4. SUSTAINABLE BONDS

BARRIERS TO ENTRY HAMPER SUSTAINABILITY PROGRESS

As central banks' mandates grow to include ESG considerations, so too does reserves managers' interest in social bonds. By Taylor Pearce.

THOUGH late to the party compared to their institutional peers, central banks are continuing to expand their environmental, social and governance considerations. Social bonds, or bonds whose funds are earmarked for projects with positive social outcomes, are a new and notable asset class falling under the sustainable umbrella. This year's GPI survey examined the ESG considerations of central banks with a specific focus on social bonds as a burgeoning ESG asset class. Consistent with our other ESG findings, we found that the majority of central banks expressed existing or future interest in social bonds – though significant barriers to their adoption as a suitable reserves asset class persist.

CENTRAL BANKS EXPANDING ESG MANDATES

This year, more central banks than ever reported implementing some form of ESG criteria. Compared to 2021, OMFIF's research reveals progress in central banks' ESG practices across nearly all categories. These include investment in sustainable finance assets, exercising exclusion/negative screening, implementing ESG integration, implementing

> COMPARED WITH 2021, WE FOUND A MARGINAL INCREASE IN CENTRAL BANKS' ESG PRACTICES ACROSS NEARLY ALL CATEGORIES.

position screening/best-in-class strategies and practising thematic investing (Figure 1).

Perhaps the most telling figure, however, was the share of respondents who reported that they do not implement ESG, which has steadily fallen to 42% from 51% in 2020. This is a significant decrease and a promising indication that ESG is becoming a more mainstream factor in central banks' reserves management strategies.

Insufficient data or lack of information remains the biggest obstacle to further adoption/integration of ESG into central banks' reserves portfolios, having increased steadily to 63% from 49% in 2020 (Figure 2). This increase most likely indicates that a greater share of central banks are now considering investment in ESG assets, rather than a decline in available data. One respondent noted, 'We gradually increase investment in green and sustainable bonds (sovereign and corporate), but this market is still immature. Classification criteria are not transparent enough and controversial in some cases.'

Two further trends have emerged on barriers to ESG implementation. First, the share of respondents reporting that ESG does not fit with their fund investment strategy has fallen to 31% from 38% in 2020. At the same time, the share of respondents reporting lack of suitable projects as a main barrier to adoption and/or further implementation of ESG has risen steadily over the past few years, increasing to 17% from 9% in 2020 and 12% in 2021, suggesting that demand for ESG assets is outpacing supply. Respondents' comments reflect this, with one stating, 'Green bonds issued by highly-rated sovereigns are very limited and we cannot invest into corporate bonds or equities in reserves portfolios according to our guidelines.' This lack of suitable asset class supply suggests significant potential for social bonds as an ESG asset.

Taken together, these figures point towards the growing acceptance and importance of ESG considerations for reserves management, as more institutions develop ESG frameworks and strategies.

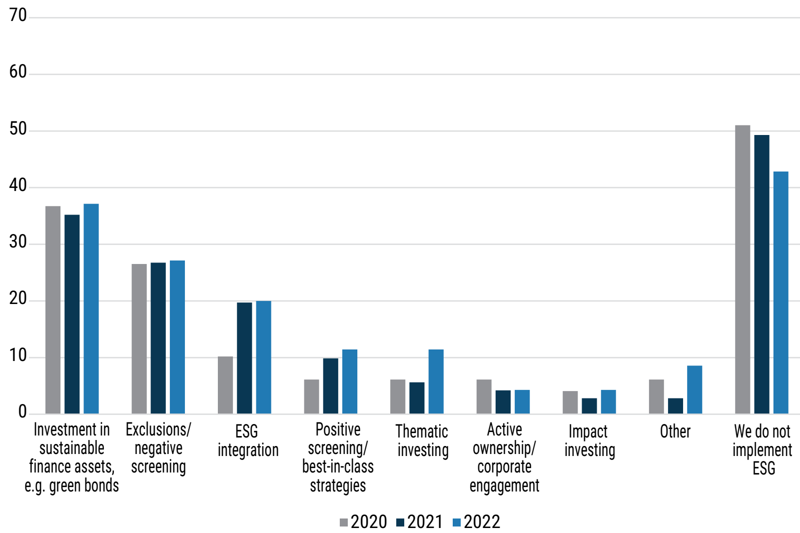
Despite these challenges, 63% of central banks intend to increase allocation to green bonds and 42% intend to increase allocation to other sustainable bonds. In fact, net increases in central banks' ESG asset allocation are anticipated across all categories over the next two years (Figure 3). As sustainability increases in global urgency, these trends in central banks' asset allocation are likely to continue over the medium to long term.

Of central banks investing in sustainable assets, 98% invest in green bonds with 'other' sustainable bonds the next most popular sustainable asset class at 41% (Figure 4). Sustainable bonds, which include social bonds, were by far the biggest gainer since last year – up a sizeable 33 percentage points – outpacing investment in green equities, sustainable mutual funds and sustainable ETFs.

The appetite for social bonds is confirmed by the

1. MORE CENTRAL BANKS THAN EVER IMPLEMENTING ESG CRITERIA

In which of the following ways do you implement ESG? Select all that apply. Share of respondents, %

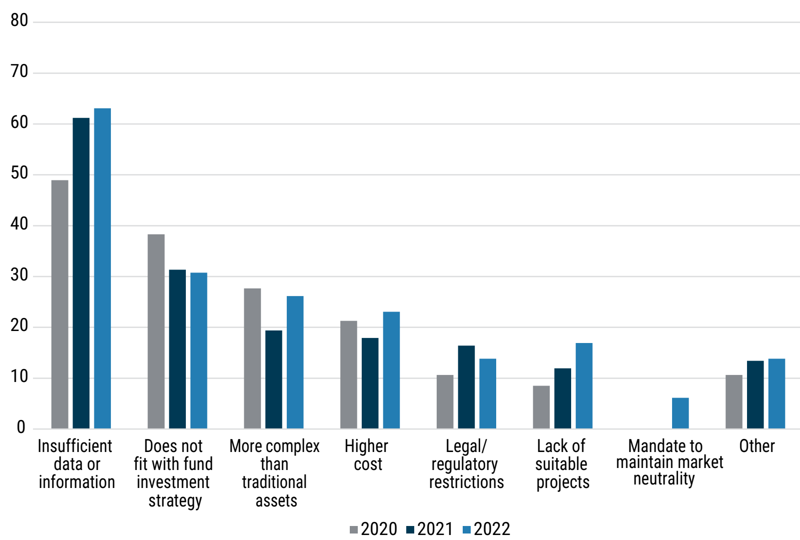


Source: OMFIF GPI survey 2020-22

2. INSUFFICIENT DATA HIGHEST BARRIER TO FURTHER ESG IMPLEMENTATION

What do you see as the barriers to ESG adoption/further implementation in your reserves management? Select all that apply. Share of respondents, %

Note: 'Mandate to maintain market neutrality' first included as option in 2022



Source: OMFIF GPI survey 2020-22

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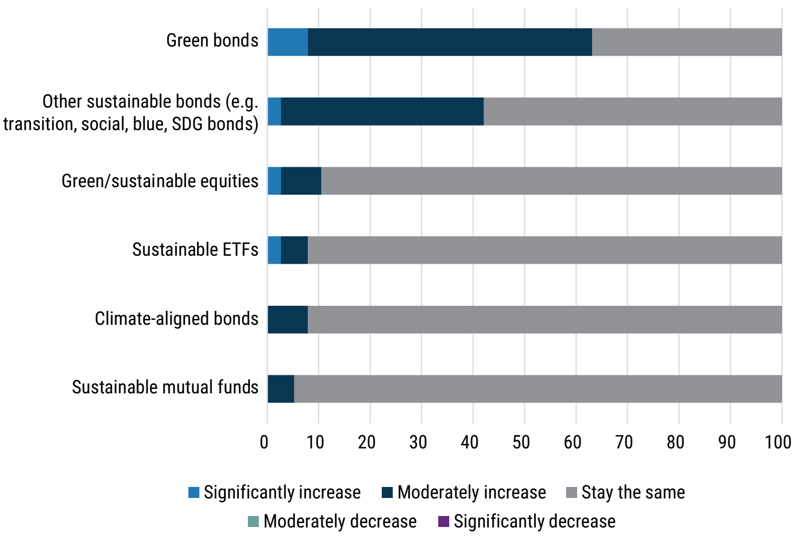
THE GROWING IMPORTANCE OF ESG CONSIDERATIONS HAS COINCIDED WITH A PARTICULARLY CHALLENGING MACRO ENVIRONMENT AND GEOPOLITICAL LANDSCAPE. THIS MEANS THAT ESG OBJECTIVES MAY TAKE A BACKSEAT TO MORE ACUTE PRESSURES OVER THE SHORT TERM.

3. SIGNIFICANT ANTICIPATED INCREASE IN INVESTMENT FOR GREEN AND OTHER SUSTAINABLE BONDS

Reserves managers' anticipated allocation to the following sustainable assets over the next 12-24. Share of respondents, %



Source: OMFIF GPI survey 2022

finding that 38% of central banks plan to invest in social bonds as part of their ESG holdings and 28% plan to invest in social bonds in the next two years (Figure 5). As in other sustainable assets, availability remains an issue – 31% of respondents reported 'lack of supply' as a key obstacle to the incorporation of social bonds into their reserves portfolio (Figure 6).

Interest in social bonds will not necessarily equate to investment, at least in the short term. Social bonds have some fundamental flaws. Nearly two-thirds of central banks reported lack of clarity about the definition of the asset class as a barrier to further investment in social bonds, while 55% reported lack of market depth and liquidity risk as a primary obstacle (Figure 6). In combination, these are perhaps the reason why none of the reserves managers surveyed by OMFIF reported investing in social bonds as a specific asset class in their portfolio (Figure 5)

In spite of these obstacles, however, 40% of reserves managers still stated that they plan to increase their allocation to social bonds over the next 12-24 months (Figure 7). This no doubt reflects the asset class' significant potential as central bank reserves managers come to terms with ESG prerogatives as a permanent factor in their investment objectives.

INCREASINGLY IMPORTANT, BUT NOT A TOP PRIORITY

The challenges facing reserves managers looking to boost their sustainable investments are consistent with those facing other asset managers. Data and performance metrics need to be strengthened and standardised, as reserves managers report that 'reputational risk can arise due to lack of common socially responsible investment standards and a harmonised, reliable rating system.' Another listed 'low quality of the ESG scoring, poor correlation between different ESG scoring institutions [and] greenwashing' as persistent concerns.

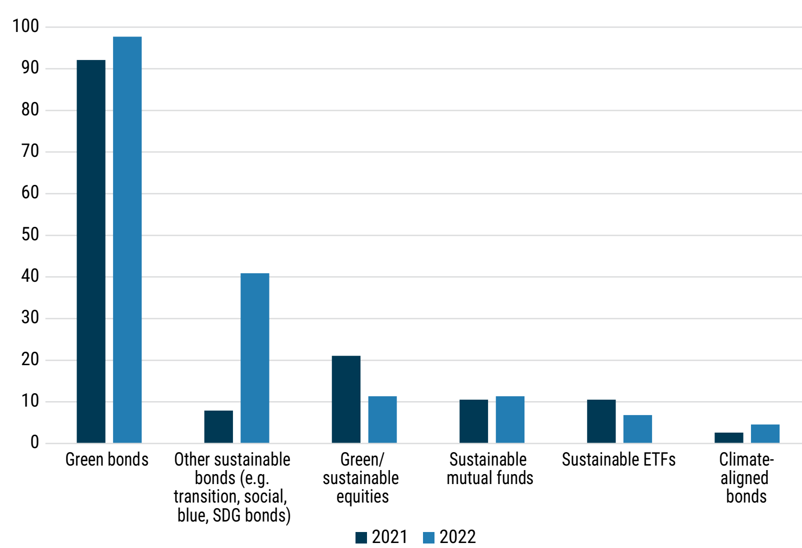
The growing importance of ESG considerations has coincided with a particularly challenging macro environment and geopolitical landscape. This means that ESG objectives may take a backseat to more acute pressures over the short term. One survey respondent lamented, 'We have started a discussion about investing in ESG, but it has been delayed because of the pandemic in the last two years.'

Furthermore, in the face of increased inflationary pressure, a number of reserves managers noted the incompatibility of long-term ESG issues with short-term portfolio duration. One stated that the 'duration of the [ESG] projects do not comply well with our aim to maintain short duration of the portfolios,' with another commenting that there is a 'mismatch between our current average portfolio duration versus the usual long maturity tenor of ESG issues.' This aspect of ESG investment has been exacerbated by exogenous geopolitical shocks (see Chapter 2).

Central banks are making progress in implementing ESG, but it is slow. It is worth remembering that although more institutions than ever are implementing ESG standards and frameworks, more than 40% of surveyed central banks have still not incorporated any ESG criteria. Reserves managers must learn to grapple with both short-term volatility and long-term climate risk. •

4. GREEN BONDS REMAIN FAVOURITE ESG ASSET CLASS

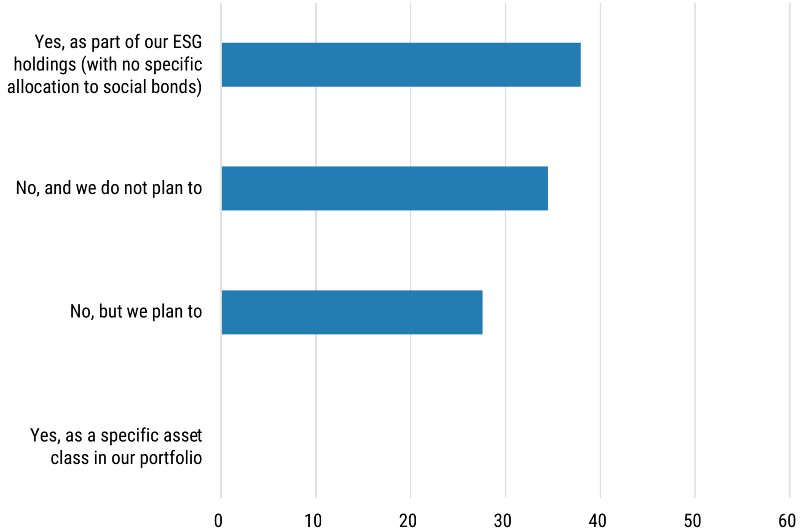
Which sustainable assets do you invest in? Select all that apply. Share of respondents, %



Source: OMFIF GPI survey 2021-22

5. TWO-THIRDS OF CENTRAL BANKS EXPRESS CURRENT OR FUTURE INTEREST IN SOCIAL BONDS

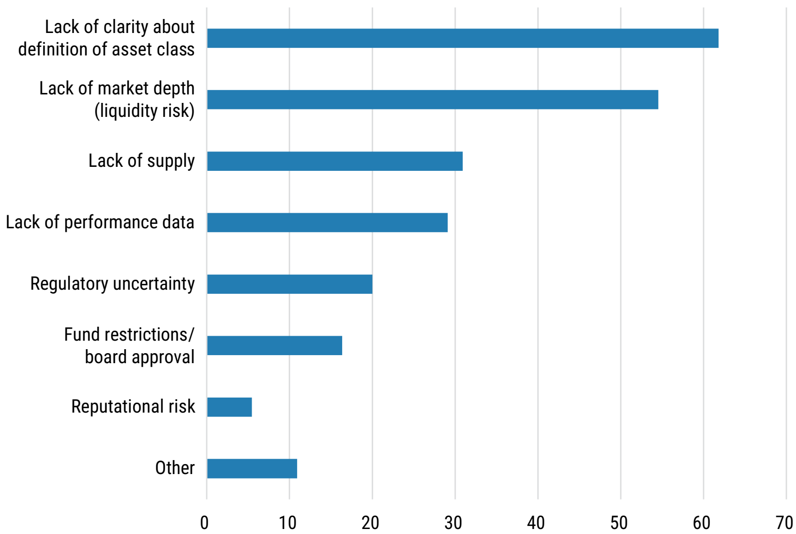
Do you invest in social bonds? Share of respondents, %



Source: OMFIF GPI survey 2022

6. SIGNIFICANT OBSTACLES TO INCORPORATION OF SOCIAL BONDS INTO PORTFOLIOS

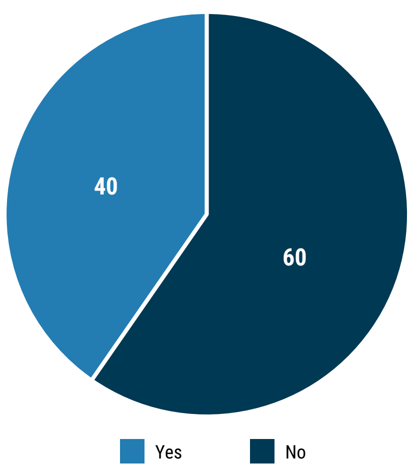
Which of the following are obstacles to the incorporation of social bonds into your reserves portfolio? Select all that apply. Share of respondents, %



Source: OMFIF GPI survey 2022

7. NEARLY HALF OF CENTRAL BANKS PLAN TO INCREASE ALLOCATION TO SOCIAL BONDS

Do you expect to increase your allocation of social bonds over the next 12-24 months? Share of respondents, %



Source: OMFIF GPI survey 2022

63% of central banks intend to increase allocation to green bonds and 42% intend to increase allocation to other sustainable bonds

Of central banks investing in sustainable assets, 98% invest in green bonds

38% of central banks plan to invest in social bonds as part of their ESG holdings and 28% plan to invest in social bonds in the next two years