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Green Bonds

A sustainable investment?

SEPTEMBER 2021

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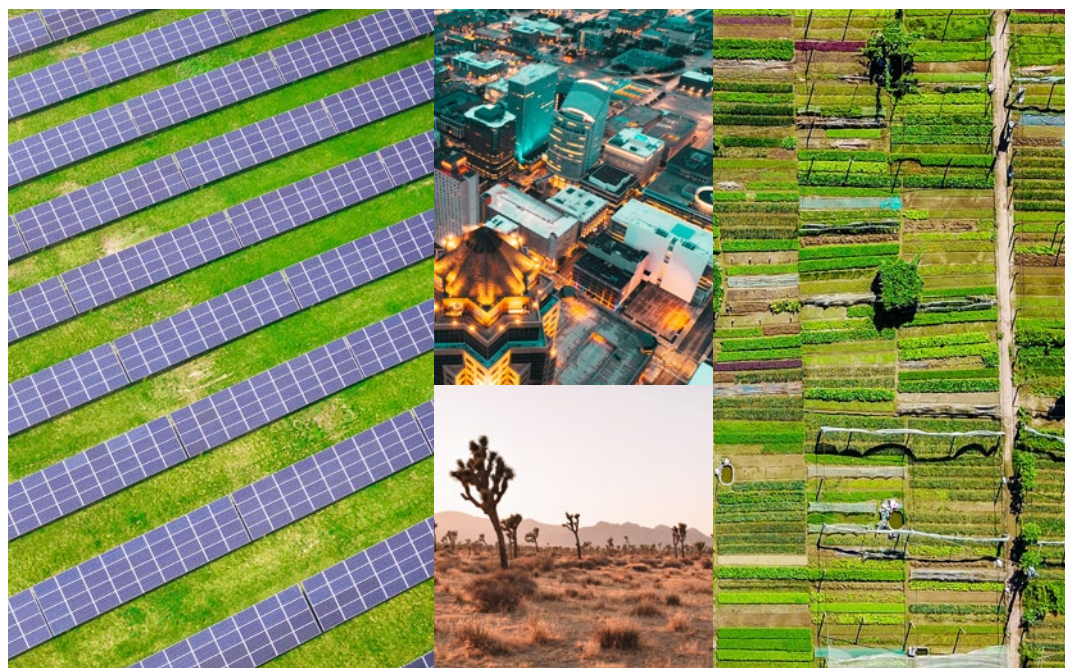
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How Green is Your Portfolio?

Green bonds are a critical part of an evolving and expanding range of sustainable fixed-income investments. Frameworks and labels are valuable, but represent just one stage in investors' due diligence.

In early September, ESG Investor brought together an experienced panel with diverse perspectives to discuss how green bonds can contribute to the efforts of asset owners to transition toward net zero fixed income portfolios.

The panel met a day after the Climate Bonds Initiative published its summary of green and sustainable bond market activity for 2021 and its predictions for the future. Based on strong H1 2021 growth across the sustainable bonds spectrum, it sees the market reaching volumes outstanding reaching US\$1 trillion by 2023.



Strong levels of demand and supply, however, do not necessarily mean that investors and issuers are embracing green bonds wholeheartedly. It doesn't mean that industry frameworks or bond structures are perfect and it doesn't mean that the impact of green bonds necessarily aligns with the priorities of every asset owner.

In a discussion moderated by ESG Investor's Founding Editor, Chris Hall, the panel addressed many of the factors affecting the dynamics at play in ESG finance. The participants looked at the market from the perspective of investors and issuers, and in terms of establishing the right frameworks to encourage, rather than hinder, the race to net-zero and a sustainable future.

The discussion began with an overview of institutional investors' perspectives in incorporating ESG factors into their investment decisions.

"Asset owners globally have a range of motivations when it comes to sustainability," said Kate Hollis, Senior Investment Consultant at Willis Towers Watson. "From those that believe sustainability is fundamental to reducing climate exposure in their portfolios, to those following their peers and regulators, to those that just don't care."

Constraints and considerations

It is not just the sustainability ambitions of a chief investment officer or trustee that count, Hollis noted. Whatever an asset owner may feel about climate change and the associated risk to portfolios, many

Roundtable Participants

- **Ozgur Altun**, Sustainable Finance Associate at the International Capital Markets Association, works on all aspects of the association's sustainable finance policies and frameworks. He is a lawyer with an international background and previously worked at the Council of Europe Development Bank, law firms in Istanbul and Brussels gaining experience in capital markets and financial regulation as well as EU law, and the European Investment Bank.
- **Paul Camp**, Co-founder and Head of Transaction Management, Climate Solutions, created the world's first green bond under the global Climate Bonds Initiative (CBI) in 2014. Paul has extensive clean energy transaction and strategic advisory experience, including at global solar, battery developer and EPC Belectric (now RWE Innogy), and as an advisor to the UK Cabinet Office on energy and to CBI on green securitisations.
- **Kate Hollis**, Senior Investment Consultant at Willis Towers Watson, has global knowledge of all asset classes, particularly fixed-income and liquid alternatives. Kate has deep experience in sales, trading and research and a track record in identifying, classifying and researching new types of funds to enable investors to make better-informed decisions. She was previously Global Head of Fixed Income/Alternatives Fund Management Research at S&P Capital IQ and has worked at several hedge funds and financial institutions.
- **François Millet**, Head of ETF Strategy, ESG and Innovation at Lyxor ETF, oversees business strategy and development in ETFs, passive solutions and ESG on a global basis. He joined Lyxor in 2009 as Head of Index and Quantitative Fund Development and was previously Director of Index Funds & ETFs at Societe Generale Asset Management AI, where he developed the index management business including passive funds, ETFs, index-enhanced and alternative beta products.
- **Liam Moore**, Fixed Income Investment Specialist, JP Morgan Asset Management, covers unconstrained fixed income for both prospective and existing clients, with responsibilities across client relationships, product development and research. Liam is closely involved with the active management of a key sustainable fixed income strategy, as well as the development of sustainable investing solutions across the fixed income platform.
- **Benedetta Pacifico**, Senior Associate, Capital Markets, Sidley Austin, has extensive experience of acting for issuers and arrangers on transactions including regulatory and hybrid capital instruments, debt restructurings, exchange offers, other liability management transactions and the establishment and update of EMTN and GMTN programmes. With a strong interest and focus on ESG, Benedetta has experience of listings on regulated and non-regulated markets including in London, Luxembourg and Ireland.

ROUNDTABLE GREEN BONDS

have their choices constrained by regulation, by liability matching, the need for diversification, a view on governance and an assessment of a portfolio's long-term resilience to multiple risks.

In addition, any measurement of climate exposure is problematic given the paucity of reliable data, particularly when it comes to measuring the Scope 3 GHG emissions of issuers. Target time frame is also important since asset owners target emission reductions in both the short- and long term. Green bonds, for instance, may not be the best instrument to use to realise long-term reduction targets.

While green bonds undoubtedly can contribute to future emission reductions, that can also be claimed for non-green bonds launched by issuers working towards science-based reduction targets.

"We support green bonds in principle, but they don't necessarily reduce carbon emissions of the portfolio immediately," said Hollis.

Money raised by a green bond to invest in a new green project, for instance, may not all be spent at once and any initial spending might increase Scope 3 emissions in the short term. The problem

is compounded when it comes to green bonds issued by banks, where proceeds are on-lent to finance customers' green projects. They do nothing for bank's Scope 1 and 2 targets, and the impact on Scope 3 emissions is likely to be positive, but this is difficult to assess at the moment.

"Banks are poor at disclosing Scope 3 emissions of their loan books," said Hollis. "We suspect they could be very large, given the global context in which they operate."

There are many ways to skin a cat, or decarbonise a portfolio, and green bonds are just one of them. "We recommend clients use green, and social and other use-of-proceeds bonds alongside non-green bonds in their mandates but leave the choice of which bonds, when and how to use them to asset managers," she added.

Increasing diversification

Some of the panel shy away from recommending 'pure play' use-of-proceeds funds due to the market's lack of diversity; green and social bond markets may be growing quickly but they have tended to be the domain of well-rated issuers from developed countries, thus not yet fully reflecting the rich diversity of the fixed income universe.

Bond holdings should also be gauged against other asset classes, such as direct investment or equity,



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Green bonds don't necessarily
reduce carbon emissions of the
portfolio immediately.**

Kate Hollis, Willis Towers Watson

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A lot of companies understand ‘business as usual’, but many have no idea of business as it could be.

Paul Camp, Climate Solutions



where an investor may get quicker and cleaner results for a portfolio.

Others were more sanguine.

“Diversification is increasing,” said François Millet, Head of ETF Strategy, ESG and Innovation at Lyxor ETF. “Now we have a real sovereign sector, as well as corporate and supranational segments. There is no excuse for a fixed-income manager not to hold a green bond element in a portfolio. There is enough diversity that you can still stick to a fund’s original design.”

This puts the onus on the asset manager. There are two approaches: passive and active.

Lyxor ETF, which launched the world’s first green bond ETF in 2017, falls into the first camp.

“We don’t advise clients on the composition of their portfolios,” said Millet. “But we provide the toolkit.”

And green bonds are a subset of that toolkit, forming part of an ecosystem of products needed to reduce carbon intensity and provide access to clean technologies or new energy.

Investors are changing their behaviour and their choices.

“In the race to net-zero, investors are judging the marginal contribution of each investment instrument to their emission reduction goals,” said Millet.

To help in their decision making, investors are increasingly using climate indices in equities and corporate bonds.

“Through these indices, investors are, in effect, selecting companies tied to emission reduction targets,” said Millet. “So, you know the path you are buying into.”

Deeper engagement, greater scrutiny

In addition to direction and the choice of instrument, asset owners trying to decarbonise portfolios are demanding better levels of reporting from asset managers to help them make choices.

“We’re seeing clients asking for reporting on the output of their portfolio and the impact they’re having on the environment rather than worrying about how many green, social, or sustainability-linked bonds (SLBs) we’re putting into the portfolio,” said Liam



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There is no excuse for a fixed-income manager not to hold a green bond element in a portfolio.

François Millet, Lyxor ETF

Moore, Fixed Income Investment Specialist, JP Morgan Asset Management. “Better reporting enables clients to better assess the profile of their portfolio.”

Active managers have additional obligations to their clients, with the responsibilities of stewardship increasingly felt by bondholders as much as shareholders.

“Clients want us to engage with issuers,” said Moore. “Many of our clients are happy to buy the bonds of some of the heavier polluters, as long as we can show we are engaging with them and that they are charting a path to a greener, sustainable environment.”

Green bonds represent a sub-set of the overall ESG toolkit, but asset managers still need to look closely at every bond that comes with a green bond label, asking themselves both: how sustainable is this issue; and are we getting value for money?

In terms of assessing sustainability, the question must be asked whether the bond’s use of proceeds aligns with the client’s intended outcome for the portfolio.

And then there’s the question of additionality.

“We ask ourselves, would this project be happening anyway? And is the client asking us for a lower cost of credit by putting a label on it?” said Moore. “Are they effectively getting a free ride?”

For SLBs – instruments structured so that issuers potentially pay a penalty for missing pre-agreed carbon reduction targets – a broader view of the corporate issuer is required as well as the targets and penalties.

Are issuers really being held to account?

“Sometimes we feel companies are setting themselves targets which they’re already close to achieving,” said Moore. “A step-up coupon might be great, but does it offer real value, and is it commensurate with the cost of pollution if targets are missed?”

The panel reiterated the importance of transparency and standards to ESG bond markets, recognising the importance of industry bodies in raising standards and providing a framework to help satisfy both investor and issuer objectives.

Opportunity for impact

Establishing the right voluntary frameworks has helped fuel the rise in green and social bonds and is now supporting the development of SLBs, which is opening the market to a whole new class of issuer.

“The SLB market has grown really quickly,” said Ozgur Altun, Sustainable Finance Associate at ICMA, which last year added guidance on SLBs to its existing Green Bond Principles and Social Bond Principles. “SLBs create an opportunity to invest in a new impact product that is structurally different to green bonds, one that is mostly focused on climate transition and one that is flexible for issuers.”

With SLBs, companies don’t have to track the use of funds, they don’t have to identify projects before issuance, and they have freedom to use funds as they see fit – as long as they hit key performance indicators (KPIs) and sustainable performance targets (SPTs).

“The instrument may be more appealing for issuers that have not been able to join the green bond market before,” explained Altun. “It opens the doors of sustainable finance to new market participants and gives an opportunity to investors to diversify their sustainable finance investments.”

The product is in its infancy, however, and there are issues that need monitoring.

“There are three core requirements in the SLB principles,” said Altun. “The materiality of KPIs, the ambitiousness of SPTs, and the adequacy of the incentive mechanism. Investors need to look at what the issuer is committing to against its peers, past performance, and science-based targets.”

This flexibility is seen as an advantage in a nascent market as it is important to find the balance between security for investors and ease of compliance for issuers.

“If need be, we can issue additional guidance,” said Altun. “It’s a new market, it’s developing, and it’s bringing in a lot of new geographies and issuers to sustainable finance. And it has additionality in the fact that it focuses on entity-wide decarbonisation.”

Reputation risk

More issuers are looking at the debt markets and there is more product for them to use. This is potentially good news for investors looking for diversification, but it needs a big commitment for a borrower to go green and doing so comes with risks.

“Greenwashing will badly affect your reputation.”

Benedetta Pacifico, Sidley Austin



ROUNDTABLE

GREEN BONDS

“The biggest fear for an issuer deciding to issue green or social bonds, or SLBs, is reputation,” said Benedetta Pacifico, Senior Associate, Capital Markets, Sidley Austin. “In a rapidly evolving market, any sort of framework or label gives a level of assurance to the issuer because it gives them parameters within which they can move.”

The problem, again, is finding a framework that aligns itself to both investor and issuer requirements. And even then, there will still a requirement to delve deeper into sustainable credentials, not least due to the specific requirements of individual investors.

A label is good for an investor, and the more prescriptive the greater the certainty that certain protocols have been followed. The disadvantage for an investor, is that the label doesn't necessarily guarantee that the borrower has a good ESG strategy. It simply means that the specific single instrument meets certain criteria.

And voluntary frameworks have no teeth.

“There is no event of default from non-compliance. There is no call, there is no put,” said Pacifico.



The investor still needs to do a lot of work irrespective of labels.

“A label is good,” said Pacifico. “But it's what's behind the label that needs to be worked on. You can be a very brown company with an awful sustainability strategy, and – purely from the point of view of these frameworks – still issue a green bond. That would be greenwashing. Issuers shouldn't just issue a green bond in isolation from a company's strategy.”

Investors may find security from more prescriptive frameworks, but the problem for issuers is that overburdening them with regulation and reporting obligations risks excluding them from the market.

“It's very difficult for regulators, and industry bodies such as ICMA, to find a balance between having a label sufficiently prescriptive to give certainty to investors but not overly burdensome to issuers, because the risk of over-burdening issuers is that they'll just stop using the instruments,” said Pacifico.

Frameworks have been evolving in the right direction but going too fast risks losing participants and shutting down the market. Perhaps it's outside of the framework where issuers find the biggest incentive to live up to ESG promises.

“Greenwashing will badly affect your reputation and make it very difficult to return to the markets,” said Pacifico. “Issuers are very aware of that.”

“**Sustainability-linked bonds are opening the doors to new market participants.**”

Ozgur Altun, ICMA

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Clients want us to engage with issuers.

Liam Moore, JP Morgan Asset Management



Education and acceleration

There are many complex issues around the financial markets funding the transition to net-zero and sustainability – financial returns from investments, the merits of labelling, and definitions of sustainability. But these discussions must be placed in a real-world context.

“The biggest issue we’ve got is education,” said Paul Camp, Co-founder and Head of Transaction Management, Climate Solutions. “A lot of companies understand ‘business as usual’, but many have no idea of business as it could be.”

Both lenders and investors have a role in this process, providing advice and incentives to the firms they fund, helping them to appreciate the urgency of the need for transition to low-carbon business models and to grasp the opportunities. This has some particularly critical implications for banks, said Camp, given their exposure to certain hard-to-abate and heavy-emitting sectors of the global economy.

“The next banking crisis will begin within the oil and gas sector. At some point, a top oil and gas analyst is going to work out that these companies are sitting on assets in the ground that have a net present value

close to zero,” said Camp. “Oil and gas companies are a systemic risk to the banking system, and the financial system as a whole.”

Banks need to look at their loan books in detail just as investors in green bonds need to judge them in terms of an issuer’s overall strategy and in terms of the global imperative. They should not be considered in isolation.

“There’s not enough linkage,” said Camp. “And we’re running out of time. Things must accelerate. We need additionality, abatement, recuperation and repair for the planet. We are at existential risk as a species.”

A Huge New Opportunity

Changes in supply and demand are driving the rapid growth of the sovereign green bond market, which is now offering investors more opportunities for impact as they restructure their portfolios to pursue net zero strategies.

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On 8 July 2021, Lyxor ETF hosted a webcast on sovereign green bonds with Sean Kidney, CEO and co-founder of Climate Bonds Initiative, alongside Lyxor's François Millet, Head of ETF Strategy, ESG & Innovation, and Philippe Baché, Head of Fixed Income Product. Below are a few edited highlights from the webcast which you can [listen to in full here](#).

Sean, what are the most interesting developments in the sovereign bond market in the past few years?

Sean Kidney: The most interesting development is that there is a sovereign bond market! A few years ago: nada, zip, nothing. It took the French government deciding to issue sovereign bonds before we saw any action. This started a bit of an arms race for sovereign bonds. The Polish government decided to pip them at the post,



quickly issuing the first sovereign green bond while the French were still organising their programme. The Agence France Trésor [the agency responsible for managing France's debt and cash position] came to market in a studied and careful way, and France now has by far the largest global green sovereign market, with around €40 billion of issuance. That said, we've seen a lot of others come to market.

The broader green bond market is exploding too. It will have some 80% growth this year alone, and will soon have €2 trillion outstanding. That sounds like a lot, but there's a €100 trillion bond market, so there's still a long way to go. The space we really have to grow into is sovereign bonds: there's about €55 trillion of those and only around €120 billion of that figure is green bonds. That means the growth opportunity is in the sovereign space. It's a late

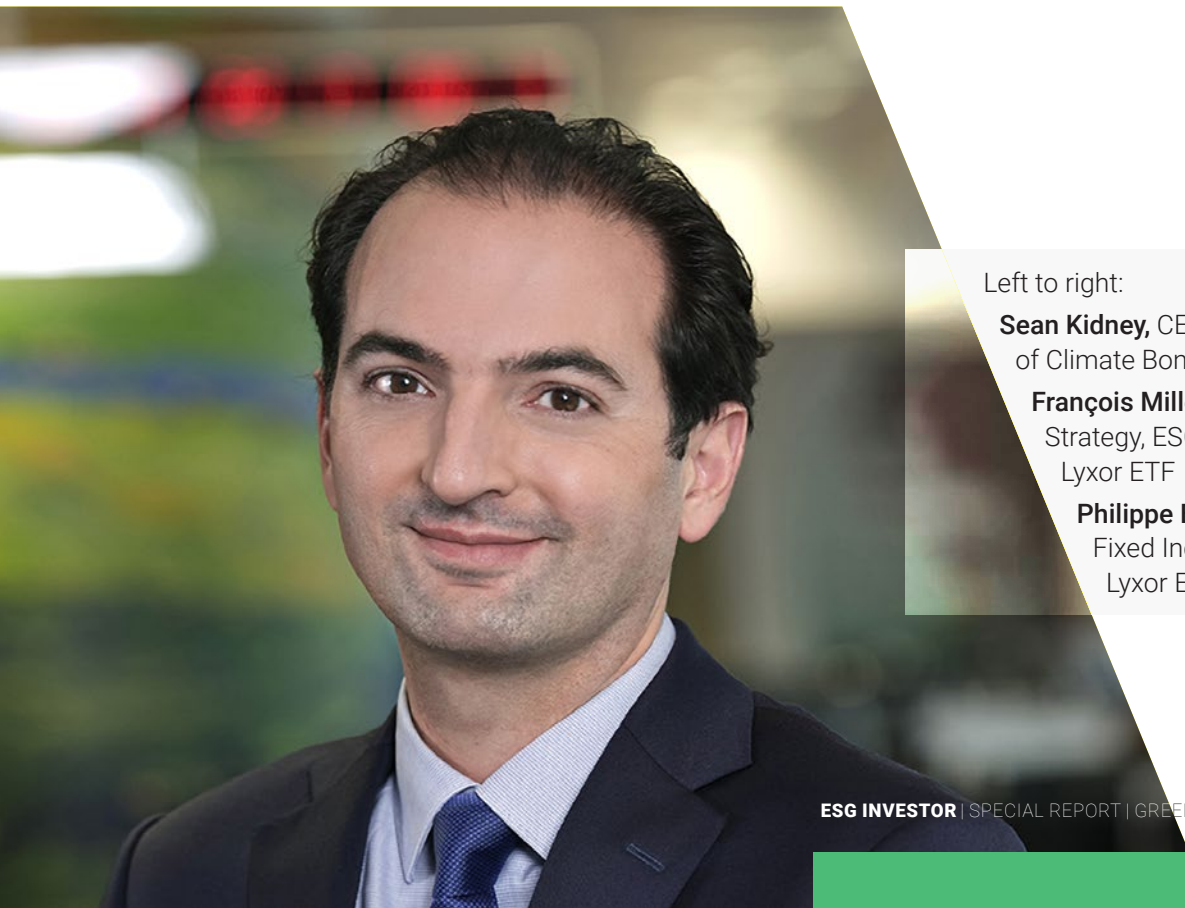
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The sovereign space is a late starter, but now we're seeing issuance everywhere around the world.

Sean Kidney, Climate Bonds Initiative

starter in the past few years ago, but now we're seeing issuance everywhere around the world.

What can you tell us about the role of individual governments in green bond issuance?

SK: I've already talked about the French government. Full credit to them: they've been fleshing out a yield curve and doing demonstration issuance and discovered, much to their surprise, that they can reap rewards for the French treasury.



Left to right:

Sean Kidney, CEO and co-founder of Climate Bonds Initiative

François Millet, Head of ETF Strategy, ESG & Innovation, Lyxor ETF

Philippe Baché, Head of Fixed Income Product, Lyxor ETF

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The liquid and diversified aspect for sovereign bonds was missing, but that’s not the case anymore.

François Millet, Lyxor ETF

Each government treasury around the world has a similar approach. There’s the benefits to grow the private green bond market, ‘pour encourager les autres’ if you like, and there are the benefits to their own scheme of signalling what the government is doing for investors, increasing investor engagement and telling citizens about the work they’re doing. When the Dutch government issued their green bond, where most of the proceeds went to coastal protection – you thought ‘ah, that makes a lot of sense’. It was fantastic they did that and drew attention to the work they’re doing.

François, what factors do you think explain the huge increase in issuance and investment? Is there a genuine drive towards net zero?

François Millet: It all starts with the role of green bonds in a portfolio. Sovereign bonds make up around 54% of a typical global aggregate index. Yet until 2016, there was absolutely zero in terms of green sovereign bonds for portfolio allocation. That was the gap, the missing link which has now been repaired. And there has been a rapid growth of the market, especially in the last two years. We’re not talking about France alone anymore, but a market where 30% of the outstanding sovereign green sovereign bonds have been issued this year.

That’s an amazing stat. Six months ago we couldn’t even have launched our new sovereign green bond ETF because it wouldn’t have met the diversification ratio needed in UCITS ETF regulation. Now we’re comfortable with that, thanks to the multiplication of issuers.

Any investor should have a green bond strategy because all the building blocks are there to do it now. The liquid and diversified aspect for sovereign bonds was missing, but that’s not the case anymore. That’s why we’ve seen the market almost double in size in about one year.

From an investor’s perspective, what’s going on in the change of attitude of investors?

FM: I think the change comes from two areas: first, portfolio objectives are changing. On top of the return-seeking objectives and ESG criteria, investors are increasingly looking to align their portfolios – committing to a certain warming scenario with no or limited overshoot, for example. This is a different concept. More investors are committing to net zero and showing that they are restructuring portfolios to meet this alignment target.

The second change of attitude is that there is an ever-growing request for traceability. Green bonds that provide info on use of proceeds but also report impact are essential, because investors want to know not only how climate change impacts the portfolio, but how the portfolio impacts climate change. Now they look for impact metrics, and are pushed that way by regulation too.

Philippe, what has been Lyxor’s response to these developments in terms of product? What does Lyxor bring to its clients?

Philippe Baché: Our current range has three different options for taking a position on green bonds. First, there’s our pioneering product, the first green bond ETF launched in 2017 which now totals more than €570 million in assets. This is an

aggregate product because it combines exposure to sovereigns, quasi-sovereigns and corporates. Second, another aggregate green bond ETF, this time with an additional [ESG screen](#) which excludes some controversial activities as well.

And third, the new product that we launched at the start of July. This trades under the ticker [ERTH](#) and it's specifically dedicated to sovereign issuers in the eurozone, to help support investors' net zero carbon objectives and to perform several potential roles in a portfolio as it has several quite interesting characteristics.

ERTH can be used as an investment tool for a net zero strategy adapted to the government bond exposure of a fixed income portfolio. Given the long-term nature of the green bond market, the rates exposure of this portfolio will be greater than the rates exposure of a standard government bond exposure. And maybe most interesting, thinking about what François said earlier, it offers dedicated

use-of-proceeds reporting, and traceability in the sovereign bond market.

[Watch the full replay](#) to hear more from each of our speakers, or [learn more about Green Bond ETFs](#).

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Our new product, specifically dedicated to sovereign issuers in the eurozone, can help support investors' net zero carbon objectives.

Philippe Baché, Lyxor ETF

Green and Co: Investors Choose From a Growing Universe

The ESG bond market continues to expand rapidly as issuers tap into an ocean of responsible investment money seeking assets, says Nick Herbert. Greater diversity, innovation and impact means bond buyers have plenty to consider when satisfying investment goals.

Green bond issuance has followed a stellar growth trajectory since the year the Paris Agreement was signed. According to Refinitiv, around US\$40 billion of green bonds were launched in 2015 while, to mid-August this year, some US\$250 billion of new borrowing has already been concluded. Facilitating the market's expansion has been a quest for transparency and standardisation, brought through efforts such as the ICMA Green Bond Principles, the EU taxonomy and preparation for impending regulatory disclosure requirements.

The same standards are transposed across other sustainable fixed income products, such as social bonds, which have become another major asset class for ESG investors. Supply of social bonds increased massively in 2020 during Covid-19 – as governments and corporates looked to raise funds to support recovery and access to healthcare and housing – rising from just under US\$14 billion in 2019 to over US\$160 billion. Demand for social bonds did not come at the expense of green bond buying, reflecting the level of underlying interest in 'use of proceeds' ESG bonds, which finance specific, ring-fenced projects.

Photo: William Felker

Syndicated ESG lending volumes are also increasing. And it is innovation in the loan markets that has led to the emergence of sustainability-linked bonds (SLB), instruments with coupon payments linked to pre-determined sustainability targets at the corporate level. Interest in these bonds, is growing.

“We saw the first sustainability-linked loans back in September 2019, and since then the market has grown to a point where there’s more talk now about sustainability-linked than about use of proceeds instruments,” said Michael Wilkins, Managing Director, Sustainable Finance at S&P Global Ratings. “That’s not to say issuance from the use of proceeds side has diminished, it’s just that interest in sustainability-linked has grown to match it.”

Over the last 12 months, SLBs have contributed around US\$60 billion to an ESG bond universe that now has a range of products that fund projects addressing climate and social issues as well as finance corporate transition to a low-carbon economy.

Addressing the climate imperative and ongoing social objectives will see sustainable debt volumes escalate.

“We were looking at around US\$530 billion in total sustainable bond issuance in 2020,” said Lori Shapiro, Sustainable Finance Associate at S&P. “And this year we’re looking at exceeding US\$1 trillion.

That’s essentially a doubling of the market and the largest absolute increase in issuance volume to date.”

Impact and influence

Developments in ESG bond markets have not only resulted in a broad array of fixed income product but they have also brought borrowers and lenders closer together. Bond buyers that traditionally assessed investment from a credit perspective also now demand detailed insight as to what their money is financing and to what impact. They are also exerting influence over the behaviour of companies they finance as long-term sustainability is a credit positive. It is another point of pressure for ESG investors.

“As a fixed income investor, you can make a difference,” said Bram Bos, Lead Portfolio Manager for Green Bonds at NN Investment Partners.

“
You could look at the greenium as an insurance payment.

Jacob Michaelsen, Nordea



FEATURE

BONDS OVERVIEW

“In the past, equity was seen as the best way of engaging with a company, through voting, attending annual general meetings, etc. But companies and governments also need funding in the end, right? We should try to have impact as investors from as many angles as possible.”

Impact can readily be assessed by green or social bond buyers thanks to improvements in transparency, measurement and reporting. Use of proceeds bonds, however, are the domain of a select group of issuers with project portfolios large enough to be financed in the bond markets.

This issuer base may have broadened from its mainly supranational beginnings to include corporates, financials and, increasingly, sovereign borrowers, but the average credit rating of bonds remains investment grade.

“It used to be a double-A rated credit market but now it’s probably high single-A which implies there’s been

more industrials, more energy companies coming to market recently,” said Mitch Reznick, Head of Research & Sustainable Fixed Income at Federated Hermes.

It will take a while for average ratings to fall further.

“We do see a little bit more interest in the high yield sustainable space, but the market is lagging,” said Bos. “A lot of companies issuing high yield are smaller, private companies that may not have the resources available to set up a green bond framework or define ESG policies.”

Smaller companies can issue sustainability bonds targeting a mix of social and green projects, which will accelerate the trend. They also have access to investors willing to support their transition to a more sustainable business model.

Targeting transition

Transition bonds were once tipped to become a major feature of the ESG bond market, but the format has not caught on.

“Talk of transition bonds has faded into the background,” said Bos. “Two years ago, there was talk they would cater to companies operating in the ‘light green’ area of the economy, but it felt a little bit dishonest. For me the label does not exist. I believe we should not invest more time trying to build a transition bond market when we have to take meaningful steps to tackle climate change. We believe issuing a green bond is more credible and will have the impact we want to see.”

The focus of transition finance has, instead, moved to SLBs. Structures for these have coalesced around the



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We should try to have impact as investors from as many angles as possible.

Bram Bos, NN Investment Partners



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More industrials and energy companies have been coming to market recently.

Mitch Reznick, Federated Hermes

borrower paying a step-up coupon, based on hitting specified key performance indicators (KPIs). But there is plenty of debate about how the market should work.

Questions centre around the ambitiousness of KPIs, the size of the step-up, whether the step-up should take the form of higher redemption payments or whether missing targets should be offset through carbon credit purchases. Even the direction of the step is up for debate.

“You ultimately want companies to hit their targets but is penalising them on that transition path fair?” asked Bos. “I think a step-up coupon gives a wrong signal because it implies you’re punishing companies for not hitting targets, whereas they should be rewarded when they reach them. After all, if a company reaches a target, then it means it is less exposed to ESG risks, and so justifies paying a lower coupon.”

Although SLBs have become more prevalent, they have yet to be widely embraced by investors. They do not fit into a pure green bond strategy, rather they provide an ESG overlay to regular credit.

“When we buy such a bond, it will be because we like the issue from a credit point of view, and also because we like the ESG profile of the company but not specifically for the SLB structure,” said Bos.

Further, if the company has committed to reach SLB targets, then exposure to its performance can be gained through conventional bonds.

More generally, a multiple approach to assessing an issuer’s ESG credentials is common with debt investors for any instrument.

“We have a three-tier framework when looking at green bonds: an ESG assessment at the issuer level; the quality of governance in the green bond framework; and transparency and impact at the asset level,” said Stephanie Maier, Global Head of Sustainable and Impact Investment at GAM.

A transparently green future

In an interesting quirk of market development, green bonds have provided issuers with slightly more favourable borrowing terms compared to conventional curves. The ‘greenium’ mostly reflects

FEATURE

BONDS OVERVIEW

supply/demand dynamic at play, rather than representing a discounted view of future sustainable outperformance. The mass of ESG funds clearly outweighs the supply of suitable assets, so giving up a few extra basis points is a minor issue for investors taking a long-term view on sustainability. The market's outperformance during periods of volatility, such as experienced at the height of the pandemic's initial outbreak in March/April 2020, is also a short-term attraction.

"You could look at the greenium as an insurance payment," said Nordea's Head of Sustainable Finance Advisory, Jacob Michaelsen. "If you could buy a bond paying two or three basis points more than the conventional curve, but the bond outperforms by 30 basis points during volatility then

there's a payoff of a factor of 10. I'd take that any day of the week."

Underlying demand for ESG bonds is only likely to increase, particularly as the effects of climate change become more apparent. Supply will also improve as the market makes issuing ESG bonds more straightforward and rewards companies with a sustainable agenda – and then there's the greenium.

"The greenium makes it easier for a treasurer to make a case for a green bond to finance a specific project," said Reznick.

As with any rapidly growing market, ESG bonds are tormented by concerns about transgressions. Nevertheless, an adherence to transparency and the threat of damage to reputations from any signs of green or social washing may be sufficient to keep markets credible. For Michaelsen, meaningful impact on the economy and environment is the main issue, not greenwashing.

"I've never been overly concerned with greenwashing," said Michaelsen. "Because standards in the market are based on transparency, you will very quickly be called out for any misdemeanour. I'm more concerned with the lack of action." ■



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There's more talk now about sustainability-linked than about use of proceeds instruments.

Michael Wilkins, S&P Global Ratings

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Finding Sustainability, Finding Value

Rising demand for sustainable bonds is being met by robust supply. But balancing sustainability and value requires careful assessment of each opportunity.

Demand is growing for investments that have the potential both to do well and do good – not only in equity markets, but across the board. Sustainable fixed income globally saw €59 billion of inflows in 2020, representing a 39% increase vs 2019¹.

A broadening opportunity set

The same trends that are driving demand are also boosting supply. As investors, companies, regulators and governments rapidly align behind the goals of the Paris Agreement, issuance of green, social and sustainable bonds is soaring, from US\$565 billion in 2019 to US\$732 billion in 2020². What has previously been a European-dominated market is now broadening out, with the US dollar looking set to become the primary currency for sustainable financing in 2021, at the current pace. Beyond the developed world, sustainable issuance from both sovereigns and corporates in emerging markets is also growing.

On a sector basis, too, the market is becoming increasingly varied, with issuance no longer confined to industries under particular scrutiny for the sustainability of their practices. Recent issuance has come from a wide range of sectors, led by utilities, banks, REITs and technology. Some companies, particularly utilities, have gone further, stating that they are unlikely to ever issue another ‘non-green’ bond since all of their financing will be linked to sustainable programmes.

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¹ Source:
Morningstar,
2019- 2020

² Source:
BloombergNEF,
January 2021.



Companies are issuing sustainable bonds for a wide range of purposes, from banks funding construction, refurbishment and/or preservation of affordable housing in low-income communities to auto companies funding research and development for electric vehicles. Government issuers have raised funds for the transition to a lower-carbon economy, to support climate resilience, and for investment in science, technology and public education.

Balancing sustainability and value

For investors in this growing part of the bond market, there are two key questions: how to assess sustainability, and how to assess value.

Some companies embed sustainability into bond covenants. For example, in the utilities sector, Italian gas and electricity provider Enel has committed to a step-up coupon programme linked explicitly to sustainability targets. For one recent sterling issuance of a seven-year bond linked to the UN Sustainable Development Goals, if the company does not achieve its installed renewable energy capacity target of 60% by the end of 2022, the coupon increases by 25 basis points (bps).

The utilities sector was one of the earliest issuers of green bonds, and best practices around accountability are becoming established, with most companies making

Photos, clockwise from left:

- Chelsea Wvius*
- Science In Hd*
- Bill Oxford*
- Christina Wocintechchat*
- Bruno Figueiredo*
- Remy Gieling*

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Issuance is no longer confined to industries under particular scrutiny.

similar commitments based on energy transition goals. In sectors where ESG initiatives align less clearly with the objectives of the sector, evaluating sustainability can be more challenging. We believe that the next stage of development for ESG-linked bonds will be more independent oversight, similar to that provided by credit rating agencies, to ensure companies are held accountable.

When it comes to assessing value, active investors need to evaluate each sustainable bond on its own merit, as they do with traditional bonds. For us, that means looking at fundamentals, technical factors and quantitative valuations. Many sustainable bonds tick the fundamental box, and we have already discussed the positive technical factors for the sector, with investor demand growing. However, some fall short on valuations.

It is reasonable to expect a green or sustainable bond to yield slightly less than its non-green counterpart. But today, with index spreads so tight, the challenge is that 'slightly less' is a significant discount. With less room for spreads to compress, every basis point of yield counts.

So how to identify value? Consider the following examples³, using two green bonds issued in 2020.

Verizon, a US telecoms company, came to the US dollar market with a 10-year green bond in September 2020. The company has reasonable fundamentals,

and management has a demonstrated commitment to sustainability. The deal was announced with initial pricing expectations of 110 bps in spread (secondary bonds were trading around 90-95 bps at the time, so 110 bps would have represented an attractive new issue premium). For context, the same company had priced a non-green 10-year bond in March, at the height of Covid-19 volatility, at 225 bps. In the September issuance, the green deal actually priced at 83 bps, significantly less than initial price thoughts: not only below the company's existing bond with a similar maturity, but importantly, offering limited upside given outright spread levels. As a result, the valuation did not look attractive.

Excel Energy Inc., a US utility, came to market in June 2020 with a green bond priced at 105 bps. We believe the company has a solid fundamental outlook, and it tends to score particularly highly from an ESG perspective due to its commitment to transition towards renewables. We felt that the deal, pricing as it did, had scope to outperform other outstanding 30-year secured bonds of peers, because of the company's favourable ESG credentials in this part of the capital structure. Subsequently, this did come to pass as the bond outperformed during the late 2020 rally.

As these examples show, a clear commitment to sustainable business practices is commendable, but total return investors also need to scrutinise valuations. Investors need to evaluate where green bonds are pricing in relation to non-green bonds, and evaluate fundamentals and the risk-return profile accordingly.

³ These securities are shown for illustrative purposes only. Their inclusion should not be interpreted as a recommendation to buy or sell.

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Sustainable bond investing does not need to be confined to bonds labelled as ‘green’.”

Beyond green bonds

Of course, sustainable bond investing does not need to be confined to bonds labelled as ‘green’ or ‘sustainable’. Improved disclosure from companies around ESG considerations – from climate risk to diversity – is supporting more informed investment decisions across the board. By looking at the whole market, traditional as well as green bonds, through the lens of sustainability, fund managers are able to construct sustainable portfolios from a wide range of types of debt.

Evidence suggests that considering sustainability as part of the investment decision does pay off in performance. More than 89% of studies find that ESG strategies generate better risk-adjusted returns over the long run.⁴ And in the extreme volatility of early 2020, sustainable funds markedly outperformed the competition. With sustainable fixed income funds allowing investors to align the goals of doing well and doing good, we expect demand – and issuance to meet that demand – to continue to grow. ■■■

⁴ Gunnar Friede, Timo Busch and Alexander Bassen, “ESG and financial performance: aggregated evidence from more than 2000 empirical studies,” *Journal of Sustainable Finance & Investment*, 5:4 (2015), 210-233, <https://www.tandfonline.com/doi/pdf/10.1080/20430795.2015.1118917>.

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Assessing Climate Risks in a World of Difference

Asset owners face steep challenges trying to differentiate between the climate performance and governance of sovereign issuers. Chris Hall reports on a new initiative aiming to identify the common ground.

A key feature of green bonds is their ringfencing of proceeds to finance projects with specific environmental objectives. However, few investors feel comfortable ignoring the issuer's credentials completely, environmental or otherwise. This partly explains the growing appetite for sustainability-linked bonds, which set targets for the issuing company's overall environmental or social performance.



When it comes to sovereign bonds, it is even harder to separate the instrument from the issuer. A growing number of governments are issuing green and social bonds, with a view to investing in low-carbon energy or transport infrastructures, or to support health, education or housing expenditure as economies recover from the Covid-19 pandemic.

The second party opinions provided by independent experts on these bonds not only comment on their alignment with frameworks such as the ICMA's Green or Social Bond Principles, but also their coherence with the issuer's strategic sustainability priorities. In short, the government's wider performance and policies are still a material factor for investors.

Further, green bonds make up only a tiny fraction of any sovereign issuer's outstanding debt portfolio. ESG factors play a large and increasing part in the ratings, performance and credit risk of traditional

government bonds too. In response, ratings agencies and data providers have developed a new and evolving generation of scores and ratings services to help investors evaluate the impact of ESG risks and opportunities on sovereign issues.

Despite this, asset owners lack a coherent assessment framework to help them understand sovereign issuers' overall environmental risks and performance, especially when it comes to the urgent issue of mitigating and adapting to climate change.

Understanding the state of play

To this end, a new initiative was launched in June, called the Assessing Sovereign Climate-related Opportunities and Risk (ASCOR) framework, to help investors measure, monitor and compare sovereign issuers' current and future climate change governance and performance.

The project was jointly launched by the BT Pension Scheme, the Church of England Pensions Board, the UN-convened Net-Zero Asset Owner Alliance, Ceres, Institutional Investors Group on Climate Change, Principles for Responsible Investment, the Transition Pathway Initiative (TPI) and Chronos Sustainability, a UK-based responsible investment and corporate sustainability strategy and policy development firm, which will co-ordinate the project.

Research will be conducted by the London School of Economics' Grantham Research Institute on Climate Change and the Environment (GRI). The project has recently secured funding support from seven asset managers, with a range of geographic footprints, including both developed and emerging markets, and perspectives.

Photos, clockwise from left:
Benjamin Voros; Florian Schonbrunner; Drew Dau; Shafagh Faridifar;
Whoisbenjamin; Carson Vara; Nicole Herrero

FEATURE

SOVEREIGN BONDS

“Attracting financial support from firms with diverse areas of expertise will help to ensure our outputs will be relevant to a wide range of asset managers and owners,” says Adam Matthews, Vice-Chair of the ASCOR Project and Chief Responsible Investment Officer at the Church of England Pensions Board.

The multiplicity of tools, data sources and philosophies on assessment does not lend itself to a common understanding on climate policy among asset owners, says Matthews, who draws a comparison between ASCOR and existing climate-focused collaborative projects developed by institutional investors.

“Asset owners are looking for a consistency in assessing countries’ approach to climate change, both in terms of mitigation and adaptation. It’s not our primary intention to develop a whole new toolkit, but to provide a commonly agreed framework, similar to how TPI and Climate Action 100+ have helped investors to compare companies,” he says.

This means an initial focus on identifying the most important criteria to investors, i.e. does the entity in question have policies, targets or reporting processes relating to a particular climate risk, rather than evaluating the efficacy of such. This leaves evaluation to the interpretation of the individual investor, but it offers the assessed entities a checklist of common concerns across major institutional investors and bond purchasers.

“Investors will still need to conduct further analysis and engagement, and consider other aspects

[of the issuer’s profile]. But ASCOR will provide a comprehensive assessment framework for understanding the state of play for a sovereign issuer’s approach on climate change,” says Matthews.

Comparing apples and oranges

When trying to understand the climate risks of sovereign issuers, a prerequisite is to assess them using common criteria. This also applies to corporate bond issuers, but the range of differences between sovereign issuers can be extreme, in terms of their ability to manage the climate risks to which they are exposed, both in terms of climate change mitigation and adaptation.

This is influenced by multiple underlying factors such as size, economic development and political system. How, for example, does one make a meaningful comparison between say Liechtenstein, Indonesia and the United States on climate policy and governance in order to make reliable investment decisions?

At an early stage, ASCOR aims to develop consensus about investors’ expectations of government policy on climate change, such as policies, targets, enforcement mechanisms. This will be a key step toward a framework through which investors can understand both the areas of alignment and difference.

“Every country’s policy mix depends on national circumstances. Regardless of whether a country has a command-and-control or market-led economy, the aim is to focus on the desired outcomes for

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Our aim is to build on credible, authoritative and publicly accessible sources.

Dr Rory Sullivan, Chronos Sustainability

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Every country’s policy mix depends on national circumstances.

Adam Matthews, Church of England Pensions Board



investors and the effectiveness of policy in achieving them,” says Matthews.

A real challenge will be ensuring less developed countries are treated fairly. Impact Cubed, an investment analytics and solutions provider, has partnered with investment teams from ten asset managers to build a sovereign bond impact model aimed at countering a “wealth bias” toward mature sovereign bond issuers in many ESG country rankings.

Using 20 years of data, the model compares the rate of progress achieved by sovereign issuers against expected levels for 29 factors across the 17 SDGs, identifying strong improvements, even from low levels. Lithuania was shown to be a leader (above average on level and faster progress pathway) in the highest number of factors, while many mature economies stalled or lagged in a wide range of factors, notably the US.

At this stage, ASCOR’s plan at the current stage is not to release traditional rankings. Despite the efforts of Impact Cubed and others, project participants

feel this would unfairly disadvantage countries with poor regulatory infrastructure, or which are less well developed economically or are highly exposed to physical climate. Further, such a ranking would not likely enhance the investor’s understanding of what each country is doing, in terms of adaption and mitigation, and what can be expected of them.

Based on corporate reactions to existing ratings models, a low ASCOR ranking would not be the ideal starting point for establishing deeper engagement between investors and sovereign issuers, notes Dr Rory Sullivan, Chief Technical Advisor, ASCOR Project and CEO, Chronos Sustainability.

“We don’t want to reinforce existing biases. How we present the information is integral to making this credible and helpful to investors as they engage with governments to improve their approach to climate change,” he adds.

Engagement with sovereigns

Reducing climate risks and greenhouse gas emissions in one’s portfolio is not merely a matter of evaluating, divesting and rebalancing. ESG investing

FEATURE

SOVEREIGN BONDS

is often most effective through engagement, not just by shareholders but increasingly by bondholders too.

In areas such as corruption and modern slavery, large investors' views have helped to shape and accelerate legislation. ASCOR participants hope the framework will serve to shape investors' collective priorities and expectations from sovereigns in terms of climate risk management, to the benefit of both parties.

"Regional investor networks already engage with policymakers on specific climate-related policy measures as important stakeholders. But it's less clear at this stage how investors should engage with governments on the broader direction of climate policy," says Matthews.

"The outcome of ASCOR will enable the kind of coordinated investor engagement undertaken by Climate Action 100+."

Climate Action 100+ pairs asset owners and managers with heavy-emitting corporates to develop detailed plans to decarbonise their operations,

processes and policies. If governments understand the criteria being used by a large number of institutional investors to assess their performance on climate-related issues, they are more likely to bear these in mind from a policy perspective.

"There is broad consensus among institutional investors in terms of expectations in areas such as fiscal discipline and transparency, for example. That does not yet exist in climate change policy. But agreement on the direction of travel that investors expect from governments will help to lay the basis for engagement," adds Matthews.

As a method of assessing issuers of bonds rather than bonds themselves, there is scope for ASCOR's methodology to be used beyond the sovereign markets, e.g. perhaps helping to assess state-owned enterprises, says Matthews.

"The ASCOR assessment framework may also be useful when investors look at a corporate issuer's exposure to country risk. For example, an investor may want to factor in the fact that 25% of a mining firm's operations are in countries without a clear



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We don't want to reinforce
existing biases.**

Dr Rory Sullivan, Chronos Sustainability

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Issuance of green bonds is certainly a candidate to be one of the indicators when assessing climate credentials.

Adam Matthews, Church of England Pensions Board

policy framework on a particular area. Further, communication of common investor expectations on aspects of climate mitigation or transition could encourage greater private-public collaboration on common solutions,” he explains.

Inputs and outputs

Initially, ASCOR’s outputs will be based on publicly available information. This may include countries’ nationally determined contributions (NDCs), as well as other well-established data sources, such as the World Bank’s Worldwide Governance Indicators and Climate Change Knowledge Portal, the data supplied by governments to the UN Framework Convention on Climate Change, and the GRI’s climate laws database.

“Our aim is to build on credible, authoritative and publicly accessible sources that are regularly updated, well-understood and validated. We want to build on data sets that are already widely used, methods that are widely recognised and outcomes already seen as valuable by investors. These are important inputs into our selection process,” says Sullivan, who nevertheless acknowledges that alternative data sources could be valuable in due course, such as satellite data on land clearance.

Rather than assessing and scoring NDCs directly, ASCOR is more likely to establish a framework for evaluating NDCs alongside other indicators of climate risk policy. If a country’s NDC does not provide sufficient detail, for example, the ASCOR framework will suggest that the asset owner take this into account.

Explaining the possible roles of NDCs in ASCOR’s sovereign assessments, Sullivan draws parallels with TPI’s assessments of management quality and company performance in specific sectors. The first is based on whether a company has certain policies and structures in place, the latter is an assessment based on company data, processed and analysed and compared via benchmarks. “Similarly, ASCOR could assess whether a country’s NDC covers six particular categories of information, but separately it could also assess the overall adequacy of the NDC,” he explains.

As ASCOR is focused on issuers not issues, it will not be focusing specifically on the attributes of specific green bonds, says Matthews. However, the proportion of an individual sovereign’s outstanding debt represented by green bonds could be a criterion for evaluating the credibility of the issuer, or their commitment to reducing carbon emissions, as could the use of particular KPIs or evaluation frameworks by their green bonds.

“Issuance of green or other sustainability bonds is certainly a candidate to be one of the indicators for consideration when assessing the climate credentials of a particular sovereign. Further, an asset owner might decide only to invest in a sovereign green bond if it is issued against a recognised standard and the country is also assessed positively on a particular number of indicators in the framework, for example,” he adds.

Diverse Harvest as ESG Bond Funds Catch up with Equities

Once primarily the domain of equity investors, ESG criteria are now just as important among bond buyers. ESG bond funds are growing in number and innovation as managers compete to meet demand for responsible fixed income product. But, writes Nick Herbert, investors must ensure their aims are aligned with strategies.

Photo: Rod Long

According to funds data and analytics provider Morningstar, global assets in ESG bond funds have tripled over the last three years to US\$350 billion. Nevertheless, fixed income remains under-represented in the growing ESG space.

Fuelling demand for ESG investments is the drive towards financing companies' net zero greenhouse gas commitments and an increased focus on sustainability on the part of asset owners and other long-term investors. Living through Covid-19 has



also highlighted the importance of social investing. Until recently, these issues have primarily been addressed from an equity perspective.

“Responsible investing was originally embraced more readily by equity investors,” said Carmen Nuzzo, Head of Fixed Income at the Principles for Responsible Investment. “They have more institutionalised channels to affect corporate strategies, partly because they have voting rights, but also because they participate at annual general meetings.”

Relationships between bondholders and borrowers have traditionally been more distant, but that is changing. Fixed income investors have realised the influence they have over how bond proceeds are used, and the pressure they can apply to a company’s strategy, both in terms of minimising ESG risks and optimising opportunities.

As demand for ESG bond product has increased, so has the supply of funds, albeit from a relatively low base.



“Bondholders have a very important role to play because they can really decide where to channel capital.”

Carmen Nuzzo, Principles for Responsible Investment

“It’s part and parcel of the product development cycle,” said Jose Garcia Zarate, Associate Director of Passive Strategies for Morningstar. “It was much easier to develop funds with ESG propositions on the equity side because there was a lot of data and historical research done on corporations. That was not so much the case on the bond side.”

Initially, appetite for sustainable investment found its supply-side response largely through product created to deliver ESG-informed exposure to the equity markets. “There’s been a bit of a lag in research for fixed income. But it’s catching up, and that’s why we’re seeing much more interest in product creation,” said Zarate.

Widening array of strategies

Product development has accelerated in the past couple of years, with the launch of 122 new ESG bond funds in 2020, and an additional 45 switching from a conventional to a sustainable mandate, according to Morningstar.

As of March 2021, the total ESG bond funds universe had reached 900, comprising both

open-ended funds and ETFs that claim to have a sustainability objective for their investment selection. The numbers discount cursory exclusionary screens, such as controversial weapons, tobacco, and thermal coal. Money market funds, feeder funds, and funds of funds are likewise excluded.

Funds are constructed along many different lines and encompass active management or passive strategies. This can be seen in the latitude granted to managers of active funds to invest in ‘unlabelled’ green bonds and the range of indexes and benchmarks being developed for passive vehicles to follow. Innovation is evident across all styles, but the sustainable efficacy of some approaches is more questionable in their potential impact than others.

“There are bond funds, corporate or sovereign, that are applying ESG or sustainability criteria, but they are used for general purposes, not specific sustainable projects,” said Stephanie Maier, Global Head of Sustainable and Impact Investment at GAM. “We also have green or sustainability bond funds, which have very clear use of proceeds so that you



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The more the market expands, the more you will be able to segment.

Antonio Celeste, Lyxor ETF

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There needs to be transparency around how methodologies are defined.

Stephanie Maier, GAM



know the money you’re investing is going towards very specific green activities and green projects.”

Straight-through proceeds

Funds referencing green, social or sustainable bonds are perhaps the most transparent vehicle for ensuring investments have a clear real-world impact as well as a financial return. Numbers of impact funds are on the rise and account for 10% of all ESG bond funds. Of these, green bond funds are the dominant flavour, which reflects the growth of these assets in the underlying bond market – issuance volumes of green bonds and social bonds have grown from around US\$40 billion in 2015 to already more than US\$430 billion this year to mid-August, according to Refinitiv.

As volumes of ESG bonds expand, the diversity of issuer-type to be found in the market has also widened. Initially dominated by supranational borrowers, the market now accommodates corporates, sovereigns, financial institutions and a smattering of high yield or emerging market debt. Greater diversity in the underlying market gives fund managers the opportunity to develop a broader product range with ESG as an overlay.

“Issuance of green bonds is really expanding,” said Antonio Celeste, Head of ESG ETF Product at Lyxor ETF. “In 2017, we issued an ETF investing in

corporate and sovereign bonds and now we are able to issue an ETF investing only in sovereign bonds. The more the market expands, the more you will be able to segment it into targeting a specific portion of the market. The risk/return with green or social bonds is no different to conventional bonds, the only difference is that proceeds will be invested to finance a given type of specified activity.”

Scores of scores

But bonds specifying the use of proceeds are not the only way of channelling fixed income investment into promoting sustainability. Managers of bond funds rather employ taking an ESG view at the corporate level to construct portfolios, either through negative or positive screening.

Company-level ESG scores can help managers avoid debt from issuers following certain undesirable practices or, increasingly, tilt investments towards borrowers with improving sustainability strategies. Yet the use of ESG scores brings with it its own potential for complexity, even confusion.

The broad array of third-party ESG rating providers can sometimes result in different sustainability ratings being assigned to the same company. In addition, managers may also rely on proprietary ESG research to determine their choice of exposure.



“**Exclusion can take a very long time to improve the ESG performance of a firm.**”

Michael Hünseler, MEAG

It is important to understand the underlying methodology employed.

“There is room for a variety of approaches to sustainability, but it absolutely needs to be clear to the end-investor what approach is being applied in assessing the underlying corporate and using those scores to either tilt or screen,” said Maier. “There needs to be transparency around how methodologies are defined.”

The need for transparency rolls up to the fund manager itself when assessing ESG credibility. And this is particularly apposite in the case of once-traditional bond funds being relabelled with green or sustainable credentials to jump on the ESG bond fund bandwagon.

“We’re seeing some existing funds that have been relabeled as sustainable by excluding a few bond issuers,” said Sarika Goel, Global Head of Sustainable Investment Research at Mercer Investments. “In order to get any level of comfort around making funds more sustainable, I think we need to see some clear changes taking place with the fund manager. If all you’re doing is taking out a few things but not really changing anything else, it wouldn’t convince me.

We’d need to see some changes to the investment philosophy and the process. Otherwise, this is where there’s a greater chance of there being greenwashing.”

From voluntary to mandatory

At a time when sustainable investing is subject to a mix of voluntary and mandatory frameworks, green bonds and the funds that invest in them play an interesting role in the journey toward greater transparency, accountability and impact.

Michael Hünseler, Head of Active Fixed Income at Munich ERGO AssetManagement GmbH (MEAG), sees green bonds as “a helpful shortcut” for sustainability-oriented investors looking for transparency on how their investment is being used by the issuer.

But the final goal is for investors to have full transparency from corporate issuers about their ESG performance across all their activities. This is also the aim of the EU Taxonomy, he notes, and other aspects of the sustainability disclosure regime being put in place by the European Commission.

ESG bond funds can be found in both the ‘light green’ Article 8 category under the Sustainable Finance

Disclosure Regulation (SFDR) and the darker green Article 9 category in which sustainability is an explicit objective, requiring high levels of oversight for managers and tough targets for issuers.

Engagement is taking bondholders' ESG ambitions to the next step, according to Hünseler. "Many SFDR Article 8 funds use exclusion criteria, but exclusion can take a very long time to improve the ESG performance of a firm, for example by increasing its refinancing costs and decreasing its competitiveness."

Engagement also helps companies to better understand the specific needs and investment criteria of bondholders, while also improving the overall ESG situation. Munich Re is one of the many institutional investors to have joined Climate Action 100+ to increase the pressure from investors on companies to make their business model more sustainable.

"Companies are already walking down this road. Some may not be evaluated from an ESG

perspective initially, but they are improving over time," he said.

Clearing the air

It seems clear that ESG bond funds will continue to grow in popularity as part of the overall approach to investing in fixed income and sustainability.

"People have realised bondholders have a very important role to play because they can really decide where to channel capital to which project, and also how to support companies in the transition to more sustainable business models," said Nuzzo at the Principles for Responsible Investment.

Transparency, regulation and the consequent credibility of ESG bond funds will determine the market's rate of growth. But investors will still need to do their homework to better understand what they are financing. ■

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Some existing funds have been relabeled as sustainable by excluding a few bond issuers.

Sarika Goel, Mercer Investments



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