Don't Judge a Bond By Its Label

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As the volume of green, social, sustainable and sustainability-linked (GSSS) bonds grows, the terms of new, supposedly green or sustainable debt are getting looser or failing to reflect current best practices (or both). Some issuers appear to be trying to use the GSSS bond market to obtain cheaper funding to support their general business activities or projects that don't deserve a GSSS label.

Investors who take the label at face value risk being taken advantage of or failing to perform their fiduciary duty. In our view, investors themselves are partly responsible for the increasing prevalence of greenwashing in new debt issues through lack of due diligence. Over the last few years of investing in green and social bonds, we on the Global Credit team avoid judging a bond's Environmental, Social, and Governance (ESG) authenticity solely by its label, and are acutely aware of the potential harm that such complacency might cause. Here we briefly describe our approach to labeled bonds and provide a case study illustrating this approach.

We Look for Issuers with a Proven Track Record

In general, we seek to fund issuers that have demonstrated their commitment to green or social goals by implementing authentic environmental or social strategy and governance practices throughout the organization, rather than standalone ESG projects. We find that companies issuing labeled bonds to finance discrete projects while lacking a broader strategy around ESG issues are less likely to be committed to achieving such goals. We make exceptions only for transition bonds, which fund discrete projects that enable a company to achieve its plan to become green companywide—if we believe the plan is sound.

To assess the authenticity of an issuer's sustainability efforts and whether a bond will further them, we ask three key questions:

- Does the issuer have a well-developed ESG framework?
- Is that framework reflected across its business practices?
- Are the projects the debt will fund well aligned with the company's mission?

If these are not present, the bond may be an opportunistic financing vehicle, not an authentic instrument of sustainable finance.

We Look for Issues with a Clear Use of Proceeds, Limited Look-Back Periods, and Strong Reporting Standards

CLEAR USE OF PROCEEDS

Our clients want their GSSS bonds to fund projects that will have a positive environmental or social impact. However, issuer descriptions of the use of funds are often ambiguous and lack clarity as to how the debt issue will contribute to an environmental or social good or generate positive change in its industry. Those aren't bonds that we are likely to purchase.

LIMITED LOOK-BACK PERIODS

Some issuers have used green bonds with a 36-month look-back feature, which allows them to use projects completed in the last three years to obtain attractive financing. The environmental or social impact of the bond may thus be limited if the completed project did not meet current standards for social or environmental benefits. We seek GSSS bonds that limit the share of proceeds used to refinance existing projects; we prefer bonds that fund the issuer's *future* environmental or social projects.

REPORTING, VERIFICATION, AND EXTERNAL REVIEWS

We are more likely to invest in a GSSS bond if the issuer commits to publishing easily accessible data on the performance of assets funded by the bond at least annually over the term of the bond, not just until the proceeds are invested. If the bond covenants specify Key Performance Indicators (KPIs), we prefer to see that a well-known and qualified external reviewer with relevant expertise will verify that the project is achieving its KPIs. To us, use of lesser-known external reviewers raises questions, just like use of an unknown auditing firm.

Recent Trends in GSSS Bonds

Standards within the GSSS bond market continue to evolve, as evident from the variety of features seen in offering documents. Some of these attributes reflect the maturing of the market. Others stand out for lacking the efficacy that sustainable investors are seeking. We aim to partner with both issuers and their advisers to improve the integrity of GSSS bond issuance. Recent efforts are focused on the following:

GREATER USE OF SLBS AND KPIS

Sustainability-linked bonds (SLBs), which are typically issued by companies that ESG screens often exclude, are worthy of consideration, in our view, if the issuer is demonstrating genuine and measurable organizational level environmental or social strategy. For example, we might buy debt that funds an automotive manufacturer's transition to electric vehicles if the covenants lay out a clear timetable for the transition and promise published annual reports on progress, verified by a reputable external firm.

We generally rate the issuer, not the issue, because we prefer investments that make the issuer accountable at the firm-wide level rather than at the project level. For SLBs, we generally seek KPIs with recent baselines to avoid counting already completed work in measures of success and ensure a more forward-looking achievement. We also seek interim annual targets that "break up" an overall KPI over the life of a bond, and transparency into the assets or projects the debt will fund.

COUPON STEPS

Some newer bond issues have coupons that change, depending on the issuer's success in achieving specific targets. In step up bonds, the coupon rises each time the issuer fails to achieve one of its KPI targets. In step-down bonds, the coupons decline each time the issuer achieves a target. These issues look appealing but pose particular risks. First, setting the initial coupon and the size of coupon adjustments is more art than science. Second, not achieving a KPI target may create more shareholder value than meeting the KPI target. If so, a company might issue a bond to get a low-cost initial interest rate, without intending to achieve the target. Authentic commitment is particularly important for these bonds.

Investors should also be wary of investing in step-down bonds, if their middle or back office cannot operationally handle changes to anticipated rates of return on investments. Financial institutions and other investors that seek to match asset returns to the cost of future liabilities would likely find such investments problematic.

RECOGNIZABLE IMPACT

Consideration of the United Nations' Sustainable Development Goals (SDGs), the EU's Sustainable Finance Disclosure Regulation Principal Adverse Impacts (PAIs), and investor demand for disclosure are likely to spur further innovations. We expect to see more GSSS bonds link their performance and coupons to achieving key SDG and PAI targets.

Case Study: Berlin Hyp

Berlin Hyp, a German mortgage bank focused on commercial real estate finance, has a solid track record of sustainable business practices. Since 2013, the bank has incorporated sustainable business practices in all its processes. For example, to grow its energy-efficient green building loan portfolio, it introduced pricing incentives for eligible green bonds. In 2015, Berlin Hyp began to tie its goals to its core business by issuing a green bond to refinance green assets. We viewed this refinancing as the first step to promoting green buildings as it allowed the bank to focus on creating new green loans and enabled the bank in 2017 to establish a target that 20 percent of the overall loan portfolio would be comprised of green loans by 2020. This target was achieved by 2019, and a new target that one-third of all loan financings be green by 2025 was established. In 2021, Berlin Hyp set out a conceptual framework that went much further, with coupon step-ups if sustainability performance targets were not achieved and raised the possibility of coupons stepping-down in future periods if targets were subsequently achieved. Reflecting a desire to keep things simple, Berlin Hyp ultimately decided to issue a sustainability linked bond with only a single step-up: a sustainability performance target linked to a carbon intensity reduction rate. The bank's performance target is to reduce the CO_2 emissions of its entire loan portfolio by 40% between 2020 and 2030. We view the bank's evolving sustainable practices and broadening goals as signs of its authentic commitment to instilling sustainability throughout the organization.

Summary

Sustainable finance is becoming more sophisticated at all levels: investor, issuer, advisor and regulator. We follow the mantra that if a company's ethos includes implementing sustainable processes, sustainable outcomes should follow.

There is a trial-and-error process underway towards aligning the interests of issuers, investors, regulators and the public.

Through these interactions, issuers and their agents are learning what corporate actions, governance practices and outcomes investors want to fund. With standards still in flux, it's prudent for investors to look beyond the label. As always, the devil is in the details, a.k.a. the fine print of an investment offering.