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ESCP Impact Paper No.2024-38-EN

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Abstract

Social bonds can be issued to finance or re-finance new or existing projects to address or mitigate a specific social issue, precisely described in the legal issuance documents. Social bond schemes bring several advantages for the issuers, allowing them to diversify their investor base effectively, with a possible positive effect on the cost of capital, and facilitating communication with a wider public. As social bond schemes are built on the 'use of proceeds' basis, the approach recommended in the Social Bond Principles regarding the project evaluation and selection, management of proceeds, and annual reporting, with the engagement of external reviewers in the whole process, they bring relevant benefits to governments in directing public spending towards the highest priority social projects for the most vulnerable populations. They also better discipline the issuer's spending. It is expected that with the maturing social bond market, the demand for these securities will only grow, and the benefits for the issuers will be more pronounced. Therefore, we recommend that European governments increasingly consider social bonds as a vehicle to finance projects addressing various social challenges that must be tackled in future years.

Keywords: Social Bond Schemes, ESG, Financing Budget Deficits

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Social bonds are fixed-income instruments with a social component embedded in their legal construction. Even if the general financial characteristics (structure, risk, and return) are considered similar to those of conventional bonds, the difference lies in the financing purpose. Social bonds can be issued to finance or re-finance new or existing projects to address or mitigate a specific social issue, precisely described in the legal issuance documents. *The Voluntary Process Guidelines for Issuing Social Bonds* recommended in *the Social Bond Principles* (SBP) by the International Capital Markets Association (ICMA) is a comprehensive and widely used framework for issuing social bonds. A carefully designed process for project evaluation and selection, transparency in the management of proceeds, and annual reporting are expected from the issuer of a social bond.

The social bond issuance was boosted substantially when, in response to the COVID-19 pandemic, the European Union launched the SURE programme to protect employment. However, there are many other purposes that social bonds can support. A list of relevant examples of eligible social projects in the European context includes affordable housing, access to and quality of education and healthcare improvements, prevention or alleviation of unemployment stemming from socioeconomic pressures, and climate transition projects. Social projects aimed at '*socioeconomic advancement and empowerment,' meaning reduction of income inequality and other considerations for a 'just transition,'* have grown in significance for governments across Europe/the world; these were also financed with social bonds. The populations targeted in projects financed with social bonds include unemployed and low-income households, people with disabilities, migrants, minorities, women, aging populations, vulnerable youth, etc. Unlike other financing schemes, the proceeds of the social bond can be only spent on the communicated projects, not on general budget funding, and the execution and financing of these projects are carefully monitored and reported to investors and other stakeholders.

Even if new types of social bonds are expected to emerge as the market further develops, four types of social bond schemes are now discussed in ICMA's SBP. In its simplest construction, a '*Standard Social Use of Proceeds Bond*' is an unsecured debt obligation with full recourse to the issuer only. With non-recourse-to-the-issuer rights, a '*Social Revenue Bond*' is a debt obligation in which the credit exposure is to the pledged cash flows of the revenue. With a '*Social Project Bond*' in hand, the investor has direct exposure to the risk of the social projects in question, with or without potential recourse to the issuer. Finally, a '*Secured Social Bond*' category may include covered bonds, securitisations, asset-backed commercial papers, secured notes, and other secured structures, where generally, cash flows of assets are available as a source of repayment, or assets serve as security for the bonds in priority to other claims.

Advantages and costs

Social bond schemes bring several advantages for the issuers. They allow them to effectively diversify their investor base, with a possible positive effect on the cost of capital, and facilitate communication with a wider audience. Additionally, as social bond schemes are built on the 'use of proceeds' basis, they represent a targeted funding pool for specific social projects, imposing discipline in the use of funds by issuers. From an investor's point of view, they provide certainty that the funding is directed towards the highest priority social projects for the most vulnerable populations.

Diversification of the investor base

Through social bonds, governments and other issuers can tap sustainability-focused investors and diversify their investor base by reaching finance providers from a wider pool. As including social bonds in their investment portfolio **can satisfy social impact-oriented investors' statutory needs and help all the investors advance their impact agenda while generating financial return**, more investors from diverse investment backgrounds and objectives can be interested in investing in social bonds. This is confirmed by the survey conducted among European professional investors in 2023 by Goldman Sachs Asset Management. In fact, the rapid growth of the social bonds market has answered the strong demand for investment opportunities with adequate financial returns combined with a positive impact on society, according to this study (Van Broekhuizen, 2023). Additionally, investors can improve their portfolio alignment with the United Nations' Sustainable Development Goals (SDGs) by including social bonds in their investment portfolio.

Also, the **value of transparency** of the 'use of proceeds' securities, translating into a reduced investment risk, makes social bonds a desired investment mode for a wide range of investors. The legal construction of the social bonds schemes facilitates transparency already at the *project evaluation and selection* stage through carefully selected and clearly communicated social objectives. Transparency is further enhanced by effective *management of proceeds* being tracked and attested to by the issuer in a formal internal process. Further, SBP involves annual **reporting** with details on the social projects under the social bond schemes, with the amounts allocated and their expected impact. The appointment of external reviewers to assist in all these stages ensures a higher level of transparency than in other schemes.

Possible positive effect on the cost of capital

Because all the characteristics of the social bond schemes discussed above have an impact on the lower investment risk, they potentially can have a bearing on the lower cost of capital for issuers when compared to instruments financing their general spending. Due to the fact that social bonds are relatively new financial instruments with a relatively low total value of issuance and stock, there isn't much relevant academic research available to evaluate this theoretical hypothesis. However, one of the recent research projects by Torricelli and Pellati (2023) sought a 'social premium' defined by them as '*the yield differential between a social bond and an otherwise identical conventional bond*' in a sample of 64 social bonds aligned with ICMA's SBP and 64 (exactly) matched conventional bonds during the peak of social bonds issuances between 2020 and 2021. According to their findings, *the social premium is significantly explained by differences in liquidity and in volatility, which are, respectively, negatively and positively correlated with the yield differential. Second, on the whole sample, the analysis of the fixed effects proves the existence of a significant and positive social premium that amounts to 1.242 bps. This result is robust to outliers, but differences emerge on subsamples especially in relation to issuer sector, thus pointing to the relevance of the use of proceeds, an issue that deserves further investigation as the SB market becomes more mature*.

As the social bonds market matures, more research will be carried out to confirm the existence of the '*social premium*'.

Independently from the above, cheaper financing through the social bond scheme can be ensured by targeting investors like the European Investment Bank, the European Bank for Reconstruction and Development, and other organisations supporting social objectives.

Improved communication with the targeted populations and wider public

The specifics of the project evaluation and selection, management of proceeds, and reporting in the social bond schemes represent a great opportunity for governments and other issuers to improve communication with the targeted populations and the wider public. There is also a good chance that with transparent information about the social projects under social bond schemes, both the populations concerned, and other stakeholders will join the governments / social bond issuers in their efforts to address the most pressing social needs. It would be highly beneficial to engage all the stakeholders to reach the targeted social objectives as effectively as possible.

Directing public spending towards the highest priority social projects and better control over public spending

As social bond schemes are based on the 'use of proceeds' approach, the recommended in the *Social Bond Principles* project evaluation and selection, management of proceeds, and annual reporting, with the engagement of external reviewers in the whole process, bring relevant benefits to governments in directing public spending towards the highest priority social projects for the most vulnerable populations.

As the management of proceeds must follow a robust formal protocol, external auditors are appointed to confirm the same, and the annual reporting to the investors is practically a formal necessity, social bond schemes can effectively help control public spending.

Costs

Social bond schemes bring several benefits but also generate management costs. Social bonds and other 'use of proceeds' bond schemes promote transparency at a higher explicit and implicit cost of establishing a complex framework, which requires close monitoring and reporting with the aid of external auditors.

Outlook for social bonds – a growth case

Social bond issuance surged during the COVID-19 pandemic, as many governments launched social support financial programs to alleviate the economic impact of lockdown and other safety measures; previously, these schemes were less frequently employed.

The European Union issued a total of EUR 98.4 billion in social bonds in 9 issuances of its SURE programme between October 2020 and December 2022. The programme aimed to protect jobs and incomes during the economic hardship of Covid-19: the EU lent the proceeds from social bonds on favourable terms to its member states to support the sectors the most affected by the pandemic. This is considered the world's largest social bond scheme, accounting for 16% of global social bond issuance in 2021. The post-Covid-19 issuance of social bonds returned to normalised levels.

Regardless of the high interest rates that could have an adverse impact on issuance volumes across various types of debt, the European and global segment of social bonds appears resilient, with global social bond sales reaching a record high of USD 14.3 billion in April 2024, according to Bloomberg. A recent example in Europe is the large EUR 1 billion offering of social bonds by the French unemployment insurance agency Unedic to fund the agency's efforts to compensate workers and help firms preserve jobs through economic or health crises.

Despite this, the long-term perspectives for this fixed-income class remain positive, and social bonds have the potential to grow significantly faster than conventional debt, in our opinion. Europe will likely face various social challenges, such as mass immigration or the housing crisis, and it will have to deal with them through targeted programmes, eligible for social bond financing. Military conflicts taking place in the proximity of Europe, climate change, and a lack of economic perspectives have triggered a wave of migration, which is likely to require specific programs supporting immigrant integration and counteracting unemployment. Housing in many European countries is in crisis with high prices, high rents, and low affordability. Consequently, social housing development will remain high on the agenda for many governments. Given the significant financing required for social housing development, a likely solution may be tapping the private investors market through social bond issuance by governments, development institutions, and banks. Social bond issuance can support programmes in various other areas, including support for small and medium enterprises, healthcare, education, and access to infrastructure.

Growing investor demand is another factor supporting the expansion of social bonds. While the market for social bond investments is still in the early stages of development, we expect growth in the listings of social bonds and investment funds specialised in social bonds. Some of the challenges, such as small average social bond deals or difficulties quantifying the social impact of bonds, should be overcome as social bonds mature as a fixed income class, thus supporting growth in the long term.

The European regulatory framework also appears supportive of the social bond schemes, with fundamental EU documents providing strong foundations for a considered 'Social Taxonomy'. The document on the European pillar of social rights and the associated action plan, the European Social Charter, the EU Charter on Fundamental Rights, and the European Convention on Human Rights are the most relevant. The regulatory framework specific to social financing is expected to further develop in the near future. This should help overcome some of the investor's concerns, with benefits for the whole social bond market.

Conclusion

Reflecting on the several significant benefits the social bond schemes bring to governments, other issuers, and society as a whole, as well as a positive long-term outlook for a social bond market, **we recommend that European governments increasingly consider social bonds as a vehicle to finance social projects addressing social challenges persisting or emerging in the years to come.**

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