

# A short history of labelled bonds

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**Labelled bonds — such as green, blue, social, sustainable, transition and sustainability-linked bonds — which promote sustainability and better Environmental, Social and Governance (ESG) performance, are becoming an important part of financial markets and highlight the key role debt markets can play in funding and inspiring companies to contribute to sustainability. This document provides background on labelled bonds and explores key considerations associated with their use.**

As an increasing number of investors look to align their portfolios with sustainability goals globally, it is important to understand how labelled bonds may help to achieve ESG as well as risk-return objectives in portfolios. Green, sustainable or sustainability-linked bonds (SLBs) for example can help mitigate climate change risks as well as have the potential to generate attractive risk-adjusted returns, although in our view the pricing of late is definitely on the expensive side. Social bonds on the other hand can finance new and existing projects with positive social outcomes. Hence, labelled bonds can help align investors' asset allocations with their ESG and performance objectives. These instruments are not just available within sustainable and impact strategies, integrated ESG investors use them as well, if the pricing is attractive.

While all labelled bonds aim to promote sustainability, there are two distinct groups; Use of Proceeds (UoP) and KPI<sup>1</sup>-linked general purpose bonds:

- UoP bonds, such as green or social bonds, fund projects with specific and dedicated environmental and/or social benefits. Adhering to standards and predetermined UoP categories is key to understanding their impact.
- KPI-linked bonds, such as sustainability-linked bonds, do not finance particular green or social projects but rather the general functioning of an issuer that sets ambitious, realistic and explicit sustainability targets at the overall company level. The coupon payments are linked to meeting their sustainability performance targets (SPTs).

There has been much debate among investors in recent years about whether UoP bonds are 'enough' to finance the transition, whether the market needs so many labels and how these instruments should be structured to avoid 'greenwashing'. In the next section we look at some key events that led to these labels and the debates about how we may use them.

## Green roots

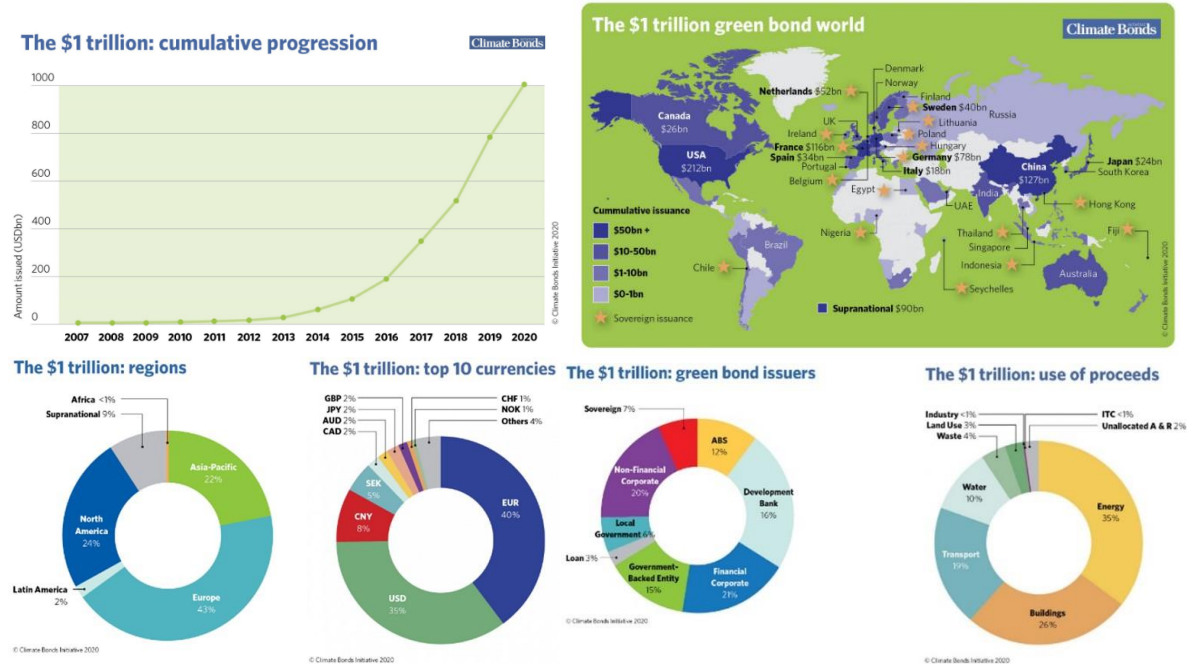
In 2007, the UN Intergovernmental Panel for Climate Change published a report linking human action to global warming, which added further weight to the growing body of data. This prompted a group of Swedish pension funds to think about how they could use the savings they were stewarding toward a solution and invest in projects that help the climate. They asked their bank (Skandinaviska Enskilda Banken — SEB) and the World Bank for help. A year later, the World Bank issued the first green bond, and with it, created a new way to connect financing from investors to climate projects.

Ensuring investment and capital raising for sustainability projects has materially helped advance positive environmental outcomes. It defined the criteria for projects eligible for green bond support, included CICERO (Centre for International Climate Research) as a second opinion provider, and added impact reporting as an integral part of the process. This also piloted a new model of collaboration among investors, banks, development agencies and scientists. It also formed the basis for the Green Bond Principles (GBP) coordinated by ICMA (International Capital Markets Association) and highlighted the social value that bonds could create and the need for a sharper focus on transparency. ICMA also instituted voluntary guidelines for social bonds, sustainability bonds and sustainability-linked bonds issuance.

Issuance has been growing fast in recent years but 2020 was a crucial year for the labelled bond market. The green bond market saw over US\$250bn issuance and passed the US\$1 trillion milestone in terms of issued bonds since 2007. The social bond market saw a seven-fold rise in the value of issuance compared with the previous year. The European Union (EU) started issuing SURE<sup>2</sup> bonds in 2020 to fight the COVID crisis, which was a significant development for the social bond market. Several large economies announced

green government bond programmes and the first sustainability-linked bonds based on the new Sustainability-Linked Bond Principles (SLBP) started coming to the market.

## Green bond issuance since 2007



Source: CBI, Climate Bonds Initiative; Author: Liam Jones; as at 15 December 2020  
 Note: link to the paper: <https://www.climatebonds.net/2020/12/1trillion-mark-reached-global-cumulative-green-issuance-climate-bonds-data-intelligence>

## Theory and practice

While the guiding principles strengthen the integrity of sustainable bonds, greenwashing remains a challenge for investors. The Green Bond Principles (GBP) are voluntary guidelines and there is a relatively broad criteria for what constitutes a green bond. There are many shades of green in terms of the bonds being issued currently that can put off some investors. Hence, the need for an active manager that can assess security documentation, UoPs and their environmental impact, and increasingly, the company’s overall sustainability strategy.

Issuing green bonds is more expensive and complex; green bonds must demonstrate their ‘green’ credentials, particularly if they want to be certified as ‘green bonds’ under various protocols. Their environmental impact must be demonstrated, which may involve periodic audits of their activities, imposing an additional cost for issuers. Rigorous reporting requirements and a second party opinion can be expensive. Passing on these additional costs, as well as the significantly increasing demand for green bonds, has led to a ‘greenium’ — a premium that buyers may pay for the green label.

Green bond yields can on average be 15-20 basis points (bp) lower than comparable conventional bonds, in both primary and secondary markets, according to recent academic research<sup>3</sup> into whether and why investors are paying additional costs for the green debt. This ‘greenium’ has increased in recent years primarily due to rising demand from ESG conscious investors. There has been very strong demand for green bonds in 2020, and supply came several times oversubscribed at issue and at very tight spreads. Still, appetite remains strong from green bond investors, holding them in an increasing number of green bond strategies, albeit reducing the secondary market liquidity for these bonds. This poses a problem for integrated ESG investors who are maximising risk-adjusted returns with no specific environmental performance objectives. This is because they often cannot justify buying a green bond at such an unattractive price compared to conventional non-green bonds from the same issuer, with the same default risk.

Concentration risk is another challenge for credit investors as there is a relatively small number of sectors in the corporate space that issue green bonds. As seen in the charts above, most UoP areas tend to be dominated by renewable energy, water, sustainable buildings and sustainable transport. Many high

emission and 'hard to abate' industries for example, a very large part of the real economy and an integrated ESG investors' investable universe, cannot or would not come to the green bond market, for lack of enough or the right type of green projects or for fear of 'greenwashing' headlines. This is a very important issue that financial markets and corporates needed to solve in order to speed up the transition and successfully decarbonise the global economy, rather than stick to a 'purist' approach to green financing.

### Recent innovation in 'transition finance'

Capital markets have evolved from a market where investors knew and cared little about what their investments were supporting, to one where purpose matters more than ever. The basic green bond premise with its model for project selection, second party opinion and impact reporting, is being applied to other areas such as social, blue and sustainable bonds that raise financing dedicated to various sustainability purposes. However, there was a need for a more inclusive solution, to finance companies that may not be able or willing to issue green or social bonds yet were willing to commit to ambitious sustainability targets at the overall company level, in order to access a lower cost of capital and diversify their investor base.

Hence, there has been much innovation in recent years and a new set of labelled instruments have emerged such as Sustainable Development Goals (SDG)-linked, transition and sustainability-linked bonds and loans. Those that focus on environmental commitments, succeed in filling the financing gap and bring issuers in 'hard to abate' industries together with investors who are willing to finance their decarbonisation over the longer term.

It began in earnest in 2017 when 'purist' green bond investors collided with more inclusive and progressive sustainability minded investors as to who should and should not be allowed to issue green bonds. In 2017, the first green bond sale by a major oil company, Spanish firm Repsol, divided the green bond industry and the securities were not included in major green bond indices. Advocates of transition bonds then called for a separate label and asset class for brown issuers who would commit to decarbonise at the issuer level and transform their business models. Going from 'brown to beige' in these high emission industries often can lead to a very large cut in their absolute emissions (which is what ultimately matters for the planet) and could constitute a perhaps, bigger impact, than investing in some green projects that do not really move the dial for the real economy. Since then, there has been an increasing acceptance of the notion that without decarbonising the brown sectors (where the lion's share of the decarbonising opportunities are), aligning the world economy with the Paris Agreement will not be possible.

There were some early movers who issued self-labelled transition bonds. For example, Cadent published a 'Transition Bond Framework' in 2019 to finance retrofitting its gas transmission and distribution network and followed through with the UK's first transition bond issue in March 2020. The replacement and repair of its pipelines were to facilitate the integration of hydrogen and other low carbon gases and reduce methane leakage.

But some issuers used the transition label opportunistically and ran into a lot of criticism. Marfrig, the world's second-largest producer of beef, issued a transition bond in 2019 in order to channel proceeds towards cattle farmers who had not encroached on the rainforest, deploy the UoP to reduce deforestation across its value chain and consequently reduce greenhouse gas (GHG) emissions. However, green bond investors at the time pushed back very hard; maintaining that beef, under no circumstances, can be green and transition bonds should only be used by those who are willing to fully transition to a low carbon operating model.

Hence early self-labelled transition bonds met with fierce criticism of their real impact from investors at the time. The risk was that the transition label could provide cover for some companies that are not fully committed to shifting quickly and meaningfully away from their carbon spewing ways. There was a need to create new standards for brown issuers that wanted to decarbonise their business models but could not do it overnight (such as steel, cement, transportation, energy), and yet had a credible, ambitious and realistic climate strategy to align with net zero by 2050.

A Climate Transition Finance Working Group was formed in 2019 (under the auspices of the Green and Social Bond Principles) covering 80+ asset managers (including Janus Henderson). The group spent a year developing guidance and common expectations for capital market participants on the practices, actions and disclosures to be made available when raising funds in the debt markets for climate transition-related purposes, whether this be in the format of:

1. Use of Proceeds instruments; defined as those aligned to the Green and Social Bond Principles or Sustainability Bond Guidelines or,
2. General Corporate Purpose instruments aligned to the Sustainability-Linked Bond Principles.

The Transition Finance Handbook, published in December 2020, aims to clarify the issuer level disclosures, which are recommended to credibly position the issuance of Use of Proceeds or sustainability-linked instruments to finance the transition, particularly of 'hard to abate' sectors.

There are four key elements to these recommendations:

1. Issuer's climate transition strategy and governance
2. Business model environmental materiality
3. Climate transition strategy to be 'science based': including targets and pathways; and
4. Implementation transparency.

### The birth of sustainability-linked bonds

The other key development in Transition Finance was the Sustainability-Linked Bond Principles (SLBP), published in June 2020. Together, with the Climate Transition Finance Handbook, it finally provided the necessary guidance and recommendations for issuers on structuring features, disclosure and reporting requirements. The SLBP are applicable to all types of issuers (including 'hard to abate', high emission sectors) and any type of financial capital market instruments. Whether a separate transition label continues to be needed remains to be seen.

Sustainability-Linked Bonds (SLBs) are forward looking performance-based instruments. In contrast to green and social bonds, proceeds are used for general purposes rather than having predefined eligibility criteria. A key feature of an SLB is that the bond's structural or financial characteristics (eg, coupon rate) are linked to the achievement of predetermined sustainability performance targets (SPTs). The SPTs chosen should be ambitious and relate to material and relevant KPIs of the issuer. The SLBP's emphasis on materiality and ambitiousness means that assessments of alignment with the SLBP must consider holistically the issuer's overall sustainability issues, focusing more on the issuer's overall business model and past performance than the Green and Social Bond principles. For the assessment of ambitiousness of the SPTs, the clarity of KPIs and the comparability of the issuer's KPIs and business model with peers, external benchmarks and past performance data are of particular importance.

SLBs have five core components: a credible KPI, ambitious sustainability performance targets, meaningful changes in bond characteristics, verification and reporting. Issuance aligned to the SLBP should provide an investment opportunity with transparent sustainability credentials. SLBs incentivise the issuer's achievement of material, quantitative, predetermined, ambitious, regularly monitored and externally verified sustainability objectives through specific KPIs and SPTs.

By complementing green, social, sustainability and transition bonds, SLBs should enable more issuers to tap the sustainable financing market and scale up decarbonisation, while serving a broader range of investors. SLBs aims to further underpin the key role that debt markets can play in funding and inspiring companies that contribute to sustainability from an ESG perspective.

We have seen over a dozen deals since the SLBPs were published and issuers had time to digest guidance on best practices. Examples from a range of different corporates issuing SLBs across different sectors are listed in the appendix. While UoP green bonds channel much needed capital towards clean energy and clean technology, SLBs opened up a whole new area of the economy to climate transition financing. We expect issuance to continue to grow as more and more corporates from different sectors come to the sustainable bond market. As the market matures, the biggest test for SLBs will be investor confidence in the ambitiousness of the KPIs and targets, and the appropriateness of the coupon adjustments, as well as being able to measure issuers' progress along the transition path.

### Next steps

Collaboration between investors and issuers has played a significant role in the development of SLBs. The measurable, specific, science based and verified metrics that SLBs embed appeal to investors, in both integrated ESG and SRI strategies. In order to progress the science-based approach, many corporates are collaborating with scientists on disclosures. The Science Based Targets Initiative — which strives for increased disclosure and transparency of corporate climate ambitions — has so far grown to include over 1,000 companies. SLBs may be the newest kid on the block but they have a great potential to give more industries and issuers the opportunity to finance their transition towards a low carbon and circular economy, or to take us closer to a fairer and more inclusive society by accessing a much wider pool of ESG investors.

UoP and KPI-linked bonds can be highly complementary. SLBs are not the panacea to all the world's problems. But it is important to stress that SLB issuers make an overarching commitment to transition their whole business models to a more sustainable one over time and a set out a credible and ambitious strategy to do so.

Is it time for corporate green bond issuers who may not necessarily have a climate strategy to follow suit? Being sensitive to the history and evolution of green bonds from corporates, it was understood that corporates issuing green bonds with UoPs ringfenced for specific eligible green projects, will still have brown assets and it will take time for them to green their entire business. Corporate green bond issuers should not be accused of greenwashing just because they have brown assets, but they should be held accountable for their intentionality, progress and whether they are trying hard enough to align their business models with a low carbon world. The world has moved on in recent years and green bond issuers may need to think about upgrading their efforts and set company level KPIs in addition to financing green projects. Bringing issuer-level commitment with specific project-level financing would be a very powerful combination for an issuer in our view.

<sup>1</sup> KPIs are key performance indicators.

<sup>2</sup> *The European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE)*

<sup>3</sup> **Drivers of green bond issuance and new evidence on the 'greenium'**; authored by three scholars from the Jönköping International Business School in Sweden and based on data from Refinitiv, assesses around 2,000 labelled green bonds issued between 2007 and 2019, and matches them with non-green bonds to determine if there is a so-called 'greenium'. The study found "significantly lower" yields for green bonds "than for comparable non-green bonds, both in the primary as well as in the secondary market", leading it to conclude that "a 'greenium' exists".

Source: ICMA, The World Bank, BNP Paribas, Janus Henderson, CBI

## Appendix

### Green Bond Principles (GBP)

The Green Bond Principles (GBP), updated as at June 2018, are voluntary process guidelines that recommend transparency and disclosure and promote integrity in the development of the green bond market by clarifying the approach for issuance of a green bond. The GBPs are intended for broad use by the market: they provide issuers with guidance on the key components involved in launching a credible green bond; aid investors by ensuring availability of information necessary to evaluate the environmental impact of their green bond investments and assist underwriters by moving the market towards standard disclosures, which will facilitate transactions.

### Green Bonds

Green bonds enable capital raising and investment for new and existing projects with environmental benefits. Green bonds are Use of Proceeds (UoP) bonds, devoted to financing new and existing projects or activities with positive environmental impacts. We believe impactful green bonds should be issued in line with the Green Bond Principles (GBP) from the International Capital Market Association (ICMA), a set of voluntary guidelines that promote more transparent, unified reporting on bonds' environmental objectives and estimated impact. Examples of project categories eligible for green bond issuance include renewable energy, energy efficiency, clean transportation, green buildings, wastewater management and climate change adaptation.

### Social Bonds

Social bonds are also Use of Proceeds (UoP) bonds where the proceeds must finance or refinance social projects or activities that achieve positive social outcomes and/or address a social issue. In many cases, social projects are aimed at target populations such as those living below the poverty line, marginalised communities, migrants, unemployed, women and/or sexual and gender minorities, people with disabilities, and displaced persons. Similar to green bonds, issuance of social bonds is oriented by a set of voluntary guidelines — in this case the Social Bond Principles (SBP) from ICMA — aimed toward improved disclosure and transparency in the social bond market. They also arm investors with the information necessary to evaluate the social impact of their investments. Recently, we have seen a new type of social bond emerge in the form of COVID-related bonds. These bonds have UoP terms specifically aimed at mitigating COVID-19 related social issues and are particularly focused on the populations most impacted. Examples of project categories eligible for social bonds include food security and sustainable food systems, socioeconomic advancement, affordable housing, access to essential services and affordable basic infrastructure. Social projects can include related and supporting expenditures such as research and development and, in situations where projects also have environmental benefits, issuers may determine classification as a social bond based on the primary objective of the underlying project.

### Sustainability Bonds

Sustainability bonds are issues where UoP terms finance or refinance a combination of green and social projects or activities. These bonds can be issued by companies, governments and municipalities, as well as for assets and projects and should follow the Sustainability Bond Guidelines from ICMA, which are aligned with both the GBP and SBP. They can be unsecured, backed by the creditworthiness of the corporate or government issuer, or secured with collateral on a specific asset. Examples of project categories eligible for sustainability bonds include those in the green and social bonds categories.

### Sustainability-Linked Bond Principles

The Sustainability-Linked Bond Principles are voluntary process guidelines that outline best practices for financial instruments to incorporate forward looking ESG outcomes and promote integrity in the development of the Sustainability-Linked Bond market by clarifying the approach for issuance of a SLB. The SLBP are intended for broad use by the market: they provide issuers with guidance on the key components involved in launching a credible and ambitious SLB; aid investors by promoting accountability of issuers in their sustainability strategy and availability of information necessary to evaluate their SLB investments; and they assist underwriters by moving the market towards expected approaches to structuring and disclosures that will facilitate credible transactions.

### Sustainability-linked Bonds

Sustainability-Linked Bonds (SLBs) are any type of bond instrument for which the financial and/or structural characteristics can vary depending on whether the issuer achieves predefined sustainability/ESG objectives. In that sense, issuers are thereby committing explicitly (including in the bond documentation) to future improvements in sustainability outcome(s) within a predefined timeline. SLBs are forward looking, performance based instruments. Those objectives are (i) measured through predefined Key Performance Indicators (KPIs) and (ii) assessed against predefined Sustainability Performance Targets (SPTs). The proceeds of SLBs are intended to be used for general purposes, hence, the use of proceeds is not a determinant in its categorisation. Regardless, in select cases, issuers may choose to combine the GBP/SBP approach with the SLBP. In the case, progress, or lack thereof, toward the selected KPIs then results in a decrease or increase in the instrument's coupon. These bonds can play a key role in encouraging companies to make sustainability commitments at the corporate level, particularly through aligning to the UN SDGs or Paris Agreements

### Sustainability-linked Bonds issuance examples:

Italian energy group **ENEL** was the first entrant into the SLB market in September 2019. ENEL chose to link its bonds to the United Nations Sustainable Development Goal (SDG) 7, to ensure access to affordable, reliable, sustainable and modern energy for all. ENEL set a target to increase its renewable energy installed capacity to 55% (from 46% as of H1 2019) of total capacity by the end of 2021 while reducing its CO<sub>2</sub> specific emissions to 0.23 kg/ kWh by 2030 and reach decarbonisation by 2050. On top of issuing several similar bonds in different currencies, it also innovated by launching a sustainability-linked share buyback programme — including a sustainable development goals (SDG) reward mechanism embedded in the price at which the company purchases its own shares linked to a target KPI.

**Novartis** was an example with its sustainability-linked notes, issued in September 2020, which tied the notes' coupon rate to the achievement of two social performance targets related to patient reach in low middle income countries through the company's (i) strategic innovative therapies and (ii) global flagship programme. The bond incorporates a coupon step up of 25bp from year five in the event that Novartis fails to reach one or both of its patient access targets. These targets have been independently assessed and verified and will be reported upon each year. Sustainalytics assessed the bond as overall aligned with the SLBP, because, among other reasons, it considered the SPTs to be ambitious, and patient reach, as an indicator for access to medicine, to be a relevant and material sustainability issue for Novartis.

The issuance was distinct from other SLBs issued to date in that it focused on social SPTs. Other issuances have so far focused on the environmental performance of issuers. In addition, the assessment of the SPT's ambitiousness focused mainly on the relation of the SPTs to Novartis' past performance and the strategy to achieve the SPTs. This focus was due to significant differences among Novartis' peers in business models that determine strategies and performances on access to medicine and the absence of external benchmarks for access to medicine. A key focus is a commitment to improving patient access in low and lower-middle income countries (LMICs) where early/affordable access remains a challenge. The company has set the following targets: at least a 200% increase in patients reached with Strategic Innovative Therapies in LMICs by 2025 versus 2019, and at least 50% increase in patients reached with Novartis Flagship Programmes. Third party opinions on these patient access targets have been obtained from the Access to Medicine Foundation and Sustainalytics, and an external verifier has been used to assess 2019 baseline.

In September 2020, **CHANEL** was the first unrated issuer to place public bonds linked to sustainability metrics, leading the way towards a more sustainable luxury sector. Its sustainability targets included decreasing CHANEL's own absolute (scope 1 and 2) emissions by 50% by 2030 (from a 2018 base year), reducing its supply chain and other scope 3-related greenhouse gas emissions by 10% by 2030 (from a 2018 base year), and shifting to 100% renewable electricity in the company's operations by 2025. If targets for renewable energy and emissions reduction respectively are not achieved by maturity, then the redemption amount increases by 0.5 and 0.75 points respectively.

In November 2020, French multinational company **Schneider Electric** issued the first sustainability-linked convertible bond, a zero-coupon bond that offers investors a premium in case the company underperforms sustainability objectives. Its three KPIs focus on delivering 800 megatons of saved and avoided CO<sub>2</sub> emission for its customers by 2025; increasing its staff gender diversity with women making up 50% of new hires, 40% of front line managers and 30% of leadership teams by 2025, and training one million underprivileged people in energy management by 2025.

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