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Sustainability-linked bonds do not fit our impact framework

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Our approach to impact investing, established in 2007, focuses on Use of Proceeds (UoP) and transparent, relevant impact measurement and reporting frameworks. We direct capital to social and environmental outcomes and continually engage with clients, industry working groups, issuers and underwriters on the merits of this approach. We believe that our impact framework provides clear line of sight into the projects and initiatives financed in the bond market, and enables us to support anticipated outcomes that benefit local communities, broader constituencies in need, our climate and natural resources. It is through this lens that we are evaluating sustainability-linked bonds (SLBs), and feel compelled to alert investors that the credibility and robustness of these deals remain highly variable.

Recently, we've seen some of the earliest SLB deals embraced by green bond and sustainable bond investors. This is a positive development, as it indicates market demand and that issuers are increasingly serious about managing climate risk, investing in cleaner technologies and creating more sustainable business operations. ***Yet we find the SLB structure lacking from the perspective of an impact investor.*** We strongly prefer UoP deals in which the projects are specified at issue and the associated outcomes can be benchmarked, measured and reported to investors. At their root, SLBs are general obligation or general corporate debt instruments, and the issuer retains full discretion for how capital will be allocated once it is raised. To us, that requires an assessment of the issuer and its credibility as an ESG leader – can it be trusted to pursue environmental and sustainable goals in a meaningful and responsible way, without extending the life of carbon-based technologies or doing harm in pursuit of headline goals?

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So far in 2021, we've seen some SLB deal features that help illustrate where the structure falls short of our impact investment criteria. We passed on deals from a U.S. high yield issuer and an Indian cement company because we felt that the SLB structure itself allowed the issuers too much latitude to invest the proceeds, while the step-up penalties didn't create sufficient incentive for management to pursue material changes in their carbon footprint. In both cases, the securities benefit from a halo effect of carrying a "sustainability-linked" label, yet reporting will be limited to a singular enterprise-wide carbon footprint or emissions reduction target. This makes it virtually impossible for an investor to know how the proceeds of the bonds were directed and what specific outcomes they delivered.

From this perspective, an SLB is derivative of what we require as an impact investor. We want to measure carbon intensity key performance indicators (KPIs), which are driven by specific projects. KPIs demonstrate the efficacy of the science and encourage borrowers and lenders to seek ways to lower the cost of capital for the most successful technologies that also improve resource efficiency within an issuer's operations.

Digging deeper, we are underwhelmed by the goals and penalties associated with recent SLB deals. The goals or targets can be gamed to make them relatively easy to achieve, sometimes based on the issuer's current trajectory, and without the need for meaningful new investment. For example, a 2021 issue, with a 2030 carbon footprint reduction goal, used its 2017 carbon footprint as the baseline. In the most egregious case, a structure included a KPI that had already been achieved. In other instances, the goals-based coupon step ups and structural loopholes aren't enough of a penalty to keep issuers focused on the SLBs' stated goals, once management considers cost of capital, acquisitions or other strategic initiatives. We've seen 8- and 10- year new issues that put off the KPI disclosure and potential coupon step-up into the fifth and ninth years, respectively. And if the goals aren't met, step-ups can be as low as 6.25 bps or 12.5 bps (from a 375 bps initial coupon), which isn't steep enough to incentivize management to make the targets a strategic priority. Instead, it provides the issuer a very low cost option on deploying capital as it sees fit. Another "loophole" in SLB structures exempts the issuer from including acquisitions from its reduction targets over the measurement period, which further undermines any genuine, enterprise-level commitment to environmental, social and governance (ESG) initiatives.

All told, there is promise in the sustainability-linked structure. For starters, it is better than no targets at all. And while it doesn't meet our impact standards, it may contribute to our view of the issuer as an ESG leader willing to source capital in public markets with a link to goal-setting and accountability. If the targets and reporting frameworks become increasingly science-based and aspirational, and the step-up provisions evolve to actually being material, we may find a compelling impact investment at some point.

Beyond our impact portfolios, Nuveen continues to enhance the way ESG factors are integrated into the investment process. SLBs could be increasingly held in Nuveen's fixed income investment strategies without impact objectives, yet we will remain vocal participants in discussions about what these structures represent for the issuers and what they deliver for investors. All the while, we will continue to advocate across industry groups, issuers and underwriters for green, social and sustainable bond standards that allow impact investors to intentionally direct capital at projects and outcomes, while offering meaningful incentives for issuers to achieve their goals.

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