January 2022
Responsible Investment

Sustainability-Linked Bonds

Our framework for assessment

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).

SLBs differ 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 – just like conventional debt, they are general purpose bonds. However, they do represent a new opportunity to fund the climate transition and other 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 (SPTs).*" [1]

Put simply, an SLB issuer will have to pay more to its investors if it fails to meet its predefined SPTs – and will still pay the same coupon if it succeeds. But this isn't about greedy 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 us, over the long term.

SLBs could therefore act as a powerful tool, in particular, but not only, for high-emitting issuers to finance their transition towards a more sustainable business model. 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 sustainability strategy may already form part of our GSSB assessment process, but it becomes the core feature for an SLB. Despite the differences, we see a common issue in these two types of instruments: There is no consensus on what a high-quality SLB is. AXA IM has therefore decided to define its proprietary framework for evaluating SLBs, and we set out our methodology and criteria below.

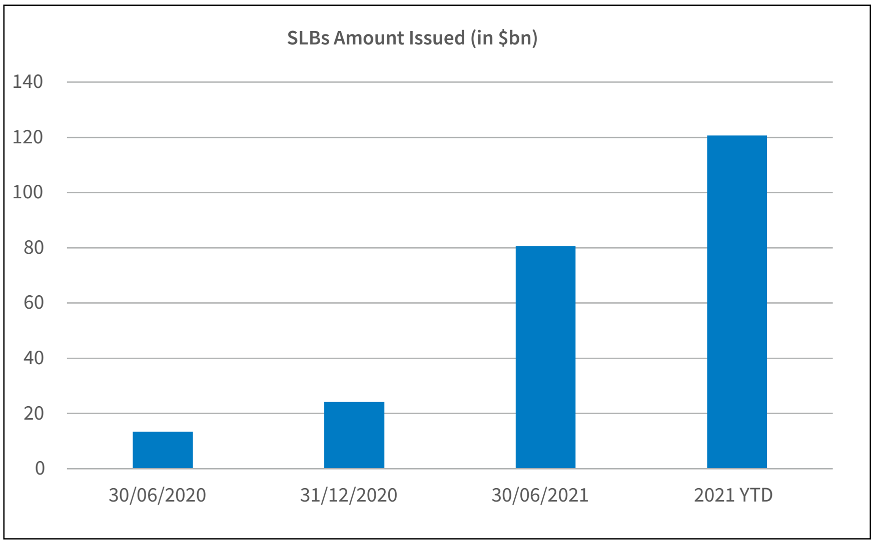
We want to highlight that SLBs will not be part of our green and impact investments – as opposed to GSSBs – but rather of our transition investments. We consider that SLBs and use-of-proceeds transition bonds both relate to transition finance instruments that will allow AXA IM to take an active role in powering that transition – in addition to our green and impact investing strategies through GSSBs.

[1] Source : Climate Bonds Initiative

State of the SLB market

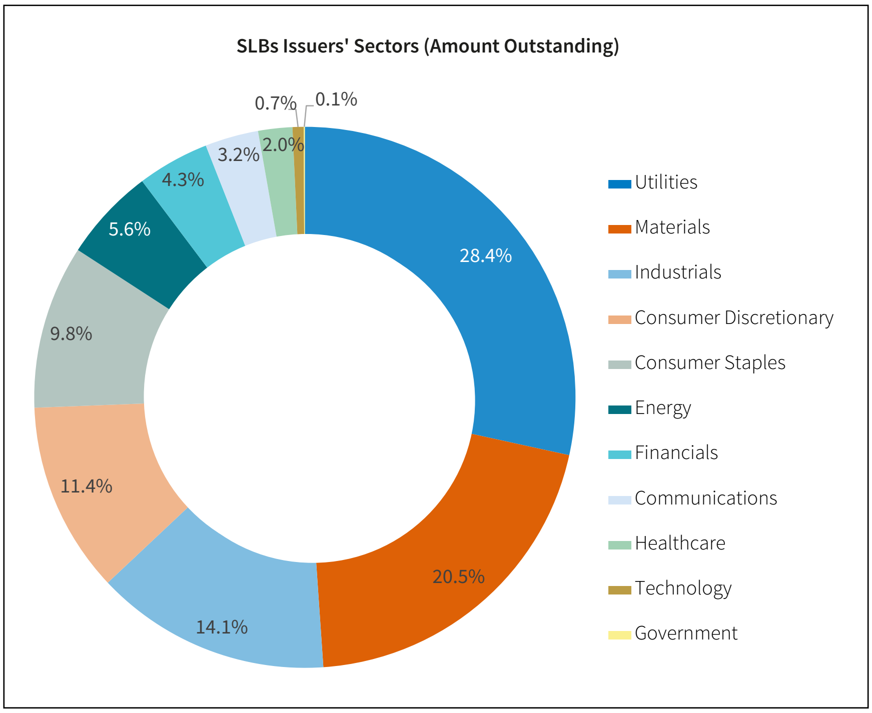
The first SLB was issued in 2019, and in 2021 the market reached the $100bn mark in terms of outstanding issuance. Unlike the GSSB market – which is dominated by sovereigns, agencies and financials – SLBs are most popular with corporate issuers. The utility, materials and industrials sectors are the largest players (see figs 1 and 2).

Figure 1: SLB volume outstanding by year in $



Source: AXA IM, Bloomberg, as of end September 2021

Figure 2. SLB Issuers by sectors (amount outstanding)



Source: AXA IM, Bloomberg, as of end September 2021

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 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 December 2020, the ICMA also came out with the Climate Transition Finance Handbook which provides guidelines and common expectations to SLB, GSSB and also transition bond issuers. The handbook comprises four core elements that act as an umbrella under which SLBs and any 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 – such 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 however, these guidelines around SLBs are only voluntary. We therefore decided to develop our own assessment framework to make sure we are better placed to invest only in high-quality SLBs. Similar to the framework we use for GSSBs, it draws on the ICMA SLB guidelines but brings a stringent approach that is proprietary to AXA IM. We have defined mandatory criteria that have to be met for us to invest in SLBs, and these are described below.

Our SLB assessment framework

AXA IM's SLB assessment framework is made up of four pillars:

1. Issuer's sustainability strategy & KPIs relevance and materiality
2. SPT ambition
3. Bond characteristics
4. SPT monitoring & reporting

For each pillar, at the very least, the issuer has to surpass our "exclusion" criteria and comply with our "requirement" criteria in order to be investable. If an SLB also meets our "expectation" criteria, it would place the issuer among the SLB leaders, in our view. All of these criteria are set out for each pillar below. 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.

Pillar 1: Issuer's sustainability strategy & KPIs relevance and materiality

The first pillar looks at 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.

The first filter here is based on AXA IM's ESG standards and policies. SLB issuers that are not compliant with our proprietary ESG standards and policies will not be considered for investment. In a similar fashion as for GSSBs, we want to ensure that SLB issuers make the basic ESG commitments that we deem essential as well as properly managing environmental and social risks.

As we do for GSSBs, we also adopt a forward-looking approach to look at the issuer's sustainability strategy and ambitions. We expect SLBs to be aligned with the issuer's overall sustainability objectives. Issuers should establish quantified, forward-looking environmental and/or social goals that are consistent with the sustainability and transition challenges they are facing. The contribution of AXA IM's credit research ESG assessment is key to evaluate the robustness of SLB issuers' sustainability strategy – especially in comparison with peers.

Our first pillar takes into consideration the first component of the ICMA's SLB Principles – selection of KPIs. As stated in the principles, we expect KPIs associated with the SLB to be material to the issuer's business model, quantifiable, externally verifiable, and able to be benchmarked. At AXA IM, we believe that a key aspect of a robust SLB is the materiality of selected KPIs – there is no point in issuing an SLB with KPIs that are not relevant to the issuer's business model and sustainability strategy. Therefore, we identified relevant KPIs for various sectors and we will only invest in SLBs with KPIs that we consider as material for the issuer, and that can drive meaningful progress regarding its ESG performance. So for a financial firm that might include the share of green or social loans included in its overall portfolio, for a utility firm we might include the reduction greenhouse gas emissions, and for autos we could consider a KPI that measured the percentage of sales related to electric vehicles.

Requirement	Expectation	Exclusion criteria
▸ Clear definition of the issuer's sustainability strategy and ambitions ▸ Clear rationale for SLB issuance ▸ Material and relevant selected KPIs	▸ Quantified, externally verifiable and comparable selected KPIs	▸ Non-compliance with AXA IM's ESG standards and policies ▸ Non-material selected KPIs

Pillar 2: SPT ambition

Our second pillar focuses on the quality and level of ambition of SPTs and is very similar to the ICMA principles' second component. To us, the key challenge here is to evaluate if the SPTs identified by issuers are ambitious enough, and as stated in the principles, "represent a material improvement in the respective KPIs and go beyond a "business-as-usual" trajectory".

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 recommendations of the principles, we believe issuers should be transparent about the action plan behind the achievement of the identified SPTs. In other words, we expect SLB issuers to explain to investors how the achievement of sustainability targets 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.

At AXA IM we also seek additionality with regards to SPTs. We think that the achievement of SPTs should be challenging for issuers. For example, we will not invest in SLBs for which sustainability targets are about to be achieved. We also favour SLBs with more ambitious or new targets formulated at issuance, rather than using existing ones. Of course, the starting point of the issuer is also taken into consideration, meaning that we do not want to penalise SLB issuers that are "best-in-class" players but rather encourage them to keep going into the right direction.

> "We decided to develop our own assessment framework to make sure we are better placed to invest only in high-quality SLBs"

Requirement	Expectation	Exclusion criteria
▶ Ambitious SPTs ▶ Comparability of SPTs ▶ Transparency on target-setting approach (including back-up mechanisms) ▶ Clear action plan to achieve SPTs	▶ Additionality of SPTs	▶ SPTs that bring no material improvement to the issuer's sustainability profile • No disclosure of SPTs

Pillar 3: Bond characteristics

Our third pillar follows the guidelines of the ICMA principles. Here, we look at the impact of a failure to achieve SPTs on the financial characteristics of the SLB – e.g. a coupon step-up if the SPT is not met in due time.

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. We also want to see 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 intermediary trigger events, as it is important to track progress over time even if the objective is long term.

One of the key aspects here is the magnitude and nature of the financial mechanism. We expect to see a clear incentive for the issuer to meet the SPTs. In the case of a coupon step-up, its level should be high enough that the achievement of an SPT has a meaningful influence on the issuer's sustainability journey and credit profile.

We also keep in mind that the financial mechanism's magnitude should be assessed relatively to the issuer's sector, ratings and currency.

Requirement	Expectation	Exclusion criteria
▸ Full transparency on the financial mechanism associated with the SLB ▸ Consistency between financial mechanism and trigger event(s) ▸ Intermediary trigger events in case of long-term SPTs	▸ Clear incentive for the issuer to meet SPTs	▸ No alignment in timing between financial mechanism and SPTs ▸ No disclosure of financial mechanism ▸ Insufficient financial mechanism

Pillar 4: SPT monitoring and reporting

The last pillar of our framework relates to updates on SPT achievement through regular reporting from SLB issuers. While the ICMA principles only encourage issuers to publish SLB reporting, it is a mandatory criterion within our assessment. We will not invest in SLBs for which the issuer does not commit to publish annual reporting.

We expect SLB issuers to make publicly available information on progress made with regards to the achievement of 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.

Requirement	Expectation	Exclusion criteria
▸ Annual update on progresses made with regards to SPTs ▸ External verification of reporting	▸ Additional information on progresses' explanation, and in case of SPTs recalibration	▸ No commitment to publish reporting

Looking forward: Our vision for the SLB and transition finance market

> **AXA IM is committed to helping improve standards definitions in this market**

We believe that SLBs could have a bright future. It remains a nascent market, but we are convinced that more and more issuers from various sectors will see it as an appealing option. We also think that the growth of the SLB market will not necessarily take place at the expense of GSSBs. In our view, these instruments are complementary in the ESG-themed bond space and both formats will attract issuers and investors.

We even think that beyond complementarity, the general-purpose structure of SLBs and the use-of-proceeds format of GSSBs and transition bonds will benefit from being combined in the same product. We have seen a few transactions that mixed well-defined and targeted green projects, with the financial characteristics of the bond linked to the achievement of sustainability targets at issuer level. We welcome this kind of hybrid format and hope to see even more in the future. In our view, it amplifies the message and could serve to strengthen issuers' sustainability ambitions.

As mentioned, we classify SLBs and GSSBs differently. While GSSBs will remain part of our green and impact investments, SLBs will be considered as transition investments – as is the case for use-of-proceeds transition bonds – provided they meet the criteria as set out above. Even if SLBs seem to have taken the lead over transition bonds when it comes to transition finance, we still believe that use-of-proceeds transition bonds have their place in the broad spectrum of ESG-themed bonds.

In our view, the transition bond market is hampered by the lack of a clear enough definition of what constitutes transition projects and assets. AXA IM is committed to helping improve standards definitions in this market. We aim to promote quality and integrity in 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.

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