Volksbanken Raiffeisenbanken
cooperative financial network

Sustainable Finance Bulletin 09

DZ BANK Spotlight:
Sustainable Bond Market Outlook 2022

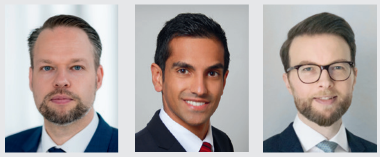
The Sustainable Bond Market in 2022: „Transition is key!“

Since the birth of the Green Bond segment in 2007, the Sustainable Bond market, with its many colours and facets, has already made a positive contribution to support financing the global sustainability agenda.

Without a doubt, Green Bonds were a good start for funding environmentally sustainable activities. However, the race to reach net zero emissions by 2050 requires all sectors to make their contribution. Hence, many issuers in those sectors have to completely rethink their business models. Some of them will find decarbonisation easy. Others face major challenges and still have to figure out the how and the when. That is perfectly fine. Rome wasn’t built in a day. It is not possible to become net zero overnight. The journey of a thousand miles begins with the first step. Moving in the right direction will involve a transition period.

Hence, banks, whose role is increasingly changing from a traditional financial intermediary to a sustainable finance intermediary, need to become a reliable partner for transition

Content



M. Pratsch D.M. Pereira J. Trautwein

Dear Reader,

We are pleased to present the latest edition of our Sustainable Finance Bulletin.

2022 will be another exciting year for Sustainable Finance. All segments of the Sustainable Bond market are still on the rise. For the first time, the new issuance volume is expected to exceed the 1 trillion US dollar mark. As we can only successfully implement the global sustainability agenda if we „get everyone on board“, i.e. also issuers from critical sectors with business activities whose path on the transformation path will still be a longer one, transition finance will become one of the most important elements in the Sustainable Bond market in the coming years. In line with the new credo „transform instead of divest“, the transformation of the real economy is also finding its way into the investment strategies of more and more investors. Moreover, the search for a common language for sustainability continues. The definition of sustainable economic activities will therefore continue to occupy market participants beyond 2022. Final recommendations for a Social Taxonomy were recently presented.

Enjoy reading! Stay healthy!

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DZ BANK

candidates who express their credible transformation ambitions through the fixed income market for example.

In line with the new credo „transform instead of divest“, the transformation of the real economy is also finding its way into the investment strategies of more and more investors. In the past, a large number of sustainable investors focused on strategies such as exclusions or best-in-class approaches. Those companies that did not fit into the grid were sold. Today, investors are increasingly interested in the transformation potential of the real economy. Identifying the „sustainable companies of tomorrow“ is becoming more and more important.

An increasing number of fixed income investors is discovering – in their role as key stakeholders - the possibility of engagement with promising transformation candidates. While they do not have voting rights, they can enter into an active dialogue with the management of the companies being transformed, either on their own or through joint collaboration with other investors. Through this active engagement, they can encourage companies to be more transparent in their disclosure of ESG factors, better manage material sustainability risks, and follow a proper and credible transformation path.

The option to divest always remains - but only as ultimo ratio if, for example, a company abandons the promised, credible transformation path.

Therefore, transition financing will become one of the most important elements in the Sustainable Bond market in the coming years.

But first, let's take a look back at the Sustainable Bond market in 2021.

2021: New records in the Green Bond segment

Without doubt, 2021 was another exciting year for the Sustainable Bond market, which just missed the USD 1trn mark.

After a conciliatory end to a COVID-19 plagued 2020, Green Bonds set new records in 2021. With a new issuance volume of almost USD 75bn, September was the most successful month to date since the birth of the Green Bond segment. Furthermore, a new giant has emerged in the market, as the European Union will raise up to 30% of the NextGenerationEU funds through the issuance of NextGenerationEU Green Bonds. With the maiden issue of EUR 12bn in October, the world's largest Green Bond to date saw the light of day. Overall, the new issuance volume in the Green Bond segment amounted to USD 500bn and hence more than 85% above the previous year's level.

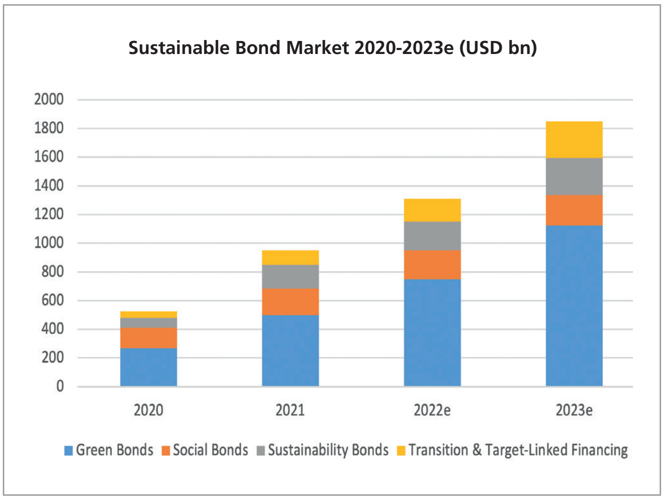
In addition, Social Bonds and Sustainability Bonds continued to enjoy tailwinds in 2021. While the new issuance volume of the former increased by slightly more than 30% to USD 185bn, the latter showed the highest growth rate in the entire Sustainable Bond market with more than 140% rising to USD 165bn. This underlines the trend „Green goes rainbow“, reflecting the ongoing diversification in the Sustainable Bond market.

The segment "Transition and Target-Linked Financing", which includes Transition Bonds as well as Target-Linked Bonds, also showed impressive growth of more than 120% to around USD 100bn. In our opinion, this segment will receive special attention in the future, as we can only successfully implement the global sustainability agenda if we „get everyone on board“, i.e. also issuers from critical sectors with business activities whose journey on the transformation path will still be a longer one.

2022: All segments continue to move in the right direction

We forecast growth in all segments of the Sustainable Bond market in 2022.

We expect the new issuance volume in the Green Bond segment to increase by 50% to USD 750bn. The segment is thus increasingly moving towards the USD 1trn mark, which we estimate will be exceeded in the course of 2023.



Source: CBI, DZ BANK (2022)

In the Social Bond segment and in the Sustainability Bond segment, we forecast a new issuance volume of USD 200bn each, corresponding to growth rates of 8% and 21%, respectively.

Due to the increasing importance of transition financing, the segment "Transition and Target Linked Financing", which includes

Transition Bonds and Target-Linked Bonds, is expected to grow the most. Here we forecast a 60% increase in new issuance volume to USD 160bn.

Overall, the Sustainable Bond market will therefore exceed the USD 1trn mark in the course of 2022 reaching a new issuance volume of around USD 1.3trn.

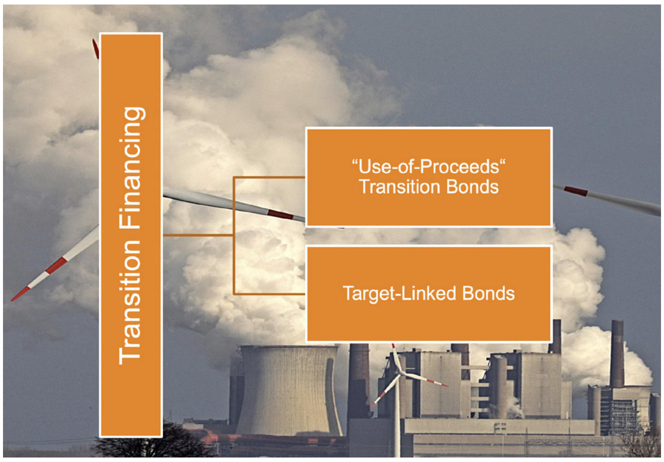
DZ BANK Spotlight:

Transition financing with the help of bonds

The need for transition financing with regard to a successful implementation of the global sustainability agenda is therefore undisputed. In doing so, it is necessary to put an end to the classic „black and white" thinking.

We cannot achieve a decarbonized and more sustainable world by focusing exclusively on economic activities, business models and sectors that are already „dark green". We can have a much greater positive impact on the global sustainability agenda by helping to make „brown" economic activities, business models, and industries „light brown" or „light green," rather than painting already „dark green" activities, models, and sectors one shade greener.

The global fixed income market has a key role to play in financing the transformation of the real economy. With an estimated volume of more than USD 100trn, it holds enormous potential to support the transition to a sustainable future.



Source: DZ BANK (2022)

Use-of-Proceeds Transition Bonds: „Enfant terrible" in the Sustainable Bond market?

The fact that transition is one of the most controversial topics when it comes to sustainable financing on the bond market is illustrated by the example of so-called Transition Bonds. Transition Bonds are a relatively new fixed income instrument that joins the ranks of Use-of-Proceeds Sustainable Bonds. It is designed to enable issuers from less sustainable sectors to finance a gradual shift to a more sustainable business model. These include, for example, carbon-intensive industries such as oil and gas, iron and steel, chemicals, aviation and shipping. Proceeds from the issuance of Transition Bonds could be used, for example, to finance transformation technologies that enable the transition to a more sustainable business model.

Opponents of Transition Bonds question the authenticity of such instruments. They see them as softening the market for Sustainable Bonds. The accusation of „greenwashing" is often raised, i.e. an attempt by the issuer to gain a „green image" through the transaction without having systematically anchored corresponding strategic measures in the operational business.

Proponents of Transition Bonds, on the other hand, argue that the transformation of our economy cannot succeed through „black and white" thinking such as sector-specific exclusions with the intention of completely restricting external capital flows. Clearly labelling a bond as a „Transition Bond" creates transparency to investors and clearly differentiates it from Green Bonds.

Credible transition financing with Target-Linked Bonds

Numerous innovations have contributed to the success story of the Sustainable Bond market in recent years. For example, target-linked structures have been extremely popular for some time. In 2021, they already accounted for around 10% of the new issuance volume in the global Sustainable Bond market. Many investors see them as a suitable instrument for transition financing. Unlike the Use-of-Proceeds Transition Bonds mentioned above, they focus on the transformation of the issuer as a whole.

Target-Linked Bonds are forward-looking and performance-oriented financial instruments in which issuers explicitly commit (also in the bond documentation) to future improvements in sustainability criteria within a predefined timeframe. Sustainability development is measured using predefined key performance indicators (KPIs) and evaluated against sustainability performance targets (SPTs).

The financing costs of Target-Linked Bonds are linked to the (non-)achievement of these sustainability targets. If the issuer fails to meet the targets, financing becomes more expensive.

As the use of proceeds of Target-Linked Bonds are not earmarked and can therefore also be used for general corporate financing, they are also suitable for less asset-intensive issuers who do not have the necessary volume for a Use-of-Proceeds Transition Bond.

For a credible transition financing using Target-Linked Bonds, it is important to choose KPIs that are measurable, comparable and relevant to the issuer's transformation process. They should also have a high strategic importance for the issuer's future operations. In addition, the SPTs should be in line with the issuer's transformation strategy and be ambitious, i.e., go beyond a „business-as-usual scenario."

Guest Commentary:

Union Investment transformation rating

Johannes Böhm,
ESG Analyst
Union Investment

The concept of sustainability has been the subject of heated debate for many years. In view of the increased importance of sustainable investments and the regulatory requirements placed on asset managers, these debates have intensified once again in recent months. At the core is the question: What is sustainability, and how do you measure it? What distinguishes sustainable companies? And what are the goals of a sustainable asset manager? Does the investor invest only in the most sustainable companies, or does he try to contribute to a more sustainable world by accompanying companies on their way there?

The answer can be kept relatively short: „Sustainability is a process!" This statement reflects an essential belief in how a modern asset manager should accompany the transition of the economy to a more sustainable one. After all, this transition can only be successful if a large number of previously non-sustainable companies undergo a corresponding change, a transformation process. To put it somewhat bluntly: First and foremost, brown companies need to become green, not already green companies even greener. Accordingly, this is also where the leverage of investors should be applied, who, after all, are supposed to co-finance the transition in-line with the political tailwinds. Sustainable investments have the strongest impact when they encourage the process toward greater sustainability – rather than rewarding sustainability that has already been achieved.

Against this backdrop, Union Investment began using self-developed, so-called transformation ratings in the investment process for sustainable investments in January 2022. These reflect a qualitative assessment by portfolio management of how successful a company will be in achieving a higher level of sustainability in the coming years. It is crucial that this assessment is made in a systematic process and updated regularly. The result ultimately distinguishes between transition leaders and transition laggards, whereby only the former are short-listed for sustainable investments.

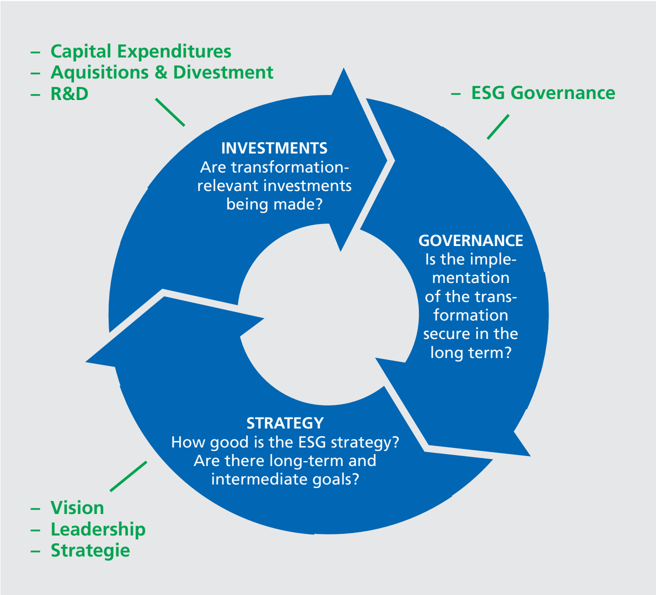
Focus on (yet) unsustainable corporations

While conventional ESG scores are used to evaluate companies in terms of their carbon emissions, the quality of governance, or social controversies (amongst numerous other factors), scores usually rely on inherently backward-looking data. Contrastingly, the transformation rating is based on a more qualitative assessment. Transition candidates are companies whose current level of sustainability is still low as reflected in a moderate or poor ESG score, but which have potential for improvement. The UniESG Score, which includes internal analysis results as well as external data, is key for this initial assessment. On this basis, we select companies that are not yet sustainable but show potential for improvement. The next question is at what speed and to what qualitative extent a company under consideration has committed itself to a sustainable transformation of its business model.

280 companies put through their paces

In a first iteration, Union Investment has created transformation ratings for 280 companies. The key questions are: Does the company under review have a convincing and ambitious sustainability strategy and does it commit itself to long-term goals as well as interim targets? Are systematic investments being made in the sustainable transformation of the business model in line with the strategy? And finally: Are there adequate corporate governance mechanisms in place such that corporate management can be expected to adhere to the sustainability strategy in the long term and to implement it consistently?

It is also clear that companies face different challenges depending on their sector. A cement manufacturer will find it much more difficult to become climate neutral than a bank, for example. Therefore, subcategories were defined for the respective industries to make the companies truly comparable.



In order to arrive at a transformation rating, we then reach out to companies in order to gather all necessary information. This is done using a questionnaire that related to the sustainable business transformation of specific sectors. Results are then jointly discussed in dedicated company meetings. Such corporate dialogues between an active asset manager and listed companies are anything but new: Union Investment analysts have continuously conducted thousands of such interviews every year, currently around 4,000. In the past, the dialogues focused primarily on fundamental aspects. In more recent years, however, ESG aspects have increasingly been the subject of meetings, for example regarding environmental issues. With regard to the creation of transformation ratings, our dedicated engagement with the company helps us to obtain the most complete and well-rounded picture with a view on the company's ability and willingness to transition its business model.

Of the companies studied, 195 where then rated positively and 85 negatively, as laggards, by January 2022. The former are therefore, for the time being, eligible for investments in Union Investment's sustainability funds. Of course, this only applies as long as the positive trend in the company's development continues. If the assessment changes as new information becomes available, pertaining securities may be excluded from sustainable funds. In addition: Classification as a sustainable company or as a transformation candidate is, after all, only one side of the coin. Equally important are other qualities such as a convincing business model, a solid balance sheet, capable management, and high profitability. These characteristics determine whether a fund is not only green, but also achieves a convincing performance.

Conclusion

With the transformation rating, Union Investment has added an important building block to its sustainable investment process. The question is „which companies want to become sustainable but are not quite there yet?". Combined with our overall investment strategy, the response to this question will incentivise corporations to take action on sustainability and to drive change. In other words: We want to encourage the better among the worse to be more sustainable and thus increase the amount of „good guys" overall. Because only if this quantity is sizable enough, is there a chance of having a significant impact that helps to solve problems such as climate change. Conversely, investing only in a few - already very green – companies won't do the job.

DZ BANK Spotlight:

Defining the S in ESG: the final Report on Social Taxonomy

Following the publication of an interim report in July 2021, the EU Platform on Sustainable Finance presented its long awaited final Social Taxonomy Report on 28th February 2022. The Platform on Sustainable Finance (PSF) set up by the EU Commission consists of various sub-working groups, which in turn deal with different topics. Sub-working group 4 is looking at the possibility of a Social Taxonomy.

As in the interim report, also in the final report the Social Taxonomy is based on international norms, principles and goals. The PSF proposes a structure for a Social Taxonomy within the present EU legislative environment on sustainable finance and sustainable governance. While this environment currently consists of various pieces of legislation, the focus of this work has been on the present structure of the Environmental Taxonomy. The PSF was also asked to: (i) consider the relationship between the Social Taxonomy and the Environmental Taxonomy; and (ii) reflect on other sustainability objectives like governance and the regulatory environment.

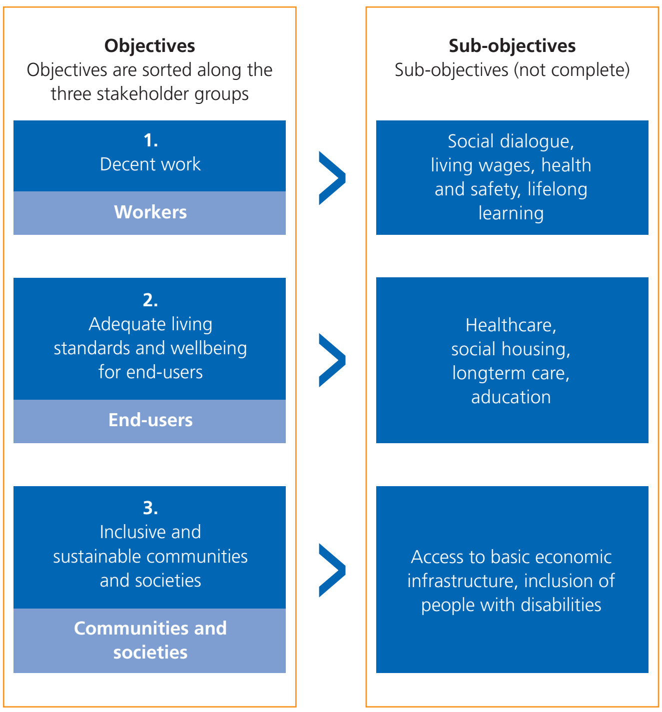
Two peculiarities of a social compared to an environmental taxonomy have been identified:

a) A Social Taxonomy has to distinguish between inherent benefits and additional social benefits that directly contribute to the realisation of human rights such as improving access to quality healthcare or ensuring decent jobs

b) A Social Taxonomy has to be based on international authoritative standards of topical relevance such as the International Bill of Human Rights. Based on that, the suggested structure of the Social Taxonomy employs the following structural aspects of the environmental taxonomy: (i) the development of social objectives; (ii) types of substantial contributions; (iii) ‚do no significant harm' (DNSH) criteria; and (iv) minimum safeguards.

Objectives, sub-objectives and stakeholders

While the initial proposal for the Social Taxonomy consisted of a horizontal and vertical dimension, the final report suggests now a single structure based on the feedback the PSF received. The suggested structure of a Social Taxonomy therefore consists of three objectives, each of which addresses a different group of stakeholders. This approach would also align with the recommendation of the EFRAG's European Lab Project Task Force on preparatory work for developing EU sustainability-reporting standards, suggesting that that the 'S' in ESG should be defined using a stakeholder-centric approach. Along these stakeholders and the objectives, the PSF proposed a non-exhaustive list for sub-objectives.



Source: DZ BANK, European Commission

Within each of these objectives, there are different types of substantial contributions. The first type is a substantial contribution that focuses on avoiding and addressing negative impacts on workers, consumers and communities, which are activities in sectors with high social risks that need to be addressed by adequate processes in companies. The second type is substantial contribution which focuses on the additional inherent social benefits of the activity itself. This relates to activities that contribute to the reductions in the number of people without access to products and services to meet basic human needs. The third type of substantial contribution is enabling activities which enable other activities to provide social benefits.

In line with the draft report published last year, the PSF again implemented the internationally recognized AAAQ approach in order to assess the qualification of public and privately offered products and services.

Availability

means that a certain good is available in a sufficient quantity

Accessibility

means that a product or service is economically affordable and physically accessible without any discrimination, and that related information about this product or service is also provided

Acceptability

means that the provision of goods and services should be ethically and culturally appropriate

Quality

means that the good or service is safe and that it meets internationally recognised quality standards that are scientifically approved

This means that public and privately offered products and services with inherent social benefits can qualify for the Social Taxonomy if they meet the criteria based on the AAAQ concept.

DNSH and minimum safeguards – the old acquaintances from the environmental taxonomy

The Do-No-Significant-Harm (DNSH) criteria in a Social Taxonomy play a similar role to the ones they play in the Environmental Taxonomy, ensuring that an activity that contributes to one objective is not doing any harm to any other objective. However, the report highlights that there are three features of the DNSH criteria, which require emphasis because they differ from the Environmental Taxonomy. The first feature to emphasise is the need for more granular DNSH criteria at the level of the sub-objectives, given that the substantial-contribution criteria will be developed and assessed at the level of sub-objectives. The second feature is that the DNSH criteria might also play an important role in some essential social topics and sub-objectives for which it might be challenging to draw up substantial-contribution criteria. The reason for that might be the difficulties to meaningfully prioritise sectors or because it is not possible to link turnover or expenditure to these activities. The third feature is that it is challenging to build a meaningful case for a substantial contribution for objectives like 'avoiding and addressing' child labour or forced labour, since these issues are generally subject to zero-tolerance in law and sometimes subject to bans or exclusion criteria.

For topics which cannot be linked to the activity but must be linked to the economic entity, minimum safeguards will be employed to avoid inconsistencies. Given that the Subgroup was asked to first work out a structure for a Social Taxonomy, and only then give advice on the minimum safeguards, the report does not provide a final proposal on this topic but highlights questions with provisional answers.

Selection of sectors

In line with the Environmental Taxonomy, the report proposes the NACE codes to build on for the development of a sector framework. Furthermore, it discusses three ways to select sectors of relevance to the proposed objectives of which each has its own advantages. These three ways are linked to the three types of substantial contribution.

One way could be by 'addressing negative impacts' substantial contribution focus on high-risk NACE sectors. While there is currently no single authoritative research resource available that provides an extensive list of such sectors, the report provides examples of organizations and initiatives with insights on various sectors. At the same time, the sources indicate that sector risks differ across different social topics or human rights. The Subgroup therefore suggests selecting economic sectors that are relevant for the 'reducing ne gative impacts' substantial contribution at the sub-objective level. 'Enhancing the positive impact inherent in an economic activity' is based on the Universal Declaration of Human Rights and to the International Covenant on Economic, Social and Cultural Rights. Based on this background, the report provides a list of sectors (e.g. water, housing, healthcare, education etc.) that are relevant to this objective.

The selection of sectors for 'enabling activities' will follow the sectors relevant for the other two types of substantial contribution.

Relationship between the Social and Environmental taxonomy

The possible relationship between the Environmental and Social taxonomy can be viewed as a continuum with two opposing extremes. At one end is a single taxonomy defining economic activities, which are both socially and environmentally sustainable. At the other end of the spectrum are two independent taxonomies. Between the two extremes, many options are possible. Two suggestions for how to ensure a balance in the relationship between an environmental and a Social Taxonomy were made:

i. In this model, the Social and the Environmental Taxonomy are related only by both having minimum safeguards for the respective other part. Therefore, this model would have general requirements for social activities and another set of general requirements for environmental activities.

ii. Integration of the Social and Environmental taxonomy more closely with environmental and social DNSH criteria being valid for both the social and the environmental part for all activities.

The full report with more details on the summarised topics plus some requirements for future social criteria and indicators alongside ideas about the next steps for developing a social taxonomy can be found here.

DZ BANK Events:

Save the date – DZ BANK Capital Markets Conference 2022

The annual DZ BANK Capital Markets Conference will take place from 11 to 13 May 2022. Participation is possible both physically on site in Berlin and virtually. Conference languages are English and German.

Discuss the latest trends and developments around the topics of capital investments, sustainable finance and digitalisation with renowned experts and high-ranking industry representatives.

Further details and a detailed agenda will be published in the coming weeks.

All currently available information about the event can be found on our website:

https://cmc.events.dzbank.de/