DEVELOPMENTS IN THE ESG BOND MARKET: SUSTAINABILITY-LINKED BONDS AND TRANSITION BONDS

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Legal Briefings

This is the third in a series of articles looking at the development of ESG in debt financing (the first and second can be found here and here). In this article, we look at the ESG bond market and focus in particular on sustainability-linked bonds and transition bonds. We will discuss the differences between these newer products and the existing green, social and sustainable ("**GSS**") bond market and will highlight the key takeaways from industry guidance published by the International Capital Market Association ("**ICMA**").

WHAT ARE SUSTAINABILITY-LINKED BONDS?

Following in the footsteps of the sustainability-linked loan market, the first sustainability-linked bond ("**SLB**") was issued by Italian energy distributor, ENEL, in 2019. The ICMA subsequently published the Sustainability-Linked Bond Principles (the "**Principles**") in June 2020 and, more recently, Q&As to support the Principles in February 2021.

The main feature of SLBs is that unlike 'traditional' GSS bonds, funds raised through SLBs are not earmarked for specific ESG purposes but for general corporate purposes. SLBs focus on incorporating measurable, forward-looking sustainability key performance indicators ("**KPIs**") and sustainable performance targets ("**SPTs**") into the financial and/or structural characteristics of bonds. It is important to note that SLBs should be differentiated from sustainable bonds - which are bonds where the proceeds will be exclusively applied to finance or re-finance a combination of both green and social projects, typically in line with the ICMA Sustainability Bond Guidelines of June 2018.

Following the publication of the Principles, a flurry of SLBs have been issued in the market, with the most recent being fashion retailer H&M's issuance of a EUR 500 million 8.5 year SLB in February 2021 where it committed to: (i) increase the share of recycled materials as inputs to 30 per cent. (from 0.5 per cent.), (ii) reduce Scope 1 and 2 emissions by 20 per cent., and (iii) reduce (selected) Scope 3 emissions by 10 per cent.; all against the 2017 baseline, by 2025. These sustainability-linked instruments have come in many forms including an SLB incorporating social targets, a convertible SLB and a sustainability-linked commercial paper programme.

The rise in popularity of SLBs is no doubt linked to the flexibility offered by the unrestricted use of proceeds: these types of bonds are often used by issuers in their green or sustainability transition and/or by issuers for whom identifying sufficient environmentally positive projects may not be feasible.

THE PRINCIPLES

The Principles are voluntary guidelines that recommend structuring features, disclosure and reporting and are applicable to all types of issuers and any type of financial capital market instruments. The Principles have five core components:

1. Selection of KPIs

The issuer's sustainability performance is measured using sustainability KPIs. 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. They should be measurable, externally verifiable and capable of being benchmarked. Issuers are encouraged, when possible, to select KPI(s) that they have already included in their previous annual reports, sustainability reports or other non-financial reporting disclosures to allow investors to evaluate historical performance of the KPIs selected.

2. Calibration of SPTs

SPTs must be set in good faith and the issuer should disclose strategic information that may decisively impact the achievement of the SPTs. The SPTs should be ambitious (represent a material improvement in the respective KPIs and be beyond a 'business as usual' trajectory) and be consistent with the issuers' overall strategic sustainability/ESG strategy. They must also be determined on a pre-defined timeline which is set before (or concurrently with) the issuance of the bond. An external review (such as a second party opinion) to confirm alignment of the bond with the five core components of the Principles is recommended.

3. Bond characteristics

The bond should include a financial and/or structural impact involving trigger event(s). On more recent SLBs, this has predominantly been in the form of a coupon step-up (typically between 10 to 75 basis points), although some issuers have offered a premium payment instead. As the market evolves, it will be interesting to see if more innovative penalty clause structures are embedded into bonds.

4. Reporting

Issuers should publish regularly, and at least annually, (i) up-to-date information on the performance of the selected KPI(s), (ii) a verification assurance report relative to the SPTs 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 (iii) any information enabling investors to monitor the level of ambition of the SPTs.

5. Verification

Issuers should, at least annually, seek independent and external verification of their performance level against each SPT for each KPI by a qualified external reviewer with relevant expertise, such as an auditor or an environmental consultant.

THE RISE IN POPULARITY OF SLBS

Outstanding SLBs reached over USD 10 billion in 2020 following the release of the Principles and the SLB bond market is predicted to grow even further in 2021. The flexibility to use KPIs to fit an issuer's specific sustainability strategy has been well received by the market and the structural possibilities of SLBs has made the format more attractive to a wider range of issuers than the GSS bond market. The fact that the failure to meet SPTs acts as a trigger event has been seen as attractive to investors, although some have questioned whether rewarding investors for a failure to meet targets is the right approach. Market participants have also flagged the risk of 'greenwashing', arguing that the lack of transparency around an SLB's use of proceeds could create a legitimacy issue for the market.

SLBs also present an additional opportunity for the buy-side to allocate capital to meet their ESG investment targets, particularly as there is a such high demand for eligible financing opportunities. This has been evident in the recent SLBs that have come to market which have all generated significant interest from a wide range of investors and have been oversubscribed.

This attractiveness of SLBs is likely to be bolstered this year following the announcement by the European Central Bank in September 2020 that bonds with coupon structures linked to certain sustainable performance targets will become eligible as collateral for Eurosystem credit operations and also for Eurosystem outright purchases for monetary policy purposes from 1 January 2021, provided they comply with all other eligibility criteria.

As the SLB market grows, it will also be interesting to see the interplay between SLBs and regulatory frameworks. For example, under the EU Taxonomy, certain corporates and banks will be required in the future to disclose the share of their EU Taxonomy–aligned business activities. Consequently, issuers of SLBs in Europe are being encouraged to reference and benchmark their sustainability performance against the EU Taxonomy's technical screening criteria (which is under development), which may also be applied as KPIs or the SPT calibration for such an issuance.

FINANCING BROWN TO GREEN: TRANSITION BONDS

Whilst the launch of the Principles was welcomed by issuers and investors, the debt capital markets also recognised that further guidance was needed for transitioning issuers. These are issuers who are on a transition pathway to Paris Agreement targets and wish to raise funds in order to help them achieve emission reduction goals. Previously, a handful of transactions carried the transition label, however, there was no singular definition of a 'transition bond'. This eventually led to the publication of the ICMA Climate Transition Finance Handbook (the "**Handbook**") and related Q&As in December 2020. Interestingly, the Handbook does not set out detailed principles in the same way as the ICMA Green Bond Principles or the Principles. Instead, issuers are encouraged to use existing tools (i.e. consider a GSS bond if an issuer wishes to allocate capital to a dedicated use of proceeds or issue an SLB in order to achieve designated ESG objectives) and use the Handbook as an extra layer of issuer-level guidance for issuers seeking to align their financing strategy to their climate transition goals and decarbonisation trajectory. It is important to emphasise that the Handbook is only relevant when raising funds for climate transition-related purposes. Issuers who wish to set other sustainable or social targets do not need to look to the Handbook for guidance, but can of course do so to lend credibility to their relevant transition strategies.

THE HANDBOOK

1. Issuer's climate transition strategy and governance

The concept of climate transition focuses principally on the credibility of an issuer's climate change-related commitments and practices. A transition label applied to a bond should serve to communicate the implementation of an issuer's corporate strategy to transform the business model in a way which effectively addresses climate related risks and contributes to alignment with the goals of the Paris Agreement. Disclosures regarding corporate strategies may be aligned with recognised reporting frameworks, such as the recommendations of the Task Force on Climate-Related Financial Disclosures ("**TCFD**"), or similar frameworks. An independent technical review of the issuer's strategy may assist investors in developing a view regarding its credibility.

2. Business model environmental materiality

An issuer’s planned climate transition trajectory should be relevant to the environmentally-material parts of the issuer’s business model, taking into account both current and future scenarios which may impact on current determinations regarding materiality. The climate transition trajectory, as far as it relates to financing, should be a material factor to the future success of the business model, as opposed to being an incidental aspect.

3. Climate transition strategy to be ‘science-based’, including targets and pathways

An issuer’s climate strategy should reference science-based targets and transition pathways. In particular, it should be (i) quantitatively measurable (based on a measurement methodology which is consistent over time), (ii) be aligned with, benchmarked or otherwise referenced to, recognised, sector-specific science-based trajectories (where they exist), (iii) be publicly disclosed (ideally in mainstream financing filings) and include interim milestones, and (iv) be supported by independent assurance or verification.

4. Implementation transparency

Issuers should, to the extent practicable, provide transparency on the investment programme underlying its climate transition strategy, as it is this programme which underpins the success or failure of any such strategy. Issuers should disclose details of capital and operational expenditure, details of where any such operating expenditure is deemed ‘nonbusiness as usual’, details of divestments, governance, process change, as well as other relevant information indicating how this programme supports implementation of the transition strategy.

THE CASE FOR TRANSITION BONDS

Up until recently, the ESG debt capital markets have been focused on GSS bonds and green industries who are already on their way to reducing emissions. However, hard-to-abate sectors, accounting for a significant proportion of total emissions, have the greatest impact to make and therefore form the biggest piece of the puzzle when it comes to reducing GHG emissions. It is well recognised that efforts to transition to low-carbon economies must be ramped up significantly in order to reach these goals and transition bonds could have a crucial role to play, particularly as regulators mount pressure on companies to rapidly address climate change.

Of course, as with SLBs, there are some concerns about the potential for ‘greenwashing’ being greater in the transition space as what constitutes a genuine transition and appropriate science based targets will vary from sector to sector. The Handbook can go a long way towards providing standardisation and transparency to the market and will give issuers in carbon intensive sectors an opportunity to raise finance to support their climate transition strategy in a credible way. Whilst ESG in debt financing e-briefing // 4 the market is still at a nascent stage, the publication of the Handbook has generated widespread interest. Asia, in particular, has seen two recent transition bonds come to market: Bank of China priced a transition bond from its Hong Kong Branch in two tranches (USD 500 million 3 year and CNH 1.8 billion 2 year) in January and Hong Kong’s Castle Peak Power Company issued its third transition bond (USD 300 million 10 year) in February 2021.

Investors too are increasingly understanding the important role ‘brown’ sectors have to play in meeting emission reduction targets and are eager and willing to help corporates achieve their sustainability goals. Stock exchanges may also be starting to recognise this importance, with the London Stock Exchange launching a dedicated Transition Bond Segment in February 2021 - the first exchange globally to do so (complementing its existing Green, Social, Sustainability and IssuerLevel segments).

CONCLUSION

Despite the year’s myriad of challenges, the ESG bond market has made huge strides in 2020 with the advent of the Principles and Handbook. There has been recognition in the market that whilst GSS bonds have played a very large role in financing environmentally friendly and social impact projects, more needs to be done to provide opportunities to ‘brown’ issuers who have the ambition to transition to green in the future. By complementing GSS bonds, SLBs and transition bonds should enable more issuers to tap the ESG bond market and scale up decarbonisation, while serving a broader range of investors. As political and societal focus on the climate crisis and ESG more broadly is at an all-time high, particularly with the aim of a ‘green recovery’ following the Covid-19 pandemic, these new products and guidance have come at an opportune time to help create real and lasting change.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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