Growing the US Corporate Green and Social Bond Market

Discussion highlights & recommendations – March 2021

In 2018, 2019, and 2020 APG hosted in-person roundtable events with institutional investors, capital market underwriters, and other stakeholders to exchange views on ways to collectively help grow the sustainable debt market. In 2021, the fourth annual roundtable was held virtually and focused on a new sustainable finance instrument– Sustainability-Linked Bonds (SLBs). These bonds differ from labeled use-of-proceeds (UOP) bonds by linking the bond's coupon payment to the achievement of a predetermined sustainability target (e.g. emissions reduction). SLBs provide an opportunity to expand the ESG-themed debt market to new sectors, but it is also critical to uphold the integrity of the SLB market, especially in its early stages. The discussion focused on three areas:

- *Where do SLBs fit in the market compared to labeled use-of-proceeds bonds?*
- *How can SLBs be structured to accommodate the unique features of the high yield market?*
- *How could/should social or governance indicators be included as KPIs.*

Sustainability-Linked Bonds and their place in the sustainable bond market

SLB issuance is poised to increase significantly, but it will compliment and not replace UOP related issuance: Several participants highlighted that growth in issuance of both types of bonds are not mutually exclusive, with a general optimism about the size of these markets in the coming years. While SLBs might make sense in certain carbon-intensive industries or to help facilitate transition, there are other investors who remain focused on issuance tied directly to specific projects.

Overall sustainability profile of the issuer still matters: Although investors had differing opinions on the role of SLBs relative to UOP bonds, there was agreement that for both sets of instruments it remains crucial to consider the UOP or KPI targets in the context of the issuer's overarching sustainability strategy. SLBs are appealing because they encourage investors to look at the overall sustainability profile of the issuer, which helps mitigate the threats of greenwashing, especially in more carbon-intensive sectors.

SLB fit in portfolios remains uncertain but will enhance diversification in ESG strategies: Some investors with dedicated ESG products were unsure how SLBs will fit in specific mandates, however there was agreement SLBs have the potential to facilitate much greater diversification in ESG-themed issuance by opening this market to issuers with transition challenges or capex light business models.

SLBs need to be further refined: Inherent difficulties in SLBs still need to be addressed – addressing M&A activity, defining materiality, determining level of ambition, incorporating second party opinions, and standardizing SLB features where appropriate. Most in the group believed resolving these issues over time will allow for greater issuance and encourage more companies to make sustainability commitments.

Structural features of Sustainability-Linked Bonds, particularly in the High Yield Market

Potential for SLBs to broaden scope of sustainable bond investing to the high yield market: Participants agreed there was an opportunity for SLBs to increase ESG-themed issuance in high yield but recognized there is an additional need to clarify and strengthen the structure of SLBs in this market.

KPI measurement date should occur before first call date: There was also general agreement across all stakeholders that the KPI measurement date should occur before the first call date, otherwise issuers should be subject to an additional penalty for calling the bond early.

Need to balance accountability against complexity: While accountability is a defining aspect of SLBs, participants stressed that the accountability mechanism needs to be balanced against complexity. Structures that are too onerous on issuers could discourage issuance and overly complex structures could make valuation more challenging for investors.

Wariness of potential for dual spread curves: Concerns were raised about the possibility of dual curves within an issuer's capital structure if only certain bonds were issued as SLBs. While an SLB-only issuance program represents an ambitious future goal for companies, several participants pointed out that expectations of continuous SLB issuance may discourage issuers from brining SLBs to market. Additionally, investors can get exposure to the same environmental commitment by investing in the general corporate purpose bonds of an issuer if they believe KPIs and sustainability targets are achievable.

Structuring questions remain: The group acknowledged that many SLB structuring questions remain – including the appropriate tenor of measurement dates in relation to the bond's maturity date, the potential for cumulative coupon adjustments with multiple measurement dates, and how to best address callability in high yield SLBs. Investors need to provide more clarity around what they are looking for, and the market should strive for some consensus around standardizing SLB structural features over time.

Concern about strong performance of poorly structured SLBs: Some poorly structured SLBs have seen significant demand and subsequent strong performance. Market technicals, such as periods of high demand, and differing standards from non-ESG focused investors can enable weaker SLB structures. High profile criticism of greenwashing has also been increasing, and market integrity is at risk if too many poorly structured deals are supported simply for their label. It is crucial for all stakeholders to continue to push for higher standards to uphold the integrity of the market and prevent greenwashing. This could create reputational risk for issuers if not addressed.

Sustainability-Linked Bonds and transition scope; the role of SLB's in a broader social agenda

Social KPIs should be included in SLBs: There was broad consensus that social indicators are relevant to SLBs. While the group agreed SLB's benefit from clear metrics such as CO_2 emissions, which have long-established frameworks for measurement and accounting, the UN Sustainable Development

Goals clearly identify other social targets for investors to focus on. Just as the social bond market grew more robust over time, participants felt the natural next step for the SLB market should be inclusion of social KPIs. The introduction of social considerations into SLBs could be gradual, potentially being introduced initially as secondary KPIs alongside environmental-focused targets.

Governance indicators not a fit: The group felt strongly around social KPIs being included, but likewise felt governance KPIs were not a fit. Strong governance should be considered a baseline expectation from all companies and not something to aspire toward via the SLB structure. Governance is a basic qualification for all issuers, representing a 'minimum requirement' and not a target for impact. Participants also highlighted that governance requirements are already covered by regulation and are better evaluated as part of an integrated investment process focused on both fundamental and non-financial ESG factors.

Materiality remains key but will vary by company: Standardization was viewed as less important when considered in the social context. Individual companies have different social objectives and different strategies to achieve them, but if the metrics produce positive impact they could potentially be included. Clarifying materiality (both financially and from a relative impact perspective) and outlining methods for measurement and comparison of social KPIs would strengthen social-focused SLBs, improve credibility, and encourage companies to maximize impact. Some participants suggested SLBs centered on social issues may be best served by initially focusing on key sectors, or in key regions, where social issues are most material.

Action items and next steps

1. **Balance standardization with bespoke company objectives.** Long-time ESG-committed investors need to encourage robust standards in SLBs and focus on market education before these efforts are potentially offset by broad demand from traditional investors. Standardization will help but should be balanced against company-specific ESG strategies, particularly with respect to generating impact via social KPIs.

2. **Evaluate quality of second party opinions.** The credibility of second party opinion (SPO) providers is necessary for ongoing assessment of KPIs and transition goals. Concerns over the specificity, scope, ambition, and structural features of SLBs may be addressed by the growing standardization of KPIs, SLB benchmarking, and a better understanding of materiality. SPOs will play an important role in this process and investors should assess their quality accordingly to strengthen the market.

3. **Determine whether KPIs should be recurring and apply to all types of financing.** Among questions that still need to be addressed for SLBs is whether the same KPI should be used for subsequent issuance, potentially with an updated target, or if new KPIs should be introduced. Investors should provide more guidance around what they are looking for and be transparent with issuers about impact objectives, both social and environmental.