Sustainable Bond Market 2023 – Mid-year forecast

Sustainable Bond Market: Quo vadis?

With a new issuance volume of approximately USD 228bn in the first quarter, the Sustainable Bond market has gotten off to a solid start in 2023. A glimmer of hope after the challenging year of 2022?

In recent years, the Sustainable Bond Market has only known one direction. "Forward ever, backward never", was the undisputed motto. Even at the epicenter of a pandemic in 2020, in which Social and Sustainability Bonds soared, the Green Bond segment, which had initially slumped in a tremendous way, fought its way back to new heights. Hence, at the beginning of the year, no one doubted that the success story of the labelled bond market would continue in 2022.

However, in 2022, for the first time in more than a decade, the Sustainable Bond market saw a decline in new issuance volume by -23% affecting every single segment. The new geopolitical reality led to tough fixed income market conditions which these labelled bonds have never faced before: rising energy and commodity prices, a global inflation surge, the end of a decade of ultra-low interest rates.

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Dear Reader,

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

Now that almost the first half of 2023 has passed, it can be said that the market for Sustainable Bonds has made a solid start. This is particularly pleasing after the Sustainable Bond market had to record a decline in new issue volume of around 23% in 2022 for the first time in more than a decade, while still the relative share of the overall market nevertheless increased. Even though we expect positive growth again in 2023, we do not expect new issuance volume of Sustainable Bonds to go through the roof in 2023 due to an uncertain macroeconomic outlook and ongoing geopolitical risks. According to our forecast, new issuance volume in the global Sustainable Bond market will increase by around 36% and exceed USD 1bn in 2023. There have also been important regulatory developments in recent months. For example, on 28 February 2023, the European Council announced a preliminary agreement between the three EU institutions (European Commission, European Council and European Parliament) on the European Green Bond Standard (EuGBS).

Enjoy reading!

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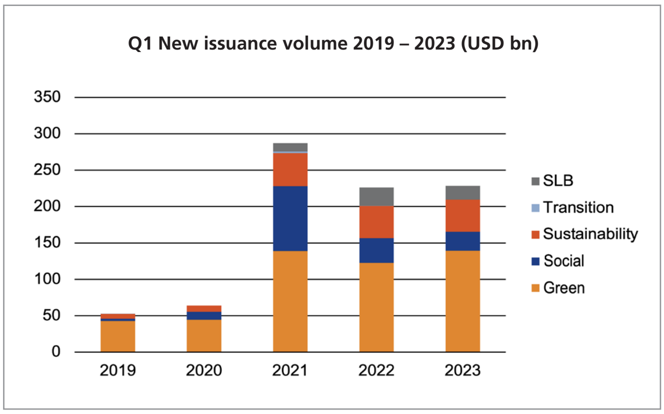


Source: DZ BANK, Bloomberg

While the mature Green Bond segment proved relatively resilient with a decline of only around 13%, new issuance volumes of Sustainability Bonds (-21%), Target-linked and Transition Bonds (-37%) and Social Bonds (-44%) were less immune to the rough market conditions. With a share of 60% of new issuance volume in the Sustainable Bond Market, the Green Bond segment hence proved to be a solid anchor in turbulent times.

The negative surprise of the year was without a doubt the fall in Target-linked Bond issuance - both in volume and market share. The 2021 darlings have had a tough time, especially in the second half of the year, as fears increasingly emerged that such a structure could expose issuers to potential legal risks. In addition, the voices of critics among investors and banks grew louder, flagging greenwashing concerns about Target-linked debt.

Despite a tough and volatile market environment, there were also bright spots in the Sustainable Bond market. The new issuance volume of Sustainable Bonds in 2022 declined less sharply than that of traditional bonds. The share of new Sustainable Bonds issues in the overall debt capital market therefore continued to rise to around 18% in 2022 (2021:15.8%). Furthermore, Sustainable Bond issuance from financial institutions surprisingly increased by approximately 21% to around USD 187.5bn. Thanks to its dynamic and resilience the Green Bond segment hit the USD 2tn milestone (cumulative issuance since the kick-off of the segment in 2008) at the end of the third quarter.

Return to qualitative growth

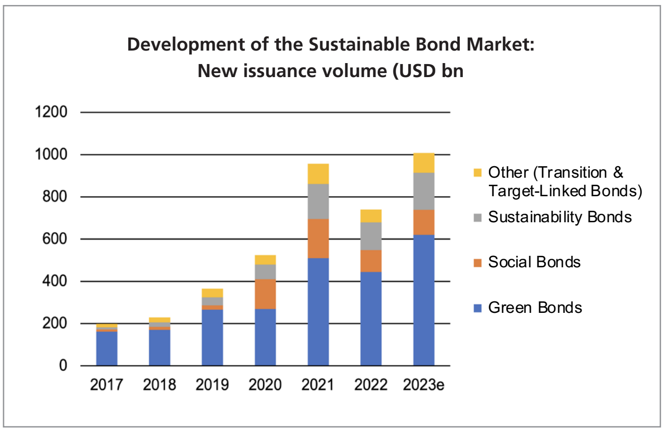
The overall bond market appears to be in a much more promising position than it was last year. However, the uncertain macroeconomic outlook and persisting geopolitical risks should still be a concern for fixed income investors. Hence, we do not expect the new issuance volume in the Sustainable Bond market to go through the roof in 2023. It will not be until 2024 before the Sustainable Bond Market sets off for new record heights in growth rates.

However, as investor appetite for Sustainable Bonds remains strong, we expect a gradual return to growth in all segments of sustainable debt in 2023. It will remain a growing portion of overall issuance and we expect Sustainable Bond issuance to outperform the broader bond market once again in 2023.

We forecast further diversification both by issuers and themes. Investor interest in Sustainable Bonds remains high. There is still too much demand chasing too little supply. ESG integration in portfolios is further on the rise. And it goes far beyond climate issues. Investors are also increasingly looking at nature-related issues or social issues in their fixed income engagements. Improving market conditions ensure that maiden issuers who deferred their sustainable funding in 2022 regain confidence and come to the market with their inaugural issues in 2023. We also expect to see a further pick-up in issuance from emerging markets.

According to our forecast new issuance volume in the global Sustainable Bond market will rise by around 36% to surpass USD 1tn in 2023 (2022: USD 740bn; 2021: USD 957bn). In contrast to some record years in the past, this regained growth will be qualitatively rather than quantitatively driven. We forecast that the share of new Sustainable Bond issues in the overall market will rise to around 20%.

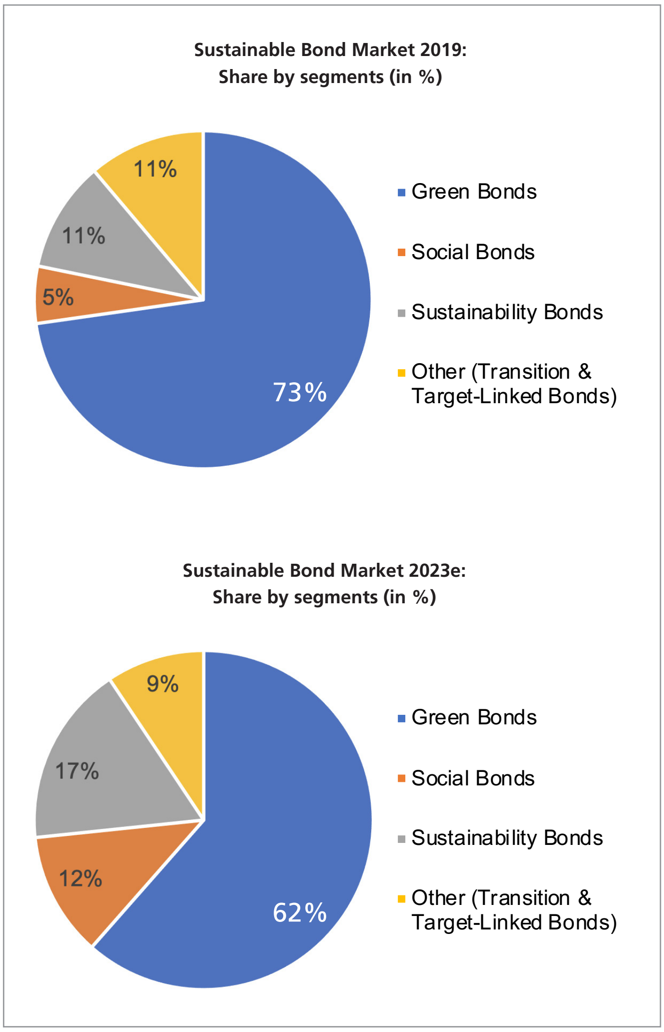
With an estimated share of 62% the Green Bond segment will remain a guarantor of growth in 2023. We expect new issuance volume to increase by almost 40% to around USD 620bn. The new geopolitical reality revealed that accelerating the energy transition is not only key to tackle climate change but that it is also pivotal to ensure energy security. Hence, growth in the Green Bond segment will be supported by the policy push towards low-carbon energy projects in key regions like the EU and the US. Furthermore, we expect that nature-related risks will move up the agenda of Green Bond issuers and investors. By putting Sustainable Development Goals like "Life on land" and "Life below water" into the sustainable funding focus, the foundation is laid for more and more



Source: DZ BANK, Bloomberg

biodiversity-focused transactions. Growth of the Green Bond segment is also backed by supportive polices and regulations around the globe. Further steps by the ECB to incorporate climate change into its monetary policy, the launch of China's Green Bond Principles or the Inflation Reduction Act in the US are only a few examples.

We expect market participants to rediscover their interest in Target-linked structures. We are confident that issuers and arrangers can address the growing concerns of this instrument by focusing on Key Performance Indicators (KPIs) that are material to the business model of the issuer and ambitious Sustainability Performance Targets (SPTs) to enhance the quality of Target-linked financing via the fixed income market and thus its credibility. Target-linked instruments play a key role in transition finance and the need for it to successfully implement the Paris agreement is undisputed. 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. Furthermore, Target-linked structures are also very suitable for addressing biodiversity issues in funding, as it is often challenging to define what a biodiversity asset or project is. Another argument for qualitative growth of Target-linked instruments, is the growing appetite of investors for a mix of Target-linked and Use-of-Proceeds structures. Austria's Verbund AG, one of the largest producers of electricity from hydropower in Europe, has issued in March 2021 the world's first bond combining Use-of-Proceeds and KPIs: a so-called "Green and Sustainability-Linked Bond". Recently the Dürr Group, one of the world's leading mechanical and plant engineering firms, has issued a Green Schuldschein whose proceeds have been earmarked solely for sustainable product innovations and climate-friendly projects and whose coupon is in addition tied to Dürr's sustainability rating. We expect other issuers in the Sustainable Bond market to follow these examples.



Source: DZ BANK, Bloomberg

We forecast a strong pipeline in Sovereign Sustainable Bond issuance as a couple of maiden issuers like Brazil are waiting in the wings to come to the market this year. Sharjah's recent sustainability debut gave an impetus for Middle East, and we expect other sovereigns in the region to line up for issuing Sustainable Bonds and sukuks. Sovereign issuers already established in the market are looking to expand their sustainable funding activities, such as Indonesia, which is planning to issue a Blue Bond. Sovereign Target-linked Bonds are becoming increasingly popular among smaller sovereign issuers. Following the success of Chile and Uruguay, it can be assumed that the instrument will establish itself in the market beyond Latin America and that we will also see issuances from Southeast Asia, for example.

EU Taxonomy – The wait is over!

The EU taxonomy is moving forward! As a reminder: Six environmental objectives have been defined for the taxonomy. However, the Delegated Acts including the technical screening criteria whether an activity makes a substantial contribution to at least one environmental objective („Substantial Contribution") without harming any of the other 5 environmental objectives („Do No Significant Harm") have only been defined for the first two climate-related objectives: Climate Change Mitigation and Adaptation. Affected companies must already report for the past business year which activities are compliant with these objectives. Whether their activities basically fall under the other four environmental goals – the sustainable use and protection of water and marine resources, the transition to a circular economy, the prevention and reduction of environmental pollution and the protection and restoration of biodiversity – companies should actually also have been reported for the past year. However, the Delegated Acts containing the technical screening criteria have been missing so far. Since the publication of a first draft of the „Platform on Sustainable Finance" at the end of March 2022, it had been conspicuously silent. This has now changed, as the European Commission published more concrete consultation drafts on 5 April 2023, combined with a call for feedback until 3 May, in which any interested person, institution or company could participate. The feedback is also publicly available for every interested party. After the end of the consultation period, the Delegated Acts will be finalised so that companies will have to report taxonomy compliance for the current financial year 2023 and taxonomy compliance for the financial year 2024 on the newly defined activities. In addition, new criteria for sectors not yet covered were added for the already existing environmental targets and some existing criteria were amended.

But what does this mean exactly? If we look at the amendments for the already existing climate-related technical criteria, two prominent changes stand out. First of all, automotive suppliers now seem to be included in the taxonomy: Activity „3.18 Manufacturer of automotive and mobility components" is added to the environmental goal „climate protection", probably to take into account the fact that although car manufacturers have been represented in the taxonomy as manufacturers of the end product of low-emission or zero-emission vehicles so far, this did not apply to the value chain. However, the steering of financial flows into this very supply chain is no less important than that of the manufacturers themselves. The new activity 3.18 now explicitly talks about „manufacturing, repair, maintenance, retrofitting, reuse and upgrading of mobility components for zero-emission personal mobility vehicles, as well as vehicle and mobility components, systems, separate technical units, parts and spare parts". The second major change concerns aviation: both the manufacturing and leasing of aircraft („3.21 Manufacturing

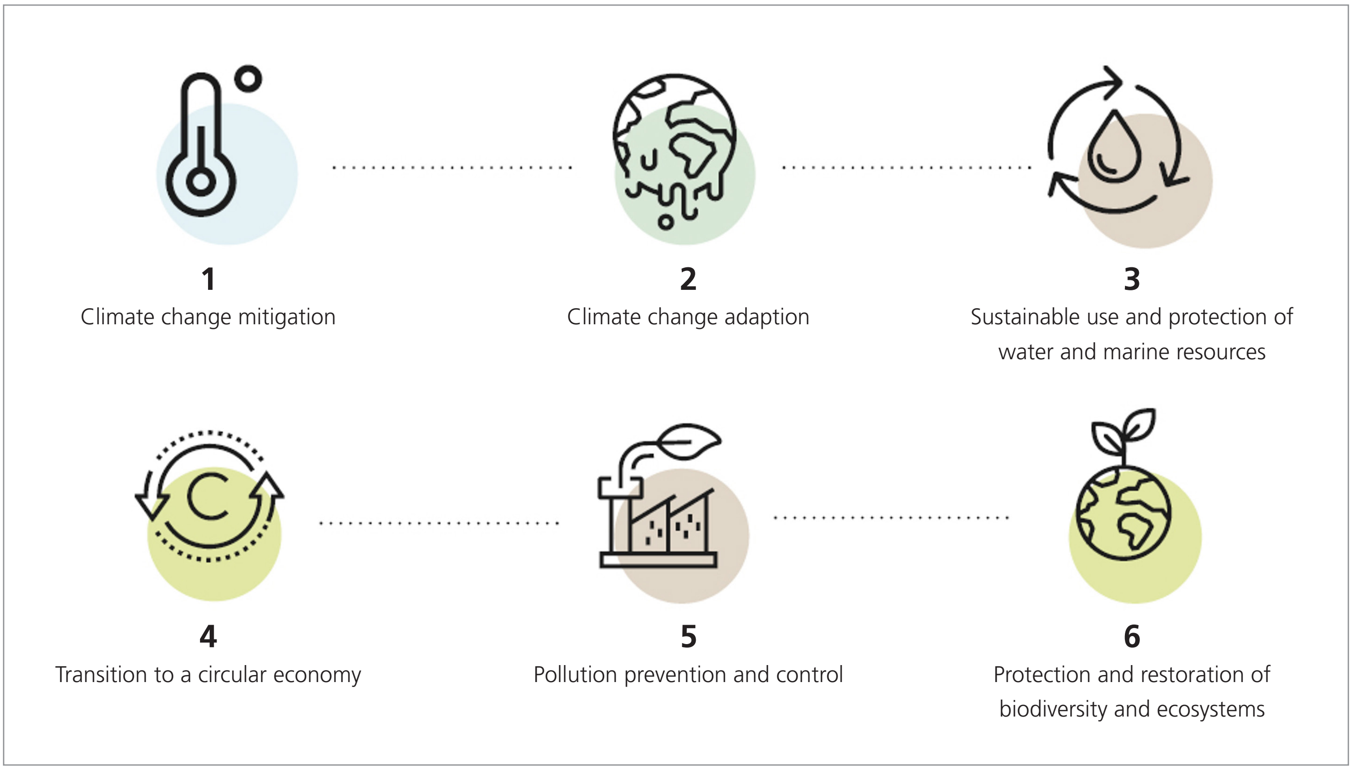
What the EU Taxonomy is	What the EU Taxonomy is not
A classification system to establish clear definations of what is an environmentally sustainable economic activity	It's not a mandatory list invest in
Tool to help investors and companies to make informed investment decisions on environmentally sustainable activities for the purpose of determining the degree of sustainability of an investment	It's not a rating of the "greenness" of companies
Reflecting technological and policy developments: The Taxonomy will be updated regularly	It does not make any judgement on the financial performance of an investment
Facilitating transition of polluting sectors	What's not green is not necessarily brown. Activities that are not on the list, are not necessarily polluting activities. The focus is simply on activities that contribute substantially to environmental objectives.
Technology neutral	
Fostering Transparency by disclosures for financial market participants and large companies related to the Taxonomie	

Source: European Commission – EU Taxonomy Navigator (2023) of aircraft", „6.18 Leasing of aircraft"), as well as passenger and freight air transport and ground handling operations („6.19 Passenger and freight air transport", „6.20 Air transportation ground handling operations") are added. For the „hard to abate" sector, which provides critical infrastructure for the economy, this is an important sign that sustainable investments are already possible here according to the taxonomy. However, these are explicitly transitional activities, unless the aircraft already have no direct CO_2 emissions, which in practice, however, does not play a major role. For all other aircraft manufactured or operated, one of the requirements is that they may not be manufactured or operated for private or commercial business aviation, are taxonomy-compliant in manufacture until 2027 and in operation until 2029 with certain efficiency improvements compared to current fleets, but must be operated with Sustainable Aviation Fuel (SAF) at the latest thereafter. For aircraft not yet operating on SAF, the technical assessment criteria specify that older aircraft must be replaced accordingly to ensure that the global fleet is not increased as a result.

In total, there are 17 new or materially adapted activities for „climate protection", whereas there are six new or materially adapted activities for „adaptation to climate change". For the four new environmental goals, the situation is as follows: for the „Sustainable use and protection of water and marine resources", six activities were defined, including „Nature-based solutions for flood prevention and drought protection" and „Sustainable urban drainage systems". The „transition to a circular economy" has the largest share with a total of 21 activities, here topics such as the „production of plastic packaging", „production of electrical appliances", „provision of data-driven IT/OT solutions and software" or „preparation for the reuse of end-of-life products and product components" are new additions to the taxonomy, while other activities such as the „construction of new buildings" were already included in other climate-related environmental goals. For the environmental goal „prevention and control of pollution", six activities have been defined (including „production of pharmaceutical products"), while for the last of the six goals - protection and restoration of biodiversity and ecosystems – two activities have been added so far, one of which is the operation of „hotels, resorts, campsites and similar accommodation".

Similarly, there are proposed amendments to the general taxonomy disclosure regulation, but these are largely technical.

The feedback period ended on 3 May 2023, so we expect the final Delegated Acts to be published probably in early Q3 2023, but in the best case already at the end of Q2 2023. As the drafts now published build on the last publication from March 2022, we do not expect there will be any material changes in the final version, so the drafts already provide companies with a good basis for preparing for the new reporting requirements.



Source: European Commission – EU Taxonomy Navigator (2023)

White smoke in Brussels – European Green Bond Standard

On 28 February 2023, the European Council announced a provisional agreement between the three EU institutions (European Commission, European Council and European Parliament) on the European Green Bond Standard (EuGBS). The EuGBS Regulation aims to establish uniform requirements for bond issuers wishing to use the designation „European Green Bond" or „EuGB" for their environmentally Sustainable Bonds that are in line with the EU Taxonomy and made available to investors worldwide.

After the European Commission had already published its first draft law on the EuGBS in July 2021, the European Council and the European Parliament also published their own drafts in April 2022 and June 2022, respectively. Based on these drafts, the trilogue negotiations between the institutions began in June 2022, which now came to a temporary end with the political agreement at the fifth meeting. The agreement is provisional, as it still had to be confirmed by the Council and the European Parliament and adopted by both institutions before it became final. After the Council confirmed the text on 10 May, it now only needs confirmation by the Parliament. The provisional date for the first plenary session in the EU Parliament is 11 September 2023. The Regulation is expected to be applicable 12 months after its entry into force and the corresponding publication in the Official Journal of the EU. This means that the EuGBS will probably only be applicable from the fourth quarter of 2024.

So far, no final text has been officially published. However, some key points regarding the design of the EuGBS have already been shared with various observers. An important announcement, which will presumably be a relief for many market participants, is that the EuGBS will in any case be applicable on a voluntary basis for the time being and that issuers of „conventional" Green Bonds (i.e. no EuGB) and Sustainability-linked Bonds will not be subject to any mandatory disclosure requirements. Here too, the regulation provides for some voluntary disclosure guidelines for issuers of bonds marketed as environmentally sustainable and Sustainability-Linked Bonds.

EU Taxonomy compliance with some degree of flexibility

One of the key issues in the EuGBS requirements is, and will continue to be, the compliance of the activities financed with the proceeds of an EuGB with the EU Taxonomy. However, the provisional agreement offers a certain degree of flexibility to EuGB issuers. Thus, a „flexibility pocket" of 15% is granted for the use of the issuance proceeds if they are used for one of the following activities: i) economic activities for which no technical screening criteria have entered into force at the time of issuance, provided that these activities meet the general „Do No

Significant Harm" requirements, or ii) activities related to international support. In the second case, the relevant technical screening criteria are to be met on a „best-effort" basis. However, the European Council has already announced that the use and need for this flexibility pocket will be reassessed as Europe's transition to climate neutrality progresses and the number of attractive and environmentally friendly investment opportunities that are likely to become available in the coming years has increased.

General grandfathering period of seven years

The question of a possible grandfathering period was also one of the main points of contention discussed in the trialogue. Issuers feared a grandfathering period that might be too short, which could jeopardise the status or label of an EuGB during the life of the bond, not to mention the impact on the secondary market performance of a bond that would lose its EuGB status. The agreement provides for the approach of a general grandfathering period of seven years, regardless of the type of activity or the type of investment of the proceeds. However, this grandfathering period only applies to issuance proceeds not already allocated and proceeds covered by an investment plan that have not yet met the Taxonomy requirements (more on this below). By way of derogation, issuers allocating proceeds under a portfolio approach may only include in their portfolio financial assets for which the underlying economic activity complies with the technical screening criteria applicable at any time during the seven years preceding the publication of the Allocation Report. It is worth mentioning the possibility for issuers to allocate the proceeds from a portfolio of one or more EuGBs to a portfolio of fixed and financial assets.

Use of proceeds and investment plan

The basic rule for the use of the proceeds of a EuGB is that, taking into account the Taxonomy requirements, they may only be used exclusively and in full for the following purposes: fixed assets (which are not financial assets), capital expenditure (capex), operating expenditure (opex), financial assets and assets and expenditure of households. In the case of financial assets, however, there is the additional requirement that they were created no later than five years after the issuance of the EuGB. Furthermore, as is common practice, there is generally the possibility of deducting any issue costs before the issue proceeds are allocated.

As already indicated above, issuers also have the option of preparing an investment plan. This is necessary if the use of the proceeds relates to economic activities that will only fulfil the requirements of the Taxonomy in the future. The investment plan must, among other things, define a cut-off date that is prior to the maturity of the EuGB and by which all financed CapEx and OpEx are in compliance with the Taxonomy. A confirmation of Taxonomy compliance must then be provided by an external auditor no later than 60 days after this cut-off date.

Transparency and external review in line with expectations

Similar to the current practice in the market of creating a Green Bond Framework, which is reviewed by an independent external party, e.g. with regard to compliance with the Green Bond Principles, the EuGBS also has high standards of transparency. For example, prior to an EuGB issue, the EuGBS requires the issuer to complete the EuGB factsheet and have it reviewed by an independent external party. The external review must be conducted by an external party registered by ESMA and must result in a positive opinion. The relevant factsheet provided by the EuGBS may relate to single or multiple EuGBs.

With regard to reporting, there is also a great deal of overlap with current market practice under the Green Bond Principles. For example, the EuGBS requires reporting on the allocation of the issue proceeds on an annual basis until the proceeds are fully allocated. The EuGBS also provides a template to be used for this purpose. However, the EuGBS requires an external audit of the allocation reporting by a registered external auditor after the proceeds have been fully allocated. By way of derogation, issuers using the portfolio approach are required to have an annual external audit of the allocation reporting. In addition, EuGB issuers shall also publish environmental impact reporting after full allocation of proceeds and at least once during the life of an EuGB using a template provided by the EuGBS. External verification of the environmental impact reporting remains voluntary.

A special feature with regard to external auditing is provided for „sovereigns" in that they can also use state auditors in addition to registered external auditors. However, the latter may only confirm the allocation of the issue proceeds, while compliance with the Taxonomy requirements must still be confirmed by a registered external auditor. „Sovereign" here means a Member State of the EU or a local authority of a Member State, public international bodies of which one or more Member States are members, the European Central Bank or the central banks of the Member States.

Prospectus requirements and further provisions

Apart from the usual prospectus requirements within the EU, EuGBs must also be consistently designated as such within the prospectus as well as stating in the chapter on use of proceeds that the EuGBs are issued in accordance with the EuGB Regulation.

Twelve months after the entry into force of the regulation, it should be applicable. The agreement also provides for the Commission to publish a report by the end of 2024 (i.e. three years after the entry into force of the first Delegated Act on the Taxonomy) and every three years thereafter, informing EuGB issuers of current developments and reviews. Five years after the entry into force of the EuGBS and every three years thereafter, ESMA and the Platform on Sustainable Finance shall deliver a report to the Parliament and the Council. This report should, among other things, describe the implementation of the EuGBS within the EU and globally. It will also describe the impact of this regulation on the transition to a sustainable economy and on the investment gap to achieve the EU's climate targets.

Furthermore, a transitional period of 18 months after the applicability of the Regulation is introduced, during which external reviewers may perform their services without registration with ESMA, subject to prior notification of ESMA and provision of the information necessary for subsequent registration.

Gold standard in the Green Bond market

So while the agreement within the trialogue is welcome as it provides more clarity on the issue of the EuGBS, it is questionable whether the EuGBS will be widely adopted in the market at the beginning of its applicability. This is especially true as the compliance (of at least 85%) of the financed activities with the EU Taxonomy will be a major hurdle for many issuers. The high demands of the EuGBS thus support the original intention of the Commission to create a kind of gold standard in the Green Bond market with the EuGBS, at least initially.

Interview:

The Council of Europe Development Bank and its social DNA: recent Developments and further Insights

Arturo Seco Presencio
Deputy CFO, Head of Funding, Treasury and ALM at Council of Europe Development Bank

We have seen a lot going on inside the Council of Europe Development Bank (e.g. the new strategic frame-work 2023-2027 being published or the overall capital increase) – Could you elaborate the core elements of this development?

The year of 2022 was quite historic for us in many respects. Our leading role in supporting the social cohesion in Europe as the only multilateral development bank with a unique social mandate and the growing need for us to deploy more capital to projects was well recognised. Member States confirmed their support with respect to Ukraine's ongoing accession process to the Council of Europe Development Bank (CEB) and the country became the 43rd member state in June this year. Ukraine, which is already a member of the Council of Europe, had requested Bank member-ship in May 2022. To make it possible, governing bodies approved an overall capital increase to a maximum of EUR 4.25 billion. For the first time in the CEB's history, the paid-in capital increase, amounting to EUR 1.2 billion, will be financed through cash contributions from the member states. This stronger capital base will help drive the CEB's new Strategic Frame-work 2023-2027. The Framework has three overarching goals:

1. Respond to the challenges of European social development and inclusion in a determined and flexible manner;
2. Invest in assisting and integrating refugees and migrants within their host communities, and in Member States' pre-paredness for a future in which migration will likely continue strongly, notably because of climate change;
3. Support the reconstruction and rehabilitation needs of Ukraine's social sectors, in particular affordable housing and healthcare.

Public institutions often face the reputation to take some time to react. CEB on the other hand responded to the COVID-19 Pandemic and the war in Ukraine (regarding the influx of refugees to the neighbour countries) immediately through the issuance of Social Inclusion Bonds. How do you keep this agility?

As stated at the outbreak of the COVID-19 crisis, the CEB is committed to providing timely, flexible, and targeted financing to our member countries, both during the COVID-19 crisis and on the road to recovery. This applied to subsequent crisis as witnessed during the Ukraine refugee crisis since February 2022 or, more recently, following the earthquake in Turkey in 2023. Here, three steps can be distinguished:

Step 1:
Identifying needs: the CEB (e.g. the Senior Management or the Country Managers) is in constant dialogue with its member countries.

Step 2:
Putting procedures on a fast-track: projects were approved within a drastically reduced timeframe (i.e. for Ukraine-related projects, the timeframe was of less than 2 months vs. 6 months under the normal timeframe; for COVID-19: All requests for COVID-19 funding were being appraised once a week and then put to the Administrative Council for approval, which reached its decisions through written procedures and on a monthly basis). Some waivers were introduced on the proportion of the total cost of projects that can be financed from the CEB loan, and the possibility for the first disbursement tranche to exceed the usual ceiling of 50% of the total loan amount.

Step 3:
Raising funds on capital markets: be it for the COVID-19 crisis or the Ukraine refugee crisis, the CEB was the first MDB to issue benchmark-size targeted Social Bonds (focused on health sector and refugees, respectively):

– COVID-19 Response Social Bonds in 2020:
  - 31 March – ICMA Guidance for Social Bonds addressing the COVID-19 crisis
  - 02 April – EUR 1 billion 7-year
  - 02-09 April – first update of the Social Inclusion Bond Framework to include Health sector into the sectors able to be financed with the bond proceeds
  - 03 June – USD 500 million 3-year

– Social Bonds targeting Ukraine refugees in 2022:
  - 06 April – EUR 1 billion 7-year
  - 27 April – ICMA guidance for the use of Social Bonds to raise capital for social projects to support fragile and conflict states
  - 08 June – upsized USD 1 billion 3-year
  - 1 September – the Bank of Lithuania invested EUR 100 million in an increase of the 7-year Social Inclusion Bond first issued in April

To summarise, the CEB is a very nimble organisation reacting fast to social challenges faced by its member states. Having this clear social mandate allows us to move fast when we see social disruption and the way we are set up as a multilateral development bank allows us to make decisions quickly.

CEB recently published its impact report on the Social Inclusion Bonds – for the first time, you made a reference to the AAAQ dimension which is also mentioned in the final report of the Social Taxonomy: What was the reason for that?

We have been at the forefront of markets developments in the harmonisation/regulation effort that is being deployed. This is to best serve the development of the Social Bond market, enhance transparency and assist investors in their assessment of Social Bonds prior to investments. Referencing to the AAAQ dimension (mentioned in the final report of the Social Taxonomy) in our impact report on the 2022 Social Inclusion Bonds is part of this effort and to serve that harmonization end goal. The CEB actively participated in the relevant sub-group of the Platform for Sustainable Finance, that proposed a structure for a Social Taxonomy.

The CEB sees value in working on a Social Taxonomy to improve Social Bond market harmonisation and transparency for investors' benefit – In the end, this would also increase overall ability to finance social projects globally to benefit the most vulnerable population.

Different member countries, different minimum safeguards: How does CEB deal with this circumstance, e.g. regarding possible investor questions but also against the background of your own internal processes and guidelines?

The CEB has a formalized project screening approach which takes into account four pillars in assessing the social added value of loans, "the four-pronged approach":

1. Country scoring of project location (e.g. GNI or the PPP of country)
2. Social scoring (e.g. social outcomes, target population, or the adequation of social and environmental safeguards)
3. Environmental scoring (e.g. potential for climate mitigation, adaptation, GHG emission reduction, or the climate change sensitivity)
4. Project scoring (e.g. the clarity of objectives or means to achieve them)

This approach is tailor-made to fit the institution's MDB nature, to address social needs in all member states based on their own specifizcities and highest standards existing in each one of them.

You define one main objective of your business model, social cohesion, as: "the capacity of a society to ensure the well-being of all its members, minimising disparities and avoiding marginalisation". Could you please elaborate on that?

Let's start with the concept of social cohesion first. No society is fully cohesive nor is that realistically attainable. However, whenever inequalities grow too large it causes widespread social and economic issues. A cohesive society has satisfactory ways of coping with these in a democratic manner and by doing so they successfully minimise disparities and avoid marginalisation.

The CEB provides member states funds to finance projects that help to meet this goal. You can see more concrete examples of such projects in our Social Inclusion Bond reporting. In the Framework, we have four Eligible Project Categories: health and social care, education, social housing, and finance to micro, small & medium sized companies. All of these categories are instrumental in improving social cohesion, because they improve access (and quality) to essential services and generate growth opportunities to MSMEs.

To give an example, under the health care category, one of the core social rights is "availability of quality services affordable by all". So far with our SIBs we have financed 1180 healthcare establishments across Europe. You can imagine that this translates into millions of patients visits every year with improved access to high quality services.

Implementation of the EU SFDR – Status quo with practical pitfalls

EU SFDR takes form – some aspects require further shaping

Let's take a quick look back. Since March 2021, the European Sustainable Finance Disclosure Regulation (EU SFDR) has been gradually introduced as part of the EU Action Plan on Sustainable Finance, which was already established in 2018 and targets to guide capital flows towards sustainable investments. In this context, the EU SFDR is intended to help raise transparency standards in the market for sustainable investments, better educate consumers, enable them to take informed suastainable investment decisions and prevent so-called „greenwashing" in the process.

What is the EU SFDR?

The EU SFDR calls for comprehensive disclosure requirements for financial products. It classifies investment funds into three different categories in terms of sustainability. Article 6 funds refer to products that do not formally have sustainability features. However, it is important to note that providers of these products are nevertheless obliged to disclose sustainability risks of the fund in the prospectus. If these are not present, the reasons must be disclosed („comply or explain" clause). In the case of Article 6 funds, there is generally no sustainable investment objective; furthermore, no investments are made in assets with formal environmental or social benefits.

If the investment funds have sustainability characteristics, they are to be classified either under Article 8 or Article 9. Investment funds are classified under Article 8 if, in addition to an investment objective, they have positive environmental or social investment objectives within the meaning of the EU Taxonomy and follow good corporate governance practices. The so-called DNSH („do no significant harm") criterion must be followed, i.e., the investments made may not conflict with the objectives of the EU Taxonomy or cause significant harm.

The investment products with the strictest requirements fall under Article 9. The primary objective of an Article 9 fund is a sustainable environmental or social investment objective and/or an emission reduction target in line with the Paris Climate Agreement. The DNSH criterion is also followed. Furthermore, the product must have a benchmark that makes the sustainability target measurable.

EU SFDR in practice

So far, the practical implementation of the EU SFDR has been challenging. Since introduction in March 2021, and in particular since the introduction of the EU SFDR Level 2 rules in April 2022, asset managers are classifying funds into the respective categories. The EU SFDR Level 2 rules also include the regulatory technical standards (RTS) which define the piece of regulation in more detail. The Article 8 category has manifested itself as mainstream category for a large number of different fund types that have formal sustainability characteristics and are described as sustainable. As the regulatory process was more closely defined with the help of regulatory technical standards, this led to many new investment fund classifications by the asset management industry. Strict control over fund classification only exists to a limited extent so far, i.e., investment companies make classifications at their own discretion and to the best of their knowledge. As of now, there is no control over how the word „sustainability" is to be defined, and investment managers are free to use their own methods.

Glut of fund classifications and reclassifications

The market has seen a flurry of fund reclassifications over the past year. Initially, the market mainly saw upgrades from the EU SFDR category Article 6, towards ESG funds of category Article 8 and Article 9, as these are now much easier to market than conventional funds. Towards the end of last year, the trend went in the opposite direction again, and there were product downgrades (as of Q4 22: EUR 130bn AuM) from Article 9 back to Article 8, after the regulatory framework was more strongly formulated over the last year, thus necessitating new adjustments on the part of asset managers. Due to the still prevailing legal uncertainty with regards to the formulation of the classification categories, most fund companies often decided to downgrade their funds for fear of legal risks. As of the end of last year, 55% of UCITS funds were in category 8 or 9, with category 9 accounting for only about 4%.

Current developments

It is to be expected that the uncertainty in regard to the clear design of the EU SFDR will continue for a while. But there are also already further developments to report. ESMA has made it clear that it intends to tighten its control over SFDR designations and to put a stop to the misuse of sustainable fund classifications.

In April of this year, the EU Commission published a long-awaited statement on the design of the EU SFDR. In particular, it was explained that the EU Commission does not want to define minimum standards for what is meant by a „sustainable investment", i.e., no minimum standards were defined for the key indicators environmental or social objective, DNSH criterion or the principles of good corporate governance. Instead, the EU Commission aims to make financial market participants more accountable for disclosing their own underlying assumptions for what defines a sustainable investment.

Another important point that was defined in more detail by the EU Commission relates to Article 9 funds, which must consist of 100% sustainable investments. There was a great deal of uncertainty in the market as to what is meant by a 100% sustainable investment, whether this statement must refer to the entire economic activities of an investment, or whether it is already sufficient if a part of the company's activities is sustainable. The EU Commission has also provided a clarification of this point in the statement. It is up to the market participants to disclose a definition, as long as the underlying methodology is clearly explained. This aspect may again lead to new fund reclassifications in the market, which, in turn, may certainly not contribute to any better transparency from the consumer's point of view.

The EU SFDR has at least achieved one thing - raising market awareness and understanding of sustainable investing, even if the full design of the regulation is still developing. Ultimately, it is about strengthening the market as well as the associated demand for sustainable investment products. The prerequisite for a prospering market is a clear framework, though, which should be the ultimate aspiration. For consumers, it will initially remain difficult to navigate the information jungle of fund classifications.

Source:

https://www.esma.europa.eu/sites/default/files/library/ESMA50-165-2438_trv_1-23_risk_monitor.pdf

https://www.linklaters.com/en/insights/publications/2023/april/commission-provides-helpful-responses-to-key-sfdr-questions