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Understanding the Booming Market for Sustainable Bonds

The sustainable bond market grew robustly in 2020, as several new types of instruments made their appearance. Ostrum AM is a significant player in this market, currently managing €16 billion in sustainable bonds, most of which are green bonds (77%), with sustainability bonds (10%) and social bonds making up the remainder. This makes Ostrum AM a leader in the European sustainable bond market. After presenting our analysis of this market and its potential, we will look at some of the main factors that are currently impacting the sustainable bond market: regulation, greenwashing risk, and the concept of a 'just transition '.

Part 1 – 2020, a record year for sustainable bonds

What is a sustainable bond?

The term 'sustainable bond' is a generic term that covers various asset classes, and in particular the following five types of bonds:

- Green bonds, are bond instruments whose proceeds, or an equivalent amount, will applied to fund projects that have a positive impact on climate or the environment.
- Social bonds, are bond instruments whose proceeds, or an equivalent amount, will applied to fund projects that have a positive social impact.
- Sustainability bonds, are a hybrid version of green bonds and social bonds where proceeds, or an equivalent amount, will applied to fund both environmental and social projects.

These three types of sustainable bonds are the 'pioneers' that investors are most familiar with.

Two new asset classes have recently emerged:

- Transition bonds, which aim to bridge the gap between projects that are already 'green' and can be financed by green bonds, and projects that are not yet low carbon, but which nevertheless have a significant impact on reducing carbon emissions and therefore contribute to achieving the objectives of the Paris Agreement
- Sustainability-linked bonds, which unlike the above sustainable bonds are not intended to fund specific projects but rather general corporate purposes like any regular bond instrument. However, their structural characteristics can vary depending on whether the issuer achieves predefined environmental or social objectives. The standard structure of an SLB is a coupon step-up mechanism that increases the interest rate paid if these objectives are not met.

Green bonds, social bonds, sustainability bonds and transition bonds are known as 'use-of-proceeds bonds', as their funds are earmarked for specific projects. This is not the case with sustainability-linked bonds.

A review of the market in 2020 and the outlook for 2021

Despite the financial shock of 2020, the sustainable bond market continued its ascension. The market remained open for issuers, the range of which continued to diversify, and saw the emergence of new and innovative instruments.

The USD 500 billion of sustainable bonds issued in 2020 represents a significant increase over the previous year. By the end of the year, inflows exceeded the symbolic amount of 1,000 billion USD equivalent and are currently at around 1,200 billion. The market continues to grow despite a problematic economic environment.

The clearest indicator of this growth is the market penetration rate of sustainable bonds in the general bond market. If we observe this rate over the past few years, an equivalent rate of growth may be seen for all currencies and all types of issues, except for sovereigns. The increase between 2019 and 2020 of the penetration rate from 9% to 17% of annual issuances in the euro market is particularly significant and has a direct impact on the overall penetration rate of sustainable bonds, which rose above 5% for the first time at the end of 2020. This market is therefore becoming increasingly significant.

The boom in social bonds

2020 also saw a surge in social bond issuance, to which the economic crisis certainly contributed. The measures that governments implemented to stimulate their economies and preserve jobs were financed in large part in the bond market and resulted in an unprecedented increase in the issuance of social bonds, from 30 billion USD equivalent in 2019 to 150 billion in 2020.

Government agencies have accounted for most of this boom, with the European Union being the largest issuer, as seen with the debt issued last year to support the European Commission's SURE programme to finance the entire short time working scheme in the EU countries and the various programmes to support employment. These bonds now total just over EUR 75 billion out of a theoretical cap of EUR 100 billion. Investor interest has been such that the demand for some bonds exceeded the issuance value by a factor of ten.

New green bond issuers

The developed countries saw their share of debt issuance in the green bond market rise from 73% in 2019 to 80% in 2020. Accordingly, the emerging market countries saw their share decline. This retraction was most significant for China, which entered the sustainable bond market with social bond issues in the first two quarters of the year. This had a negative impact on the green bond issuance of the other emerging countries.

Europe has been active player in this market, which saw the emergence of new issuers. Sovereign and government agency issuance grew substantially, while the corporate market was also a very dynamic issuer of non-financial bonds, with the arrival of new sectors that had been much awaited for several years, such as the automotive industry, which brought several issuers to this market.

In the sovereign bond segment, much debt has already been issued over the past few years, with France being the first country to issue a large bond. This momentum was maintained in 2020. New issuers also appeared, such as Germany, Sweden and Hungary in the eurozone. Elsewhere in the world, Chile also issued new sustainable bonds as part of its green funding efforts.

What type of projects are funded?

In terms of the types of projects financed, 2020 saw no significant changes in sectors, with renewable energy, building energy-efficiency, and sustainable transport projects accounting for over 80% of the projects financed over the year.

The funding of energy and transport projects is on an upward trend. A surge in the funding of projects to increase the energy efficiency of buildings was observed in the first quarter of 2021.

All of this has made 2020 a record year for sustainable bond issuance. Growth was very strong despite the difficult social context, which augurs well for the future development of this market.

The outlook for 2021

Another record year of issuance is expected in 2021, with estimates ranging from USD 600 to 700 billion.

Green bond market

Green bond issues are expected to continue to do well, with estimated issuance of about EUR 300 billion for the year. Since 30% of this figure has already been achieved in the first quarter of 2021, there is room for further improvement.

There are two main forces that suggest that this trend is likely to continue.

The first is the European Union's stated intention to refinance about EUR 225 billion of debt in the green bond market over the next few years. This issuance is expected to begin in the second half of 2021, mainly to finance the EU's 750-billion-euro recovery fund.

The second is the expectation that governments will pursue their efforts to finance their energy transitions and meet the emission reduction targets that have committed to for 2030 and 2050, which should help maintain this market's momentum. New issuers such as Spain, the UK and Austria are expected to enter the green sovereign bond market this year.

Social bond market

We also expect the social bond market to continue to expand, with total issuance in 2021 ranging from 200 to 250 billion EUR equivalents. Just over 100 billion EUR equivalents has already been

issued, mainly by the European Union and government agencies. Since some of the latter have already made good progress on their 2021 funding programmes, the pace of issuance could be more moderate toward the end of the year. 2021 should therefore give investors a good idea of this new market's potential.

More dollar-denominated bonds

The third thing that Ostrum AM is expecting from this year is an increase in dollar-denominated issuance, particularly on the part of US issuers, with more new issuers jumping into the market in the wake of the United States' return to the Paris Agreement. The Biden administration's USD two trillion infrastructure plan, a significant portion of which will be allocated to energy-transition projects, should also deploy massive funding to sustainability projects in various sectors of the US economy.

We therefore expect the corporate market to start making up for its lag in green bond issuance and foresee strong growth in some 'niche' segments, such as municipal bonds.

What does the future hold for sustainability-linked bonds and transition bonds?

Although both asset classes are likely to grow, we expect much stronger growth for sustainability-linked bonds.

1. Transition bonds

There is a general consensus on the need to get all sectors of the economy committed to the energy-transition process, and the most carbon-intensive issuers in particular. However, there is no consensus on the types of projects that transition bonds should finance. This subject is even a rather substantial bone of contention that is currently holding back the development of this market. There are diverging views within the International Capital Market Association (ICMA) on the relevance of developing a specific label for this asset class.

Given the urgency to fight climate change, we believe these new principles should be promoted, as this would enable us to have a more holistic approach of energy-transition within our investment process. In terms of carbon impact and the reduction of CO_2 emissions, some projects financed with transition bonds could be more effective than those financed with green bonds. For example, transition bonds could finance projects to convert coal-fired power plants to gas-fired plants in developing countries, which could also combine carbon capture systems. This would have a much greater impact, for example, than refinancing a portfolio of existing buildings in Europe, which may benefit from environmental certifications, but offer little additionality and are ultimately more or less 'business as usual', given the current level of regulation.

In any case, we do not expect much growth in transition bond issuance this year.

2. Sustainability-linked bonds

The outlook for sustainability-linked bonds is much brighter. Given the ICMA's publication of its Sustainability-Linked Bonds Principles and the ECB's announcement that these instruments would be eligible both as collateral and asset purchase programmes (APP and PEPP), this asset

class is likely to grow much more significantly in 2021. Sustainability-linked bonds could be more effective debt instruments for some type of issuers, especially corporate issuers, which would like to address social issues that are relevant to their business activity, such as promoting more inclusive health care in the pharmaceutical sector.

Sustainability-linked bonds are an excellent complement to green bonds, as they make it easier for issuers that cannot participate in the use-of-proceeds bond market (due to a lack of eligible assets) and for controversial issuers (such as the ones in the oil and gas industry) to make a commitment to their transition.

These debt instruments are ideal for promoting the Sustainable Development Goals in a given economic sector, such as pharmaceuticals (SDG 3 on ensuring health and well-being) and real estate (SDG 11 on sustainable cities and communities).

However, attention must be paid to the development of good practices in this market, as certain characteristics of these instruments may induce a risk of greenwashing:

- The higher interest rates paid to investors if sustainability targets are not achieved creates a decorrelation between financial and non-financial interests, which first appears counter intuitive.
- Sustainability performance targets must be relevant and sufficiently ambitious to ensure that issuers must make a real effort and not simply conduct business as usual.
- Sectoral KPIs also need to be standardized, to establish reliable benchmarks and define the most relevant KPIs for each sector.
- Lastly, it should be borne in mind that sustainability-linked bonds are not impact investments strictly speaking, as funding is not allocated to a specific project. Instead, they are great tools to engage with issuer, and as such are highly complementary to green bonds.

The sustainable bond market is therefore becoming both more structured and more diversified. As a result, we need specific analysis and evaluation methodologies for each type of bond to properly assess their sustainability performance and thus avoid the risks of controversy and greenwashing.

Part 2 – The EU Green Taxonomy and the future green bond standard: constraint or opportunity?

There are both advantages and disadvantages to these new regulatory standards. However, we believe that the opportunities outweigh the constraints.

The Green Taxonomy's opportunities

The Green Taxonomy addresses one of the prerequisites to the development of the green bond market, which is to clarify the definition of green activities and establish a common language within the European Union for business activities that are consistent with the Paris Agreement and will make a positive contribution to the objective of achieving carbon neutrality by 2050.

The taxonomy also promotes the idea of a 'just transition', which is a key concept as it enables a holistic vision of projects that takes into account not only their climate and environmental impact, but also their potentially negative side effects on the environment or society. With the 'Do No Significant Harm' principle and the 'Minimal Social Safeguard', the Green Taxonomy Taxonomy makes it possible to move towards this concept of just transition.

The taxonomy also prepares the way for the implementation of the future EU Green Bond Standard, the objective of which is to bring more transparency and promote best market practices. This is expected to limit the risks of greenwashing, bring more credibility to the green bond market and contribute to its sustainable development.

Finally, the taxonomy provides a framework for the European Union recovery plan. Among other things, it will make it possible to verify that the 37% of the current European Recovery Plan that is earmarked for climate protection will be allocated to activities that are indeed aligned with the EU objective of carbon neutrality by 2050. The main tool of this recovery plan is the Next Generation EU (NGEU) fund, a EUR 750 billion package of which 30% is funded by green bonds.

Constraints

Implementing of the taxonomy can turn out to be complex for some activities, mainly because of a lack of reliable data, and could hinder the entry of certain issuers into the market.

For example, in the building sector, the taxonomy refers to two distinct alignment criteria: the energy performance certificate (EPC) and the top 15% most efficient buildings in terms of primary energy demand. However, these benchmarks cannot currently be implemented uniformly throughout the EU, as many buildings do not have an EPC or their EPC is not up to date. Issuers and sustainability analysts therefore do not have access to complete and consistent data.

As for the top 15% most energy efficient buildings, this is difficult to determine as stakeholders do not know which data to refer to.

The lack of data also makes it difficult to comply with the 'Do No Significant Harm' Principle. For example, to comply with environmental objective #3 relative to the "sustainable use and protection of water and marine resources", property companies will have to ensure that taps in kitchens and bathrooms have a flow rate of six litres a minute. Yet they often do not have this information, which makes it hard to implement the taxonomy.

The second problem is the evolving nature of certain regulatory thresholds, which may be reviewed every three years and possibly expose the oldest green bonds to the risk of obsolescence and adversely affect their price.

Lastly, the taxonomy is sometimes criticised for being too restrictive which might lead to the creation of a niche market. For example, only a very small proportion of assets in the cement sector are current aligned with the taxonomy. The very demanding requirements of the Technical Screening Criteria (TSC) may therefore hinder the development of the green bond market and its sectoral diversification.

While European issuers are obliged to disclose their data under the Non Financial Reporting Directive (NFRD), non-European issuers have no such obligation. We therefore run the risk of creating a market composed of bonds based on relatively strict or lax taxonomies and therefore very heterogeneous in terms of quality.

With the EU Taxonomy, we are thus facing a double challenge: a challenge of implementation in the short term and a challenge of cohabitation in the long term, with bonds that will comply with different standards and more or less stringent taxonomies.

How can the quality of sustainable bonds be ensured?

The market for sustainable bonds is 'self-labelling' with no specific regulation at this time. The only reference for stakeholders in this market are the ICMA's principles. Sustainable bonds are therefore governed by 'soft law' since they can be issued without meeting any particular regulatory requirements.

At Ostrum AM, we employ an analytical process that is underpinned by our group's policies on specific sectors (such as coal), exclusion lists for the most controversial issuers and a proprietary sustainable bond analysis and rating methodology.

This methodology is based on two axes:

- The 1st axe focus on the issuer. We assess the quality and ambition of the issuer's climate and environmental strategy and how does the green bond fits within such strategy.
- The 2nd axe focus on the structuring of the bond instrument. We analyse the bond in terms of its transparency regarding proceeds allocation, level of materiality and effective impact of the projects financed.

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This analysis results in a rating of 1 to 10, with 1 being the best and 10 the worst. This rating is reviewed at least annually and especially after the first report. We reclassify all bonds that are rated from 8 to 10 as 'non green bonds'.

We will check that the nominal issuance amount is consistent with the size of the eligible portfolio and will also look at additionality, in other words 'are we financing a new project or refinancing an existing one ?', 'Are we financing development CAPEX or financial CAPEX such as equity investment ?' etc... We have also established a matrix for assessing project materiality. In the real estate sector, for example, we will prioritise energy-renovation projects, which we consider to be the primary lever for decarbonising this sector.

In order to ensure consistency in the overall investment process, we will also review the management of non-allocated funds and will prefer issues where the issuer has committed to investing these non-allocated funds in SRI instruments that address ESG criteria or in liquid green or social sustainable assets.

Lastly, we will look at impact reporting and check that it refers to recognised standards, that it deals only with the impact of the portion of the project that is financed by the green bond, that it takes into account the project's life cycle, and that the results are certified by an independent third party.

Other factors that should contribute to the development of the sustainable bond market

There are other factors we believe will further the cause of sustainable finance and the development of the sustainable bond market.

The decision of central banks to address climate risk

Some central banks have deployed climate-related initiatives, such as the Central Bank of Sweden, which has included sustainability criteria in its asset purchase programme and in determining the eligibility of certain bonds. Other national central banks, such as the Banque de France and the Bank of England, are reviewing the situation. Earlier this year, the Eurosystem banks also announced their agreement to use sustainability criteria in managing their non-monetary portfolios.

The ECB has been very vocal about its intention to prioritise the fight against climate change and now intends to assess the potential negative impact that climate change could have on the overall stability of the financial system. The announcements on the results of stress tests a few weeks ago give credence to this initiative and to the idea that climate risk may prove to be a systemic risk.

The ECB is a major player in the market and wants to expand on its current efforts. The bank's purchases of green bonds under its asset purchase programme are in line with the growing share of green bonds in its eligible universe. All sustainable bonds (i.e. green bonds, social bonds and sustainability-linked bonds) are eligible for this programme as collateral and for liquidity

operations. The Eurosystem holds almost 20% of the universe of green corporate bonds that are eligible for the ECB's purchase programme.

The over-representation of certain sectors in terms of green bond issuance is also reflected in the corporate sector purchase programme (CSPP). Sectors with a high 'negative' contribution to climate change and high carbon emissions, such as the utilities and infrastructure sectors, traditionally account for 35% of the overall eligible universe, yet represent almost 90% of the eligible green bond universe.

The ECB and other central banks are therefore effectively underpinning this market and thus providing an incentive for issuers to use it. Furthermore, their support contributes to putting a market price on climate-change related factors. Lastly, in their role as regulators, they could further encourage private-sector investors to invest in this asset class.

Recovery plans

Economic stimulus packages play a very important role in the market's development, in both Europe and the US. COP26 will provide an opportunity to measure the commitment of each participating country. The following actions have already been planned or decided.

Within the framework of the European recovery plan, for some time there has been talk of a 'Green Deal' which represents EUR 1,000 billion of project funding over 10 years.

The Commission has also decided to be a little more demanding with regard to its emission-reduction target for 2030, which it has raised from 40% to 55%. The sectors mainly concerned by this Green Deal (energy, construction and transportation) are well known to green bond investors. There is clearly a new impetus in terms of potential projects in the eurozone.

This is also the case in the United States, with the Biden administration's infrastructure programme totalling some USD 2,000 billion, of which 1,000 billion over eight years is targeted to reduce CO2 emissions. This programme's initiatives include decarbonising the automobile sector, developing the electrical power industry, increasing the resilience of energy networks, and developing renewable energies and related research efforts.

The US and European stimulus packages will therefore set the stage for the emergence of new energy transition projects, which will be a great opportunity for bond issuers to finance these projects through green bond issues.

Investor engagement

The sustainable bond market enables institutional investors (i.e. insurance companies, pension funds and asset managers) to align their ESG strategy and CSR vision with specifically measured and targeted projects. They will continue to support this market, given its accessibility and significance for these stakeholders.

Sustainable bonds will help investors meet their commitments to the Paris Agreement and other initiatives, such as the Net Zero Asset Owner Alliance, which has brought together investors with combined assets of over USD four trillion who have committed to making their invested portfolios

carbon neutral by 2050. Sustainable bonds will provide a means for engaging investors in the achievement of their transition goals.

Sustainable bonds will also have an impact on the sustainability reporting of various types of investors. Since the SFDR regulation classifies assets according to the extent to which they address ESG concerns, sustainable bonds will help ensure that financial products meet the requirements of Article 9.

In the insurance sector, the European Insurance and Occupational Pensions Authority (EIOPA) has invited all companies to report their proportion of green investments. This is a major development that will encourage insurance companies to increase their green asset holdings. One way to do this would be to increase the proportion of sustainable bonds among their general assets.

As for banks, the European Banking Authority (EBA) has proposed a new KPI, the green asset ratio, which will enable bankers to report on the proportion of green assets they hold. Its launch is planned for 2022.

Given the above factors, new reporting opportunities and the commitment of stakeholders, we believe the sustainable bond market will see strong demand over the coming years.

Part 3 – Increasing investor interest the social dimension of the energy transition

At Ostrum AM, we intend to increasingly integrate the concept of a 'just transition' into our investment processes.

For a few years now, impact investing has been playing a greater and greater role in portfolio construction, and sustainable bonds have a role to play here. Today, we are entering a new era where there is clearly more commitment to integrate climate strategies into investment processes, but also the requirement that the energy transition be achieved in a way that is fairer to all of members of society.

This is why we are attentive to invest in this transition in a way that is more just and which addresses the environmental issue of reducing the carbon footprint while also including efforts to improve social justice and local communities.

Including the objective of a just transition in our investment process

At Ostrum AM, we are working to integrate this new concept, which is becoming increasingly relevant to our investment process and have recently developed a Just Transition indicator.

For issuers of sovereign and equivalent debt, this indicator is based on the SDG Index scores, among which we have selected the four objectives we believe are most relevant for promoting a just transition for these issuers:

- SDG 4: Access to quality education
- SDG 7: Access to renewable and affordable energy

- SDG 8: Achieving economic growth and decent work for all
- SDG 10: Reducing inequalities between and within countries.

For corporate issuers, we will rely on the scores of two pillars of our ESG rating methodology:

- Sustainable Resource Management, which assesses the issuer's practices in the sustainable management of human and environmental resources and covers such aspects as Working Conditions, the Supply Chain, and Environmental Protection, and
- Local Development, which evaluates the issuer's efforts to further employment in local communities, manage corporate restructuring, promote the development of the local economy, and provide sustainable and inclusive products or services.

We are also modifying our aforementioned project materiality matrix to account for the issuer's identification and management of potential environmental and social externalities of projects financed by sustainable bonds.

Lastly, in compliance with our regulatory duties, we will use the Green Taxonomy to map the projects that are funded with the bonds in which we invest, while making sure to take into consideration the 'Do No Significant Harm' principle and the 'Minimal Social Safeguards'. Our objective is to eventually collaborate with external data providers in order to automate our process and make it more scalable

Additional notes

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A European institutional investment management leader[1], Ostrum Asset Management supports its clients in their liability-driven investments, offering both asset management solutions on the back of its long-standing fixed-income and insurance-related management expertise (equity and fixed income), and investment services via its innovative technological platform.
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1. IPE Top 500 Asset Managers 2020 ranked Ostrum AM as the 77th largest asset manager, as at 12/31/2019. Any reference to a ranking, a rating or an award provides no guarantee for future performance.
2. Ostrum AM was one of the first French asset manager signatories to the PRI in 2008. More details; www.unpri.org
3. Source: Ostrum Asset Management, consolidated data at end-March 2021. Administered assets include Ostrum AM's assets. The services provided for a given client may concern certain services only.

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