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AXA's New Bond Proposal May Expand Sustainable Finance

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New investor-published guidelines for transition bonds could expand sustainable finance to a broader variety of conventional businesses. On June 12, 2019, AXA Investment Managers published an article calling for the market to recognize transition bonds, a new category of thematic sustainable finance.

AXA's call to action and suggested bond guidelines reflect an evolution in how investors grapple with bringing conventional businesses into the sustainable finance world. Transition bonds have the potential to create opportunities for a tremendous number of businesses not traditionally seen as sustainable to participate in sustainable finance, but would still be limited to businesses committed to robust transition strategies.

Background

Sustainable finance is a booming subset of the broader debt finance space, with more than $30 trillion in assets under management globally using various sustainable investment strategies. Historically, the bulk of these assets have been deployed based on the nature of the borrower, such as through exclusionary strategies — e.g., no investment in arms manufacturers — or integrating into the investment analysis how proficiently a borrower manages its risks and opportunities in relation to environmental factors.

Over the past decade, a different sustainable investment category has captured the lion's share of the headlines — thematic sustainable finance and its best known example, the green bond. Thematic sustainable finance refers to investing based on a connection between the financing and business activities perceived as having positive sustainability effects. The classic example is investing in a bond the issuer labels as green because the proceeds of the bond are earmarked for investing in projects meeting disclosed criteria for environmentally friendly outcomes, such as wind farms.

The green bond innovation allows investors to identify a bond's sustainability by the story connecting it to positive sustainability outcomes instead of the nature of its issuer. This innovation opened the door to corporations, sovereigns, financial institutions and municipalities identifying their green spending needs and creating green bond frameworks to highlight their sustainability strategies. Any company that could identify a sufficient quantum of spending on business activities could participate.

The Transition Bond Innovation

AXA's proposal picks up on a recent theme in the sustainable finance world: That many investors are in some cases willing to support issuers that are part of the transition to a more sustainable economy, even if those issuers are not seen as sustainable at the time of issuance.

More broadly, the idea of supporting a transition to improve sustainability aligns with governmental efforts across several different jurisdictions, such as creation of a Ministry for the Ecological Transition in Spain, the National Strategy of Ecological Transition towards Sustainable Development in France, and the United Nations Sustainable Development Goals.

AXA's transition bond guidelines mirror the authoritative, nonbinding process guidelines governing much of the green bond world, the green bond principles. The transition bond guidelines, like the green bond principles, call for robust disclosure answering four core questions:

1. What type of projects will the bond proceeds be allocated to?
2. How will allocation decisions be made?
3. How will the proceeds be managed?
4. What reporting will be provided?

Where the green bond principles require the issuer to allocate proceeds to "eligible green projects," the transition bond guidelines require the issuer to allocate proceeds to "climate transition-related activities." A nonexhaustive list of project categories in the transition bond guidelines includes:

- Energy
    - Cogeneration plants (gas-powered combine heat and power)
    - Carbon capture and storage
    - Gas transport infrastructure that can be switched to lower carbon intensity fuels
    - Coal-to-gas fuel switch in defined geographical areas, with defined carbon avoidance performance
    - Waste-to-energy
- Transportation
    - Gas-powered ships
    - Aircraft alternative fuels

- Industry
    - Cement, metal, or glass energy efficiency investments

Another significant way in which the transition bond guidelines depart from the green bond principles is that they make explicit the requirement that issuers articulate “what climate transition means in the context of their current business model and their future strategic direction” and state that issuers “should make a commitment to align their business with meeting the COP21 Paris Agreement Goals.” In summary, the transition bond guidelines require that the issuer tells a clear story, supported by short term targets, about how they are on the path to being seen as sustainable.

Limitation

AXA’s transition bond guidelines seek to overcome an implied barrier to entry for issuing a sustainable bond: That the issuer’s operations meet minimum standards for sustainability, regardless of how the financing will be used. This implied barrier has largely excluded from the green bond market conventional oil and gas issuers that would use proceeds to reduce their own emissions even though, in theory, thematic sustainable finance looks to the instrument, not the actor, and these uses of proceeds could have significant benefits. This implied barrier departs from the approach of many development finance institutions, as well, which tend to focus on project-specific impact analysis.

AXA’s transition bond guidelines remove this barrier only in certain cases. They open the door to sustainable finance for an issuer telling a credible story about how it will transition to itself being sustainable. They do not open the door, however, for an issuer telling a story about how its business is critical to the issuer’s industry or sector evolving to become more sustainable. This distinction could be interpreted as keeping the door shut for issuers with carbon-intensive business models, such as nonrenewable energy companies.

Conclusion

The transition bond guidelines are meant to initiate dialogue and spark debate. They represent one vision of how sustainable finance can relate to the broader economy. To what extent a consensus will emerge among the broader investor and issuer community remains to be seen. In any event, the transition bond guidelines reflect the increasing sophistication and clarity of purpose in the sustainable finance world.

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