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COP29 and Azerbaijan's Green Finance Capacity

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As the international campaign to address climate change intensifies, countries around the world are seeking innovative financing mechanisms to "contribute […], in a nationally determined manner, taking into account the Paris Agreement and their different national circumstances, pathways and approaches [to transition] away from fossil fuels in energy systems, in a just, orderly and equitable manner, accelerating action in this critical decade, so as to achieve net zero by 2050 in keeping with the science"—to quote from the COP28 decision text. The question of climate finance, which the Azerbaijani Presidency of COP29 has indicated will be its "top negotiating priority" has become paramount, with the $100 billion per annum amount now understood by everyone as being far too low: on 27 July 2024, U.S. Treasury Secretary Jannet Yellin stated in Bélem, Brazil (the host city of COP30), that "no less than $3 trillion in new capital from many sources" will be required "*each year* between now and 2050" to combat change—or, as she put it, to "transition to a lower-carbon global economy."

It is within this global context that we enter into the topic of green bonds as one possible new financing mechanism for advancing the adaptation and mitigation strategies of climate action. We will focus on Azerbaijan, because this is the country we know best.

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In Azerbaijan, a country rich in natural resources but facing the challenges of carbon emissions and energy sustainability, the concept of green bonds has emerged as a promising avenue for mobilizing investment towards sustainable practices, environmental projects, and other forms of climate action. This article explores in depth the potential of green bonds in Azerbaijan, their role in driving the "transition away from fossil fuels," and the challenges and opportunities they present.

Understanding Green Bonds

Climate and environmental changes pose significant mid- and long-term risks to all economic sectors. The current conventional scientific wisdom is that continuous greenhouse gas (GHG) emissions contribute to global warming, which may have catastrophic economic, financial, and social consequences. Therefore, implementing comprehensive actions to mitigate these risks is essential for sustainable development.

One mitigative action that has been gaining traction globally has been the issuance of what are called "green bonds," which are *financial instruments specifically designed to raise capital for projects with environmental benefits.* These projects encompass a wide range of initiatives, including renewable energy infrastructure, energy efficiency improvements, sustainable land use practices, and clean transportation systems. The defining feature of green bonds is in their targeted use of proceeds, which must be allocated exclusively to environmentally friendly projects and verified through a set of demanding standards and certifications such as the Climate Bonds Initiative (CBI) or the International Capital Market Association (ICMA) Green Bond Principles.

The global green bond market has seen significant growth since its inception, with cumulative issuance surpassing $1 trillion by the end of 2020. In 2021, green bond issuance reached approximately $500 billion, up from $297 billion in 2020. Current estimates suggest that annual issuance exceeded $1 trillion in 2023. Comparatively, the global bond market, including all types of bonds, was valued at around $128.3 trillion in 2020. Green bonds represent, in other words, but a few drops in the global bond market bucket; on the other hand, the number of drops seems to be compounding.

Green bonds typically have lower interest rates compared to traditional bonds, known as the "greenium" (green premium), where yields can be up to 10 basis points lower. This is because investors are willing to accept lower returns in exchange for the potential positive environmental impact of their investment. Traditional bonds, without this environmental incentive, usually offer higher yields.

Investor demand for green bonds is driven by the focus on what is called Environmental, Social, and Governance (ESG) criteria. In 2021, more than 60 percent of green bond investors were dedicated green funds or funds with significant ESG mandates. Traditional bonds attract a broader investor base but do not specifically cater to ESG-focused investors.

Green bond proceeds are earmarked for projects with clear environmental benefits, such as renewable energy and energy efficiency. Traditional bond proceeds, however, can be used for a wide range of purposes without specific environmental or social focus.

Issuers of green bonds must adhere to standards and frameworks like the aforementioned Green Bond Principles by the ICMA, ensuring transparency and accountability in reporting environmental impact. Traditional bonds follow standard financial regulations without these specific mandates.

Studies show green bonds can perform comparably to traditional bonds in terms of price stability and default rates. For instance, a study by Barclays found green bonds had slightly lower volatility, making them attractive to risk-averse investors. Traditional bonds provide stable returns and are becoming a staple in some investment portfolios.

Green bonds have rapidly increased in issuance and market size, reflecting growing investor interest in sustainable investments. Traditional bonds continue to dominate due to their long-standing presence and versatility. Green bonds attract ESG-focused investors willing to accept lower yields for environmental benefits, whereas traditional bonds attract a broader range of investors focused on returns. Green bonds require adherence to environmental standards, enhancing transparency, while traditional bonds follow general financial regulations.

Traditional bonds remain a cornerstone of the global bond market, but green bonds are gaining traction due to their alignment with sustainable development goals, increasing investor demand for ESG-compliant investments, and climate action financing imperatives. The green bond market's significant growth is solidifying its role in financing environmentally sustainable projects and adaptation and mitigation strategies dealing with climate change.

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The Context in Azerbaijan

Azerbaijan, having substantial oil and gas reserves, has historically relied heavily on fossil fuels for its energy needs. However, the government of Azerbaijan recognizes the importance of diversifying its economic streams and reducing greenhouse gas emissions in alignment with global climate goals. This is reflected in the country's sustainable development strategies, such as "Azerbaijan 2030: National Priorities of Socio-Economic Development" and the "Socio-Economic Development Strategy of 2022-2026," aligned with the 17 Sustainable Development Goals (SDGs). Azerbaijan has been part of the United Nations Framework Convention on Climate Change (UNFCCC) since 1995 and aims to reduce GHG emissions by 35 percent by 2030 compared to 1990 levels and by 40 percent by 2050. On top of that, the government of Azerbaijan has set a target to create a "zero emission zone" in the liberated territories and increase renewable energy share in total energy production to 30 percent by 2030 throughout the whole country. A stronger light is being shined on the country given its Presidency of COP29, the annual Conference of the Parties to the UNFCCC that will take place in November 2024 in Baku.

The global trend towards greening and decarbonization presents opportunities for Azerbaijan's financial sector, particularly in funding green projects and promoting sustainable financial products, hence making its role particularly important in supporting the transition to a sustainable economy and the global fight against climate change. However, opportunities must be considered along with physical and transition risks, such as those posed by extreme weather events and the shift to a low-carbon economy. This is especially vital as according to the Central Bank of Azerbaijan (CBA), approximately 55 percent of the banking sector's loan portfolio is exposed to climate-related economic risks.

Sustainable Practices

In the past two years, Azerbaijan has undertaken several initiatives towards sustainable practices, focusing on various sectors including energy, environment, and economic development.

In the energy sector, a feasibility study is currently underway under the curation of the Ministry of Energy on the Caspian-Black Sea-Europe green energy corridor. A Memorandum of Understanding (MoU) has already been signed with the Governments of Georgia, Hungary, and Romania to build a subsea cable under the Black Sea. Another MoU has been signed by WindEurope and the Azerbaijan Renewable Energy Agency to accelerate the deployment of onshore and offshore wind energy. Furthermore, large-scale solar and wind power plants, such as the 230 MW Garadagh Solar Power Plant and the 240 MW Khizi-Absheron Wind Power Plant, have also been developed in collaboration with international partners.

The establishment of SOCAR Green LLC by the country's state oil and gas company SOCAR solidifies the commitment of the energy sector to increase the country's capacity for sustainable energy. SOCAR Green LLC focuses specifically on renewable energy projects, signifying a strategic move not only to diversify SOCAR's portfolio but also to contribute directly to Azerbaijan's broader energy transition objectives by promoting renewable energy sources.

In the transport sector, the Ministry of Digital Development and Transport (MDDT) has developed an ambitious mobility program that aims to completely transform urban transportation in Baku. This program has introduced bike-sharing schemes in urban areas to promote cycling as a sustainable mode of transportation and developed pedestrian zones and walkways to encourage walking and reduce reliance on motor vehicles. Public transportation is planned to be further greenified as 3,000 electric buses are set to be deployed in Baku to electrify the bus fleet. This announcement goes in line with a statement by BYD, a leading Chinese manufacturer of

electric vehicles, to invest $34 million in the establishment of localized production of electric vehicles in Azerbaijan.

However, it is not only public transportation that is getting greenified: the private Electric Vehicles (EVs) market continues to expand in the country, with around 4,000 EVs already on the road supported by nearly 90 charging stations around the country. It has also been reported that the customs duty on certain types of hybrid and electric motorcycles and bicycles has been reduced to 15 percent in order to expand the usage of EVs.

The Central Bank's Role

Following the strategic direction provided by the Azerbaijani government, the Central Bank of Azerbaijan (CBA) has integrated sustainable finance into its strategic priorities to ensure financial sector alignment with the SDGs and climate action goals. The Sustainable Finance Roadmap (SFR) outlined by the CBA in 2023 underscores the promotion of green finance instruments, including the issuance of green bonds, as integral to the country's sustainable development and climate action agenda.

This roadmap sets a multifaceted agenda aimed at transitioning Azerbaijan's financial sector to align with national and global sustainable development and climate action goals, emphasizing the need for regulatory support, capacity building, and international cooperation to achieve these aims. The CBA aims to integrate climate-related and ESG factors into financial regulation and market standards.

According to the CBA's 2024 Sustainable Finance Report, initiatives have already been undertaken to enhance the capacity of financial institutions in sustainable finance, including training sessions with IFC experts. Efforts include developing standards for climate-related and ESG risk assessments and ensuring market transparency to prevent greenwashing.

The Report provides four pillars of the sustainable finance roadmap. One, *Raising Awareness and Capacity Building* focuses on educating both financial intermediaries and the public about climate-related and ESG risks. This includes internal capacity building within CBA and external awareness-raising initiatives. Two, *Enabling Environment for Sustainable Finance Flows* involves developing sustainable finance guidance, establishing a taxonomy, fostering green finance ecosystems, and exploring green sovereign bonds. Three, *Integrating Climate-Related and ESG Factors into Risk Management* incorporates climate and ESG risks into the CBA's supervisory framework, financial intermediaries' strategies, governance, and risk management. And four, *Ensuring Market Transparency and Discipline* enhances transparency through climate-related risk disclosures, publishing progress on the roadmap, and setting regulatory expectations for financial intermediaries.

While these initiatives showcase a governmental commitment to transition towards sustainable and climate-friendly practices, in order to meet the ambitious targets and remain in alignment with the SDGs, more efforts will be required, spanning regulatory and policy issues, business incentives and initiatives, as well as garnering public support through targeted awareness campaigns and community engagement.

Green bonds can play an instrumental role in enhancing efforts to achieve these targets; however, the approach must be calculated and holistic as the green bonds market in Azerbaijan is still in its early stages, which poses a number of opportunities and challenges.

Opportunities

Green bonds have significant potential to attract both domestic and international investors interested in supporting sustainable projects. For example, the Dutch government issued a €6 billion green bond in 2019, which financed offshore wind farms generating 3.5 GW of electricity. Similarly, France's €7 billion green bond issued in 2017 was used to expand the Paris Metro, reducing urban emissions, and improving public transportation. These examples illustrate how Azerbaijan can leverage green bonds to fund renewable energy projects, energy-efficient buildings, and other sustainable initiatives, thereby attracting substantial investment.

Green bonds have significant potential to attract both domestic and international investors interested in supporting sustainable projects.

Furthermore, green bonds offer favorable financing terms, such as lower interest rates and longer tenures, compared to traditional bonds. California's $600 million green bond issuance in 2019, which funded the construction of a high-speed rail line, exemplifies the cost-effectiveness of green bonds. This approach could make green bonds an attractive financing option for Azerbaijan's sustainable projects.

Issuers of green bonds are required to provide detailed information about the use of proceeds and the environmental impact of funded projects, fostering investor trust and promoting accountability. For instance, Apple issued $4.7 billion in green bonds between 2016 and 2020, funding energy-efficient upgrades and renewable energy projects, and showcasing the positive impact of such transparency.

Participating in the green bond market also positions Azerbaijan as a proactive player in global efforts to combat climate change. Nigeria's issuance of its first green bond worth ₦10.69 billion ($30 million) in 2017 positioned the country as a leader in sustainable finance in Africa. Similarly, by aligning with international trends, Azerbaijan can enhance its reputation and attract sustainable investors.

Green bonds also integrate Azerbaijan into the global sustainable finance market, improving the country's international financial standing and opening up additional funding opportunities from global institutions. This financial integration can lead to increased investment and collaboration with international partners.

Collaboration between the public and private sectors is essential for the effectiveness of green bonds. Governments can establish favorable regulatory frameworks and incentives, while private enterprises can bring innovation and efficiency to project implementation. Public-private partnerships (PPPs) can leverage the strengths of both sectors, ensuring that green projects are financially viable and effectively managed.

Green bonds can also fund the development of sustainable infrastructure projects such as electric vehicle (EV) charging stations, energy-efficient public buildings, and smart grids. Mexico City's issuance of $50 million in green bonds in 2017, which financed energy efficiency projects in public buildings and reduced energy consumption by 20 percent, thereby demonstrating the potential impact of green bonds on infrastructure development.

Investing in green projects through green bonds can spur job creation and stimulate economic growth. Renewable energy installations, sustainable agriculture, and clean technology innovations generate employment and foster economic resilience. For example, Morocco's $100 million green bond issuance for solar and wind projects has created numerous job opportunities while advancing the country's renewable energy goals.

Developing the green bond market in Azerbaijan also presents several challenges. The market is in its nascent stages, requiring efforts to raise awareness, build capacity, and develop regulatory frameworks.

Green bonds support projects that provide long-term environmental benefits, such as reduced carbon emissions, improved air quality, and enhanced biodiversity. These projects contribute to the global effort to combat climate change and preserve natural resources, aligning with Azerbaijan's environmental objectives.

Challenges

Developing the green bond market in Azerbaijan also presents several challenges. The market is in its nascent stages, requiring efforts to raise awareness, build capacity, and develop regulatory frameworks. In 2023, the CBA conducted its Sustainable Finance Survey, revealing significant barriers: 73 percent of respondents were unaware of sustainable finance activities, 48 percent cited an insufficient regulatory framework, 52 percent pointed to a lack of human capacity, and 23 percent identified a lack of regulatory requirements. These findings highlight the need for comprehensive education and capacity-building initiatives.

Ensuring a robust pipeline of eligible green projects is critical for sustaining investor interest. Targeted investments in research and development are necessary to identify and prioritize viable projects that align with Azerbaijan's environmental and energy objectives.

Green bonds require cross-sectoral collaboration and accurate, transparent data flow. Technologies like blockchain can ensure transparency and accountability in the use of green bond proceeds. Enhanced data governance

and digitalization efforts are also needed to ensure investor confidence. For example, implementing blockchain technology can provide real-time tracking of how funds are allocated and spent, ensuring that projects meet their environmental goals.

Moreover, developing a comprehensive regulatory framework that supports green bond issuance is crucial. Azerbaijan must establish clear guidelines and standards for green bond issuance to align with international best practices. The lack of a robust regulatory framework can hinder market development and investor confidence. Adopting frameworks like the aforementioned Green Bond Principles by the ICMA can provide the necessary regulatory support.

Engaging stakeholders across the public and private sectors, including financial institutions, regulatory bodies, and environmental and climate action experts, is key to fostering a thriving green bond market ecosystem in Azerbaijan.

Building local expertise in sustainable finance is also essential for the growth of the green bond market. Financial institutions, regulators, and market participants in Azerbaijan may lack the necessary knowledge and skills to effectively manage and issue green bonds. Capacity-building initiatives and training programs are needed to address this gap.

Moreover, green projects often involve high upfront costs, which can be a barrier for issuers and investors. Developing innovative financing mechanisms and leveraging international support can help mitigate these costs and make green projects more attractive.

In addition, building investor trust in the green bond market is crucial. Investors may be skeptical about the environmental impact and financial returns of green projects. Transparent reporting, third-party verification, and adherence to international standards can help address these concerns and build confidence. For example, Apple's issuance of green bonds included detailed reporting on the environmental impact of funded projects, setting a standard for transparency.

Furthermore, ensuring market liquidity is essential for the success of green bonds. Developing platforms for trading and tracking green bonds can enhance market liquidity and transparency, making green bonds a more attractive investment option. For instance, the establishment of green bond segments on stock exchanges, such as the London Stock Exchange's dedicated green bond segment, has improved market liquidity and investor access.

Achieving substantial environmental and climate benefits requires a long-term commitment from all stakeholders. Continuous monitoring, evaluation, and adaptation of strategies are necessary to ensure the sustained impact of green projects. This long-term perspective may be challenging to maintain, especially in the face of short-term economic pressures. Implementing robust monitoring and evaluation frameworks, as demonstrated by the World Bank's climate finance initiatives, can ensure ongoing project success and impact.

Strides have been made in the fields of data governance and digitalization in the public sector, particularly through the efforts of the Innovation and Digital Development Agency, under the curation of the MDDT. However, more efforts are needed to streamline and cascade good data governance models that ensure transparency, traceability, verifiability, and accuracy of data related to green bonds-funded projects to ensure investor confidence and simplify collaboration between multiple stakeholders.

Engaging stakeholders across the public and private sectors, including financial institutions, regulatory bodies, and environmental and climate action experts, is key to fostering a thriving green bond market ecosystem in Azerbaijan. Collaboration can lead to knowledge sharing, innovative financing structures, and enhanced market transparency.

Next Steps

To build a successful green finance capacity, Azerbaijan must adopt a systematic approach, addressing regulatory, strategic, and operational dimensions. There are a number of measures that, when taken concurrently, could bring Azerbaijan into the global green bond mainstream. Each will be briefly outlined below.

Developing a comprehensive regulatory framework that integrates environmental and financial policies is essential. Starting with voluntary guidelines for green bonds and progressing towards

mandatory regulations informed by international best practices, such as the Green Bond Principles by the ICMA, will provide the necessary regulatory support.

Collaboration among government bodies, financial institutions, the private sector, and international partners is crucial. Leveraging expertise and resources from international organizations like the World Bank and the International Finance Corporation (IFC) can enhance local capacities and improve access to global markets. For instance, Morocco's collaboration with the World Bank to develop its green bond market has resulted in successful issuances and increased investor interest.

Implementing stringent and transparent reporting standards for green projects will ensure that investors are well-informed about the use and impact of their investments. Introducing third-party verification and auditing for independent assurance of compliance with green standards can build investor trust. For example, Chile's green bond issuance included third-party verification to ensure transparency and accountability.

Developing standardized criteria for what qualifies as a green project, aligned with international classifications such as the EU Taxonomy for sustainable activities, will simplify the identification and approval process for green bonds. Introducing a certification scheme for green projects can further enhance this process. South Africa's Green Finance Taxonomy, aligned with the EU Taxonomy, provides a useful reference.

Training programs for government officials, financial institutions, and project developers are necessary to enhance understanding of green bonds and sustainable finance. Public awareness campaigns should also be conducted to highlight the benefits of green bonds and sustainable investments.

Developing the necessary market infrastructure, including platforms for trading and tracking green bonds, will enhance market liquidity and transparency. Launching pilot projects to demonstrate the viability and benefits of green bonds can create case studies that attract future investments. The Asian Development Bank's support for pilot green bond projects in Vietnam illustrates the potential impact of such initiatives.

Conducting thorough social and environmental impact assessments for all green projects will ensure they deliver substantial environmental and climate benefits without negative social consequences. Implementing robust monitoring and evaluation frameworks to track the performance and impact of green projects over time is essential. The World Bank's comprehensive impact assessment frameworks provide valuable guidance.

By adopting these systematic and comprehensive recommendations along with the implementation of the CBA's Roadmap, Azerbaijan can build a robust green bond market that attracts sustained investor interest, promotes sustainable development, and aligns with global environmental and climate goals.

Strategic Tool

In conclusion, green bonds represent a strategic tool for accelerating Azerbaijan's energy transition and fostering sustainable development. By leveraging the principles of green finance, fostering collaboration among stakeholders, and embracing international best practices, Azerbaijan can unlock significant investment opportunities, reduce carbon emissions, and contribute meaningfully to global climate action.

Green bonds offer Azerbaijan a promising avenue to fund its ambitious sustainability projects, particularly in critical sectors such as energy and transportation. Coupled with digitalization, these financial instruments can significantly accelerate the nation's transition to a greener economy.

By attracting environmentally-and climate-conscious investors and leveraging cutting-edge technologies, Azerbaijan can pave the way for a sustainable future, setting an example for other resource-rich nations aiming to balance economic growth with environmental and climate responsibility. The strategic use of green bonds can ensure that Azerbaijan not only meets its environmental and climate goals but also enhances its economic resilience and global competitiveness in a rapidly changing world. BD

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