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A Pandemic-Driven Surge In Social Bond Issuance Shows The Sustainable Debt Market Is Evolving

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Key Takeaways

- We expect social bonds to emerge as the fastest-growing segment of the sustainable debt market in 2020. This stands in sharp contrast to the rest of the global fixed income market, for which we expect issuance volumes to decline this year.
- We believe recent growth in social bond issuance indicates that the COVID-19 pandemic has not turned issuers' or investors' attention away from sustainable finance, but rather interest seems to be growing.
- Corporations and financial institutions will become more active in the social bond market as the pandemic accelerates private issuers' interest in social considerations.
- While significant steps have been made to standardize social bond disclosure and reporting, we believe issues persist and improvements have been slow to proliferate.

During the past few months, the COVID-19 pandemic has dragged countries around the world through a period of economic disruption, the depths of which have not been seen since the Great Depression. Increased unemployment, rising fatality rates, and strained health care systems have placed a spotlight on a future fraught with social risks. In parallel, corporations and financial institutions have been looked to for leadership in addressing these unforeseen challenges. This call for a greater focus on mitigating social risks has spilled over into the capital markets, particularly through the rapid rise of social bond issuance, which has more than quadrupled so far this year, even as credit conditions have weakened sharply.

Social bonds, which finance projects with primarily social objectives, have emerged as an unlikely tool in the economic fight against the virus to address the demands of consumers and communities that are increasingly aware of current social issues. The growth of social bonds is outpacing that of green bonds, portending a pivot away from a historically climate-centric sustainable debt space and reflecting a diversification of sustainability objectives financed by investors. And, while the recent surge may have been precipitated by COVID-19, the appeal of social bonds as a sustainable finance instrument may endure long after its effects have subsided.

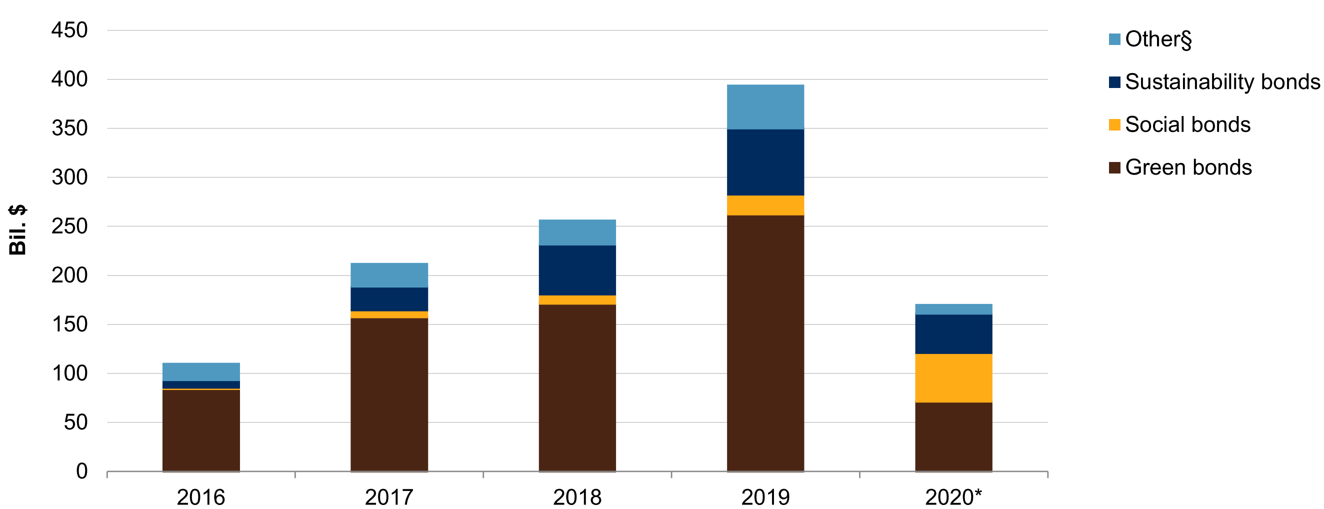
In response to this recent proliferation of social bonds, the International Capital Markets Assn. (ICMA) updated its Social Bond Principles (SBPs) in June 2020 to include an expanded list of social project categories and target populations. We believe the updated principles could encourage greater issuance of social bonds, potentially leading social bonds to emerge as the fastest-growing segment of the sustainable debt market in 2020. In our opinion, as this trend continues, social bond reporting and disclosure practices will gain importance particularly as concerns around "social washing"--when an issuer misrepresents the social impact of its financed projects--grow in the investor community given the challenges of tracking the impact of social bonds. This challenge is compounded by the fact that benefits are often more qualitative than quantitative. We believe the updated SBPs could be a key step in addressing these risks. Yet many social bonds issuers do not follow the governance and reporting practices ICMA recommends, so we expect improvements in tracking and disclosure could be relatively slow. Nonetheless, echoing the growth of the green bond market, as social bond issuance picks up, we anticipate market demand for transparency will grow and social bond impact reporting will be imperative to developing a harmonized social bond market.

Social Bond Issuance Has Reached Record Levels

ICMA defines social bonds as bonds whose proceeds fund new and existing projects with positive social outcomes such as improving food security and access to education, health care, and financing. They constitute a relatively small part of the overall sustainable debt market, which also includes green bonds, sustainability bonds, green loans, and sustainability-linked loans and bonds. Of the $400 billion in sustainable debt issuance in 2019, according to the Climate Bonds Initiative (CBI), social bonds made up approximately $20 billion, or 5% (see chart 1).

Chart 1

Social Bond 2020 Issuance Surpassed Total Issuance In 2019
Annual issuance in sustainable debt by instrument type



Note: Data apply to green, social, and sustainability bonds issued under the International Capital Markets Assn.'s Green Bond Principles, Social Bond Principles and Sustainability Bond Guidelines. *Year to date through June 15, 2020. §Other includes sustainability-linked loans, green loans, and other excluded financing. Source: Climate Bonds Initiative.

However, social bonds' share of the market is growing rapidly. According to Morgan Stanley, US$32 billion of "social" and "sustainability" bonds were issued in April 2020. This marked the first month in which social and sustainability bond issuance surpassed green bonds. Undoubtedly, much of this rapid growth can be attributed to the effect of the COVID-19 pandemic, which has accelerated issuance of social bonds to finance both public and private responses and create positive social outcomes, especially for target populations. In March 2020, ICMA underlined the relevance of social bonds in addressing the coronavirus pandemic and provided additional guidance for eligible social projects, which could include coronavirus-related health care and medical research, vaccine development, and medical equipment investments.

> According to the International Capital Markets Assn.: "Eligible social projects can include for example COVID-19-related expenditures to increase capacity and efficiency in provisioning healthcare services and equipment, medical research, small to medium-sized enterprise (SME) loans that support employment generation in affected small businesses, and projects specifically designed to prevent and/or alleviate unemployment stemming from the pandemic. The general population is likely to be affected by the pandemic, including by any resultant socioeconomic crisis, and social bonds, while seeking to achieve positive social outcomes for target populations, may also serve to address the needs of the general population."

The increased scope of projects eligible to be considered under the social bond designation likely led issuers, particularly supranationals, to become more active in the space. In March 2020, the International Finance Corporate (IFC) completed its largest social bond issuance since its social bond program was launched in 2017, to finance its response to the coronavirus. Soon after, the African Development Bank launched a $3 billion "Fight COVID-19" social bond, which according to the Institute of International Finance (IIF), was the world's largest dollar-denominated social bond transaction to date. Furthermore, In April 2020, Guatemala became the first country to issue a sovereign social bond aimed at financing COVID-19 response efforts. The proceeds were allocated to initiatives such as health infrastructure improvements and food security, support for businesses and professionals, and preventative health and medical practices. As the crisis unfolds, we believe a number of supranational, government agency, and corporate COVID-related issuances will likely follow.

These recent issuances indicate that the pandemic has not turned issuers' or investors' attention away from sustainable finance; in fact, interest in this space seems to be expanding. We do not believe that market engagement in green bonds or loans will tail off entirely, as issuance stands at over $72 billion so far this year according to the CBI. However, as the sustainable debt market grows, we anticipate social bonds will make up a significantly larger share. We further believe diversification in the types of issuers using social bonds to fund a variety of issues (medical equipment shortages, public health infrastructure improvements, and employment/income generation) will continue in the longer term.

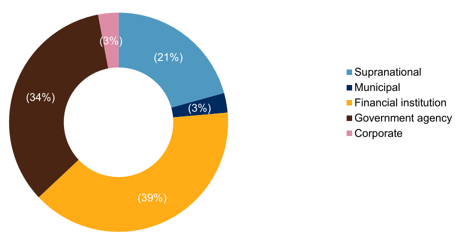
Supranationals have historically dominated the social bond space, but we expect this to diversify. Supranationals' unique social mandates allow them to prototype, raise awareness for development priorities, and support growth in the sustainable debt markets, and as a result these issuers have dominated much of the activity in the social bond space, contributing the market's credibility and liquidity (see "Can Multilateral Lending Institutions Support Rising Demand in the Green and Social Bond Markets?" published Oct. 29, 2018). However, according to data from

Environmental Finance, an online news and analysis service, this trend seems to be changing; government agencies became the dominant issuers of social bonds in 2019 with a 10.5% increase in share, while corporates also became significantly more active, increasing their share to 13% in 2019 from 3% the previous year.

Corporates and financial institutions are becoming more active in the social bond market

Chart 2a

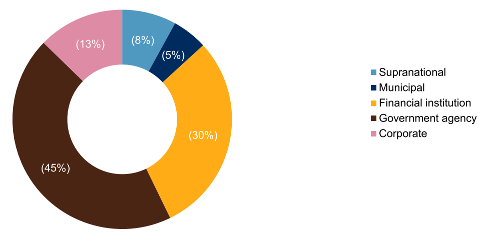
Social Debt Issuer Types 2018



Source: Environmental Finance.

Chart 2b

Social Debt Issuer Types 2019



Source: Environmental Finance.

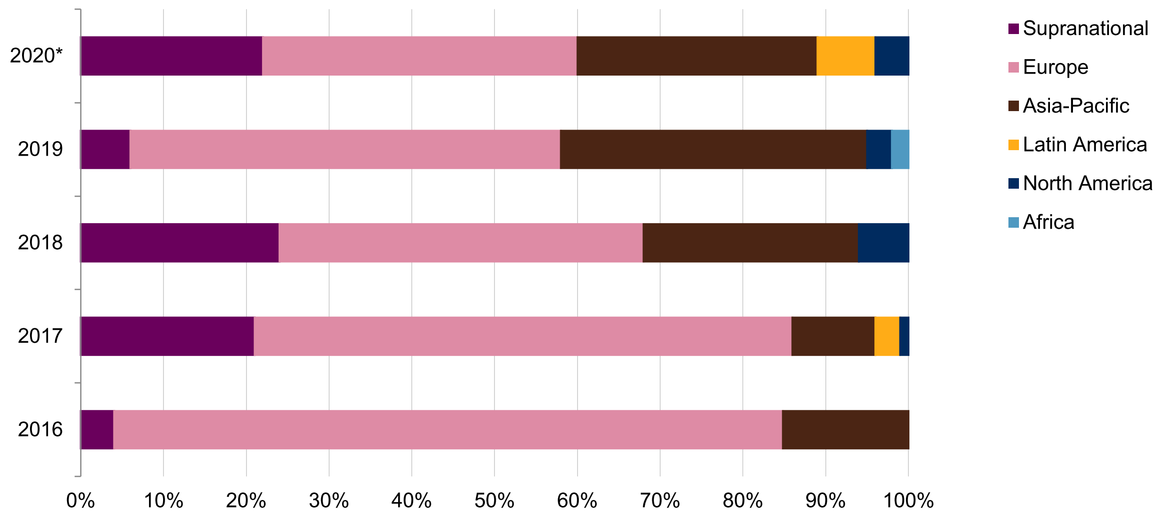
We expect diversification among issuers to continue at a steady pace. For example, financial institutions are playing an increasingly important role in the social bond market, representing about 30% of issuance 2019. In 2020, new market entrants included the Bank of China and Spanish financial institution Banco Bilbao Vizcaya Argentaria (BBVA). Aside from financial institutions, in January 2020, Ecuador became the first country to issue a sovereign social bond and most recently, in June, the U.S.-based Ford Foundation announced it will issue US$1 billion of social bonds, making it the first nonprofit foundation to offer a labelled social bond in the U.S. corporate bond market.

In our opinion, the diversification of the social bond market mirrors that of the green bond market, which was also largely driven by supranationals in its early years. Similar to how the green bond market rose off the back of climate policies and the transition to a low carbon/net-zero economy, we believe renewed interest from organizations and investors in social risk factors could have a galvanizing impact on social bond issuance. Some emerging trends could also support long-term growth in social bond issuance, including aging populations in developed countries, increased concerns over food security, and growing health-driven consumer preferences. However, we ultimately expect social bond issuers to include more public issuers such as sovereigns, sub-sovereigns, public agencies, and foundations/not-for-profits since they have a wider mandate to provide social services than private institutions.

Social bond issuance is growing in emerging markets. Europe has consistently represented the largest portion of new social bond issuance, reflecting its unique regulatory and political push for sustainable finance. However, Europe's 40% share of the market year to date is notably down from the 80% that it represented in 2016. At the same time, emerging market issuance has continued to rise. According to Bloomberg, social bond issuance across emerging market sovereign and corporate borrowers has more than doubled to $5.2 billion so far this year, compared with $2.3 billion in 2019. Asia-Pacific and Latin American have shown the fastest growth, representing 29% and 7% of issuance, respectively, so far this year. On the other hand, the U.S. has been relatively absent from the social bond market, whereas it has been very active in the green bond space over the past few years. In our opinion, this trend indicates that riskier investments earmarked for social objectives may be drawing increasing investor interest.

Chart 3

Europe Continues To Lead Social Bond Issuance
Social bond issuance volume by region



*Year to date through May 31, 2020. Source: Bloomberg.

The rapid growth in social bond issuance sharply contrasts the rest of the global fixed income market, for which we expect issuance volumes to decline 9% in 2020. On one hand, public social bond issuance in both mature and emerging markets is providing debt managers with a more diverse investor base as government deficits are set to sharply increase, according to the IIF. However, in our opinion, private social bond issuance has also gained rapid momentum because it is a way for companies to demonstrate support for stakeholders, including employees, customers, and local communities. This is particularly important as consumers are more attuned now than ever to social issues, putting company reputations increasingly at risk. We believe a company's response to these social disruptions can provide visibility into its level of preparedness, not just for pandemics, but for unforeseen risks in general (see "People Power: COVID-19 Will Redefine Workforce Dynamics In The Post-Pandemic Era," published June 4, 2020). As a result, even amid today's tumultuous economy, we expect social bond issuance will persist as companies demonstrate sensitivity to a variety of social issues and work avidly to mitigate their exposure. (See "Global Financing Conditions: Bond Issuance Will Likely Contract 9% In 2020," published April 27, 2020).

We believe tracking and reporting on social bonds is still nascent and remains largely unstandardized. Historically, green bonds have been more popular than their social bond counterparts, partly because their impact can be tracked using more easily quantifiable and science-based metrics (i.e. reduction in greenhouse gas emissions or energy use) that are well understood by investors. This mitigates the risk of "greenwashing," where a company misuses the "green" label by overstating the true environmental benefit of a transaction and, in doing so, misleads market participants. The standards surrounding social bonds, however, are more complicated because assessing social impacts tends to be more qualitative and less standardized than for green projects. As interest in social risks grows, particularly amid the COVID-19 pandemic, investors now face a new issue--social-washing--which, in our opinion could arise if the proceeds are labelled as "social" but the implied social benefits are questionable.

In an attempt to standardize the definition of social projects and mitigate this risk, ICMA developed a set of SBPs in 2018, which it later updated earlier this year. The principles encourage companies to define what they consider "eligible projects," structure their transactions to avoid misallocation, and regularly report on use of proceeds. Adherence to the SBPs is generally valued as a sign of credibility and market integrity given enhanced transparency and standardized disclosure practices. However, the guidelines are voluntary and unlike for green bonds (where around 80%-90% of issuances are aligned with the Green Bond Principles) a number of institutions have issued COVID-19 and other self-labelled social bonds that are not aligned with ICMA's SBPs. In addition, with so many issuers currently accessing the social debt market, speed to market has become the most important factor, with many issuers foregoing external verification/review. Therefore, while we are seeing growth in social debt for crisis response, improvements in tracking and disclosure are experiencing a significant lag.

Perhaps conscious of rallying market interest and support around social bonds in recent months, ICMA updated its SBPs on June 10, 2020, to expand the list of eligible projects and include a broader range of vulnerable communities (see Table 1). In its SBP guide, ICMA recommends that issuers exhibit impact through qualitative performance indicators complemented by quantitative performance measurements such as the number of new houses built in a deprived area, patients or students served, or microfinance loans made. As social bond issuance picks up, we anticipate expectations for transparency will grow and social bond impact reporting will be imperative to developing a more standardized social bond market.

Table 1

Suggested Project Categories And Target Populations Under The Social Bond Principles

Social project categories include, but are not limited to, providing and/or promoting:
Affordable basic infrastructure, e.g. clean drinking water, sewers, sanitation, transport, energy
Access to essential services, e.g. health, education and vocational training, health care, financing, and financial services
Affordable housing
Employment generation, and programs designed to prevent and/or alleviate unemployment stemming from socioeconomic crises, including through the potential effect of SME financing and microfinance*
Food security and sustainable food systems, e.g. physical, social, and economic access to safe, nutritious, and sufficient food that meets dietary needs and requirements; resilient agricultural practices; reduction of food loss and waste; and improved productivity of small-scale producers*
Socioeconomic advancement and empowerment, e.g. equitable access to and control over assets, services, resources, and opportunities; equitable participation and integration into the market and society, including reduction of income inequality*

Table 1

Suggested Project Categories And Target Populations Under The Social Bond Principles (cont.)

Target populations include, but are not limited to, those that are:
Living below the poverty line
Excluded and/or marginalized populations and/or communities
People with disabilities
Migrants and/or displaced persons
Undereducated
Underserved, owing to a lack of quality access to essential goods and services
Unemployed
Women and/or sexual and gender minorities*
Aging populations and vulnerable youth*
Other vulnerable groups, including as a result of natural disasters*

*Newly introduced categories under the June 10, 2020 update. SME--Small to medium-size enterprise.

Looking Ahead

Although still small, we believe the social bond landscape is growing and evolving rapidly and that the correct steps are being taken to ensure sustained capital flows toward socially beneficial objectives. The recent surge in social bond issuance to address the COVID-19 pandemic has given investors the rare opportunity to evaluate an entity's commitment to its stakeholders--including employees, customers, and communities--in the short-term. Improved transparency and reporting practices will ultimately help reduce some of the social bond risks, including social-washing, and solidify investors' confidence in the asset class as it grows, ultimately propelling further issuance.

Related Research

- People Power: COVID-19 Will Redefine Workforce Dynamics In The Post-Pandemic Era, June 4, 2020
- Global Financing Conditions: Bond Issuance Will Likely Contract 9% in 2020, April 27, 2020
- COVID-19: A Test Of The Stakeholder Approach, April 21, 2020
- The ESG Lens On COVID-19, Part 1, April 20, 2020
- Led By Green Bonds, The Sustainable Debt Market Looks To Surge Ahead, Feb. 13, 2020
- Environmental, Social, And Governance Evaluation Analytical Approach, April 10, 2019
- The ESG Advantage: Exploring Links To Corporate Financial Performance, April 8, 2019
- Can Multilateral Lending Institutions Support Rising Demand In The Green and Social Bond Markets?, Oct. 29, 2018

This report does not constitute a rating action.