energy efficiency, renewable energy, water and sanitation, health, and education projects, in the state of Minas Gerais, Brazil (IDB Invest, 2020). BDMG issued the bond—with the support of the Inter-American Development Bank (IDB) Group—under a Sustainability Bond Framework (BDMG, 2020) in accordance with the Green Bond Principles (ICMA, 2018a), the Social Bond Principles (ICMA, 2020), and the Sustainability Bond Guidelines (ICMA, 2018b).

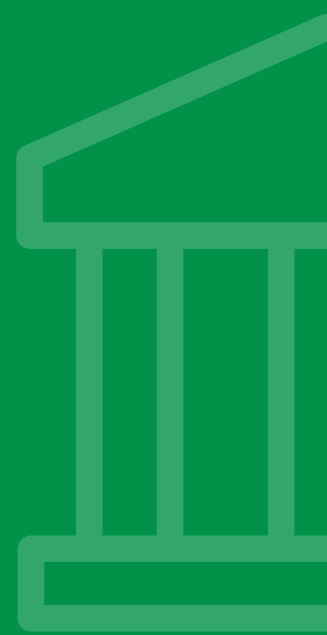
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JEL codes: F3, F34, G1, G2, G23.

¹ BDMG is a regional development financial institution controlled by the state of Minas Gerais with the mandate of promoting economic, financial, and social development within its region.



BDMG’s Sustainable Bond: Summary Term Sheet

Issuer: BDMG
Amount issued: US\$50 million.
Currency: US dollars.
Tenor: 7 years.
Use of proceeds: The proceeds will be utilized to finance sub-borrowers that meet the criteria for “eligible green categories” and “eligible social categories” as set forth in the Sustainability Bond Framework. Eligible categories will lead to positive environmental and/or social impacts and advance the UN SDGs, specifically goals 3–9, 11, 12, and 15.
Independent reviewer of the social bond framework: Second-party opinion issued by Sustainalytics (2020).
Social impact reporting: BDMG will report on both the allocation and impact of the proceeds on an annual basis.
Issuance: Private placement under Section 4(a)(2) of the U.S. Securities Act of 1933.

Sources: BDMG (2020), IDB Invest (2020), and Sustainalytics (2020).

The BDMG sustainable bond meets 10 of the 17 Sustainable Development Goals (SDGs).



Highlights of the BDMG's Sustainable Bond

1

While Brazil has been the largest green bond market in Latin America and the Caribbean (LAC), the market for other thematic bonds in the country is slowly gaining steam.

Thematic bonds (green, social, and sustainable) were created to facilitate the financing of investments that provide environmental and/or social benefits, thus supporting an economic transition focused on sustainability. In recent years, thematic bonds have taken on greater significance in international markets.² Brazil has been the largest green bond market of the LAC region, with over 47 bonds issued for a total volume of US\$8 billion in a variety of sectors such as energy, land use (e.g., forestry, environmental conservation), and transport industries. The social and sustainable bond markets in Brazil are, however, still incipient with only two social bonds that make up a total of US\$110 million, and only three sustainable bonds (US\$362 million) so far, all of which were issued in 2020.

2

Public financial institutions can help accelerate the development of the thematic bond market in Brazil.

Public financial institutions, such as BDMG, devoted to the development of the country, play a crucial role in financing investments with environmental and social impacts, thus helping Brazil to achieve its Sustainable Development Goals (SDGs) (Sachs, et al., 2020). In 2019, public financial institutions provided 30 percent of total credit to small and medium-sized enterprises (SME), accounting for 58 percent of their portfolios. By supporting these enterprises and long-term projects focused on renewable energy, energy efficiency, or sustainable agriculture, public financial institutions become critical to the development of the thematic bond market in Brazil.

² By linking a financial instrument with the ability to target specific SDGs, thematic bonds have proven in several developed countries to be a fitting alternative to build on the momentum for impact investment. For example, the consistent growth of the new thematic bond market can be illustrated by the fact that the aggregate amount of thematic bonds issued by mid-2019 reached approximately US\$700 billion, of which US\$619 billion corresponded to green bonds—the most common type of bond within the category of “thematic” fixed income instruments, next to “social bonds”, “blue bonds”, and “sustainability bonds”, which amounted roughly to US\$65 billion. LAC represented approximately 10 percent of green bond issuances between 2012–2018 in emerging markets.

3

Brazil issued its first sustainable bond by a public financial institution.

With the IDB Group support, BDMG issued Brazil's third sustainable bond, the first one issued by a public financial institution. IDB Invest purchased the bond, in a private placement issuance under Section 4(a)(2) of the U.S. Securities Act of 1933 for a total amount of US\$50 million with a seven-year tenor.

4

BDMG is committed to support green and social projects.

BDMG will use the proceeds to finance sub-borrowers that meet the criteria for "eligible green categories" and "eligible social categories", as set forth in the Sustainability Bond Framework. BDMG identified 11 portfolio categories to be eligible to be financed by the sustainable bond's proceeds. The Sustainability Bond Framework and the Second-Party Opinion (Sustanalytics, 2020) for this bond have been issued with the support of IDB.

5

BDMG wants to generate positive impact.

The BDMG's sustainable bond is expected to increase credit to green and social projects in Brazil. It is also expected that the investments in the renewable energy and energy efficiency portfolio of BDMG will generate positive tangible effects on the environment, measured in terms of the reduction in greenhouse gas (GHG) emissions. In addition, BDMG is committed to contributing to the United Nations' (UN) 2030 Agenda, through the SDGs. In that respect, BDMG reports on their progress through a yearly Sustainability Report.³ Thus, it can be said that the generation of impact is at the center of its action strategy, aiming to promote the efficient allocation of resources for sustainable development and to boost the investments adhering to the SDGs in its territory.

³ For more details on BDMG's Sustainability Report, see BDMG website: <https://www.bdmg.mg.gov.br/sustainability-report/>

The Role of Public of public Financial Institutions in Developing the Thematic Bond Markets in Brazil: Key Points

1

The current COVID-19 crisis has had a major economic and social impact in the country.

The Banco Central do Brasil focus survey (BCB, 2021) estimated a fall of 4.36 percent in the gross domestic product (GDP) in 2020 and a growth of approximately 3.4 percent in 2021. Government fiscal measures to reduce the impact of the pandemic comprise more than 8 percent of the country's GDP and include the protection of the most vulnerable population, informal workers, and micro, small, and medium-sized enterprises (MSME), as well as subnational entities. The initial impact of the crisis caused 89 percent of Brazilian small businesses to suffer a median drop in monthly sales of 64 percent (SEBRAE, 2020). Similarly, there has been a large social toll: the unemployment rate reached 14.4 percent in September 2020 (IBGE, n.d), and it is estimated that the economic fall will drive 5.9 million people to poverty and nearly a quarter of a million to extreme poverty. In response, government and multilateral support has been focused on addressing the immediate needs of the population and providing liquidity to MSME in order to increase their chances of survival. Notwithstanding, the next step of economic recovery must lay the foundations for a sustainable recovery.

2

Public financial institutions such as BDMG could lead Brazil's sustainable recovery.

As the initial effects of the economic crisis gradually fade, the next wave of economic policy measures will need to focus on addressing the economic recovery. In addition to long-standing environmental challenges in Brazil, the pandemic has highlighted key vulnerabilities associated with social inequalities in the country. However, the economic recovery path ahead presents the opportunity to rebuild the country in a more sustainable and inclusive way, avoiding long-term negative impacts on the environment that some recovery policies may induce, aiming to reduce the likelihood of future shocks, and improving the resilience to future crises. Among others, a key aspect of this process is the alignment of recovery objectives with long-term goals to reduce GHG emissions, for example, by investing in cleaner technologies associated to the productive process, and seeking a people-centered recovery that embraces inclusiveness and equality.

The potential economic and environmental benefits of this approach are significant. A recent study estimates that the adoption of a post-COVID-19 economic recovery path based on policies that embrace sustainability could lead to a net increase of two million jobs in the country by 2030 when compared to a business-as-usual (BAU) scenario (Barros et al., 2020). In addition, such policies could help obtain a total GDP gain of US\$535 billion (14.8 percent more than BAU), and a significant reduction in GHG emissions (28 percent less compared with BAU). Given their importance to employment and GDP, it has been noted that MSME will play a crucial role in the achievement of sustainable and inclusive growth. As a public financial institution, BDMG is leading the way for a sustainable recovery in Minas Gerais aligning 57 percent of its 2020 disbursements to projects falling within a clearly determined SDG category.

3

Other public financial institutions can replicate BDMG's role in increasing credit to green projects in Brazil.

As of December 2019, 13 percent of BDMG's total portfolio was made up of green operations; this participation was expected to diminish in 2020, due to BDMG's response to COVID-19, and grow significantly in the following years (15 percent in real terms).

At that point in time, BDMG's green portfolio was made up of five sub-portfolios: (i) renewable energy and energy efficiency (57 percent), (ii) pollution prevention and control (13 percent), (iii) sustainable water and wastewater management (11 percent), (iv) sustainable agriculture and sustainable management of living natural resources (6 percent), and (v) clean transportation (13 percent). It is expected that the investments in the renewable energy and energy efficiency sub-portfolio, some of which are linked to MSME investments, will generate net positive effects on the environment measured in terms of the reduction of GHG emissions. In this regard, BDMG expects to reduce emissions by 114 thousand tons of carbon dioxide equivalent between 2020 and 2025. Other public financial institutions with similar portfolios could replicate and further BDMG's impact by obtaining adequate funding to offer credits to green projects in Brazil.

4

Other public financial institutions can replicate BDMG's role in increasing credit to social projects in Brazil.

As of December 2019, 22 percent of was made up of social operations; this participation was expected to reach 30 percent in 2020, due to BDMG's response to COVID-19, and return to 18-19 percent in 2022-24. At that point in time, BDMG's social portfolio was made up of six sub-portfolio: (i) affordable basic infrastructure—inclusive and sustainable urbanization (32 percent); (ii) access to essential services—economic recovery after disasters (33 percent); (iii) access to essential services—health (19 percent); (iv) employment generation—micro and small enterprises (MSE) (13 percent); (v) socioeconomic empowerment—gender inclusion (3 percent); and (vi) access to essential services—education (1 percent). BDMG defines targeted groups - such as areas with Human Development Index below Brazilian municipalities' average, vulnerable communities and minority groups, women (gender inclusion), and general public living in certain municipalities of Minas Gerais—for eligible projects under the social use of proceeds. It is expected that the financed instruments will play an important role in fostering economic opportunity and social development and reducing inequalities across municipalities in Minas Gerais. Other public financial institutions with similar portfolios could replicate and further BDMG's impact by obtaining adequate funding for social projects in Brazil.

5

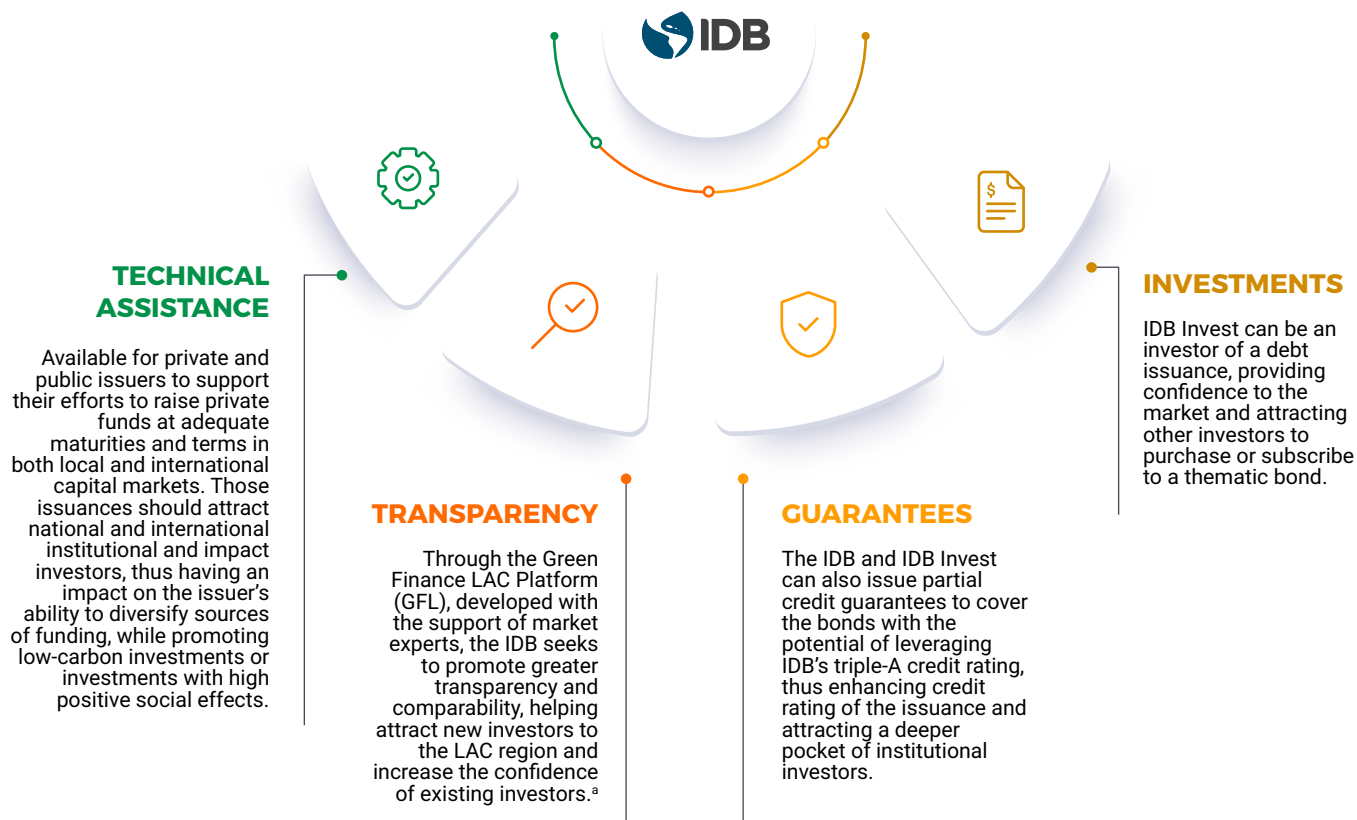
The IDB Group can play a catalytic role in strengthening public financial institutions' capacity to issue thematic bonds in Brazil.

The IDB Group experience with BDMG shows that the use of a broad set of tools to support public financial institutions can lead to concrete and meaningful results. The IDB assisted BDMG in developing its Sustainability Bond Framework and in obtaining a second-party opinion (Sustainalytics, 2020). The IDB also supported BDMG in expanding the eligible portfolio categories to include social categories by updating the classification developed for the previously validated Green Bond Framework. In addition, the IDB supported the development of a GHG emissions calculator, improvements of the key performance indicators (KPI)⁴ to implement a green and social tagging, and provided recommendations for BDMG's monitoring and evaluation system as a way to better measure the impacts of its portfolio.

⁴ For a detailed description of KPIs for BDMG's sustainable bond, please refer to its Framework and Second-Party Opinion (Sustainalytics, 2020).

To this it must be added that the IDB assisted BDMG in the process of certifying the issuance of a sustainable bond and has provided legal support and institutional strengthening, which included capacity-building activities for the effective implementation of the framework to enable this thematic bond issuance. Finally, BDMG was chosen to be a pilot for the development of an SDG ranking methodology in partnership with the IDB. The methodological framework, developed for the BDMG sustainable bond and the additional technical cooperations, ensures specific criteria in the selection and evaluation of projects, as well as in the monitoring and dissemination of results, which may be replicated in the future. The broad set of tools at the disposal of the IDB Group to support public financial institutions in Brazil can be a game changer which may enable them to access the thematic bond market for the first time.

The Role of the IDB and IDB Invest in Developing Thematic Bonds in the LAC Region



Source: Author's elaboration following GFL (n.d) and adjusted based on inputs from IDB Invest.

^a For more details, see <https://www.greenfinancelac.org/our-initiatives/green-social-and-thematic-bonds/>.

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