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Social bonds: financing the recovery and long-term inclusive growth

Executive summary

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With its triple impact on education, income and health, the Covid-19 crisis has exacerbated existing inequalities, both among and within countries. An additional 71 million people, concentrated in South Asia and Sub-Saharan Africa, could be pushed into extreme poverty in 2020 as a result of the pandemic.

The rise in socioeconomic inequality represents a real threat to financial stability, both at the macro and microeconomic levels of analysis. In this unprecedented context, social risks can have a significant impact on asset values and thus should increasingly be taken into account by investors. Moody's estimates that US$8trn of the total debt it rates is subject to material social risks, i.e., four times the amount exposed to climate change risks.

A first possible strategy to integrate the social 'pillar' is to invest in social bonds, i.e., 'use-of-proceeds' fixed income instruments aimed at mitigating a specific social issue or at generating a positive social outcome. According to the most broadly accepted definition, a social bond is a regular or 'vanilla' bond that exclusively finances or refinances projects that address or mitigate a social issue, or that aim to achieve a positive social outcome.

The current period is especially propitious for this strategy, with the amount of new social bonds issued in 2020 ($142bn) more than eight times larger than in 2019. Remarkably, the European Commission, on behalf of the EU, successfully issued the first bonds of its SURE unemployment scheme under a social bond format.

Social bonds can be an optimal fit in the thematic pocket of investors' fixed income portfolios to add diversification, to serve as a solid platform for engagement with issuers on social themes and as a guarantee of measurable impact reporting to avoid 'social impact washing'. Long-term investors should consider investing in this nascent market to support its development and to take advantage of its future expansion.

As Covid-19 is a social cause that all market participants around the world can agree on, the moment is propitious to mobilise more private capital to meet the ever-increasing financing needs for social projects.

In this context, the development of the social bond market could provide opportunities for investors to align their strategies with key global challenges, above and beyond the pandemic. Although social bonds are not the only instruments with the potential to tackle social challenges, they do represent an optimal starting point for investors to actively engage with corporates and for the latter to start considering how their business models can contribute to the alleviation of social issues.

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Covid-19 is worsening the rising trajectory of inequalities

"The ongoing Covid-19 crisis puts a spotlight on inequality and has revealed an ever-pressing need to direct more capital flows towards mitigating social issues. In this unprecedented context, investors can start positioning on these issues by investing in social bonds that finance socially beneficial projects without giving up on returns."

While environmental and climate change-related risks and opportunities have increasingly been taken into account by investors around the world, their social counterparts have comparatively received much less attention in the last decade. However, the 'social' pillar of environmental, social and governance (ESG) investing should be of at least as much interest to investors as the 'environmental' pillar, both from a macro and microeconomic point of view.

Although studies on the macro impacts of social issues on financial markets are scarcer than those dedicated to climate change, **it is safe to say that inequalities pose a real threat to the global economic system.** On top of being an obstacle to growth, income inequality leads to socioeconomic imbalances within countries that can, in turn, affect financial markets' stability. Moreover, inequality tends to reduce social, economic and institutional resilience to shocks, as it erodes social cohesion and undermines trust in public institutions. This point should be given due consideration, especially in such a moment of concurrent demand and supply shocks. Finally, there seems to be a **vicious circle between income inequality and financial instability:** higher levels of inequality lead to greater macro-financial risks that can further induce greater inequality.

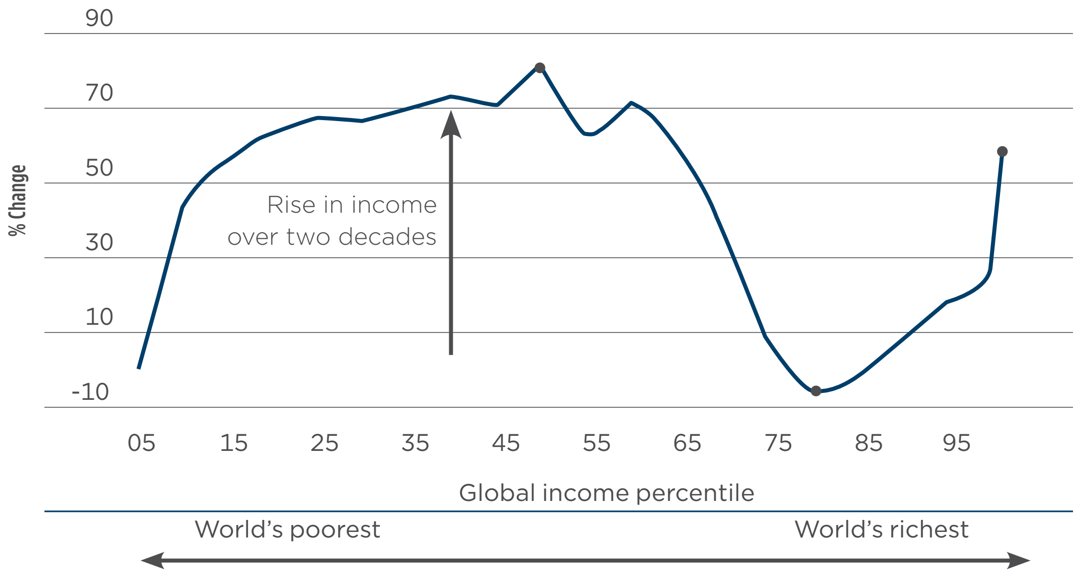
Moreover, from a microeconomic standpoint, there is no general agreement on which categories of social risks can be considered material to investors. However, **regulatory and litigation risks** -- for example, those related to equal pay infringements -- should be on investors' radars for the significant impacts they could have, especially with the increasing scrutiny enterprises are likely to experience after the crisis. Specifically, the pandemic has brought about specific issues (e.g., employee treatment or paid leave) that could partially shift the focus away from the 'usual suspects' contributing to global warming towards the financial and healthcare sectors, to name a couple. To give some concrete figures, **Moody's – one of the main rating agencies – estimates that $8trn of the total debt it rates is subject to material social risks, i.e., four times the amount exposed to climate change risks**.

It has to be highlighted that a strong link between climate change and social challenges can be identified, as exemplified by the 'just transition' concept. There is a compelling need to tackle social challenges engendered or worsened by the transition to a low-carbon economy, which affect workers across certain economic sectors, as well as communities around the world. The idea of a just transition has particularly caught on in Europe, where the European Commission established a Just Transition Mechanism to smooth the low-carbon transition across the continent, especially for those nations that are most dependent on extractive and carbon-intensive industries.

In addition, the new proposal for the EU Green Bond standard now integrates a social dimension requiring compliance with minimum social safeguards, in line with the International Labour Organisation's (ILO) regulations. In light of these developments, **even investors that are mostly climate change-focused should start considering integrating social risk into their investment frameworks.**

The social dimension has come to represent an increasingly important theme for investors, given its potential for systemic destabilisation, as mentioned above. The 1980s growth episode managed to decrease global inequality, with an improvement in living conditions for the poorest half of the population. However, there has been a decrease in equality since then, especially among developed liberal democracies and especially after the 2007-08 Global Financial Crisis. The outbreak of Covid-19 has only accelerated a pre-existing trajectory of increasing inequalities.

Figure 1. Change in real income in 1998-2008



Source: Branco Milanovic, Global inequality. A new approach for the age of globalisation. Copyright: BBC. Data as of 14 October 2020.

"Some 1.6 billion workers in the informal economy -- which employs almost half of the world's workforce -- could have their livelihoods destroyed as a result of the pandemic."

In the short term, the pandemic has exposed and heightened disparities, both across and within countries. On the one hand, the least developed nations have been hit harder by the crisis due to poor health infrastructure as well as living conditions that make their citizens more vulnerable to contagion. Some 1.6 billion workers in the informal economy – which employs almost half of the world's workforce – could have their livelihoods destroyed as a result of the pandemic. Further, remittances, on which developing countries crucially depend, are expected to decline by 20% in 2020. An additional 71 million people will be living in extreme poverty conditions due to the pandemic's effects, mostly in South Asia and Africa.

Table 1. Disparities across countries

	Very high human development countries	Least-developed countries
Health system capacity for 10,000 people	55 hospital beds 30 doctors 81 nurses	7 hospital beds 2.5 doctors 6 nurses
Remittance inflows	0.3% of GDP as of 2018	4.6% of GDP as of 2018

Source: United Nations, World Bank, as of 14 October 2020.

On the other hand, developed nations were better equipped to impose broad lockdowns on their populations. However, the pandemic has been managed in very different ways across the developed world, and with varying rates of success. For instance, in the United States socioeconomic inequalities have been exacerbated more than ever, with higher mortality rates experienced by the most marginalised groups. Moreover, job losses have reached staggering heights in country: as of October, the unemployment rate had reached 6.9%, compared to 3.5% before the pandemic, and more than 65 million people have filed for unemployment since the pandemic began.

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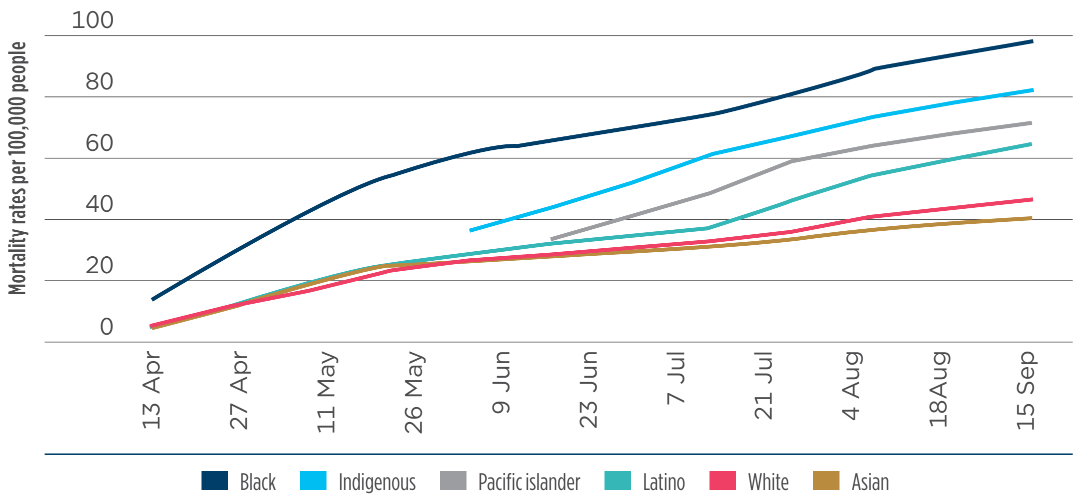
Figure 2. Black and indigenous Americans experience highest death tolls from Covid-19

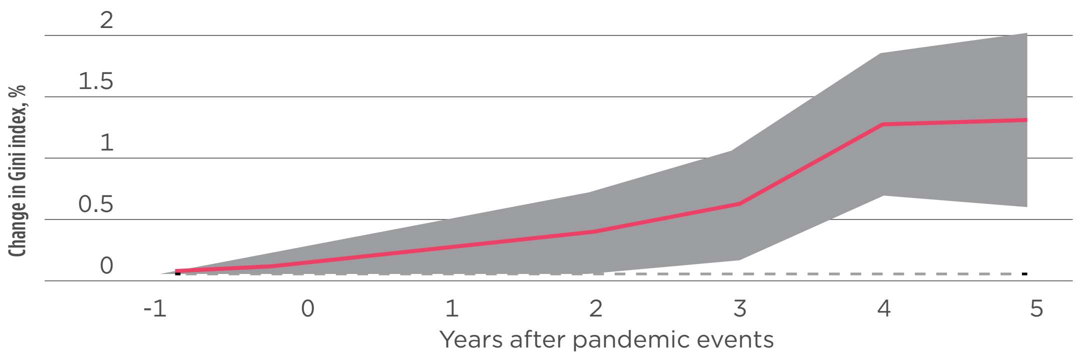


Note: Dates prior to 8 August 2020 are 14 days apart, except for 11 May - 26 May, which is a 15-day period. The interval from 18 August to 15 September reflects a four-week period, unlike the two-week period in most series. Midpoint data between 18 August and 15 September has been interpolated. Cumulative actual Covid-19 mortality rates per 100,000, by race and ethnicity, 13 April - 15 September 2020. Source: APM Research Lab. Data as of September 2020.

"The pandemic has highlighted the importance of integrating social risks into investment decisions. More importantly, it has also brought about significant opportunities for investors."

In the long term, income inequality is expected to rise by a significant extent. A recent study shows that past epidemics accompanied by important economic contractions have been followed by an increase in the Gini coefficient, the most widely used metric for income inequality.

Figure 3. Impact of pandemics on inequality

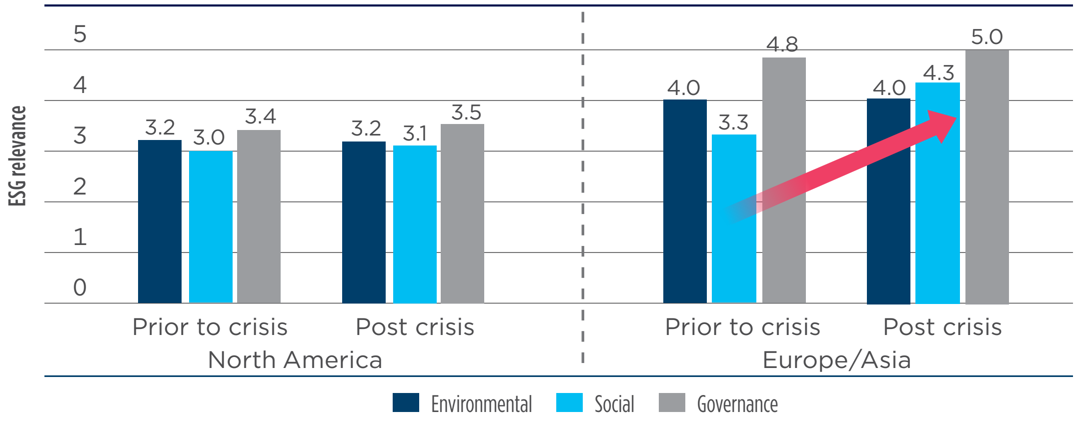


Source: Vox EU. Data as of May 2020.

The pandemic has highlighted the importance of integrating social risks into investment decisions. More importantly, it has also brought about significant opportunities for investors.

In fact, **in North American markets, the social pillar – which had been lagging behind the environmental and governance pillars in previous years – outperformed the other two pillars in the first quarter of 2020.** Also, while the perceived relevance of the environmental and governance factors has not changed much as a result of Covid-19, **institutional investors in Europe and Asia have recently reported to give a much greater importance to the social pillar in their investment approach.**

Figure 4. Importance of ESG for institutional investors



Source: Greenwich Associates Coronavirus Flash Study, May 2020. ESG relevance is measured on a scale from 1 to 5, with 1 being the least relevant and 5 the most relevant.

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The social bond market is developing, offering new investment opportunities

The first bonds identified as 'social' had the objective of saving the lives of children in poverty around the world by providing them with the necessary vaccinations. These 'vaccine bonds' were issued by the International Finance Facility for Immunisation in 2006. They managed to raise more than $4.5bn, a first signal of the great potential of this instrument among investors.

In 2017, the International Capital Market Association (ICMA) published the first guidelines for issuing social bonds, aimed at supporting the development of the market for this innovative financial instrument. **The Social Bond Principles (SBP) list the necessary components for a bond to be "certified" as social,** namely:

- the proceeds need to be used to finance or refinance social projects;
- the process to evaluate and select projects should be clear and communicated to investors;
- the proceeds must be tracked adequately; and
- issuers should provide investors with an annual report on the use of proceeds.

Furthermore, the SBP list examples of eligible social project categories (e.g., access to essential services such as health and education) and of target populations (e.g., populations living below the poverty line) to provide issuers with some guidance.

Focus: the Social Bond Principles and 2020 updates

The 2017 Social Bond Principles were updated in June 2020 to reflect changes in the market and improve the user-friendliness for issuers and investors. The modifications were the result of the shared efforts of members of the ICMA Social Bond Working Group.

The list of potential target populations was revised to include two new categories and more examples were added to the social project categories. Moreover, in the middle of the pandemic crisis, "programmes designed to prevent and alleviate unemployment stemming from socioeconomic crises" were added as an acceptable project category to encourage organisations to issue bonds in line with the SBP during this emergency.

The concept of 'social issue' was given a precise definition as an issue that "threatens, hinders, or damages the well-being of society or a specific target population". The updated SBP also acknowledge that the identified target population strongly depends on the context in which proceeds will be used and that – in specific cases such as a pandemic – it can be equated with the general public.

Examples of SBP project categories include:

- Affordable basic infrastructure (e.g., clean drinking water, sewers, sanitation, transport, energy);
- Access to essential services (e.g., health, education and vocational training, healthcare, financing and financial services);
- Affordable housing;
- Employment generation, **and programmes designed to prevent 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);** and
- 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)**.

Examples of target populations include:

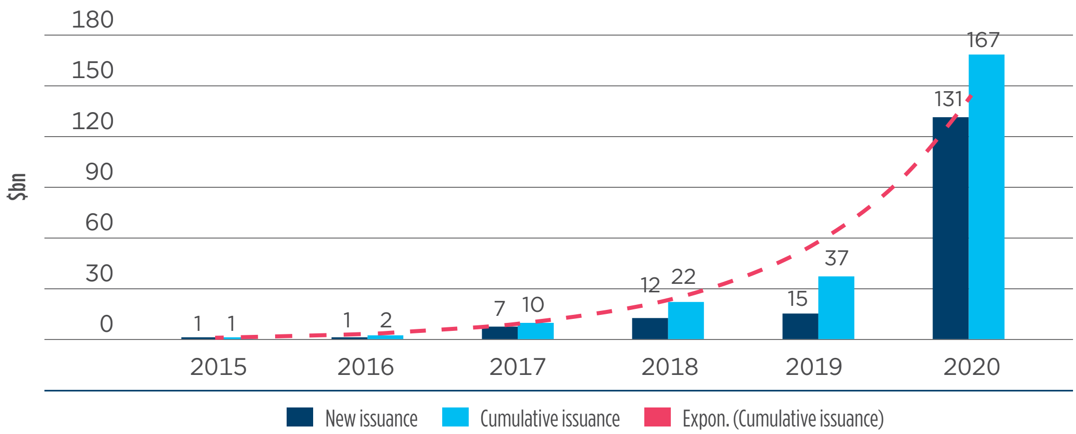
- Those living below the poverty line;
- Excluded and/or marginalised populations or communities;
- People with disabilities;
- Migrants and/or displaced people;
- The undereducated;
- The underserved, owing to a lack of quality access to essential goods and services;
- The unemployed;
- **Women and/or sexual and gender minorities;**
- **Ageing populations and vulnerable youths;** and
- Other vulnerable groups, including as a result of natural disasters.

Source: Social Bonds Principles ICMA, June 2020. Bold text corresponds to 2020 updates to the SBP principles.

The global social bond market has experienced strong growth in recent years.

"Of the $1,280bn in cumulative sustainable fixed income issuance, social bonds account for around 14% of the total."

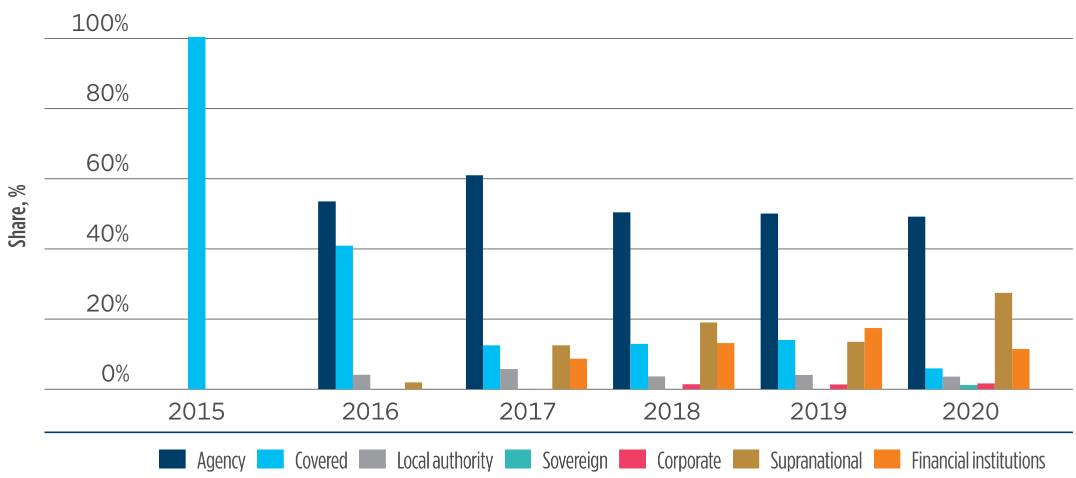
Figure 5. Social bonds market, dollars



Source: Amundi analysis on Bloomberg database on social 'use of proceeds' bonds, as of 16 November 2020.

Of the $1,280bn in cumulative sustainable fixed income issuance, social bonds account for around 14% of the total, amounting to $180bn. Considering cumulative volumes over the 2015-20 period, issuance was mainly driven by agencies (49%), supranational entities (27%), and financial institutions (11%). The over-representation of agencies and supranational issuers is not surprising at this stage of the market's development as it mirrors the early days of the green bond market.

Figure 6. Issuer type breakdown



Source: Amundi analysis on Bloomberg database on social 'use of proceeds' bonds, as of 12 November 2020.

In terms of geography, Europe is leading with respect to social bond issuance, accounting for 45% of new social bond issuance in 2020. However, this share has significantly decreased from 70% in 2017, as issuances in other regions, especially Asia-Pacific and North America, have been rising.

Although Asia has experienced the fastest growth in social bond issuance over the last years, the market is still underdeveloped and SSA issuers have not been providing a sufficient push yet. In the region, the South Korean government issued the sole social bond of 2019. Nonetheless, last January, India's Shriram Transport Finance Co. sold a $500m social bond, with the proceeds targeted at truck financing for small and medium enterprises (SMEs).

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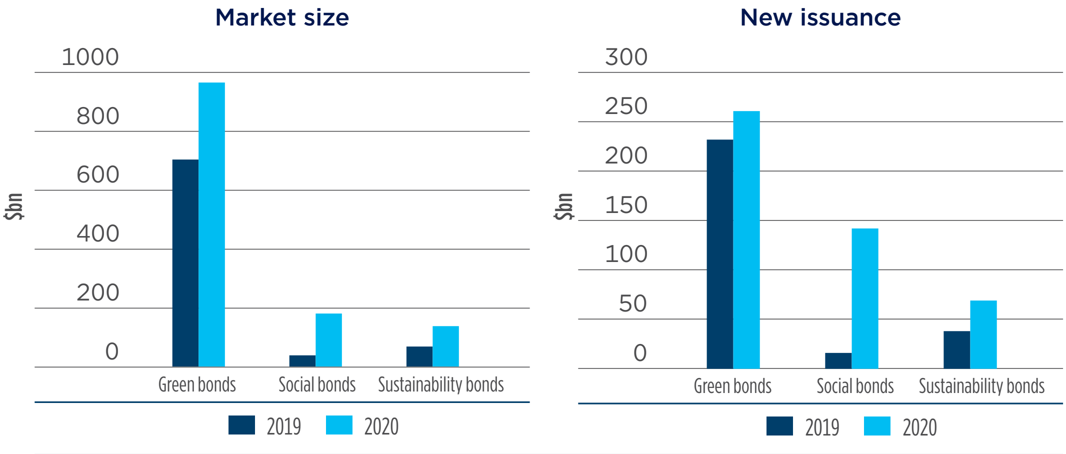
"Not only could social bonds provide necessary funding during the pandemic, they could also address the aftermath of the crisis and help economies become more resilient to future unexpected shocks."

This overall expansion trend has intensified during the pandemic. In fact, the growth of the social bond market in 2020, i.e. +374% with respect to 2019 levels, dwarf both the green and sustainability bonds markets' expansion, respectively +37% and +100%.[1]

New issuance of social bonds year to date totalled $142bn, more than eight times compared to 2019. This figure does not include the so-called 'Covid-19 response' bonds -- which not completely aligned with the ICMA SBPs - or sustainability bonds with proceeds mostly used for social projects; thus, the total amount of bond issuance with a social focus is even larger than that.

Figure 7. Green, social and sustainability bonds, US$bn



Source: Bloomberg/use of proceeds, Amundi. Data as of 12 November 2020.

Cumulative social bond issuance remains far below the levels reached in the global green bond market (a mere $180bn against $963bn, respectively). However, the crisis has led to a clear expansion across regions of social bond issuances, as these can be used as a tool to respond to a wide range of pandemic-related financing needs.

Social bonds can be the right instruments to respond to the Covid-19 crisis

To guide issuers in this unprecedented period, the ICMA recently published guidelines on resorting to social bonds to finance emergency response measures. Most importantly, the ICMA announced that the Social Bond Principles were immediately applicable to bonds addressing the virus outbreak.

"The crisis has led to a clear expansion across regions of social bond issuances, as these can be used as a tool to respond to a wide range of pandemic-related financing needs."

Before the crisis, proceeds from social bonds mostly targeted social housing, support to SMEs, socioeconomic advancement and education programmes. However, **in the context of the Covid-19 outbreak, proceeds are expected to be earmarked for a wider range of project categories, such as expenditures to increase capacity in healthcare services and equipment.**

Examples of social bonds issued during this crisis include the African Development Bank's $3bn "Fight Covid-19" social bond in March 2020, aimed at alleviating the economic and social consequences of the pandemic on its member countries and the continent's private sector, as well as the first-ever sovereign social bond issued by the Guatemalan government.

[1]HSBC Global Research (April 2020) "Green Bond Insights - Delayed but not denied."

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As for the EU, "it is *"for the first time in history, [...] issuing social bonds on the market, to raise money that will help keep people in jobs"* (U. von der Leyen, President of the EU Commission). On 20 October, the EU issued its first social bond under the €100bn Support to mitigate Unemployment Risks in an Emergency (SURE) programme. The €17bn social bond was accompanied by a Social Bond Framework, that was assessed to be in line with the four components of the ICMA Social Bond Principles by Sustainalytics' Second Party Opinion (SPO). The issuance sparked great interest among investors, who oversubscribed it more than 13 times, reaching a record order book of €233bn. According to Refinitiv, it is the highest demand for a bond in history. The second issuance on 10 November was also very popular among investors, with a high degree of over-subscriptions.

Social bonds appear to be an appropriate financing instrument for these times for several reasons. The Covid-19 pandemic has worsened existing social challenges that are affecting the health and well-being of the world's population. On top of this, the imposed lockdown in most areas of the world and the subsequent global economic crisis it brought about have already impacted millions of people as a result of job losses and social isolation. While social bonds seek to mitigate issues for target populations, they may be beneficial to the general population as a whole in the context of this global crisis.

As it is the case for green bonds, SSAs can play a role in spearheading the development of the social bond market, which would enable capital to be front-loaded rapidly. **According to the Asian Infrastructure Investment Bank, at least a quarter of the sovereign bonds issued this year have targeted pandemic-related concerns.**

Issuers claim that proceeds from such social bonds will be used to finance the long-term needs of the real economy, and particularly to support healthcare infrastructure investments and provide credit to struggling businesses. **As a result, not only can social bonds provide necessary funding during the pandemic, they can also address the aftermath of the crisis and help economies become more resilient to future unexpected shocks.** Beyond the current Covid-19 context, social bonds hold immense potential as they constitute adequate tools to meet broader developmental objectives in the decades to come.

"Social bonds also offer a solid platform for dialogue and engagement with corporate issuers."

The ICMA recently published a document detailing how social bonds – as instruments that channel resources to mitigate major social issues – could contribute to the achievement of the UN Sustainable Development Goals (SDGs). Some examples of SDGs that social bond financing could address include eradicating world poverty, achieving food security and ensuring the availability of water and sanitation for all. However, the realisation of the SDGs requires massive amounts of capital: according to the UNCTAD's World Investment Report, **the financing gap to achieve the SDGs in developing countries is estimated at $2.5-3.0trn per year. In this context, social bonds could help fill the SDG financing gap,** especially since the pandemic could delay the achievement of the SDGs by 10 additional years until 2092.

Why social bonds for institutional investors?

Institutional investors should be interested in social bonds for several reasons.

First, the possibility to finance socially beneficial projects does not come at the expense of returns: in fact, as is the case with green bonds, **the risk-return profile of a social bond is in line with that of a vanilla bond from the same issuer.**

While this is normally not feasible with fixed income, **social bonds also offer a solid platform for dialogue and engagement with corporate issuers.** Active ownership, also known as stewardship, is increasingly recognised as one of the most effective strategies to influence issuers to integrate long-term sustainability into their business models and practices. Indeeed, by issuing a social bond, the issuer is explicitly committing to using the proceeds for social projects and it is 'signaling' to the market its plans to focus its business model on more socially impactful products and services. **Thus, it gives an optimal opportunity to investors to put forward an effective engagement strategy while investing in a debt instrument.**

"The increasing diversity of issuer profiles seems to indicate that social bonds are starting to follow in the footsteps of the green bond market: thus, social bonds in the future are expected to become an established aggregate fixed income market."

Furthermore, **issuers are strongly encouraged to provide annually a sufficient level of reporting on the use of proceeds, with the description of the social projects the bonds are financing.** This enables investors to report with clarity on their considerations for global social issues and on the measurable social impact their investment is producing. It also decreases the risk of 'social impact washing', which can be significant with any investment strategy claiming to produce positive impacts. In order to guarantee the quality of both issuers and issuances, it is vital to facilitate a constant exchange and collaboration between the ESG and fixed income teams within large asset managers.

At the current stage of the market, **social bonds fit well in a fixed income portfolio as thematic investing.** However, the increasing diversity of issuer profiles seems to indicate that the social bond market is starting to follow in the footsteps of the green bond market: thus, **social bonds in the future are expected to become an established aggregate fixed income market.**

In the meantime, **we will focus on the whole social fixed income spectrum by looking also at 'traditional bonds' brought to the market by issuers with very strong social practices.**

In conclusion, this year's boom in issuance was brought about mostly by the Covid-19 crisis but has revealed the great potential of social bonds in financing projects with positive impacts for society as a whole. The shake-up caused by the pandemic is expected to support such growth in the aftermath of the crisis and beyond. Thus, long-term investors should consider jumping on the 'social bonds wagon' at an early stage to support the development of this innovative instrument and reap the benefits of the expected market expansion away from Europe and SSA issuers and towards more attractive profiles.

Definitions

- **Diversification:** Diversification is a strategy that mixes a variety of investments within a portfolio, in an attempt at limiting exposure to any single asset or risk.

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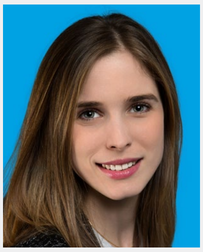

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