SUSTAINABILITY-LINKED BONDS – MAKING SENSE OF SLBs, KPIs AND SPTs

On 9 June, the International Capital Market Association (ICMA) published the Sustainability-Linked Bond Principles (the Principles), a set of voluntary guidelines aimed at fostering the development of a sustainability-linked bond (SLB) market.

Key issues

- Sustainability-linked loans are now a mainstream product. The aim is that SLBs will be too
- 5 core components – credible Key Performance Indicators (KPIs), ambitious Sustainability Performance Targets (SPTs), meaningful changes in bond characteristics, verification and reporting
- May be particularly useful for issuers that want to demonstrate ESG commitments but are less able to issue a "use of proceeds" bond
- Careful consideration of disclosure, drafting and sustainability impact will be essential
- Part of a growing trend for new capital markets products in sustainable finance, such as transition bonds, ESG labelled programmes and, soon, the new EU Green Bond Standard

SLBs are "any type of bond instrument for which the financial and/or structural characteristics can vary depending on whether the issuer achieves predefined sustainability/ESG objectives" – the typical example would be a change in interest rate depending on whether a target sustainability key performance indicator (KPI) is met.

Sustainability-linked loans are already commonplace – that market is estimated to have reached USD122 billion in 2019[1]. The intent is to replicate that growth in the public bond markets. The Principles aim to provide issuers with guidance on how best to issue an SLB whilst ensuring that investors are provided with adequate information. At the same time, the Principles look to assist underwriters by moving the market towards standardised approaches to structuring and disclosure.

We take a look at the basics of the Principles and how they might be used. In addition, we discuss some of the points issuers and underwriters should consider when bringing this product to market.

The basics

The Principles have five core components:

1. Selection of Key Performance Indicators (KPIs)

As a first step, an issuer will need to select the KPI (or KPIs) it wants to use. The Principles note the importance of the selected KPIs being "credible". That is KPIs should be "material to the issuer’s core sustainability and business strategy and address relevant environmental, social and/or governance challenges of the industry sector and be under management’s control".

In addition, 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;

[1] Bloomberg New Energy Finance

- externally verifiable; and
- able to be benchmarked using external reference or definitions to facilitate the assessment of the SPT's level of ambition.

Various KPIs have been used in the loan market including greenhouse gas emissions, ESG ratings, water and energy consumption, proportion of renewable energy production, carbon footprint, solid waste sent to landfill and gender equality measures such as percentage of women in senior management roles. The key point is that the KPI should matter not only to the issuer's business but also to wider society.

2. Calibration of Sustainability Performance Targets (SPTs)

Once a KPI has been chosen, an appropriate target level needs to be calibrated. The Principles state that SPTs should be "ambitious". That is:

- 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 issuers' overall strategic sustainability/ESG strategy; and
- be determined on a predefined timeline, set before (or concurrently with) the issuance of the bond.

It is recommended (although not required) that an issuer appoints an external review provider confirming the alignment of the bond with the five core components of the Principles. External reviewers are encouraged to disclose their credentials and relevant expertise and communicate clearly the scope of the review conducted. The Principles point to ICMA's Voluntary Guidelines for External Reviews which have been developed to promote best practice in this area.

3. Bond characteristics

The defining feature of an SLB is that the financial or structural characteristics of the bond vary depending on whether the selected SPT is reached. As mentioned above, variation in interest rate is likely to be the most common example but the Principles stress that other structural features could be considered. We have, for example, seen some loans that require a sustainability premium to be paid into a specific account used by the borrower only for ESG-specific purposes - thus avoiding the potentially challenging outcome that lenders benefit from a borrower's failure to meet sustainability targets, and directing additional funds to improve the borrower's sustainability performance. Alternative structures could include prepayment events or an undertaking to put a corrective action plan in place to remedy the failure to hit the SPT.

According to the Principles the variation in the bond terms should be "meaningful" relative to the original characteristics of the bond. In our previous article The Rise of Sustainability-Linked Loans, we cited 2.5 to 3 basis point variations as common in investment grade loans, albeit with examples of larger redeterminations. The only public sustainability-linked bond to date, issued by the Italian energy company, ENEL, featured a larger step-up of 25 basis points.

4. Reporting

Issuers of SLBs should publish and keep available and accessible:

- up-to-date information on the performance of the selected KPI(s), including baselines where relevant;
- a verification assurance report relative to the SPT outlining the performance against the SPTs and the related impact, and timing of such impact, on the bond's financial and/or structural characteristics; and
- any information enabling investors to monitor the level of ambition of the SPTs (e.g. any update in the issuer's sustainability strategy or on the related KPI/ESG governance, and more generally any information relevant to the analysis of the KPIs and SPTs).

Reporting should be at least annual and for any date or period relevant for assessing whether a particular SPT has been reached.

5. Verification

Whilst a second party opinion on alignment with the Principles is not mandatory (albeit something we would expect the majority of issuers to obtain), the Principles do require independent and external verification of the performance of the issuer against each specified SPT.

Again, this should be done at least once a year and for any date or period relevant for assessing whether a particular SPT has been reached. It should be carried out by a qualified external reviewer with relevant expertise, typically an auditor or environmental consultant.

A few points to consider…

A welcome development but with some added complexity

We have seen considerable interest in sustainability-linked financings and the publication of the Principles is a welcome development. For many issuers, the Principles will provide legitimacy to the product and enable them to participate in the market with increased confidence. SLBs are likely to be attractive for issuers that want to demonstrate their commitment to sustainable finance but do not have sufficient green or social projects to underpin the issuance of a green, social or sustainability "use of proceeds" bond.

In addition, as there is no exhaustive list of KPIs that can be used, issuers have relatively free rein to use KPIs that fit their specific sustainability and business strategy. The Technical Expert Group on Sustainable Finance have suggested that KPIs could be linked to an improvement of the share of EU Taxonomy-aligned activities – a potentially attractive proposition for Issuers looking to demonstrate their commitment to sustainability within a regulated framework. Certainly, we have seen increasingly bespoke and inventive KPIs used in the sustainability-linked loan market.

The additional structural complexity is, however, likely to lead to additional preparation time and some increase in costs. This may be little more than faced by issuers on standard sustainable "use of proceeds" financings, but issuers will have a new counterparty to negotiate with in the provider of verification reports, additional drafting to consider and further reporting requirements.

Issuers and their advisers should also be alert to the fact that novel structures may lead to new technical and legal points to consider. It is not clear that the variable coupon step structures envisaged by the Principles will be treated as eligible collateral by the ECB under current eligibility frameworks. That would prevent issuances from participation in initiatives such as the ECBs Corporate Sector Purchase Programme or Pandemic Emergency Purchase Programme. Similarly, SLBs may not satisfy the requirements of regional incentive schemes such as the Hong Kong Green Bond Grant Scheme or Monetary Authority of Singapore Sustainable Bond Grant Scheme which are currently based on existing "use of proceeds" models.

Careful drafting will be essential

Unlike use of proceeds green, social and sustainable bonds, SLBs will embed sustainability concepts into the contractual terms of bonds in a way that has not been common to date. Particular attention should be paid to ensure those terms are precise, clear and unambiguous to avoid future disagreement.

A number of structural questions will also need to be considered. To give some examples:

- is the KPI properly defined? For example, if the KPI is linked to CO2 emissions are we looking to Scope 1, Scope 2 or Scope 3 emissions? How are they being calculated?
- if an issuer fails to hit a SPT leading to an interest rate step-up, what happens if the SPT is met at a later date? Should a subsequent step-down be built in?
- What if the verification provider disappears or cannot confirm whether the SPT has been hit? What is the fallback mechanism in that case? How would a new verification provider be chosen?
- How to deal with ESG ratings as a potential KPI? Is it a sufficiently reliable and predictable metric? There are considerable differences in methodology and outcomes between ratings providers, and the criteria are not always transparent.
- Standard bond terms and conditions often feature a separate event of default that is triggered if obligations other than payment of principal and interest are not met. We would typically expect it to be made clear that a failure to meet an SPT or reporting requirement would not result in an event of default.

What to disclose and where?

The Principles encourage disclosure on a range of matters including how KPIs have been selected, historic performance of the KPI and what might affect future performance or achievement of the SPT. Appendix II of the Principles provides further guidance on these disclosures. Issuers should consider these recommendations in tandem with their legislative and contractual obligations to include all material information in the prospectus and care around the inclusion of forward-looking statements. The existing green and sustainable bond market has developed an increasingly standardised set of risk factors, disclaimers and disclosure practices to address the particularities of that market. It is likely a similar set of practices will grow up around the SLB market.

Greenwashing can apply here too

Accusations of greenwashing and associated negative publicity have affected certain issuers of green and sustainable bonds. The sustainability-linked loan market has not been immune from similar commentary. Typically, this has focussed on whether the product brings tangible sustainability benefits or stretches the issuer to materially improve the sustainability of its operations. Issuers and their advisers should therefore consider carefully the requirements of the Principles to include "credible" KPIs, "ambitious" SPTs and "meaningful" variations in bond characteristics. The use of third party verification reports confirming alignment with the Principles is also likely to be helpful in mitigating these risks.

The Principles and SLBs are part of a wider trend for new forms of sustainable debt. Transition bonds (aimed at financing industries with high GHG emissions to become more green) and self-labelled ESG programmes highlighting an issuer's ESG rating are becoming increasingly common. At the same time, the European Commission is currently developing a new voluntary EU Green Bond Standard with use of proceeds linked to the new EU Green Taxonomy.

Each carries with it particular considerations as to proper structuring, documentation and sustainability impact important not only to issuers and underwriters from a risk and reputational perspective, but also to the integrity of the sustainable bond market as a whole. The existing ICMA Green, Social and Sustainability Bond Principles have been important in encouraging a consistent approach and best practice for those products. The Principles should serve a similar purpose for the new SLB market.

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