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# Focus on: Credits
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## Sustainability in the SSD market: On track to becoming standard practice

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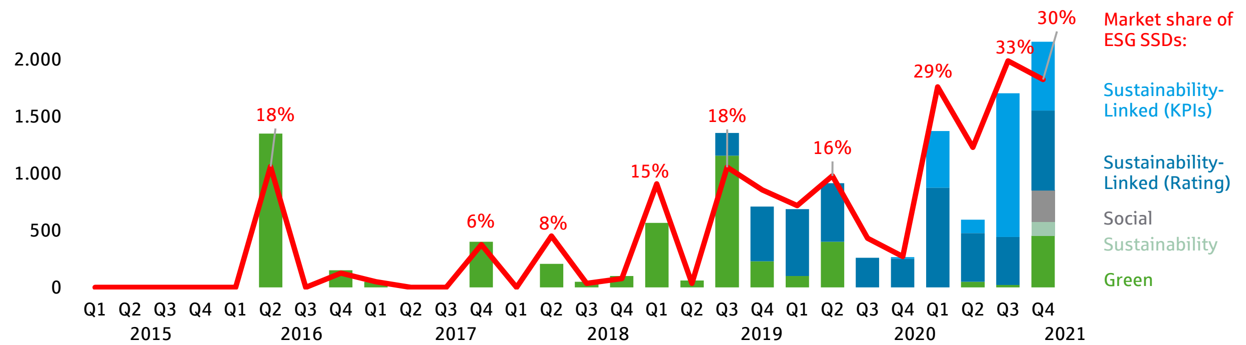
**In 2021, the volume of Sustainable Schuldschein placements reached a level of EUR 5.8 billion, propelling the market share of use of proceeds transactions or coupons linked to the achievement of ESG targets to 29 %. This year, our expectation is that SSD issues with ESG components will hit the EUR 10-billion milestone, accounting for at least 50 % of total issuance in the Schuldschein market. An increasing number of issuers are developing their own dedicated sustainability strategies and incorporating them into their funding activities. This trend is also being driven by a growing interest from investors as well as by the regulatory environment. We anticipate that Sustainability-Linked issues will enjoy particularly strong growth, followed by use of proceeds Green and Social Schuldscheine.**

### A review of 2021: Breakthrough for sustainability on the Schuldschein market

The first Schuldschein notes with sustainability components were issued at the beginning of 2016, shortly after the 2015 UN Climate Conference in Paris (COP21). Having got off to a flying start, with a placement volume of EUR 1.35 billion in Q2 2016, volumes initially remained at a modest level. It was not until the second half of 2019 that the momentum in the market gradually started to increase and the share of Sustainability-Linked issues has been rising ever since. This funding instrument involves the coupon being linked to an overall assessment of an issuer's sustainability performance, e.g. in the form of external ratings, and/or specific sustainability metrics. Unlike use of proceeds Green, Social or Sustainability SSDs, however, the proceeds raised can be freely disposed of, which is regarded as a key advantage by issuers in view of the often-limited number of Green or Social projects available to support. The final breakthrough for ESG on the Schuldschein market came in 2021 as the entry into force of the EU's Taxonomy Regulation, in particular, as well as the Covid-19 crisis galvanised interest in sustainability on the part of investors and issuers alike. The volume of Schuldscheine structured with sustainability components rose to EUR 5.8 billion. As a result, their market share increased threefold to 29 %, dominated by sustainability-linked transactions at more than 80 % of total ESG issuance. The placement highlights of 2021 included the first-ever issuance of a Social corporate SSD by the Swedish healthcare provider Medicover, which paved the way for use of

**Rapid growth of ESG Schuldschein issuance since Q3 2019**

Issuance volume* of Schuldscheine with sustainability components in EUR (millions) or market share (in %)




*based on value date
Source: Helaba Research & Advisory

proceeds issues with a social focus. Meanwhile, Nassauische Heimstätte, one of the leading housing companies in

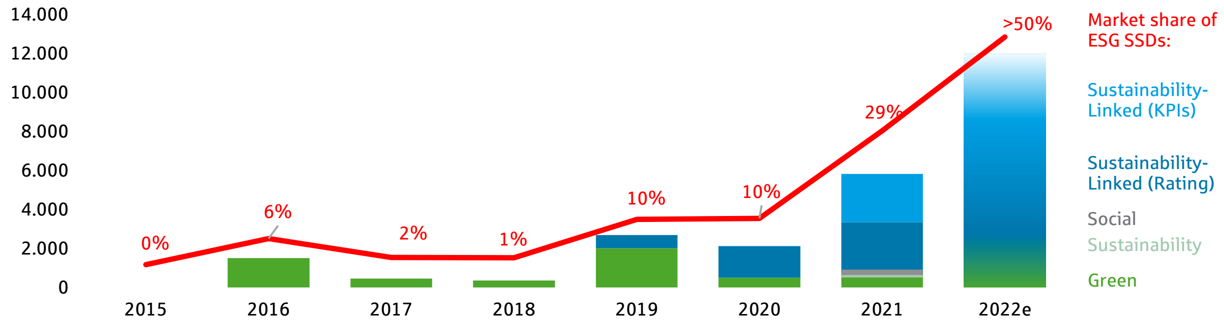
Germany, pioneered another innovation: its Sustainability Schuldschein was the first transaction whose proceeds were used to fund both green investments in energy-efficient housing schemes as well as social investments in affordable housing.
With respect to Sustainability-Linked transactions, Faurecia broke new ground. Rather than adopting the step-up/down system of linking the interest rate to the achievement of ESG targets, which has so far been standard practice in the SSD market, the largest French automotive supplier opted instead for a novel step-up only concept - an approach that is customary in the bond market. This means that a coupon step-up is triggered if predefined sustainability targets are not met. In contrast, achievement of these targets does not result in a corresponding step-down. On the whole, ESG-linked transactions have been very well received by investors, as companies with sound corporate governance and lower sustainability and reputational risks are considered to be stable investments with limited susceptibility to disruption from exogenous factors[1]. This is also reflected in the ratio of final placement amounts to initial issuance volumes: compared to traditional issues (with an average upsizing of 1.6x), green, social and sustainability transactions have seen a slightly above-average upsizing of 1.7x, while the multiple among sustainability-linked SSDs is as high as 1.9x.[2]

## Outlook for 2022: Sustainability megatrend set to drive market share of ESG transactions above 50 %

The transformation of the financial system is poised to gain further impetus. Political decisions play a significant role here, such as the recent UN Climate Conference in Glasgow in 2021 (COP26), during which the first tangible steps towards implementing the Paris Climate Accords in line with scientific findings were agreed, as well as initiatives related to the EU Green Deal. Furthermore, investors are facing more stringent regulatory requirements. For instance, the European Banking Authority (EBA) has been pushing ahead with measures to limit climate risks among financial institutions and establishing sweeping reporting requirements. Companies seeking to raise capital will also find themselves confronted with greater regulatory hurdles. In the future, they will not only have to report on the extent to which their sales and investments comply with the EU taxonomy, but will also have to provide much more extensive information on their ESG performance as part of the planned Corporate Sustainability Reporting Directive (CSRD). At the same time, as a new generation of executives takes over at the helm of companies and financial institutions, the importance of sustainability will steadily increase. Given these trends, we expect that the overall number and volume of SSD transactions with sustainability components will continue to rise sharply. Specifically, we anticipate that the share of Schuldscheine with coupons linked to ESG metrics or ratings, in addition to sustainable use of proceeds issues, will amount to more than 50 % of total market volume in 2022. Taken together, it is likely that the total placement volume will exceed EUR 10 billion in the current financial year. For large-volume issues, in particular, we assume that transactions with ESG components will account for the majority of deals.

**2022 likely to see further rise in market share of ESG notes**

Issuance volume* of Schuldscheine with sustainability components in EUR (millions) or market share (in %)




*Based on value date
Source: Helaba Research & Advisory

[1] Cf. Helaba study "ESG survey among Schuldschein investors: Positive feedback on sustainable issues" (28 January 2021).
[2] Based on an analysis of more than 110 transactions in 2021. Upsizing is defined as the ratio of final issuance to initial placement volume.

## New reporting requirements as a catalyst for further growth in sustainable issuance

In our view, one of the principal reasons that has so far deterred many issuers from pursuing Sustainability-Linked transactions has been the lack of an explicitly defined sustainability strategy or the absence of sustainability reporting with specific and externally verified ESG indicators. In this regard, we expect that the CSRD will act as a catalyst by imposing significantly more enhanced reporting requirements. Many companies are likely to spend this year preparing for the new regulations by ensuring their sustainability reporting is future-proof and by defining precise ESG targets that are consistent with their respective corporate strategies.
This will result in a dramatic fall in the additional cost and effort of issuing Sustainability-Linked SSD notes. With this in mind, we believe that the market will experience very strong growth in 2022, especially with regard to KPI-linked transactions. At the same time, though, ESG ratings will remain a factor as it is not possible to find adequate ESG metrics in every sector or it is difficult to quantify the most critical aspects of sustainability. In addition, taking a holistic approach to assessing a company and obtaining independent third-party ratings may represent an alternative to specific KPIs, especially in the case of controversial industries or companies in a phase of transition. Agencies that assign ESG ratings are also looking to expand the range of companies they assess and it will be interesting to see the extent to which hybrid structures, with a mixture of specific KPIs and external ratings, become an established method of analysing corporate ESG performance.

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## Snapshot: CSRD

Large public-interest corporations, insurance companies and banks have been required to report on non-financial aspects of their activities since as early as 2017 under the EU's Non-Financial Reporting Directive (NFRD). So far, however, a lack of comparability and relevance has prevented any effective reporting and this is why the European Commission published a draft amendment to existing corporate sustainability reporting rules on 21 April 2021.[3]

**The thrust of the proposal is an expansion in the scope of companies subject to mandatory reporting**. Under the draft Corporate Sustainability Reporting Directive (CSRD), released in April 2021, all major companies (with total assets of > EUR 20 million / net sales of > EUR 40 million) in the EU with 250 or more employees (previously 500) would be required to submit ESG indicators for the 2023 financial year[4] as well as, from 2026, all publicly listed SMEs (with the exception of micro-enterprises).
While around 500 companies in Germany have been subject to reporting requirements up to now, this number is projected to increase tenfold as a result of the new criteria. In the EU, the new directive will mean around 50,000 companies will be required to disclose sustainability performance indicators.[5]

**Furthermore, the proposals include broadening the scope of disclosure information:** In addition to aligning them with the objectives of the taxonomy, it will introduce a requirement to publish them in companies' management reports and, by requiring limited assurance by an external auditor, it will also establish the principle of dual materiality. In future, companies will therefore have to disclose both the adverse material impacts of their own business activities on sustainability issues (the inside-out perspective) as well as the material sustainability risks to their own performance (the outside-in perspective).

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## More "step-up only" performance-linked coupon structures likely

Up to now, Sustainability-Linked issues have involved a step-up/step-down structure in linking the coupon to the achievement of ESG targets, which generally ranged between +/- 5 bps in the most recent transactions. This resulted in the interest rate increasing or decreasing depending on the extent to which sustainability targets were achieved or missed. On the bond market, however, the only established interest-linked structure is one in which coupons rise if targets are not met. These “step-up only” structures do not provide for a coupon reduction if ESG goals are achieved. I Should traditional bond issuers emulate Faurecia's example and increase their presence on the Schuldschein market, they can be expected to deliberately forego a step-down in order to avoid any disparity

[3] The draft directive was published on 21 April 2021, the draft report with proposed amendments on 16 November 2021. After its adoption at EU level, the directive must be transposed into national law by 1 December 2022.
[4] All enterprises are considered "large companies" as soon as two of three criteria (total assets, net sales or number of employees) are met.
[5] Based on estimates by PWC and KPMG.

in the treatment of bond and SSD investors. This development could become more widespread if sustainability targets that are openly disclosed and quantifiable also become standard practice for non-listed companies and SMEs, and if investors expect these targets to be reached.

### External references increasingly important, SPOs for Sustainability-Linked notes to remain the exception

In terms of linking coupons to specific ESG metrics, most issuers have so far opted for one to five indicators. While there are usually good reasons for choosing certain metrics that can be supported by a materiality analysis in a company's sustainability reporting, such as $CO_2$ emissions, resource conservation and diversity, it is often more challenging to determine whether targets are sufficiently ambitious.

For this reason, we assume that there will be a greater tendency for companies to have their sustainability targets externally validated or align them towards reference values that are scientifically proven and recognised. This is likely to occur irrespective of whether these targets are used for financing purposes, since the issue of sustainability is becoming an increasingly key factor in providing a competitive edge for many issuers - both in terms of their fundraising and operating activities. By way of example, more and more companies are aiming to have their $CO_2$ reduction targets validated by the Science Based Targets Initiative (SBTi), which verifies whether the respective targets are consistent with limiting global heating to considerably below 2.0 °C or 1.5 °C. In future, it is also conceivable that companies will be guided by the EU taxonomy's technical screening criteria, especially those from sectors in a phase of transformation. Nevertheless, we believe that the level of ambition of ESG targets used in the structuring of Schuldscheine will, in most cases, remain unverified by a so-called second party opinion (SPO) from a professional, independent external agency. Although this is standard practice on the bond market, we feel that the additional cost burden as well as the considerable effort involved present too great a hurdle for small and medium-sized issuance volumes. We therefore expect that most sustainability-linked issues based on sustainability metrics will continue to be placed without an SPO in future. One exception to this may be transactions by companies that, due to their bond market activities, are able to fall back on an SPO for an existing issue.

### Volume of use of proceeds issues also set to rise

Coinciding with a sharp increase in Sustainability-Linked placements, we also anticipate that issuance of use of proceeds notes will pick up this year from a comparatively low recent level. As the precise nature of the EU taxonomy, which essentially defines a catalogue of green investments, becomes clearer and market participants become more familiar with its application, the absolute volume of green SSD transactions should rise again. Moreover, demand from investors for use of proceeds issues is likely to remain high, as the latter provide the best possible transparency in terms of how proceeds are deployed, and taxonomy-compliant investments also offer advantages when it comes to calculating the green asset ratio (GAR).

## Snapshot: Faurecia's Sustainability-Linked Schuldschein

In November 2021, the French automotive technology company Faurecia issued Sustainability-Linked SSDs with a total volume of around EUR 700 million. The transaction was used to part-finance the acquisition of the German automotive supplier Hella GmbH & Co KGaA and represented the hitherto largest-ever sustainability-linked issue by a non-German company. The metrics and performance targets were aligned with Faurecia's ambitious $CO_2$ reduction strategy. According to Bloomberg data, an annual step-up of 10 bps for longer maturities was agreed that will apply if the company is not successful in achieving (i) a 20 % reduction in its $CO_2$ intensity (based on scope 1 and 2 emissions in relation to sales) by 2023 compared to 2019 levels, and (ii) an 80 % reduction in its absolute $CO_2$ emissions (scope 1 and 2) by 2025 compared to 2019 levels. Given that the acquisition will significantly impact Hella's $CO_2$ footprint, Faurecia has the option to recalibrate these targets accordingly. In this case, the new targets will have to be re-validated by the SBTi and publicly communicated by Faurecia. This transaction is a departure from the standard step-up/step-down system of linking the coupon to the achievement of ESG targets that has so far been standard practice as Faurecia deliberately opted against a step-down if it achieves its strategic $CO_2$ reduction targets. In other respects, too, the transaction aligns more closely to requirements on the bond market than has been previously observed on the SSD market. For example, the key metrics and performance targets are set out in a publicly available Sustainability-Linked Finance Framework, which Faurecia designed to address both a simultaneous EUR 1.2 billion bond placement issued as well as the Schuldschein. In addition, a second party opinion by the sustainability agency ISS ESG confirmed the level of ambition of the reduction targets and compliance of the framework with the Sustainability-Linked Bond Principles.

### Importance of social impact to grow in medium term

At the time of writing, the majority of companies are already considering their carbon footprint and are thus addressing environmental concerns as part of their business strategy. However, the issue of social impact has so far taken more of a back seat. One reason could be the infinitely more complex definition and quantification of this factor. The International Capital Market Association (ICMA), for example, defines social bonds as ".any type of bond instrument where the proceeds, or an equivalent amount, will be exclusively applied to finance or re-finance in part or in full new and/or existing eligible Social Projects and which are aligned with the four core components of the Social Bond Principles".[6]

The European Commission has committed itself to strengthening this pillar. A group of experts commissioned by the EU is currently developing a corresponding social taxonomy[7] that will build on the EU taxonomy. With a wide-ranging scope, which will include the provision of essential infrastructure, healthcare and education as well as affordable housing, social SSDs may not only appeal to traditional corporates but also to local governments and, at the very latest, will likely grow in significance with the publication of the social taxonomy.

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## Disclaimer



[6] **ICMA: Social Bond Principles**
[7] **Draft Report by Subgroup 4: Social Taxonomy, Juli 2021**