Sustainability-Linked Bonds and the Sustainability-Linked Bond Principles

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In brief...

A key point of discussion at the 25th Conference of the Parties (COP25) of the UN Framework Convention on Climate Change which met in December 2019 was climate finance. States party to the Paris Agreement debated whether to create a new climate finance goal (the current target of USD100 billion expires in 2020), and whether long-term climate finance initiatives (also to end in 2020) should be renewed. While states party to the Paris Agreement were unable to agree on the way forward in terms of these issues, the discussions at COP25 highlight how fundamental sustainable finance mechanisms are to achieving climate mitigation and adaption targets.

In the absence of a clear direction from the COP25 meetings, the capital markets have continued to respond to the dynamic need for sustainable finance to help issuers meet sustainability targets which align with the objectives of the Paris Agreement or the United Nations Sustainable Development Goals.

What are Sustainability Linked Bonds and the Sustainability Linked Bond Principles?

Sustainability Linked Bonds (SLBs) are any type of bond instrument for which the financial and/or structural characteristics can vary depending on whether the issuer achieves predefined environmental, social and governance (ESG) goals and targets. In 2019, Enel SpA raised USD1.5 billion from an offering of bonds linked to the United Nations Sustainable Development Goals. The coupon on the bond is linked to Enel SpA's ability to achieve its sustainability targets and is widely credited to be the first sustainability linked bond.

SUSTAINABILITY LINKED BOND PRINCIPLES

On 9 June 2020, the International Capital Markets Association (ICMA) issued the Sustainability Linked Bond Principles (SLBP) which offer guidance to issuers wishing to raise environmentally friendly debt with terms tied to specific ESG goals and targets. The SLBP outline best practice for financial instruments to incorporate forward looking ESG outcomes and aim to promote integrity in the development of the SLB market by clarifying the approach for issuance of an SLB. The SLBP have now provided the market with greater clarity around the parameters of SLBs, likely encouraging a wave of new issuers.

The five core components of the Sustainability Linked Bond Principles

KEY PERFORMANCE INDICATORS (KPIS)

Unlike other ESG finance options, the proceeds of SLBs are intended to be used for general purposes directed towards sustainability objectives. This means instead of tying bond proceeds to specific green projects such as renewable energy, pollution prevention, or climate change adaption, the use of proceeds is instead tied to sustainability Key Performance Indicators (KPIs) and Sustainability Performance Targets (SPTs).

Under the SLBP, the KPIs reflect the relevance and materiality of the issuer's core sustainability and business strategy, and address the ESG challenges of the industry it operates in. The KPIs should be:

- relevant, core and material to the issuer's overall business, and of high strategic significance to the issuer's current and/or future operations;
- measurable or quantifiable on a consistent methodological basis;
- externally verifiable; and
- able to be benchmarked, as much as possible using an external reference or definitions to facilitate the assessment of the SPT's level of ambition.

SUSTAINABILITY PERFORMANCE TARGETS

On the other hand, the SPTs reflect the level of ambition the issuer is ready to commit to and considers realistic. The SPTs should be ambitious, for example, SPTs should: represent a material improvement in the respective KPIs and be beyond a Business as Usual trajectory;

- where possible be compared to a benchmark or an external reference;
- be consistent with the issuer's overall strategic sustainability/ESG strategy; and
- be determined on a predefined timeline, set before (or concurrently with) the issuance of the bond.

BOND CHARACTERISTICS

The financial and/or structural characteristics of SLBs depend on whether the issue meets its pre determined SPTs. This means an SLB will need to include a financial and/or structural characteristic which involves a trigger event. For example, in Enel SpA's sustainability bond, if its target of at least 55% renewable generation within its total installed capacity is not achieved by 31 December 2021, a step up mechanism will be applied. This increases the coupon rate by 25 basis points starting from the first interest period subsequent to the publication of the assurance report.

The SLBP suggests a variation in the coupon rate is the most common example; however, ICMA advises the SPT and associated trigger event should be commensurate and meaningful relative to the issuer's bond financial characteristics. Issuers should also consider accounting for exceptional or extreme events, including drastic changes in the regulatory environment, that could substantially affect the calculation of the KPI or the restatement of the SPT.

REPORTING

Issuers should make and keep readily available, up to date information on the performance of the selected KPIs and SPTs. A verification assurance report should also be prepared. This report should outline the issuer's performance against the SPTs and any associated impact this has on the bond's financial and/or structural characteristics. To provide additional clarity to both issuers and investors, ICMA has prepared a checklist of recommended or necessary pre – and post issuance disclosures, which is included at Appendix II to the SLBP. Reporting should be at least annual and for any date or period relevant for assessing whether a particular SPT has been reached.

VERIFICATION

Issuers should employ a qualified third party who has recognised expertise in environmental sustainability or other aspects of the issuance of an SLB, to provide independent and external verification of the issuer's performance benchmarked against each KPI and SPT for the bond. This verification should be made publicly available. Post issuance verification is a necessary component under the SLBP.

How do SLBS differ from other ESG products?

While SLBs fall broadly into the same category of ESG labelled finance options such as green, blue and social bonds, there are several key differences which make them an attractive option for issuers pursuing sustainable targets.

FLEXIBILITY FOR USE OF PROCEEDS

A key distinction between SLBs and other categories of ESG finance such as green or social bonds, is that funds for SLBs are not tied to specific sustainable projects as green or social bonds are. Rather, SLBs are used for general purposes making them highly versatile instruments that can be directed towards initiatives targeting climate change mitigation and adaption. This means issuers are not tied to a specific project and can relocate funding across projects provided it is directed towards achieving the issuer's sustainability KPIs and SPTs, offering greater flexibility.

ATTRACT A BROADER ISSUER BASE

Many issuers are unable to issue a green bond (or other labelled ESG finance products) because they cannot identify sufficient expenditures on business activities connected to sustainability. SLBs help overcome this challenge. While green, blue and social bonds focus on how the proceeds will be used, SLBs do not focus on the use of proceeds, rather linking a key term of the transaction to SPTs. This opens the labelled ESG finance market to issuers with lower levels of sustainability spending requirements. SLBs therefore create opportunities for issuers at the beginning of their sustainability transition and for issuers where divestment forms part of their sustainability initiatives. Ultimately, SLBs capture a broader issuer base, encouraging issuers who operate in any space to pursue a capital raising tied to their sustainability agenda.

FOCUS ON OUTCOMES OVER SPENDING

Both issuers and investors would agree that achieving SPTs with the least amount of spending possible is advantageous. SLBs focus on measuring outcomes as opposed to business spending activities, promoting both economic and sustainable benefits to investors and issuers. Some investors or issuers may prefer SLBs to focus on outcomes as opposed to spending. Focusing on outcomes is also more readily aligned with frameworks such as the Paris Agreement or United Nations Sustainable Development Goals.

Some considerations regarding Sustainability Linked Bonds

SUSTAINABILITY WASHING

Sustainability washing occurs when a bond which is marketed as being tied to sustainability targets, but where the issuer fails to meet those targets.

SLBs may reduce the risk of sustainability washing. This is because the bond characteristics are tied to a trigger event which increases the cost of the bond to the issuer if the sustainability KPIs and SPTs are not met. The adoption of ESG pricing creates a financial incentive for issuers to follow through on their environment plans. In addition to negative financial consequences, there is also significant potential reputational risk to the SLB issuers if the issuance does not achieve the desired outcome.

QUANTIFYING AMBITION

As noted above, a key difference between green bonds and SLBs is that the bond characteristics vary depending on whether the issuer satisfies its predetermined KPIs and SPTs. It is critical issuers choose criteria that are ambitious and meaningful to their business. Tying a capital raising to such KPIs and SPTs may encourage issuers to adopt a low threshold for their sustainability agenda and targets for fear of not achieving them.

EXTERNAL REVIEWS

The SLBP recommends that an SLB issuer should consider appointing an external review provider to confirm the alignment of their bond with the five core components of the SLBP. External reviewers are encouraged to assess the relevance, robustness and reliability of selected KPIs, the rationale and level of ambition of the proposed SPTs, the relevance and reliability of selected benchmarks and the credibility of the strategy outlined to achieve them. After issuance, issuers are recommended to engage external reviewers to assess any of these changes which may be material to the KPIs, the SPTs or the methodologies employed.

Conclusion

The creation of SLBs has confirmed the need for a bond instrument linked to an issuer's sustainability strategy and ambitious, credible targets, including those connected to climate transition. SLBs complement the existing ESG finance options such as green, blue social and sustainable bonds, diversifying both issuer and investor choice, and driving the sustainability agenda across all industries. A greater variety of issuers can participate in the sustainable finance market because SLBs focus on sustainable outcomes as opposed to sustainable focused expenditure. As more issuers enter the SLB market, more issuers will set and achieve their SPTs, driving greater ambition among new issuers to push for meaningful targets. Ultimately, SLBs are a welcome addition to the suite of ESG finance products, offering a practical tool to encourage an issuer's sustainability agenda and attracting outcome focused investors. The market has also responded rapidly to the issuance of the SLBP. The London Stock Exchange has introduced the ability for issuers to display SLBs on the Issuer Level Classification segment on its Sustainable Bond Market, providing they are issued in accordance with the SLBPs.

SLBP

As with green bonds, the SLBP make it clear underwriters of SLBs are not responsible if issuers do not comply with their commitments to SLBs and the use of the resulting net proceeds. We expect it to be made clear that a failure to meet an SPT or reporting requirement would not result in a bond event of default.

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