CORPORATE & INSTITUTIONAL

Sustainability Markets Insights

Sleeve of impact: Review of 2024

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Edition 1

LLOYDS

Sleeve of impact

Introduction

Building on the years preceding it, 2024 saw wide-reaching sustainability-related developments in the capital markets. Despite the challenges that persist for sustainable bonds, in this article we suggest they remain a tool you'd still want to be able to access as an issuer or investor in 2025.

With the comprehensive integration of ESG into regulated reporting and investment assessments, top investors now have teams of eagle-eyed ESG analysts working alongside portfolio managers and research teams. What worked for issuers in 2021 won't necessarily work going forwards. We showcase why through the following observations from the past year. They centre on core themes that fixed income issuers and investors are grappling with across Green, Social, Sustainability and Sustainability-linked (GSSS) bonds.

1. Starting with the questions facing issuers when considering sustainability in their fixed income plans:

What makes a compelling sustainable bond?

The answer to this varies industry to industry and fund to fund. Common markers of quality are relevance and reliability of eligibility criteria for use of proceed bonds. For sustainability-linked bonds, materiality and ambition in sustainability performance targets is the focus. With sustainability disclosure and anti-greenwashing rules now in force across Europe, an investor's ability to evidence decisions and to engage with issuers is ever more important. "In an ideal world, investors would not need the label as the information would be disclosed anyway, but we are not there yet," said one investor.

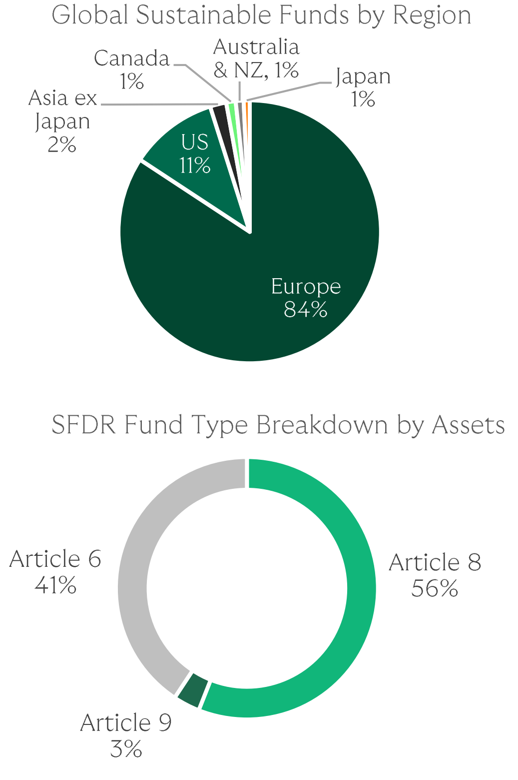
Through Sustainable Finance Frameworks, issuers integrate their financing and sustainability strategies, typically receiving independent verification on the quality and alignment of the framework with market expectations. These frameworks are company specific, so investor assessments typically look at the credibility and connectivity with the issuer's overarching strategy and at peer comparisons. In 2024, to aid these assessments, we have seen issuers improve the granularity of eligibility criteria and of exclusions as well as EU taxonomy alignment become more common place in these frameworks. This can help ensure sustainable bonds are eligible for sustainable investment mandates, and don't breach ban lists or screening criteria – which can form part of any investment decision, whether labelled or not.

Why should we issue sustainability-labelled debt?

A sustainability-related label on a bond can enable access to a greater number of funds and indices, where labelled debt meets not just regular criteria, but also thematic ESG focuses e.g., ESG Screened MSCI Indexes. Assuming a company aligns with International Capital Market Association (ICMA) sustainable bond principles, or the EU Green Bond Standard, investors receive enhanced information on CAPEX, OPEX, and sustainability impact.

Investors value this issuer transparency and accountability to help them meet asset owner mandates and regulation on sustainability-related assessment and reporting. 59% of EU funds have self-categorized as 'Article 8' or 'Article 9' under the EU SFDR regime[1] so issuers that facilitate investor disclosure can garner greater interest from investors.

Figure 1: Europe hosts 84% of the estimated USD 3.3tn of global sustainable funds.



Source: Morningstar. SFDR Article 8 and Article 9 Funds: Q3 2024 in Review

This year we heard many investors say that they are less willing to pay extra for a green, social, sustainability or sustainability-linked label. This has meant, versus previous years, there is less evidence of the "greenium," the discount on all-in costs for companies' labelled bonds versus conventional bonds. This can make it harder for treasury teams to justify the expense of preparing a Sustainable Finance Framework and related reporting.

The lack of meaningful greenium is not necessarily for bad reasons; investors now have the data and capabilities to analyse issuer-level sustainability credentials as part of their credit analysis, so a labelled bond is viewed by investors in the round rather than standalone.

Where do sustainable bonds sit in my corporate strategy?

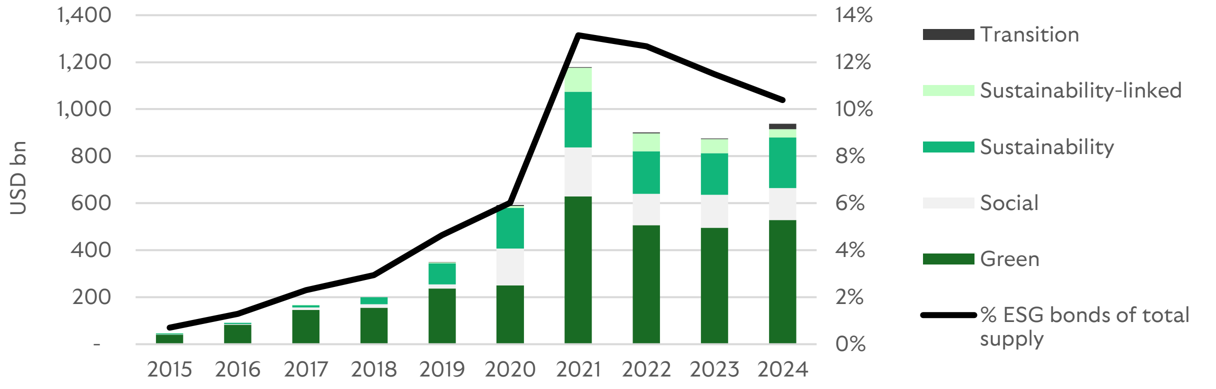
Announcing an ambition to reach net zero emissions by 2050 was the easy part. Achieving this and integrating sustainability is hard – it represents a radical shift away from what, five years ago, would be considered business-as-usual. Indeed, such is the learning journey and effort, that ESG fatigue has been reported.[2] New datasets, regulation, reporting, skillsets, costs, and policies have developed at such pace that sustainability can feel a burden rather than a competitive advantage.[3] Expectations are high.

Having a portfolio of sustainable bonds on your balance sheet can be an indicator of consistency and clarity within a company. Launching a sustainable bond successfully to investors requires robust management who know their business well, a track record of delivery and a credible forward-looking trajectory. These frameworks allow for investor engagement and - particularly for debut issuers of sustainable bonds - can be seen as a sign of management strength, of transparency and of accountability.

In 2024, cumulative sustainable bond issuance reached $5 trillion. With the green bond product gaining maturity - market share now at $2.8 trillion[4], it is greater in size than the US high yield bond market - and one that both issuers and investors are likely to want access to.

[1] Morningstar. SFDR Article 8 and Article 9 Funds: Q3 2024 in Review
[2] Slaughter & May. Sustainable Finance Re-examined, 26th September 2024
[3] Mario Draghi for the EU Commission. The Future of European Competitiveness, September 2024
[4] Environmental Finance, as of 3rd January 2025

Figure 2: Global Sustainable Bond Issuance by Corporates and Governments Sorted by Sustainability-related Label



Source: Bloomberg, as of 3rd January 2025. Notes: Data includes debt securities issued globally by corporates and governments that are league creditable, with minimum maturity of 18 months and self-led deal size of USD50m.

2. Having covered core themes for issuers, we now look at what investors have been grappling with in sustainable finance during 2024:

The search for value

Financial performance remains the primary metric for most fund managers and sustainability is not immune to this. However, the search for value now happens within the context of sustainability regulation and changing consumer preferences that affect asset owner (e.g., pension funds) mandates. Sustainable funds are not the only buyers of labelled bonds. Indeed, we heard from one investor group in January 2024 that most funds even if not sustainable, look for a sleeve of impact in their portfolio. This can come from labelled or conventional bonds from companies with high sustainability credentials.

Indeed, some sustainable bond focused funds can only include labelled debt. Perhaps needless to say, the broader market context remains important for labelled bonds - they are not immune.

International regulation

Globally, we have seen sustainability regimes evolve. Prominent examples include the:

• EU's CSRD, CSDDD and SFDR.[6]
• UK's introduction of FCA-governed Anti-Greenwashing Rules and Sustainable Disclosure Regulation.
• SEC finalising - then pausing - US climate-related disclosure rules.
• South Africa, India, Singapore and Hong Kong are amongst many other countries advancing in this space.

As standards and regulation cover more areas of sustainability markets, the datasets and guardrails of investment will need to change in response. Areas to follow in 2025 include carbon markets, labelling and naming rules for funds, ESG ratings and data providers.

Importantly, many regulatory frameworks are being developed for wide adoption; they are not isolated to companies defined as pursuing sustainability objectives. Indeed, 55% of asset owners report a plan to increase resources dedicated to sustainable investment regulation in 2025.[7]

[5] Alexander, Kern and Cooper, Emmeline, Investor Sustainability Preferences: Empirical Insights and Regulatory Analysis (15th June 2023). Available at SSRN: https://ssrn.com/abstract=4493980 or http://dx.doi.org/10.2139/ssrn.4493980
[6] Corporate Sustainability Reporting Directive, Corporate Sustainability Due Diligence Directive and Sustainable Finance Disclosures Regulation
[7] Sustainable investment asset owner survey 2024 | LSEG

Optimising impact measurement and reporting

Asset owners can request that asset managers carry out ESG-related assessments ahead of investment and that sustainability impact be assigned to the funds deployed. For sustainable bonds, issuers publish annual reporting on allocation and impact – assuming alignment with ICMA Principles for Green, Social and Sustainability Bonds – making this data collection and onwards reporting easier for asset managers.[8]

For investors, quality of information is key to making well-evidenced decisions and fulfilling investment mandates, whether an instrument is labelled or not. Finding solutions to the manual processes of sustainability data collection, collation and impact reporting remains on the minds of many ESG specialists and asset managers.

3: Bringing these six themes together to look at consequences for business and the areas for collaboration in 2025:

Firstly, expect to see ESG data precision as well as scrutiny of businesses increase. Sustainability knowledge and assessment methodologies have improved and will continue to do so, particularly beyond climate and into social, just transition and nature metrics. This will be happening in the context of international politics, organisational power dynamics and personal values. Education and strong leadership networks will be key in 2025.

Secondly, taxonomies and regulation are supporting a drive for language consistency across different industries and geographies. However, comparability and interoperability between different disclosure frameworks will present ongoing challenges for investors. 2025 will hold many opportunities for engagement in industry working groups and regulator consultations – ongoing, for example, we have the FCA's Green Taxonomy and Voluntary Carbon Markets.

Finally, the quest for impact: what is there to show in terms of financial outperformance and sustainability-related additionality? Demonstrating leadership will remain a moving target for both issuers and investors as assessment processes integrate the new raft of regulated disclosure metrics. Additional guardrails will come into play and themes like greenwashing, ESG ratings and sustainability-linked bond target observation dates will be ones to watch in 2025.

[8] The Principles & related guidance » ICMA

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