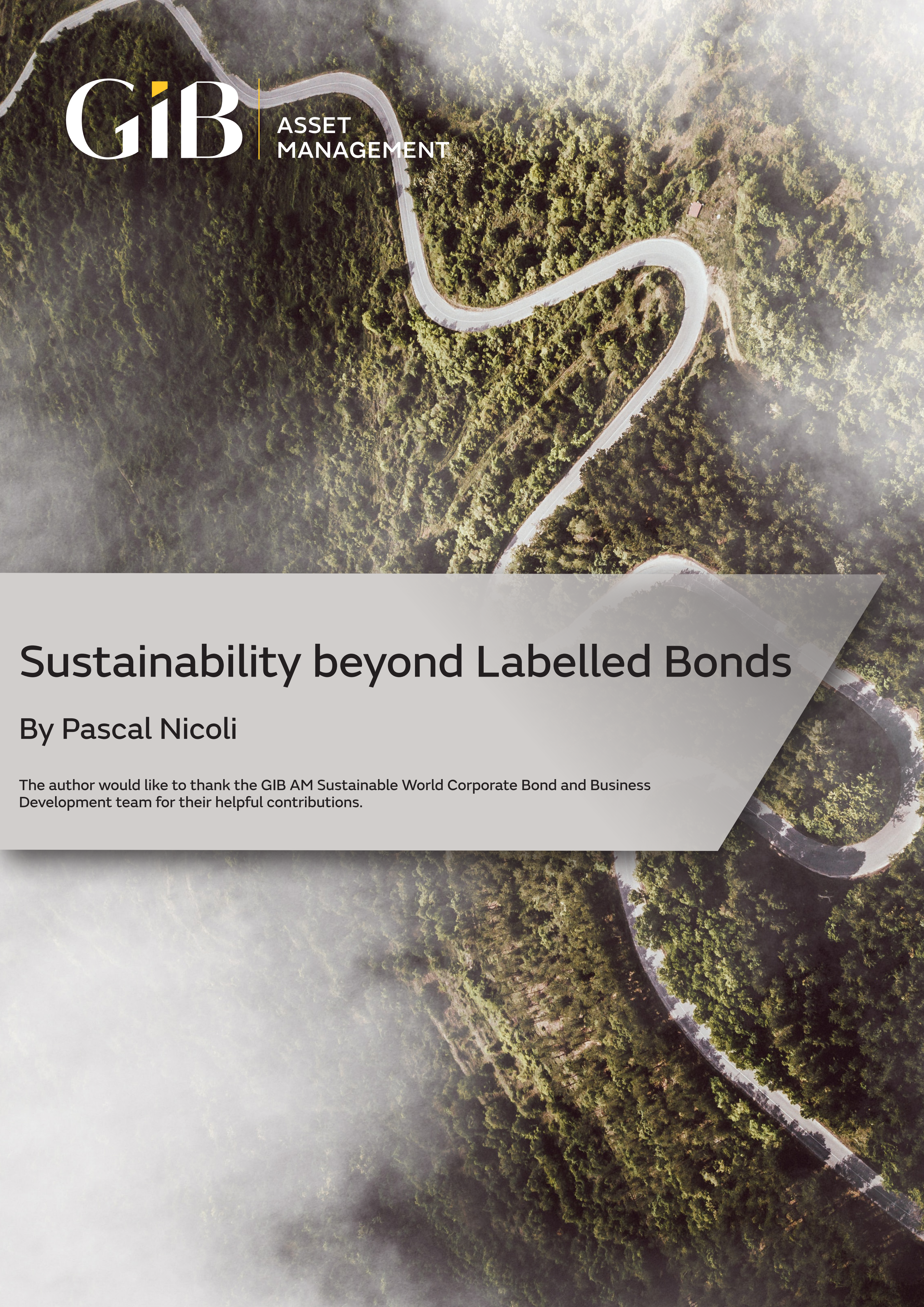


GIB ASSET MANAGEMENT

# Sustainability beyond Labelled Bonds

## By Pascal Nicoli

The author would like to thank the GIB AM Sustainable World Corporate Bond and Business Development team for their helpful contributions.

By Pascal Nicoli - Portfolio Manager, GIB Asset Management

## Executive Summary

The adoption of Labelled Bonds was undoubtedly a crucial early step in encouraging fixed income investors to incorporate sustainability considerations in portfolio construction. However, as instruments, they carry structural limitations. In particular, the classification process is broadly unregulated, they are linked to projects rather than companies, and sector and geographic concentration is high. As a result, we believe it's now time for market participants to go the extra mile and apply their own analysis to the issuer, its business activities and practices, as well as the specific bond features.

## Labelled Bonds, what are they and how do they work?

The introduction of 'Labelled Bonds' represented a critical early milestone in capital markets' ability to efficiently incorporate sustainability factors in Fixed Income. In 2007, the European Investment Bank issued a first self-assessed green bond, followed by the World Bank in 2008, and both issuances contributed to raising awareness about the possibilities of impact investing in fixed income markets.

In 2014, a consortium of banks then established the "Green Bond Principles" to provide a framework for market participants, before their monitoring and development was passed on to the International Capital Market Association (ICMA)[1]. The framework, which establishes a range of voluntary guidelines to enable capital raising for "projects with environmental benefits", quickly set the most widely recognised standards for green financing.

Building on the success of green bonds, ICMA then extended the range of Labelled Bonds and developed the Social Bond Principles, the Sustainability Bond Guidelines and the Sustainability-Linked Bond principles.

| Principles | Role | Key Bond Characteristics |
|---|---|---|
| **Green Bond Principles** | Support issuers in financing environmentally sound and sustainable projects that foster a net-zero emissions economy and protect the environment | Normal bond, use of proceeds dedicated to specific projects |
| **Social Bond Principles** | Support issuers in financing socially sound and sustainable projects that achieve greater social benefits | Normal bond, use of proceeds dedicated to specific projects |
| **Sustainability Bond Guidelines** | Proceeds will be exclusively applied to finance or re-finance a combination of both green and social projects | Normal bond, use of proceeds dedicated to specific projects |
| **Sustainability-Linked Bond Principles** | Encourage companies that contribute to sustainability (from an environmental, social and/or governance perspective) | Normal bond, reduction in interest rate subject to issuer achieving specific ESG targets |

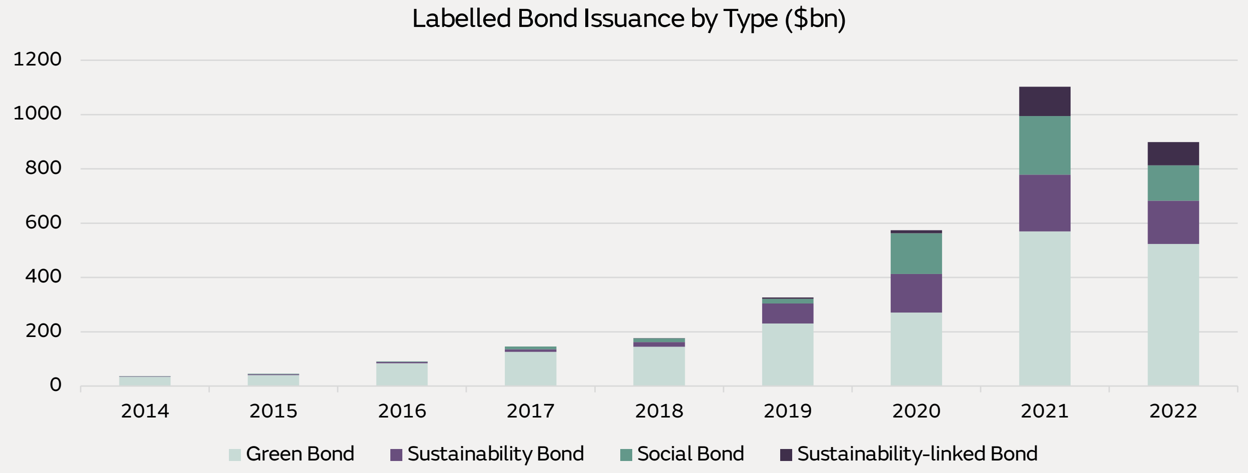
[1]https://www.climatebonds.net/market/best-practice-guidelines#:~:text=Voluntary%20best%20practice%20guidelines%20called,%2C%20HSBC%2C%20Mizuho%20Securities%2C%20Morgan

The Green Bond Principles quickly became the flagship of Labelled Bonds and helped drive the growth of the asset class, with green bonds representing over 80% of Labelled Bonds' annual issuance until 2018 (see graph below).

The breakout of the Covid pandemic abruptly brought social factors to the world's attention and spurred the rapid development of social, sustainable and sustainability-linked bonds, which represented nearly half of issuance in 2020 and 2021.

At the end of Q3 2022, the labelled bond market crossed the $3.5trn mark in combined issuance, with Green Bonds alone reaching $2trn, highlighting the scale reached by the asset class[2].

Green bond indices also started to develop and include, amongst others, the S&P Green Bond Index or the Bloomberg MSCI Global Green Bond Index.




Source: Bloomberg, February 2023

### However, Labelled Bonds face a number of structural limitations

Although Labelled Bonds benefit from their simplicity and distinguishable tag, they still face significant limitations.

#### 1. The labelling process remains largely unregulated

Issuers can self-label "green bonds", without external certification or control, subject to a description of their process and the type of projects they intend to finance (typically recorded in documents like "Green Bond Frameworks").

ICMA principles do recommend extensive transparency, including pre and post issuance external review (e.g. Secondary Opinions assessing alignment with the core components of the Green Bond Principles and tracking progress) but compliance with ICMA principles remains voluntary* and is not a requirement.

The European Commission is aiming to bridge this gap with a new "Regulation on European Green

[2]https://www.climatebonds.net/market/best-practice-guidelines#:~:text=Voluntary%20best%20practice%20guidelines%20called,%2C%20HSBC%2C%20Mizuho%20Securities%2C%20Morgan
*While this is volunatary at present, we can't guarantee there won't be changesand ICMA could potentially become mandatory in the future.

Bonds" proposal, which is currently under development. The regulation could introduce new Euro-specific standards and a supervisory framework to "improve the effectiveness, transparency, comparability & credibility of the market"[3]. Final details about the scope and implementation of the new regulation will have to be considered, as well as its future adoption by the broader market.

Rules for index inclusion also vary and should be carefully considered. For example, the Bloomberg MSCI Global Green Bond Index includes an independent assessment of securities by MSCI on a range of criteria set to "reflect the themes articulated in the Green Bond Principles". Self-Labelled Bonds are eligible for inclusion.[4]

| The 4 components for alignment with the Green Bond Principles |
|---|
| 1. Use of Proceeds |
| 2. Process for Project Evaluation and Selection |
| 3. Management of Proceeds |
| 4. Reporting |

## 2. Labelled Bonds are project-focused and ignore issuers' other activities or practices

The focus of Labelled Bonds is limited to the projects they finance rather than a more holistic assessment of the issuer.

Use of proceeds is the first element considered for alignment with Labelled Bonds principles and proceeds must be spent on projects with positive environmental and/or societal impact. However, ICMA principles do not specify or restrict the type of eligible projects, leaving room for issuers to come up with their own selection and disclosure criteria. This feature calls for specific attention and confirms the relevance of an independent external assessment.

What's more, the guiding principles cover investment projects but do not go beyond. Practices, behaviours or governance standards applied to their execution are not covered, leaving potential gaps in the overall assessment of the sustainability impact of these securities and opening the door for potential controversies. This point is particularly relevant in the context of companies like Credit Suisse, which faced numerous scandals and allegations over the years[5] (spying news, Archegos collapse... to name a few), yet continued to issue green debt instruments.

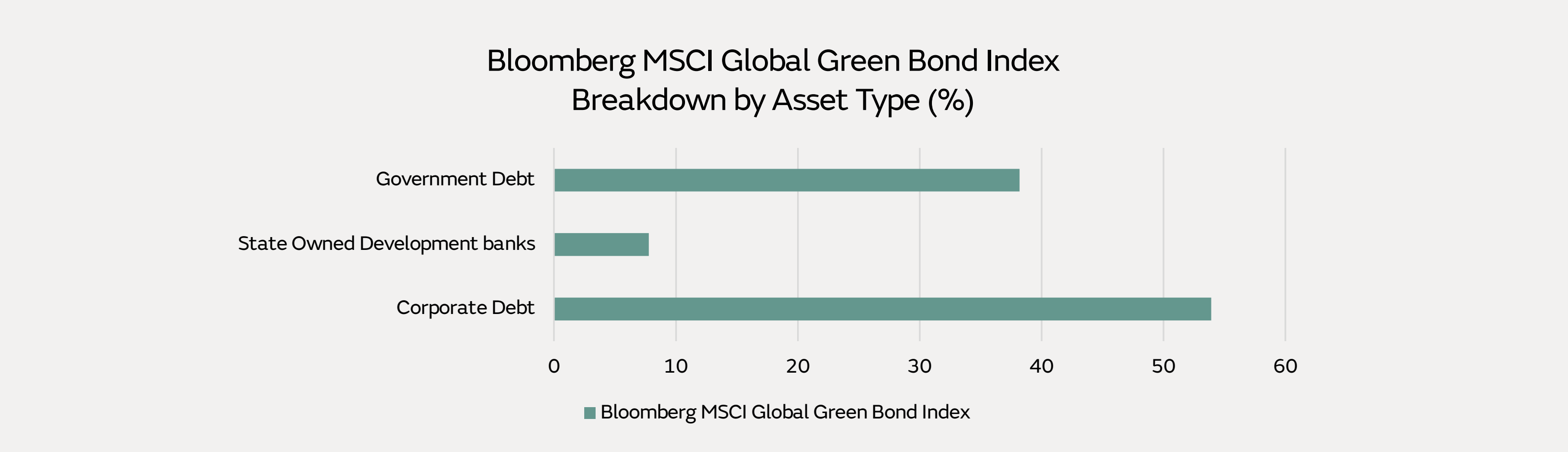
Finally and from a legal point of view, non-compliance with the environmental commitments of a green, social or sustainability bond does not constitute an event of default on the part of the issuer, as consistently stipulated in the legal documentation. As such, non-compliance with the sustainability

[3] https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/european-green-bond-standard_en#overview
[4] https://www.climatebonds.net/resources/press-releases/2023/04/green-and-other-labelled-bonds-fought-inflation-amass-usd8585bn
[5] https://www.morningstar.co.uk/uk/news/233178/credit-suisses-demise-a-timeline-of-scandal-and-failures.aspx#:~:text=Credit%20Suisse%20was%20fined%20%24475,loans%20to%20state%2Downed%20companies.

terms of a green bond does not lead to direct legal consequences.

### 3. Labelled Bonds tend be issued in specific sectors and geographies, limiting the ability for investors to build truly diversified portfolios

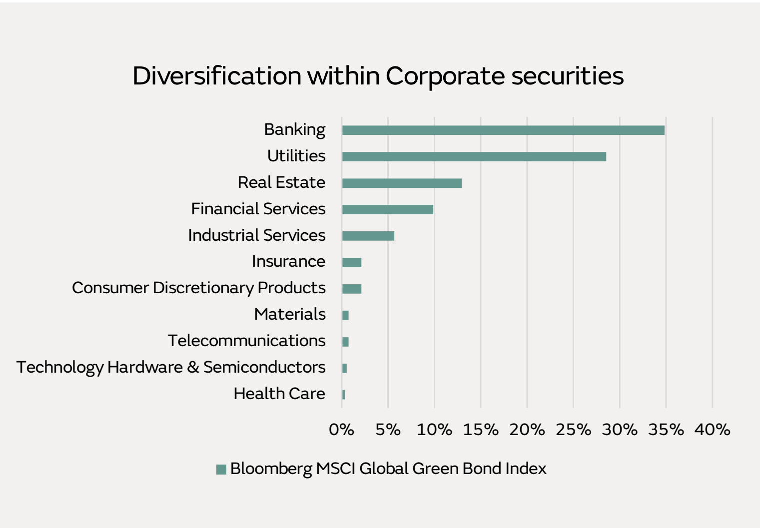
Using the Bloomberg MSCI Global Green Bond Index as a proxy, we highlight that Governments and state-owned development banks represent almost half of the Green Bond universe[6], making it difficult for corporate bond investors to adequately benchmark their portfolios.

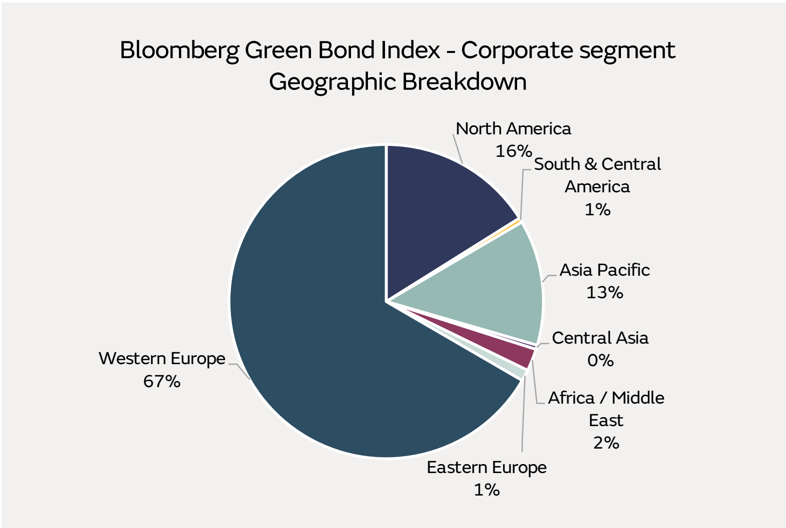



Source: Bloomberg, February 2023

Even when specifically focusing on corporate green bonds, the exposure tends to be skewed towards three specific sectors, namely Banking, Utilities and Real Estate (together making up over 75% of the universe).

Geographic diversification is also limited, with nearly two thirds of assets still being issued out of Europe, the pioneer and most advanced region in terms of sustainability commitments. Issuance out of the US or emerging markets remains limited, despite a recent pick-up in issuance from China.




Source: Bloomberg, February 2023

[6] Bloomberg, February 2023

Finally, and from a financial point of view, Labelled Bonds tend to be more "expensive" and trade at lower spreads than conventional bonds, given the limited supply and growing demand. A study for the Federal Reserve by John Caramichael and Andreas Rapp published in 2022[7] estimated the premium of global green bonds at 8bps on average.

*These gaps incentivise, in our view, fixed income investors to go the extra mile and apply their own analysis to the issuer, its business activities and practices, as well as the specific bond features.*

**Active management combined with a multi-thematic approach brings Fixed Income sustainable investment to the next stage**

Sustainable funds domiciled or marketed in the European Union are subject to a significant level of scrutiny and regulation, irrespective of the location of the manager.

Indeed, the SFDR was introduced by the European Commission as part of the European Green Deal and requires extensive disclosure from Asset Managers to classify their funds as Article 6, 8 or 9.

Article 9 represents, at this stage, the highest level of sustainability disclosure and entails the most stringent regulatory requirements for those funds with sustainable investment objectives.

This increased level of oversight allows fixed income investors to derive greater confidence in regulated funds' disclosure and reporting commitments and be less reliant upon the classification of the underlying holdings.

## SFDR

*The Sustainable Finance Disclosures Regulation (SFDR) is a regulation introduced by the European Commission to improve transparency in financial markets and create standardised ESG disclosure requirements for asset managers.*

*It came into effect in March 2021 and formed part of the European Commission's Action Plan on Sustainable Finance, alongside the Taxonomy Regulation and the EU Climate Transition Benchmarks Regulation.*

*Asset managers such as AIFMs and UCITS managers are required to provide prescript and standardised disclosures on how Article 8 and 9 funds integrate ESG factors and funds must also report against any ESG commitments periodically.*

**Managers under the scope of SFDR must thoroughly review the products, behaviours and governance of corporate issuers to comply with the regulation.**

ESG assessment greatly complements the traditional credit analysis, as it goes beyond the usual financial and strategic reviews and puts the spotlight on areas that are often overlooked.

| Classification of Funds under the Sustainable Finance Regulation | |
|---|---|
| Article 6 | Funds that do not have a sustainable investment objective, nor do they promote environmental or social characteristics |
| Article 8 | Funds that promote environmental or social characteristics |
| Article 9 | Funds that have a sustainable investment objective |

[7] The Green Corporate Bond Issuance Premium by John Caramichael and Andreas Rapp, https://www.federalreserve.gov/econres/ifdp/the-green-corporate-bond-issuance-premium.htm

Staff health and safety is, for example, an area that can fall under the scope of the EU regulation (under the review of additional Principal Adverse Indicators) but rarely appears in classic credit analysis. Yet, the topic deserves much greater interest, as studies show that workforce health and safety tends to positively correlate with superior financial performance[8].

The SFDR also requires that Article 8 and 9 funds invest in companies that follow good governance practices. As such, the board composition, its expertise and practices as well as previous company controversies are topics that naturally fall under enhanced scrutiny. This aims is to limit the risk of future negative headline on a company and avoid the negative mark-to-market resulting from the financial / reputational damage caused. As such, comprehensive ESG assessment does not only enhance risk analysis, it can also enhance financial performance.

A strong investment process becomes even more appealing to investors when applied to a large and diversified investment universe and we believe that multi-thematic strategies exhibit appealing features in that respect. Thematic strategies are well known to equity investors as they focus on identifying the long-term trends that will shape our world in the coming decades and the companies that will benefit the most, through superior growth. We see an equally fertile ground in thematic approaches for corporate Fixed Income strategies, as growing top lines can, in our view, also help well-run businesses reduce debt and improve overall creditworthiness, as much as boost their stock price.

Thematic strategies work particularly well with sustainability because they channel investment towards solutions that best contribute to achieving long term goals. Such goals can include the development of renewable energy capacity, improvement of water treatments or the promotion of responsible finance.

However, these strategies can be relatively “niche” if dedicated to a single theme and lack the diversification and scalability that fixed income strategies typically need to be successful.

As such, we believe that multi-thematic strategies are a better fit for fixed income investors. Multi-thematic strategies cover a larger number of sustainability aspects, allowing, for example, a valuable combination of social (People-orientated) and environmental (Planet-orientated) factors and by doing so, allow a larger range of companies to be part of their investment universe.

This way, multi-thematic strategies tend to be more scalable. For reference, the “Bloomberg MSCI Global Green Bond Index” comprises of around 1,200 securities, making up a $1.1 trillion investment universe whilst the “Global Agg Investment Grade Corporate incl High Yield and EM Custom Index”, which comprises of most global corporate issuers, gathers over 18,000 securities for a total amount outstanding exceeding $14 trillion[9].

As they pursue several objectives, multi-thematic strategy cover a higher number of sectors and industries, ranging for example from Utilities to Healthcare, Banking or Telecommunications. Those sectors exhibit diverse features, reactions to macro-economic shocks and consequently generate different market volatility or beta, helping fund managers to create more diversified and resilient portfolios over the long run.

**By providing the relevant market depth and diversification, multi-thematic strategies allow asset managers to build truly diversified portfolios and help them deliver resilient performance over the medium to long-term.**

[8]https://journals.lww.com/joem/Fulltext/2013/09000/The_Link_Between_Workforce_Health_and_Safety_and.1.aspx
The Link Between Workforce Health and Safety and the Health of the Bottom Line, Journal of Occupational and Environmental Medicine
[9] Bloomberg, February 2023

To conclude, we value Labelled Bonds as a crucial early step in encouraging fixed income investors to embrace sustainability. However, these instruments carry structural shortcomings (lack of regulation, focus on projects rather than issuer, limited diversification) and we think that investors should start to look beyond.

We see significant benefits in multi-thematic strategies, as they match the long-term focus of sustainability, allow for an in-depth analysis of issuers and maintain a scalable and diversified investment universe.

GIB AM has developed a cross-asset thematic framework by for its “Sustainable World” range of funds where we identify the world’s greatest challenges for People (social matters) and the Planet (environmental). The approach is split across six main themes (Health, Inclusivity, Safety, Efficiency, Clean Energy and Circularity) and over 30 sub-themes.

Within Fixed Income, the GIB AM Sustainable World Corporate Bond Fund delivers this approach to the global corporate bond universe, with a focus on Investment Grade securities (minimum 70%).

*For more information, please contact us at info@gibam.com*

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