abrdn Position Statement – Green, Social and Sustainable Bonds

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Definition and history of GSS bonds

Green, social and sustainable (GSS) bonds are generally considered to be fixed income instruments whose proceeds will be exclusively used to finance or refinance activities with clear environmental benefits, social benefits or both. GSS bonds are use of proceeds bonds, meaning that the funds raised are ringfenced or earmarked for particular projects. Conversely, Sustainability Linked Bonds (SLBs) proceeds are not ringfenced and may be spent on general corporate purposes, or other activity. Instead, the SLB's financial and structural characteristics are based on whether the issuer achieves sustainability Key Performance Indicators (KPIs) within a given timeframe. Our position on SLBs can be found on our Sustainable Investing webpage.

The International Capital Markets Association (ICMA) initially established the **Green Bond Principles**, a voluntary set of guidelines for green bond issuance. ICMA has also published the **Social Bond Principles** and the **Sustainability Bond Guidelines**. These guidelines cover the use of proceeds; project evaluation and assessment; management of proceeds and reporting.

What is abrdn's view of Green, Social and Sustainable Bonds?

In our view, GSS bonds help to fund numerous activities that have positive benefits for the environment and society. Green bonds are key enablers in the transition to a low carbon economy, whilst social bonds' projects aid the most vulnerable in society. Sustainable bonds can target both outcomes. At abrdn, we have capabilities to invest in sovereigns, public issuers and private credit, therefore we don't only target large cap companies which have access to the equity and public bonds market. In the private credit space, GSS transactions can help in a transition to a low carbon economy for smaller issuers/projects. Investing in the illiquid private credit market can provide clear environment and/or social benefits in sectors such as utilities, healthcare and transportation.

Allocating capital to improve the environment, mitigate climate change or to achieve social benefits is positive in our view. However, as responsible investors, it is essential we consider numerous factors in order to find the most attractive and high quality GSS bonds. In both public and private credit, we focus not just on how the bond's use of proceeds are spent, but also on the ESG credentials of the issuer itself. We invest in GSS bonds from issuers we perceive to be ESG leaders as well as laggards. This is because we believe that GSS bonds can be an indication of improving ESG credentials, as issuers take a step toward funding projects with clear environmental and societal benefits.

What are the challenges associated with GSS bonds?

At abrdn, we have identified two main challenges to GSS bonds:

Variation in quality: The increase in popularity of GSS bonds in recent years has led to greater scrutiny of the quality and robustness of bonds labelled "green", "social", or "sustainable". Several guidelines, principles, taxonomies and standards have been established to define and provide clarity to what constitutes as a GSS labelled bond. Namely these guidelines aim to address the main features of GSS bonds, the types of activities that are eligible, the governance of sustainable financing and provisions around reporting. However, there is still significant variation on the quality of GSS bonds because such standards are often non-mandatory. Therefore this requires investors to make assessments and differentiate quality between GSS bonds.

Greenwashing: With such flexibility around standards of GSS bonds, issuers and investors are exposed to risks of greenwashing – where issuers overstate or misrepresent green credentials. Issuing a bond with a sustainable label is not enough to make an issuer sustainable. For example, allocating capital to a project with excellent green credentials may not be appropriate if the issuer displays contrary practices throughout the rest of its organisation. This exposes investors to greenwashing and reputational risks, where the GSS label does not fully reflect the ESG credentials of the issuing entity.

What is abrdn's approach to GSS Bonds?

For the reasons above, we have developed an internally consistent GSS bond evaluation framework. This approach ensures a minimum level of consistency in our GSS bond evaluation and enables us to distinguish between stronger conviction/high quality GSS bonds versus controversial/lower quality ones. This framework for assessing GSS bonds is in addition to our fundamental credit and ESG research of the issuer.

We principally agree with the goals and benefits of GSS bonds. Purchasing these bonds can support an issuer's ability to raise capital to fund projects with positive externalities such as tackling climate change or providing affordable housing.

However, we believe investors need to take a holistic approach to investing in GSS bonds. **At abrdn, we consider the issuance and the complexity around GSS labels in tandem with the ESG creditability of the issuer.** We consider all factors that could influence a GSS's performance including ESG and fundamental aspects.

For the public credit space where there is more uniformity in GSS bonds, we have developed the following assessment to identify credible GSS bonds:

Does the issuer meet minimum credit and ESG standards?

It is important that the credit profile of the issuer is attractive regardless of the projects promoted by the bond. If the issuer is rated a sell by the credit analyst, it is unlikely that we would consider purchasing a GSS bond from that issuer and we would not pursue the issue in question. We consider the ESG view of the issuer using our proprietary Fixed Income ESG Risk Rating framework and our ESG House Score to ensure that the issuer meets minimum standards. For sovereigns, we take into account our proprietary ESGP score, where "P" stands for politics.

We expect the issuer to demonstrate that GSS financing is part of its overall strategy and sustainability effort. The issuance of a GSS bond is not a substitute for a long term sustainability strategy. A key consideration is whether the issuer has broader ESG commitments and targets. We also focus on governance, as we believe that well managed issuers will have the ability to execute a sustainability strategy.

Alignment with Green, Social or Sustainability bond standards

When considering an issuer's green, social or sustainable financing framework, we look for alignment with at least one of any widely acceptable green, social or sustainability bond standard. We also view positively alignment to regional guidance and taxonomies such as from the EU, China and ASEAN. In particular, we look for clear disclosure of use of proceeds. In order to avoid greenwashing, the bond should be clearly funding green or social activities/projects with 100% of the financing raised, with no proceeds earmarked for general corporate purposes.

We also seek to gain a comprehensive understanding of the management of proceeds and expect disclosure regarding how unallocated net proceeds are managed, the type of instruments they are invested in, and the timescales for distribution. Unclear disclosure of management of proceeds may provide loopholes for issuers. For example, some issuers may hold unallocated proceeds in Greenhouse Gas (GHG)-intensive or non-climate friendly instruments if its framework is weak.

External review

To ensure that the green, social or sustainable financing framework relevant to the bond issuance is credible, we expect an external review to have been carried out. This may include: second-party opinion, verification, certification or a rating. Self-labelled bonds require further investigation. For example, some issuers may label their bond as a GSS bond without seeking any external validation of this claim. In these instances, the issuer's credibility is undermined.

Does the GSS bond meet 'Do No Significant Harm' criteria?

Finally, we ask ourselves whether it is reasonable to assume that the overall project will result in a net positive outcome from an environmental and social perspective. We expect issuers to clearly list activities that the proceeds will not be spent on. For example, we would expect a utility issuer with fossil fuel assets to confirm that fossil fuel operations are excluded from the scope/list of eligible projects.

Conclusion

Our approach to assessing GSS bonds ensures a minimum level of consistency in our evaluation and enables us to distinguish between stronger high quality GSS bonds versus lower quality ones. However, it is important that the framework is considered as part of the overall credit and ESG evaluation process of the issuer and bond.

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