AXA IM is committed to the idea that investors will be better positioned if they acknowledge and address climate change and sustainability in their portfolios. This has prompted us to carefully monitor the arrival of a new type of fixed income asset class – Sustainability-Linked Bonds (SLBs).

What are SLBs and why invest in them?

SLBs are different from Green, Social and Sustainability Bonds (GSSBs), a market where we have worked to achieve a leadership position for some years now. Unlike GSSBs, SLBs are not ‘use-of-proceeds’ instruments where the deployment of financing received is tightly restricted to a set of eligible projects. Just like conventional debt, SLBs are general purpose bonds and a company can spend the money raised through the issuance as it wishes. However, they do still represent a new opportunity to fund the climate transition and tackle other relevant and material environmental and social challenges. They may also have the potential to deliver long-term, sustainable performance for our clients.

The main difference between SLBs and conventional bonds is that SLBs integrate objectives linked to environmental, social and governance (ESG) factors. According to the SLB Principles set out by the International Capital Market Association (ICMA) they are:

“...any type of bond instrument for which the financial and/or structural characteristics can vary depending on whether the issuer achieves predefined Sustainability/ESG objectives....Those objectives are (i) measured through predefined Key Performance Indicators (KPIs) and (ii) assessed against predefined Sustainability Performance Targets.”

1 Sustainability-Linked Bond Principles | ICMA, June 2023
Put simply, an SLB issuer will be financially penalised if it fails to meet those Sustainability Performance Targets (SPTs) – and if it succeeds, will still pay the same coupon, or could be rewarded with a coupon step-down depending on the structure. But this isn’t about opportunistic investors hoping SLB issuers fail in their sustainability ambitions – it is about responsible investors like AXA IM using SLBs to incentivise companies towards behaviour that we believe will benefit them, and investors, over the long term. SLB issuers effectively open themselves up to reputational and financial risks linked to their ability to hit sustainability objectives.

With this in mind, we think SLBs could therefore act as a powerful tool for issuers to finance their transition towards more sustainable business models. These instruments are particularly relevant for high-emitting issuers. While GSSBs focus on specific projects and assets to be financed, SLBs establish a link between the issuer’s ESG ambitions and the financial characteristics of the bond. An issuer’s broad sustainability strategy may already form part of our GSSB assessment process, but it becomes the core feature for an SLB.

We see an important issue though – there is no consensus yet on what represents a high-quality SLB. AXA IM has therefore decided to define a proprietary methodology for evaluating SLBs, and we set this out below, alongside its constituent criteria. This is an update of the assessment methodology we published in January 2022 – since then, we have gained experience and maturity on the SLB market by looking in detail at more than 100 different bonds.

We want to highlight that SLBs are not currently part of our green and impact investments – where GSSBs sit – but rather of our transition investments. We consider that SLBs and use-of-proceeds transition bonds both relate to transition finance instruments which will allow AXA IM to take an active role in powering that transition.
The first SLB was issued in 2019, and the market has since grown to reach the €300bn mark in terms of outstanding issuance in 2023. Unlike the GSSB market – which is dominated by sovereigns, agencies and financials – SLBs are most popular with corporate issuers. The utility, materials and industrials sectors are the largest players (see charts below).

The market’s development has been accompanied and boosted by improved governance and guidelines from the ICMA. The **Sustainability-Linked Bond Principles** were published in June 2020 and updated in June 2023 and have likely helped to improve confidence in the market. They provided guidance for SLB issuers and set out five key components to assess:

1. Selection of Key Performance Indicators (KPIs)
2. Calibration of Sustainability Performance Targets (SPTs)
3. Bond characteristics
4. Reporting
5. Verification

In June 2023, the ICMA also came out with the updated **Climate Transition Finance Handbook** which provides guidelines and common expectations to issuers of SLBs, GSSBs and transition bonds. The handbook comprises four core elements that act as an umbrella under which SLBs and other transition-related instrument should be issued:

1. Climate transition strategy and governance
2. Business model environmental materiality
3. Science-based targets and pathways to define climate transition strategy
4. Implementation transparency

AXA IM was closely involved in the discussions that produced these guidelines and will remain engaged in future debates around SLBs and transition finance – just as we do for GSSBs. We are active members of the Sustainability-Linked Bonds and Climate Transition Finance working groups of the ICMA’s Green and Social Bond Principles.
Importantly these guidelines around SLBs are only voluntary and in this context, we decided to develop our own assessment methodology as we aim to set a high bar for the SLBs in which we invest on our clients’ behalf. Similar to the methodology we use for GSSBs, it draws on the ICMA SLB guidelines but seeks to apply a more stringent approach that is proprietary to AXA IM. We have defined what we believe are strict eligibility criteria that need to be met for us to invest. These are described below.

Our continuous involvement in the development of the SLB market and our pursuit of quality issuance has led to growth in our SLB investments. As of end-March 2023, we held more than €800m in SLBs as part of our fixed income strategies. It is important to note that this accounts only for SLBs that have been reviewed and validated by our ESG research team.

**AXA IM investments in SLBs (in millions of euros)**

*Source: AXA IM, end-March 2023*
AXA IM’s SLB assessment methodology is made up of four pillars:

1. Issuer sustainability strategy and the relevance/materiality of KPIs
2. SPT ambition
3. Bond characteristics
4. SPT monitoring and reporting

For each pillar, the issuer must comply with our eligibility criteria to be investable. We have identified a range of red flags that systematically lead us to assign a negative view on a given SLB. The factors outlined are intended to be indicative and non-exhaustive. This is primarily due to the fact that individual SLBs can vary greatly and therefore their individual assessment involves company-specific factors, as accepted within qualitative analysis approaches.

It is also important to note that for repeat SLB issuers – which is quite often the case – we provide views at an SLB framework level. This implies that our view on the issuer’s framework would apply to all SLB instruments issued under a given framework – unless there is a significant difference in the structural feature of a particular bond/instrument that merits a differentiated opinion. We believe being comfortable around the quality and ambition of an SLB framework will lead us to invest only in good quality SLBs – even though we also pay attention to the specific features of each SLB transaction. We set out a snapshot of our methodology in the graphic below, and then dig deeper into the detail of each pillar over the following pages.

Snapshot of AXA IM’s SLB methodology

Source: AXA IM
Pillar 1: The issuer’s sustainability strategy and the relevance and materiality of KPIs

The first pillar assesses the issuer, not the issuance. We want to make sure we only invest in SLBs from issuers with a robust ESG profile and strong sustainability ambitions.

This requires full compliance with AXA IM’s ESG Standards and Sectorial Policies, which are applicable to all SLB and GSSB issuers. If an issuer is non-compliant with these standards, it would result in the exclusion of its SLB. If these are met, we conduct an issuer-level analysis to ensure issuers are applying the basic ESG practices and forward-looking commitments deemed essential to properly integrating and addressing key sustainability considerations.

We apply the same approach as for GSSB issuers, drawing on proprietary internal ESG credit and impact research, including our qualitative ranking of the credibility and ambition of climate ambitions, as well as a range of external research to form our view on an issuer’s relative positioning.

Once we have assessed the sustainability strategy, we then take into consideration the first component of the ICMA’s SLB Principles – selection of KPIs. We look at the KPIs holistically, focusing on the quality of the set of KPIs indicated within the issuer’s SLB framework. We take a framework-driven approach to SLB selection as we expect an issuer to utilise all KPIs indicated within its framework across its future SLB issuances.

This stems from an expectation that SLBs should be representative of and aligned with an issuer’s overall sustainability objectives, which can be multifaceted, and that KPIs can be complementary with some often only meaningful when viewed together. A framework-driven approach also recognises that there may be limitations of a single instrument to carry a range of KPIs and SPTs.

Let’s take a hypothetical example of a utility company issuing an SLB to illustrate that point:

**Issuer’s SLB Framework**

3 KPIs selected:
- KPI 1: Reduction of scope 1 and 2 GHG emissions
- KPI 2: Reduction of scope 3 GHG emissions
- KPI 3: Increase renewable energy installed capacity

At framework level, we make sure that all KPIs are material to the issuer’s business model and sustainability profile, and that there is at least one core KPI

**SLB issuance #1**

1 KPI used with 1 associated SPT:
- KPI 1: Reduction of scope 1 and 2 GHG emissions
  - SPT: Reduce scope 1 and 2 GHG emissions by X% by 2030

**SLB issuance #2**

2 KPIs used with 2 different associated SPTs:
- KPI 2: Reduction of scope 3 GHG emissions
  - SPT: Reduce scope 3 GHG emissions by Y% by 2030
- KPI 3: Increase renewable energy installed capacity
  - SPT: Increase renewables capacity to X GW by 2030

An issuer may pick one or several KPIs identified in the framework to be used in each of its SLB issuances

---

3 Scopes 1 and 2 refer to direct emissions created by a company through production or energy consumption. Scope 3 relates to indirect emissions up and down the value chain, from suppliers to consumers.

Source: AXA IM
Consequently, a pre-requisite for an SLB issuance is that an issuer should have already established quantifiable, forward-looking environmental and/or social goals that are consistent with the sustainability and transition challenges they are facing.

As stated in the ICMA principles, we expect the KPIs selected to be material to the issuer’s business model, quantifiable, externally verifiable, and able to be benchmarked. Materiality is needed to avoid opportunistic SLB issuances and greenwashing. This is a key consideration at AXA IM and we expect an issuer to have at least one KPI that we consider to be core to its sector, business model and sustainability strategy within its SLB framework.

To determine this, we may refer to ICMA’s KPI Registry, although we have the discretion to take our own view which can be particularly relevant for social KPIs. While climate change remains a universally relevant issue, we welcome the ability of SLBs to bring accountability to a company’s efforts to address other sector- or geography-specific ESG topics that may be material.

Climate Related KPIs and SPTs
Climate-related KPIs are the most widely used KPIs in the SLB market. We have a clear preference for KPIs referencing greenhouse gas (GHG) emissions to be expressed in absolute terms, not intensity.

With regards to scope, we view the inclusion of a KPI related to scope 3 indirect emissions as best practice. Some SLB issuers already do this, but it is not a requirement at this stage. Our basic expectation is that companies, including SLB issuers, should include scope 3 in their climate reporting. However, this does not absolve companies of a responsibility to address their scope 3 emissions.

We understand the difficulties of including scope 3 emissions as a KPI or related SPT within an SLB framework, but as GHG accounting evolves and as the ability to meaningfully address scope 3 emissions matures at company level, we will expect scope 3 to become part of SLB transactions. As scope 3 represents the vast majority of issuers’ total GHG emissions, its exclusion diminishes the materiality of an issuer’s climate ambitions and therefore its SLB. More insights into our views on scope 3 can be found here.

Social KPIs
In contrast to climate-related KPIs, social indicators have thus far been much less well represented. We hope to see that change and encourage issuers who have already conducted materiality analyses to include social indicators that are material for their sector, business model, and/or geographical context. The disclosure of these factors in the rationale for KPI selection help investors to evaluate whether the select social KPIs can be considered core.

Social KPIs selected may be impactful for progress made within the company or for external stakeholders such as suppliers or clients. As an example, in the case of a key transition industry such as the automotive sector, we might expect upskilling and/or reskilling objectives with quantified targets for employees in keeping with a just transition approach. For a pharmaceutical company, by contrast, accessibility-related criteria are paramount. Each company and each sector has its own specificities and these may be reflected in the selected KPIs and SPTs in the context of an SLB structure.
Pillar 2: SPT ambition

Our second pillar focuses on the quality and level of ambition of the SPTs and is very similar to the ICMA principles’ second component. Although the SLB market has matured, evaluating whether the SPTs selected by issuers are ambitious enough remains a key challenge. We have the same expectations as the principles, which state that SPTs should: “Represent a material improvement in the respective KPIs and go beyond a ‘business-as-usual’ trajectory”.

We believe that an opinion provided by an external verifier is a vital resource in forming that view and see this as a pre-requisite for any SLB.

Following the principles, we also expect every SPT to be comparable against:

- The issuer’s past performance (for three years at least), and/or
- Its peers’ performance, and/or
- Science-based benchmark(s)

In addition to the above, we may measure the ambition of an SPT against industry benchmarks as well as AXA IM’s own commitments.

Another fundamental component of the SPTs is the roadmap to attain them. We view an issuer’s action plans as a necessary element to evaluate the relative effort needed to achieve an SPT and therefore its ambitiousness. We think that the achievement of SPTs should be challenging for issuers.

As an example, we will not invest in SLBs for which stated sustainability targets are already on the brink of being achieved. We therefore expect issuers to disclose to investors how the achievement of the SPTs will materialise in terms of investments, strategic direction, and potential policy changes. When selected SPTs are medium- or long-term objectives, we also expect issuers to provide us with intermediate targets that make progress trackable.

Overall, SLBs are a tool that publicly binds issuers to a direction of travel and an ambitious endpoint. The starting point of the issuer is taken into consideration. AXA IM’s philosophy remains to encourage ‘best-in-class’ issuers to keep progressing whilst also leaving room for those that are not best-in-class to turn the tide.
Pillar 3: Bond characteristics

Our third pillar follows the guidelines of the ICMA principles. Here, we look at the impact of a failure – or success – to achieve SPTs on the financial characteristics of the SLB. There are many potential financial mechanisms that can be used for an SLB – we have seen mechanisms that actually reward issuers if they succeed, like a coupon step-down, although it remains rare, while the step-up penalty has become mainstream as the market develops.

Most importantly, we expect issuers to provide full transparency on the financial mechanism associated with the achievement or otherwise of an SPT, so that investors are aware of the financial consequences of such an event. When would the financial mechanism be triggered? How many times would it occur until the maturity of the SLB? We also want to see timing consistency between the financial mechanism and trigger events related to the SPTs. Once again, in the case of long-term SPTs, we expect issuers to establish intermediate trigger events, as it is important to track progress over time.

The magnitude (size and nature) of the financial penalty is an important and distinguishing parameter of an SLB structure. It is not, however, an overriding or exclusionary criteria in the SLB analysis conducted by our ESG research team. We do not currently have a prescriptive view on the structure and size a financial penalty should take – beyond our belief that there should not be a standard and universal penalty applied across the market.

Rather, we are of the view that that the financial mechanism’s magnitude should be assessed relative to the issuer’s sector, ratings and currency. Although simple in principle, timing constraints of SLB transactions can still make it difficult to have a clear view on this. Hence, while important, it is not currently a prevailing factor for our SLB opinion.

We do however pay close attention to events and mechanisms that could prevent the financial penalty from actually occurring – e.g. an SLB that can be called before the target observation date. In our view, such mechanisms (or loopholes) adversely affect the credibility of an SLB, and we consider them a red flag which would result in exclusion.

Pillar 4: SPT monitoring and reporting

The last pillar of our methodology relates to updates on SPT progress through regular reporting from SLB issuers. While the ICMA principles only encourage issuers to publish SLB reporting, it is mandatory within our assessment. We will not invest in SLBs where the issuer does not commit to publish annual reporting – conversely, we may also change our views if an issuer does not actually publish SLB reporting post-issuance.

We expect SLB issuers to make publicly available information on the progress they have made to achieve an identified sustainability target – and for each SPT if several are used. Any additional information about qualitative or quantitative explanation of progress on SPTs, and/or potential recalibration of KPIs and SPTs, is also expected. As stated in the principles, SLB reporting must be externally verified by a third party.

After looking at what has been done so far in the SLB market in terms of reporting, we realise that this can be done in various ways. It is sometimes quite difficult to access relevant information related to the selected KPIs and SPTs when such data is diluted into a broad sustainability report. The same is valid for external review, where investors may struggle to distinguish whether the verification specifically relates to the SLB or to the overall sustainability metrics of the issuer.

For the sake of greater transparency and clarity of information, our preference is for separated SLB reporting and an external review, but the format of reporting is not a discriminatory criterion – once issuers do publish updates on progress made.
Engaging with SLB issuers and market players

Engagement with bond issuers is an important aspect of our active ownership, as we are long-term investors and often hold bonds to maturity. Engaging on ESG issues is a critical way to ensure we manage the value of our bond investments over time.

Having direct discussions with SLB issuers is a great way to monitor the robustness and ambition of their sustainability strategies – as well as the quality of their SLB framework. We engaged with 21 SLB issuers in 2022, which allowed us to better identify good practices and clarify our expectations with this market. Engagement is a key aspect of our SLB assessment process, and we have direct dialogue with issuers whenever we can for SLBs in which we may invest. We believe this is essential to get all the information we need to make a comprehensive analysis and go beyond issuers’ SLB frameworks and public disclosure.

Another way we seek to influence the SLB markets is by having regular discussions with underwriting banks. We often have these kinds of discussions to share our eligibility criteria for SLBs, our views on specific deals or our broader ESG expectations for issuers. We believe it is a very effective way to spread our views and expectations across the market, as banks can share our thoughts with their broad base of clients on the issuers’ side. This kind of indirect engagement with SLB issuers can allow for our feedback and expectations to be taken into consideration within issuers’ SLB frameworks and/or sustainability strategies even before these are officially published.
This remains a nascent market, just four years on from the first SLB issuance. Standards are still being formed, but we remain convinced of the potential for high-quality SLBs to foster and support company-level transformation.

We believe a growing number of issuers from a wide range of sectors will continue to see SLBs as an appealing option. As investors, we view SLBs as a complementary instrument to use-of-proceeds instruments, in the ESG-themed bond space. Both formats have their own merits and functions, enabling investors to participate across the spectrum of the climate transition as well as in the attainment of the United Nations Sustainable Development Goals. We also believe that SLBs can be particularly attractive, and appropriate, for emerging market issuers as they seek to establish their transition credentials.

At AXA IM, SLBs are considered transition investments – as is the case for use-of-proceeds transition bonds – while GSSBs remain part of our impact investments. Even if SLBs seem to have taken the lead over transition bonds when it comes to transition finance, we still believe there is a place for use-of-proceeds transition bonds. As issuers accelerate their sustainability journeys, they will need to access a range of instruments that are suitable for their sector, for the nature of their projects, and for the type of spending they need to finance.

As the SLB market has grown, so has our understanding of the kinds of SLB structures that we appreciate. We see strong benefits of an SLB and use-of-proceeds format – whether GSSB or transition – being combined in the same product. We have seen a few transactions that mixed well-defined and targeted green projects with financial characteristics that were linked to the achievement of sustainability targets at issuer level. In our view, this hybrid format amplifies the message and could serve to strengthen issuers’ sustainability ambitions.

Thus far, the unique characteristic of the SLB market has not yet been thoroughly or consistently tested. Only a minority of SPTs have had target observation dates that have come to pass. Hence, the ways in which investors should perceive and react to an SPT failure is still the subject of debate.

At AXA IM, we are of the view that a failure to meet an SPT does not necessarily call into question the credibility of the SLB market. Rather, it could attest to the level of ambition in the SPTs and may reflect extenuating circumstances that could build our understanding of how this market may evolve. What remains important for us as investors is to know both what led to a failure and, more importantly, what remediation measures are in place to ensure an issuer can still meet any longer-term targets or continue in the direction of the objectives.

Overall, AXA IM is committed to helping improve standards in this market. We aim to promote quality and integrity across the GSSB, SLB and transition bonds markets, which we hope will pave the way for more issuance, more take-up by investors, and ultimately a beneficial impact on people and the planet.
Disclaimer

This document is for informational purposes only and does not constitute investment research or financial analysis relating to transactions in financial instruments as per MIF Directive (2014/65/EU), nor does it constitute on the part of AXA Investment Managers or its affiliated companies an offer to buy or sell any investments, products or services, and should not be considered as solicitation or investment, legal or tax advice, a recommendation for an investment strategy or a personalized recommendation to buy or sell securities.

Due to its simplification, this document is partial and opinions, estimates and forecasts herein are subjective and subject to change without notice. There is no guarantee forecasts made will come to pass. Data, figures, declarations, analysis, predictions and other information in this document is provided based on our state of knowledge at the time of creation of this document. Whilst every care is taken, no representation or warranty (including liability towards third parties), express or implied, is made as to the accuracy, reliability or completeness of the information contained herein. Reliance upon information in this material is at the sole discretion of the recipient. This material does not contain sufficient information to support an investment decision.

Issued in the UK by AXA Investment Managers UK Limited, which is authorised and regulated by the Financial Conduct Authority in the UK. Registered in England and Wales, No: 01431068. Registered Office: 22 Bishopsgate, London, EC2N 4BQ.

In other jurisdictions, this document is issued by AXA Investment Managers SA’s affiliates in those countries.

Image source: Getty Images