

Issuers of Sustainability-linked Bonds Could Step Up Efforts to Enhance Investor Confidence

Potential To Unlock New Capital and Facilitate Sustainable Financing May Be Limited Without Improving Credibility

Three Key Takeaways

1. Sustainability-linked bonds (SLBs) grew significantly in 2021. Despite strong issuance growth, investors' views on SLBs are still polarized with greenwashing risks as a key concern.
2. Investors' concern has led to the development of newer structures like the "use of proceeds SLBs" which combines the fundamentals of green bonds and SLBs. Although still nascent, investors consider these hybrid instruments to provide the benefits of both worlds—transparency, certainty and accountability.
3. Improving the credibility of SLBs is pivotal, as weak structures can limit issuers' ability to access new pools of capital, especially from leading ESG investors. SLBs with loose sustainability performance targets (SPTs) could undermine an issuer's reputation and future refinancing needs.

Executive Summary

SLBs have gained strong traction with improved issuances since it was first introduced in 2019. SLBs grew significantly higher in 2021 after the International Capital Market Association (ICMA) released the Sustainability-Linked Bond Principles (SLBP) in June 2020 which encouraged more issuers to tap the SLB market.

Despite strong issuance growth, investors' views on SLBs are still polarized. Some investors have remained cautious about these instruments amid concerns over credibility and greenwashing risk. These concerns have led the ICMA to release further guidance in June 2022 with an updated registry of approximately 300 sustainability key performance indicators (KPIs) for selected sectors and a supplementary question and answer (Q&A) to address queries on SLBs.¹

¹ International Capital Market Association. [Updates to Sustainability-Linked Bond Principles - Expanded Registry for SPTs and Q&A related to SLB](#). June 2022.

Additionally, investors' concern also led to the development of newer structures like the "use of proceeds SLBs" which combines the fundamentals of green bonds and SLBs. Although still nascent, investors consider these hybrid instruments to provide the benefits of both worlds — transparency, certainty and accountability.

The call for action to improve the credibility of SLBs is pivotal, as weak structures will impact an issuer's ability to access new pools of capital, especially from leading ESG investors. SLB structures with loose sustainability performance targets (SPTs) could undermine an issuer's reputation and future refinancing needs. Weak investor demand for SLBs also exposes arranging banks to underwriting risks.

For the SLB market to develop further, robust discussions amongst issuers, investors, lead arrangers, and underwriters are crucial to address credibility gaps which will help tighten and improve these debt instruments.

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Market Trends of Sustainable Debt, Growth in SLBs Should Not Be Ignored

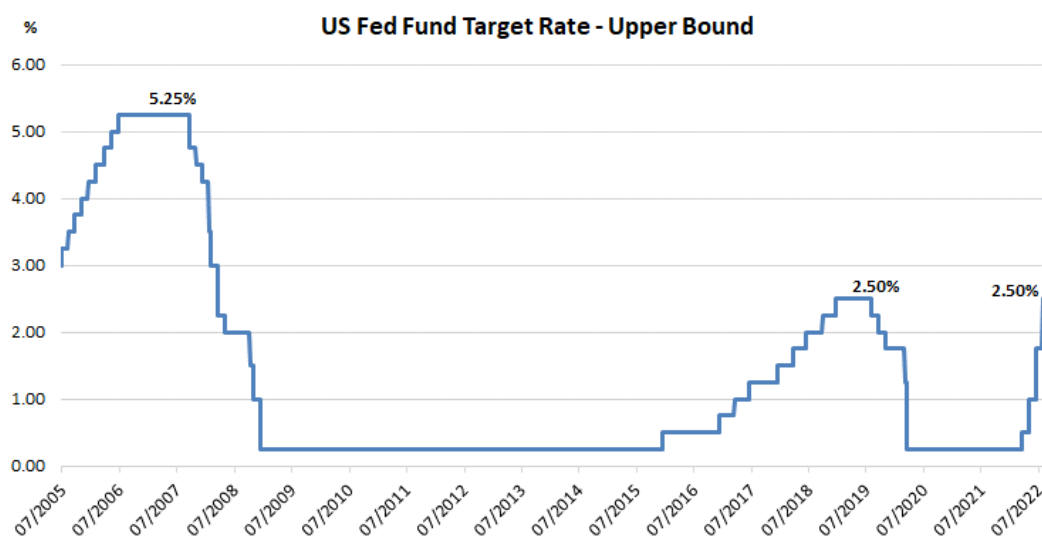
The prospects of sustainable debt markets are likely to remain positive as both governments and companies continue to meet their pledges and accelerate the transition toward a net-zero economy.

Despite market headwinds arising from higher inflation and rising interest rates, opportunities to lock in borrowing costs could persist as central banks have signalled more interest rate hikes are to come through to 2023/2024.

In July, the US Federal Reserve (US Fed) raised its key policy interest rate by another 75bps, bringing the current US Fed fund target rate to a range of 2.25%-2.50%. The current rate matches the pre-Covid level of 2.50% as of March 2019 but is still below the previous high of 5.25% back in November 2006.

US Fed officials in June projected rates to reach 3.40% by end of 2022 and around 3.80% by end of December 2023.²

Figure 1: US Fed Fund Target Rate, Interest Rate Hikes Remain on the Cards



Source: Bloomberg.

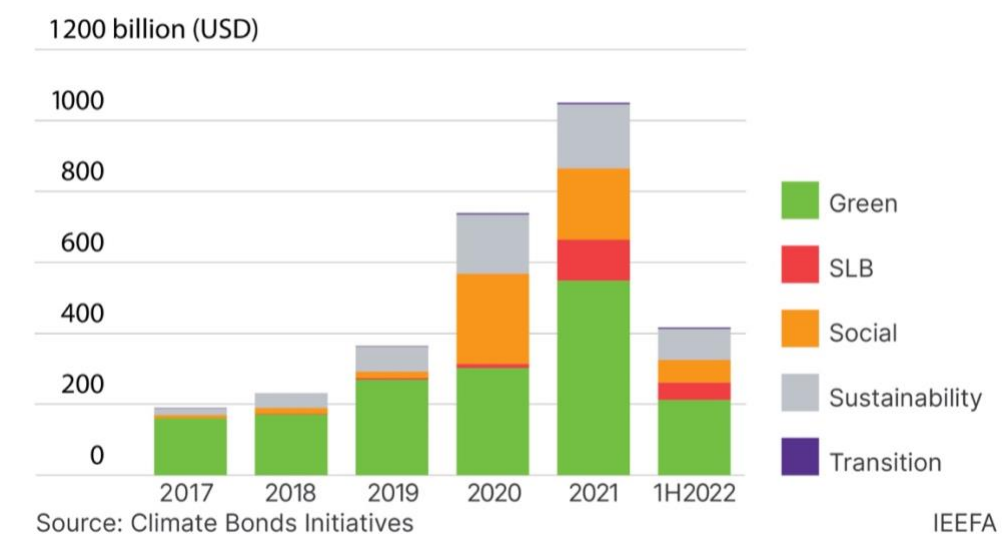
² Bloomberg News. Powell Signals More Hikes Coming, Leaves Out Details This Time. 27 July 2022.

Sustainable Debt Volumes Reached USD3.3 Trillion in 1H 2022

At the end of 1H 2022, sustainable debt issuances, comprising green, social, sustainability, SLB and transition bonds have collectively reached USD3.3 trillion.³

Green bonds led the sustainable debt issuances which grew to a cumulative size of USD1.9 trillion at end of 1H 2022. Annual green bond issuances grew from USD159 billion in 2017 to USD548 billion in 2021.

Figure 1: Sustainable Debt Market Issuances Led by Green Bonds but Growth in SLB Should Not Be Ignored



SLB issues have grown significantly since it was introduced in 2019 with a nascent volume of USD4.5 billion. SLB issuances rose to USD115 billion by the end of 2021 following the release of SLBP by ICMA in June 2020. Cumulative SLB issuances have since reached USD175 billion as of 1H 2022.⁴

In 2019, the Italian utility company Enel issued the world first's SLB with a five-year USD1.5 billion print. It remains the world's largest SLB issuer, having completed 23 SLB issuances to date, with combined issuances worth USD24 billion.⁵ It has issued in USD, EUR and GBP currencies to finance its operations. The Swiss-based construction material company Holcim is another notable SLB issuer having tapped the market between 2020-2022 with seven prints, with issuances denominated in USD, EUR and Swiss Francs.

³ Climate Bonds Initiative. [Sustainable Debt Market Summary 1H2022](#). August 2022.

⁴ Climate Bonds Initiative. CBI Analysis. August 2022.

⁵ Bloomberg. Bloomberg Data. July 2022.

Key Sectors of SLB Issuances: European Issuers Continue to Lead as a Region

By sector, utilities and industrials are the top 2 sectors by volume, having contributed 20% and 16% respectively.⁶ Significant growth in SLB volumes last year saw European issuers contributing a share of 55.7%, with issuers in the Asia Pacific region sharing 21% of the total issued amount. By country, Italy continues to lead with the highest number of issuer counts and volumes.

Figure 2: Key Sectors of SLB Issuances

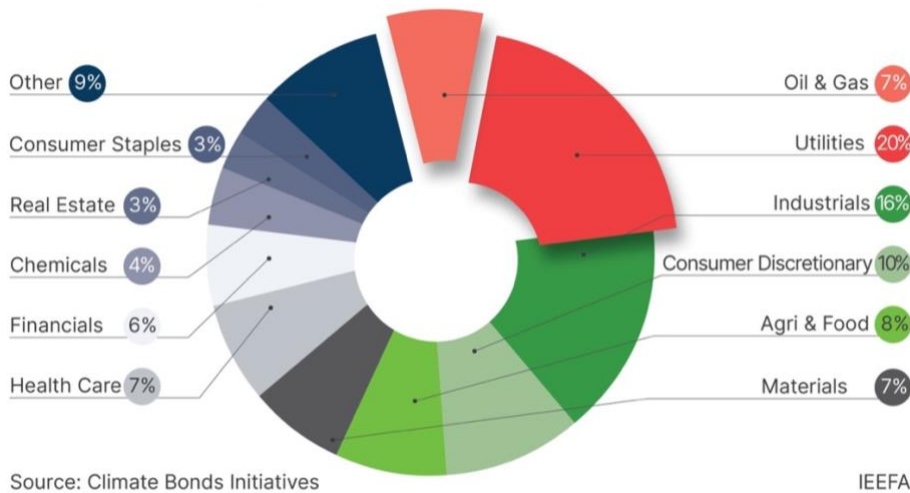
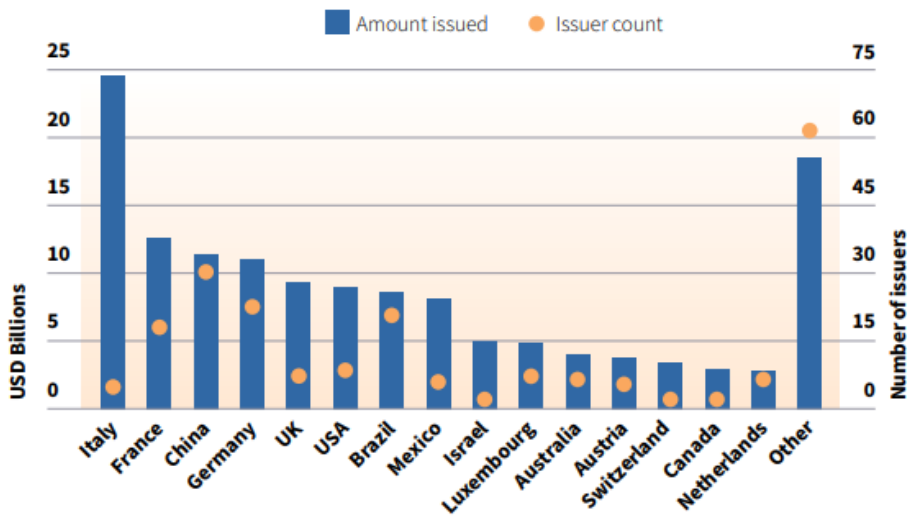


Figure 3: Italy Tops SLB Volume, Followed by France



Source: Climate Bonds Initiative.

⁶ Climate Bonds Initiative. Sustainable Debt Global State of the Market 2021. April 2022.

In March 2022, Chile issued the world's first sovereign SLB. The USD2 billion 20-year sovereign SLB was priced with a coupon of 4.346% with coupon step-ups linked to two predefined SPTs, reduction in GHG emissions and increase in renewable energy capacity.⁷

SLBs Explained

SLBs are forward-looking performance-based debt instruments in which the bond's financial structures via coupon rate adjustment depend on the firm's achievement of pre-defined sustainability performance target (SPT).

SLB issuers face an upward coupon adjustment as penalty when they fail to meet the SPT. Issuers can be incentivised with a lower adjusted coupon rate if an SPT is met. An issuer may have more than one SPT embedded in the SLB structure.

SLBs were initially introduced with the objective of broadening the scope of issuers to gain access to sustainable financing, especially for companies in hard-to-abate sectors that aspire to transition but have limited green or sustainable capex to issue green bonds. Hard-to-abate sectors consist of companies operating in high-emitting industries like steel, petrochemical, cement, fertilizers, aviation and shipping.

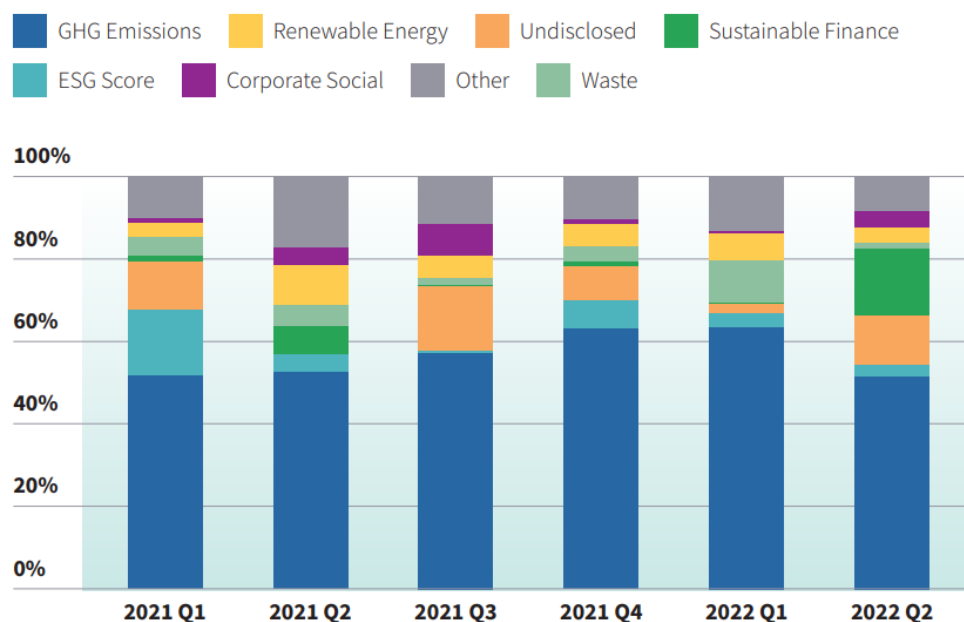
Unlike green bonds, the use of proceeds under SLBs need not be specified and can be utilised for general corporate purposes. Instead, issuers specify one or more predefined SPT as part of the issue. Predefined SPTs include environmental targets, such as reducing greenhouse gas (GHG) emissions and increasing renewable capacity generation.

Climate Bonds Initiatives found that the most popular SPT for SLB is the reduction of GHG emissions, accounting for 58% in 1H2022.⁸ Other notable SPTs include increasing capacity in renewable energy generation and improving waste management.

⁷ Environmental Finance. [Chile issues ground-breaking sovereign sustainability-linked bond](#). March 2022.

⁸ Climate Bonds Initiative. [Sustainable Debt Market Summary 1H2022](#). August 2022.

Figure 4: Reducing GHG Emissions Most Prominent KPI Underlying SLBs



Source: Climate Bonds Initiative.

Despite recent strong growth, investors views on SLBs are still polarised and issuers should be mindful of the reputation of these debt instruments.

Investors' Concerns over SLB

ESG investors have remained cautious, having raised greenwashing risks as a key concern. French asset manager Amundi opined that compared to green bonds, there are greenwashing risks in relation to SLBs as some issuances have come online with sustainability KPIs that were not relevant to the issuers' business and the targets assigned to the sustainability KPIs were not stringent enough.⁹

Investors are of the view that sustainability KPIs need integration with credible climate targets that are aligned with the Paris Agreement climate goals. It is important as issuers need to support nationally determined contributions (NDC) targets pledged by respective countries. Netherlands-based asset manager NN Investment Partners suggested that for an SLB to be credible, the issuer should publish an externally verified 1.5 degrees climate target aligned with net zero.¹⁰ The KPIs should also be directly linked to how the issuer plans to achieve those targets.

⁹ Environmental Finance. *SLBs without 1.5 °C targets 'don't hold water'*. 24 November 2021.

¹⁰ Environmental Finance. *SLBs without 1.5 °C targets 'don't hold water'*. 24 November 2021.

Additionally, issuers should set SPTs that are robust to allay the lack of ambition concerns raised by investors. SPTs ought to be material and beyond “a business-as-usual” trajectory. The SPTs/KPIs should also enable tracking and produce tangible results by stretching issuers to show significant sustainability improvements across business operations. Sustainability targets will need to be consistent with the issuer’s sustainability strategy, with a minimum tracking record of at least three years for comparability, whilst allowing for benchmarking using an external reference.¹¹

SPTs ought to be material and beyond “a business-as-usual” trajectory.

In general, investors revealed that most SLBs currently have a step-up-problem. The current norm of a 25bps step-up for coupon adjustment is untenable and unhealthy for the development of the SLB market.¹² Penalties in the form of step-ups need to be financially impactful and aligned with the size of the issuer’s business profile. Step-up to coupon adjustments for SLB needs alignment with the issuer’s business size and profile, i.e. profitability, market capitalization and balance sheet presence. A flat 25 bps step-up can run the range from material to insignificant. The same 25 bps step-up might be insignificant to large companies but material for smaller firms, as the impact is dependent on the business size of the issuer. The solution to the problem is to more appropriately align the magnitude of the step-up with the issuer’s size and scale of business.

From an impact perspective, ESG investors want to know how the money invested in SLB is being used and how these are being tracked.¹⁴ Investors expect a higher standard of reporting and impact analysis from SLB given that these debt instruments can be raised for general corporate purposes. Whereas, financing for green bonds are directed towards green projects which offer certainty as to where proceeds will be directed. Accordingly, some investors view that SLBs should be treated like general corporate debt instruments, as SLB issuers generally retain full discretion for how the capital raised will be allocated.¹³

Investors have also questioned whether SLBs deliver genuine sustainability impacts. In providing assurance and confidence to investors, issuers need to communicate a clearer link between sustainability-linked bond financing and sustainability impacts achieved.¹⁴

It is observed that Enel—a seasoned SLB issuer—has taken investors’ concerns and views into consideration as part of the process of setting up sustainability targets.

¹¹ International Capital Market Association. [Sustainability Linked Bond Principles](#). June 2020.

¹² Federated Hermes. [Do Sustainability-Linked Bonds have a step-up problem](#). March 2022.

¹³ Nuveen’s Investment Insights. [Sustainability-linked bonds do not fit our impact framework](#). 16 March 2022.

¹⁴ Capital Monitor. [Sustainability-linked bonds: Markets doubts spark rethink](#). 6 July 2022.

Enel's first issuance included an SPT to increase renewable energy capacity but was quick to expand its sustainability targets by including a second SPT on GHG reduction (Scope 1). In January 2022, Enel brought forward its target from 2050 to 2040, to fully decarbonize its energy mix. Enel plans to have all its net-zero targets progressively include Scopes 1, 2 and 3 emissions – verified by the Science Based Targets initiative (SBTi).¹⁵

On sovereign SLBs, a senior European sovereign debt official cautioned that any funds raised through sovereign SLBs should “commensurate” with sustainability spending and action, or risk being open to greenwashing claims. The proceeds for sovereign SLBs should match the transition efforts of sovereigns.¹⁶ As such, most sovereigns have opted for use of proceeds structure either via green, social or sustainability bonds.

Sovereign bonds are also issued with dual objectives, to finance federal government projects and develop liquid bond markets. As such, sovereigns are likely to focus more on green sovereign bonds as these debt instruments have direct financing linked to green projects and where investors' demand are the strongest amongst other sustainable debt instruments. Sovereign SLB issuance are more ad-hoc in nature and will be harder to demonstrate from a commensurability angle. Sovereign SLBs are unlikely to be issued frequently with repeat issuances as compared to green sovereign bonds.

The concerns expressed by investors highlight that SLB issuers must prepare for a higher level of scrutiny than previously faced from the fixed income market. ESG investors are reluctant to fund issuers that lack transparency and accountability.

Efforts To Strengthen SLBs' Credibility

Improving the credibility and ambition of SLBs is key to gaining investors' acceptance.

This led ICMA, for example, to update and expand its SPTs and KPIs registry across different sectors as well as supplementary question and answer (Q&A) to address queries on SLBs.¹⁷

Boosting Impact with Use of Proceeds SLB

Other efforts to improve the credibility of SLBs led to the development of newer structures like “use of proceeds SLBs” which combines the fundamentals of green bonds and SLBs. Although still nascent, investors consider these hybrid instruments to provide the benefits of both worlds—transparency, certainty and accountability.

¹⁵ Environmental Finance. [Why Enel turned to sustainability-linked bonds](#). 14 June 2022.

¹⁶ Environmental Finance. [SLBs risk becoming 'greenwashing' product for sovereigns](#). 21 July 2022.

¹⁷ International Capital Market Association. [Updates to Sustainability-Linked Bond Principles - Expanded Registry for SPTs and Q&A related to SLB](#). June 2022.

A broader sustainable finance framework with the use of proceeds and sustainability KPIs in a hybrid model is emerging as the best practice for sustainable debt issuances.¹⁸

Combining the use of proceeds green bonds with SLB structures could also make these debt instruments more impactful and more intentional. As investors already have expectations for green bond issuers to deliver climate action at a corporate level, tying in sustainability-linked targets could help boost the issuer's commitment.¹⁹

The benefits of hybrid green bonds with sustainability-linked targets also help to ease concern over the lack of forward-looking impact.¹⁷ The nature of green bonds tends to be project-level focused by allowing issuers to claim green credentials without undergoing more sustainability impacts beyond the funded projects themselves.

Issuers that have experimented with use of proceeds SLBs include Austrian energy company Verbund AG and Japanese construction conglomerate Takamatsu Construction Group.

Verbund AG is one of Austria's largest producers of electricity from hydropower in Europe. Its power generation comes from 95% of renewable sources, primarily via hydropower and supplemented by wind power and solar photovoltaics. Verbund issued a 20-year EUR500 million use of proceeds SLB in March 2021.

Asian companies have also started to explore with use of proceeds SLB structure. In March 2021, Takamatsu issued a JPY10 billion 5-year green use of proceed SLB to fund the construction of a green and energy-efficient building in Tokyo. Its use of proceeds SLB was oversubscribed three times. Other issuers of use of proceed SLBs include GLP J-REIT, Yunnan Provincial Energy, and China Construction Bank.

Verbund's Use of Proceed SLB Case Study

Although still relatively nascent in terms of volumes, Verbund's 20-year use of proceeds SLB was oversubscribed four times.²⁰ In comparison, Enel's 20-year straight SLB issued in July 2021 was oversubscribed 2.2 times.²¹ Both companies are investment grade, government-supported (via shareholder presence) and from the same sector. In addition, their respective issues are of the same tenor.

The difference, however, is that Enel is a seasoned issuer — having raised a total of 23 SLB issuances²² — compared to Verbund²³ which have issued three issuances comprising of two green bonds and one use of proceed SLB.

¹⁸ Environmental Finance. [The rise of hybrid sustainable debt frameworks](#). 15 December 2021.

¹⁹ Environmental Finance. [Combining sustainability-linked and green bonds would be "more impactful"](#). 9 February 2021.

²⁰ Bloomberg News. [Priced -Verbund EU500 million WNG 20Y Green SLB](#). March 2021.

²¹ Bloomberg News. [Enel's Sustainability-Linked Bonds Leads List of Six](#). July 2021.

²² Bloomberg. Bloomberg Data. August 2022.

²³ Bloomberg. Bloomberg Data. August 2022.

The demand for Verbund's use of proceeds SLB led to a 25-30bps of cost savings with the pricing of coupon at 0.90%.

While many factors ultimately determine demand, Verbund's oversubscribed use of proceeds SLB is notable. More hybrid structures like this are likely to emerge as ESG investors refine their expectations on sustainable debt instruments.

Conclusion

SLB issuances have gained traction but investors' concerns over greenwashing risks will still need to be addressed. The credibility of KPIs/SPT is a key driver in gaining investors' acceptance as investors continue to demand certainty on how the money invested is going into projects and whether positive outcomes are delivered. These projects will need to contribute to meeting the climate objectives of the Paris Agreement.

Improving the credibility of SLB is pivotal, as weak structures will impact an issuer's ability to access new pools of capital, especially from leading ESG investors and this could negatively impact longer-term refinancing needs. For SLBs to be credible, structures will need to be tightened further with robust, financially impactful and material SPTs to reinforce issuers' climate commitment and trajectory.

Heightened investors' concerns and greenwashing claims have also given rise to the development of newer use of proceeds SLB structures. Combining the use of proceeds from green bonds with SLB structures could make these debt instruments more impactful. These hybrid debt instruments could boost the issuer's climate ambition via forward-looking sustainability commitments.

Moving forward, SLB issuers will need to be prepared for a higher level of scrutiny as investors continue to evaluate SLBs closely. Investors will expect issuers to provide a higher standard on impact reporting, detailing steps and strategies to achieve medium- and longer-term climate targets. SLB issuers that can demonstrate consistent and credible sustainability performances against their climate ambition will have a better advantage in gaining investors' acceptance and access to capital.

Appendix A: Verbund and Takamatsu - Use of Proceeds SLB

Issuer	Verbund	Takamatsu
Rating	A3(Moody's)/A (S&P)	A- (Japanese Credit Rating Agency)
ISIN	XS2320746394	JP345790BM38
Issuance size	EUR 500 million	JPY 10 billion
Coupon	0.90%	0.29%
Issue Date	1-Apr-21	13-Mar-21
Maturity Date	1-Apr-41	19-Mar-26
Use of proceeds (Eligible green projects)	<p>To finance Investments relating to the construction, development, acquisition, maintenance, and/or operation of renewable energy installations including solar and wind power, hydropower, and associated grid infrastructure</p> <p><i>For hydropower: Only hydropower developed in EU countries and subject to EU environmental legislation will be considered eligible for allocation</i></p>	<p>Proceeds raised exclusively for green projects, construction of new environmentally friendly office building in Tokyo</p>
SPT	<p>SPT 1: Newly-installed Relevant Renewable Energy production capacity of the Issuer (including its Subsidiaries) reached at least 2,000 MW by the SPT Observation Date</p> <p><i>New Capacity refers to installations commissioned after 31 December 2020</i></p> <p>SPT 2: Additionally installed Transformer Capacity of the Issuer (including its Subsidiaries) reached at least 12,000 MVA by the SPT Observation Date</p> <p><i>Additional capacity refers to capacity which is commissioned after 31 December 2020</i></p>	<p>To achieve a cumulative total of JPY 391.1 billion in SDGs contribution revenue over the next four years (financial year ending March 2022 to 2025).</p> <p>As per Takamatsu's press release, the issuer in the past three years (financial year ended March 2018 to 2020), its average of SDGs Contribution Revenue per financial year was around JPY 92.7 billion.</p> <p>Identified UN SDG alignment:</p> <ul style="list-style-type: none"> • SDG 15, SDG 11 and SDG 3 - Good health and well-being • SDG 7 - Affordable and clean energy • SDG 11- Sustainable Cities and Communities • SDG 15 -Life on Land. <p>Some areas of SDG contribution revenue quoted by Takamatsu:</p> <ul style="list-style-type: none"> • Civil engineering revenue directly linked to renewable energy • Revenue of buildings that comply with energy conservation standards • Construction revenue that maintains safety and high-quality standards • Revenue related to housing services for the elderly

SPT Observation Date	31-Dec-32	31-Aug-25
Step up margin	<p>An increase in step-up coupon margin at 25bps payable from the first coupon payment date following the SPT Observation Date, until maturity of the relevant Sustainability-Linked financing instrument.</p> <p>This applies if SPT 1 & SPT 2 are not achieved by SPT Observation Date.</p>	<p>A premium will be paid to investors if the issuer cannot achieve its SPT by 31 August 2025. A premium of 0.5 yen per 100 yen for each bond will be paid.</p>

Source: Bloomberg, issuers' websites and corporate press releases.

About IEEFA

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