Bonds making impact: financing a sustainable future

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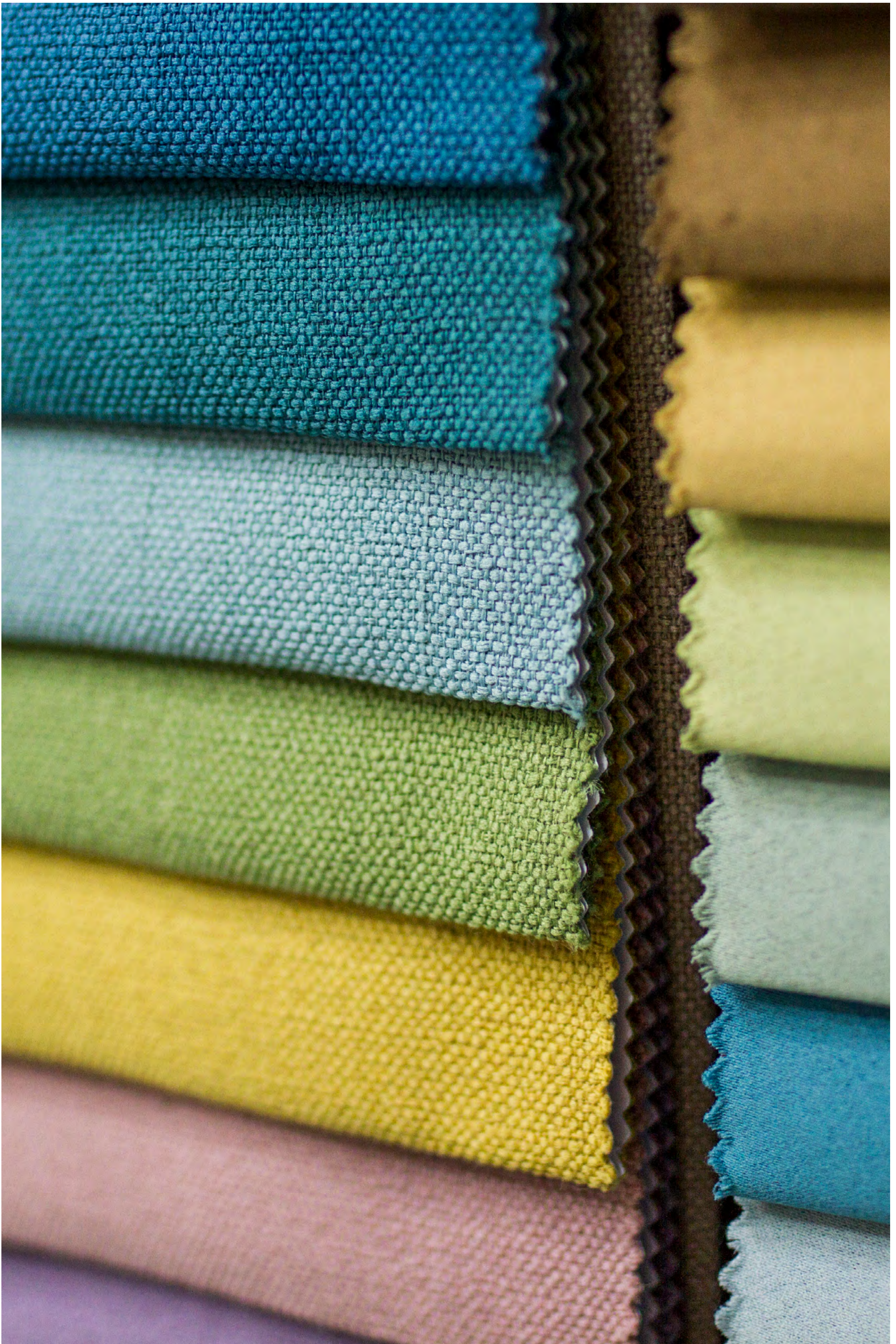


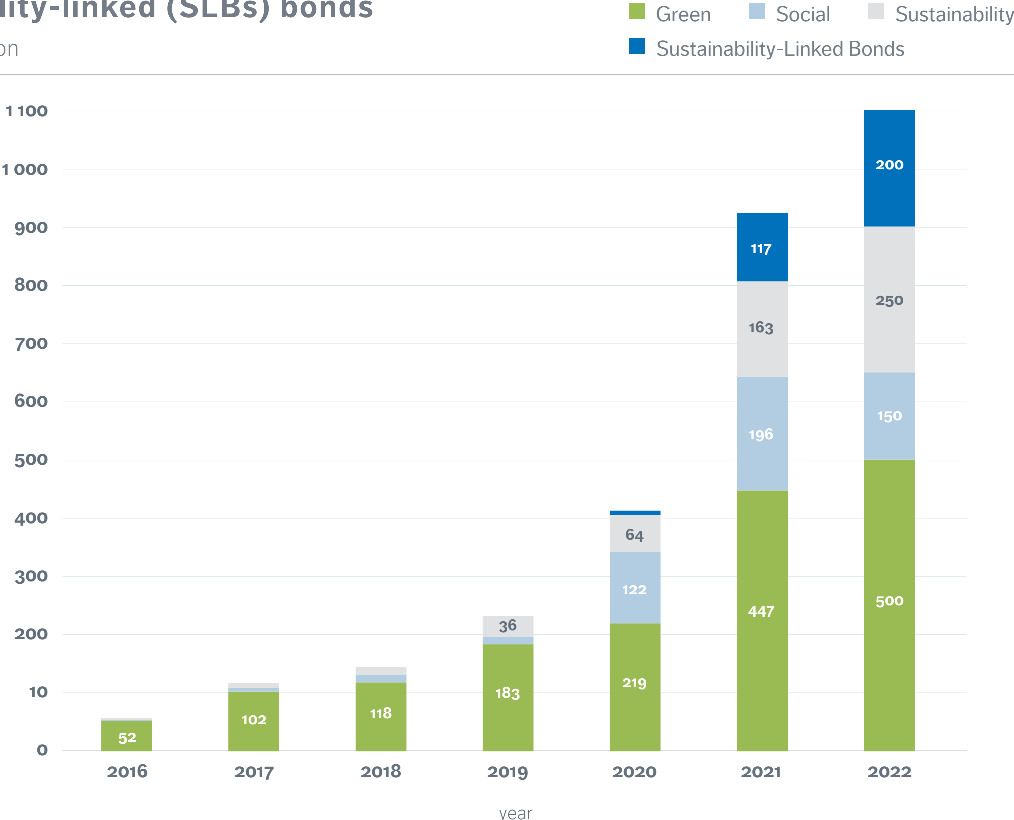
Bonds making impact: financing a sustainable future

In the past few years, bond markets have witnessed the emergence of a new set of instruments that are categorised under the now relatively well-recognised term "sustainable debt". **Sustainable bonds aim to help governments and corporates to raise proceeds to finance specific sustainable activities**.

This new area of fixed income has enjoyed a healthy organic growth (see Figure 1), thanks primarily to its targeted contribution towards the sustainable development goals.

Figure 1: Issuance of sustainable and sustainability-linked (SLBs) bonds

Yearly, USD billion



Source: Candriam, Bloomberg© as at 15/12/2021, Candriam's expectations for 2022.

Narrowing the focus

In the past, sustainable investing in fixed income was mainly about issuers' ESG credentials. By placing project objectives at their heart, sustainable bonds effectively moved the focus of responsible investors from issuers right to the actual environmental/social impact that their proceeds are expected to make.

This provides investors/lenders with the ability to:

- Evaluate the project(s) financed by the bond
- Track the use of bond proceeds
- Assess bond proceeds' overall impact through the entire life cycle of the project

In contrast to traditional bonds, investing in sustainable issues does not just involve a lending transaction. It gives investors an opportunity to actively engage with issuers on project implementation, as well as become an active participant in achieving this objective.

This is one of the most remarkable features of sustainable fixed income – by engaging and monitoring successful implementation, bondholders not only become involved in the process of building a sustainable future but also acquire a sense of ownership and engagement that ordinary bonds simply never offered.

Complexity that requires specialised expertise

Sustainable bonds' focus on objectives also created a certain level of complexity for issue selection decisions. Investing in this area is not without challenges and hence requires a high level of expertise, mainly for the following reasons:

1. Tracking of bond proceeds and project impact evaluation are crucial elements of the investment process. But they depend largely on issuers' ESG corporate and sovereign reporting meeting a certain level of disclosure and transparency for an investor to make an informed decision. Often this is not an easy task because international sustainability reporting standards do not yet exist and investors will have to know how to identify and fill the gaps in reported data (see point 2).

2. There is still a general lack of ESG data across the sustainable bond universe. Investors will need to continuously engage with sustainable issuers to ensure that all the required information is provided.

3. The analysis of issuers and their use of proceeds - two essential elements of sustainable bond due diligence - requires a great deal of specialist knowledge. They are based on detailed and comprehensive frameworks, each tailored to a particular type of sustainable debt.

Coming up...

In this paper, first we explore, in more detail, some of the key points we have just made, define sustainable bonds and introduce some of their **key distinctive characteristics in the way they are structured to make impact**. We examine the **central importance of Key Performance Indicators (KPIs)** and explain **how they hold the key** to different types of bonds.

Many investors and readers have undoubtedly noted the growth of the social bond market. The development of **social bonds** has been accelerated by the COVID-19 crisis which highlighted existing inequalities in the access to basic needs like healthcare, affordable housing, employment and food security.

We will also look at how **sustainable-linked bonds'** key characteristics, such as covenants, are linked to their sustainability objectives. We will also examine the role of the EU Taxonomy categorisation system in this market and future developments. We also consider whether SLBs offer distinct alternative features for some types of issuers who want to address ESG risks.

Finally, we explore the **role of sovereign issuers** across all types of sustainable bonds. The all-important role of governments, both central/national and local, deserves greater emphasis, and so does the importance of asking the right questions when selecting sustainable sovereign bonds.

Across this paper however, **we specifically seek to highlight the importance of detailed bottom-up research**. We believe that rigorous fundamental research can offer investors an effective way to fully understand sustainable fixed income, analyse sustainable issuers, assess their projects and, ultimately, make the right investment decisions that will have the best long-term impact from the sustainability perspective.

Defining the sustainable debt market

One of the less well-known facts about fixed income, by far the largest asset class within financial markets, is that it is the biggest and the most reliable source of capital to governments and corporates for the implementation of Sustainable Development Goals (SDGs)[1]. In comparison, very little new financing comes from capital raised in the stock markets. Sustainable bonds are used to raise finance for specific environmental or/and social projects.

As with most areas of investment, investors will find that sustainable bonds are a collection of different shades in terms of their impact – from light green to really deep rich colours. Some bonds marketed as "green" do not actually belong to that category. To build a portfolio of true and promising representatives of the sustainable universe, an in-depth analysis of their key features is essential, combined with the issuer's sustainability strategy as it can maximise the sustainable impact of the projects or activity being financed.

"Sustainable bonds are a collection of different shades in terms of their impact – from light green to really deep rich colours."

Sustainable bonds, in contrast to most fixed income securities, are forward-looking, performance-based debt instruments, and are linked to a specific set of sustainability objectives.

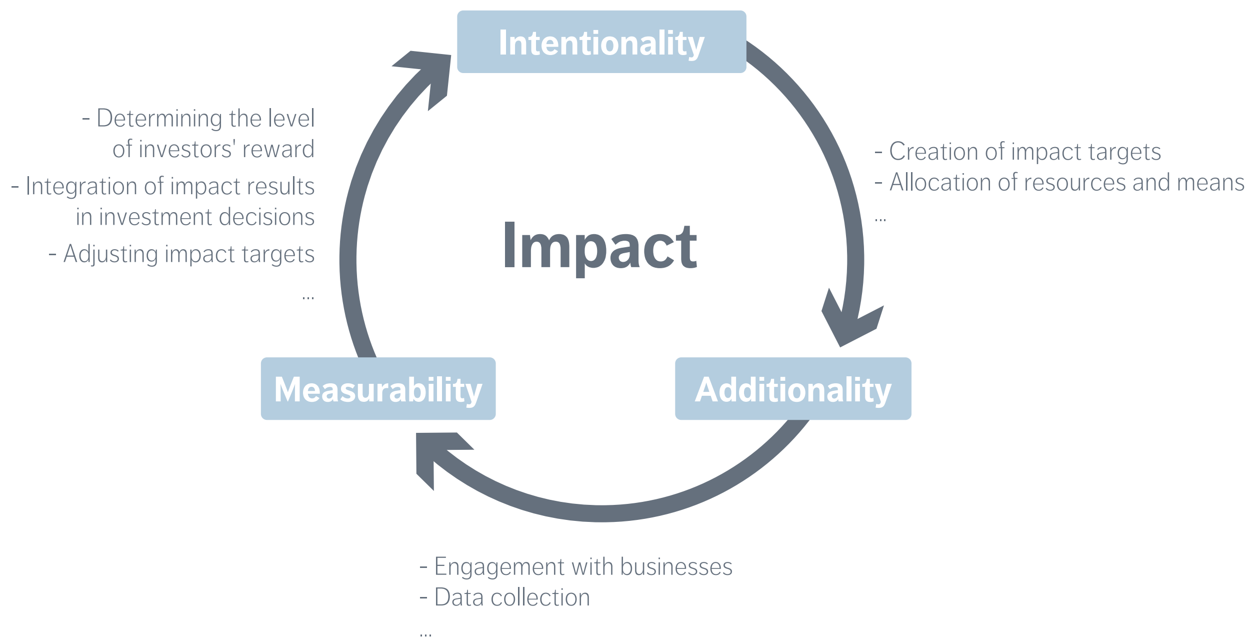
Notion of “Impact”

Impact investments, regardless in which asset class, are made with the intention to generate measurable societal impact – environmental, social, or both – alongside a financial return.

Sustainable bonds clearly come under the definition of impact investments because they aim to **raise money for projects that intend to generate positive, transparent and measurable environmental or social benefits**, alongside long-term financial returns. Sustainable fixed income instruments are regulated and are subject to the same capital market rules as other listed fixed income securities.

Their key impact investment characteristics that analysts should pay attention to are Intentionality, Additionality and Measurability. We describe these elements below in greater detail as they are of vital importance when assessing impact within sustainable debt.

Figure 2: Key characteristics of impact investments



Sources: Candriam, GIIN, May 2022

Intentionality - the intention to make a positive social or environmental impact is what defines impact investing, according to the Global Impact Investing Network (GIIN). This intentionality is at the heart of what differentiates impact investing from other investments that may happen to incorporate impact considerations. Impact investing actively sets out to positively contribute to social or environmental solutions by establishing clear objectives and thorough strategies to achieve these goals ahead of execution[2].

For example, would Iberdrola's "Nunez de Balboa" project - the biggest photovoltaic plant in Europe - have been possible without the company's desire to advance sustainable change? If it was simply part of a refinancing operation, then the project would lack vision and intention to make a real sustainability impact. In reality, the project's strength and ambition, quantified by its mere electricity production capacity of 241 MW, are key indicators pointing to its intentionality.

Additionality is the extent to which desirable outcomes, such as increasing renewable capacities of the electricity network in our example of Iberdrola, would have occurred without the investor's involvement. By mapping out improvements across all levels, it is possible to see the extent to which the investment has contributed to them.

Measurability: the benefits of the investment should be measurable and transparent. Project monitoring is carried out using its KPIs, such as achieving certain levels of reductions in CO_2 emissions or loans granted to SMEs. Adjustment of impact objectives and incorporating the resulting changes in the impact they make in investment decisions is an integral part of enabling measurability. Returning to our example of Iberdrola, assessing the company's renewable energy funding allows investors to measure the benefits of their project, using indicators such as the renewable energy capacity added to the grid (MW) and the avoided CO_2 emissions for each project.

KPIs: at the heart of sustainable debt

Currently there are three types of sustainable bonds: green bonds focus on environmental projects (such as construction of wind turbines), social bonds on social projects (such as better access to clean water, healthcare or education), and sustainability bonds combine both green and social initiatives projects. The proceeds of these types of bonds are used for projects which are linked to impact measures clearly defined through key performance indicators (KPI).

Green bonds are the most long-established members of the sustainable fixed income universe. They continue to dominate this market with a 60% share of outstanding sustainable bond issuance. We approach their analysis by examining the type of projects they aim to finance. This analysis of projects may seem trivial but being selective is key for every impact investor. Some infrastructure projects, for example building airports, might be eligible by market standards, but are not aligned with the Paris Agreement.

One of the examples of the projects aligned with the Paris Agreement include construction of renewable energy infrastructure, such as solar energy sites or onshore/offshore wind energy turbines. Their KPIs may be linked to the estimated installed capacity in gigawatt (GW) or/and the indicative volume of carbon emissions avoided.

Another example are manufacturers of hybrid vehicles, who support the UN SDG11 goals, such as providing sustainable transport. The KPIs of green bonds financing this activity would typically be linked to the reduction of CO_2 that is achieved per vehicle.

In the utilities sector, the use of CO_2/kwh targets as a KPI is a relevant metric in order to measure its alignment with the Paris Agreement on climate.

As we mentioned, the lack of traceability and transparency on the use of proceeds are the two factors that may lead to a lack of impact and consistency in the sustainability strategy deployed, which is why impact reporting is so important.

Our case study looks at a "clean" transportation project financed by a green bond, and shows an assessment of its environmental impact.

Figure 3: Case Study: Assessing Environmental Impact in Transportation

Clean Transportation	Impact
Green Expenditures - Railway Projects The largest rail transportation operator in the Netherlands has 91% of its main track electrified and it uses 100% renewable energy. ProRail, the network infrastructure manager, has taken steps to reduce the carbon footprint while the tracks are being maintained and constructed. By investing every year in the management, maintenance, renewal and expansion of the railways, passengers in the Netherlands are provided with a lower carbon mode of transport.	**5 realised railway projects** in 2018 and 2019 **14,211 km railway track maintained** **3 Investments in 47 projects** in 2018 and 2019

Source: Candriam, March 2022.

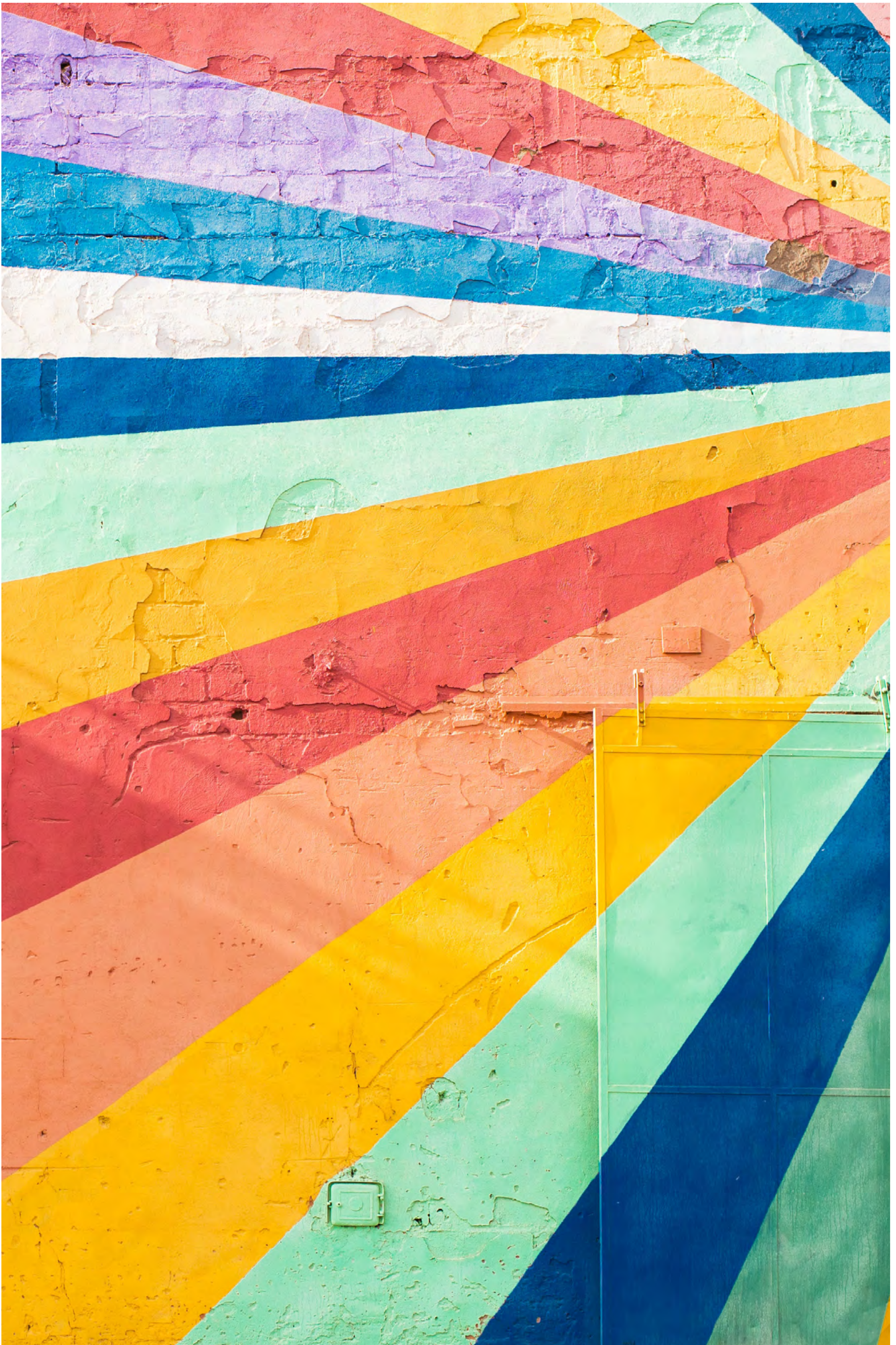
Following the rise of green bonds which focus predominantly on climate change, **social bonds** emerged in response to demand from both public and private issuers around financing positive social outcomes in communities. These can be new or existing projects for instance, aiming to improve access to essential services including basic infrastructure, employment creation and housing development.

If we take the real estate sector, social bonds can be used to finance the construction and renovation of old peoples' homes and hospitals, contributing to SDG 3 (Good Health & Wellbeing) by increasing the number of beds. Other projects can be assessed in terms of the number of jobs created, number and amount of outstanding loans or volume of water saved.

At about the same time as social bonds, we also saw the emergence **sustainability-linked bonds** (SLBs), which fund general corporate activities rather than specific projects and whose coupon is linked to predefined sustainability objectives. They are typically issued by non-financial companies, while other types of sustainable bonds tend to come from all kinds of issuers such as banks, governments, international financial organisations (like the World Bank and EBRD). Among non-financials, this type of bonds is used by less capital-intensive companies that do not have entire green or social projects to finance but instead need to invest to improve their sustainability profile.

For this, issuers raise funds through bonds which contain financial covenants linked to ESG factors. An SLB's coupon depends on a step-up clause linked to KPIs, which are in turn aligned with one or several SDGs; the clause can trigger an increase in the coupon payment if predefined ESG objectives are NOT met. This mechanism was created as a clear incentive for issuers to meet its extra-financial targets.

Impact investing in bond markets is a growing phenomenon which is utilised by investors across the sustainable bond market. That said, as discussed earlier, there are differences in the way green, social and sustainability bonds generate quantifiable impact and achieve material change. In the rest of our paper, we will examine in greater detail social bonds, sustainability-linked bonds and sustainable sovereign issues, and will present several case studies. We will also highlight the importance of an in-depth analysis and the type of questions that investors should ask in the course of issue selection.



Social Bonds

Social bonds have been one of the sustainable bond market's fastest growing segments. Partly it is due to their ability to finance solutions for some of today's big challenges, such as gender inequality, and to support pandemic relief. Social bonds form a crucial element in the delivery of the global 2030 agenda formulated through UN's Sustainable Development Goals (SDGs).

What are they?

As defined by the International Capital Market Association (ICMA), **social bonds are use of proceeds bonds which raise funds for new and existing projects** that address or mitigate a specific social issue and/or seek to **achieve positive social outcomes**[3].

Together with green and sustainability bonds, social bonds come under the general definition of sustainable bonds: forward-looking, performance-based debt instruments, linked to a specific set of sustainability objectives.

Social issues in the ascendant

The COVID-19 pandemic has amplified the importance of social factors, and their impact on asset values is already significant. Investors are increasingly taking social factors into account. Social bonds go one step further - they offer an effective way of addressing social factors directly by financing specific projects.

The first social bond was launched in 2013 – it was the “Banking on Women” bond from the International Finance Corporation (IFC), followed by the “Inclusive Business” bond in October 2014. This market grew quickly since then, with particularly impressive growth seen in the last few years, from less than USD10 billion in 2019 to USD 194 billion in 2021 (see Figure 1).

Social factors affecting corporate issuers cover a wide range of areas, from well-being of employees to relations with local communities. According to the rating agency Moody’s[4], social risks, directly or indirectly, impact issuers of USD 8 trillion of the debt that the agency rates (both corporate and sovereign). This is four times more than the volume of debt which Moody’s believe is affected by environmental risks. We expect that this fact will help the social bonds market maintain the strong growth momentum it has gained during the pandemic.

What can social bonds finance?

The proceeds from social bonds can be used for a wide variety of purposes, making them a potentially powerful driver of social change. For example, affordable housing and essential infrastructure, access to essential services, employment generation, food security, sustainable food systems, and socioeconomic advancement and empowerment.

Social bonds have been crucial in supporting relief efforts of public sector issuers and development agencies, backed by a variety of pandemic and post-pandemic spending plans. Many of these issues financed projects to improve access to healthcare and support job creation, for instance the EU's €100 billion SURE social bond program launched in October 2020 to finance short-term employment schemes and keep people in jobs during the coronavirus pandemic.

During 2020-21, 81% of social bonds' proceeds financed activities broadly fall into three key categories – access to essential services, employment generation and socioeconomic advancement and empowerment. In 2014-19, only 55% of social bonds focused on those areas[5].

Case Study:
Icade Santé

Icade Santé is a leading French investment firm specialising in private clinic facilities. The company enjoys a prominent position in the French healthcare sector, and believes that issuing social bonds is consistent with its growth strategy for the healthcare and elderly care sector.

Icade Santé's activities contribute to UN SDGs and its investments are in line with sustainability policies. Among the eight SDGs defined by Icade Santé as being a priority, two are of particular relevance: SDG 3 – Good Health and well-being and SDG 10 – Reduced Inequalities.

The company issued their first €600 million Social Bond in 2020. It has already refinanced investment projects carried out between 2017 and 2019 throughout France, benefiting 77% of acute care facilities. See Figure 2 for an example of how social bonds can be used successfully to support long-term investment efforts in the healthcare industry.

Figure 4:

	Medical Care Facilities	Elderly Care Facilities
Allocated Amounts	€459m (76.6%) in Acute Care €40m (6.7%) in Post-Acute Care €10m (1.6%) in Disability Care Home	€91m (15.1%) in Nursing Home
About the project	Acquisition and development of acute care, post-acute care and disability care homes of around 179,608 sq m in total. The demand will be driven partially by an increase in outpatients. The average outpatient ratio for France is set to increase from 57.8% in 2018 (according to According to Agence Technique de l'Information sur l'Hospitalisation, to around 70% in 2022, which is the target set by the French Ministry of Health.	The acquired nursing homes cover a floor area of 28,052 sq m and, unlike other nursing homes, almost all of them have a dementia special care unit, intended in particular for elderly people suffering from Alzheimer's disease and related illnesses.
Case Study	**Development of Reims-Bezannes polyclinic** €36.3m in proceeds from the Social Bond was used to finance the development of the Reims-Bezannes polyclinic. It operates largely on an outpatient basis (72%) and has 26 operating theatres. The polyclinic's building was rated Excellent" for the highest energy and environmental performance in terms of comfort, health, water and air quality. It is one of the largest healthcare facilities in its region. It received the 2019 MIPIM Best Healthcare Development Award, recognising the quality of its eco-design, cutting-edge technologies and functionality. The Polyclinic also boasts the Reims Sustainable City label. Dedicated to acute care, the healthcare establishment consists of a private hospital and two buildings housing doctors' offices, a medical laboratory and a medical imaging and nuclear medicine centre.	**Acquisition of the Les Séolanes nursing home, Marseille** The Les Séolanes is a 129 bends nursing home of 5,081 sq m in Marseille was acquired for €20.1m. Built in 1958, it was subsequently expanded and renovated in 1991 and 2010. It is located in the Bouches-du-Rhône department which has a nursing home bed-to-population ratio of 119 beds per 1,000 people 75 and over, i.e. around 20% less than the median for French departments (at 151 per 1000 people). Therefore, the company makes a positive contribution by increasing the supply of care for dependent elderly people in their region.
Impact Indicators	3,375 beds and places 223,458 stays 4,846,000 people served by facilities in France	638 beds and places 97% average occupancy rate 620 residents

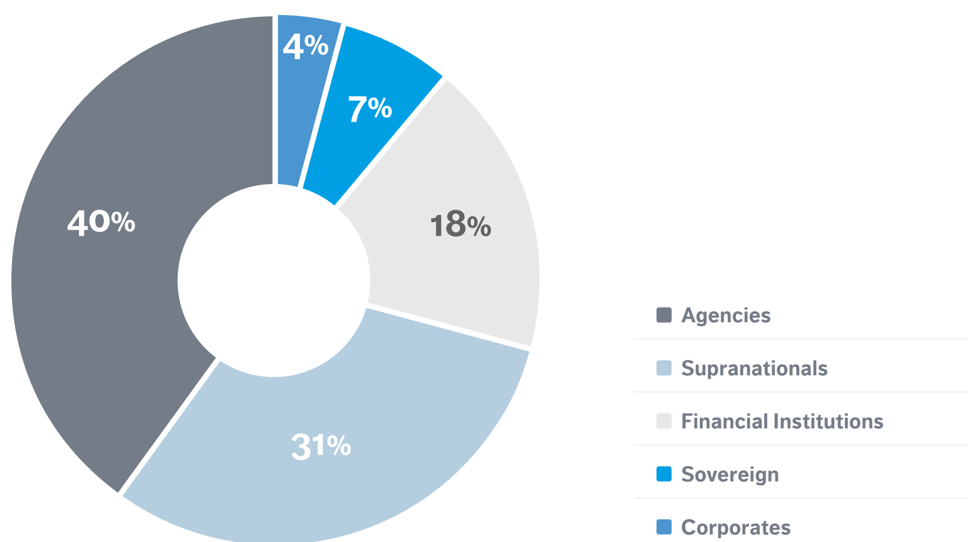
Source: Candriam, March 2022

The multifaceted role of financial institutions

Following the Social Bond Principles (SBP) published by the IMCA in 2016, the first in the new wave of investors in social bonds were public financial institutions. They included supranational organisations like the International Finance Corporation (IFC), governmental bodies like the Spanish Instituto de Credito Oficial and local authorities like the City of Madrid (see Figure 5).

The social bonds market is not as mature and diverse as the green bond market but it is growing fast. Euro-denominated issues accounted for 71% of all new social bonds in 2021, while agencies and sovereigns represented almost three quarters of the total from a sectoral perspective.

Figure 5: Share of 2021 global social issuance by issuer type



Source: Moody's ESG Solutions and Environmental Finance Bond Database as at 31.12.2021

Development banks' three hats

Issuers: Development banks typically borrow on private capital markets at favorable financial terms, which they can obtain due to the backing of governments and their high credit rating. They can use the proceeds of their bond(s) to fund green, social or other sustainable projects within their loan portfolios.

Anchor investors: Public development banks can play the role of an anchor or cornerstone investor for issuances. Their participation can enhance the perceived credibility of the issuer and strengthen the market by reducing perceived risk for private investors.

Support policy reform: Public development banks can also assist market regulators in the development of national sustainable bond frameworks, as well as support initiatives aiming at developing local capital markets infrastructure.

"Public development banks can play the role of an anchor or cornerstone investor."

Appeal to institutional investors

There is a common misconception that investing in social bonds comes at the expense of returns. In fact, the risk-return profile of a social bond is in line with that of a vanilla bond from the same issuer. The bond's social impact is an independent non-financial added value.

Social bonds can also help diversify the bond investor base by including buy-and-hold investors. This can help enhance both the company's reputation and its appeal to stakeholders[6].

Another attractive feature for institutional investors is that social bond issuers are strongly encouraged[7] to provide a certain level of annual reporting on the use of proceeds, with the description of the social projects the bonds are financing. This leads to better transparency around the use of proceeds and reduces the likelihood of "impact washing". It is true that there are still no accepted reporting standards for sustainable bonds. However, the EU is currently considering and consulting on new social taxonomy rules that may ultimately result in new reporting standards.

Towards Social Taxonomy

In July 2021, the social taxonomy subgroup of the EU Platform for Sustainable Finance published its first draft report on Social Taxonomy. If enacted, the new rules may give a much-needed focus on the social objectives of sustainability.

In response to public feedback, the Subgroup on Social Taxonomy decided to align their framework more closely to the EU's environmental taxonomy, which entered into force in July 2020. The proposed social taxonomy's original structure of the horizontal and vertical activity dimensions (essential activities and those related to human rights) was abandoned in favour of three objectives covering three major stakeholder groups:

Workers: decent work (including value-chain workers), including social dialogue, health and safety, and living wage.

Clients: adequate living standards and well-being, including healthcare, social housing and education.

Communities: inclusive and sustainable communities and societies, including basic economic infrastructure and helping people with disabilities participate in the life of their society.

However, there will be an important difference between the social and environmental taxonomies. Unlike social objectives, most environmental objectives and technical screening criteria can be determined and assessed based on science around climate change and nature conservation. In contrast, social objectives and screening criteria will be inevitably more subjective.

We are convinced that sustainable finance taxonomies will play an increasingly important part in directing capital to sustainable activities. They are expected to form the basis for the SDG investment fund labelling schemes, sustainable classification to company activities, and certification of green and social bonds issued under the proposed EU standards.

Sustainability-Linked Bonds (SLBs): an alternative to sustainable bonds?

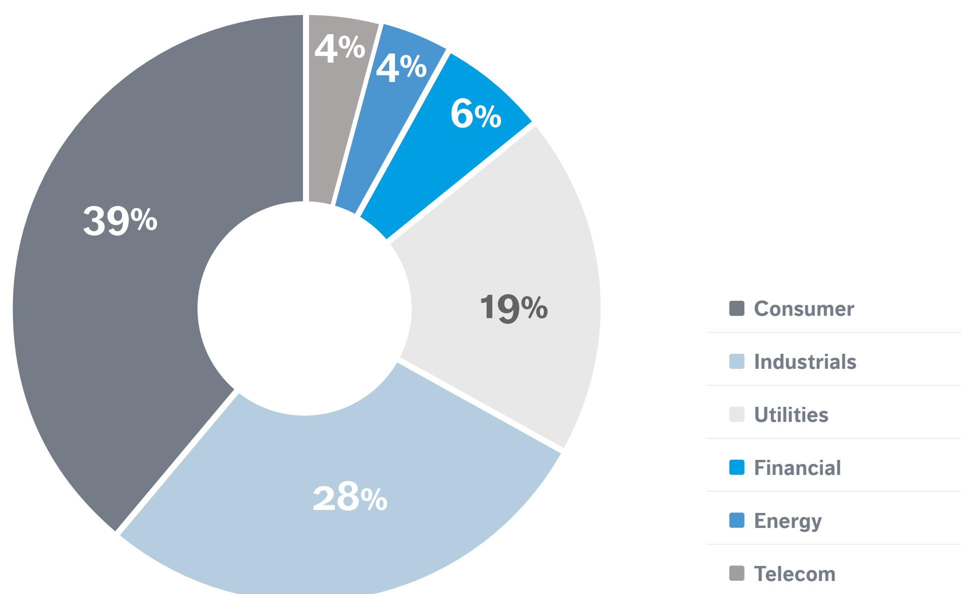
Since the publication of the Sustainability-Linked Bond Principles by ICMA in June 2020, the market of sustainability-linked bonds grew to USD 125 billion[8].

These bonds have become a popular vehicle, especially among non-financial companies, and we expect USD 200 billion of new issuance in 2022. According to the data available at the time of writing, 90% of SLBs issues are from non-financial companies (45% of their issuance was in high yield and 50% investment grade), with the consumer, industrial & utilities sectors represented particularly well.

SLBs are also supported by the European Central Bank and, as from 1 January 2021, are eligible to be used as collateral. They can be used as a guarantee for a creditor to obtain funds and can participate in credit operations in the Eurosystem. They are also potentially eligible for monetary policy purposes subject to compliance with specific eligibility criteria for them.

The SLB market growth was also helped by the EU Taxonomy classification system. Issuers of SLBs are encouraged to reference and benchmark their sustainability performance against the EU Taxonomy's technical screening criteria (TSCs), which may also be used as the bond's formal KPIs or its Sustainable Performance Target (SPT) calibration.

Figure 6: The main issuers of sustainability-linked bonds, by sector



Source: Candriam and Bloomberg as at December 2021

How different are SLBs from green and social bonds?

In contrast to green, social and sustainability issues, SLBs have financial covenants that are linked to predefined environmental or social or sustainability objectives within a timeline. Unlike sustainable (green, social and sustainability) bonds, **SLBs are used not to fund specific projects, but general corporate advancements in order to meet specific sustainability objectives.**

SLBs offer **more flexibility** for issuers who cannot identify eligible assets or expenditures to be earmarked for funding and reporting. The SLB's structure incorporates measurable forward-looking sustainability KPIs and sustainable performance targets. Their approach is more direct and effective, with a clear focus on issuer sustainability strategy and its alignment with the Paris Agreement.

A good alternative to sustainable bonds?

As we mentioned previously, SLBs can be a good alternative to sustainable bonds for issuers that are less capital intensive. They can also be used in combination with green and/or social bonds to optimise the financial structure of the issuer's credit requirements.

An issuer can use SLBs to link sustainability efforts not only to the usual business activities, but also to their financial structure. These bonds can help businesses diversify the financial instruments they employ and broaden their investors base. For example, Enel, a well-known green bond issuer, has also issued SLBs to add to their offering precisely for these reasons.

SLBs can also be an effective vehicle for communicating the details of the issuer's strategic sustainability activities according to a specific timeline, particularly for the sectors with the most challenging sustainability profiles, such as shipping.

Case study:
Norwegian seaborne transportation company

The Norwegian provider of seaborne transportation and storage of chemicals, Odfjell, issued an SLB linked to reducing carbon intensity by 50% between 2018 and 2030. Sea transportation is essential to global trade, but it will need to be transitioned to a carbon-neutral basis. Odfjell's SLB framework can help the market learn about its shipping fleet replacement, technical improvements and the use of an alternative fuel. However, if the targets for the CO_2 emission reductions contained within the bond are missed, investors will be paid 1.5% (in Norwegian krone) extra on the principal amount lent, at the bond's maturity in 2025.

SLBs can be subject to quite sophisticated financing engineering. NextEra Energy, an American energy company issued a hybrid bond which combines the features of both conventional green bonds and SLBs. The bond structure follows the ICMA Green Bond Principles (GBP) and ties the bond's proceeds to specific renewable energy projects. However, like a SLB, the bond also contains a stipulation that if the company fails to fully allocate the proceeds within two years, investors will receive a 0.25% interest premium until maturity. Furthermore, projects must become operational within 12 months after issuance, or be subject to higher coupon rate. These features were included to add a layer of accountability compared to conventional green bonds.

Analysing SLBs: How robust are they?

Before delving into the details of the KPIs, which are linked to the SLB's coupon, an investor should first assess the ESG quality of the issuer in question. This will help to establish the ESG profile of the company and get a clearer idea of how likely it is to achieve it KPIs contained within the bond. The alignment of KPIs with UN SDGs could also demonstrate the validity of the issuer's sustainable strategy and be a testament to their ambition.

The bond's KPIs need to be relevant, material, consistent and sufficiently ambitious. It means that they should be both consistent with the issuer's strategy and relevant to the business activity and based on an external benchmark reference. Any KPIs related to climate should be aligned with the company's carbon neutral target by 2050 (1.5 degrees scenario). They should also focus on the key emission scopes, which might vary for each given issuer and sector. Comparison with peers based on a track record of 3 years will help. Sustainability Performance Targets should be well defined, with certain level of granularity as measurable objectives for KPIs on to which issuers commit to a predefined timeline.

Let's take an example of SLB based on decarbonisation KPIs. An issuer in the utilities sector can use CO_2/kwh targets for the bond's KPIs to measure its alignment with the Paris Agreement on Climate. However, an issuer in the industrial sector will instead apply reductions under scope 1 & 2 of Greenhouse Gas (GHG) emissions. At the very minimum, targets should be set either in line with science-based scenarios or other official system, such as the EU Taxonomy for sustainable activities.

If we take a retailer, for example, then reducing food waste will probably be their the most relevant KPI in relation to the Paris Agreement objectives. A healthcare provider may find that the social objective of improving patient access will be the most relevant for its sector.

The issuer needs to report regularly on the progress made towards achieving the KPIs, ensuring high transparency in all calculations, perimeter and scope, to avoid misinterpretation. An external verifier can provide an independent review and ensure that reporting is done to an expected general standard.

The question of insufficient financial compensation

As forward-looking performance-based instruments, SLBs help demonstrate issuer's integrity in respect to its sustainability ambitions. The company intends to impose a financial implication for the non-achievement of one or both KPIs by increasing the coupon. On the SLB market, the current (as of January 2022) average standard increase is 25 basis points in the coupon rate. It represents, on average, 16% of the coupon rate (1.50% as of today)[9]. The small 'penalty' may not incentivise management enough to reach their sustainable performance target.

However, set a much higher compensation and your issue may attract a different type of investor, such as credit arbitrage specialists, whose only interest would be financial. So what is the right answer?

At Candriam, we believe that 25 basis points of extra coupon seems insufficient as it does not compensate for the reputational risk linked to the non-achievement of the bond's sustainability-linked objectives. For impact investors, selecting the bonds aligned with realistic sustainability-linked objectives is a bigger focus than chasing return. That is why we spend considerable amount of time and resources in monitoring closely the issuer's progress in achieving its pre-defined KPIs. Any disruption observed in the sustainable performance target trajectory or any specific ESG issues could potentially jeopardise the achievement of the bond's KPIs.

Transparency and reporting

The success of SLBs will also depend on issuers' quality of disclosure. With the absence of industry reporting standards for sustainable investments, issuers should strive for better transparency and reporting. These two elements will be crucial for maintaining the integrity and credibility of this growing market. Investors need to carefully scrutinise SLB's KPIs to verify that they are ambitious and robust enough and ensure they can be easily confirmed and tracked.

It is important to remember that SLBs' flexible structure means that investors will have lower visibility and less concrete data on the use and potential impact of bond proceeds. However, we must not underestimate SLBs as they play a very important role – they allow a direct and effective view of the issuer's sustainability strategy to all stakeholders.

The role of Sovereigns in Sustainable Debt

With the increasing urgency of meeting the Paris Agreement's climate objectives, governments around the world find themselves with a bigger burden of responsibility. A large part of their job today **is helping households, banks and companies to align closer to UN's sustainable development goals.**

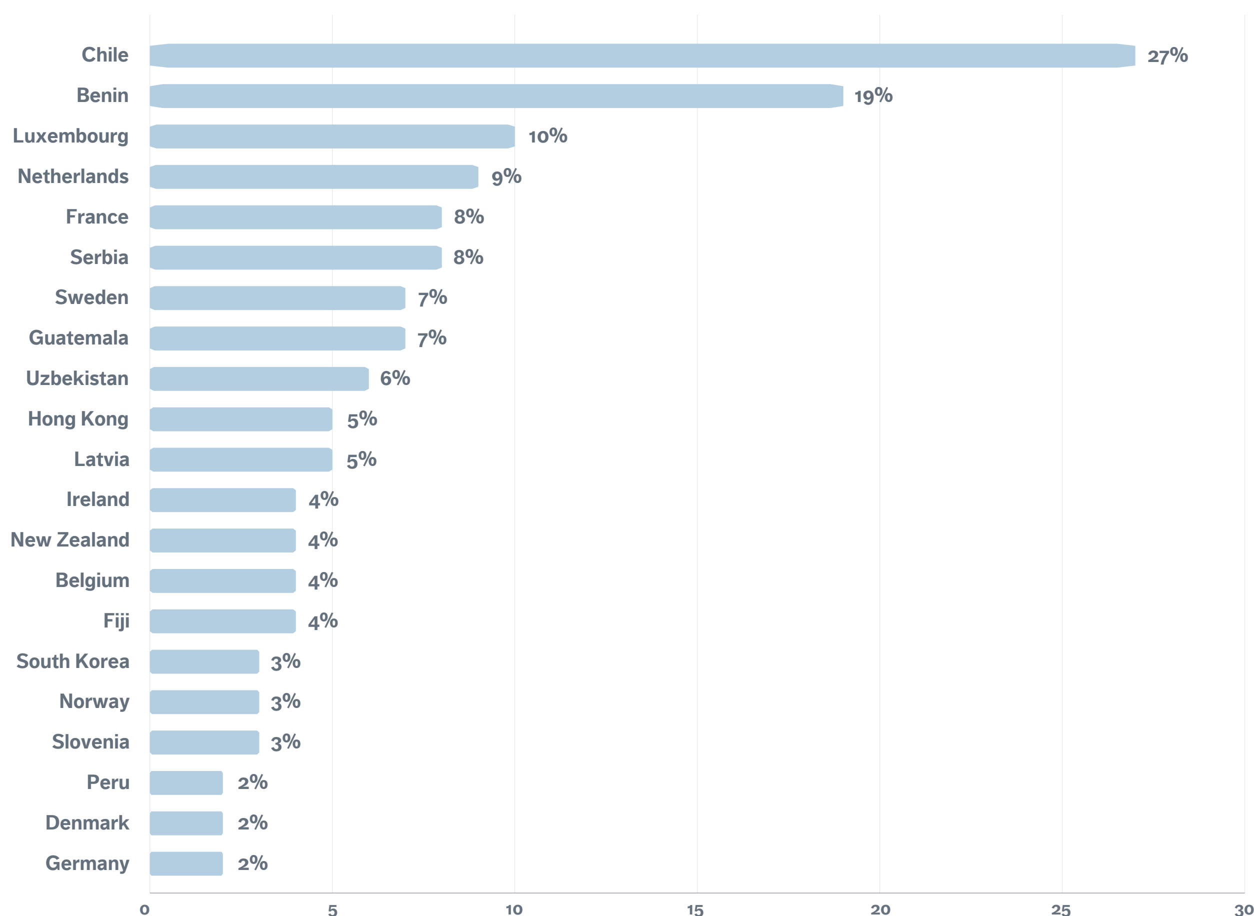
All types of authorities will have different parts to play in implementing the 2030 agenda – including local and regional governments, and various agencies. The success of this big task will depend a lot on the effective cooperation of cities, regions, supranational agencies and governments. Furthermore, these different entities employ sustainable bonds to raise funds for a multitude of different projects and initiatives.

About a third of the sustainable bond universe

Out of the total global universe of sustainable debt, government and sub sovereign bonds currently represent about 35% of the global universe. About 30% of this slice came from national governments and 70% is issued by supranational bodies, regions and agencies[10].

Figure 7: Most active national government issuers in sustainable debt

Sustainable issuance as share of the country's total government bond issuance



Source: Bloomberg and Candriam as at February 15 2022

Currently (see Figure 7), the Chilean sustainable debt accounts for about 27% of the total Chilean debt issuance. Luxembourg, the Netherlands and France are leaders among the developed economies. Luxembourg was the first European country to issue a sustainable bond in 2020, and then Slovenia in 2021. Over the past two years they were followed by Germany, Britain, Italy, Spain, the European Union and Denmark. Greece and Cyprus are planning to issue green bonds later in 2022.

Key Benefits

High **transparency** is sustainable government debt's key advantage. Linking debt with specific social or environmental type of expenditure ensures both the fulfilment of the bond's objectives and the ease with which the bond's proceeds can be tracked.

For each new sustainable bond issued, the government needs to sets-up a process to report about the allocation of proceeds as well as about the latest progress of the project that is being financed. The sovereign issuer will then need to quantify their project's impact and external verifiers are contacted to provide audit.

Another feature of sustainable government bonds is that they typically **contribute to larger strategic initiatives and support a local model.** Often, these sustainable bonds are linked to net zero target, address UN SDGs, or objectives related to the mitigation of climate change, and the reduction of carbon emissions at the national level. Sovereign issuers can hence serve as a model or example for other type of issuers and support the economy.

Finally, these bonds benefit the governments themselves as they contribute to a **greater policy coordination.** For example, discussions around the bond issue between the Ministry of Finance, Debt Management Office and the environment minister can raise awareness of specific sustainability issues in government. Moreover, if a bond is a successful, the resulting positive dynamic creates a momentum across the relevant government departments to find other sustainable projects.

Sub-sovereign debt: the role of local government

Local government will play an important role in building a more sustainable world of the future. According to a survey by CEMR, while 69% of the countries questioned have national sustainability programmes, 78% of these countries recognise the need to be supported by local governments[11].

In France, for example, Caisse d'Amortissement de la Dette Social (CADES) finances the deficit of the French social security system. It issued social bonds amounting to USD77 billion, to finance better access to healthcare, cover work-related accident expenses, as well as the expenses related to the elderly and families. These bonds are focused on improving social conditions in France over the long term.

Other examples of successful sustainable bonds issued by local government include the City of Madrid in Spain and the Canadian Province of Ontario. The proceeds were used to fund sustainable projects focused on public transport, energy efficiency, social development and climate change.

Ambitions for the Future: Next Generation EU?

The Next Generation EU (NGEU) fund is a European Union economic recovery package that supports member states adversely impacted by the COVID-19 pandemic. About a third of this package goes to the European Green Deal, the main objective of which is to transform Europe into the world's first carbon neutral economy.

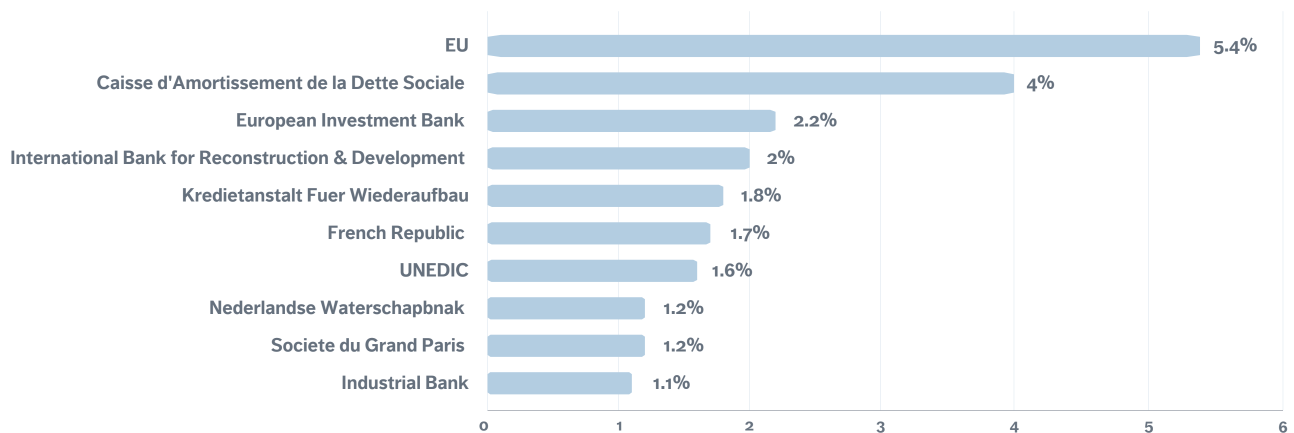
The EU used social bonds to raise nearly €90 billion to finance its SURE programme which supported jobs and kept people in work during the pandemic. Now the EU Commission will, once again, issue sustainable bonds to fund NGEU.

The NGEU package of €750 billion will help build a post-COVID EU that is greener, more digital, more resilient, and better fit for the current and forthcoming challenges. The NGEU package consists of loans €360bn and grants €390bn. The EU will become the largest green bond issuer worldwide. The European Commission will lend most of the NGEU proceeds to EU countries under the Recovery and Resilience Facility (RRF). The funds under the RRF will be distributed according to the national recovery and resilience plans prepared by each Member State and in line with an agreed allocation key. 26 countries have submitted plans and 19 have received positive assessments so far.

EU, the world's sustainable bond champion

The European Investment Bank (EIB), the lending arm of European Union which issued its first green bond in 2007, will use its resources to support the European Green deal. Among others, EIB plans to align green finance with EU taxonomy and increase the share of green financing to 50% of all its new annual operations by 2025. So far, the EIB has issued about USD40 billion of sustainable debt (see Figure 7 for comparison)[12].

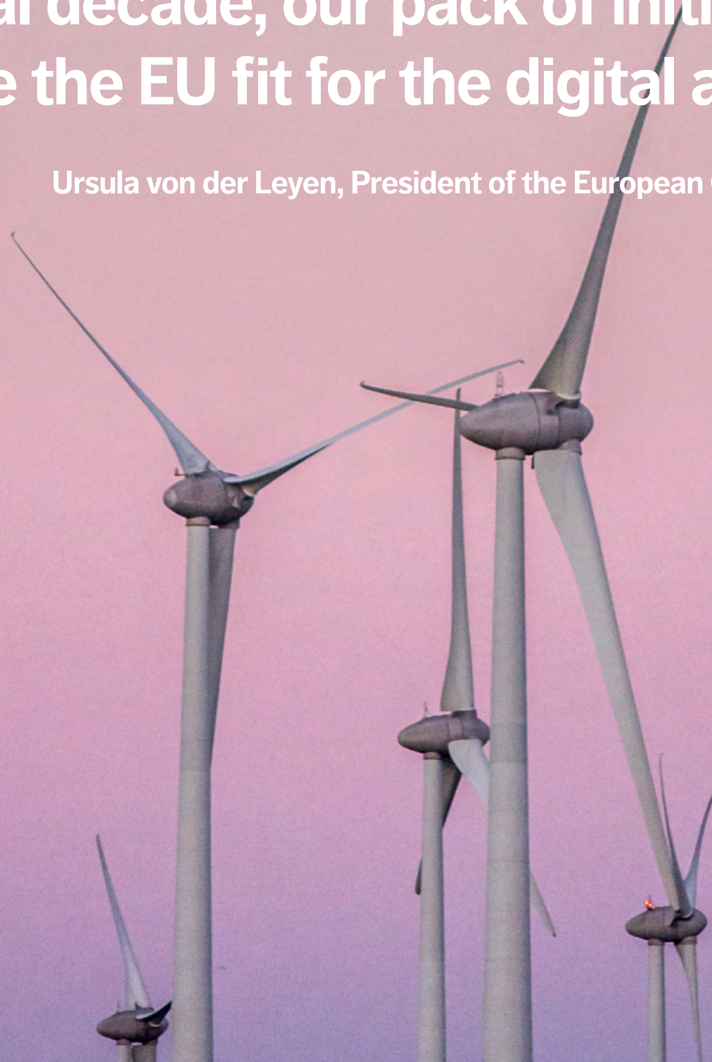
Figure 8: Share of global sustainable debt issuance by the largest issuers



Source: Bloomberg & Candriam as at December 2021

“The pandemic has taken a heavy toll on the economic and social fabric of our society. But this can serve as an opportunity to build a better Europe, impervious to future crises. The Commission is taking decisive action to shape Europe’s post coronavirus future with the European Green Deal, our green growth strategy and Europe’s digital decade, our pack of initiatives to make the EU fit for the digital age.”

Ursula von der Leyen, President of the European Commission



Use of Next-Gen Proceeds:
Example of France[13]

By August 2026, **France** will be in receipt of €39.4 billion in grants to finance reforms and investments. 46% of these funds will go to support climate objectives and 21% will finance digital transformation. After the adoption of this plan in July 2021, France has already received €5.1 billion in August 2021, followed by the EU's first assessment of satisfactory fulfilment last year.

With its climate objectives in mind, France will allocate €18 billion to green investments, including building renovations, sustainable transport and low carbon hydrogen. It is expected that about 400 000 households will benefit from help to renovate the buildings where they live.

In the context of digitalisation, €8.4 billion will go to cybersecurity, cloud, digitalisation of schools, public services and fibre. It is expected that 45 000 classrooms will be equipped with digital solutions.

In order to support social and economic resilience, €13 billion would be injected to foster jobs and training for young people, modernisation of the health system and reform governance of public services. For example: it will finance 337 000 youth targeted hiring subsidies[14].

Use of Next-Gen Proceeds:
Example of Spain[15]

Spain is set to receive €69.5 billion in grants to finance reforms and investments by August 2026. 40% of that funding will go to support climate objectives and 28% will fund the country's digital transformation. Since the plan was adopted in July 2021, Spain already received €9 billion last year[16].

In terms of green investments, Spain will allocate €27.8 billion to energy efficiency of buildings, sustainable mobility projects including charging stations, green public buses, clean technologies and infrastructure and measures to protect biodiversity and develop circular economy. For example, 500 000 residential buildings will be renovated to reduce energy by 30%.

Spain will allocate €19 billion to digitalisation of public administration, skills, inclusion, cybersecurity, and connectivity. For example, 300 000 students from low income families will receive portable computer devices. And 240 000 classrooms will be able to use hybrid learning.

As part of its economic development objective, Spain's plan aims to improve employment opportunities for young people, help with better vocational training, support public policies and assist with tax system modernisation.

Sustainable Debt: Lynchpin in ESG investment

Sustainable bonds emerged less than a decade ago, but their impact is already being felt across the globe. They are gaining prominence within national and regional governments, international financial institutions and corporates as a source of financing for a sustainable future.

The targeted and specific nature of these innovative bonds have made it possible for them to be used by issuers for achieving their sustainability goals. For investors, sustainable bonds offered a way of tracking the use of proceeds, the progress of the projects they financed, and measure the all-important impact of those projects.

This latest innovative development in the evolution of fixed income offered investors a greater involvement through deeper analysis and ongoing monitoring of extra-financial, sustainable aspects of debt.

Helping to be at the forefront of change

The COVID-19 pandemic had emphasised environmental risks and placed social factors centre stage, accelerating sustainable trends across global markets. To keep up with the evolving markets, issuers in many sectors and industries have also had and continue to make changes to their business models. Sustainable debt has proved to be a very popular and useful tool fixed income investors **not just to participate in the change, but also accompany issuers in their transitions.**

Better diversification

As the sustainable bond market continues to grow and gain maturity, it is also becoming an increasingly important source of long-term diversification and yield. The emergence and development of several distinctive types of bonds within the sustainable universe offers investors a more diverse choice of performance drivers. The growing issuance, size and investor interest in such instruments all point to their future importance. Vitally, their targeted nature allows them to make a sizable and quantifiable impact not just on the fixed income universe but on societies at large.

The force of their contribution to sustainable objectives is fuelled by an objective-targeting structure of these bonds, which is distinctive but adds complexity. That is why to invest successfully in this area requires significant expertise. While a good understanding of the market is very important, a bottom-up approach based on fundamental research of the issuer is also vital.

Proximity to the market enables us to get a clear view on the ever-evolving regulation that it is subject to and that has material consequences on the individual instruments. Fundamental research helps to fully understand the issuer's sustainable profile and creditworthiness, as well as the specific nature of the debt issuance. It allows us to evaluate the pertinence and ambition of the projects, their potential impact and contribution to the sustainable development goals as well their ability to deliver upon their objectives at maturity. The close monitoring through a thorough study of reporting on company and the project, while constantly re-assessing the issue ensures that we track the progress, ensure fruition, and ultimately assist the issuer in fulfilling its objectives.

Sustainable bonds have certainly been a key innovation of a new era of investing, and their distinctive objective of contributing to building a sustainable future ensures a prominent place in the financial markets. They offer a partnership between bond issuers and investors, to better facilitate a move towards a better and more sustainable market and society.

Albert Einstein once said "We cannot solve our problems with the same thinking we used when we created them." We believe that sustainable debt goes well beyond the traditional fixed income assets and even beyond the traditional ESG investing. From investors, they will requires a different, more sophisticated, and expertise-intensive approach.

Notes & References

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