

CAPITAL MARKETS
BLUE BONDS

Out of the blue

Latham & Watkins lawyers, counsel to World Bank on the milestone transaction, discuss the creation of this new asset class and how the model can be adapted by other issuers

On October 9 2018, the Republic of Seychelles launched the world's first blue bond, a pioneering financial instrument designed to support sustainable marine and fisheries projects on the archipelago and in the waters comprising its exclusive economic zone.

The bond was supported by a partial guarantee from the World Bank and further supported by a concessional loan from the Global Environment Fund. This transaction could herald the growth of a blue bond market, in ways reminiscent of how the first green bond issuance more than a decade ago saw the green-labelled debt market develop into a market of approximately \$180 billion last year.

Thematic bonds: from green to blue

Incorporating sustainability considerations into financial products is a big and growing enterprise. In the US alone, sustainability-related strategies are used for about 26% of assets under management as of the beginning of 2018, a 38% increase from the beginning of 2016. One such strategy is investing in thematic bonds, where the purpose of the bond is tied to a positive sustainability outcome which is meaningful to investors. The thematic bond standard bearer is the green bond.

Green bonds are debt securities whose proceeds are connected to business activities that contribute to positive environmental outcomes. For example, the proceeds of the bond may be used to develop a wind farm, which reduces carbon dioxide emissions. The first green bonds were issued in 2007 and the market has grown rapidly since then. The year 2018 saw approximately \$180 billion in new green bond issuances. Along the way, market participants developed norms for how a green bond should work – most prominently, the Green Bond Principles – and stock exchanges, regional trade associations and, in some cases, government regulators have developed guidelines for what types of projects are sufficiently beneficial to the environment to qualify.

1 MINUTE READ

The Republic of Seychelles' pioneering issuance of blue bonds offers insights on how other island nations and coastal states may mobilize funds to support projects to sustainably develop their blue economies, and features an innovative guarantee structure that may facilitate credit support by international financial institutions and development banks for similar transactions in the future. Here Latham & Watkins lawyers, who acted as external counsel for the World Bank on the seminal deal, discuss how it came together.

The progress of the green bond market has helped provide momentum for other thematic finance products, such as social bonds, sustainability bonds (addressing both environmental and social priorities), bonds linked to the United Nations' Sustainable Development Goals, and loans of a similar variety. The Seychelles' blue bonds issuance was a significant addition to these types of thematic finance products.

The concept of a blue bond has existed, in theory, for several years, as a debt instrument issued to raise capital to finance marine and ocean-based projects that have positive environmental, economic and climate benefits. In practice, before the Seychelles' blue bond issuance, no other blue bonds had reached the market. The proceeds from this blue bond were specifically earmarked to pay for three components of a larger strategy to advance the blue economy of the Seychelles:

- *Expanded sustainable-use marine protected areas:* investments in planning, implementing and enforcing the planned expansion of areas within the Seychelles' exclusive economic zone subject to restrictions on fishing;
- *Improved governance of priority fisheries:* investments in finalising key fisheries management plans and building the institutional capacity to implement those plans; and
- *Sustainable development of the blue economy:* investments in developing greater value addition from the aquaculture, industrial, semi-industrial and artisanal fishing and processing sectors.

The Seychelles' blue bond broke new ground as a thematic financing expressly linked to the marine ecosystem and blue economy. The future will likely see other states and sub-state actors use blue bonds to pursue similar policy goals. Other issuers should feel confident in using blue bond proceeds to finance initiatives similar to those included in the Seychelles' blue bond

Depending on the size and type of placement, future issuances will likely tend to follow more closely the procedural guidelines applicable to the green bond market, which require disclosure on the use of proceeds, selection of projects and management of proceeds and post-issuance reporting. These guidelines were however less applicable to a relatively small private placement, as was the case with the Seychelles' blue bond. The recently issued SEK2 billion (\$219 million) blue bond from Nordic Investment Bank, in contrast, was issued under an existing environmental bond framework more closely following green bond norms.

Another way in which the Seychelles' blue bond may influence the future of thematic financings is that it addressed both environmental objectives and the resulting unintended social consequences. The Seychelles would have broken no new ground by using a green bond to finance components one: expanding sustainable-use marine protected areas; and two: improving governance of priority fisheries. The Green Bond Principles include in their non-exhaustive list of eligible project categories 'environmentally sustainable fishery and aquaculture' and 'aquatic biodiversity conservation'.

However, by including component three, the sustainable development of the blue economy, the Seychelles acknowledged that although restricting fishing activities was necessary to preserve the long-term viability of their economy, it would negatively affect the livelihood of the people no longer allowed to engage in such activities.

Component three was expressly justified as a means to help compensate fishers for any reduced access to the resource from the implementation of components one and two. The projects meant to help those fishers, which include developing ports and value-added industrial processes, do not fit neatly with preconceived notions of green or

This aspect of the Seychelles' blue bond is noteworthy given the recent protests in France in response to the unintended social effects of the government's environmental policies.

An innovative structure in bond guarantees

A second innovative aspect of the Seychelles' blue bond issuance involved the World Bank's partial guarantee. The World Bank developed a structure, which we will call the Good Actor Regime, to determine whether payments under the guarantee would be permitted under World Bank policy guidelines. Through that structure, the World Bank was able to retain customary safeguards despite the bonds trading in a manner that is generally not conducive to knowing the identity of the guarantees' beneficiaries.

Like many international finance institutions and development banks, the World Bank follows strict know-your-customer (KYC) policies designed, among other things, to safeguard its reputation and to prevent the bank from being used, intentionally or unintentionally, by criminal elements for money laundering activities or other nefarious purposes.

In traditional loan guarantees, these policies include restrictions on the transfer of the underlying loan without the World Bank's knowledge of the identity of the transferee and, in certain cases, consent over such transfer. This protects the World Bank from transfers of its guarantees' right to payment to transferees that, for example, are the subject of sanctions in applicable jurisdictions.

However, in the case of the Seychelles' blue bonds, the identity of beneficial owners of the bonds could become unknown from time to time, because the bonds are intended to be freely tradeable through electronic clearing systems. As a result, the World Bank needed to devise an innovative solution to retain its customary restrictions on the transfer of obligations that it guarantees.

The solution, under the Good Actor Regime, is that upon transfer of the bonds, the guarantees' effectiveness becomes conditioned on the transferee's certification to the World Bank that it qualifies as a good actor. Failure to deliver such certification results in the suspension of that transferee's rights to collect payment under the guarantee. The World Bank thus retains its customary protections against the possibility of having to make payments under its guarantee to holders

Other issuers should feel confident in using blue bond proceeds to finance initiatives similar to these

framework, which was established in cooperation with one of the most highly-respected development finance institutions, the World Bank.

sustainability bonds. The Seychelles' decision to still include such projects demonstrated a more holistic approach to its overall goal of a sustainable blue economy.

Just as investors limit which issuers they are associated with, issuers...may in the future seek to manage who can hold their securities

that do not meet the good actor qualifications.

The Good Actor Regime, however, presented a challenge in its implementation, because electronic clearing systems do not generally permit payments to only a subset of beneficial interest holders. Payments to a subset of holders would be necessary in the event of bondholders not certifying their eligibility, or being ineligible for payments under the guarantee.

To address this challenge and allow such partial payments, the Good Actor Regime requires the bonds to be blocked from trading on the clearing systems while the question of eligibility is determined; then payments can proceed. This process is expected to operate similarly to a ten-business-day consent solicitation, with the trustee or paying agent acting in the role of solicitation agent. This process undoubtedly adds some complexity to enforcement of the guarantee, but in the Seychelles' transaction the World Bank guarantee can only be called upon under limited circumstances: in the event of a scheduled principal payment default.

The Good Actor Regime's solution to the technical issue of partial payments through clearing systems may be relevant in other contexts. Issuers and guarantors are generally not required to perform KYC checks on beneficial holders of their securities held through clearing systems, but that may change due to the expansion of economic sanctions or anti-money laundering laws.

This could especially be the case for development finance institutions, or other situations where the instrument is closely held, as was the case with the Seychelles' blue bonds. Just as investors limit which issuers they are associated with, issuers and those institutions acting as their guarantors may in the future seek to manage who can hold their securities.

The Republic of Seychelles' pioneering issuance of blue bonds in October 2018 was a much-anticipated addition to the various thematic bonds available. The transaction sheds light on how other island nations and coastal states may mobilise funds to support projects to develop their blue economy in

ways that build on the green bond model that was pioneered by the World Bank over a decade ago. It may also serve as a model of an innovative guarantee structure facilitating credit support in future transactions of this type by international financial institutions and development banks.

Overall, the transaction showcased the collaboration between an innovative issuer working hand-in-hand with a multidisciplinary group of experts at the World Bank that provided technical and financial support, and together brought the first blue bonds to market.



Paul Hunt
Partner
Latham & Watkins,
Washington DC



Aaron Franklin
Associate and global
coordinator for sustainable
capital markets
Latham & Watkins, New York



Carlos Ardila
Associate
Latham & Watkins,
Washington DC