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POLICY BRIEF

A Swedish market for sustainability-related and socially labelled bonds: Institutional investors as drivers

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This work is part of a broader SSFC project on social finance. The full study is available as SSE Working Paper in Business Administration No 2019:3 and can be found online at hhs.se

Key messages

- Sweden is a front runner in green bonds but lags behind many other western economies in the novel market for sustainability-related and social bonds. This study shows, however, that there is increasing activity outside of the public eye among Swedish financial market actors and their stakeholders that could propel the market for sustainability-related and social bonds.
- Swedish institutional investors take a variety of approaches to socially labelled bonds, ranging from active commitment to showing no interest. A handful of potential issuers are currently working to develop sustainability frameworks, which represents an emerging market.
- The Swedish experience with green bonds can act as a stepping stone to expanding into sustainability-related and socially labelled bonds. However, bond managers have been given only limited guidance by boards and policymakers. Furthermore, the bond teams need to build in-house competence related to evaluating impact metrics, which differ from the equity side.
- Engagement by local government entities as issuers of sustainability-related bonds has so far been limited. Commitment is hampered by similar difficulties to those experienced with other social financial instruments, such as complicated and obstructive accounting practices, silo-based organizations and societal scepticism about the private sector funding of public welfare.
- The study makes three recommendations: (i) the Swedish government must reform rules and regulations, and contribute financially to the development of a market for impact financing; (ii) institutional investors need to enhance their commitment and take a more proactive role in financing public provision; and (iii) the market would be enhanced if standardized metrics were developed for evaluating social projects, bond managers learned to evaluate risk/return in social financial instruments and local government increased its commitment to the social Sustainable Development Goals (SDGs).

”A major difference between socially labelled bonds and green bonds is that social impact is typically more complex to measure than it is for standard green bonds.”

Introduction

Engagement by the financial sector is seen as essential to society’s ability to cope with growing stresses on welfare systems and the demands presented in the United Nation’s 17 Sustainability Development Goals (European Commission 2018; UNDP 2019). Sweden has been a front runner in green bonds but the country lags behind many other western economies on sustainability-related and socially labelled bonds.

The research presented below focuses on the role Swedish institutional investors might play in the development of a Swedish market for sustainability-related and social bonds. Given the virgin nature of the market, it represents the first attempt to provide a cross-sectoral description. The research was conducted between October 2018 and October 2019, and revolves around three research questions (see also Nachemson-Ekwall 2019):

– What do the Swedish and international markets for sustainability and socially labelled bonds look like?

– What is the interest in/ appetite for developing socially labelled bonds in the Swedish financial sector?

– What are the driving facilitators of and obstacles to the development of a sustainability-related and socially labelled bond market in Sweden?

The study draws on interviews with around 60 stakeholders, as well as the literature on the international experience with socially labelled bonds. The study also lists 20 international bond investments by institutional investors and 20 potential Swedish issuers, and maps institutional investors’ views on socially labelled bonds.

The market for sustainability-related and socially labelled bonds

Socially labelled bonds are bonds where the use of proceeds is earmarked for social, or green and social projects. All designated social projects must provide clear social benefits or seek to achieve positive social outcomes for a target population(s). In this study, sustainability-related and socially labelled bonds are defined according to International Capital Market Association (ICMA) principles. Four categories are singled out, of which two are of special interest to ordinary institutional investors: general proceeds bonds and bonds with proceeds tied to specific projects. A major difference between socially labelled bonds and green bonds is that social impact is typically more complex to measure than it is for standard green bonds. The study found that the number of actors involved in social impact financing is much larger than when dealing with green financing, and that actors are drawn from different areas of society, and have different aims and rationales, as well as varying degrees of access to financing.

France, the United Kingdom and Japan have taken a lead by each issuing a handful of socially labelled bonds of investment grade. Spain, Germany, the Netherlands and the United States are also present in the market. Among the issuers can be found public financial institutions and a number of local governments. Many of these target SDG 11 and other goals related to its achievement, but also access to finance for small and medium-sized enterprises (SMEs) in economically weaker regions, with the aim of promoting employment as expressed in SDG 8. Among Sweden's Nordic neighbours, Iceland launched its first purely social bond, targeting SDG 11 and affordable housing, in 2019. A first pure social bond in the Nordics was issued by the European Investment Bank (EIB) in Norwegian Krone in the spring of 2019. (It is listed on the Luxembourg fixed income exchange.) To date, Sweden has one sustainability bond listed on Nasdaq in New York, with a credit ranking by a Swedish issuer that follows ICMA's principles. It has no pure social bonds (ICMA 2019). Since the spring of 2019, Nasdaq has also had two corporate sustainability high-yield bonds listed: one issued by the property developer, Trianon, targeting SDG 11 and the other by the mobile network provider, Millicom.

Resilient and sustainable cities - one sustainable development goal which social bonds may target.
Photo: Chris Barbalis/Unsplash

What Swedish institutional investors have bought so far

The study asked 21 Swedish institutional investors to provide an inventory of the socially and sustainability labelled bonds that they have invested in. The investors represent close to 90 per cent of Swedish pensions' fund capital, from the state as well as the private sector, and also retail savings. The respondents also make up 40 per cent of the domestic bond market, and are therefore a dominant actor driving investment in labelled bonds.

A list of 22 instruments was compiled from the results of the interviews. Given the lack of domestic investment opportunities, Swedish investors have had to go abroad to find suitable investments.[1] Of the 22 instruments, 16 had been issued in the two years to August 2019. Eight of the bonds are labelled social, two are linked to the SDGs and the rest are labelled sustainability bonds, two of which are also positioned as SDG bonds. The vast majority of the bonds have Nordic banks as lead managers. SEB Debt Capital Market (DCM) takes a lead on bond issues. Nordea DCM is lead manager of Trianon and Millicom, two high-yield bonds issued in the spring of 2019.

Half of the bonds (11) were issued by supranationals and agencies focused on aid to developing countries. Among these are an investment by four institutions in a SEK 2.5 billion bond issued by the International Bank for Reconstruction and Development, targeted at SDG 11 (October 2018). This has received international recognition and is seen as a model by the World Bank for aligning with investors and collaborating through national aid agencies, in this case the Swedish International Development Cooperation Agency (SIDA), to attract groups of institutional investors from specific countries (SIDA 2018b; 2018a). It is new and ground-breaking in the Swedish market for bond investors to work together to develop investment solutions.

Institutional investors' views on social bonds

The interviews with five large Swedish commercial wholesale banks generated important insights on the investors' perspective. DCM teams act as intermediaries between a potential issuer and the investment community. From the banks' perspective, sustainability-related and socially labelled bonds are not about price, but about being able to

1) It should be noted that some of the institutional investors looked at related social financial instruments such as micro-finance funds or credits with a social impact.

Malmö: a front runner among Sweden's municipalities when it comes to social bonds.
Photo: Pontus Ohlsson/Unsplash

address a larger "investor-sphere", which is good for liquidity. All the banks interviewed claimed that labelled bonds attract more investors, and that there is a surge in variations on themes, for instance bonds that target other SDGs in addition to SDG 13 on climate action. Theoretically, this should result in a higher price for the bond as demand increases, but this outcome is not supported by studies. In addition:

– The trend is for green investors to ask more questions in relation to social issues. This is partly a result of the increased understanding of the impact that climate change has on social issues. As a result, issuers are encouraged to broaden the scope of their impact reports.

– There is also a general growth in investors that wish to include a broader range of SDG-related goals in their bond -portfolio, but without a negative impact on return. They wish to have more items in the use of proceeds, but without having to pay any extra.

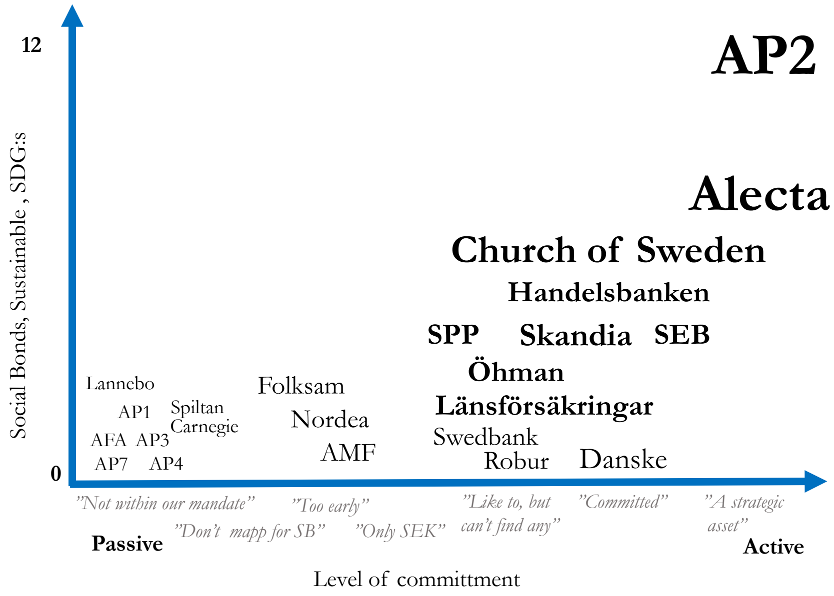
The study presents a unique survey of what institutional investors think of social bonds. In order to structure the attitudes to sustainability-related and socially labelled-bonds derived from contact with the institutions, the comments and impressions from emails, telephone conversations and interviews were organized in a table and plotted on a graph with the number of socially labelled bonds on the vertical axis and comments on the horizontal axis. The institutions plotted in the lower left corner were less active and had a "negative" attitude, while the institutions in the upper right corner were more active and had a "positive" attitude.

Figure 1 divides the institutions into three groups:

– Committed to socially labelled bonds. One-third already had a portfolio containing several sustainability-related and socially labelled bonds.

– Interested but not there yet. A further one-third of the institutions demonstrated a positive attitude and were generally curious to learn more about sustainability and socially labelled bonds, but their actual investments were limited.

– Low interest, no investments. There was also a third group, which responded that the question of sustainability and socially labelled bonds had "been raised prematurely" and that they "did not map labelled bonds beyond green".



Notes: The middle letter corresponds to position on the x-axis. *State pension funds*: AP1-4; Independent pension fund: AP7; Occupational and private pension-funds: Alecta, AMF, Folksam, Länsförsäkringar, Skandia; *Wholesale bank funds*: Danske Bank, Handelsbanken, SEB, Swedbank, Nordea. Retail funds: Carnegie, Lannebo, SPP, Spiltan, Öhman; *Occupational injury insurance fund*: AFA Insurance and Church of Sweden. *All respondents screen investments using sustainability guidelines and metrics from i.e. UNPRI, the UN Global Compact, the TCFD and Swesif.*

Figure 1: Swedish institutional investors' views on social bonds: What they answer when asked if they invest in sustainable and social bonds

Figure 1 plots the activities of Swedish institutional investors. It frames a market that is in its infancy. The detailed discussions showed that there is no clear relation between the position taken and the type of institution – state-owned pensions fund, corporate and private sector occupational pensions fund or retail bond investor. In addition, many told how they worry about the risk and reward in relation to evaluating impact measures, and explained a lack of investment by a policy of focusing on returns. Nonetheless, committed investors claim to be able to find attractive investments, where their size as investors in the market makes them attractive to banks and issuers. Finally, regulations and fiduciary obligations, as well as the lack of guidance from the institutional investors' own boards, appear to leave scope for subjective interpretation.

Other aspects, however, such as a long-term-commitment can compensate for the above. The public sector pension fund AP2 claims that its long tradition of being a sustainable investor with commitments in both fixed-income and equity teams means that it is shortlisted by the banks, so that it is always contacted when sustainability-related and socially labelled issues are about to be launched.

Alecta by contrast highlights that size and familiarity matter on the fixed-income market. Consequently, the ambassadors for sustainable and social bonds are not automatically the same as the ambassadors for green bonds. For example, the public sector pensions fund, AP4, which has a history of engagement in corporate governance going back to the 1990s, has been one of the front runners on green bonds in Sweden, but lacks interest in social bonds. This is linked to a lack of resources, but also to the absence of attractive instruments to invest in.

Finally, the interviews reveal that there is a competence gap in relation to project financing, where the banks' credit analysts lack experience of evaluating uncertain cash flows.

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“The front runners among the municipalities are Malmö, a municipality in southern Sweden that has been the focus of attention due to problems of violence in its suburbs, and Vellinge, an affluent neighbouring municipality.”

The perspective of the issuers

The interviews, available literature and information gained during the seminars were used to compile a list of potential issuers that might be interested in acting as frontrunners. (The list is available in the full version of this study.) It comprises 20 potential issuers gathered from “market talk” by public financial institutions, private property developers and local municipalities and regions. Of these, four are about to develop sustainability frameworks following the ICMA guidelines. As is the case in other Western countries, public sector financial institutions appear to be at the forefront. In Sweden, the Swedish export agency (Svensk Exportkredit, SEK), which has had positive experiences with issuing green bonds, and a government-sponsored residential mortgage lender (SBAB) are at the early stages of developing a sustainability-related or social bond framework for the refinancing of loans made to private property developers in deprived suburbs across Sweden.

The front runners among the municipalities are Malmö, a municipality in southern Sweden that has been the focus of attention due to problems of violence in its suburbs, and Vellinge, an affluent neighbouring municipality. Both are working to identify projects that can be branded social. Kommuninvest is playing a central role as the organizer of around SEK 400 billion in loan funding for 289 of the 310 municipalities and regions in Sweden. Kommuninvest has been a driving force behind the development of green bonds and has instigated a concept study together with seven municipalities to develop a framework for socially labelled bonds. All will be targeting SDG 11 alongside other social SDGs, particularly the green SDGs.

The study shows that part of the lack of interest in socially labelled bonds among the public sector can be traced to the Swedish housing market. This is highly regulated but there is a severe housing shortage and no concept of social housing. It is therefore difficult to target actions to social aims or the socio-economically disadvantaged. Problems have been compounded by an influx of new migrants, turning deprived suburbs into socio-economically troubled areas that require special attention to address gender inequality, unemployment and health issues, keep children in school and tackle criminality. There is therefore increasing interest in SDG 11 among property developers and housing providers. The market talk revealed interest from Stena Fastigheter and Svea Fastigheter, the housing cooperative SKB and Hemsö, which issued the first sustainability-related bond in Sweden.

In addition, Sweden has applied public procurement regulations in a highly market liberal manner. Until recently, for example, it eschewed its ability to restrict social service contracts in the tax financed welfare sector to non-profits and similar third sector actors, instead letting them compete side by side with for-profits including private equity.

Local government also faces additional obstacles compared to private property developers that hinder public policy. These include budgetary practices that only allow municipalities to use loans to invest in infrastructure projects, and limit payments for social services to the current budget. Other hindrances include silos within organizations and the lack of interest in finance departments in having to deliver on the results of pre-decided social commitments. There is also widespread scepticism about opening the welfare sector up to private capital, which is compounded by an unwillingness among civil servants to be evaluated by external actors.

However, there are also forces at work with a more open-minded attitude to developing socially labelled bonds for the public sector. In the report three forces were highlighted as primary drivers of change:

– the move from New Public Management (NPM) to New Public Governance (NPG), which fosters co-creation by breaking down organizational silos, through which different public departments begin to collaborate.

– the growing focus on preventive work, which at the macro-level is less expensive for society than actions taken later in life. Ensuring that high school dropouts return to learning, for example, costs less than a prison place a few years down the line.

– public accounting practices that prevent local government from earmarking investments to projects tied to socially pre-emptive activities, which could be delivered on the proceeds of a socially labelled bond, are now being revisited.

For local government, the green bond experience has acted as a stepping stone:

"The work with green bonds has helped us develop collaboration between the finance department and facilities management. This has created a platform for dialogue and creativity, and opens up discussion of possible projects. We can see how this influences how each of us works. Commitments made in the green bond need to be validated. This creates accountability: it becomes concrete rather than a short-term project. I am confident that the same effect can be achieved on social issues."

– Chief Financial Officer, City of Malmö

In Malmö, the experience with green bonds serves as a stepping stone for developing a social bond.
Photo: Pontus Ohlsson/Unsplash

The public-private partnership dilemma

The interviews with Swedish public sector participants showed that their views on the development of a market for sustainability-related and socially labelled bonds were intertwined with their previous experience of two other financial vehicles for impact investing: Social Investment Funds (SIFs),2 and Social Impact Bonds (SIBs) or Social Outcome Contracts (SOCs).3 Both are well positioned to deal with SDG 11 but have been slow to take off.

A SIB/SOC is usually constructed as a private placement involving four parties: a social company providing a service; a public institution, which pays for the outcome; a private investor, which provides finances and is paid an agreed amount on completion; and an intermediary or adviser, which sets up the SIB vehicle. Together, these actors identify a recognized social problem, and agree on how it could be resolved and, if effective, the solution could be scaled up. If the outcomes are achieved, the investors are rewarded and the public institution pays for the results. If not, the investment is lost but the government or municipality avoids the economic cost of failure.

2) SIFs are internal public funding vehicles to enable transfers of cash between different budgetary time periods and between different departments. They enable the public sector to allocate operational income from expected savings in the future. In a standard budgetary process the payout today, e.g. from a school's service for teenage high school dropouts, would only be accounted for as current operational expenditure. SIFs have been used as a financial instrument in municipalities since 2010.

3) The name SIB is somewhat misleading. It is not a bond but a loan with a variable repayment stream, a "payment by results instrument" tied to a predetermined outcome that works as an options programme. Sweden uses the phrase social outcome contracts (SOCs, sociala utfallskontrakt). SIBs can address a range of social issues, such as workforce development, foster care, education, health care (diabetes and dementia) and homelessness. Around 130 social impact bonds have been issued globally, many of them in the UK. Sweden is yet to launch a single complete SIB/SOC in the sense of involving different parties, but the study describes the experiences of five municipalities and regions.

What is the outlook for the socially labelled bond market taking off? Photo: Annie Spratt/Unsplash

For the financial community, the SIB instrument has some merit, offering risk diversification as the return/ income stream is not linked to the stock market. However, an institutional investor will not be attracted to an investment in a single SIB. These usually involve a small target group and are thus limited in size, usually around SEK 20–30 million. In addition, the variability of the pay out and the requirements of private placement make them time-consuming to follow and difficult to evaluate. SIBs are excluded from most standard investment mandates. Instead, target investors are mainly private impact investors or impact investment funds. However, SIBs can be bundled or wrapped up together in a single contract, making them scalable like collateralized debt obligations.

SIFs and SIBs could be seen as complementary financial structures to socially labelled bonds. However, the experience of SIFs and SIBs has influenced civil servants' views on and level of interest in supporting or obstructing the development of socially labelled bonds. At the time of the study, only five municipalities were undertaking work to develop metrics for the evaluation of social investments, three of these with support from expertise drawn from RISE, a Swedish public agency research platform.

Swedish work on SIBs/SOCs highlights various drawbacks of the institutional fabric that constitutes the Swedish market for social impact financing:[4]

1. Local government has been slow to evaluate success metrics, validation and impact measures upfront in the public sector, and to recognize that parts of the development of metrics are also applicable to evaluating the use of proceeds in socially labelled bonds.

2. There is uncertainty in relation to public accounting practices on future pay outs. A framework is needed for accounting for performance-based external payments and reclaims from the SIF.

3. Sweden lacks a large investment fund that can scale-up SIB contracts and attract institutional investors.

4. There are risks related to the big ambitions for the evaluation of reporting metrics on transformative innovation. If there is too much focus on exact calculations on risk-sharing to establish the correct formula for splitting costs, the variable cash flow stream for the SIB will become too uncertain to attract investment.

Swedish work on SIBs has thus far been highly focused on innovation. One possible explanation for this might be that Swedish procurement rules enable municipalities and regions to bypass public procurement regulations if a service is branded R&D. Such problems are not unique to Sweden, but the Swedish tax-financed public sector plays a larger role in the provision of social services to citizens. In addition, there is a lack of financial capital for SIBs/SOCs. Sweden lacks a dedicated government-sponsored social investment fund, similar to the British 'Big Society Capital', and does not have a system of credit guarantees for social enterprises. At the same time, it is relevant to compare Sweden with Finland and Denmark, which share various commonalities with the Swedish welfare system but where the state and politicians have

4) For a comprehensive list of recommendations see Brännvall and Eriksson Åshuvud (2019), p. 99. See also Fryshuset (2017); and Balkfors, Bokström and Salonen (2019).

shown a more open approach to private sector actors in the market for financing social investment. Thus, domestic institutional investors can and do play a different role in Sweden than in liberal market economies such as the UK, France and Belgium.

Final comments

A reconsideration of the complexity of the different rationalities at work in public-private partnerships will probably be the most important discussion moving forward. Norms and regulations must be developed to put the issue of societal value creation upfront in corporate board rooms, the public sector, institutional investors, financial institutions and social enterprises alike. This will also require commitments from the regulatory authorities on public sector accounting practices and the oversight of financial supervisors (in Sweden, Finansinspektionen) when evaluating a financial actor's performance and returns. These will need to be involved if institutional investors and local government are to deliver on the UN SDGs and Agenda 2030.

The study makes recommendations on how to help the socially labelled bond market take off, such as enhancing the development of government- and private-sector sponsored financial vehicles, and speeding up work on the development of standardized metrics. To increase the chances of this happening, Swedish institutional investors could step up by pushing their investment rationales beyond green goals to also include social impact goals when investing in the Swedish bond market. A key message to issuers is not to ask for too much in relation to risk-sharing – socially labelled bonds must not be too complex in structure or too complicated for investors to evaluate.

A connecting thread throughout the study is the need to develop collaborative platforms where institutional investors (the private sector), local government (the public sector) and intermediaries such as the banks (DCM desks and social intermediaries) can meet. Moving beyond the complexity of actors' different rationalities, the study provides reasons for optimism regarding market growth. A handful of concrete examples emerged during work on the study of potential issuers working on the development of sustainability frameworks. Having presented the current situation as an ongoing process, this study serves as one of many stepping stones to mobilizing the Swedish financial market to provide finance to achieve SDG 11.

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