edentree
investment management

EDENTREE INSIGHT **Fixed Income**

The rise of social and sustainable bonds

PROFITS WITH PRINCIPLES

Introduction

by David Katimbo-Mugwanya

Responsible and sustainable investments are experiencing ever-increasing demand. The COVID-19 pandemic has accelerated this trend, as investors seek to address societal needs, as well as longer-held environmental concerns. Global accords, such as the Paris COP21 agreement and new regulations specifically targeting sustainability considerations, such as 2020's European Union Taxonomy, are playing a vital role in driving demand for innovative ways to address climate change and or other pressing societal issues.

While equities have perhaps been the dominant focus for responsible investment, **fixed income has quietly been addressing these challenges through a series of innovative Environmental, Social and Governance (ESG) products.**

These trailblazing bonds, which include green, social and sustainability bonds, have enjoyed a surge in popularity in 2020, with issuance expected to approach USD425 billion for the year[1]. While this figure only represents a fraction of overall global debt issuance, the growing status of ESG integration underlines the greater focused being placed on how companies tackle both social and environment issues.

This Insight aims to provide a brief overview on each of these fixed interest vehicles, outlining their key objectives, the differences between them and provide examples of outstanding holdings that exist with EdenTree's responsible and sustainable fixed interest portfolios. Additionally, we recognise that there are a number of frameworks investors use to assess their responsible investment exposure, therefore we reference the relevant UN Sustainable Development Goals of these instruments and also highlight the ESG criteria they seek to address.

Firstly, we will cover green bonds – these are arguably the most widely known ESG fixed interest instrument, with many governments having launched (or are considering launching) these bonds to help finance their environmental initiatives. Secondly, we will consider social bonds and retail charity bonds – a category of securities possessing strong social characteristics that have largely remained under the radar until 2020 when issuance has skyrocketed. We then turn to sustainable bonds and touch on their more recent subset, sustainability-linked debt, while our final section examines the novel concept of transition finance.

[1]Source: Moody's as at 16/11/2020; link

We believe it is equally important to conduct thorough due diligence into these vehicles, as would be done with equities.

The sheer breadth of societal issues that social bonds support introduces an added layer of complexity.

Our approach to responsible and sustainable investing

Despite their ESG labels, these instruments are just as susceptible to 'impact/green-washing' as their equity counterparts. Therefore, we believe it is equally important to conduct thorough due diligence into these vehicles, as would be done with equities. Such analysis should consider issuing entities' corporate practises, cultures, as well as their strategic vision from a responsible perspective, instead of relying solely on ESG labels.

It can also be argued that while green bonds often have clear, quantifiable and almost universal target metrics, such as a reduction in C02 emissions, the same is not always true for social bonds. In fact, the sheer breadth of societal issues that social bonds support introduces an added layer of complexity – particularly for those lacking a robust responsible and sustainable investment framework.

At EdenTree, we apply a 'profit with principles' ethos to our investment approach. This means our portfolios not only seek to meet clients' financial objectives, via diversified portfolios of high quality debt instruments, but they also set out to ensure their underlying holdings represent suitable entities as determined by our screening criteria. The latter is values-based, to enforce absence of harm via exclusions, as well as being 'responsible' in nature by including pillars such as Environmental Management, Corporate Governance and Human Rights. Where sustainability can be integrated under the themes of Education, Health & Wellbeing, Social Infrastructure and Sustainable solutions, investment opportunities are routinely sought and seized upon.

Our six ESG / Responsibility criteria and four Sustainability themes can also be mapped to the UN's 17 Sustainable Development Goals:

This means our ongoing monitoring of investments also goes beyond financial performance to incorporate periodic reviews that gauge companies' direction of travel with respect to our responsible and sustainable investment objectives. Where necessary, we will engage with companies to better understand material risks, encourage best practice and spark positive change.

At EdenTree, our responsible and sustainable investment framework determines whether securities are suitable for portfolio inclusion by screening the issuers against our mandatory values. As a consequence, EdenTree's Fixed Interest fund range actively invests in green, social and sustainable bonds whose proceeds are deployed towards projects with clear and verifiable positive environmental impacts (green), funding initiatives that target specific societal issues or segments of the population (social) and /or sustainability-led undertakings combining both green and social elements along with other themes such as education. In short, our primary focus is the attainment of quantifiable ESG benefits alongside financial returns.

A fuller overview of our responsible and sustainable investment framework can be accessed **here.**

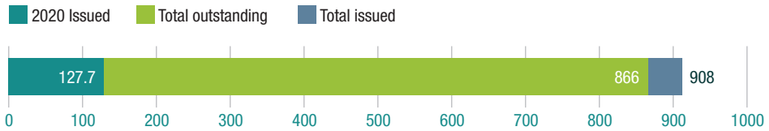
Green bonds

Prioritising environmental concerns

In essence, green bonds are debt instruments whose proceeds are deployed exclusively to finance projects with clear environmental benefits. They first came to market in 2008, as a novel way for bond investors to play an active role in mitigating climate change. Over the subsequent 12 years, an increasing number of companies have sought to reduce their environmental impact and this, alongside growing investor demand for ESG products, has resulted in an exponential growth in supply of these instruments.

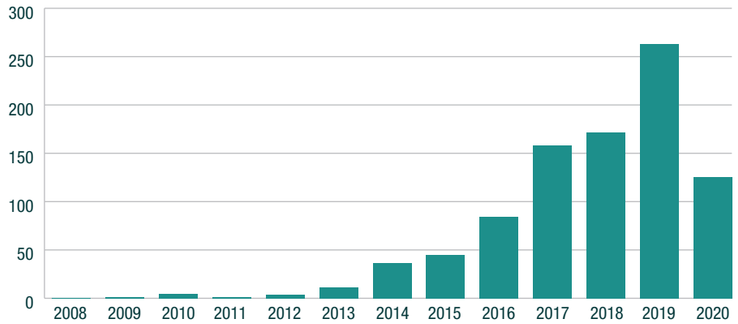
Global green bond issuance has so far been strongest in Europe, with China also being a major contributor to the cumulative total USD900 billion in bond volumes since the market's inception.

Climate Bonds USD Bn



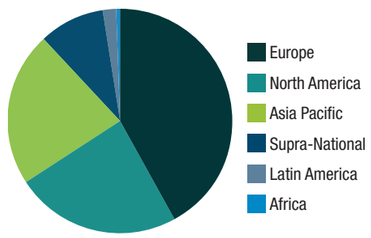
Source: Climate Bonds Initiative. (Data as of 16th September 2020)

Green Bond issuance by year ($bn)

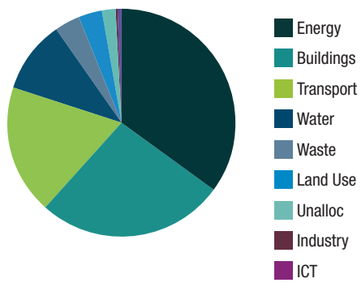


Source: Climate Bonds Initiative. (Data as of 16th September 2020)

by Geography



by Use of Proceeds



Source: Climate Bonds Initiative. (Data as of 16th September 2020)

Green gilts: better late than never

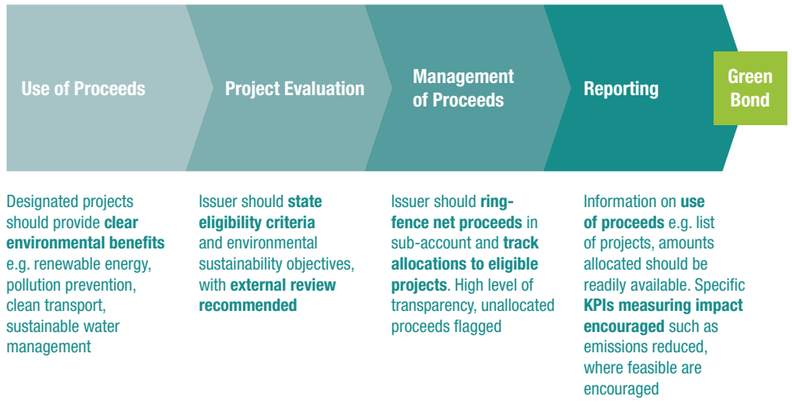
UK Chancellor Rishi Sunak's November 2020 announcement of a green sovereign UK government bond was arguably long overdue and should provide a boost the country's green finance markets.

Poland was the first country to issue a sovereign green bond in 2016, followed by France the year after, therefore, the UK has been a notable absentee from a market that now includes government issuers such as Belgium, the Netherlands, Sweden and, more recently, Germany.

Funds raised from the issuance of green gilts are likely to fund projects in the renewable and clean energy sectors. We believe strong investor demand could result in better pricing terms for the government relative to its conventional debt yield curve when the bonds launch.

It is important to note that issuers cannot just label their bonds green. Use of the green bond categorisation is subject to the voluntary Green Bond Principles (GBP), created by the International Capital Markets Association (ICMA), whose transparency and disclosure guidelines seek to uphold the market segment's integrity. Qualifying project areas include renewable energy, energy efficiency and green buildings, pollution reduction, clean transportation, sustainable water and sustainable agriculture.

The Principles propose adherence to the following framework:



The category of green bonds shown in this example are 'use of proceeds' bonds, where the bond's coupon interest and principal repayments originate from the issuer's general cashflow rather than from revenues generated by the designated green projects.

Such nuances underline the reason why we believe stringent due diligence is critical. While the use of a green bond's proceeds are clearly stated, it is important to also consider the wider company's business activities.

In our view, focusing mostly on how the proceeds of green bonds are used could make investors more susceptible to 'greenwashing' as the green bond label could falsely suggest these values represent a company's wider sustainable practises and / or products, which may not always be the case.

Daimler AG

Daimler AG's green bond, issued in September 2020, is one such instrument that fell short of our issuer assessment (using the Environmental Management pillar), even though the proceeds of the German Auto manufacturer's EUR1 billion 10-year debt were going to projects that included the production of zero-emission vehicles and the recycling of batteries as well as fuel cells.

Teekay Shuttle Tankers

Another example where the underlying issuer of a green bond failed to live up to scrutiny is Teekay Shuttle Tankers' USD125 million green bond, issued in October 2019 to help with the purchase of energy-efficient tankers. Canadian company Teekay specialises in transportation for the offshore oil industry – a carbon-intensive sector that rightly falls short on ESG screens.

While these issuances failed to meet the stringent EdenTree Responsible and Sustainable Investment criteria, we have also identified a number of green bonds that passed with flying colours.

Scottish and Southern Electric Transmission (SSE)

In 2019, Scottish and Southern Electric Transmission (SSE) issued a GBP350 million green bond, with a coupon of 2.25% maturing in 2035, under its Scottish Hydro Electric subsidiary. The FTSE 100-listed company is the UK's largest generator of renewable energy, with further interests in electricity transmission following the sale of its supply unit in 2020. SSE is committed to playing a key role in the UK's transition to low carbon and is using bond proceeds to develop its transmission network infrastructure and support the electrification of transport by constructing electronic vehicle charging points. The company also finances, and or refinances, windfarms – SSE co-owns the Beatrice offshore windfarm, the largest in Scotland, and is involved in the Seagreen and Dogger Bank projects.

As part of its company-wide strategic objectives, the group has set four 2030 business goals which align with the UN's Sustainable Development Goals:

- Climate Action: Reduce by 50% the carbon intensity of electricity generated by 2030, with a 2018 baseline to around 150gCO2e/kWh.
- Affordable and Clean Energy: Develop and build enough energy to treble its renewable output to 30 TWh per annum.
- Industry, Innovation and Infrastructure: Build electricity network flexibility and infrastructure to help accommodate 10 million electric vehicles in the UK by 2030.
- Decent Work and Economic Growth: Be the leading company in the UK and Ireland championing Fair Tax and the real Living Wage.

Bazalgette Finance plc (Tideway)

Bazalgette Finance plc (Tideway) is a company that was set up with the sole purpose of constructing the Thames Tideway Tunnel, also known as London's "super-sewer". Tideway issued a GBP250 million green bond with a coupon of 2.375% that matures in 2027 and has since issued five other green bonds taking the total amount issued to £775 million.

Built in the 1860s to service a maximum population of 4 million people, London's sewer system is frequently overwhelmed particularly by rainwater following heavy downpours. Consequently, the river Thames suffers sewage overflows at a rate of one or more per week.

The Thames Tideway Tunnel is a 25km tunnel stretching from Acton to Lee and will be 7.2m wide and 66m deep, with a projected design life of 120 years. When complete, the new sewer will all but eliminate these Combined Sewer Overflow (CSO) discharges, reducing their rate of occurrence by 90% and leave behind a cleaner river that should enable the UK to meet the European environmental standards of which it is currently is breach. Other benefits include a new foreshore and the regeneration of fish species.

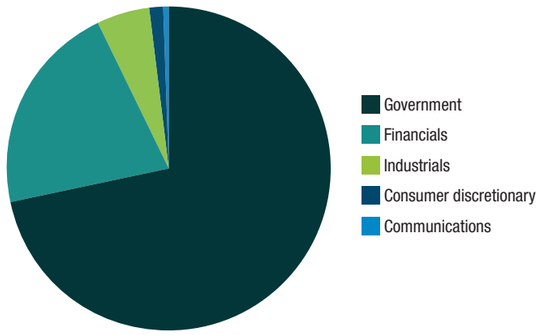
Aside from constructing the tunnel, Tideway also runs an education programme encouraging students to take up STEM subjects in the 14 London boroughs in which it operates. Tideway has also partnered with Construction Youth Trust in London to extend support to approximately 7,000 young people seeking to reach their full career potential in the construction industry. In addition, the company has a target of gender parity by the end of the construction process – at the end of 2019 34% of its staff were female.

Social bonds

Addressing societal needs

Rather than focus solely on addressing climate change, bond issuers have also sought to address other societal issues more explicitly over the last few years, via social bonds. By way of definition, the International Capital Markets Association (ICMA)[2] defines social bonds as instruments whose proceeds help tackle key societal issues such as education, health, poverty and/or target a specific facet of the population.

by Sector



The COVID-19 pandemic has accelerated the issuance of social bonds, having brought to light the pressing need for funding towards projects addressing societal needs beyond climate change. In fact, they have become a key plank of the strategy to confront the pandemic, funding projects with social impact in an attempt to tackle the global outbreak's adverse consequences, including unemployment and mitigating the lack of access to essential services, such as quality healthcare.

From the groundwork laid by the successful emergence of green bonds over the last decade, it should also come as little surprise that the trajectory of growth in social bond issuance far exceeds that of their trailblazing counterparts – particularly at a point in time when ESG assessments have moved from niche to mainstream investment considerations.

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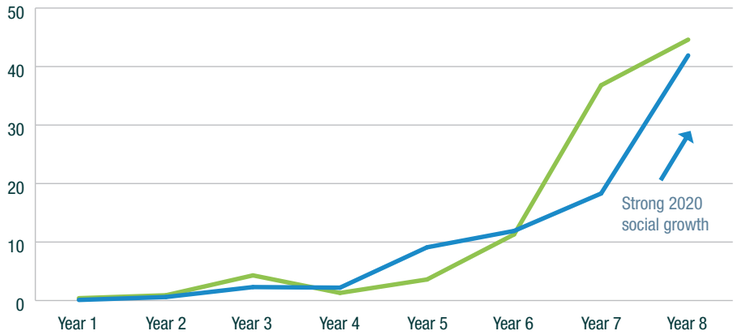
[2] Social bond definition as noted in the International Capital Markets Association (ICMA) Social Bond principles

Issuance by year ($bn)



Source: Bloomberg NEF data as at 29th July 2020

Again, there are strict criteria regarding the social bond label. The ICMA's voluntary social bond guidelines, also known as the Social Bond Principles, aim to help market participants classify social projects while promoting the integrity of the market. Project categories include, but are not limited to, those supporting:

- Affordable basic infrastructure such as water, sanitation, energy and housing
- Access to essential services such as health, education and financial services
- Socio-economic advancement and empowerment, in addition to reducing income inequality

Similar to green bonds, the core makeup of these instruments constitutes four key attributes, which set out how proceeds are ultimately used and accounted for:

Designated projects should tackle **specific societal issues** e.g. health, education, social housing **and or target populations** such as elderly or those with disabilities

Issuer should **state social objectives, project eligibility process** as well as **exclusion criteria**

Issuer should **ring-fence net proceeds** in sub-account and **track allocations to eligible projects**. High level of transparency, unallocated proceeds flagged

Information on **use of proceeds** e.g. list of projects, amounts allocated should be readily available. Specific qualitative and quantitative **KPIs measuring impact encouraged** where possible e.g. number of beneficiaries

Lloyds

Lloyds was the first UK bank to issue a bond where proceeds were allocated on the basis of social and environmental factors under its "Help Britain Prosper" plan. From the inaugural social bond issued in 2014, the bank was able to allocate GBP250 million to 1,468 qualifying loans[3]. These loans specifically targeted small and medium-sized businesses (SMEs), as well borrowers with a high social and environmental impact. Moreover, 96% of these loans were disbursed to borrowers coming from the country's most economically-deprived areas, we view this as a key tenet of social bonds. Additionally, over GBP19 million of funds were allocated to 79 healthcare providers located in disadvantaged areas.

The first Lloyds social bond matured in 2018, but the company has moved on to establish its Help Britain Prosper strategy across the wider banking Group. Lloyds' lending to start-ups and SMEs has increased by a cumulative GBP6 billion in the three years to 2020. The company has also committed GBP10 million to support the Advanced Manufacturing Training Centre (AMTC) over a 10-year period, facilitating the training of apprentices, graduates and engineers.

In April 2020, ShareAction – a charity that promotes responsible investment – also named Lloyds as Britain's "greenest" bank. The report ranked the 20 largest European banks[4] based on an environmental impact assessment, such as their willingness to fund carbon-intensive sectors and the level of engagement with key actors, also placed Lloyds as second best in the region.

World Bank

World Bank's 3-year International Bank for Reconstruction & Development (IBRD) sterling-denominated bond is an example of a social bond that we invested in at launch. It was issued in April 2020 to fund projects aligned with the UN's Sustainable Development Goal 3: Good health & Wellbeing and seeks to lend support to global relief efforts in the battle against the COVID-19 pandemic – primarily in emerging market countries.

The first phase of funding focuses on emergency healthcare support by not only strengthening existing health systems, but also reinforcing disease surveillance preparedness to mitigate subsequent infection rate spikes. Co-ordinated emergency operations to fight the pandemic now span over 100 developing nations, home to approximately 70% of the worlds' population.

For the second phase of its COVID-related support, World Bank is implementing means of mitigating the adverse economic impacts of the outbreak, thereby helping the private sector continue to operate and sustain jobs. The institution believes that adopting this approach will ultimately shorten the timeframe to economic and social recovery.

Established in 1944 to rebuild Europe after World War II, World Bank has a long history in supporting development and sees poverty alleviation as its raison d'etre (it already had health projects moving forward in 65 countries pre-COVID). As such, the organisation's purpose is undoubtedly social in nature. All of its bond issuance support sustainable development across education, energy, agriculture, transportation and themes including environmental management and gender, to name but a few.

[3] Lloyds Bank completes allocation of inaugural £250 million Environmental, Social and Governance bond (24/03/2015).
[4] Banking on a Low-Carbon Future II – A ranking of the 20 largest European banks' responses to climate change.

Retail Charity bonds

A tool for the socially-conscious retail investor

EdenTree is proud to be a patron of the Retail Charity Bond platform since its launch in 2014. The platform enables UK-based charitable organisations to raise unsecured debt that trades on the London Stock Exchange. The issuance of debt focuses on projects supporting social housing, elderly care homes, mental health, dementia care and pre-dates the arrival of social bonds, although these instruments could just as easily be categorised as such. To-date, GBP287 million in debt has been issued across nine securities, including GBP84.5 million of retained bonds.

While most of the bonds we have discussed so far are largely targeted towards institutional investors, retail charity bonds trade in denominations beginning from GBP500, which explains the 'retail' classification. Moreover, the economic case for purchasing a credit rating is perhaps not as strong as for commercial Investment Grade issuers and so it is important to note that the bulk of Retail Charity Bonds are unrated.

While most of the bonds we have discussed so far are largely targeted towards institutional investors, retail charity bonds trade in denominations beginning from GBP500, which explains the 'retail' classification.

In the wake of the 2008 financial crisis, deleveraging saw commercial banks cut back on their lending to Small to Medium-sized Enterprises (SMEs), therefore the Retail Charity Bond platform has been essential for charities seeking to raise unsecured funding.

Admission onto this platform follows a rigorous approval process that entails strict selection criteria based on profitability, as well as in-depth credit assessments. In fact, the various bonds' borrowing covenants stipulate that unencumbered assets must equate to at least 130% of the organisations' total debt.

Here are a few examples of charities that have issued bonds on this platform, with brief summaries of their backgrounds and activities, including the social impact achieved in recent years.

Golden Lane Housing

Golden Lane Housing works alongside Mencap, one of the UK's largest mental health charities to provide specialist accommodation. The very first charity to raise funds on the platform, Golden Lane's two outstanding Retail Charity Bonds (maturing in 2021 and 2027) have allowed it to procure, lease and adapt properties to enable approximately 2,200 individuals[5] with learning disabilities to live more independently across England, Wales and Northern Ireland. Over the last two decades, Golden Lane has purchased 454* properties and leased an additional 486* dwellings (*as at 31 March 2019).

The charity estimates that of the 1.5 million people with a learning disability in the UK, over 70% wish to live independently. The tenants' rents are paid directly to Golden Lane as the landlord by the local authorities, ensuring this is stable and government-backed rental income.

Golden Lane also lends support to various mental health campaigns such as Mencap's Treat Me Well campaign and has continued to fund research conducted by the National Development Team for Inclusion, a not-for-profit organisation seeking to enable individuals at risk of societal exclusion, due to age or disability, live the life that they choose.

[5] Golden Lane Housing social impact report 2020

Hightown Housing Association

Hightown Housing Association was established over 50 years ago with a stated aim of providing as many homes as possible at sub-market rates and now offers a broad range of housing and support to people that are vulnerable and / or disabled. Hightown owns and manages 6,818 homes[6], primarily operating in the areas of Hertfordshire and Buckinghamshire, with some affordable housing in Bedfordshire, as well as care and support projects in Berkshire. In 2019/20 alone, Hightown built 477 homes, making it Inside Housing's fastest growing housing association in the UK.

A founding member of the Homes for Cathy group of over 100 organisations that seek to end homelessness, Hightown has continued to be a leading voice in the industry and has demonstrated commendable commitment to tackling this societal challenge. In 2018, Hightown allocated 36% of its new and vacant homes[7] to homeless households, rising to 42% in 2019. From its more recent annual report, the association also extended support to 221 rough sleepers via its outreach services. It provides ongoing homelessness support via hostels in Hertfordshire in mother and baby and domestic violence projects.

The organisation is also acutely aware of its environmental footprint and strives to enhance efficiency in its new and existing homes. Hightown has an ongoing investment programme to install air source heat pumps, solar panels and incorporates water-saving features into new homes with the dual goals of boosting energy and water efficiency, as well as reducing fuel poverty. A total 2,800 of its properties now possess an environmental performance certificate (EPC) score of B or better. Its consistent record of operating surpluses and financial resilience saw it assigned a credit rating of A3 stable by Moody's in January 2020. Hightown's two outstanding bonds mature in 2025 and 2027.

Charities Aid Foundation (CAF)

The Charities Aid Foundation (CAF) offers banking services to charities and individuals, enabling the latter to give to charitable causes efficiently. CAF has existed for over 90 years and has a network of offices across six continents[8].

CAF has also claimed tens of millions of pounds in Gift Aid for its donors over the years, significantly reducing the administrative burden borne by charities. Using the proceeds of its retail charity bond, which matures in 2026, CAF has been able to further its support of charities across the UK. It also conducts thought-leading research into charitable giving trends by FTSE 100 companies, as well as individuals in the UK and runs the country's largest payroll giving scheme.

Under CAF Venturesome, its social investment arm, CAF provides affordable finance for enterprises to enhance their social impact through its Development Fund, Community Land Trust Fund and SE-Assist for start-up social enterprises. CAF Venturesome has supported over 650 social enterprises and not-for-profit organisations with funds totalling GBP55 million since 2002[9]. When repaid, the capital is recycled into loans made to other social enterprises. Projects have included providing healthy school meals for schoolchildren, as well as tackling homelessness by offering training and education.

[6] Hightown Housing social impact report 2019/2020
[7] Hightown Housing Association Ltd social impact report 2018/19
[8] CAF facts – data as at August 2018
[9] CAF Venturesome data as at Feb 2020

Greensleeves Care

Greensleeves Care was born out of the Women's Royal Voluntary Service (WRVS), from which it acquired a number of elderly care homes in 1997. Greensleeves provides high quality and round-the-clock nursing care, specialist dementia care and residential support for the elderly in 25 care homes across England. Since issuing its retail charity bond in 2017, Greensleeves has increased the number of residents it supports from 789 to 1,388 and now employs over 1,500 staff (at above the national living wage) whose skills it continues to enhance through learning and development programmes.

By investing in and promoting its staff, Greensleeves is also able to record a lower than average employee turnover rate of 18.5% versus the typical care sector average of over 30%, a feat that also affords its residents better quality of care from staff they are ultimately more familiar with.

In addition, Greensleeves plays an integral role in its local communities, organising events whose positive impact goes well beyond the borders of their care homes. For instance, 2019's BBC Music day at Trinity Methodist Church in Lowestoft, which featured a special performance by Britain's Got Talent winner Colin Thackery, engaged the whole community. Lowestoft locals also attended various 2018 events at the Broadlands care home including: Party in the Garden, murder mystery evenings, jazz afternoons, quiz nights and firework evenings. Last year, the residents of Greensleeves' Tickford Abbey in Newport Pagnell knitted clothes that were sent to Africa for mothers to clothe their new-born babies.

COVID-19 statement: Greensleeves has adapted quickly to a fast-evolving situation, implementing robust procedures to limit incidents and closing its homes to all but essential visitors. The organisation's liquidity levels remain strong.

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[10] Greensleeves Care social impact report 2019-2020

Sustainable bonds

Combining green and social initiatives

Not content with the choice of either environmental or social objectives, some issuers have opted for project selection criteria that incorporate elements of both. Sustainable bonds support undertakings that aim to generate clear environmental benefits, while also deploying funds to those tackling societal issues and / or targeting a specific demographic of the population.

Co-Operative Group

Co-Operative Group issued one such bond in May 2019. The UK's largest consumer co-operative raised GBP300 million to fund its social and environmental projects that include expanding its Fairtrade campaign, establishing more academies in the north of England, as well as improving its environmental impact.

Already sourcing 100% of its energy from renewable sources since 2005, the Co-Op Group has embarked on bettering its environmental efficiency by targeting a 50% reduction in direct greenhouse gas (GHG) emissions by 2025. The Group is also seeking to lower its product-related emissions by 11% over a 9-year timeframe commencing from 2016 and has set science-based GHG reduction targets to limit both direct and indirect climate impacts. Co-Op published its first full end-to-end GHG footprint data for 2019 and committed to publishing details of its approach at the end of 2020. The company further notes that its science-based targets align with the 'ambitious best practice' standards set by the Science Based Targets Initiative (SBTi) to limit global warming to no greater than 1.5°C. To that end, the group is investing in technology and infrastructure to increase energy efficiency.

As one of the first UK retailers to sell Fairtrade products across all of its stores in 1998, well before it became 'fashionable', Co-Op has remained an avid supporter of equitable and sustainable trading. The retailer is the UK's largest convenience seller of Fairtrade products. Co-Op has allocated GBP240.3 million[11] of its sustainable bond proceeds towards the purchase of Fairtrade products, focusing on segments where it has the greatest impact on producers such as wine, cocoa, tea, sugar, flowers, coffee and bananas. Co-op aims to strengthen producer communities and workers by embedding the costs of bringing Fairtrade products to customers, such as certification, packaging and transportation.

Besides Fairtrade, Co-Op has also identified water sanitation projects and education as key planks of its sustainable bond framework in its desire to promote socio-economic advancement and empowerment. With a goal of improving access to clean water, Co-Op donates 3p/litre of its own-brand bottled water to The One Foundation and a further 1p/litre to the Global Investment Fund for Water. Efforts have included the construction of piped water infrastructure and community toilets in ten cocoa-producing towns, which improved water sanitation for 178,000 people in sub-Saharan Africa.

Through its Co-Op Academies Trust, that focuses on the north of England, the Group has grown the number of academy schools that it runs in Greater Manchester, Yorkshire, Wirral and Staffordshire to 25. It aims to reach a tally of 40 academies by the end of 2021 by funding the non-educational costs of converting schools to Co-Op Academies, while also sponsoring costs associated with their education programme. The retailer also took the commendable step of extending free school meals to the applicable 6,000 Co-Op academy students during the summer of 2020.

- Business Ethics
- Community
- Employment & labour
- Environment & climate change
- Education

[11] Co-Op Sustainability Report 2019

Sustainability-linked instruments

Setting sustainability targets

Sustainability-linked instruments are the newest iteration in this fast-evolving marketplace. No doubt inspired by the increased mandatory adoption of ESG assessments, sustainability-linked instruments tie company performance on set environmental and / or social targets to the cost of financing.

For market participants new to the responsible and sustainable scene, of which there are a rapidly increasing number, spotting the differences between these securities and their predecessors may not come easily. The key difference is that issuers outperforming their ESG targets can result in coupon interest payments being lowered; conversely, an ESG assessment coming in below a minimum threshold would trigger higher financing costs for the remaining term of the instrument's agreed lifecycle.

Enel was one of the first to issue sustainability-linked bonds when it launched a three-tranche debt offering in October 2019 (at 5-year, 8-year and 15-year maturity tenors). In October 2020, the company became the first issuer to launch a sterling-denominated sustainability-linked bond, raising GBP500 million on a 7-year bond, an issuance that was so oversubscribed the bonds could have been sold six times over. Enel is seeking to generate value by contributing to the achievement of SDG 7.2 – to "increase substantially the share of renewable energy in the global energy mix by 2030". Failure to achieve its stated objective by the end of 2022 will result in an additional coupon interest payment of 0.25% for the remaining life of the bond.

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Examples of recent sustainability-linked bonds:

Issuer company	Launch date	Coupon & Maturity	Amount borrowed	Theme	UN SDG / EdenTree Pillar	KPI	Baseline	Penalty
ENEL	Oct-19	Enel 0% June 2024	EUR1bn	Renewable Energy - Increasing installed capacity	Environment & climate change; Sustainable solutions; 7 Affordable and clean energy	Installed renewable capacity of at least 55% by end of 2021	46% capacity in 2017	0.25% coupon step-up
		Enel 0.375% June 2027	EUR1bn					
		Enel 1.125% Oct 2024	EUR500m	Climate Change - Reducing GHG emissions	Environment & climate change; Sustainable solutions; 13 Climate action	GHG reduction to at least 125g/kWh by end of 2030	411g/kWh in 2017	0.25% coupon step-up
Novartis	Sep-20	Novartis 0% Sept 2028	EUR1.85bn	Healthcare - Access to Medicine	Community; Health & Wellbeing; 3 Good health and well-being; 10 Reduced inequalities	Minimum 200% increase in patients accessing its SITs* by 2025 Minimum 50% patient increase for its Flagship Programmes*, also by end of 2025	vs. 2019	0.25% coupon step-up
ENEL	Oct-20	Enel 1% Oct 2027	GBP500m	Renewable Energy - Increasing installed capacity	Environment & climate change; Sustainable solutions; 7 Affordable and clean energy	Installed renewable capacity of at least 60% by end of 2022	51.9% capacity as of 30th June 2020	0.25% coupon step-up

Source: Bloomberg, EdenTree, HSBC; * in low- and lower middle income countries, where SIT stands for Strategic Innovative Therapies

ECB offers a boost

In late September2020, the European Central Bank (ECB) added sustainability-linked bonds to the universe of securities that it considers acceptable for the purposes of collateral and eligible for outright purchase via its monetary policy initiatives. This includes its ongoing Asset Purchase Programmes and its Pandemic Emergency Purchase Programme from 1 January 2021 onwards, subject to compliance with all other eligibility criteria.

The ECB has stipulated that coupons on qualifying securities must link to environmental performance targets noted in the European Union's taxonomy or climate-related UN Sustainable Development Goals.

This means, in its current form, the Novartis bond shown in the table is unlikely to qualify for ECB purchases, nor for use as collateral, as its performance metrics are of a social rather than an environmental nature.

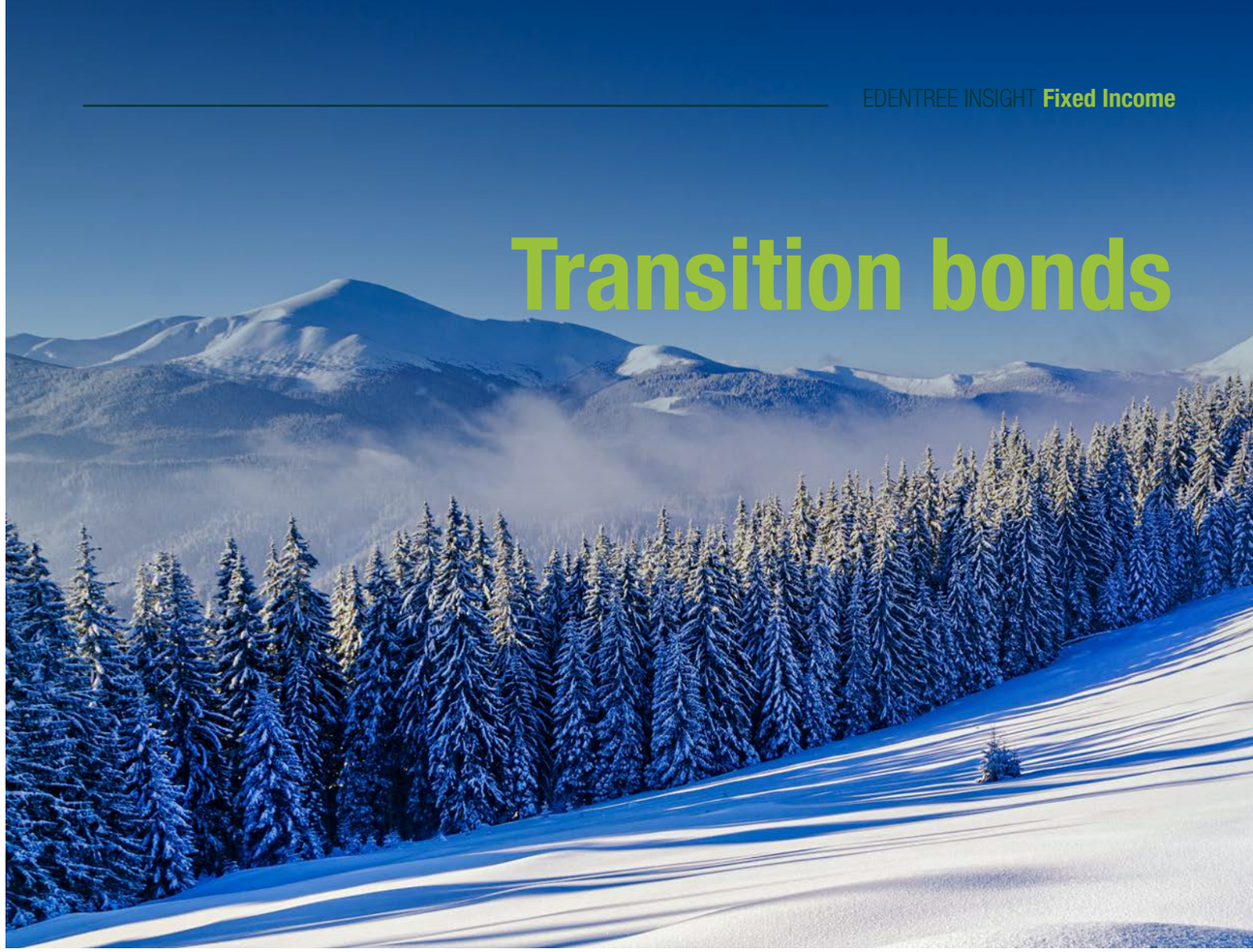
Despite its sole focus on the environmental factor, the participation of a major central bank in this fledgling market is still a welcome development that could ultimately result in larger issuance aimed at sustainability.

We believe one of the attractions of sustainability-linked instruments is that they offer issuers an opportunity to eschew some of the costs arising from demonstrating accountability. While the explicit linking of performance objectives to funding costs is welcome, these securities come without core ingredients we would generally seek in sustainable bonds, such as the stated use of funds, the mandatory ring-fencing of bond proceeds, as well as the management and reporting of fund disbursements. From a company perspective, sustainability-linked debt funding could be interchangeable with other monies for "general corporate purposes" and yet these instruments benefit from the strong investor demand for ESG products.

To the uninitiated, and without much research into the underlying mechanics, these instruments could easily pass for other ESG vehicles with more transparent and stringent frameworks regarding how they deploy, manage and report on their use of proceeds. This calls for investor vigilance not just at an instrument level, but also encompassing the issuer's wider corporate operations – analysis which has long been a staple part of EdenTree's responsible and sustainable screening process.

An example of why such scrutiny is recommended is the recent EUR850 million issuance of sustainability-linked notes by LafargeHolcim in November 2020 (note, this is not held in any of EdenTree's portfolios). Even though the company's goal of reducing its CO2 emissions by 17.5% from a 2018 baseline appears noble, the company's core business is cement manufacturing, a highly carbon intensive process which failed to meet our ESG criteria. More significantly, alleged abuses* by its subsidiary in Syria did not augur well for responsible investment according to the EdenTree Business Ethics pillar.

*Following an inquiry into indirect financing of armed groups in Syria, LafargeHolcim admitted that it had resorted to "unacceptable practises" to continue operations at a factory in the country. The factory was closed and its CEO at the time of this internal investigation has since resigned.



Transition bonds

A new frontier

Transition bonds are the newest form of instruments in the sustainable fixed interest arena. The transition towards net-zero is a herculean task. It requires a staggering USD3.5 trillion of funding per year to achieve the desired goal of a more sustainable global economy that will deliver on low carbon targets by 2050. While green, sustainable and sustainability-linked bonds are significant contributors to this journey, they will not be sufficient to finance the transition alone.

What are transition bonds?

These instruments focus on helping firms to raise capital to help finance their transition from a high carbon emitting business model to one that is low carbon over a clearly defined period and according to science-based targets. Very few of these instruments actually exist at this precise point in time, therefore our discussion on this subject will be conceptual rather than factual.

How do transition bonds differentiate with other ESG bond instruments?

We believe that the transition label is the key differentiator here, as it allows for a wider set of participants. For issuers such as SSE plc or Enel, whose sustainability credentials are in little doubt, the transition label matters little. However, for those non-green newcomers aspiring to a greener future, and for whom acceptance among the investor audience may not be automatic, these instruments could be a game changer. That said, this also means investor scrutiny needs to be intensified – for instance, the risk of inadvertently supporting an oil & gas company, albeit one with quickly materialising green ambitions, is understandably high.

The transition towards net-zero is a herculean task. It requires a staggering USD3.5 trillion of funding per year to achieve the desired goal of a more sustainable global economy that will deliver on low carbon targets by 2050.

By necessity, there is a long list of potential transition candidates. A flurry of regulations and initiatives aimed at catalysing our shift to a low carbon, world such as the Paris Agreement on climate change has seen more 'brown' companies set out plans to play a more active role in the transition.

The UK now has a target of net zero carbon emissions by 2050. To that end, British Petroleum (BP) is pledging to become a net zero company by 2050, or sooner, through a ten-fold increase on low carbon investments to the tune of USD5 billion per annum and reducing its oil and gas production by over 40%. Royal Dutch Shell also intends to reduce its carbon footprint and is working to offer customers a range of lower-carbon energy sources, such as renewable electricity and hydrogen. Shell also aims to cut the carbon intensity of its products by 30% by 2035 and by 65% by 2050 versus a 2016 baseline.

Whether or not these two companies adopt the transition label to fund these projects, their role is still to try and move these companies to a low-carbon future. In its role as financier, the investment community at large must ultimately keep a close watch on their progress and hold them accountable via continued engagement. We envisage that exerting pressure on the sector in this manner will actively help achieve global climate goals within the desired timelines.

Why does the definition matter?

We are of the view that the current definition of transition bonds misses a social element and that such transitions should also occur via means that are socially just or they run the risk of faltering. Some high-profile renewable energy projects have stalled and are facing legal challenges, for instance, due to the developers' neglect of indigenous land rights, human rights and community consultations.

Incorporating such social aspects ensures that the climate transition contributes to the broader Sustainable Development Goals framework and is the focus of the "Just Transition" work done by the London School of Economics and the Grantham Research Institute on Climate Change and the Environment, among others.

While changing the definition of these instruments will add a further layer of complexity, it may prevent transition finance instruments from ignoring key social issues on human rights, land rights, living wages and job security, to name a few.

We are of the view that the current definition of transition bonds misses a social element and that such transitions should also occur via means that are socially just or they run the risk of faltering.

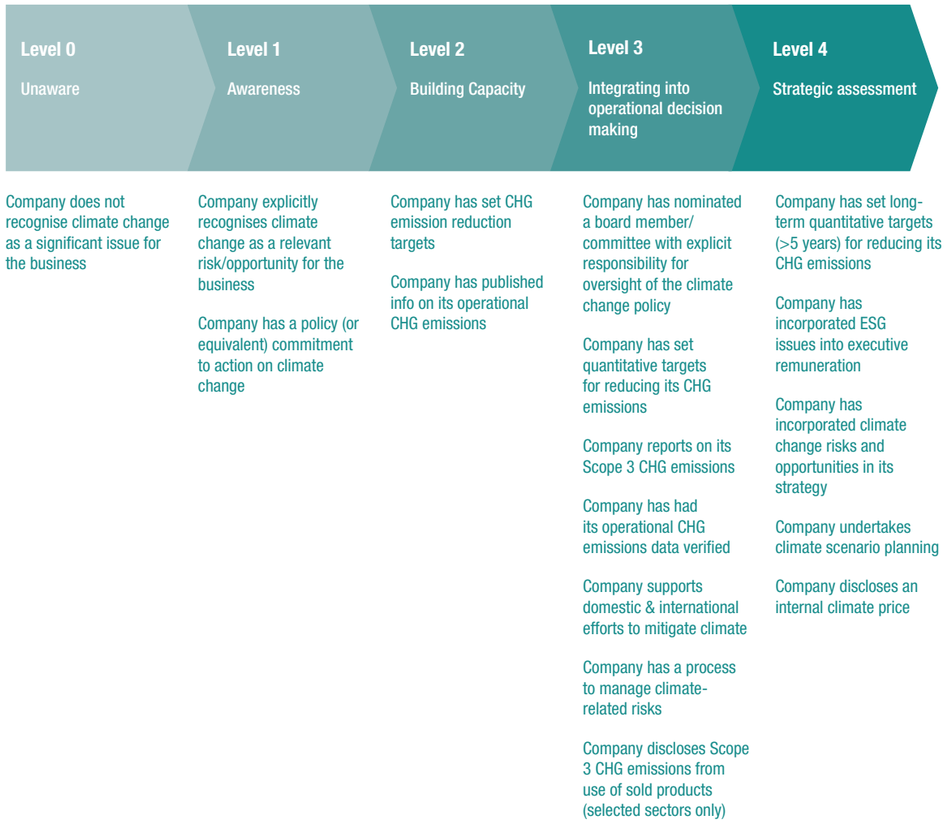
Furthermore, the concept of becoming a low carbon business model also has a raft of potential pitfalls that investors need to be aware of. We are seeing an increasing number of companies using "offsets" to claim that their net carbon emissions are declining. In our view, transition must be focused on reducing the absolute lifecycle emissions of products and or services provided by companies. We would add that proceeds from transition bonds should, therefore, not be used to purchase carbon offsets such as forests.

Other important considerations

In our view, for a transition strategy to be credible, it ought to be based on robust, scientific transition pathways that are in line with the rapid reductions needed to limit global warming to well below 2°C above pre-industrial levels. A credible transition framework should adhere to recommendations set out by the Task Force on Climate-related Financial Disclosures (TCFD) and should include a Transition Pathway Initiation (TPI) Management Quality Level 4 (see chart below) and a Paris Pledge Carbon Performance scenario to ensure appropriate levels of ambition on the part of the issuing company. As noted earlier, it must also be socially just and have buy-in from local communities and workers.

Management Quality

TPI's Management Quality framework is based on 16-17 indicators, each of which tests whether a company has implemented a particular carbon management practice. These 16-17 indicators are used to map companies on to 5 levels/steps. The data are provided by FTSE Russell.



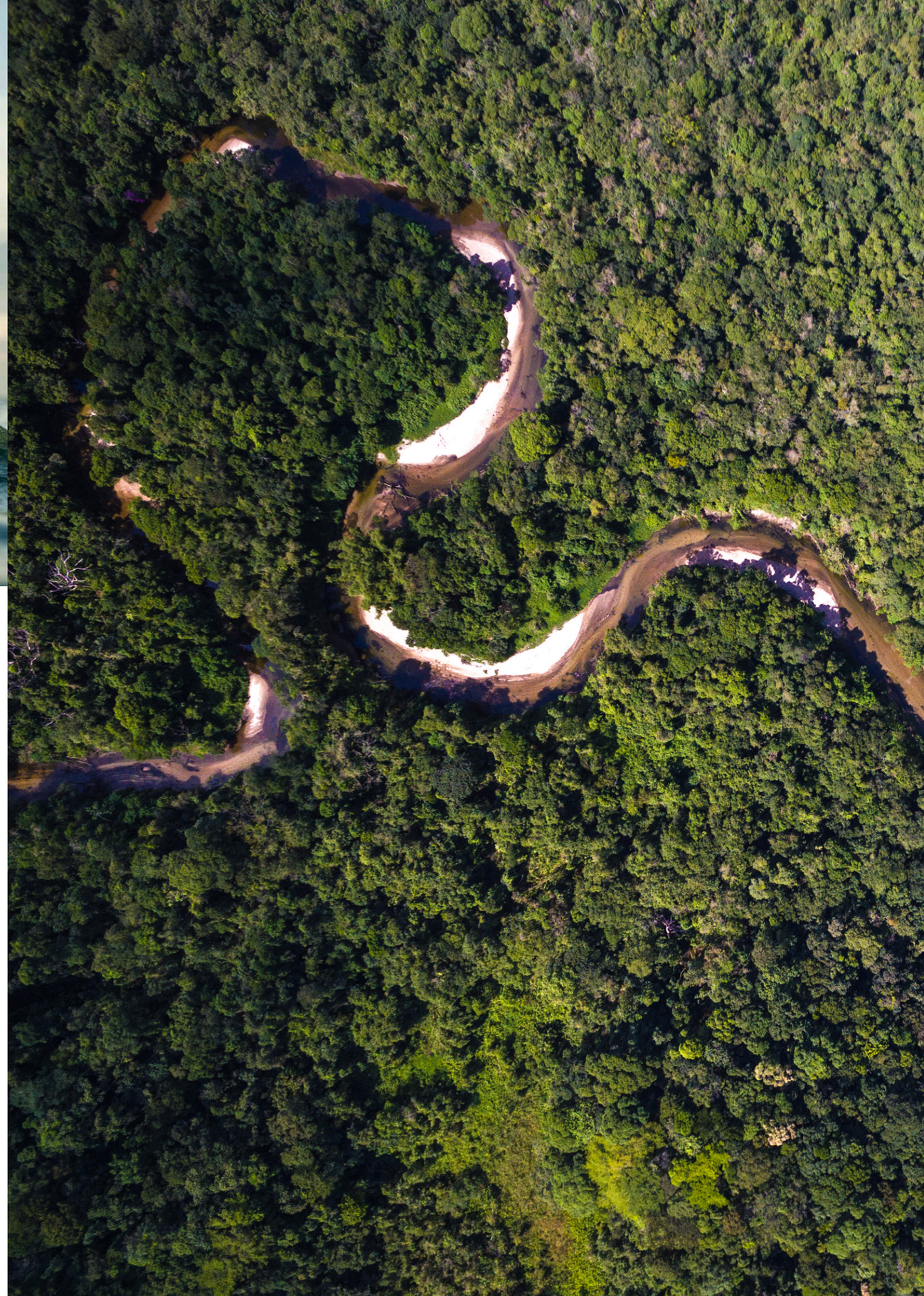
ESG bonds

A noble initiative that still demands scrutiny

In this Insight, we have sought to explain how the world of fixed income is evolving to support the transition to a more sustainable world. The different types of ESG bond instrument are helping fund this transition, incorporating societal as well as environmental drivers to help companies and governments achieve this vital change.

However, an ESG bond label is not a guarantee of good intent. **As the scale of bond issuance in this space increases rapidly, so does the requirement for investors to make sure they fully understand the detail of the instruments** and the responsible values of the companies they are supporting.

At EdenTree, we believe it is essential to conduct thorough due diligence not only on the investment instrument under consideration, but on the issuing entities themselves. We do this in order to truly understand their corporate practices, cultures and strategic vision from a responsible and sustainable investment perspective. Our responsible and sustainable investment framework benefits from 30 years of experience in delivering 'profits with principles' and we take pride in doing this thoroughly and with integrity on behalf of our clients.



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