A guide to Green, Social, Sustainability & Sustainability-Linked Bonds

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Appetite for sustainable investing is growing fast. Institutional and individual investors want to know that their money is being put to productive use – not exploiting people, nor harming the planet.

At the same time, regulators are also imposing stricter environmental, social and governance (ESG) requirements on companies – driving a unification of standards and guidelines across markets.

These twin drivers have led to a sharp rise in sustainable investing, and bond markets – as the single largest source of financing in global capital markets – offer a fundamental investment channel. Increasingly bonds are being issued with sustainable labels (labelled bonds) in two main categories:

1. Green, Social and Sustainability (GSS) bonds;
2. Sustainability-Linked Bonds (SLBs).

In this paper, we break down the world of labelled bonds in Asia ex-Japan (AxJ) and outline the opportunities and risks that investors face. In addition, we touch on sustainable opportunities for investors that exist outside of the universe of labelled bonds and simplistic ESG screens.

The differences

GSS bonds and SLBs are much the same as conventional bonds with regards to yields, spreads, tenors, coupons and credit ratings. The key difference is that GSS bonds specify what their proceeds are spent on: green bonds are used to fund environmental activities (i.e. renewable energy, waste management), while social bonds fund projects with a positive social impact (i.e. housing, health, education).

SLBs are tied to sustainability targets, but have no restrictions on projects funded. If issuers meet these targets, they may receive benefits (i.e. reduced coupons); if they miss, they may get penalties (i.e. coupon step up or buying carbon offsets). This is designed to drive a positive net impact.

Labelled bond	Use of proceeds	Eligible projects	Debt recourse
Green	Earmarked to finance or refinance activities with environmental benefits.	Renewable energy, clean transport, water/waste management, energy efficiency, green building.	Standard/full recourse to issuer. Bonds bear same credit risk as vanilla bonds of similar rank.
Social	Earmarked to finance or refinance activities with social benefits.	Covid, housing, gender, health, education. Includes affordable housing, affordable infrastructure and community development.	Same as above.
Sustainability	Earmarked to finance or refinance activities with environmental and/ or social benefits.	Similar to categories for bonds labelled Green and Social.	Same as above.
Sustainability-linked	Issuers commit to key performance indicators (KPIs) on sustainability.	No restrictions.	Bond terms are linked to sustainability targets. Failure to meet targets can result in changes to bond terms, including a coupon step-up/step-down.

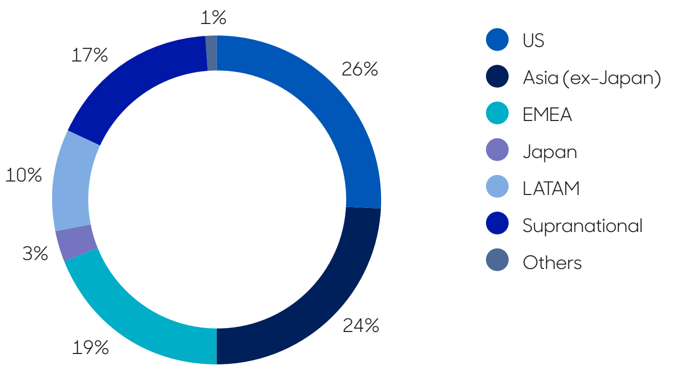
The opportunities

Today the labelled bonds market stands at USD3 trillion globally across currencies including USD, EUR, KRW, RMB and JPY.[1] By currency, USD labelled bonds represent the largest portion at USD902 billion, with AxJ accounting for 24% of this USD market – only just behind the US (26%).

Issuance of USD labelled bonds has risen rapidly in AxJ. It reached USD86 billion annually in 2021, more than triple the year before and amounting to 17.1% of total USD bond issuance in the region. Green bonds account for by far the largest share of labelled bonds in AxJ, followed by Sustainability bonds.

Despite severe volatility and weak investor sentiment, labelled bond issuance has been resilient this year and will likely drive growth in Asia's bond markets, backed by increased demand and regulation.

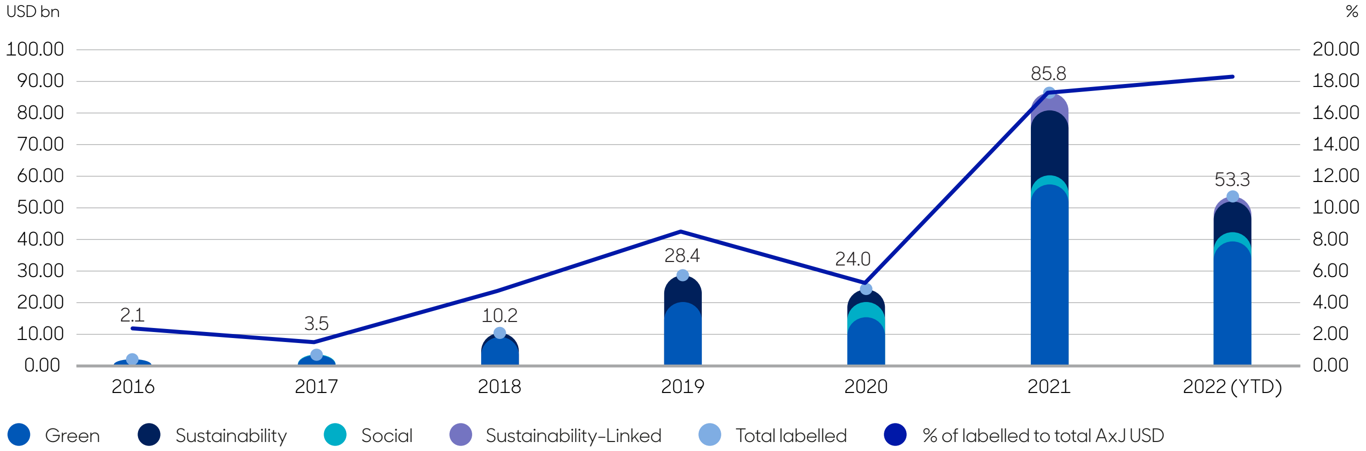
Outstanding USD labelled bonds, by region



Source: abrdn research, Bloomberg, 16 August 2022.

[1]Bloomberg, abrdn research, 16 Aug 2022.

Asia ex-Japan USD labelled bonds issuance, by label

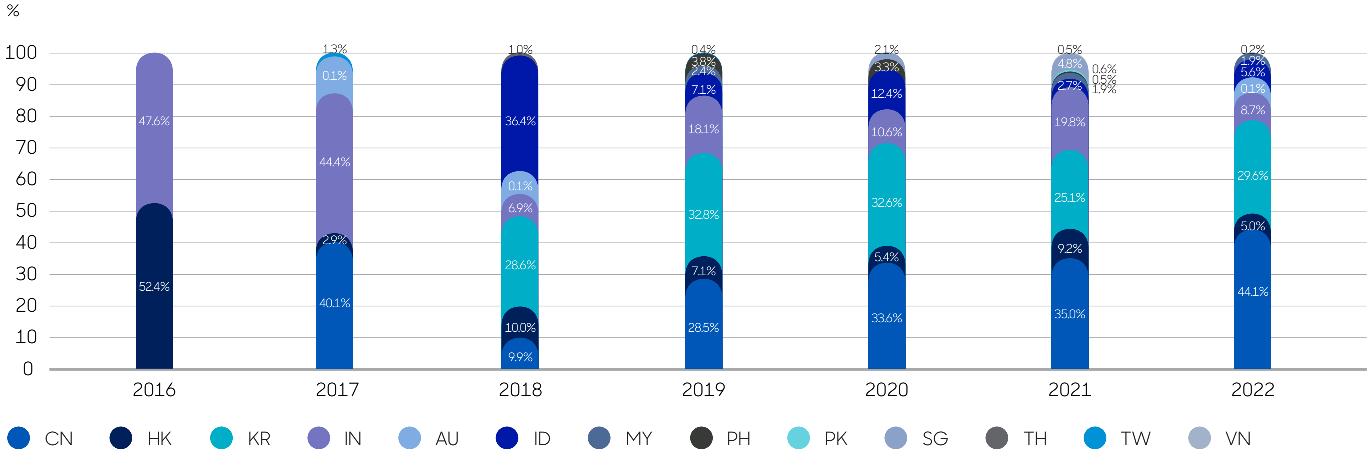


Source: abrdn research, Bloomberg, 16 August 2022.

The opportunities - continued

China leads the growth of USD labelled bond issuance in AxJ, while Korea accounts for a substantial share.

The bar chart below illustrates how issuance in AxJ has diversified in recent years.



Source: abrdn research, Bloomberg, 16 August 2022.

The rise in investors seeking sustainable assets has fuelled rising demand for labelled bonds. This has led to a supply-demand imbalance (not enough bonds to meet demand), which has lowered bond yields. From an issuer's perspective, this has created a premium – or 'greenium' as it has become known.

Compared to the relatively advanced adoption of sustainable investing in developed markets, Asia is still in early stages, making the greenium for labelled bonds less pronounced in Asia. However, we expect this to change as global standards and regulations (i.e. Sustainable Finance Disclosure Regulation) become more widely adopted. Given these factors, alongside Asia's growing sustainable development needs, we believe that labelled bonds will continue to be the key growth driver of the USD bond market in AxJ.

The challenges

While rising investor interest has spurred more firms to issue labelled bonds, it has driven greater variation in the standards and quality of issuance. We see two main challenges for investors:

1. Lack of enforced standards. There's a need for standardisation in what counts as GSS bonds. Eligible projects are at an issuer's discretion and can be defined loosely, although we've seen improvements with the EU Green Bond Standard and the China Green Bond Principles. We anticipate further guidance and regulation. For SLBs, some targets/KPIs remain unambitious and can be immaterial to an issuer's ESG profile. This hinders investors' understanding of what funds are used for, and in fact whether financing is used for sustainable purposes at all.

2. Greenwashing. With such flexibility around standards of GSS bonds and SLBs, inevitably issuers and investors are exposed to risks of greenwashing – where companies overstate or misrepresent green credentials. Issuing a bond with a sustainable label does not make the issuing firm sustainable. Investors need to take a holistic view of a company's behaviour.

Labelled bond	Structure	Potential pitfalls
Green; social; sustainability	Use of proceeds	• Eligible projects loosely defined, not ringfenced robustly. • Large proportion of refinancing is used for old projects, raising doubts over claims about new positive impacts. • Defining standard operations (i.e. staff welfare) as an eligible social project raises questions over credibility. • Lack of exclusions preventing firms investing unused proceeds in unsustainable projects (e.g. thermal coal). • Lack of follow-up reporting requirements for issuers once a bond is issued, preventing tracking/monitoring. • Ambiguity over metrics to reflect green/social impact. • Too many eligible categories for sustainability bonds, raising doubts over their effectiveness without a comprehensive ESG strategy from the issuer.
Sustainability-linked	Sustainability targets linked to penalties/ rewards.	• Weak targets and KPIs neither in line with issuer's long-term strategy nor best practice. • Targets immaterial to a company's overall operations. • Penalties ineffective (i.e. bonds callable before KPI assessment date). • Step-up in coupons not meaningful as a penalty. • Need for robust monitoring of data, such as third-party verification to ensure compliance with SLB terms.

Look beyond the label: case studies

- **Company A issued an SLB with targets for building green facilities to reduce its operational impact. But we learned the building cost would be a fraction of total proceeds raised, with the remainder used for general purposes and potentially allocated to assets without robust ESG safeguards.**
- **Company B with a large Scope 3[2] footprint issued an SLB with unambitious targets around Scope 1 and 2 emissions intensity. The bond's targets did not cover material aspects of the company's emissions profile, raising credibility doubts over its overall approach to sustainability.**
- **On the other hand, Company C had committed to exit coal fully by 2030 and issued multiple green bonds to finance a renewable energy build-out. Backed by a robust strategy supported by green financing, Company C's transition plan is now well underway.**

Examples A and B demonstrate misalignment of labelled bonds to their issuers' overall ESG strategy. In both cases they overstated sustainability outcomes, and therefore run the risk of greenwashing. The example of Company C demonstrates that firms can also use labelled bonds to enhance transition ambitions. It shows how green bonds can support positive outcomes, backed by an issuer's ESG commitments.

Responsible investors need to take many factors into account to find high-quality, attractive bonds. They should not only focus on how bond proceeds are spent, but also on the issuer's ESG credentials. Research is vital to determine how sustainable or green a bond issue is. Scrutinising use of proceeds, impact reporting, alignment with standards and an issuer's overall ESG credentials are essential.

[2] **Scope 1**: greenhouse gas emissions as a direct result of a company's activities.
Scope 2: indirect emissions from sources a company does not own or control.
Scope 3: emissions from sources a company does not control tied to business travel, procurement, waste and water – most of a company's carbon footprint.

Managing risks

Investors should partner with an asset manager with a proven process both for evaluating labelled bonds to distinguish quality and with access to fundamental credit and ESG research on issuers. It's vital that both the bond and ESG credentials of issuers are attractive. Managers need to look beyond the label to avoid potential greenwashing risks, but also to capture opportunities. We see the key factors as:

1. Minimum standards

Issuers should be able to show that sustainable financing is part of an overall sustainability strategy, not a substitute for it. The most credible will have time-bound, science-based targets that address major sustainability issues, and will disclose progress such as milestones and KPIs. Asset managers should conduct due diligence to ensure issuers are not subject to controversies, ideally using a risk-rating framework and internal ESG scoring system.

2. Global best practice

Labelled bonds should align with global best practices. GSS bond issuers should disclose use of proceeds, which in turn should finance green or socially impactful activities. Eligible projects should provide clear benefits – assessed and quantified where possible. SLBs must align with an issuer's sustainability approach. Issuers should also disclose use of unallocated net proceeds, type of projects and/or assets and timescales for distribution.

3. External verification

It's useful to secure external reviews to confirm that a company's green financing framework or bond issuance is credible via second-party opinion, verification, certification or rating. Self-labelled bonds demand deeper investigation.

4. Annual reporting

Issuers should report on funded projects' environmental and/or social impact annually, outlining the characteristics of sustainable investments. These should be verified by a third-party and align with global guidelines. This lends credibility to the bond and the issuer. Ideally, issuers should also report on positive impacts that proceeds generate. They should have adequate safeguards and disclose how they manage ESG risks using mechanisms such as an environmental and social impact assessment.

In summary

Asia requires an estimated USD1.5 trillion a year to develop sustainably[3] – underlining the pressing need to secure financing across its capital markets. Governments across the region are incentivised to effect change, to commit resources and to align domestic regulations with global standards.

At the same time, they recognise the critical role investors have to play in sustainable development. Accelerated by regulation, demand for sustainable assets is rising worldwide. Increasingly, firms are seeking to tap investor interest by issuing labelled bonds. We expect these trends to accelerate.

This will create investment opportunities. Asia ex-Japan accounts for a quarter of the USD900 billion global market for USD labelled bonds, and issuance of USD labelled bonds in AxJ represents 17% of total USD bond issuance in the region. We're confident it will continue to drive the market's growth. While Chinese companies are leading issuance, it's diversifying quickly across the region's markets.

Despite severe volatility and shaky investor sentiment this year, investors should note how USD labelled bond issuance has remained resilient.

But the universe is complex, with challenges ranging from a lack of common standards to potential for greenwashing. Investors need experienced partners to navigate this market and to identify sustainable investment opportunities in fixed income.

Importantly, sustainable investing in fixed income doesn't purely rely on labelled bonds and ESG screens. There is a wide range of opportunities offering sustainable yield – although that's not the focus of this paper.

But with sound advice, labelled bonds – along with carefully selected sustainable opportunities outside of this category – can bolster exposure to sustainable investments in a diversified portfolio.

[3]Filling the Finance Gap for a Green and Inclusive Recovery **(adb.org)**.

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