

Fixed On ESG, Ep. 4

Transcript

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Female Voice: You're listening to Fixed on ESG, a monthly podcast series brought to you by PGIM Fixed Income, an active global fixed income investment manager.

Armelle de Vienne, Co-head of ESG Research: Welcome to Fixed on ESG. I'm Armelle de Vienne, co-head of the ESG Research Team of PGIM Fixed Income and your host for this month's episode. Today, we'll be talking about blue bonds, what they are, the challenges, and potential impacts for more sustainable marine environment. I'm particularly excited about this topic because I have a very personal love for the oceans. I'm a certified divemaster. And previously, I was studying marine and freshwater science with the thought that I'd become a marine scientist. Obviously, that career path took a little bit of a different turn, but I certainly see the value and, quite frankly, the need for overlapping investing in our oceans. I'm particularly excited today to introduce our guest, Mark Spalding, who I've had the pleasure of working with in the past and he is an undeniable expert in international environmental policy and law, ocean policy and law, the coastal and marine philanthropy. Mark Spalding is currently president of The Ocean Foundation, which is the only community foundation for the ocean and whose mission is to support, strengthen, and promote organizations dedicated to reversing the trend of destruction of ocean environments around the world. A lawyer previously by training, Mark's expertise in this field has been noticed by many. I certainly won't do all of his credentials justice, although I'll give it a shot. He serves as a member of The Ocean Studies Board and the U.S. National Committee for the Ocean Decade of Ocean Science for Sustainable Development, which is part of the National Academies of Sciences, Engineering, and Medicine. He's a senior fellow at the Center for the Blue Economy at the Middlebury Institute of International Studies. He's an adviser to the High-Level Panel for a Sustainable Ocean Economy. He also serves as an adviser to Rockefeller Climate Solutions Fund and the Credit Suisse Rockefeller Ocean Engagement Fund. In addition, he's a member of the United Nations Environment Programme guidance working group for its Sustainable Blue Economy Finance Initiative. The last comment I'll make is Mark has also designed the first ever blue carbon offset program known as SeaGrass Grow. So welcome, Mark.

Mark Spalding, President of the Ocean Foundation: Thank you very much. Great to be here.

Armelle: So maybe, just to set the stage for our listeners, we've heard about green bonds. We've heard about social bonds, sustainability, and sustainability-linked. What are blue bonds?

Mark: They're basically in the same class. Blue bonds are a form of sustainability bond, which will finance projects related to ocean conservation or water-related projects. Like green bonds and social bonds, blue bonds operate similarly to any other debt instrument that you're already familiar with by providing capital to issuers who repay the debt with interest over time. The main difference is that blue bonds are going to be used to fund ocean-related projects to preserve and protect the environment, promote biodiversity, sequester carbon via blue carbon ecosystems, and support economies reliant upon healthy and sustainable fisheries.

Armelle: Okay. Great. And how new are these types of instruments? How many blue bonds have been issued so far? And what have we seen to date?

Mark: This is new territory. The first one of these ever done was in 2019 for an African country. And a second one was done later in 2019 in North Atlantic. And a third one recently done in Central America. Because the bond market is worth about \$120 trillion and is the largest asset class, I think private and public blue bonds going to be developed to catalyze large-scale investments that will support the UN Sustainable Development Goals number 14, which is about life underwater, Paris Agreement, Nationally Determined Commitments to deal with carbon emissions and the expansion of a sustainable blue economy more generally.

Armelle: All right. So, we've only had a handful of these already. It would be great to get your thoughts on these issues today and what you see as some of the pros and cons.

Mark: The two most important of the ones that have been done so far were the African and Central American one. And both of those were debt for nature swaps to a great extent, traditional sort of Paris Club debt was bought and retired and replaced with new debt that was to be spent on these blue conservation agenda items as the use of funds. A problem, in terms of cons is that research has shown over and over again that debt relief alone does not spur environmental conservation. And of course, that for nature swaps, where you're taking away Paris Club debt and replacing it with new debt, is only a minor debt reduction. So, you don't even have a big incentive constructed there. You're not getting it. The underlying institution does not magically create a political will to spend the savings on conservation. And sadly, in many of the events we've seen in the past, government officials who tend to be elites have traded land conservation for debt reduction for their country. And the non-elites, who are the landholders or the people who work the land, lose access and lose it without compensation or fair transition. The flip side, the pros, are that, you know, if this really is used for the purpose it's intended, we can jumpstart a blue economy. We can sequester carbon. We can clean the water. We can improve food security, all of which will pay back the bond and improve the economy of the country who borrowed the money in the first place.

Armelle: Got it. Okay. So maybe also asking a little bit what the incentive for some of these countries are to issue blue bonds and spend on conservation and marine and coastal sustainability. I think people really understand the benefits of green bonds trying to meet their Paris Climate Agreements. And now you've also mentioned this SDG goal number 14, but maybe you can talk a little bit more about what really are the benefits of these blue bonds. And is it really more of a philanthropic issue or a longer-term financial investment?

Mark: So, while philanthropy could play a role in the sense of, say, buying down the Paris Club debt or providing a loan guarantee or somehow else making the terms of the debt deal better, this is straight-up debt. This is borrowing money. And so, you have to make the case that there's going to be a good result from incurring the debt. Right? You don't want a situation where a country borrows a bunch of money or a private corporation borrows a bunch of money, blows it on stuff that sounds good, but doesn't actually help the environment in this case, or the economy, which it should, and then be unsuccessful in repaying the debt. So, what we want to see is a situation in which they actually spend on the intended use of funds and the environment gets healthier and abundance increases. And that abundance can be seagrasses, mangroves, estuaries that take up carbon. Or they can be abundant in fish and shellfish and other seafood that helps with food security. All of those things also can help with coastal resilience. The seagrass, estuaries, and mangroves

slow down storm surges and wave height and thus protect communities that are on the coastline. All of this can make an economy more stable, more resilient, and more successful. And that's what we ultimately want out of a bond like this. That's got to be the central incentive. A secondary incentive is every one of us has to do something about addressing the global crisis of climate change. And one of the things that the Paris Agreement created was this thing called Nationally Determined Commitments in which each country basically says what they're pledging to do. And one opportunity here, which is an incentive for these bonds, is that countries can pledge to restore and protect seagrasses, estuaries, and mangroves that will take up and store carbon. And it's all-natural, and the storage is natural, and the storage is mostly in the seafloor and soils. And therefore, it is very, very long-term storage. So, it's an excellent carbon dioxide removal strategy that is a nature-based solution that is going to make a difference. And so, the countries who want to meet their commitments on reducing emissions, who want to take carbon out of the atmosphere, have an incentive to take out these bonds and do this kind of investing.

Armelle: There's two things about what you said that I really appreciate. One is expanding this definition, or rather explaining what "blue" really means. Because I think a lot of us think of the ocean and the problem with the ocean is overfishing. And obviously, everyone cares about fish, but that's not really people's main concern. You really raised other issues like seagrass, for example. Also, the second point linking this to climate change and the Paris Climate Agreement, because I think the stability and the security of our ocean's heavily linked to climate change as well. So, maybe going into my next question, do you think that blue bonds should really be seen in the context of achieving these green objectives like the Paris Agreement, or should we be thinking of this really as a standalone objective? Maybe we can get your thoughts on that.

Mark: It's got to be a little bit of both, unfortunately, which makes it hard to classify. Right? It's the first incentive I talked about, about improving the blue economy by improving the health, the ocean environment, food security, and protection of coastal resources is a different thing than the carbon sequestration and meeting Paris commitments, then it's blue in the first case and sort of like green bond in the second case. And so, because it's all integrated, that's what makes it unique. Obviously, we could have called these ocean-focused green bonds, but it's more exciting to talk about them as their own classification as blue bonds. So, I think we're going to accomplish multiple objectives at the same time and calling them blue bonds allows us to talk about the stuff that's not in that sort of climate green bond space.

Armelle: Okay. Great. That actually makes me think of one other thing, but let's move on first. We've talked and mentioned that the blue bond is being issued by sovereign issuers. But what's the opportunity? And in your opinion, is there an option on the corporate side as well? And what kinds of industries do you think we'd see these in?

Mark: We've seen some corporates do blue bonds, a large fishing conglomerate from Thailand, a shipping firm from Japan, and these have been in the hundreds of millions of dollars. And their, again, intended use of funds when they issue these bonds is sustainability, ocean sustainability. Again, trying to meet the United Nation's Sustainable Development Goal number 14. And obviously, the first company's case, thinking about fisheries and aquaculture, and the other company's case, thinking about shipping emissions, thinking about harm to the ocean that comes from shipping. And I think these finance mechanisms allow them to call out very clearly what the use of funds are going to be when they receive the funds that they're putting out there. And it's obviously early days right now to see how this plays out. And whether they actually fulfill their intentions. And it's not just greenwashing, but we're cautiously optimistic. The fishing company went from being a very, very bad actor to very good actor, and now is doing this on top of it. So, we have reason to be cautiously optimistic.

Armelle: Got it. So, this actually allows me to come back to that other question I was thinking of. So, I know that the Thai fishing company that issued its loan is actually labeled under a sustainability-linked bond, yet the indicators that it was looking to target or looking to meet, I should say, were heavily ocean related. With that, you know, we're seeing these types of blue bonds getting classified under a different label. Do you think that's going to continue? Are we going to keep being creative in that way? Are we eventually going to call these blue bonds? Or will we see blue bonds labeled as green bonds? How is this going to go? And how do we deal with that and figure out what we really want?

Mark: Exactly, exactly. Interestingly, you're absolutely right that Thai corporate call it a sustainability-linked bond. But all of the press, if you look at the press media and the announcement for last November, call it a blue bond. So, no matter what they labeled it, it got interpreted as the other. I think that I don't care what these things are called. If we're actually helping to save the planet, save the ocean, restore the ocean's health, and abundance, you can call them anything you want. I think that the phrase "blue bond" is short. It presumably draws your attention to ocean issues and can be more linked, if you will, to the use of funds being ocean-focused. Other than that, these have social qualities to them. As you pointed out earlier, they have green bond qualities to them. And they all certainly should be sustainability-linked in a way. So, it is a nomenclature issue that is without agreed definition per se partly because it's such early days.

Armelle: I'm sensing a void that needs to be filled. And I know we've seen databases and nonprofit have databases for different types of green bonds and how to classify them. So maybe we can see The Ocean Foundation come up with its own database for blue bonds telling us what's really credible, what's a blue bond, what's not, even we'd have a different label. If you do that, Mark, I'll take credit for this idea.

Mark: Excellent, excellent. Good.

Armelle: So, you know, the one thing I definitely wanted to touch on is I think people still underestimate or maybe forget about reliance on our oceans. This is one of the oldest parts of our international trade economy. Ninety percent of goods still travel by sea. We rely on it for extractive uses. Things like copper, nickel, manganese, and other precious ores come from our oceans. Deep sea mining is definitely an industry of its own. Tourism. Tourism is a primary contributor of GDP for over 10% of countries. Obviously, food uses, we rely on it for fishing. And hundreds of thousands of people live in coastal areas that will be impacted by sea level rise. So, point being, and we rely on these oceans so heavily, why have we only started seeing blue bond issuances happen as of 2019? What's the hang-up? What are some of the challenges? And where's the problem?

Mark: So, a couple of things. I mean, as we just talked about, to a great extent, these are a form of green bonds, where we're talking about addressing climate change. And the ocean was ironically left out of climate negotiations to a great extent. There were sort of three stages. Stage one, we said the ocean is going to warm and storms are going to whack us. We then eventually got to a second stage where we said, well, actually, our human disruption of the climate is going to harm the ocean. And then we finally got to the third stage where we're talking about how the ocean is an ally in addressing climate change. And it wasn't until we got to that third stage that we started talking about, okay, what projects can we do to work with the ocean as an ally to take up carbon, to store carbon, to transport goods in a way that has a smaller carbon footprint? What else can we do with renewable energy in the ocean? So, you end up with this whole list of projects you're finally opening the door to, but it took a long time before we recognized the role of the ocean in climate negotiations and in climate solutions. Also, I think, as we said earlier, the first time anybody tried one of these

was 2019. So, it's only been a couple of years and there was this pandemic thing going on in the middle there. So, it was kind of hard to concentrate, meet, and chat about things. I think what we're going to, hopefully, see is these first few of these be a demonstration that this is a workable model that could be replicated, and that some of the big investment houses in Wall Street, some of the big investment banks, private and public, get more and more interested and involved once it's demonstrated as a workable model. When the Central American one was done, we started a conversation with one of its neighbors to do one for them. And just going through the process of identifying where we could do blue carbon projects, how many we needed to do, how much money it would cost to do the restoration's conservation, etc., etc., money to put together for the measurement of carbon and carbon uptake. It's taken a year and a half, and we haven't even gotten to a term sheet for the deal yet. It takes a while. So, I think we're in this place where we can begin talking about this in a way we haven't previously because the world is woken up to the role the ocean plays in climate. And we've got a model here that we're test driving and are going to see if it really works.

Armelle: And that's fair. I think I'm just getting antsy.

Mark: We're all antsy.

Armelle: Yeah, I was stuck at home for two, two and a half years, so somehow that escaped my mind. Maybe one thing we can touch on and get your insights on, you've obviously been a part of a lot of these international organizations where a lot of these conversations are happening. Why did it take so long for us to get to this realization that we should see the oceans as our ally? What changed? What all of a sudden dawned on people that made them realize, like, oh, we need to focus on this?

Mark: So in about 2007, we joined with a bunch of others and created something called the Ocean and Climate Platform. And we started showing up at the international negotiations under the UNFCCC, the agreement to deal with climate change, and said, "What about oceans? What about oceans? What about oceans?" And the first few years, everybody was like, "Come back next year. We'll think about it." And it took forever to break through into the conversation. But we eventually got to a place where we had a blue conference of the parties to that agreement. We eventually got to the UN International Panel on Climate Change issuing a report on oceans. We finally got to the point where the Paris Agreement commitments can include ocean-related things. So, it was more than a decade of beating our heads against the wall to get this in the door. But you know, as you said, we're all antsy. We need this done yesterday. We need more of this done and we need it done quickly. And this is proven solutions. We know that these three different plant categories do photosynthesis, take up carbon, put it into their structure, and then move it into their roots and then move it into the soil. So, this is a no-brainer, if you will, to be spending money on. This is a real opportunity for transfer of money as well. Right? Part of the big challenge at the international negotiations is the countries who are causing climate change are not necessarily the countries who are the worst victims. And ironically, some of those places who are the victims of climate change—small island, developing states, coastal states, and developing countries—are the places where we can do this blue carbon restoration. And so, the role they can play in solving this problem only needs one thing, money. We need these debt instruments and maybe even just transfers from the developed world to the developing world to do this work. And that makes this a real climate justice opportunity. Bonds like this can be seen as a finance vehicle for the transfer of money, of support from greenhouse gas polluting nations to those who are the victims of the disruption that comes from climate change.

Armelle: But it does seem like it offers a solution exactly to one of the challenges that's being discussed, you know? At COP[26], like you mentioned, a lot of these emerging or developing markets are the victims of

climate change and it's the developed markets that have been the greatest contributors to that climate change. So, developing nations don't necessarily feel like they can or should bear the burden of changing, let's say, their energy generation mix as quickly. So, we have this financing need for these markets to also adapt to the impacts that inevitably will come. So, it definitely does seem like a viable solution. Just one question also. Through these conversations, what do you think the education gap still is in terms of, a, thinking the linkages between climate change and ocean, but also, b, understanding that it's not just a carbon sequestration program, you think that seagrass, but also a resiliency measure of protecting against coastal erosion? All of these issues, do you think everyone's fully grasping that yet?

Mark: Probably not. I mean, I live in this world, so it's second nature to me, but yes, I think there are a lot of people who don't know all of the nuance of how integrated all of these ecosystems are with the global climate cycle. And that means that we do need to do more education, have better understanding. Right now, though, because we're talking about sovereign nations borrowing money to make these accomplishments, we only need to educate a small group of people, the finance ministers of countries and the loan officers that multilateral and private investment banks. And if we can get them all in one room, I'll talk to them. So, it's just a matter of getting them comfortable with the idea that this is a solution. This is a fundable solution. And that the result will be something that is good for the blue economy of the country and make the debt repayable, which is obviously the number one concern of the lender. Although in this case, I think the lenders too are increasingly recognizing the need to help finance addressing climate change.

Armelle: So, in your opinion, what is needed to make blue bonds increasingly impactful? How do you see them evolving from these sort of debt for nature swaps? What needs to change to make them as impactful as they can?

Mark: I think we need to really be clear about measuring the improvements to each country's economy, food security, and human health as a result of this particular kind of use of funds of this bond. We want to see cleaner water, more food, less health problems, fewer algae blooms, all of these kinds of things that could come from this. And those are the things I want to be truly measurable outcomes of this investment. We know how to measure the carbon sequestered. That's a nice easy measurement to do. As you mentioned, we've been doing blue carbon offsets with our calculator for a decade now. That's easy. But how do we talk about how these healthy coastal and ocean ecosystems will help tourism, help commercial fishing, help all of the sort of coastal uses and activities that will show, measurably show in the economy of these countries so that we get them into a virtuous cycle rather than always just being in debt? This is a chance to get rid of traditional loans and replace them with something that could, if done right, create a virtuous cycle for the economy of the borrower.

Armelle: Great. And maybe my last question I have for you. What can organizations like The Ocean Foundation do? What can investors do? And what can asset owners also do?

Mark: So, our role in looking at these things has been, and will be in the future, to provide technical blue carbon restoration and conservation expertise. Right? That's our strength. As part of that, we can identify high-impact projects and partners in country that can work with us to get the jobs done. And then we can actually help with the project execution as a grant recipient, let's say from the country who has borrowed the money. I think that investors can start asking questions about these bonds. If you think about some of the large private investment banks, 80% of their investing is in fixed equities. Well, this should be part of their portfolio. So, if you have money in an investment bank, or you lead an investment bank, where is this in your portfolio? Are you opening the door to this? Are you thinking about this? I think is absolutely critical. I think

that we can also think about this as if you're an individual investor, can you play a role? Can you get involved in some of these loans when they are created? If these come into the market more and more, do you know how to access them? That is got to be the goal of all of us, is putting the money that's needed behind addressing climate change, putting the money that's needed behind restoring the ocean's health and abundance.

Armelle: That's great. I know from our perspective as an asset manager, having gone through some of those green bonds and, you know, I was kidding earlier, but I do think having some sort of an organization that validates some of these bonds for us, obviously, especially if they're sustainability-like the instruments also where they go under a different label would be very helpful. We've also seen greater guidance coming from EFMA on these KPIs and targets by industry for sustainability-linked loans. I imagine something around blue bonds and really expanding our definition of "green" and allowing for that inclusion, I can imagine [that] being very useful for this industry.

Mark: Yep, I think you're absolutely right. And I think a critical moment in time will be 2019 plus five years when we see, did these countries spend the money on what they were supposed to spend it on? And can we see new stands of mangroves? Can we see healthier seagrass, etc.? And can we, therefore, begin to talk about KPIs being met and improvements that are measurable?

Armelle: Absolutely, Mark. Thank you so much for sharing these insights with myself and our audience. I think you left certainly me, and I'm hoping our listeners also, with a good call to action of how we can just get more involved. Maybe just to summarize some big takeaways that I have from this conversation. I think it's obvious that we need to see blue bonds from the context also of meeting our green objectives and our climate objectives. I love the phrase you used, "seeing our ocean as our ally," and I think we increasingly need to recognize that. And the blue bonds, whether they're called blue bonds or green bonds or whatnot, are really an opportunity to gain access to financing that should be seen as a solution and really a virtuous cycle that can benefit these types of developing and emerging markets from some of the challenges they're going to see with regards to climate change. Well, also hopefully, having an attractive risk-adjusted return for investors. So those are just some of the main takeaways, but is there anything else you think I missed that you just want to leave our listeners with?

Mark: The ocean can survive without us, but we can't survive without it. And figuring out how to work with it to save ourselves and save it has got to be everybody's responsibility. And if we can play a role in the finance sector, the lending sector, the fixed asset investment sector, let's do it.

Armelle: I love that. So, on that note, I just want to thank our listeners for tuning into this conversation on blue bonds. Please don't forget to listen, share, and subscribe to Fixed on ESG on whatever platform you get your podcasts. Thank you so much.

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