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Cutting Through Labels' Noise in the Sustainable Bond Market: The Merits of a Research-Driven Framework

SUSTAINABLE INVESTING | November 2023

With a steady supply of labelled Green, Social, Sustainability and Sustainability-Linked Bonds (i.e., Sustainable Bonds) having built up over US$3.6 trillion in outstanding value globally, sustainable investors can tap into a universe that has reached critical mass, improved liquidity and lowered pricing trade-offs versus vanilla bonds compared to the early days of these labels.

But investors should not be lured into dropping their guard. In this paper, the first of a series on Sustainable Bond investing, Calvert describes the growing opportunities associated with this market and the merits of conducting in-depth research on each transaction to determine the legitimacy of green and social claims, and discusses whether these instruments can contribute to an issuer's decarbonisation and other sustainability objectives.

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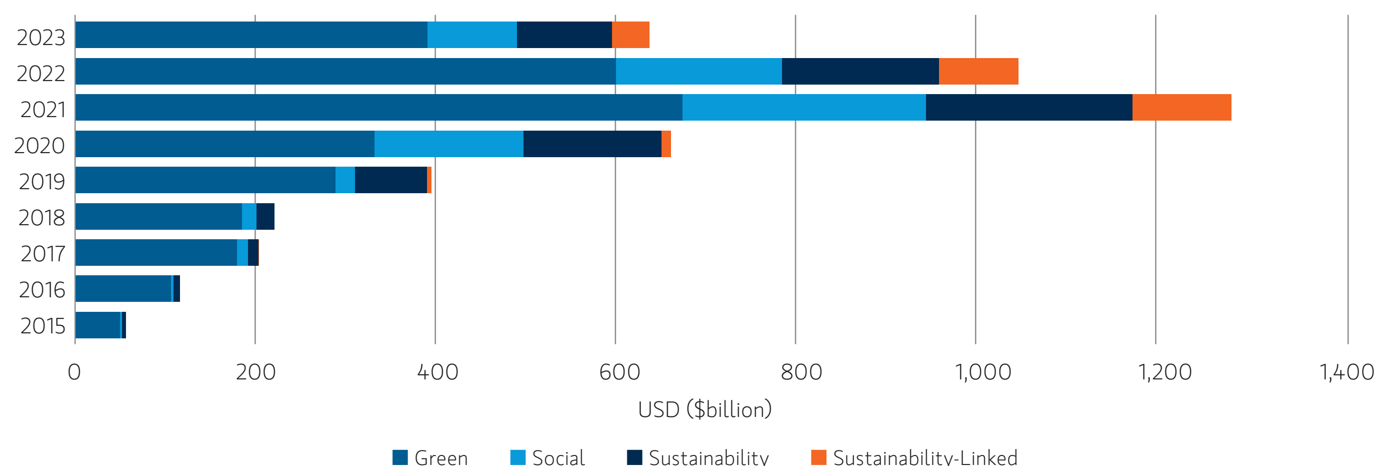
An Evolving Sustainable Bond Landscape

Whilst 2022 seemed to mark a slowdown in the global supply of labelled Sustainable Bonds, YTD issuance has already exceeded last year's figures for the same period, with over US$600 billion as of June 2023. In Q1 and Q2 2023, the labelled bond market saw its strongest two quarters since Q2 2021, primarily thanks to Green Bond issuance, which continues to solidify its role in the wider labelled bond market, with a focus on the environmental side dominating new issuances. 2023 has been penned to be a record year for Green Bonds despite increasing regulatory scrutiny[1]—in fact, our Calvert ESG analysts have identified greater standardisation amongst green financing frameworks (i.e., the documents published by Green Bond issuers, outlining their sustainability strategy, eligible Green projects, and governance around issuance of these instruments), especially following a pick-up in guidance from the European Union (EU) on their Taxonomy, and on the provisional EU Green Bond Standard.

[1] Linklaters, *Global green bond issuance reaches record high of $351bn in first six months of 2023 amid evolving regulatory landscape* (2023).

DISPLAY 1

Global Sustainable Bond Issuance by Label and Year



Source: Bloomberg, Morgan Stanley Research. As of June 30, 2023.

The Sustainable Bond market has grown to a total of US$3.6 trillion in outstanding value. While this is still small when compared to the estimated size of the global bond market (~US$130 trillion),[2] it is a meaningful universe for sustainable investors to operate in. To put it into perspective, when breaking down the global bond market into more specific investable universes, the Euro Corporate Bond universe is about US$2.7 trillion in size, whilst the U.S. High Yield Bond universe is about US$1.2 trillion.[3]

FAVOURABLE CONDITIONS FOR A STEADY SUPPLY OF SUSTAINABLE BONDS AND DECREASING TRADE-OFFS WITH VANILLA BONDS...

We view the key drivers of demand for labelled sustainable issuances, particularly green and other use-of-proceeds structures, to be twofold:

1. PRODUCT-LEVEL REGULATORY EVOLUTION

The EU Sustainable Finance Disclosure Regulation (SFDR) has contributed to higher demand for labelled use-of-proceeds bonds, as outlined in our 2023 ESG Outlook paper. In Q2 2023, Article 8 and 9 assets surpassed the EUR 5 trillion mark,[4] with some Article 8-classified funds committing to making a minimum allocation to "Sustainable Investments",[5] and Article 9 funds intended to invest exclusively in Sustainable Investments. In our view, the earmarking of financing dedicated to strictly sustainable projects makes use-of-proceeds sustainable bonds ideal candidates for being considered Sustainable Investments, as long as their underlying frameworks are robust and aligned with market best practice—something that we assess in depth through our Sustainable Bond Evaluation Framework, described below. As a result, we believe the need to fulfil Sustainable Investment allocations across the over 50% of the European-domiciled universe[4] of Article 8 and 9 funds that have set such commitments continues to drive investor demand for these sustainable instruments.

2. LIMITED TRADE-OFF WITH VANILLA COUNTERPARTS

Whilst we identified a potential risk in our 2023 ESG Outlook paper of the "greenium" (i.e., the excess new-issue premium associated with a bond's label) being driven up due to increased demand for Sustainable Bonds, there seems to be growing research evidence that greeniums are, over time, starting to dissipate. We note that in general, the presence and magnitude of a greenium depends on the nature of the issuer (in terms of sector, jurisdiction, credit and ESG ratings) and the frequency of labelled bond issuance. Sectors with a consistent and ample supply of Sustainable Bonds and recurrent issuance, in particular utilities, and sovereign, supranationals and agencies (SSA), which constituted approximately 45% of total sustainable bond issuance in H1 2023,[6] tend to show negligible/diminishing greeniums.

Even in the presence of some visible basis points of greenium, we do not think that this will have a meaningful impact on the performance of a portfolio invested in such instruments, for a number of reasons. Firstly, the greenium, whilst being a constant in the market, is

[2] International Capital Market Association (ICMA).

[3] Source: Bloomberg Euro Agg Corporate Bond Index, and ICE BofA US High Yield Index, respectively, as of September 2023.

[4] Morningstar, *SFDR Article 8 and Article 9 Funds: Q2 2023* in Review (2023).

[5] The EU SFDR refers to "Sustainable Investments" as those that make a positive contribution towards environmental or social characteristics, whilst doing no significant harm to other sustainability factors, and abiding by minimum social safeguards and good governance. The regulation does not prescribe specific eligibility thresholds for Sustainable Investments.

[6] Source: Environmental Finance Bond Database, as of 30 June 2023.

relatively small in terms of carry. This is especially the case as risk-free rates are significantly higher today than they have been over the past decade. As such, the negative contribution to carry from the greenium has become increasingly marginal. In addition, whilst the yield may be lower, green bonds tend to be very closely held due to their relative scarcity. As such the volatility of the bond price tends to be lower than the volatility of unlabelled equivalents. We find that this increases the attractiveness of the security. Finally, there are some parts of the market where the greenium is less apparent, for instance, the higher spread parts of the market, such as High Yield and Securitised bonds, where greenium has been less constant and, in fact, the green bond sometimes trades wider than the non-green versions.

Liquidity has also historically been a concern for green bond investors. We believe this has continued to improve as a result of increasing supply and greater alignment to market standards—studies have also shown that green bonds with strong "greenness ratings" from Second Party Opinion (SPO) providers have higher liquidity.[7]

...WITH A SMALLER PORTION OF THE MARKET STILL WORKING TO FIND ITS FOOTING

Whilst the market for Green and other Sustainable use-of-proceeds bonds is starting to mature, other instruments still have a long way to go. This is the case for Sustainability-Linked Bonds (SLBs), where the issuer commits to the attainment of one or more specific sustainability targets (or, the payment of a penalty), but proceeds are directed towards general corporate purposes. Whilst we see that efforts in the market have been made to improve transparency for these instruments,[8] and we see this structure as a potential lever to grow sovereign sustainable bond issuance, especially from emerging markets, we believe the risk of greenwashing, particularly for corporates, is higher than for use-of-proceeds bonds, especially in cases where the sustainability performance target(s) lack ambition or robustness (such as targets covering a non-material proportion of carbon emissions, or call dates predating sustainability targets' trigger dates). Against the backdrop of SFDR then, the ability of these sustainability-linked structures to meet sustainable investment allocation requirements is reduced—such as for SLBs from high emitters, which may not pass the emissions indicators in the regulation's Do No Significant Harm test. Increasing regulatory and investor scrutiny on these instruments has been reflected in a declining share of issuance of SLBs versus use-of-proceeds bonds.[9]

To avoid these concerns, across both SLBs and use-of-proceeds bonds, we believe it is imperative to fully analyse the robustness of sustainable financing frameworks, in order to leverage the full potential of these investment to result in positive impact and help achieve real-world outcomes.

Cutting Through the Noise of Labels With Proprietary Sustainable Bond Evaluations and Research

The rapid growth and development of the Sustainable Bond market, and the large quantity of unique information available to investors in these instruments, makes it a priority for investors to conduct an in-depth assessment of each transaction. This process helps ensure these securities live by the issuer's claims, abide by market standards, and, if intended to be purchased for a Sustainable Bond portfolio, align with the product's objectives.

At Calvert, we believe that undertaking a rigorous process to evaluate the sustainability characteristics of these investments not only maintains the quality of bonds held in our portfolios but shows our commitment to supporting positive environmental and social outcomes alongside financial returns.

SPOs and other verifications by external providers play an important role in providing Sustainable Bond investors with a more standardised set of information while increasing the transparency surrounding Green Bond frameworks and transactions. However, we believe that the true value of this granular information lies in its interaction with our proprietary Calvert ESG research platform. The investment team's own view on the materiality of a labelled bond transaction in the context of the issuer's sustainability strategy and its performance on related topics, allows for a nuanced assessment of the credibility of these investments, supplementing the underlying fundamental credit analysis.

Calvert has developed a comprehensive **Sustainable Bond Evaluation Framework** (*Display 2* - see page 4) to drive a structured, systematic assessment of our investments in Sustainable Bonds, both at issuance and throughout the life of the bond. Our Sustainable Bond Evaluation Framework is aimed at:

- Determining whether a labelled transaction is aligned with, and can materially contribute to, the issuer's overall sustainability objectives;
- Assessing the extent to which the use of proceeds or targets associated with the bond can help catalyse

[7] Dorfleitner, Eckberg & Utz, *Greenness Ratings and Green Bond Liquidity* (2023).
[8] Morgan Stanley Investment Management, *Key Fixed Income Considerations for 2023* (2023).
[9] Morgan Stanley Research, *What's Going on With Sustainability-Linked Bonds?* (2023).

additional financing towards innovative, low-carbon or other environmental solutions, and identify any risks of lock-in of high-carbon, polluting technologies; and

- Verifying the transaction's alignment with applicable market standards, including the International Capital Market Association's (ICMA) Green and Social Bond Principles and additional guidance, international taxonomies such as the one developed by the EU, and the Climate Bonds Standard, and benchmarking it against leading practices within the applicable peer group and jurisdiction.

These evaluations enhance the information available to portfolio managers and credit research analysts, furthering their understanding of how effectively issuers are managing material ESG issues and leveraging opportunities stemming from the low-carbon transition, and they are an integral component of the investment decision process for these instruments. Calvert's Green Bond strategies only invest in labelled bonds that have been assessed positively through this framework.

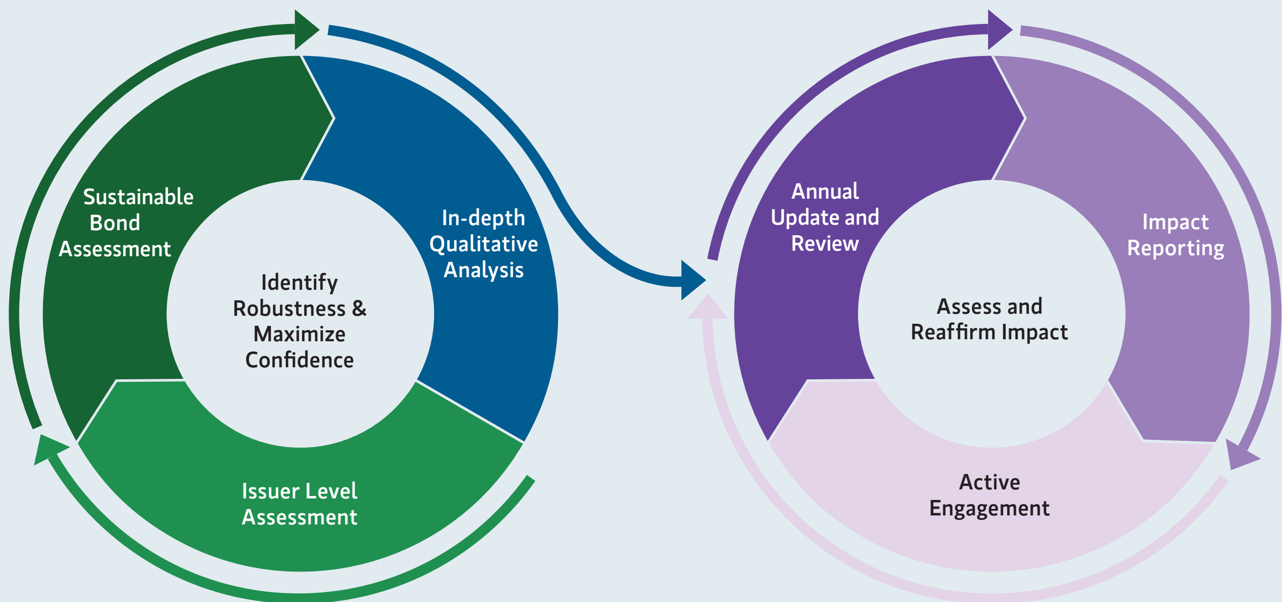
We rely on our deep experience in the market to uphold standards for the additionality of selected projects or targets to be financed. In particular, the Sustainable Bond market offers a unique opportunity for fixed income investors to engage with issuers, at a time when issuers and their management are particularly sensitive to investor feedback on sustainability. Applying a robust research process provides us with an effective platform to push for improvements in the structure of these instruments as well as surrounding disclosure. We do this through bilateral engagement with issuers during their preparation of new transactions, especially for inaugural Sustainable Bond issuances, but also by communicating with structuring advisors and contributing to multistakeholder platforms.

With over 10 years of experience in managing Calvert Green Bond strategies, we believe we have a duty to contribute our viewpoints and encourage issuers and underwriters to strive to implement best practices to achieve meaningful positive sustainability outcomes through the issuance of robust sustainable bonds. Hence, Calvert actively engages with Green Bond market players, and participates in industry initiatives, to promote robust sustainable financing frameworks that help effectively catalyse capital towards environmentally and socially impactful projects, transparent disclosures, and reporting.

DISPLAY 2

Calvert Sustainable Bond Evaluation Framework

A dynamic evaluation framework to inform Green and other Sustainable Bond investment decisions at bond issuance and throughout the security's life:



DISPLAY 2 (CONT.)

Key elements of our Sustainable Bond Evaluation Framework:

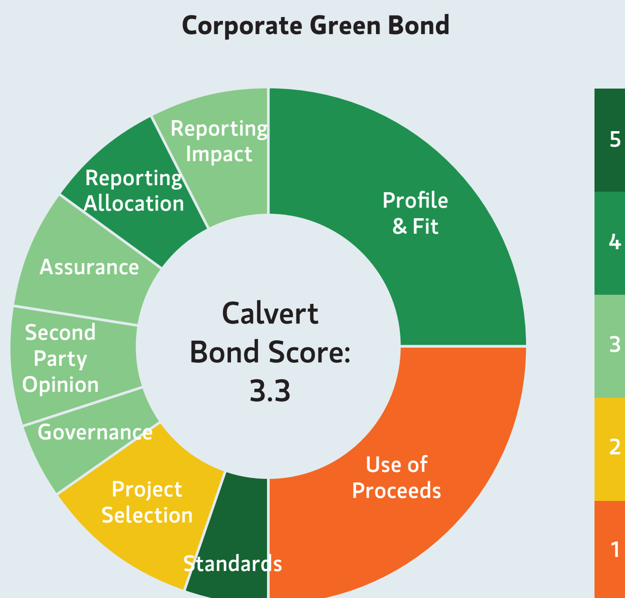
- **MATERIALITY ASSESSMENT:** Analysing the fit between the labelled bond and the issuer's business model and sustainability strategy, as well as the likelihood that the issuer will continue to generate eligible projects throughout the life of the bond, leveraging Calvert's deep ESG research expertise and the application of the Calvert Principles for Responsible Investment.
- **USE OF PROCEEDS/TARGETS DEEP-DIVE:** Identifying the additionality of selected projects and indicators specific to the security being issued; ensuring that projects and business activities receiving financing align with Calvert's view on what represents a credible effort to address environmental and social challenges; engaging issuers and underwriters to transparently disclose expected use of proceeds allocation and performance trajectories ahead of issuance.
- **DYNAMIC WEIGHTING OF EVALUATION FACTORS:** Depending on whether a Sustainable Bond is assessed at or after issuance, the relative importance of different factors will vary. During the ex-ante period—up to one year from the bond issuance date, when allocation and impact reporting becomes due—investors need to rely more heavily on information pertaining to the issuer's commitments, included in their Green Bond Framework, presentations, prospectus, and other third-party reviews. During the ex-post period, we expect issuers to publish information on the actual allocations of their green proceeds, or progress on their sustainability-linked targets, as well as on the impact achieved through the deployment of the allocated sustainable funds. Hence, the quality of reporting and the magnitude of reported impact will bear greater weight in our periodic review of the bond.

DETERMINING A GREEN BOND'S ELIGIBILITY FOR CALVERT'S STRATEGIES

Calvert's ESG research analysts score each Green or other Sustainable Bond they assess from 1 to 5, where 5 is best, based on multiple factors from the Calvert Sustainable Bond Evaluation Framework. The chart below presents an illustrative Green Bond Evaluation for a utility company, conducted at the time of issuance.

The final, weighted score is not intended to be used in isolation: it is an informative input, accompanied by a detailed qualitative review by the analyst, ultimately resulting in an eligibility decision for investing in the bond.

Corporate Green Bond



CASE STUDY

The devil is in the details: Spotting project double-counting and carbon lock-in through a targeted assessment

In early 2023, Calvert assessed a new **Green Hybrid bond issuance by a utility company**. A recurrent, established Green Bond issuer in the market, the company has a robust Green Financing Framework aligned with market practices, and comprehensive reporting. Some of their previous senior Green Bonds have been assessed as eligible to be held in Calvert's Green Bond strategies.

While the new Green Hybrid issuance followed the same issuer's framework, the issuer's handling of the use of proceeds under their green hybrid programme presented some concerns: notably, the **same assets previously financed through an older Green Hybrid Bond were now being refinanced through the new issuance**. This point had not been captured by the Second Party Opinion, which focused on the broader framework and not the instrument. Considering the ample availability of new green CapEx to the company, most of which is also aligned with the EU Taxonomy, we considered that this double-counting approach not only lagged the Green Hybrid market, but also compromised the additionality and overall quality of the investment. As a result, our ESG research analyst deemed it **ineligible for Calvert**.

Around the transaction time, the investment team **engaged with the company** on this matter, requesting them to be more explicit, going forward, about the intended use of its Green Hybrid Bond programme. We also recommended the issuer try and report the impact, at least estimated, of its green assets at issuance, whenever those assets are already pre-identified and operational.

In a similar manner, in Q1 2023 we assessed another **Green Bond issued by an automotive components manufacturer**.

The core use of proceeds associated with this transaction focused on Clean Transportation. However, we identified that some of the company's components specific to electric vehicles, included in the issuer's green project pool, could be subsequently deployed in Plug-in Hybrid Electric Vehicles (PHEV) and also in Internal Combustion Engine (ICE), due to the potential dual usage of those components.

This concern around the **potential lock-in of high-carbon vehicle stock** through the green proceeds contributed to a significant **dilution of the Calvert Green Bond score and overall evaluation**, and to the portfolio manager's **decision not to invest** in the new issuance.

CASE STUDY

Good Green Bonds gone bad: The merits of ongoing monitoring and review

Calvert initially participated in a 2019 **Green Bond offering by a manufacturer of commodity/specialty chemicals and batteries**. Proceeds were anticipated to focus on low carbon transport given the issuer's role in manufacturing batteries for electrified transportation end-uses. These projects were deemed likely to address a significant bottleneck to decarbonizing transportation systems. Given the clear materiality of executing such projects to the issuer, we added the security to one of Calvert's Green Bond strategies.

We regularly monitor our Sustainable Bond holdings against issuers' ex-post reporting. In this case, we noted that despite this bond being bought by international investors, the issuer had **published a Green Bond report only in their local language**, thereby limiting access to such information to local investors. We engaged with the issuer to encourage the publication of such information in English, for broader usage.

We also assessed the issuer's reporting in terms of granularity and consistency with their commitments at the time of issuance, and identified some limitations. In their report, the issuer only disclosed the share of proceeds distributed to their subsidiaries, which our research indicated manufactured and sold automotive batteries. This **left significant questions as to what projects such proceeds had ultimately supported** (construction of battery manufacturing facilities, R&D, OpEx, etc.). Further questioning revealed that proceeds were used by subsidiaries for CapEx, although this was still not publicly disclosed. Although the issuer said it would disclose the portion of net proceeds spent on new financing vs refinancing, it did not do so in its report. Nor were specific financed projects disclosed as the issuer had suggested they would be in their framework. Impact reporting was found to utilize generalized GHG savings figures that were not specific to funds allocated, and when pushed the issuer could not provide any production figures attributable to the note in question.

Overall, **Calvert considered the information to fall short of meaningfully informing investors** about how proceeds were allocated, and the outcomes associated with this expenditure.

The review process resulted in the **Green Bond being assessed as no longer eligible for Calvert's strategies**, and, as a consequence, it was sold by the investment team.

CASE STUDY

Investing in Climate Change Mitigation and Adaptation Through Sovereign Green Bonds

In late 2022, Calvert participated in the **inaugural sovereign Green Bond issuance of a country in the APAC region**, which is held in one of Calvert's Green Bond strategies. The country scored highly in the Calvert Sovereign ESG Methodology, with a strong focus on sustainability substantiated by significant budget allocations as well as dedicated public funds and institutions. The government's key target sectors for climate-related action include transport and agriculture, plus a thematic focus on plastics and waste.

The government has revised and updated its Nationally Determined Contribution (NDC) under the Paris Agreement to better take into account the positive impact of carbon sinks in the country and carbon removals programmes, measuring emissions and setting targets on a net basis. Nevertheless, to meet the NDC, the government intends to **prioritise domestic action by reducing gross emissions and increasing carbon removals from forestry**.

The **country's GHG emissions have declined** on a per capita basis between 2005 and 2019, however absolute levels remain high relative to peer countries, mainly due to high emissions associated with exported agricultural products. Calvert sees the government as having **ample fiscal space to continue allocating funds to climate adaptation**, and to introduce carbon pricing, in line with recommendations from the International Monetary Fund (IMF), as a mechanism to incentivise the adoption of new technologies and methods to lower emissions.

The country is touted to be among the few nations in the region **at the forefront of sustainability-related regulation** and constantly striving towards meeting their climate goals. As a sovereign entity, governance and corruption risks are relevant, but the government has, in our view, been adequately managing them and does not appear to face any outsized or unmitigated risks related to these issues. This is in line with the country's high rankings in the World Governance Index (WGI).

In addition to the positive evaluation of the strategic rationale for the government to embark on a green financing programme, Calvert also supported the selection of the use of proceeds associated with the inaugural Green Bond issuance, targeting investments and areas that are likely to generate positive impact, with a particular focus on **accelerating the decarbonisation of public transportation**, for the benefit of the broader population, but also on **climate change adaptation projects intended to protect the country's extensive coastline** from sea level rises and extreme weather events.

The robust green structure of the transaction, combined with the investment team's positive macroeconomic views on the country and attractive valuation, made this a palatable investment for our Green Bond strategy.

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Diversification does not eliminate the risk of loss.

The value of investments held by the portfolio may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the U.S. and global markets. As **interest rates rise**, the value of certain income investments is likely to decline. Investments in **debt instruments** may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of **income securities** also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. **U.S. Treasury securities** generally have a lower return than other obligations because of their higher credit quality and market liquidity. While certain **U.S. Government-sponsored agencies** may be chartered or sponsored by acts of Congress, their securities are neither issued nor guaranteed by the U.S. Treasury. Investments rated **below investment grade** (sometimes referred to as "junk") are typically subject to greater price volatility and illiquidity than higher rated investments. Investments in **foreign instruments or currencies** can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical, currency exchange rates or other conditions. In the event of a default by a **sovereign entity**, there are typically no assets to be seized or cash flows to be attached. Investing primarily in **responsible investments** carries the risk that, under certain market conditions, the portfolio may underperform strategies that do not utilize a responsible investment strategy. The portfolio is exposed to

liquidity risk when trading volume, lack of a market maker or trading partner, large position size, market conditions, or legal restrictions impair its ability to sell particular investments or to sell them at advantageous market prices.

Environmental, Social and Governance (ESG) strategies that incorporate impact investing and/or ESG factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performances.

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