Transition Bonds Special Interest Commentary

27 May 2024

Transition Bonds: In the shadows of Sustainable Finance

Andrew Wong
Credit Research Analyst
WongVKAM@ocbc.com

Assisted by Ian Teo

Current landscape in Sustainable Financing

To understand what transition bonds are, we must first see what other existing sources of funding are available within sustainable finance to see how transition bonds fit in. Currently, there are four main bond categories for sustainable finance, namely Green Bonds, Social Bonds, Sustainability Bonds and Sustainability-Linked bonds. Together, they are collectively known as green, social, sustainable, and sustainability-linked ("GSSSL") bonds, in which their total issuance in 2023 was around USD1tn, making up roughly 15% of total bond issuances. Given the rising popularity of sustainability and sustainable finance, various forecasts expect a similar to slightly higher amount of GSSSL bonds to be issued in 2024 although the future trends within this amount could vary. For example, data compiled by the International Capital Market Association ("ICMA") on developments and trends within Asian International Bond Markets (4th Edition, March 2024) show significant growth in sustainable bond issuance by Asian issuers through 2021 before stabilising in 2022 and 2023. Within this, Hong Kong issuance doubled y/y in 2023 although remained behind total issuance from Chinese, Japanese and Korean issuers.

Green Bonds

Green Bonds make up the bulk of GSSSL bond issuances at around 60% in 2023 according to the Environmental Finance Bond Database. They provide a source of direct finance for new and existing green projects. Green bonds usually require a higher standard of commitment from the company to reduce its carbon footprint and their environmental profile is often assessed before it is eligible for funding. Examples of these projects include building solar power farms or sustainable waste management facilities.

Social Bonds

Social Bonds are second in terms of GSSSL bond issuance size at around 18% in 2023. Proceeds of social bonds must finance activities that at least achieve positive social outcomes or address a social issue. These projects are aimed at target populations such as those living below the poverty line, marginalized communities, migrants, unemployed, women and/or sexual and gender minorities, people with disabilities, and displaced persons. Examples include Latin America's first gender-focused social bond in 2020 to fund loans to eligible women-led businesses in Colombia and to first-time female home buyers on low incomes.

Sustainability Bonds

Sustainability Bonds are a close third in terms of GSSSL bond issuance size at around 16% in 2023. These are issues where proceeds are used to finance a combination of green and social projects or activities.

Sustainability-Linked Bonds

Sustainability-Linked Bonds have the smallest GSSSL bond issuance size at around 7% in 2023. They are not restricted to green projects. Instead, they are associated with the sustainability goals set by the issuer. Bond coupons are linked to achieving those specified goals or outcomes, and the issuer is usually liable to pay additional interest if these targets are not met. Some sustainability linked bonds instead require the issuer to divert more funding to sustainability related projects. This is meant to address a perceived complaint that investors in sustainability-linked bonds stand to benefit financially from an issuer's inability to meet its sustainability goals per the bond documentation.

To put things into perspective, sustainability-linked bonds, the smallest group, had about USD66bn in issuances in 2023. Transition bonds on the other hand only had ~USD3bn in issuances. This speaks to how relatively small and unknown transition bonds are compared to existing GSSSL bonds, albeit they were only introduced recently around 2021.

What are transition bonds?

Transition bonds are a nascent financing tool, in which use of proceeds are used to reduce an issuer's environmental impact through decarbonising fossil fuel and hard-to-abate sectors that would not normally qualify for green bonds such as steel, cement and petrochemicals to name a few. Companies issuing transition bonds are also required to have a transition strategy and transition bond framework.

How do transition bonds compare?

Transition bonds are like a combination of both green and sustainability-linked bonds but with both similarities and differences. Their similarity to green bonds lies in that the finance they both provide can or are directed at a specific sustainable project. However, the existing standards required to issue a transition bond is not as high as that of a green bond where the green bond issuer typically is viewed as already operating sustainably. To this end, transition bonds are more alike to sustainability-linked bonds, in which the bond issuer is not required to already be operating sustainably but is usually in the process of transitioning to lower-carbon operations. However while the intention of transition bonds and sustainability-linked bonds are the same, a difference is that sustainability-linked bonds contain very specific issuer-appropriate targets to facilitate the transition. Transition bonds on the other hand are not required to contain such targets and can instead refer generally to use of proceeds categories such as energy conservation and improved energy efficiency that are tied to a transition bond framework. This highlights the frequently raised challenge for transition bonds that they are open to greenwashing given that issuers are arguably operating in an unsustainable way at the point of issuance when this capital could instead be diverted to better credentialled or more reliable GSSSL bond types.

Filling the gaps left by GSSSL bonds

In the past, the Asian Development Bank ("ADB") refused to outright fund coal mining and oil and natural gas production and exploration in its draft 2021 Energy Policy. This was for obvious environmental reasons but also for related social ones with pressure from the NGO Forum on ADB, an Asian-led network of civil society organizations based in Asia and the Pacific region, to stop funding coal projects given their detrimental impacts on local communities. This decision however was reversed in a subsequent revision of the ADB's Energy Policy given its intention to also ensure reliable and affordable access to energy throughout developing countries in Asia and the Pacific, in addition to promoting the low-carbon transition in the region. Driving this change of stance is the relative dominance of coal fired power generation within Asia and the region's contribution to over 50% of global greenhouse gas emissions. At the time of the revision, the NGO Forum on ADB also noted that ADB should develop clear steps on how it will support developing member countries in their efforts to transition away from fossil fuels and super-pollutants.

The introduction of transition bonds therefore may give ADB an avenue to support the dual aims of its energy policy and provide financial support to coal plants transitioning to cleaner solutions. In a sense, transition bonds provide companies in frequently shunned industries an opportunity to receive funding when they would have been rejected on traditional guidelines based on traditional green bond requirements due to their excessive greenhouse gases emissions.

The gap that transition bonds are seeking to fix is large despite (1) expectations from the International Energy Agency ("IEA") that, based on the current momentum of investment in clean energy[1], the world may see peak fossil fuel demand (comprising coal, oil and natural gas) before 2030, and (2) the weakening relationship between global economic growth and fossil fuel demand. This is because according to various research[2], fossil fuels will still be a significant proportion of the global energy mix in 2050, notwithstanding its contribution will decline from around 80% towards the 50-60% level.

[1] Based on the Stated Policies Scenario ("STEPS") that provides an outlook of future energy composition based on current government policies over energy systems
[2] World Energy Council World Energy Scenarios, Statista

Why are transition bonds having difficulty gaining traction?

We believe there are two factors that are the biggest hurdles in the adoption of transition bonds.

The poor reputation transition bonds have attained

Transition bonds have a reputation for being a potential outlet for greenwashing, or "transition washing" to coin a more recent term, where a company's environmental performance or intentions are exaggerated or misrepresented. Such perception exists as (1) most issuers of transition bonds are companies with significant existing levels of carbon emissions, and (2) most of them are not known for being environmentally conscious to begin with. Furthermore, the lack of consistent international standards required to issue a transition bond could be interpreted as greenwashing as the steps taken may be too small or inconsequential or, at worst, undefined.

Hence, these companies face much more skepticism when trying to issue transition bonds as many question their intentions. From the investor's perspective, most would be hesitant of having such transition bonds in their portfolio as well, due to the reputation of such bonds and to also avoid questioning as to why the fund supports something that is possibly controversial.

A lack of established standards for transition bonds

Transition bonds also have transparency concerns that stem from the absence of clear and consistent international standards regulating them. This shortcoming though may be changing. Following the release of the International Capital Market Association's ("ICMA") 2020 Climate Transition Finance Handbook, Japan formulated its Basic Guidelines on Climate Transition Finance in May 2021 with the Financial Services Agency (FSA) and Ministry of Economy, Trade and Industry (METI) and Ministry of the Environment. The guidelines were aimed at promoting transition finance in Japan together with net-zero roadmaps for high-emitting sectors including cement, chemicals, electricity, gas, steel, oil, and paper/pulp.

The ICMA, a trade association that represents financial institutions active in international capital markets worldwide and a key standard setter for labelled bonds, also published a report titled "Transition Finance in the Debt Capital Market" in February 2024 seeking to define transition finance and "unlock further the potential of the sustainable bond market to finance transition." While noting the slow growth and adoption of transition finance and transition bonds due to greenwashing concerns and the prevailing use of green and sustainability bonds for climate finance, ICMA also recognised that climate transition finance was "at the top of the agenda among both policy makers and market participants[3]" and also highlighted the recent release of various guidelines on transition finance by the OECD, European Commission and the ASEAN Capital Markets Forum. ICMA further noted the International Sustainability Standards Board's new sustainability corporate reporting standards and the European Sustainability Reporting Standards as opportunities for transition finance to play a more mainstream role in the GSSSL bond market and proposed the voluntary adoption of transition plans in preparation for more established market standards.

Global outlook for transition bonds

While there are significant possibilities for transition finance, particularly in Asia-Pacific, their global potential remains somewhat constrained by the hurdles mentioned above. Global growth in transition bond issuance has been non-existent over 2020-2023 (and in fact has declined) while global issuance totals for the overall GSSSL bond market have risen significantly over the same period (albeit with a recent decline that has been somewhat in line with global bond markets).

It is also worth noting that the ICMA has not issued principles for transition-labelled bonds. Its Climate Transition Financing Handbook argues that transition is "best conceived as a theme that can be financed by green and sustainability bonds, as well as sustainability-linked bonds, while recognising the development of a "climate transition" label adapted notably to certain jurisdictions and regions. The handbook also adds that transition plans can be financed by unlabelled bonds.

Since the release of Japan's Basic Guidelines on Climate Transition Finance, only Japanese issuers have dominated the transition bond market and following the release of its Climate Transition Bond Framework in November 2023, this could still be the case. The country is planning to issue JPY20tn of Economy Transition Bonds (~USD140bn) in the next 10 years according to ICMA, including the JPY 800bn 10-year Japan Climate Transition Bonds issued on 14 February 2024 (more information below). In this

[3] ICMA Transition Finance in the Debt Capital Market, February 2024

regard, the transition bond outlook is somewhat promising, albeit coming from a low base and solely based on Japan's issuance plans.

Outside of Japan, the trajectory of transition bonds remains uncertain, although we could have a rough sensing of where they might be headed by assessing the key drivers behind them. We have identified three main drivers:

1. The incentives issuers and buyers have for using transition bonds.
2. Push for domestic issuances over international issuances.
3. Continued demand for fossil fuels, even in 2050.

Incentives issuers and buyers have for using transition bonds

As the late Charlie Munger once said, "Show me the incentive and I'll show you the outcome". To understand the behaviour of these stakeholders, we must first see what the incentives are and whether they are sufficient.

From the issuer's perspective, their main incentives would be attaining a lower issuing cost and an improvement in reputation by showing their commitment to the environment. However, this pricing premium, otherwise known as "Greenium", has been diminished lately due to stabilising demand from buyers amid record issuances of GSSSL bonds. In 2018, the average Greenium was around 5%, however in 2023, this has declined to near zero [4]. Consequently, if the Greenium on existing GSSSL bonds are already so low, the expected Greenium on transition bonds should be non-existent due to lower demand for the reasons mentioned above. From a reputation standpoint, transition bonds are not any better off as well. Hence, unless there is greater support from governments to lower issuing costs, for example in the form of tax incentives or a change in perception on transition bonds, it is unlikely for transition bonds to gain traction, among both buyers and sellers.

The exception would be companies in fossil fuel and hard-to-abate sectors that are unable to tap into existing GSSSL Bonds. Transition bonds provide these companies a chance to rebrand their image, though demand for such bonds could remain low for now.

Push for domestic issuances over international issuances

Despite the headwinds faced by transition bonds in getting accepted internationally, there might be a bright spot for transition bonds in the domestic market where clear transition guidelines are in place and where domestic financial institutions play the dominant role in the domestic market. On 14 February 2024, Japan was the first in the world to issue sovereign climate transition bonds. A total of JPY800bn (USD5.3bn) in 10-year transition bonds were issued to fund low-cost wind power generators and airplanes that use alternative fuels. Japanese Prime Minister Fumio Kishida intends to sell JPY20tn (USD140bn) of climate bonds over the next decade to attain the goal of cutting greenhouse gases to zero by 2050.

Japan has been a huge advocate for transition bonds. In fact, about two-thirds of all transition bonds have come from Japanese issuers, supported by the world's first sovereign Climate Transition Bond Framework published in November 2023 that includes areas such as nuclear energy, carbon capture, and alternative fuels and feedstocks for the manufacturing industry. The transition roadmaps for sectors including iron and steel, chemicals, and cement published by Japan's Ministry of Economy, Trade, and Industry also highlighted its commitment to assist the transition for hard-to abate sectors that have a high dependence on fossil fuels and no simple solutions for reducing emissions. It is likely that Japan is pushing for Transitions Bonds due to its heavily industrialized economy and sees a need to reduce its emissions to meet global standards and net zero commitments. This localised emphasis, and absence of globally accepted taxonomies and guidelines, has likely driven the dominance of domestic or local currency issues of transition bonds as opposed to USD issuances in the past three years.

Another major issuer of transition bonds could be China. In January 2021, Bank of China issued the country's first transition bond with USD780mn raised in two tranches, stating their commitment to sustainable finance and the greening of the steel industry across the country. The steel industry in China accounts for ~5% of its GDP, and currently represents around 15% of China's total carbon emissions[5]. The Climate Bonds Initiative estimates that China's steel industry will require investments of around RMB20tn (USD3.14tn), to achieve carbon neutrality. Recently, Bank of China Luxembourg issued a EUR300mn transition bond to be used in the development of the steel sector's decarbonisation in Hebei Province, China's top steel province.

[4] Based on Alliance Bernstein research

[5] BNP Paribas: Transition bonds: evolving across financial institutions and governments in Asia 19 October 2023

Such issuances are supported by the development of guidelines on technical pathways for decarbonisation of carbon-intensive industries by China's National Development and Reform Commission ("NDRC") and other relevant ministries. In its "Transition Finance in the Debt Capital Market" report published in February 2024, the ICMA also noted that China's mandatory Green Bond Endorsed Project Catalogue (2021 edition) contains a "white-list", measure-based approach for transitional areas while the People's Bank of China is leading the development of a broad national policy framework for transition finance that will focus on specific high emitting sectors. It is likely that the future of Transition Bonds are going to be heavily influenced by the success of the issuances in these economies.

Continued demand for fossil fuels, even in 2050, makes transitioning all the more important

While great amounts of effort are being put into eliminating the need for fossil fuels, there is currently no widespread alternative to jet fuel or ship diesel, which would mean steady or even rising fossil fuel use as the economies of developing countries grow. There is still a range of industrial processes, such as cement-making and the production of plastic, that will possibly collectively fail to meaningfully cut carbon-intensive fuels by 2050 as well.

While industries like motor vehicles and electricity production have seen great levels of innovation and commitment to reducing carbon emissions in the form of electric vehicles and wind/solar energy respectively, other industries like aviation, shipping and manufacturing are facing much greater difficulty transitioning as there really is no clear cost-effective alternatives to fossil fuels. Industrial processes, notably, make up a huge fraction of emissions and yet are extremely difficult to reduce. Global fossil fuel use is expected to flatten or decline by mid-century before starting to grow again due to rising energy demand in various parts of the world. This increase will be led by natural gas demand which is projected to increase 126% by 2100 according to The Guardian.

There is wide recognition that achievement of net zero in 2050 will be an uphill battle, albeit a vital one. The faster growth in renewable energy is encouraging but it is unlikely to be the main driver for a successful energy transition. It may be time to look past the reputation of companies in hard to abate sectors and give them a chance to change. Transition bonds could provide the avenue for that with proper incentives guided by established standards for transition bonds leading to an improved reputation and more market acceptance.

Explanation of Issuer Profile Rating / Issuer Profile Score

Positive ("Pos") – The issuer's credit profile is either strong on an absolute basis or expected to improve to a strong position over the next six months.

Neutral ("N") – The issuer's credit profile is fair on an absolute basis or expected to improve / deteriorate to a fair level over the next six months.

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To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings into a 7-point Issuer Profile Score scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

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Overweight ("OW") – The bond represents **better relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Neutral ("N") – The bond represents **fair relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Underweight ("UW") – The bond represents **weaker relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Please note that Bond Recommendations are dependent on a bond's price, underlying risk-free rates and an implied credit spread that reflects the strength of the issuer's credit profile. Bond Recommendations may not be relied upon if one or more of these factors change.

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Macro Research

Selena Ling
Head of Strategy & Research
LingSSSelena@ocbc.com

Tommy Xie Dongming
Head of Greater China Research
XieD@ocbc.com

Keung Ching (Cindy)
Hong Kong & Macau
Cindyckeung@ocbcwh.com

Herbert Wong
Hong Kong & Macau
HerberthtWong@ocbc.com

Lavanya Venkateswaran
Senior ASEAN Economist
LavanyaVenkateswaran@ocbc.com

Ahmad A Enver
ASEAN Economist
Ahmad.Enver@ocbc.com

Jonathan Ng
ASEAN Economist
JonathanNg4@ocbc.com

Ong Shu Yi
ESG Analyst
ShuyiOng1@ocbc.com

FX/Rates Strategy

Frances Cheung, CFA
Rates Strategist
FrancesCheung@ocbc.com

Christopher Wong
FX Strategist
ChristopherWong@ocbc.com

Credit Research

Andrew Wong
Credit Research Analyst
WongVKAM@ocbc.com

Ezien Hoo, CFA
Credit Research Analyst
EzienHoo@ocbc.com

Wong Hong Wei, CFA
Credit Research Analyst
WongHongWei@ocbc.com

Chin Meng Tee, CFA
Credit Research Analyst
MengTeeChin@ocbc.com

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