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SUSTAINABLE FINANCE 2021: Engaging Capital to Drive the Transition

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This report was written and researched by Julian Lewis, with the exception of the keynote interview and the roundtable discussion which was moderated by *GlobalCapital*

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Sustainable finance builds unstoppable momentum

With sovereign ESG bonds passing a clear inflection point, sustainability-linked bonds seeing notable growth and acceptance, and social bonds catapulted forward by a key borrower — the European Union (EU) — that is also poised to boost the green bonds market with an unprecedented €250bn programme, sustainable debt capital markets are reaching a new peak of activity across the capital structure from every issuer and credit type. So what's driving the current boom and what will follow it?

ONCE A MARGINAL 1%-2% of new fixed income sales, ESG debt offerings have now reached a more substantial share of as much as 10%, according to Moody's ESG Solutions. The landmark $1tr a year target for green bond sales long called for by NGO Climate Bonds Initiative to meet the global need for climate change adaptation and mitigation spending is now moving into reach.

Overall, new issue volumes have risen from $50bn in 2015 to more than $500bn in 2020, Morgan Stanley data shows. 2021 has ramped up this exponential rise further with an increase of 100% to date over the same period last year.

"ESG is now a major focus for all key stakeholders in the market and will remain a central theme for years to come," says Alexander Menounos, managing director, head of EMEA DCM and global co-head of IG syndicate at Morgan Stanley.

Morgan Stanley sees the take-off in ESG debt picking up further from here. "Issuance has more than doubled this year and we expect the pace of supply to continue to accelerate," Menounos adds.

Deep diversification

Importantly, growth has been accompanied by a significant broadening of the market. "In recent months we have witnessed a greater diversification with respect to sectors, issuers and instruments," he affirms.

Besides investment grade credits, high yield borrowers too (both from developed and emerging economies) are increasingly active in multiple formats. In addition, the product range has soared far beyond traditional senior bonds: ESG debt investors have now also bought corporate hybrids, financial subordinated and senior non-preferred bonds, convertible bonds, and even securitizations using some form of use-of-proceeds structure. Sustainability-linked securitizations are on the way too, while sales of convertible sustainability-linked bonds (SLBs) have also begun.

While not all investors are equally comfortable with each of these innovations, a significant proportion of buyers are open to less standard ESG debt. If they are comfortable that the borrower's core strategy (and the instrument's KPIs, if included) meets their criteria, they gain access to higher returning debt with the potential to enhance their returns.

While ESG debt has always featured sporadic instances of higher-return issues (generally from lower rated borrowers), this expansion across the capital structure marks a key development in building the market out.

"Investors are keen to see the market evolve and develop in some of the higher yielding formats and instruments. They want to see the market develop across the credit quality and subordination spectrum. They don't want to miss out on higher yielding opportunities," judges Menounos.

Fundamental for investors

ESG debt's new traction coincides with ESG considerations having become mainstream for both equity and fixed income investors — and increasingly influential. "ESG is a fundamental component of how you invest," says Navindu Katugampola, global head of sustainability at Morgan Stanley Investment Management (MSIM).

"Questions of sustainability and the impact of funds are inherent in managing risk and assessing valuation," he affirms, noting that assessing which companies are best placed to benefit from recovery across sectors, industries and countries is a potential source of alpha.

"If credit quality, returns and liquidity have so far been the three most important investment criteria within each sector and product, ESG will surely be the fourth," adds Menounos.

He notes how internal or external ESG ratings are already as important to credit ratings for many investors. "And these drive investment mandates, they drive credit lines and they drive overall sector and issuer-specific investment appetite."

What investors particularly appreciate about ESG debt is the additional transparency over and information on issuers' business models and strategies they provide, as well as opportunities to engage, Katugampola argues. "Essentially you are performing a sustainability deep dive with issuers when they come to market."

"ESG is now a major focus for all key stakeholders in the market and will remain a central theme for years to come"

Alex Menounos, Morgan Stanley

However, MSIM insists that it is not a forced buyer, even though it holds ESG debt in its portfolios — particularly those under Article 9 of the EU Sustainable Finance Disclosure Regulation (SFDR). "We like the instruments, but if they come significantly tight we may choose to buy regular bonds instead," Katugampola says, though the firm is open to buying bonds priced with a greenium if it expects them to perform in the secondary market.

MSIM believes that all ESG debt "has its place" and is open to both use-of-proceeds and SLB structures, Katugampola says. But while it welcomes the market's acceleration and broadening, it regards bond labels as "in some ways irrelevant". "It's more pertinent to look under the hood. These bonds only have credibility if they help improve the issuer's strategy."

Ultimately, greater disclosure requirements of issuers or access to their data in an on-demand way may make the labelling of ESG bonds redundant. But this could still be a decade away, Katugampola cautions.

In the meantime he expects the instruments to continue their expansion and to serve as a useful part of issuers' toolkits. Over this period he anticipates a divergence in companies' cost of capital that reflects the robustness of their ESG strategies and their capacity to manage their sustainability risks.

Divergence in the availability of capital from investors for some sectors is likely to exacerbate this and add to the volatility of their bond spreads and equity prices.

Strategic commitment

ESG's growing centrality for investors makes it central too for issuers seeking to access their capital. "ESG is now becoming critically important for issuers, who need to align their funding strategy to the company ESG strategy and demonstrate commitment to sustainability," Menounos notes.

"Most of our work is to try and advise C-suites around the transition, around building a credible transition strategy, around effectively capturing the new opportunities, and using the capital markets to precisely highlight those initiatives and commitments," agrees Maxime Stevignon, head of fixed income capital markets for France, Belux and Switzerland at Morgan Stanley.

Stevignon hails the shift from companies' earlier "tactical" engagement with ESG. "The shift from tactical to strategic is absolutely paramount in what we've seen over the past 18 months, and I've been quite staggered by the speed at which it has happened. We were discussing it with clients three years ago, and no one was really expecting it would change so quickly."

This new emphasis has created a strong link between sustainability strategy and market access or cost of capital. "If you don't have a credible ESG strategy, there is a real risk of being left behind. It's not merely a case of extracting a small pricing advantage — it may soon have a material impact on depth and breadth of investor audience," Menounos emphasises.

At high-emissions companies, this link is now clear all the way to the top. "This is something that in certain sectors is recognised and understood at the C-suite and board level," Stevignon notes.

This creates opportunities for what he terms "ESG enablers" to access investor demand while communicating their leadership. He cites the recent landmark social hybrid bond by EDF, the first such corporate offering in euros. Already an active green bond and green convertible bond issuer, the French utility created a social bond framework to highlight the second pillar of its ESG strategy — social responsibility.

Proceeds will fund expenditure with SMEs in regions across Europe

Sovereigns set sail for ESG

Although the biggest issuers of all — the US, Japan and China — remain outside the market for now, sovereign ESG debt has gained real momentum in the past 18 months, as a growing number of developed and emerging market issuers have endorsed green, social and sustainable bonds as part of their financing options. As a result, investors are seizing new opportunities to engage on national pandemic recovery and net zero strategies and targets.

THE ARRIVALS OF Germany and Italy this year, to be followed by the UK in September, Canada before the end of its 2021/22 financial year and the super-sovereign European Union (EU) most likely before the end of 2021 too, underscore the rapid take-up of green bonds in particular among major sovereign names.

The EU, which is poised to become the world's top green bonds issuer by dedicating 30% of its €800bn-€900bn 'Next Generation EU' funding programme to the product, has also been key to growth in social bonds. Solely financed with labelled social bonds, its €90bn SURE (Support to mitigate Unemployment Risks in an Emergency) programme has boosted volume in the newer use-of-proceeds instrument significantly.

Moreover, EM names have added valuable diversification to the ESG market through their green, social and sustainable offerings. While Latin American issuers such as Chile, Mexico and Uruguay have been especially prominent in this trend, Asian and EMEA credits like Egypt, Indonesia, Nigeria and Thailand have featured too.

Upward trajectory

Further growth appears certain as the recent host of debut sovereign issuers build out their ESG curves and further new names (Spain, for one) arrive too. More broadly, the fact that around 20% of pandemic recovery spending globally — around $410bn in total — has been green in nature and an even higher proportion qualifies as social expenditure is likely to drive volumes up.

The development of a sovereign sustainability-linked bond (SLB) market could spur additional flows, though this product poses multiple challenges for sovereign issuers and to date only Uruguay has voiced the intention of offering it (*see accompanying SLB chapter for further discussion*).

"We think there are several reasons why this market will continue to grow," notes Ana Colazo, head of sustainable finance for the UK & Nordics at V.E, part of Moody's ESG Solutions. She cites countries' Nationally Determined Contributions (NDCs) under the Paris Agreement, as well as national strategic initiatives against climate change and action to address social inequalities, as key drivers.

"The trends are favourable," agrees Rahul Ghosh, managing director for ESG outreach and research at Moody's ESG Solutions, who points to sovereign ESG bond volume of over $40bn since the start of the year — "already well on course to eclipse last year's full-year total".

and the UK to upgrade the company's nuclear power facilities and develop new clean energy technologies.

Socialising SSAs

Social bonds are also in focus in the sovereign, supranational and agency (SSA) sector. This follows the EU's near-€90bn endorsement of the product through its SURE 'Support to mitigate Unemployment Risks in an Emergency' programme — an unprecedented addition of supply to the sector.

Although very few sovereigns have offered pure social bonds in their own names, agencies such as France's Cades (Caisse d'Amortissement de la Dette Sociale) have already raised substantial funding in the social format. Recently, the sub-sovereign Communaute Francaise de Belgique (CFB) also funded education and sports expenditures through a debut social bond.

"It will be quite key to see how the sovereigns, particularly those with established ESG programmes, look to proceed on the social bond front over the next year or so," says Ben Adubi, head of SSA syndicate EMEA at Morgan Stanley.

Social bonds raise even more questions than their green bond counterparts over use-of-proceeds and transparency. "Clearly those two elements are more challenging to define and measure on the social side," adds Adubi. "So they require greater attention — particularly around the transparency on the impact and outcome of social bond programmes."

One important question is whether other SSA borrowers can adopt best practice from the EU SURE framework. But a more pivotal issue may be long-term commitment to the product.

"A lot of the social issuance has been skewed towards the effects of Covid," says Adubi. "The question of whether these short-dated, temporary issuances under social bond frameworks will be there in the long term?" He cautions that "sovereigns and issuers of that category of bonds should be mindful, particularly where they already have large green bond funding programmes as a starting point — we know that investors value consistency."

(*See Sovereign box in the accompanying Expansion of Sustainable Finance chapter for further discussion*)

HY heating up

The increasing involvement of high yield issuers in ESG debt stands out as a key sign of the market's growing maturity. "It has been a real sea change. There was a lot of discussion last year around when the wave of issuance was going to come, how it was going to come and what it was going to look like — and now

At the same time, sovereign ESG debt is broadening. "We are starting to see more development in this market," Colazo says. "We are starting to see governments issuing consistently — some frameworks, like Mexico's for example, are mapping their whole federal budgets to the SDGs. They are looking at a broader strategy for labelled issuance to become more recurrent in their sovereign debt financing plans."

Ghosh emphasises, though, that "bond issuance is not the end-goal here". Rather, ESG debt is only "part of an extensive toolkit that governments have at their disposal to encourage greater flows into sustainable projects, alongside tax incentives, specific policies on disclosure, or net zero country targets of which we have seen a proliferation of the last 12 months."

He cites the UK as an example. The sovereign announced its first labelled bonds (both institutional and retail green offerings) as part of "a broader suite of actions".

This includes changing the Bank of England's mandate to explicitly factor in climate risk and the establishment of a technical expert group to develop the UK sustainability taxonomy.

Upping EM momentum

Despite growing sovereign traction in developed economies and sporadic activity from emerging markets too, as noted, one key challenge is bringing more EM sovereigns into the ESG debt market. None of the BRICS countries (Brazil, Russia, India, China, South Africa) has yet issued a sovereign ESG bond, for example.

"Another important area will be how to encourage labelled issuance from emerging markets sovereigns with weaker credit profiles that are most in need of sustainable financing," says Ghosh. "With a few exceptions, this market has been dominated by investment-grade governments, and we know

"Governments are looking at a broader strategy for labelled issuance to become more recurrent in their sovereign debt financing plans"

Ana Colazo, V.E

that many emerging markets have larger sustainable development challenges that they need to finance."

Moody's ESG Solutions sees a combination of official sector support to help EM sovereigns with the workload behind issuing, plus market innovation and investor demand for 'transition' sovereign paper, providing a solution.

The task can be substantial, Colazo acknowledges. "Issuing a labelled sovereign bond involves bringing together representatives and information from different government departments."

Most sovereigns that have issued set up a dedicated sustainable finance working group to co-ordinate the work. This breaks down the national budget, moves different budget lines into eligible categories, and determines which are large enough to justify inclusion in the framework. Other substantial tasks include understanding how KPIs monitored by multiple ministries and international departments could be consolidated to provide transparent and clear reporting.

Social switch

Despite initiatives like the EU's SURE programme, combined green/social sustainable bonds from Luxembourg and others and very significant social issuance from agencies such as France's Cades (Caisse d'Amortissement de la Dette Sociale), it's here," reports Jane Bradshaw, co-head of leveraged finance capital markets EMEA at Morgan Stanley.

Although the bulk of this year's high yield ESG new issues have been for industrial, transport and real estate companies, a broader array of sectors is also showing appetite to access this form of investor demand. "Essentially every conversation we are having, whether sponsor-owned business or corporate and no matter what sector, is including a discussion of both ESG broadly and the benefits or potential benefits on SLBs and green bonds," adds Bradshaw. Given all of that, I think the growth is going to continue apace and that sector list will certainly start to grow."

The increasing level of activity is also helping to draw further issuers. "Having a bunch of concrete examples out in the market for prospective issuers to look at and to understand in terms of what others have done and what they as issuers could do is really helpful," she judges.

"ESG is a fundamental component of how you invest"

Navindu Katugampola, Morgan Stanley Investment Management

Greater clarity on pricing benefits may also bring more new issue flow. "If we are able to evidence to issuers that there is a concrete pricing benefit in addition to the broader benefits of doing a positive ESG trade, that would be helpful as well."

A further significant driver in the high yield sector is the influence of private equity (PE) owners. As underscored by EQT's landmark gender-linked SLB, many PE firms put great emphasis on ESG. "For some of the private equity sponsors ESG is a really important internal policy matter and a lot of the firms now have their own frameworks," Bradshaw notes, adding that these can be "quite robust".

In turn, this leads to PE owners encouraging their portfolio companies to pursue ESG issuance "not just for purposes of price and yield".

Although high yield names account for a higher share of SLB volume (estimated by Moody's ESG Solutions at around 25%) than in green bonds, Bradshaw sees the longer established format continuing to attract high yield issuers too. "There has been a pretty decent mix in the year to date and I would expect that to continue. But I wouldn't expect high yield is just going to go down the path of SLBs with use-of-proceeds bonds forgotten about."

Several factors could lead to greater

very few sovereigns have yet issued pure social bonds. Chile is an ultra-rare exception.

Even so, Moody's ESG Solutions sees "robust potential" here, as Ghosh puts it. "If we just think about the nature and mandate of government expenditure, we see fertile ground for growth and diversity in social bonds from sovereign issuers — particularly in post-pandemic recovery spending."

Colazo expects social spending on the green recovery to feature most heavily, along with social issues highlighted by the pandemic. These include income inequality and access to health care.

Impact reporting is a significant challenge for sovereign social bonds, however. "We have a pretty defined and widely accepted set of indicators for measuring carbon emissions," says Ghosh. "With social bonds, depending on the projects being financed, impact assessments can be more qualitative in nature, more challenging to aggregate at the portfolio level or compare from transaction to transaction."

Even so, he does not expect this to hold growth back.

At the same time, Moody's ESG Solutions sees scope for sovereigns to show leadership in environmental reporting. Ghosh notes that the use of proceeds for sovereigns' labelled bonds is already significant in areas such as clean transportation, waste and water management, and adaptation. He anticipates that they may direct more financing towards flood mitigation, drought management, disaster reconstruction and sustainable land use.

Growing engagement

Engagement on national pandemic recovery and net zero strategies/targets is a key benefit for investors in sovereign ESG debt.

"Institutional investors are really looking to engage with governments on ESG and on their climate and environmental plans in a way that wasn't really possible in the debt markets even a few years ago," says Ghosh. "But it is today, not least because of the development of green bonds and the opportunity that transparency and reporting on funds have provided for bondholder engagement."

Transparency is a further benefit, Colazo notes. "For use-of-proceeds bonds it is important to keep in mind the level of transparency that they provide to investors on how the funds are being used, and on the impact of those funds. They are a tool that provides a high level of transparency to investors on the results of their investment."

This offers sovereigns the potential to tap into a broader and more diverse investor base. That is particularly relevant for EM names.

"Institutional investors' focus on ESG risks and opportunities in the government space is increasing, and there is a desire to engage on sustainability issuers either individually or collectively. For now, green bonds provide a certain level of information and commitments to allow investors to engage effectively," Ghosh adds.

Regardless of whether debt is labelled, investors are going to continue wanting to engage with governments around their ESG credentials and objectives. So might the need for labels on ESG debt wither away over time?

Perhaps, but Moody's ESG Solutions is doubtful for now. It sees labelled debt staying a useful instrument for investor engagement for some time to come.

"Labelled bonds will remain a pretty attractive tool for sovereigns to tap into this huge expansion of ESG investing that we are seeing," Ghosh concludes. "There is still value in the signalling that these bonds provide for a government on its intentions, particularly given the Paris agenda over the next 10 years." GC

BerlinHyp is, so far, the only bank issuer of SLBs

high yield activity in SLBs, however. One is the capacity constraint of companies lacking green or social expenditures for use-of-proceeds bonds to fund, which SLBs' use for 'general corporate purposes' sidesteps. Another is the significant burden of green or social bond reporting for smaller companies.

As the market deepens, any indication of one instrument having a pricing benefit over the other — perhaps because more fund types can buy it — is also likely to influence the skew within overall volume.

FIG finding traction

Further high yielding ESG debt is also starting to emerge from the financial institutions (FIG) sector where banks have begun issuing subordinated capital in green and social format, along with green senior non-preferred (SNP) debt — though some regulatory uncertainty remains over these products and bank SLBs, of which only a solitary issue from an untypical German credit has yet been sold.

"In the MREL space — senior preferred and non-preferred — we have reached a stage of maturity where European banks can voluntarily choose to issue the majority or even the entirety of their funding needs in ESG-compliant formats, which wasn't the case before because it was a nascent asset class," notes Charles-Antoine Dozin, head of capital structuring at Morgan Stanley.

Increasingly, the only limits on banks' senior ESG issuance are their capacity to originate green and social assets and their need for MREL (minimum requirements for own funds and eligible liabilities)-qualifying debt. "The capacity constraint is firmly on the asset side," Dozin comments.

As a result, sales of ESG bank capital are also picking up. While only one bank — Spain's BBVA — has issued AT1 debt (the most deeply subordinated layer of banks' quasi-equity) in green format, Tier 2 sales are finding traction. Recently Spain's newly-merged Caixabank introduced Tier 2 social bonds, building on green Tier 2 offerings by a number of issuers.

"Although it has been slower, we are seeing the take-up in the capital space increase and a decent level of activity in the tier two space," Dozin comments.

(*See accompanying regulation chapter for discussion of regulatory issues around ESG bank capital.*)

A further aspect of capacity constraints has been that some banks have opted to confine all their ESG debt issuance to a single asset class, such as SNP. "It's a matter of consistency and coherence," says Dozin. "The rationale is 'if we're going to be issuing green but we're going to be limited in terms of volumes we can raise, we might as well do it in one asset class'. This facilitates comparisons, benchmarking pricing and liquidity, and makes the process more consistent."

Even so, in the longer term at least some banks are looking to commit all of their funding to green and social instruments. "There's already a couple of institutions that have announced intentions to meet all their requirements and funding needs in green and social format," Dozin notes.

He cites de Volksbank of the Netherlands as an example of a lender taking this stance.

(*See accompanying SLB chapter for discussion of the challenges of bank SLBs.*)

Currencies coming into view

Observers could be forgiven for assuming that ESG debt is a euro-only area, so dominant is the European single currency in recent deal flow — a phenomenon underpinned by the European Central Bank (ECB)'s role as the key buyer of much ESG debt in the currency and which the EU's gargantuan green bonds programme is likely to exacerbate.

But this primacy does not mean that other currencies have no activity. Within Europe alone, the Norwegian kroner, sterling, Swedish kronor and Swiss franc sectors have all seen flows of corporate and financial ESG new issues. So too have the US and, to a lesser extent, Japanese domestic markets — including from municipal and other sub-sovereign names.

Pockets of activity have been seen in all other regional markets — Asia-Pacific, Middle East/Africa and Latin America — too. This includes ESG debt sales by foreign credits, such as supranationals into Australia's Kangaroo bond market and corporates into Taiwan's Formosa sector.

This picture suggests that the broad trajectory is likely to be the same for all markets. As local investor demand builds, even lagging areas such as some Asian countries and other emerging markets will eventually see more sustained ESG debt supply too.

"In years to come, ESG is likely to be relevant across all currencies," affirms Menounos. While today's core ESG debt investors in countries such as France and the Netherlands are typically euro-based or have most investment capacity in the currency, "it's only a matter of time before others catch up". GC

Fixing the tragedy of the horizons

Central banks have become integral to the fight against climate change in financial markets. Participants now expect them to wield their immense influence through many avenues of their work — economic analysis, metrics, supervision, investment and even monetary policy.

None of this is explicitly in the mandate of any central bank. In the past four years, first a few central banks and now many have rethought and reinterpreted their mandates, in light of the realisation that climate change poses an existential threat to our way of life — and hence, inevitably, to financial and price stability.

The main channel for that rethinking has been the Central Banks' and Supervisors' Network on Greening the Financial System (NGFS), formed in December 2017 by institutions from eight countries, which now has members from some 70 jurisdictions.

Morgan Després has been centrally involved in that process, as head of secretariat for the NGFS from its inception until June 2021, when he returned to a full time post at the Banque de France as director of strategy.

He talked to **Jon Hay** about central banks' responsibility in the face of climate change, and what they can do to help. Crucial goals, he argues, are to tackle the financial markets' tendencies to misprice climate risks and to concentrate on the short term — the failing known as the tragedy of the horizons.

GlobalCapital: Do you think central banks have a responsibility to mitigate climate change?

Yes, clearly they do. At the end of the day it depends on their mandate, but almost all have a financial stability mandate. In the NGFS we made the case that climate change is a source of financial risk, therefore it falls squarely within the mandate of central banks.

When we started the Network there were a lot of sceptics saying 'is this really part of your mandate?' We turned the question round — if you're not taking climate risk into consideration then you're not fulfilling your mandate. It seems there is now a very broad consensus on that.

GlobalCapital: For central banks to consider climate risk, does it have to be a risk to financial stability within a certain horizon — within three years, for example?

That is the question of the tragedy of the horizons. Sometimes you hear that climate change will materialise in the medium to long term. But you can see some impacts now, especially physical risk. A few years ago there was an intense drought in Europe and the level of the Rhine fell very low. Because of it, some boats couldn't go up river and transport coal, gas and oil, and the impact was very clear on commodity prices.

Transition risk may materialise in the next five to 10 years, but some impacts are there already.

Morgan Després, Banque de France

GlobalCapital: Should central banks try to fulfil that responsibility for mitigating climate change in all areas of their activity — or only in some?

You have to be consistent. If you're telling the banks and insurance companies you supervise that they need to be able to flag their exposures to climate risk and do something about them, then you also need to practise what you preach and reflect it in your own risk management approach.

Many central banks are reflecting this in their own investments — it's about consistency and being credible.

The recent NGFS publication on reflecting climate risk in central banks' monetary policy operational frameworks also shows that some actions are possible on that front as well.

"If we wait for perfect data, the transition will never happen"

GlobalCapital: **What are the most powerful things central banks can do to protect society and the economy from climate change?**

The prerequisite behind the creation of the NGFS was the question of risk mispricing. A few years ago we had the intuition that climate risk was not being priced appropriately. Therefore investors in their risk-return analysis were financing sectors exposed to climate risk, because their returns were overestimated and their risks underestimated.

Therefore we wanted to help market participants by providing tools so they would be in a position to price climate risk properly.

That is the way to fix the tragedy of the horizons, have scenario analysis and the last link is carbon pricing, which is in the remit of governments. It's part of the equation to have this repricing fixed.

To bring this about, we are carrying out climate stress tests, issuing supervisory guidance, requesting things to happen in firms' internal governance.

We can lead by example, disclosing our own exposures. The Banque de France did that two years ago in our non-monetary portfolio. We can promote research — we have very strong relationships with academics.

GlobalCapital: **Within prudential policy, there could be two approaches. There is a systematic one, of changing risk weightings and capital requirements — there has been a lot of talk about green supporting factors and brown penalising factors. And there is a more informal, specific one — you have a conversation with the CEO of a bank and say 'let's talk about your climate risk; what are you going to do about it?' Which do you think is better: the more gradual, mechanical approach or the more individualised one?**

It's probably a matter of sequencing. Before moving to calibrating risk weights or brown penalising factors, you need to be able to measure risk and calibrate the quantum of exposure.

You need to get to a point where analytically you have a pretty good idea of how these risks are going to affect probability of default and loss given default. In my view, we are not there yet.

So it definitely makes more sense now to have private conversations, because the level of exposure of banks does vary very much, according to their business models, sectoral exposure and geographical exposure. Some supervisors are having these conversations already. It's a very interesting first step. Then later, it might move to the policy space.

GlobalCapital: **Do you think by emphasising the importance of measurement, and waiting for perfect data, there is a risk of wasting time?**

I couldn't agree more. If we wait for perfect data the transition will never happen.

There is probably a trade-off. I remember when we tried to do this exercise in France we struggled to identify the exposures because there was no brown taxonomy — we had to decide what sectors were more prone. Of course there are obstacles, but that doesn't mean it's not possible. We may need more manpower and more manual processes. It's an obstacle to uniform, standardised stress testing.

Nevertheless, we are making great progress. At the Green Swan Conference at the beginning of June we had many leading figures from central banking and finance speaking on these issues.

Now we really have a political willingness to do something. But we need to move from willingness to commitment. I hope we will do so at Cop 26. Being willing is good, but it's not sufficient. GC

Ramping up ESG regulation

Originally a self-regulated sphere in which voluntary principles underpinned activity, ESG debt is attracting increasing regulatory focus — especially in Europe, where the EU's ambitious Action Plan on Sustainable Finance is creating a demanding new framework around the market. What does this imply for issuers and investors? And are other regions in step with European developments? Clifford Chance and Latham & Watkins clarify the state of play.

THE RAFT OF measures that make up the EU's Action Plan on Sustainable Finance — including the Taxonomy for Sustainable Activities, the Green Bond Standard (GBS) and the Sustainable Finance Disclosure Regulation (SFDR) — represent European regulators' response to the need to mobilise more capital in pursuit of Paris Agreement targets.

The original Sustainable Finance Action Plan in 2018 plan was bolstered in July 2021 by the publication of the EU's Sustainable Finance Strategy, a second wave of regulatory actions to be implemented and considered, including exploring the possibility of official labels for sustainability-linked and transition bonds, consideration of regulating green mortgages and consumer loans, an expansion of the Taxonomy and a clarification that investors' fiduciary duty includes considering the effects of their investments on the environment and society.

"There has been a proliferation of legislation on the buy side to support the ultimate objective of the Sustainable Action Plan, which was to focus on the re-orienting of capital flows towards sustainable activities and making sure that long-termism is built into all strategic objectives," says Kate Vyvyan, partner at Clifford Chance.

But while sustainable finance products, particularly ESG debt, have seen exponential growth in recent years, inconsistent definitions of sustainability were nonetheless constraining its capacity to scale up.

"The market generally considered that the absence of a taxonomy was one of the main factors holding the sustainable finance market back," says Ed Kempson, counsel, capital markets and global co-ordinator of sustainable finance at Latham & Watkins. "There was uncertainty on the investor side and on the corporate side as to what was or was not sustainable, and without certainty there just was no prospect of moving this market forward as it needed to be. It was and continues to be an essential development."

"The growth in the volume of green and social bonds has been remarkable in the last few years," adds Cristina Lacaci, head of ESG structuring for global capital markets at Morgan Stanley. "This has also led to additional complexity. The EU Taxonomy and other regulatory initiatives will be helpful in providing a common language when it comes to structuring ESG financings."

She highlights the EU Taxonomy thresholds as a useful measure that provides consistency. "We now tend to use them for many categories, like generation of electricity or clean transportation."

The EU's initiative highlights its self-appointed role as the driver of sustainable finance through its Green Deal and Action Plan. "The Taxonomy is the clearest evidence of the way in which Europe and the European investor base is leading the market," Kempson believes.

A key feature will be the EU's unprecedented €240bn green bonds programme, which will make it the world's largest issuer of the product by far. Not only will 30% of the funding for its huge €800bn 'Next Generation EU' recovery plan be through EU green bonds, but these will model the new standard by being fully compliant with the taxonomy and GBS.

"In the second half of 2021 and particularly next year, we expect the EU Taxonomy and EU Green Bond Standard will become increasingly important in terms of disclosure requirements facing issuers, as well as in the structuring of new transactions," says Alexander Menounos, head of EMEA DCM and global co-head of IG syndicate at Morgan Stanley. "That should be helpful in achieving consistency and transparency for the market."

Issuers set to step up

Despite the EU Commission's recent proposal for a Corporate Sustainability Reporting Directive (CSRD) to extend the reach of the older Non-Financial Reporting Directive (NFRD), adopting the Taxonomy is not yet mandatory — though Article 8.2 of the Taxonomy legislation does require issuers to disclose the extent of their operating and capital expenditure's alignment.

"The requirements aren't there on the new issuance side at the moment — for those corporate issuers that are coming to market to be disclosing in their issuance documentation their overall ESG objectives or strategy," notes Vyvyan.

"Under the Transparency Directive amendments, you bring in all issuers, even non-EU issuers with retail debt or equity listed on a regulated EU market"

Kate Vyvyan, Clifford Chance

As a result, many new issues are still launched with no reference to the new benchmark for sustainable financial products. For example, the recent landmark sustainability-linked bond for EQT (notable for its gender KPI, *see accompanying Diversity chapter*) makes no reference to the Taxonomy, though it does reference the Paris Agreement.

"That is in line with ICMA recommendations and certainly consistent with how the market has been approaching compliance with the EU Taxonomy or otherwise," notes Manoj Tulsiani, partner, debt capital markets at Latham & Watkins.

"Of course this is a work in process to embed this into the market," says Kempson. "The most important thing is for market practice to develop into a position where if you're doing a green bond you should be taxonomy-compliant and this will come, hopefully, in Europe with the Green Bond Standard."

L&W judges that it will. "We expect to see more issuers explicitly aligning their sustainable finance products to the EU Taxonomy and hope to see that more broadly in other markets," Kempson affirms.

Certainly, issuers are moving up the ESG debt learning curve. "Focus among the issuer community has increased exponentially over the last 18 or 24 months," Tulsiani reports.

Grappling with GBS

As it is a voluntary standard for now, major investors are unlikely to rely on the GBS exclusively. Morgan Stanley Investment Management (MSIM), for example, regards part of its responsibility as a steward of capital as being to not take labels for granted. "In the same way as we approach the Green Bond Principles and second-party opinions, we feel it is important to develop our own processes to assess these instruments," says Navindu Katugampola, global head of sustainability at MSIM.

"We feel there is an obligation on asset managers to think critically and not just buy things because they correspond to a standard," he adds, noting that the "spectrum of [ESG debt] issuance is almost outpacing labels as the pace has accelerated and moved laterally".

Moreover, some investors question whether 100% GBS-aligned holdings would constitute appropriate diversification of exposures. "The base case is that we are likely to still have a spectrum of issuers to achieve well diversified portfolios," Katugampola says.

'Taxonomy shopping'

One growing concern is the potential for regulatory arbitrage — 'taxonomy shopping', as some have termed it

Valdis Dombrovskis and Mairead McGuinness announce the publication by the European Commission of the first two chapters of its sustainable finance Taxonomy

— as further taxonomies emerge around the world. Already both China and the UK (no longer bound by EU legislation after Brexit) are developing their own taxonomies, while some observers see scope for the new Biden administration to promote a US taxonomy.

The Chinese scheme is an outlier. Although Chinese regulators have said that they are seeking alignment with the EU Taxonomy, this appears questionable as China is on a non-aligned pathway to net zero in 2060, not 2050.

More generally, as disputes over the inclusion of natural gas and nuclear power in the EU Taxonomy underscore, there is a risk of regional and national taxonomies deferring to industries and sectors with greater weight in their jurisdiction.

In turn, that could incentivise issuers to adopt whichever taxonomy is least burdensome for them. "That's certainly something that we hope that we do not see," says Kempson. "We hope that people understand the fundamental importance of making this a truly sustainable transition. But to expect there to be no discussion as between regional taxonomies is probably naïve."

Reporting inconsistency

The current raft of European legislation and initiatives creates potential inconsistencies in disclosure and reporting requirements under the Taxonomy, SFDR, NFRD and future CSRD for entities under different regimes. One example is the prospect of banks needing to disclose data about exposure to companies that are not under the same requirement.

"It is a concern that there is not a universality in reporting standards in the taxonomies. What you'll find in the future is a lot more focus at the policy level to try to bring that together in a coherent disclosure regime," says Kempson, who notes that some reporting requirements under the taxonomy are "imperfect, as you would expect in a very nascent and developing regulatory framework".

More generally, the CSRD has far broader scope than the NFRD, which applied only to the largest European companies. "This is hugely increasing the scope of entities that are brought within the regulation," Vyvyan notes.

This expansion includes bringing non-EU entities under the legislation. "Under the Transparency Directive amendments, you're bringing in all issuers, even non-EU issuers that have retail debt or equity listed on a regulated market of the EU," she adds, noting that purely wholesale debt offerings are not caught.

While the burden for smaller companies is significant, especially as the CSRD appears more stringent than its predecessor, Vyvyan points out that they may be spared the legislation's full force. "When we see the finer detail, we are going to find that the particular characteristics and capacities of SMEs are taken into consideration and they may be able to either comply voluntarily or have some lesser standards applied to them."

More generally, she emphasises the spirit of the proposal. "That's helpful for the investment community, a real extension of scope in a useful way."

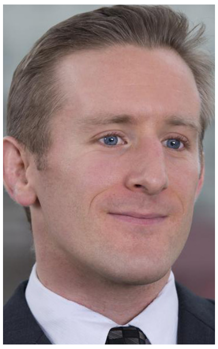
Investors feel push and pull

More broadly, investors are facing an even greater near-term regulatory burden than issuers. "Pressure around disclosure has come in through the buy side with a need for investors to disclose in accordance with the regulations that apply to their activities," says Vyvyan.

"There is a swathe of regulation coming our way," Katugampola acknowledges. Besides the EU Taxonomy, he cites the Task Force on Climate-related Financial Disclosures (TFCD), as well as the prospect of scrutiny from the US Securities & Exchange Commission (SEC).

"To expect there to be no discussion as between regional taxonomies is probably naïve"

Ed Kempson, Latham & Watkins



"TCFD represents best practice in climate disclosure, providing financial market participants with important and decision-useful information. This is validated by the 2,100 companies across 78 countries that are supporters of TCFD, representing $23tr in market cap," says Matthew Slovik, head of global sustainable finance at Morgan Stanley.

As a result, asset managers are experiencing push from regulators and pull from clients towards sustainability. This includes both greater emphasis on ESG and transparency over how they factor sustainability considerations into their investment decision-making.

Katugampola describes the twin influences as a "virtuous circle" that will help embed appropriate practices.

The need to satisfy the new regulations also highlights the dynamic environment for asset managers around ESG. "It is a continually evolving landscape, in the same way as the processes, tools, models and data that we use are evolving."

This evolution represents "something of an arms race" as asset managers keep looking to improve the range and diversity of their products.

Katugampola views this positively. "It benefits clients and places additional duty on us to be a responsible steward of capital," he affirms. GC

Bank capital receives EBA green light

REGULATORY ACTION is likely to shape the future trajectory of ESG debt from banks — both sustainability-linked bonds (SLBs) and subordinated capital instruments, including AT1 quasi-equity, in green or social format.

SLBs are challenged by MREL (minimum requirements for own funds and eligible liabilities) eligibility (see accompanying sustainability-linked bonds chapter). In addition, the European Banking Authority (EBA) has required additional investor disclosures for ESG capital — the highest risk debt banks offer.

"The EBA is focused on enhancing disclosure of capital risks to make sure that green investors know exactly what they are getting into," notes Charles-Antoine Dozin, head of capital, ratings and liability management advisory at Morgan Stanley.

While bail-in risk is the main concern, the flagged areas also include rollover risk (the potential for green proceeds to be in cash temporarily if asset and liability maturities do not match perfectly).

The guidelines the FIG sector had been eagerly anticipating, following the EBA's initial observations on green and social Tier 2 debt in an MREL report last autumn, were finally published in late June.

"Thanks to the additional guidance, whoever had concerns regarding residual regulatory risk of issuing capital in green/social format should now feel comfortable," Dozin judges, adding that "while in line with expectations and the key themes of the Q4 MREL report, the EBA's best practice recommendations provide a concrete approach to improve issuance programmes and minimise the reputational risk authorities have identified".

However, market participants have focused on the EBA's reminder that step-ups and fee-based constructs are not compatible with regulatory instruments. The confirmation dashed hopes that banks may be allowed to issue SLBs in the wake of their great popularity in the corporate sector and appears likely to slow down the evolution of the asset class.

"The EBA is walking a fine line here between maintaining a neutral stance on the format and ensuring that eligibility criteria do not get diluted in the process," Dozin comments. "Barring targeted changes in the level one text to clarify notions such as credit standing, it may be some time before SLBs take off".

"The EBA is focused on enhancing disclosure of MREL risks to make sure that green investors know exactly what they are getting into"

Charles-Antoine Dozin, Morgan Stanley

Clarification of the regulator's stance on ESG AT1 is also crucial. "The acknowledgment of the instrument in the AT1 monitoring reporting where the EBA flags that coupon cancellation risks should be properly highlighted should revive interest in the format." GC

Social dimension brings greater depth to ESG

While the initial focus of sustainable finance efforts was largely on environmental action, social factors have grown increasingly prominent in recent years – underscored by the establishment of the Social Bond Principles in 2017. Subsequently, Covid and racial tensions in the US have each highlighted social disparities that are leading issuers and investors to treat diversity and inclusion as key parameters too.

"THE DUAL PANDEMICS last year, both a health crisis and a racial one, have shone a light on the 'S' pillar of ESG," says Melissa James, vice-chairman and head of the ESG Center of Excellence for Global Capital Markets at Morgan Stanley. "Now, as a consequence, what we are seeing is that investors and companies both recognise how social factors such as diversity and inclusion and other things like worker health and safety can create material risks and opportunities for companies that need to be managed.

"This is a moment in time and many investors and corporates want to be part of creating lasting and meaningful change."

This appetite for change is already translating into new sustainable finance approaches — both in investors' ESG lenses and in ESG debt structures.

"We see the diversity and inclusion (D&I) space going the way of ESG more broadly," adds James. "There will be a need for more data and disclosure around what people are doing so that stakeholders can measure and monitor performance against those goals. You need specific KPIs in the D&I space to ensure accountability towards goals and targets. After all, you get what you measure and that's what we're starting to hear from investors."

Bond build-up

In turn, sustainability-linked bonds (SLBs) with KPIs tied to social goals — including specific D&I targets — are taking off. This development is taking place despite the European Central Bank (ECB) being limited to funding instruments linked to environmental KPIs only. Having begun buying euro SLBs this year under its Corporate Sector Purchase Programme (CSPP) and Pandemic Emergency Purchase Programme (PEPP), the ECB has quickly grown into the market's dominant investor.

A euro SLB issued recently by Sweden's EQT highlights the new trend. This features KPIs tracking greater gender diversity within the private equity investor and its portfolio companies, with percentages of both investment professionals and board members measured.

Along with SLBs, use of proceeds bonds tied to D&I goals are also gaining traction. "Both are excellent ways for investors and companies to signal their commitment to social impact," James believes.

A recent landmark saw Amazon launch its first sustainable bond, for example. Proceeds finance social projects (affordable housing, upskilling) as well as environmental ones. The company's sustainable finance framework specifically targets training expenditures "to populations that include the unemployed and underemployed individuals from underserved and underrepresented communities."

Amazon has launched its first sustainable bond, with proceeds financing social projects including affordable housing and upskilling as well as environmental ones

This followed an earlier sustainable offering from Google parent Alphabet in 2020. Again, the triple-tranche jumbo funds both social and green investments. Besides affordable housing, small business support and pandemic recovery, eligible social uses of proceeds included the explicit D&I target of racial equity.

More should follow, James reports. "We are having conversations with a number of corporates around how they think about including social projects in their use of proceeds issuance. You're going to see more of this."

In addition, large US banks have become active issuers of social bonds. Like the tech titans, affordable housing has been the typical use of proceeds from these deals — such as a Morgan Stanley fixed-to-floating-rate structure in October 2020.

While corporate social bonds had been largely a US phenomenon, a recent landmark also emerged in Europe recently when French energy company EDF issued the first quasi-equity 'hybrid' corporate social bond. The deeply subordinated perpetual offering is linked to supporting small and medium-sized enterprises (SMEs) and regional and employment impact.

European banks such as the newly-merged CaixaBank (Spain's largest lender by assets) has begun issuing social bonds to finance eligible assets.

These financings are meeting strong demand from buyers. "Investors are willing to reward companies for incorporating these features in their debt instruments," James says. "We've seen it in the form of the sustainability premium that issuers are able to achieve in terms of lower coupons on their debt obligations."

Moreover, demand is both growing and becoming more specific about KPIs. "Investors are asking for more of this type of issuance," she judges. "We're seeing specific reverse enquiries in some cases on what type of KPIs investors want to see."

Capacity challenge

Even so, the further development of D&I financing still faces challenges. One is many companies lack sufficient expenditure to build frameworks and use of proceeds bonds around — a limitation that many observers see as supporting future growth of SLBs linked to issuer-level ESG performance rather than the project-level measurement of green and social bonds.

The capacity problem is not limited to social investments. Depending on sector and business model, companies may also lack environmental assets

"This is a moment in time and many investors and corporates want to be part of creating lasting and meaningful change"

Melissa James, Morgan Stanley

to finance — particularly if their uses of proceeds bonds are to reach benchmark size. "That has been a potential impediment," James agrees.

A further issue has been uncertainty over social expenditures that companies would have made routinely as part of their corporate philanthropy efforts. "There has been some wariness on the part of corporates about designating certain investments as part of their framework," she notes.

"I think they feel like you need something a little bit more programmatic and more concrete that's outside of what you would be doing in the ordinary course."

A further challenge is a perception among some investment grade corporate issuers that offering step-up debt — the default SLB structure — signals potential weakness to investors. "In the investment grade market coupon ratchets have usually had a negative association," James acknowledges. "Getting corporates in the IG space over that hurdle is one of the impediments to seeing more sustainability-linked issuance."

In addition, the high yield market has been later to engage with ESG debt than its IG counterpart. James is optimistic, though. "I think that will likely evolve over time as well."

Seeking stewardship

The rise of D&I concerns meshes with investors' increasing emphasis on ESG stewardship — how effective and accountable companies are as stewards of capital from environmental, social and governance perspectives.

"Institutional investors are coming up with their own assessment of companies based on how they think different ESG factors should be weighted within a particular sector and then more specifically within a particular company," James believes. "You are going to have more investing along the lines of who's a good ESG steward and who is not.

"They are looking at a whole range of ESG factors — not just environmental factors but also social and governance factors," she adds, noting that governance is a particularly long-standing element within investment analysis.

She expects this approach to be refined over time. While this may not lead to widespread adoption of exclusionary screening, as commonly practised by European ESG investors, it is likely to bring "differentiation and discernment along the lines of ESG stewardship, broadly speaking, whether it be environmental or social."

One dimension of this will be increasing focus on progress within ESG strategies. "No investor expects the company to be able to flip a switch and all of a sudden they are great environmental and social stewards. I think the market is sophisticated enough to realise that these things take time, that these changes are evolutionary — not revolutionary."

This makes publicly announced goals and targets key. "Investors recognise that this is a journey that companies are on, and they want to be able to chart the company's progress along that journey," James adds.

She cites Morgan Stanley research that shows that alpha or total return is more highly correlated with rate of change on ESG measures than absolute performance. "Companies that are perceived to have a lot of potential upside and who are working towards capitalising on that upside are a really good ESG story even if they don't start out in such a great place on day one. Similarly, if companies are perceived to have a lot of downside and are not doing anything to manage it, that would be a bad ESG story — even if they are starting out in a relatively OK place." GC

Inclusive expansion

Besides their involvement in ESG debt offerings, investment banks are trying to support and promote diversity and inclusion in further ways. These include initiatives like Morgan Stanley's new Institute for Inclusion, which seeks to invest in underserved communities and support them philanthropically. It also aims to help Morgan Stanley attract diverse talent and improve its culture of inclusion.

In addition, in November 2020 Morgan Stanley increased the use of D&I/minority-owned firms in its debt syndicates, with up to five firms among the lead managers and co-managers of its recent US debt capital markets offerings.

This commitment represents "a significant change across investors, underwriters and issuers", judges Cristina Lacaci, head of ESG structuring, global capital markets at Morgan Stanley. She points to "the willingness and desire of issuers to partner with D&I firms and for underwriters and investors to reaffirm our commitment to this space."

Moreover, Morgan Stanley recently launched a new share class product that it markets in the US in co-ordination with a D&I broker-dealer. The goal is "to provide our clients with the opportunity to align their investing with their values because we are seeing increased demand for impact or ESG cash management investments," says Melissa James, vice-chairman and co-head of the ESG Center for Excellence for Global Capital Markets at the bank.

Now the firm is looking to do more in the wake of these steps. "There are definitely other initiatives afoot," James affirms. GC

Tracking the ESG trajectory

Pivotal players in capital markets through their credit ratings, rating agencies are responding to investors' increasing focus on environmental, social and governance (ESG) factors by providing ESG ratings too. But how do the two products differ and is there room for both, given ESG's growing influence on credit risk? Experts from Moody's ESG Solutions explain their approach.

UNLIKE TRADITIONAL credit ratings, ESG ratings have not yet evolved to the point where they offer an instantly recognisable scale on the model of triple-A and below. Moody's ESG Solutions acknowledges appetite for standardisation.

"We are hearing a call for greater clarity across ESG data and scores, especially as they are often used for benchmarking. Market participants want to understand what different scores mean and how to interpret them," says Angela Brown, senior vice-president — product strategy at Moody's ESG Solutions. "It's early days but we are seeing quite a dramatic shift both by investors and companies wanting to understand the comparability of ESG scores with expectations that a standard will emerge."

"As these scores become increasingly used in decision-making, we expect that a more engaged and forward-looking assessment process for sustainability performance will emerge," she adds.

The firm argues that the value of its ESG ratings lies less in standard scales than in what goes into its assessments. This includes forward-looking views of companies' ability to adapt to future ESG risks.

"The focus on the final ESG score today is less important than the opinion and narrative that underpins it. In our analysis, we emphasise the key ESG drivers for a particular organisation — both now and in the future — and what that company is doing to ensure that it addresses stakeholder needs and remains resilient to material sustainability challenges," says Rahul Ghosh, managing director for ESG outreach and research at Moody's ESG Solutions.

"A Sustainability Rating ultimately looks at whether a company or an entity can manage the ESG risks and opportunities that it faces now and in the future," Brown notes.

She sees scope for recognised scales in future. "But for now, it's really getting from data and data analysis to issuer-centric opinion and insight."

Moody's ESG Solutions emphasises a so-called 'dual materiality' approach. This looks both at the impact of ESG factors on companies' financial operations and operational performance, but also on the impact of each company on its stakeholders. This perspective is gaining increasing traction with the standardisation of disclosure frameworks and reporting requirements, particularly in Europe.

"We think that that's an important distinction that is valued and appreciated by investors," says Brown.

This systematic perspective is accompanied by the concept of 'trajectory'. "It is important that companies are able to demonstrate where they are on their sustainability journey, and make sure that they are progressing and developing strategic KPIs and performance metrics that will help continue to advance that performance," she adds, noting how this is reflected in the targets embedded in sustainability-linked bonds (SLBs) and even remuneration policies.

"It's that continued improvement in metrics over time that moves us towards sustainability."

In addition, ESG ratings seek to capture the sustainability context in which organisations operate. Crucially, this includes future developments. "We look at material factors today but also topics or considerations that are likely to emerge in the future, and whether a company is positioned to respond to them effectively," as Brown puts it.

Broad needs

Though much of their use is for portfolio construction, monitoring and maintenance, Moody's ESG Solutions emphasises that its ESG ratings are intended as input to a broad range of investor activities. "ESG issues can be material for risk analysis; they can also be material for stewardship and engagement activities; or opportunity determination," notes Ghosh, citing the spectrum of ESG investment strategies from pure exclusion through to impact investing.

"There are broad market needs for ESG, which is reflected in different types of tools. We have to be clear on what those tools are there to deliver."

This raises the question of the rating industry's multiplicity of approaches. "There are already a diverse range of approaches to measuring sustainability — different methodologies, different strengths and different insights," says Ghosh.

However, he views the resulting diversity of conclusions as positive. "In 10 years' time, some of the factors that we look at and ultimately the data that we use will be materially different to what it is today. We need to encourage good debate around the question of measuring sustainability and that we are innovative, perhaps even disruptive, in our approaches."

'Engaged' ratings

This relates to the key ESG concept of 'engagement', Brown points out. "Both on the investor side and on the issuer side, what we're seeing is an increased desire for pro-active engagement on the topic of sustainability."

"Investor engagement has gone from 'we want you to disclose specific information or data' to 'we want to talk to you about your strategy and how you're going to manage risk and capitalise on opportunity going forward," she adds. "That's where the idea of an engaged Sustainability Rating is really important.

"A sector specification of a methodology may not capture the nuance of an individual company. An assessment based on engagement and interaction with senior leaders within an entity provides a much more powerful tool for investors to leverage, whether shareholders or any type of bond investor"

"ESG ratings are becoming much more relevant for the market," agrees Cristina Lacaci, head of ESG structuring for global capital markets at Morgan Stanley. "Many investors will have their own ESG scoring systems but will use the information in the ESG rating reports as inputs for their own models.

"So it is increasingly important for issuers to ensure that the information in these reports is correct, and properly reflects their strategy."

A good ESG rating report also helps to limit the potential number of requests for ESG information from investors or lenders, Lacaci notes. GC

Finance finds the right direction: now to reach the right speed

In the past two years, environmental, social and governance matters, especially climate change, have gone from a fringe issue in capital markets to — almost — the main issue. Banks, investors, companies and governments have shouldered the responsibility of helping move the economy to net zero emissions in 30 years. That duty has joined the fiduciary obligation to make money for customers and shareholders that have been the markets' main motivation in the past.

The destination is agreed — what remain to be decided are the route and the pace.

GlobalCapital and Morgan Stanley gathered together three leading sustainable finance issuers and four prominent investors in early June to discuss how capital can best be engaged to drive the transition.

They pointed out the urgency of the transition to net zero, but also the need to build robust strategies based on evidence. Standards are needed for how fast industries are decarbonising. Taxonomies such as that from the EU can help, by giving market participants a common language, but are not the whole answer.

Meanwhile, investors themselves are being regulated, in ways that are likely to steer and deepen their engagement with ESG issues, such as the Sustainable Finance Disclosure Regulation.

Along the way, much use will be made of sustainable finance instruments — the speakers discussed the relative merits of green and social use of proceeds bonds and sustainability-linked structures.

Participants in the roundtable were:

Alban de Faÿ, credit portfolio manager and head of fixed income SRI processes, Amundi

Bernard Descreux, group treasurer, Electricité de France

Joshua Kendall, head of responsible investment research and stewardship, Insight Investment

Cristina Lacaci, head of ESG structuring, global capital markets, Morgan Stanley

Samuel Mary, senior vice-president and ESG research analyst, Pimco

Aldo Romani, head of sustainability funding, European Investment Bank

Laure Villepelet, head of ESG and CSR, Tikehau Capital

Bodo Winkler-Viti, head of funding and investor relations, Berlin Hyp

Moderator: **Jon Hay**, *GlobalCapital*

GlobalCapital: The Paris Agreement commits the financial sector to striving to limit global warming to 1.5°C. Is the financial industry doing enough?

Alban de Faÿ, Amundi: It is a hot topic for us. As an asset manager, we have a responsibility to follow the various agreements, meaning that we make sure financial flows are going in the right direction and build strategies with attractive financial returns to ensure that investors will be interested in investing.

We may be asked by a regulator to push companies to move forward and sometimes it is quite complicated when companies do not publish key data — for example, on carbon intensity. The most carbon-intensive sectors do it, but for other sectors it is not the case. We do not always have the information we need to track companies' environmental commitment, which is why engagement is a core component of this trajectory.

Joshua Kendall, Insight Investment: My interpretation of the Paris Agreement is that it is for governments to meet the 1.5°C target. What has followed is separate initiatives for asset owners and asset managers to get behind those overarching goals, which the financial community is clearly supportive of.

Joshua Kendall,
Insight Investment

Ultimately, our role in society as a financial industry is to service our clients and broader society to align with their financial needs for retirement many years into the future. So clearly we have a broader responsibility than just making financial returns.

Do we have the right information to distinguish between leaders and laggards and guide us towards the most appropriate investment decision? We are well short of that.

Fortunately, the European Union has recognised that and launched initiatives for greater transparency. That information can guide portfolio construction, engagement with issuers and help investors make better informed decisions.

We know what our responsibility should be, what our clients are expecting, but there is a big gap between what is realistic and possible and what clients or regulators might be looking to achieve in five, 20, 30 years' time.

Samuel Mary, Pimco: There is a very strong momentum in investors' commitments and engagement on climate change. So the direction of travel is clear.

The questions are more about the pace, the coverage, the real world impact and challenges of implementation.

If we look at the pace and the coverage, in the past two years there has been particular interest and signs of acceleration — illustrated by the momentum for net zero pledges.

At Pimco, we have been focused on helping our clients and developing a range of proprietary tools to help align portfolios with the net zero pathway. We have also been working with emerging industry standards such as the Net Zero Investment Framework.

This effort can always be broadened and accelerated. In fixed income, we want to cover all the asset classes, not only corporates and sovereign.

What is interesting is that the discussion has partly shifted from the commitments to their actual impact — evaluating what measures are most effective and can amplify the positive impact of the finance industry.

Laure Villepelet, Tikehau Capital: The finance industry is clearly not doing enough yet and now there is an urgency. We are very optimistic at Tikehau Capital because recently we have been getting more reports supporting us to drive investments towards where change is needed — increasing renewable capacity, energy efficiency and low carbon mobility.

There are a number of pathways and frameworks, on top of the International Energy Agency's *Net Zero by 2050* report. The EU Taxonomy is also a great tool that we are already using and applying to investment.

So we have the means to develop strategies based on robust evidence. As investors we need to be pragmatic and not wait until we get the perfect data but start now.

We launched a private equity fund dedicated to the energy transition in late 2018. It was a success, with more than €1bn raised, so we want to really pursue this, developing funds that will help decarbonise our economic environment.

We need to partner with mid-cap companies which are offering products and services that may not only contribute directly but help them focus on where they have a positive impact, so that at some point we can contribute to reaching this net zero target.

For example, we have been investing in a company which does building renovation, maintenance and repairs including insulation and efficient boilers. We support them in structuring their energy efficiency offer so they can benefit from the market and maximise their impact.

Cristina Lacaci,
Morgan Stanley

GlobalCapital: Cristina, do you think the investment banking industry is doing enough yet?

Cristina Lacaci, Morgan Stanley: In the last few months, we've all taken quite significant measures. One of the key steps has been the establishment of net zero financed emissions targets by 2050.

The next step for the industry is to agree on the standards. What will be the methodology? Can all activities be included? The second is to establish interim targets that will help us meet those longer-term objectives.

The final ingredient is to make sure we support our clients in this transition. A lot of steps have been taken in the last few months but it is just the starting point of a journey to help our clients meet these targets.

GlobalCapital: Bernard, do you feel the financial industry is helping you on your journey to sustainability? Are you dragging it with you, or is it pulling you from in front?

Bernard Descreux, EDF: It's not pulling us too much — it gives us an incentive to do so. EDF is well advanced in its path towards carbon neutrality in 2050, but the pathway to go there gives the opportunity of exchanges with investors.

We are not very fond of sustainability-linked bonds, but on our credit lines we like to have commitments that we share with the banks.

What is disappointing is that we would welcome bilateral commitments, step-ups and step-downs, in the commission or in the yield on swaps, that would affect the company as well as the bank, given their relative ESG performance.

When we talk with investors, they want transparency on the use of proceeds. That is why we prefer to issue use of proceeds bonds. They have a fiduciary duty to display what they are doing on financing the energy transition, so it's important for them to see how their money is deployed and how it serves the transition, and the just transition also.

Bodo Winkler-Viti, Berlin Hyp: Hardly a day passes when one bank or another does not issue a green bond, a sustainability-linked bond, a social bond. Especially in the financial industry, it was not always like this — in some of these segments we banks have been slower than others.

Bodo Winkler-Viti,
Berlin Hyp

The direction is the right one. The question is whether we should speed up a little bit more. Cristina mentioned the net zero emission commitments of banks for 2050. These commitments are a very good sign and lead in the right direction.

However, you really have to be aware of how to get there as a bank, how to assess your business. For us, only doing one business — commercial real estate lending — that is much easier than for more complex banks which operate in many different sectors.

We have defined our own journey with interim targets, how to get to carbon neutrality, but for the wider financial industry this is a more difficult question. But we all need to develop faster in that direction because the number of years until 2050 gets shorter every year by one year. There are not so many left.

GlobalCapital: Aldo, everybody in the financial sector has their eyes now focused on net zero in 2050, but as Cristina and Bodo have mentioned, setting interim targets is very important. Is it possible to align the interim targets of issuers and investors, or is everybody still confused about that?

Aldo Romani, European Investment Bank: A lot of confusion still exists. Much more could be done if there were more clarity as to what needs to be pursued.

All the steps by the Commission in the past few years have led to a clarification of certain core principles that in my view need to be reiterated.

First of all, what counts is not the financial instrument you use but the sustainability of the economic activities you finance.

Second, you must establish a shared set of definitions that permit fair competition among market participants across jurisdictions — national regulators should not be able to determine by themselves what is green or sustainable.

Most importantly, also, this should apply vertically along the investment chain, because investors must speak the same language as intermediaries that funnel investor funds.

This is the sense of the EU Taxonomy Regulation that came into force in July last year.

If you take the EIB as an example, as part of our climate bank roadmap, we will increase to at least 50% the share of green finance in our new lending by 2025. We will measure this using the Taxonomy.

We will be able to reflect this in capital markets by issuing climate and sustainability awareness bonds, which we plan to align with the EU Green Bond Standard.

The conditions are there for markets to become more than just providers of capital. They can really become an instrument of strategic knowledge for society by finding out where capital should be best deployed for the sustainable development of the real economy.

GlobalCapital: That is a lofty aim! I would like to ask the investors: the financial world is now striving to limit climate change, which is obviously a focus on impact rather than risk and return. Does that mean the traditional concept of an investor's fiduciary duty has changed?

Kendall, Insight: I might dispute the idea that managing climate change issues is about impact. I would see it as being central to risk management.

In 2017 we built a climate risk model to identify issuers that are going to be more vulnerable to that transition, because we believe climate issues that are not managed are a credit risk at their heart.

But clearly, the movement of green bonds is creating great opportunities for impact to sit alongside risk management.

There doesn't appear to be a fundamental disconnect between managing climate risk issues and fiduciary responsibility, neither do I believe that the concept has changed.

What we are starting to see from legal experts is more clarity that this is compatible with your fiduciary responsibilities. By considering climate risk issues you are aligning with your responsibilities to manage the issues associated with climate change.

Where I think there is going to be more need for debate is the question of whether impact creating positive change is compatible with fiduciary responsibility.

What we need over the next few years is more academic research and more regulatory input into how much of a positive change you can incorporate into your portfolio management and asset allocation, given issues such as the availability of impact opportunities. The green bond market is still significantly smaller than it needs to be for most institutional investors.

The other issue is how do you define impact? We've seen some more direction from the EU but there are still huge amounts of disagreement on that.

So we are well short of being in a position where we can say impact is aligned with fiduciary responsibility, but wide agreement that climate change is a necessary component of fiduciary responsibility.

Lacaci, Morgan Stanley: I have a question for the investors: are there any situations when you need to make a decision between impact and risk-returns, and what do you do in those cases?

Kendall, Insight: We are getting more clarity from clients where impact is a core part of their objectives, but that is the exception. For most clients it is about maximising the financial returns in an active portfolio, or in a more stable long-term portfolio.

With an oil and gas bond, you have got to be thinking 'in 10 years I will have strong visibility, in 100 years I will have less visibility'. For a long-term portfolio the climate risks are going to be real and therefore it is not the sort of instrument you would want to be holding; but for more active positions, it is much less relevant to think about them.

If you have a sustainability mandate, or if a mandate aligns with the Article 8 or Article 9 guidelines from the EU Sustainable Finance Disclosure Regulation, that changes the very nature of what issues are important to you. You should be looking at sustainability metrics. That is going to be relatively new for many portfolio managers because it is not a natural part of how portfolios are constructed.

Once we create a system to align with Article 8 and Article 9, these issues have to be routinely considered. Then I think we will start to see a greater change in how the market considers these factors on a consistent basis.

GlobalCapital: There can be a distinction between impact and risk and return and they can occasionally be in competition or in conflict.

We ought to think about the idea of the 'universal owner', as well. You can have a portfolio where you think about the climate risk to the assets in that portfolio and decide they are safe, but this could have bad effects on the wider world and economy which would be felt in your other assets.

Alban de Faÿ,
Amundi

De Faÿ, Amundi: Our fiduciary duty is still the same. We have to buy bonds at fair value and that's about credit risk. Clearly credit risk is also moving, taking into account more and more long-term risks, and it is the role of a regular credit agency to monitor that.

We have a dedicated strategy of impact investing, in which we manage both financial and environmental impact, where impact could be seen as a return.

If you want to improve your returns, your impact, you have to take some risk. So, do you want to finance a wind farm in the Netherlands or an emerging market?

Clearly, if you finance a wind farm in an emerging market, you will have a higher environmental impact but you may have also a higher credit risk — though sometimes you can do it through bonds issued by a European bank.

From time to time, you have to make choices. Evidently, our first responsibility is our fiduciary duty, but today it is not enough. You also have to be a responsible investor and be sure that in the activities you finance you take full responsibility and consider the impact of your investment on society for the long term.

That's why, at Amundi, we have a 100% ESG integrated strategy. We want to take into account the impact of our investment on society, but we are also working to better understand how a company is moving around climate. So we integrate new impact indicators like temperature ratings, carbon reduction targets, Science-Based Targets and so on.

We try to combine all the dimensions. Bernard mentioned the just transition — clearly, when we are financing the energy transition we want to be sure that it is socially acceptable.

We do not want to focus on one theme. Behind some pure dedicated themes like the environment, you may also have social issues which could be very important.

GlobalCapital: Green and social bonds have developed very well over 14 years, but what

is their future, as the whole economy starts to become much greener?

And how do they interact with sustainability-linked bonds? Is one better than the other?

Descreux, EDF: Both markets will co-exist because they are complementary. All sectors and all companies are not at the same level in their pathways towards carbon neutrality. It can come from history; very often it comes from physical constraints on certain industry processes.

In the case of electricity, EDF has the possibility to be in advance in that transition, but that means we have very large investment to make in low carbon assets. So it is useful for us to issue use of proceeds bonds. Investors like to target their investments and make sure they are going in the right boxes.

Companies that are changing their business models, that are in transition, cannot give today very high performance indicators, but they may have a strategy and can give objectives that show their commitment to change.

For them, the sustainability-linked bond market is the perfect tool to tell investors their commitments. My guess is that, progressively, they will be able to change their issuance from these SL bonds towards use of proceeds bonds.

I think the strategy of the European Commission will favour use of proceeds bonds, as they will create scarcity for these bonds and this will help issuers to lower their cost of funding.

GlobalCapital: **Berlin Hyp has been an enthusiastic green bond issuer for some time and has recently introduced a sustainability-linked bond. So, Bodo, I'm guessing you don't think the order of transition is necessarily from SLB to use of proceeds?**

Winkler-Viti, Berlin Hyp: No, I don't agree with Bernard there. It is definitely not like this in our case.

We issued 13 benchmark green bonds before we issued our first sustainability-linked bond.

Both instruments follow totally different concepts. I use my green bonds to refinance a very specific portfolio at Berlin Hyp. I use the sustainability-linked bond to demonstrate to investors and other market participants what the bank's ambitious goals are as a whole, and I share our way to get there.

I think that is something totally different from a use of proceeds bond. It is not better and not worse than a use of proceeds bond. The functioning is simply different.

As a fully capital market-funded bank, we are not able today to issue every debenture as a green use of proceeds bond. There is other business that needs to be done as well.

The point of transition has already been mentioned. If we finance the acquisition of a non-green building today, that is not bad per se if the bank gives, after that advice, the financial means to do a proper renovation of that building. But, for that reason, it is not possible to have only a green portfolio.

GlobalCapital: **Aldo, you mentioned that the EIB is going to move towards 50% green lending, so that will mean a lot more green bonds, I expect, but what do you think of Bodo's point that for the other assets you can also use the capital markets to demonstrate your sustainability commitments. Could the EIB do sustainability-linked bonds for its ordinary bonds?**

Romani, EIB: I am convinced that the transparency use of proceeds bonds provide on the underlying assets is of paramount importance in the overall design of transforming the economy on to a sustainable path.

Sustainability-linked bonds can be meaningful in an issuer's communications strategy, as they clarify the attention it dedicates to specific objectives.

We have a focus on environmental protection, a whole set of objectives, and we finance our activities also via general purpose bonds.

I agree that there should not be an opposition or a contrast between the instruments. They serve different purposes and as long as these purposes are clear, it is perfectly fine to use them. It is up to investors to decide whether they make sense or they don't.

It seems that investors also give these instruments a role in their dialogue with issuers. From our point of view, in terms of the strategy the bank has adopted, use of proceeds bonds are a priority.

GlobalCapital: **Laure, as an investor, how do you evaluate these two structures? If you're forming portfolios, can you use the two together?**

Laure Villepelet,
Tikehau Capital

Villepelet, Tikehau: On top of being an investor, we are also an issuer. Tikehau Capital recently issued its first sustainable bond. It is a use of proceeds bond, but we are also considering sustainability-linked loans at our level.

At portfolio company level we have a pretty big private debt activity. In our 2021 direct lending deals, more than two-thirds have had SLB features.

We think it is really a great instrument because it helps us to put ESG considerations at the heart of the deal.

The next frontier is impact. If we want to progress on impact, we need to really tackle the topic. Investment teams need to think and negotiate these ESG ratchets with issuers.

In high yield over the past months we have seen many sustainability-linked bonds, as well as some higher rated issuers issuing green bonds. The two can co-exist in one portfolio, it makes sense.

We are maybe today more interested in the sustainability-linked bonds because we have this transition approach. On top of financing companies, we want to try to engage with the smaller players.

Typically companies that issue green bonds are a bit more mature, so they may need less support from investors. On the other hand, we also see high yield issuers in the developing markets, such as Greenko, a leading Indian renewable energy company. Their reporting is not as robust as what we see in Europe. So here we also have a means to engage.

GlobalCapital: Samuel, Laure referred to SLBs as having impact — do you agree?

Mary, Pimco: We see both instruments as complementary. We have been a strong supporter of both approaches.

When we evaluate green bonds, we systematically evaluate their alignment with the strategy of the issuer. Green bonds are important if they help advance the issuer's broader commitment and performance.

Samuel Mary,
Pimco

The SLB enables us to take a more holistic perspective from the start, emphasising the entire issuer performance, not a limited number of projects.

A KPI can be linked to reducing ESG risk, as well as to mitigating negative environmental or social impact or amplifying positive impact. So SLBs can address both risk and impact, and that is connected to your previous question about fiduciary duty and impact.

The other important element of SLBs is that they are forward-looking. They emphasise the issuer's future ESG performance and connect this with recognised benchmarks.

We have seen it in relation to climate change and the Paris Agreement, and increasingly a broader range of factors, such as the Sustainable Development Goals.

SLBs also allow a broader range of sectors to participate. The future of the sustainable bond market will encompass more and more sectors and issuers.

We had this week the first SLB from an oil major. Since the beginning of the year we have had strategic sectors in the energy transition such as steel, cement and shipping issuing SLBs.

Our climate bond strategy, launched over two years ago, highlighted that it was key to not only include high quality green bonds but also 'climate leaders' — they may not yet be perfect and low carbon but are showing leading practices in their industries and have the highest ambition in decarbonising and environmental strategies.

KPIs that could be connected to SLBs include zero net deforestation, circular economy commitments or science-based water goals.

The bottom line is that we see SLBs as a very appealing opportunity to amplify the positive impact of bond markets.

Lacaci, Morgan Stanley: One of the key questions we get from issuers is what happens if they miss the target? Does it mean investors need to sell the bond? We also get questions around the step-ups. Currently, step-up payments tend to be made to investors. Could they actually go to a charity or third party, so that investors wouldn't profit from the ESG underperformance of a company?

Mary, Pimco: For both green bonds and SLBs, what is key is the level of transparency and disclosure.

We encourage issuers to align with emerging standards such as the Sustainability-Linked Bond Principles, which encourage them to disclose from the start what factors could influence the achievement of the target.

The issuer might fail, but what is important is that investors have the relevant information in a timely fashion, to evaluate the consequences.

Could it mean a deterioration of the issuer's ESG score? Or does the issuer have a clear remediation plan? Is the failure maybe associated with factors that are not in its direct control, and the issuer may still be showing leading practice and commitment?

On step-ups, so far, we have encouraged simplicity, to ensure scalability and make this issuance mainstream. So we have encouraged coupon step-ups, instead of an alternative approach that relies on philanthropy or CSR-related measures.

That might not be scalable or understood by broader market participants, or might not send the right signal regarding the issuer's level of ambition and the incorporation of the SLB target into its broad sustainability and business strategy.

Kendall, Insight: Every company needs to transition and has to be thinking about raising the necessary capital. Therefore, it is warranted to think about whether SLBs are suitable for helping a broader set of industries get there.

We would encourage companies to set the appropriate transition targets and use the financial community to help them get there. We recognise it isn't enough for us to simply analyse ESG risk metrics and build that into our appraisal. There has to be a point at which we say 'let's do more', and I think we've reached that point. Therefore, it is very encouraging to see any company making those first steps.

I am agnostic on the benefits of setting coupon steps. It is such a new asset class that it is not appropriate to say a 25bp step-up is enough, or it should be 50bp or 100bp. It is also very difficult to know when they should be. If you're setting a 10 year target, should step-ups be after five years or seven or two?

For me, this is a bit of sideshow. Much more important is the level of accountability and scrutiny a company will agree to. It could mean compensation for executives. I haven't seen that yet but I certainly would encourage a broader way of thinking than simply step-ups.

Villepelet, Tikehau: I agree with Joshua regarding the direction of travel. We would not divest from a company missing its SLB target but we would divest from one not responding to our enquiries and requests, if we thought they lacked transparency.

Actually we will not divest, we will stop investing for the next bond issue. We try not to penalise the investor, coming back to fiduciary duty, but still show that there are some consequences if issuers fail to respond to requests.

On coupon steps, we launched a corporate direct lending fund. Here we decided that if companies miss their targets, we will set the money aside to hire an energy consultant to help them to correct it, accelerate and hopefully meet their target next year.

The idea is to have a progressive approach and be aligned with the issuers and with our investors.

Winkler-Viti, Berlin Hyp: I found Cristina's question very interesting — whether you should give the step-up to a special project, and maybe the investors should not benefit if the issuer fails to meet its target.

First of all, the investor does not benefit, because what happens when an issuer misses its target, which comes directly from its corporate strategy? It is very likely that its credit deteriorates because of that. For that reason, it says to the investor: 'I will compensate you if that happens.'

I would not be a fan of giving this step-up somewhere else because it is a compensation for the investor and not a penalty for me as an issuer. I think there is a very good rationale behind this instrument of a step-up or higher repayment amount, which should not be put in question.

Villepelet, Tikehau: I agree with you on the risk profile of the company. If they miss their targets we also think the risk increases, so the return should be slightly higher. On the other hand, when we lend in private markets we can be more engaged and try to support the portfolio company to improve.

De Faÿ, Amundi: I'm fully in line with Bodo's view. The step-up is a kind of compensation because the KPI is supported by the top management of the company and if the company does not reach this KPI, the market will have less confidence in the company and all its curve will suffer. So it is an opportunity for the investor to sell the bond without a penalty.

However, on the other side, there is some room to think about other ideas, which we have done at Amundi with private placements. Clearly, when you are in direct dialogue with a company for a private placement, you can envisage compensation. But for the bond market, I really push for standardisation, a clear definition and, as Aldo mentioned, we need to have a common language.

I recommend an issuer to come to the bond market with very simple ideas, simple KPIs, with a simple step-up. Nevertheless, there is a smaller market for private placements where we can imagine another way because the compensation and engagement could be very important to think about.

GlobalCapital: Bernard, you're not particularly enthusiastic about SLBs, but you've also issued your first social bond recently. It is very much the sort of thing somebody might do an SLB about. It's linked to a target — you want to procure from SMEs in the regions where you're building power plants. I'm interested why you didn't go that way. What benefit do you feel you've got with the social bond?

Descreux, EDF: What we value in the use of proceeds bond, especially a social bond, is the reporting we will provide to investors, and I think investors will value it.

For the recent issue we did a quick roadshow to present our new social bond framework and we received a lot of remarks that will help us build our reporting, taking into account what kind of indicators investors would appreciate.

More and more, investors have to report to their clients. It's very important for them to have very precise figures of the impacts of their investment. The reporting, which is the fourth pillar of a use of proceeds bond, is what they will value in this approach.

SLBs are a more tick-the-box approach. It would be less burden for me to do an SL bond using a KPI that we already publish. We think investors want to have in-depth information and it's an occasion to highlight some activity we hadn't entered in our Green Bond Framework. In our Social Bond Framework, we will see works in nuclear power, and new nuclear activity is not today admitted as a green activity in the new Taxonomy.

Lacaci, Morgan Stanley: You raise two very important points: on the social side and the Taxonomy. How do we think the Taxonomy is going to evolve? There are a lot of discussions around this. From a structuring perspective we now follow all the key thresholds wherever possible for the activities that are covered by the Taxonomy, especially electricity generation and clean transportation.

But there are limitations, because a lot of activities are not yet covered in the delegated act. How do you see this evolving? There's so much speculation in the press at the moment around a possible social and/or brown taxonomy.

Romani, EIB: The whole Taxonomy framework is going to grow in an incremental process, as a result of various forces interacting with each other.

The Taxonomy Regulation foresees, by the end of this year, a report on whether the Taxonomy could be extended, including to cover social objectives.

I am absolutely convinced that the delegated act for the climate parts of the Taxonomy that has just been formally adopted by the Commission proves that it is possible to establish a consensus among different interests that can be carried forward by the whole market.

It has put the EIB in a position to apply the logic of the Taxonomy to all the relevant activities beyond climate change mitigation — the other areas of environmental protection or social sustainability that are not yet covered by the Taxonomy — and we are gradually doing so.

Even in the areas where no taxonomy exists, it is possible for issuers to put in black and white, in a transparent manner, what they are doing and why, using the logic of the Taxonomy. Then it will be up to investors to judge whether what they are doing is appropriate.

This will also provide food for thought to the working groups that are elaborating the Taxonomy. Any issuer can thereby participate in the process by way of its own experience.

Aldo Romani,
European Investment Bank

I have noted in the past year a remarkable improvement in the quality of dialogue with investors, who are asking questions that are really to the point, and urging us even more than before to take action rather than stay inert.

Villepelet, Tikehau: A question for you Aldo: we asked a number of issuers whether they will start reporting on their mix of revenues according to the Taxonomy, but they said they would do so only when the technical standards were available.

Does that mean we should also push, for example, a plant-based food or sustainable packaging business to publish a theoretical mix of green revenues, so they can start a discussion regarding their activity?

Romani, EIB: Why not? I think investors have a crucial role to play here in promoting action.

The Taxonomy regulation is an enabling framework for issuers and investors to unleash the healthy dimension of market forces. If every issuer realises that sustainability matters are becoming increasingly relevant for investors, they will consider with much more attention what their strategic options are and where they should be if they want to live up to the requirements of the world to come.

This is something strategic investors can take on board as a responsibility now.

We have to be realistic about things and we have to work with what is available, i.e. the logic of the Taxonomy, also because there can be delays in its implementation — we have seen what happened with the Taxonomy for climate — even if the direction is clear.

GlobalCapital: Bodo, commercial property is one of the areas where the Taxonomy in its final stages went through considerable revision. There are other areas too where what Aldo describes as competing forces influenced the Taxonomy and changed it in its last phases, and there are certainly controversies that still persist around it, including biofuels and forestry.

So, Bodo, is the Taxonomy helpful? Do you think investors are going to follow it? Is there a danger that perhaps they follow it too literally, instead of doing what Aldo, I think, would like to see? He said it is up to investors to judge.

Winkler-Viti, Berlin Hyp: Of course it is helpful because we need a common language and that is basically what this Taxonomy provides.

There might be parts that one party or another feels unhappy about because they are too strict or not strict enough. But it is the beginning of a common language that should help all of us to distinguish business that is a beneficiary of meeting our climate change goals from what creates a danger to achieving these goals. Therefore, I think it is a very good thing.

On real estate, if you sum up all the changes to the articles, in the end we were back almost at what the Technical Expert Group first recommended.

Otherwise, it would have simply been misleading, asking for real estate that has an Energy Performance Certificate label 'A' and then you look at how many European countries do not have label 'A' on the scale — that simply made no sense. Therefore I think these changes were necessary and they led to quite a good outcome.

GlobalCapital: Bernard raised the point that at the moment nuclear power isn't included in the Taxonomy. Samuel, I don't know what your view personally or as a firm is about nuclear power, but what I want to ask is: as an investor, should your view of whether nuclear power is sustainable be influenced by whether it is in the EU Taxonomy or not?

Mary, Pimco: We have developed our own ESG scoring methodology, evaluation and database. We use it for our ESG integration process firm-wide and also for ESG-focused strategies and mandates. These could include in due course the Taxonomy as a consideration.

We leverage a broad range of frameworks and indices. The Taxonomy is one of them, but ultimately we have our own view regarding a particular security, issuer or project's greenness or ESG profile. The Taxonomy can help, it can be a source, but it will not be necessarily applicable and relevant for all cases.

We follow very closely the EU Taxonomy developments. In principle, it provides a wealth of data and definitions and criteria that can be useful. But it is still a very early stage to draw conclusions about its applicability.

There are practical challenges around usability and the coverage is limited and may remain so for a period.

GlobalCapital: We are drawing to an end but I'm going to just ask each of you, if you could wish for one thing that would assist the progress of sustainability in finance, what would you wish for?

Villepelet, Tikehau: Given the urgency — we have only a decade, meaning only 3,000 days to act — I wish all the investors would start to think about their intentions on top of generating competitive financial returns. That is what we are trying to start at Tikehau Capital and we see that when we launch impact funds, it actually benefits the wider strategy and helps also to move things faster for all the other investors.

So I really wish that investors feel the sense of urgency and see the opportunity they have because it is the biggest finance opportunity for the next decade.

Lacaci, Morgan Stanley: Laure mentioned a very important point which is this sense of urgency, and I think one way to move forward is to ensure consistency and more integration of ESG. There shouldn't be such a difference in standards when we think about the ESG and the non-ESG activities of institutions. It has to be integrated to make sure we all meet the goals, and that is what I would like to see more going forward.

Descreux, EDF: For me, it is very simple. I will welcome the re-opening of bars and restaurants so that we can all meet up and discuss these points more efficiently than in a video conference. I think all the events where we network, when we talk about initiatives are sure accelerators of this innovation. So I think this will be good news.

Bernard Descreux,
Electricité de France

GlobalCapital: That's a great point and I'm sure we all agree with that. Josh?

Kendall, Insight: For me, there are two critical things. The first is that regulators should be considering the needs of the fixed income community. I don't think they have done that to date. They've got some green bond proposals but that doesn't really stretch to what is required.

The second point is: don't overfit and standardise the financial community. There are efforts to create standardisation, which makes sense from a practical perspective, but in reality investors are very different, our clients are very different and forcing us towards standardisation and ubiquitous reporting and metrics is going to really weaken the overall transition.

GlobalCapital: That's very interesting. Could you explain the first of your points slightly more fully?

Kendall, Insight: If you look at the regulatory technical standards for the Sustainable Finance Disclosure Regulation, for example, they haven't been designed for global aggregate bond portfolios, for municipal portfolios.

They've got very standardised KPIs for corporates and it doesn't consider the realities you may experience as a fixed income investor — for example, investments in private companies where you don't have access to the same data.

They don't think about the needs of the fixed income investor, even though we have a greater amount of capital and a greater influence than a shareholder. To date most of the regulation has been about encouraging shareholders to do more, and I think that needs to change.

De Faÿ, Amundi: My wish is to move forward, to build this common language.

We know that thanks to engagement between issuers, investors and banks, we have been able to set up a very nice market.

So let's move forward and be inclusive because the risk is to have a very strict label where we exclude some part of activities. We need to be inclusive. We need to focus not only on environmental but also on social. Let's move all together and keep an inclusive mind.

Mary, Pimco: The Taskforce on Nature-related Financial Disclosure was launched last Friday and we are one of the founding members, as part of the informal working group.

My wish is for this initiative to be successful because the development of common standards on biodiversity and broader nature-related risk and opportunities is much needed as a complement to the TCFD climate-related disclosure framework.

That could have a broad range of benefits in the green and sustainability-linked bond market, and more broadly for quantifying and mitigating environmental risk in fixed income.

GlobalCapital: Great point. Bodo?

Winkler-Viti, Berlin Hyp: I would wish for more data, better data, data that are publicly available and easily accessible, relevant data. In our case, this would be energy efficiency data on the whole European real estate sector.

GlobalCapital: Thank you. Aldo, you get the final word.

Romani, EIB: I would strongly appeal in favour of more awareness, more engagement, more determination and, above all, more sincerity.

We first need good-willed people that everywhere, in each organisation, should try and make things work.

It is not a question of just complaining about the imperfections of what is available. We all know reality is complex and very difficult to tackle, but things need to be done and this is only possible with the empowerment of people determined to take action and make things better.

It is also a question of making clear to everybody that reality is not the way it has been described so far. What we need now is clarity.

We know many more things than just a couple of years back but a lot more needs to be unveiled and this is not possible without the involvement of all. For me, this is the most important thing. GC

Linking finance to sustainable strategies

Arguably the most important sustainable finance innovation since the development of green bonds, sustainability-linked bonds have picked up notable traction in the year since the launch of the Sustainability-Linked Bonds Principles. But while the instrument provides the holistic issuer-level engagement that many investors are seeking, in contrast to use of proceeds bonds, questions remain over both the credibility of KPIs and applicability to financial and sovereign credits.

IN THE CORPORATE realm, sustainability-linked bonds (SLBs) are going from strength to strength. Already a broad range of industrial sectors — from pulp and paper, steel and oil and gas to luxury goods, retail and even private equity — have seen transactions. These have been sold in a range of currencies that includes sterling, yen, Norwegian kroner and Swedish kronor besides euros and US dollars.

Moreover, SLBs have emerged across the capital structure, with several deeply subordinated corporate hybrids already sold, and across the credit spectrum. High yield and unrated issuers constitute as much as 35% of volume to date, according to Moody's ESG Solutions.

Innovation has also brought the first SLB with a dedicated green use of proceeds (*see accompanying Verbund interview*).

In addition, flows from emerging markets have been significant. Brazil has been a particularly fertile source of issuers. At around 25%, EM names constitute a notably higher proportion of total SLB volume than of total green bond volume, for example.

Overall, sales so far in 2021 stand at around $10bn, according to Morgan Stanley data. This compares with under $5bn across all of 2020.

Broader church

"The growth of the SLB market reflects the increasing recognition that financing of sustainable activities — whether they are green, social or otherwise — should have a clear link to an entity's overarching ESG objectives or performance," says Rahul Ghosh, managing director for ESG outreach and research at Moody's ESG Solutions. "We're seeing that concept take root in the use-of-proceeds market as well, but the SLB structure takes the idea a step further. Entities can embed their public sustainability commitments into their debt capital strategies, which is a really important and exciting development."

This also answers investors' increasing appetite for broad engagement with issuers rather than the project level access that use of proceeds structures provide. "SLB structures fit very well with investors that want to look at companies holistically, rather than having to scrutinise case by case use of proceeds," says Alexander Menounos, managing director, head of EMEA DCM and global co-head of IG syndicate at Morgan Stanley. "The feedback on these instruments is highly supportive."

SLBs "open the door to a much broader suite of sectors and issuers that can use debt financing to show and commit to their sustainability credentials", Ghosh adds.

"Over time, we will increasingly see frameworks with several KPIs to address companies' various priorities"

Cristina Lacaci, Morgan Stanley

The product offers potential to highlight issuers' overall ESG strategy. "It is very attractive from that perspective — a great platform for management to really reflect on the strategy and the commitments they make, and communicate that to the capital markets," comments Maxime Stevignon, head of fixed income capital markets for France, Belux and Switzerland at Morgan Stanley.

"When we think about SLBs we typically think about decarbonisation, but it goes far beyond that. ESG strategy is also about social commitments and about good governance. Ultimately an SLB should be a driver for the three legs of ESG."

Although volumes remain relatively small, the resulting diversification of issuers is striking. "We've seen companies from a variety of sectors, including consumer staples, transport and logistics, construction, paper and pulp, healthcare and financial sectors," says Ghosh.

Addressing the need to transition entire businesses is a merit of SLBs over project-level use of proceeds bonds, Stevignon judges.

Ghosh argues that SLBs provide institutional investors with a wider spectrum of opportunities to finance, support and engage with companies' efforts to transition to more sustainable business models.

In turn, the product's diversity is drawing demand from investors because of its intrinsic mitigation of diversification risk in ESG bond portfolios, which are typified by heavy sector, geographic and credit quality. "We think that strong investor appetite for this kind of paper is going to be an engine of growth," Ghosh says.

The European Central Bank (ECB)'s new ability and willingness to buy SLBs since the start of 2021 is particularly significant. "That is a real game-changer and will spur significant additional issuance," says Menounos. "It's not just potential incremental demand. It's a vote of confidence in the product."

A further important factor is efficiency. "The ongoing resource commitment in monitoring multiple investments or instruments is cumbersome and much less efficient than monitoring the issuer in an SLB format. That development is key for standardisation and to facilitate significant growth in volume," he believes.

At the same time, SLBs address the capacity problem that companies in many sectors face over use of

The role of the ECB is affecting KPI selection by issuers, including, perhaps, Tesco

proceeds structures. They simply lack the eligible assets to finance through green or social bonds. "Not every sector will have solar plants as core to their operations, for instance. Yes, you can look at green activities that support your operations — maybe an energy-efficient project for one of your buildings. But it may not be core to your business," Stevingon says.

In contrast, the SLB model accommodates companies that are not green or social pure plays. "They are still able to demonstrate their commitment to moving towards a lower carbon or more resilient model while retaining the flexibility that general corporate purpose allows," notes Ghosh.

Increasing credibility

One key question over SLBs is the credibility of the targets and KPIs that companies embed in their bonds. "An important driver of critical mass will be issuers' ability to really deliver beyond a business-as-usual pathway on sustainability," Ghosh says.

Moody's ESG Solutions identifies interim goals, historical KPI performance, science-based criteria (particularly for GHG emissions-related targets) and limited reliance on offsets, plus clear transparency and ambition on scope and coverage, as critical elements.

"Robust commitments in these areas can strengthen the credibility of targets," believes Ghosh, who expects best practice to emerge "pretty quickly". He cites the two-thirds of 43 SLBs in a recent Moody's ESG Solutions study that provide three-year prior trend data for their KPIs as an example, whereas only eight reference Scope 3 emissions and only 10 directly reference science-based targets.

Some question the environmental focus of many SLB KPIs to date. This tendency may be exacerbated by the role of the ECB which, for now at least, can only purchase the product when it features exclusively environmental KPIs. This is affecting KPI selection by eligible issuers (eurozone companies and eurozone entities of companies from outside the currency bloc, such as Tesco of the UK). It may serve as a deterrent to the inclusion of social KPIs, which are in greater focus in the US.

Although assessment of the ambition of environmental KPIs is aided by guidance from Science-Based Target Initiative and other bodies, investor demand exists for non-environmental KPIs too, reports Cristina Lacaci, head of ESG structuring for global capital markets at Morgan Stanley.

"Investors are open to other KPIs and we have already seen several bonds with water conservation, waste reduction or diversity KPIs. Several investors have specifically mentioned that they would like to see more diversity KPIs," she says.

Despite the ECB, broader KPI sets appear to be the direction of travel. "Over time, we will increasingly see frameworks with several KPIs to address companies' various priorities," Lacaci anticipates. (*See accompanying Diversity chapter for further discussion.*)

As the product matures, greater differentiation among SLBs of different tenors and credit quality is also likely. Currently the product's structure typically defaults to a 25bp step-up in the event of issuers failing to hit KPIs, regardless of other factors.

"This reflects the relatively immature market. Over time we expect the financial features of SLBs to become more precise," Ghosh says.

This raises the question of interplay between KPIs and credit quality — particularly the possibility that missing targets could indicate increased operational, financial and reputational risk. In turn, that could raise issuers' cost of capital.

"Over time a failure to hit targets could constrain an issuer's ability to raise additional ESG financing and have material financial implications above and beyond the 25bp. As that differentiation becomes more apparent in the market, you'll start to see more variability ex-ante in some of the pricing of the structures," he anticipates.

"The fact that the Commission will work on other bond labels such as transition or sustainability-linked instruments is a positive development," says Lacaci.

Conflict of interest?

Some have charged that SLBs involve a conflict of interest, since investors are paid more if issuers fall short of their KPIs. But Ghosh dismisses these concerns. "Investors aren't looking for issues to fail in pursuit of these objectives," he affirms.

Rather, he anticipates that indications that issuers are not on course to hit targets will lead to increased engagement with investors. Consistent failures are more likely to lead to bondholders selling out of SLBs than holding on for additional coupon.

This makes the exhaustiveness and timeliness of post-issuance communication a critical element of the market's future development.

"Timely reporting will ultimately give investors the information they need to understand where an issuer stands on meeting the selected KPIs," Ghosh notes, pointing to the need for post-issuance assurance on indicators and targets, as well as annual disclosures.

Perceived failures over reporting are likely to be looked upon "particularly unfavourably" by bondholders, he judges.

MREL obstacle

Despite banks' growing issuance of ESG debt, they still face significant challenges in offering SLBs. This is because the MREL (minimum requirements for own funds and eligible liabilities) regime introduced by the Financial Stability Board as part of the concept of bail-in after the 2008 global financial crisis prohibits step-ups and credit-sensitive features.

Even if banks were to adopt the step-down variation which SLBs have very occasionally employed, they would still not circumvent the credit sensitivity prohibition. "The core of the question is whether meeting a KPI is something that reflects on your credit standing as an issuer," believes Charles-Antoine Dozin, head of capital structuring at Morgan Stanley. "It's difficult to make the case that the coupon step-up resulting from not being able to deliver on your ESG commitment is separate from your credit standing as an issuer. This is why the concept should be clarified."

"We are seeing an increasing number of governments not just put out net zero targets up to 2050 but making increasing steps to have clear interim targets as well"
Rahul Ghosh, Moody's ESG Solutions

As a result, very few European banks that do not require their debt to achieve MREL-eligibility could be candidate issuers without a change to the 'level one' MREL text, according to Dozin. One of these is Berlin Hyp, the only bank to issue an SLB to date.

Germany has issued use of proceeds green bonds, but SLBs are potentially complementary for sovereign issuers

Moreover, unlike banks' use-of-proceeds bonds, the European Banking Authority (EBA) has made no recommendations over issuing SLBs.

"Until we resolve the disconnect between the MREL rules and typical SLB structures I think activity in that space will remain subdued," Dozin concludes.

Sovereign search

Could sovereign borrowers begin embedding their Paris Agreement commitments in SLBs? A lively debate over this possibility continues, but no issuer has yet taken the decisive step. Even so, analysts and bankers see a case for a sovereign version of the product.

"We are seeing an increasing number of governments not just put out net zero targets up to 2050 but making increasing steps to have clear interim targets as well. And so this structure could make sense," Ghosh says.

"SLBs are complementary to green, social and sustainable use-of-proceeds bonds. It's an instrument that the market is exploring," says Ana Colazo, head of sustainable finance for the UK & Nordics at V.E, part of Moody's ESG Solutions. "Investors expect some sovereign issuers to come to market with inaugural SLB issues either in H2 2021 or 2022."

The prospect of governments making commitments that future administrations would also have to honour or face financial penalties that taxpayers would have to fund may be off-putting to some sovereigns — even though they are likely to have already made public commitments to Paris and net zero.

"If you're targeting eight or 10 year KPIs, it doesn't really matter about changes in political environment — issuers will have quite a significant economic liability and incentive to reach the targets," says Dan Shane, managing director and head of EMEA investment grade syndicate at Morgan Stanley.

Ghosh doubts that political sensitivity over potential failure to hit targets will deter sovereigns from SLBs. "The collective ambition that we're seeing right now and the need to translate the Paris Agreement into clear concrete, tangible policies means that governments are increasingly going to have to show how they are meeting targets on a five and 10 year basis, rather than just out to 2050."

Accordingly, failure to hit targets would be highly visible to civil society — regardless of whether that sovereign has issued SLBs.

The recency of the product's take-off may also be a factor. "It's a relatively new instrument, sovereigns just haven't had a chance to really consider it," believes Shane.

Even so, he regards sovereign SLBs as "probably quite compelling" for investors and believes the product will migrate to the sovereign realm in time. "That's what investors want to see." GC

Verbund: strategic pioneer

With a host of landmark transactions that include the world's first sustainability-linked loan and the world's first green digital Schuldschein, Verbund stands out as a pioneering issuer of ESG debt. Most recently, it broke significant new ground by combining normally separate green use of bond proceeds with a sustainability-linked coupon.

"WE HAVE ALWAYS tried to be at the forefront of developments, to be ahead of the curve," says Peter Kollmann, chief financial officer at Austrian utility Verbund. "It is a track record where step-by-step we tried to push the envelope, to be brave and be the first one with new structures."

This leadership in sustainable finance reflects what Kollmann terms Verbund's corporate DNA. "Sustainability has been a core element of our strategy for many years," he notes, citing the company's production of CO_2-free electricity for decades. "Our first hydro power plant was built in the 1950s. Today we're one of the largest hydro generation companies in Europe."

Reaping the benefits

Verbund identifies two key benefits from its sustainable financing. The first is that it aids the company's efforts to articulate its values. "It supports us in communicating, externally but also internally, what we stand for as a business," says Kollmann. "I think it is a tool to be very clear in terms of how serious sustainability has been for us — not just in the past or the present, but definitely looking into the future."

The second is pricing. As so-called 'greeniums' have grown more pronounced on ESG debt, the company has reaped the benefit of having established a track record with buyers.

"We get a lot of investor demand," says Kollmann. "We see that there is a loyalty developing from our investor base, who want to own Verbund paper. They are very keen to come in with very large orders, they want a big allocation and, because of that credibility and those loyal investors, we are able to have a real price advantage through our structures."

More generally, Kollmann — a fan of Mark Twain — cites the writer's famous aphorism that "it's never wrong to do the right thing".

At the same time, the company also acknowledges that issuers must overcome challenges in building a presence in sustainable finance. Credibility is one. This requires the financing strategy "to be fully integrated and synchronised with the strategy of the company," Kollmann believes.

"It cannot be a highly sophisticated finance department working in an ivory tower and producing clean instruments. You need a lot of input from people outside the finance department. It needs to be part of the organisation and part of the thinking."

This requires articulating the case effectively to the company's internal audience, Kollmann notes. "So that your own people all understand why this is important and why you want to make a contribution — not just to your own company, but to the entire market."

Senior management's support also plays a key role. "You need a lot of support, and there leadership is very important," he adds.

'Super green'

Termed "super green bonds" by some investors, Verbund's most recent ESG debt offering stands out as a new sustainable finance landmark. The 20 year deal meshes a dedicated use-of-proceeds standard in green bonds with the newer sustainability-linked bond (SLB) coupon structure.

SLBs usually compensate investors if the issuer fails to meet the targets embedded in the instrument by increasing their coupon — often through a 0.25% step-up.

"When we started with the planning six months ago, we thought 'what would be a structure that really combines a lot of different features — and is that something that is do-able?'" Kollmann recalls. "During the construction process we realised that if it is well received by investors, it could indeed be ground-breaking because it covers so many different elements which are very important for sustainability."

Verbund incorporated two targets that both it and investors regard as important. The first was that it must add at least 2,000MW hydropower, wind power and photovoltaic (PV) solar renewable energy production capacity by the end of 2032.

Determined in conjunction with Verbund's 100%-owned subsidiary Austrian Power Grid, the second

Peter Kollmann, Verbund

highlighted the need for renewable energy to be integrated into countries' high voltage grids. It requires the company to install additional transformer capacity of at least 12,000 MVA to facilitate interaction with the grid — also by the end of 2032.

In addition, the structure is fully aligned with the new EU taxonomy for sustainable activities. This reassured buyers about its compatibility with the EU's criteria — a new benchmark for the greenest investments.

It was also targeted to dedicated sustainable investors. Indeed, since the €500m deal was subscribed more than four times over, Verbund was able to allocate all of the bonds to signatories of the UN-supported Principles for Responsible Investment.

The structure is likely to provide Verbund's default financing format in future, Kollmann believes. "It should definitely be the role model. A lot of investors feel that it could well be one of the innovations that will really make a difference."

The company also hopes that peers will make use of it too. "A lot of people will follow, though perhaps not with all four features. But for similar entities we could well see it being a future part of capital markets," Kollmann judges.

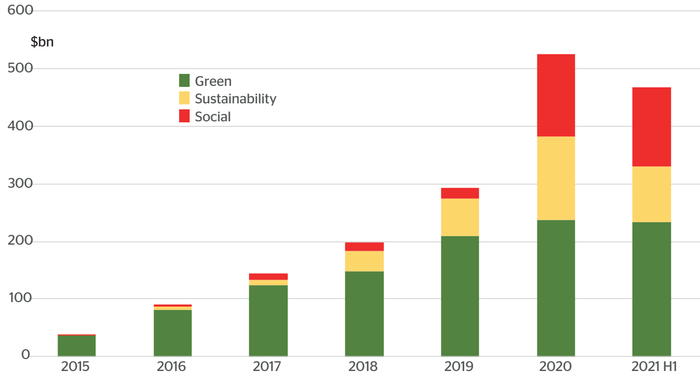
Pushing innovation

Verbund still sees scope to continue innovating in sustainable finance. Kollmann laughingly dismisses the idea that it may have exhausted potential for this: "I hope not! I really hope we can continue to be a leader in innovation and I actually am very positive."

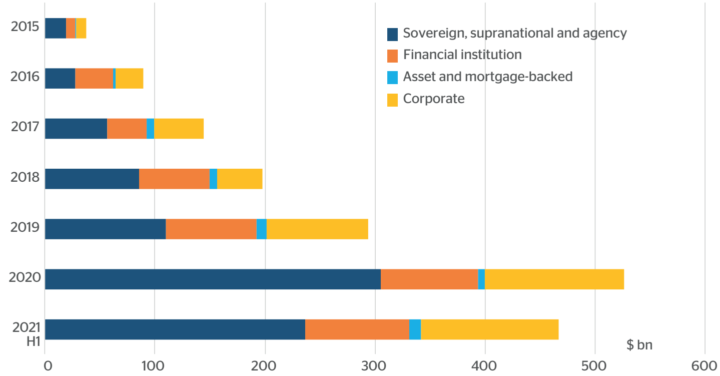
He emphasises that the company "is not interested in gimmicks". Rather, "we want the features which we introduce in our financing to be fully understood and for our investors to really recognise the value of those features." GC

Sustainable financing booms as climate urgency rises

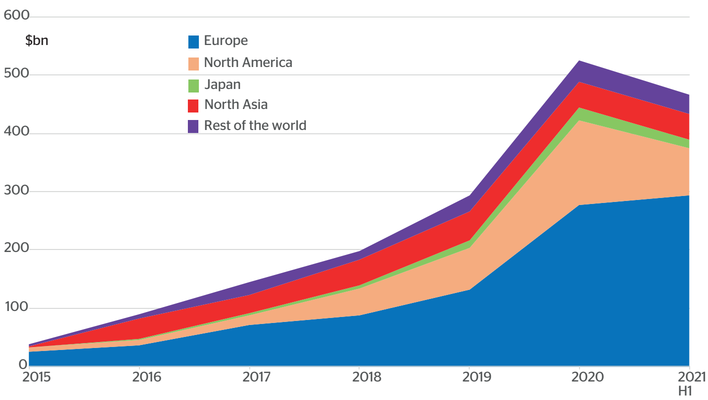
Green, social and sustainable bond issuance



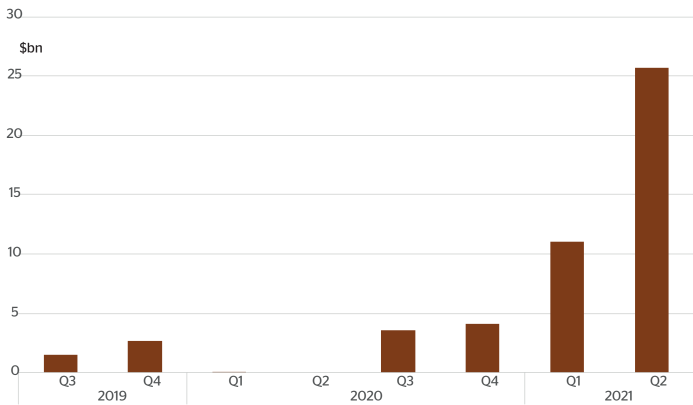
Green, social and sustainable bond issuance by type of issuer



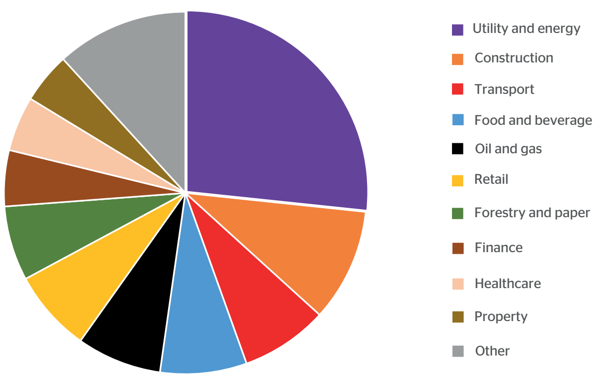
Green, social and sustainable bond issuance by region



Sustainability-linked bond issuance



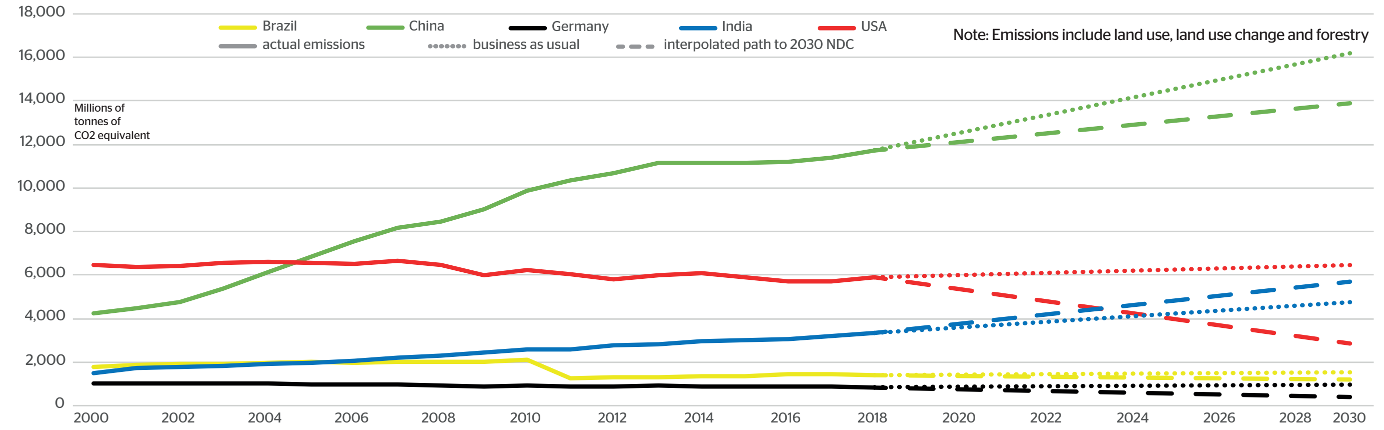
Sustainability-linked bonds by industry



Green and sustainability-linked loan signings

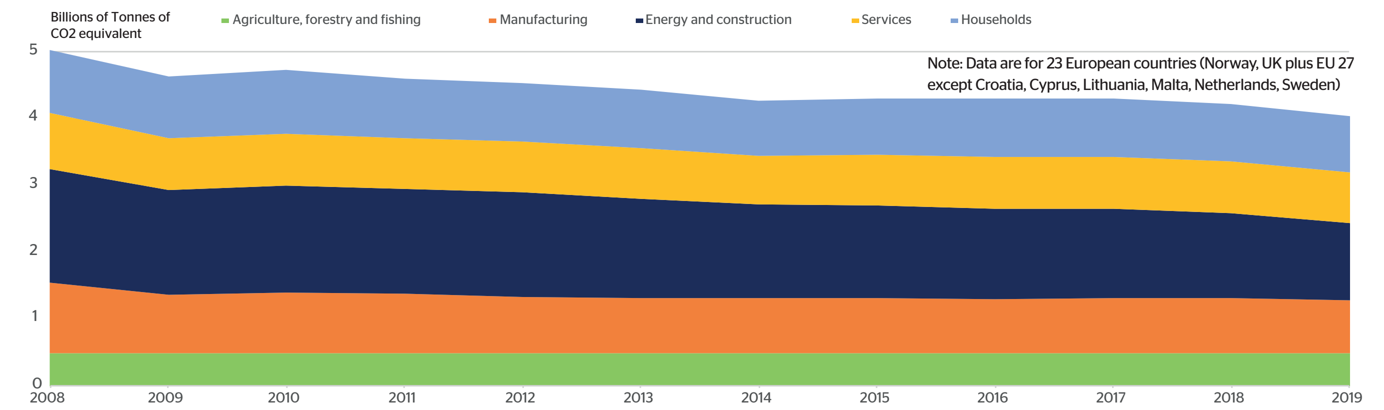
Reported greenhouse gas emissions and Nationally Determined Contributions for 2030

Source: IMF, UNFCCC, Climate Watch



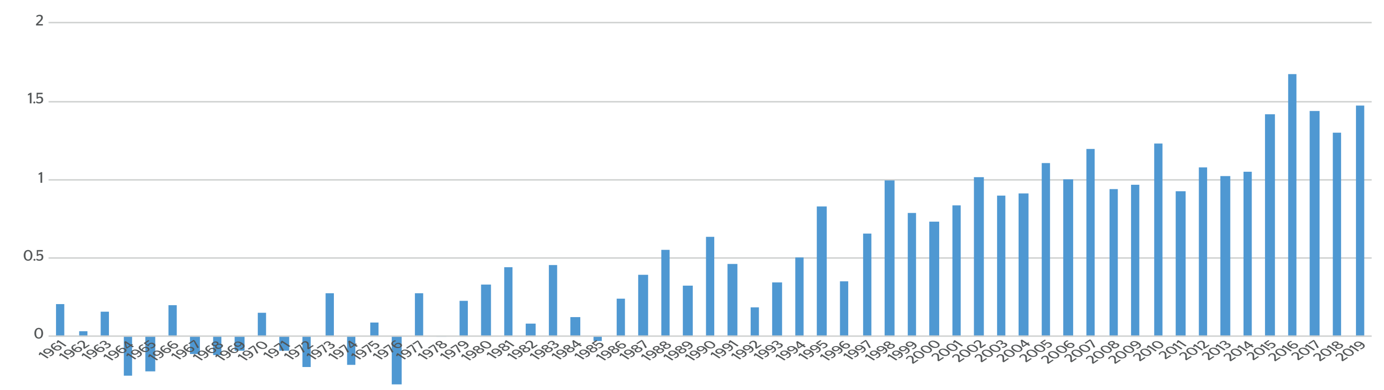
European greenhouse gas emissions by sector

Source: IMF, OECD, IEA, national accounts



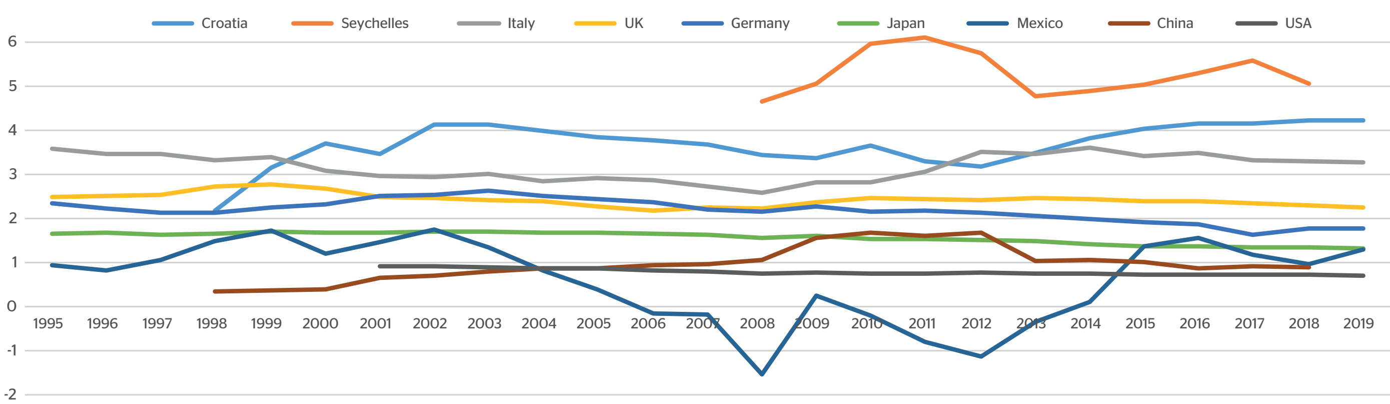
Annual mean global surface temperature (°C above 1951 to 1980 average)

Source: IMF, FAOSTAT, NASA GISS



Environmental taxes (% of GDP)

Source: IMF



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