

Sustainability-linked bonds_ innovations in green finance

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You're listening to the ONVIF podcast, the show that explores the latest insights and discussions on global finance, economics, and policy for people who love staying informed about the rapidly evolving landscape of the financial world. Join us as we break down complex topics, interview key thought leaders, and provide essential insights to keep you informed about the evolving world of finance.



00:26

Hello, and welcome to this on Fifth podcast. My name is Edward mailing the economist with on cliffs Economic and Monetary Policy Institute. I'm delighted to be joined today by have allanson, chief executive and co founder of the Anthropocene fixed income Institute. And today for a discussion covering some of the recent developments in sustainable finance, in particular sustainability linked bonds. Thank you for joining us. It's great to have you here today.



00:58

Thank you very much. And I commend you on the nice pronunciation of the institute's name, Anthropocene. It's not many people do that that well. The first attempt



01:07

is what's behind the choice of the name, Anthropocene. Actually, it's interesting.



01:13

Well, generally, the Anthropocene is defined as this geological time age, whether we're there or not, is still an open debate. But where we're human kinds effect on the planet is such that it can be compared to a geological force, I think it's interesting use of the word because it sort of

says that this is the reality we live in. And also as investors, you have to think about, relating to not the world as you would like it to be. But what is here right now and how we sort of work with the situation of what we are having. So



01:47

very apt, under on the choice of name for the type of work that you're involved in. So just to set the scene for the discussion, the last five to 10 years in sustainable finance have been characterized by a lot of sort of great progress, rising issuances of sustainability, labeled debt, lots of supporting market standards being developed alongside and now more recently, the deepening of social and sustainability of markets. Also, the last couple of years have seen a slight slowdown in that progress if you're measuring it by levels of debt issuance. But I wanted to start off by asking you for your perspective on how the global fixed income market has come on. And in particular, in the first half of this year, key market movements.



02:40

Yeah, now, it's very clear that the global fixed income market is very dependent upon what we think about the macro interest rate environment, and so on, which has been volatile, to say the least with you know, inflation's and what central banks are doing. So that has been an interesting sort of dimension of it. ations spin been going on pretty well, and so on. So the market as such, feels healthy. So it No, no, no big caveats on that really.



03:12

Certainly, what we see in our research is, particularly amongst institutional investors, a preference for sustainability bonds, this came across recently at our global public investor report, Central Bank, reserve managers have a particular affinity for these labeled traditional bonds, less equities, and alternative assets. So when we think about the enormity of the funds needed to get to net zero, and to finance a sustainable transition, why do you believe that fixed income markets are so critical in that context?



03:48

Well, number one, fixed income markets as a pool of assets is the biggest asset pool out there, you generally think about it of size around 125 \$230 trillion. So that's, that's the pure sort of quantum that you think about it. But secondly, what's really important is the fact that this is a market that rolls over the whole time. So if you think about maybe it's, let's say, an average lifetime of the bond for five years, and you take that 120 5 trillion, then you go down and say, Okay, there's actually 25 to \$30 trillion of new renewed issuance every year, that's primary market activity. That's companies and other entities have gone to the market and asking for new money, because the other money they had borrowed had rolled off. So it's a very sort of primary market focus marketplace. And that is important in terms of engagement and being able to get leverage on whoever wants wants the capital. Thirdly, the reason why this market is so big and also why it's so powerful when it comes to climate transition and other discussions is that it affects not only a publicly traded equities, it affects private equity vehicles or private

companies. It affects supranational issues. It affects sub national issues, your municipality, your federal state, and it affects sovereigns as well. So you can have an engagement effect and clearly on Fifth, fifth will be very clear on that that no other investors can have. And especially when you're looking at things like decarbonisation, we have done some analysis indicating that roughly 30% of the sort of the large, super large emitting entities of the world are actually accessible or engageable, through public equities, but almost all of them you can engage if you're a fixed income investor. So that gives you a very large pool of the decarbonisation period, that actually the markets will be looking to fixed income investors. That's quite compelling argument, I think four or five, this marketplace such a big role.



06:01

And in recent years, in particular, with your right to highlight the fact that fixed income markets offer this space for the involvement of SSS as well as private equity. In terms of the products on offer, what kind of trends are you seeing across fixed income markets as as issuers and investors alike look to tap into these into the market?



06:29

So thinking specifically here on the sort of the sustainability focus space in the climate, climate space, there are two main types of vehicles if you if you wish, that we think about and one is the traditional sort of green bond, use of proceeds vehicle where the issuer, the borrower of capital, says that, you know, if I get to borrow this money, I promise that I will invest it in these types of assets. So that's the use of proceeds. Then the second part on which we have been working a lot on the sustainability length type of structures are more general corporate purpose, what happens there is that the issuer, the borrower of the capital, they say, Okay, I commit to some target in the future, some outcome. But how I get there? Well, of course, I need to have a plan and so on. But that's not You're not going to directly dictate to me what assets or what methods I am going to use to get there. So that's like one, which is sort of acid tied. It's not properly acid backed one should say, but the use of proceeds product, and then the other one, which is more outcome focused, where we think they there's great complementarity. But you know, if you think about the quantum of product out there, it's very much the use of proceeds bonds, the green bonds that are the dominant ones, but we think there is great potential on the general corporate purpose, outcome focused types as well.



07:59

And given those differences that you highlight between the traditional use of proceeds bonds, and then the sustainability linked bonds, on the other hand, have you noticed any differences in terms of the type of corporates that are looking into these markets, whether it be by sector or industry or geography? What do you think's driving interest in the soybean market?



08:26

Yeah, there's, there's quite a clear and we've done a fair bit of analysis on that. And there is more of a lower down the rating spectrum, smaller companies tilt when it comes to the SMB market historically. And the reason for that is fairly simple. If you want to do a benchmark size

market historically. And the reason for that is fairly simple. If you want to do a benchmark size bond, which is what most people are looking to do, then you need to get an excess of \$250 million in terms of the size of it often \$500 million dollars. And when you're doing a use of proceeds bonds, well, then you need to think about having you know, that amount of green assets, if you wish, in order to actually do it the benchmark size. So that tells you that if you're a company that has only 25% of your assets, that you can sort of denominators green, though, then you need to be at least a 2 billion size of asset company. And so you restrict smaller companies from that. And also, there's the use of proceeds instruments and usually not hard coded legally. So that means that there has to be a very great deal of trust between the issuer and the investor that also says that, you know, at higher rate, the type of companies are having an easier time to tapping into the use of proceeds product. But this is great in terms of winning, thinking about the sustainability, linked structures, they are providing this complementarity, they're allowing other type of issuers. So especially if this becomes interesting when you're thinking about, you know, develop market versus emerging markets, and or investment grade versus crossover and high yield corporates. At last, you're able to tap in to other groups that traditionally have not been able to access the use of proceeds smart yet. Thank



10:08

you. And you highlight quite quickly, the smaller companies, the SLB structures lend themselves more to those on the sovereign and SSA side, we've seen two particularly well documented and high profile issuances from Latin America, from Uruguay and Chile. Do you think these characteristics that lend SLBs to smaller companies might be behind why there's been a slower uptake from sovereign and SSA issuers and bearer relative lack of uptake of this?



10:45

So if we think about just sovereigns, to start with, I mean, it also took a long time in the green bond market before you had any sovereign bond issuance and two green bonds. So having been in that market, you know, some of the patterns you can see in terms of the ebb and flow, some volumes, and so on are not too dissimilar. Just shift SLP issuance a number of years as the start date later than the green bond market and market started. So some of the patterns you can recognize in terms of that. Now, it is true that there hasn't been that much SNB issuance on these names for other types of reasons. It's been easier to approach, like the corporates to begin with, we do see some really exciting potential and developments in the market. Where is lots more in discussion? And you know, there are even several market organizations focused on sovereign sustainability linked type of issuance. And, actually, one one thing that has been been very, very interesting use case for this is the fact that when you're looking at sovereigns, you have this electoral cycle, you're looking at someone if you're lending money for 10 years to sovereign, well, you have one government in place this year, but you know, what, about four years from now, and the problem might be that the holistic strategy under which green bond or use of proceeds bonds is being issued, may not be the strategy that the next government's going to have in place. And that puts you in a difficult position as as the use of proceeds investors, as you know, probably the green bond investors in the Swedish government bond, a green government bond, or the UK green gilt can testify to right now, strategy has shifted, suddenly, we want to emit more carbon during the life of those bonds. And that's where the outcome focused type of structure is becoming quite interesting, because that means that I can set as an investor, I can request for a target that's being set at least one electoral cycle out where, you know, I wanted to decarbonisation by 2030 to this amount, and

that is what you're going to deliver or there's going to be a compensation for me as an investor. And you're providing that incentive, which whatever government is coming into play is actually going to be bound to, I do think it's, it's a powerful way to look at this, why it could be very good in terms of sovereign sovereign nations.



13:14

So it's a very interesting point, one thing has come up in our research, that may be a point of attraction for software, this was could be the obstructions to use of proceeds bonds, and those more traditional avenues, whether it be legal or regulatory, obstructions, a prevent them raising money for specific projects, the SLB, then would offer another avenue by which that they think could then raise this finance and also benefit from those positives that you mentioned.



13:47

Yeah, there's a very real, right. I mean, I think there was a lot of queasiness around some of the green bond issuers and the use of proceeds format where the Treasury said that, you know, we just cannot, you know, guide money one way in this way, it's not entirely intellectually honest, to do that. But let us add another point here, which I think is quite important when it comes to, to the climate transition. What we're looking for is again, the outcome, right? So if we're looking at something that's going to be in 2030, we've been looking, for example, for the Japanese and the South Korean case. Maybe you don't want to look in the technology, the assets, that the way you're gonna get there, you want to allow for some sort of technological flexibility. So you don't bet everything on, for example, green hydrogen, and you invest, you know, billions of dollars in green hydrogen facilities, because you've promised that to your bond investors. And then suddenly, a new technology comes along and he says, Well, we actually have to keep with this other technology because we just promised that whereas you know, under a more flexible approach, you're just like, okay, whatever is the best way to hit the decarbonisation target. We're going to apply that technology. So it gives a lot of flexibility for new changes in the nature and technology and such, especially on when you're looking at the longer end of the curve.



15:04

And then thinking about that principle, applying it more. So perhaps the corporate context, do you think that there is any scope for SLPs? And particularly, not having that holistic element that use of proceeds bonds at such a degree but having these KPIs which I'll come on to shortly, do you see any scope for SLPs in supporting transition plans for corporates? Are there any use cases that you've come across the times that



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I've were very adamant about asset base as being, you know, good transition instruments, again, what you're targeting, and in looking for something like the carbonization is your what we call the negative carbon Delta, you say that if I look at the proposal we made on a Japanese

government SD, for example, well, the target is going to be minus 46% emissions since the peak in 2013. And that's going to be achieved by 2030. That is, you know, almost pure definition of transition happening. And that is what I want to tie this instrument to. Now what's really good with it is that as an investor, you can say, Okay, I have I've bought this bond, and look at this negative carbon delta that I'm getting, I am decarbonizing at this rate, this is what I have sort of tried to lock in, within the structure within, you know, the performance targets and so on. And I think that's, that's quite compelling. The the point there being that, you know, you can invest in something which is started today, that's going to be green in 2030, that gives you the maximum negative carbon Delta, rather than investing a lot of money in something which is green today. And it's going to be as green and 2030. But doesn't, you know, reduce carbon carbon emissions in the same way, which could be traditionally more seen the use of proceeds type of instruments. So we really hope investors, you know, a warm to that idea that the negative carbon delta you can achieve in the s&p structure is actually very strong proposition.



17:09

So, Anthropocene recently published this SLB handbook. I've had a read there, and it's very comprehensive, and very much geared towards helping practitioners. What was the motivation behind the handbook? And why do you feel as though it was necessary? And actually, how how's it going to benefit investors? And how do you think it will benefit market?



17:38

So we started looking at SLPs recently, and we were skeptical like everyone else, but then after a while, we said, Okay, but how do we actually price these things, you know, there are some conditions here, and there is a little bit that looks something like your financial difference in the bond in the future if you get the achieve the target or not. So we built this option pricing model around it. And then we've spent a lot of time over the past two years to sort of analyze the market out of this option pricing perspective. And at this point, well, late last year, we felt that, okay, there's so much around this, that it's actually worthwhile to write this up in a bigger type of format. And, you know, the option pricing approach that we're using in the book is very much something that's looking at the financial dimension of the s&p and unties a lot of the knots and question marks that have been around the products that also gives us guidance for what we think better product product, and more impactful product, and more financially interesting product should look like in the future. So that's been that's been the sort of the, the main motivation for it. We've been also analyzing lots of individual s&p cases. So they are like case studies in the book where we try to illustrate, you know, the methodology and thinking around this financial markets, they operate the best way when people feel comfortable with the product. So this book was really an attempt to make more and more investors with also issuers and other stakeholders in the market to feel more comfortable with it.



19:17

Yeah, as you mentioned, there's a lot of very useful case studies in there. There was one, perhaps, that is come quite recently, the case of an owl and their recent step up and that brings me on to the subject of KPIs because we've had a lot of emphasis on both sides about firstly, making sure that KPIs are generally ambitious enough. And then on the opposite side,

there's been these fears of companies perhaps being overly punished for missing their, their targets. Just how important do you think it is to by these two ways of thinking up, and more broadly, what is the importance of making sure that KPIs that are being set are ambitious enough, and from the investor perspective, making sure that they are having investors understand that missing targets is part of how the SLD market is supposed to function accepting these and not punishing corporates or sovereigns for missing targets.



20:32

So a lot of what we do with is focused around unpacking these questions. And, you know, we go into more on a basic sort of finance one on one level, where it is extremely important to recognize that, for example, when there is a step up in an SSP structure that represents financial value. So let's say there's a step up happening in the future on a bond, we'll just Earth \$1 and present value, well, then the investor says, Okay, that's that higher coupon that I'm going to get in the future is worth \$1, to me in terms of the bond price today. And I think there was a 50% probability that we'll actually get that \$1. So what's the value of that for me today? Well, that's 50 cents. So I can buy the bond, which has the Step Up feature 50 cents more extensively than I would do with a vanilla bond. Now, this then manifests itself that, you know, they buy the bond more expensively, which means that the, on inversely on the side of issue, that bond is issued to a higher price, ie with a lower coupon, everything else equal. So that means that if the issuer is achieving a lower coupon, and if they achieve the targets, they actually retain that lower coupon throughout the life of the bond. So that is the quid pro quo that's going on here, the investor might get the step up and crystallize that, that financial value, but the issuer might as well get the lower coupon level of the bond for the whole life of it, crystallizing a lower cost of capital. So this is the trade off that goes on here. Now, empirically, you haven't been able to observe that that much in the in the market, the Enel case that came through a couple of weeks, illustrates actually some of these effects quite well. But this idea that there's a penalty in some ways, and there's no upside for the issue. It's just from the mathematical standpoint, incorrect, that's not how it should be operating. Now, the other thing here that you're touching on this ambition level, go back to my \$1 50% probability example. Now 50% probability that there's going to be a step up that would probably be seen like a pretty high probability for failure, inverted commas. But the other way to see it is that it's actually a quite an ambitious target. Right? And you can look at it we make an example in the book, they're saying that, you know, if you're going for the Olympic gold, you're really ambitious, but you're fairly likely to fail. So then this goes back to this probability number, how do you how do you assess that and well, the more ambitious, the more likely it is that you're going to get your dollar. So the benefit for the issue of having an ambitious target is that then they then get the higher price for the bond today, they get the high or lower potential cost of capital throughout the life of the bond if they actually succeed. So there's, there's a tug of war here, or there's something going on between investors and issuers that they have to agree on, what's the target, and then that's going to get priced. And it's going to go up to the benefit of the issuer in one state of the world. And the benefit of the investor not stated well, and it's very important to to remember this, that there's a betrays they don't happen in a vacuum, it is actually this negotiation going back and forth. It's not an issue of issuers, fooling investors, as some people like to claim.



24:24

And those suppose that one thing that is we're able to conceptualize is continue continued SLB

issuance and invest are holding a bundle of these can expect it assuming that these KPIs are ambitious enough, and they hold a 50/50 probability, you're going to have 50/50. You're going to have a 50% chance of a step up or step down across the whole of your book. Is that a good way to frame our thinking where the SLP market could go? It's a case of, as you alluded to, at the beginning, it's a case of of time seeing how adoption develops and see how market standards continue to evolve and emerge.



25:07

Yes, I mean, the market is going to evolve. But I think you yourself here illustrate actually a very important point, sudden you start thinking about probabilities that companies sovereigns will actually transition and they will reach these targets, whatever the targets we are setting in there. So we start to sort of weaponize probabilistic thinking in terms of achieving targets and saying there is there is an extensional financial value in that. And that is how you get markets really engaged in these types of things. And you start analyzing this in a much, much more important way. I mentioned earlier, our proposal on you know, a sovereign sub from Japan. And once you started thinking about that, and you start thinking about yellow, does this new story here mean that it is more likely or less likely that Japan will actually hit the 2030 transition target, decarbonisation target, and then suddenly, your mind set has shifted, and you're starting to think about numbers about these things, rather than good to have sort of features. And I think that is actually going to be a game changer in terms of how people are looking at the market, and the Enel case with the bond price changes that happen post to step up there definitely has changed some market participants may be not necessarily ESG investors, but general investors say, oh, I need to look at the probability that a certain certain company is going to hit their renewables target or not. And what is markets? Effective for if not actually, when they start being interested in that way?



26:40

That's very good point. Thank you. So looking ahead, where do you see the SRB? market moving in the future? And are there any particular challenges or opportunities that you feel are important to highlight?



26:55

So on the one side, I essentially think that you know, the sky is the limit, no transition is something happening for everyone who's borrowing through bond markets. And one way to suss out what people who believe in the transition targets decarbonization targets, and not just ask them to put it into bone structure and say, you're going to get this like a different cost of capital if you achieve them, and a higher cost of capital if you don't, because I as an investor, I believe effective transition is actually going to de risk my investments. So please, let me let me invest accordingly. Now, there are difficulties with the market insurance hasn't been great to say the least this year. And last year, there has been a first batch of SMBs that have had all the critiques and so on. And there's also a little bit of, I think, an issue or a challenge with this classification frenzy, when it comes to sustainable products, or labeled bonds out there. If you're an insider, you want it to be exactly what is already there. If you're an outsider, it's hard to get on the inside. And as the beasts are definitely sort of seen as outsiders right now. So

there's definitely some challenges for the market. But we'd get theory and ambitious targets. And so sort of Lighthouse deals coming through on this. And we hope to be a part of crystallizing or capitalizing someone that it could be an extremely powerful type of instrument. There's no restrictions. You could have it on all bonds out there. You could essentially put in sustainability links if you were going to be extreme. But



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