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SUSTAINABILITY-LINKED BONDS

What are they?

Sustainability-linked bonds (**SLBs**) are a form of ESG-responsible bond issuance, in which the financial and/or structural features of the bond vary depending on the achievement of (and/or failure to achieve) pre-set ESG objectives.

In response to the first SLB being issued by Enel in 2019, the International Capital Markets Association (ICMA), one of the leading proponents of the ESG capital markets through its Green, Social and Sustainability Bond Principles, developed a formal framework for SLBs which was published in June 2020 (the SLB Principles), and released a set of frequently asked questions in relation to the SLB Principles in February 2021.

The terms and conditions of an SLB:

- define certain Key Performance Indicators (**KPIs**) that measure any one or more environmental, social or sustainability metrics;
- define one or more sustainability performance targets (**SPTs**) applicable to each KPI, against which the issuer will be assessed during the life of the bond, and which may trigger a change in the structural or financial features of the bond when the SPT is either reached or missed at a certain date (the **SPT Trigger**);
- require regular (at least annual) reporting of the issuer's KPI performance and whether that performance, when compared to the SPT, meets the SPT Trigger; and
- contain the mechanics for the adjustment of either structural or financial features of the bond upon the SPT Trigger being reached (or missed). There may be multiple SPT Triggers over the life of the bond, with different structural or financial changes resulting from each SPT Trigger.

Why SLBs were developed

The limitations of "use of proceeds" instruments: The original green, social and sustainable (**GSS**) bond market focused on "use of proceeds" instruments. GSS bonds require that the proceeds raised from the bond issue have to be applied to eligible GSS projects. The proceeds of GSS bonds cannot therefore be used for general corporate purposes funding. GSS bonds therefore focus on the issuer's intended application of the proceeds, rather than on the outcome achieved by their application. SLBs instead focus on the measurable outcome of the issuer's progress measured by the KPIs.

Marketing difficulties for companies in "brown" industries: Issuing a standard green bond may create marketing difficulties for a company in an industry that is not regarded as a green sector of the economy. Even if the proceeds of the bonds were intended to be applied towards environmental projects, certain issuers prefer to use the term "transition bonds". Such issuers may prefer an instrument such as an SLB that can transparently demonstrate their commitment to improving their GSS performance, rather than claiming to be an issuer of "green" bonds, focusing on their direction of travel (or transition) from "brown" to "green".

Financing needs may not match GSS spending requirements: Certain issuers, perhaps lacking a pipeline of potentially eligible GSS projects to fund using the proceeds from a GSS bond, or simply because of the timing mismatch between issuance windows and their GSS spending requirements, may seek the flexibility of an instrument that can be used for general corporate purposes, yet can still demonstrate the issuer's commitment to GSS improvement. An SLB has the advantage of being linked to the ESG strategy of the issuer as a whole, rather than the funding of one particular eligible project or aspect within that ESG strategy.

Investor demand for ESG finance instruments: Throughout 2020, the empirical evidence for a "greenium" (a premium paid by investors for an ESG finance instrument compared to a conventional issuance) became stronger. Furthermore, the moral imperative for all participants in the capital markets to play their part in the ESG challenges facing the world is constantly increasing. Corporates and governments (including the UK and the EU) have made commitments to achieve "net zero" greenhouse gas emissions by 2050 (if not before), while pension funds, insurance companies and asset managers are increasingly incorporating ESG factors into their investment decisions. The net zero by 2050 target is consistent with the 2015 Paris Agreement to pursue efforts to limit temperature increase to 1.5°C above pre-industrial levels. For this to be achievable, all industries, not just the "green" economy, need earnestly to focus on ESG strategies and transitions towards significant ESG improvements – which will require massive investments. SLBs can play a part by aligning financing instruments with issuers' ESG strategies.

A financial instrument must be investible: No matter how environmentally or socially responsible an issuer is, a bond instrument must be creditworthy and investible for private capital to be put at risk. SLBs maintain the fundamental requirement of the bond being a sound credit risk, and then layer on top of that a future adjustment of the structural or financial performance of the bond based on the issuer's performance against an ESG factor or factors.

Key features

The return that an investor receives and/or the structural features of an SLB change depending on the ESG performance of the SLB issuer within a certain timeframe.

The KPIs should be relevant, core, material and of strategic significance to the issuer's overall business and future plans. They need to be capable of being quantified and consistently measured (including by external verification).

The SPTs should be science-based and should reflect either an ambitious new ESG target for the issuer, or commit the issuer to adhere to its already stretching ESG agenda. The issuer is therefore likely to have to undergo a form of benchmarking against peers to gauge whether the target is appropriate and/or realistic.

To date, SLBs have focused on a penalty for issuers if the issuer fails to reach the SPT, in the form of increased cost of funding (coupon step-up/premium payment). A non-exhaustive list of SPT features in SLB issuances to date include:

SPT Trigger	Result of trigger
Failure to reach a minimum percentage of renewable energy generation by a certain date	Coupon step-up
Failure to reduce greenhouse gas (**GHG**) emissions by a certain percentage by a certain date	Coupon step-up
Failure to increase patient reach in certain categories by a certain amount by a certain date	Coupon step-up
Failure to shift to 100% renewable energy in operations by a certain date	Coupon step-up
Failure to deliver GHG emission savings, increase gender diversity in workforce and leadership, and train 1 million underprivileged people in energy management, all by a certain date	Premium payment

There is no reason that more innovative structural or pricing feature changes cannot be included in SLB terms, such as a graded coupon step-up (to incentivise achieving a result as close as possible to an SPT, even if it is becoming evident the SPT is not going to be reached in full), or testing of the SPT at multiple levels at different times (to incentivise continual improvement year-on-year). In addition, there is no reason why the instruments should only bear a penalty for issuers. Will 2021 be the year that investors accept financial responsibility for ESG progress in the form of structural changes reducing the cost of funds to issuers over-performing against their SPT? For example, coupon step-downs could feature alongside coupon step-ups. Alternatively, the penalty applied to an issuer's failure to meet an SPT could be redirected, not as an increased payment to the investors, but instead applied to other verified ESG projects in a transparent manner.

External opinions and verification

The SLB Principles recommend that a second party opinion is delivered pre-issuance of an SLB by an external review provider. This would usually be provided by an environmental consultant. The SLB Principles also require at least annual and, for any date/period on which the SPT Trigger is to be assessed, mandatory post-issuance auditing or review by an environmental consultant of the performance of the issuer against each SPT for each KPI.

Listing on ESG bond market segments

While the first SLB in 2019 did not qualify for listing on an ESG market segment due to the innovative nature of its structure and the fact that it was not a standard green bond, the major exchanges have adapted and developed their ESG segment structures specifically to contemplate SLBs. The London Stock Exchange's Sustainable Bond Market now explicitly recognises SLBs as one of its five distinct routes to eligibility. The Luxembourg Stock Exchange's LGX (the Luxembourg Green Exchange) and Euronext's EURONEXT ESG Bonds (which combines all six of Euronext's market locations in one ESG market segment) also accept SLBs.

Potential issues

A contradictory result of the structural features in SLBs issued to date is that a coupon step-up, or premium payable as a penalty on the issuer for failing to meet an SPT, results in a gain for the investor. The market presumption is that the motivation to invest in SLBs arises at least in part from a desire to advance the ESG agenda, not to receive a financial reward for an issuer's failure to achieve its ESG agenda. Further innovations in the structural features of SPT Triggers can address this somewhat counterintuitive outcome.

Like any ESG instrument, SLBs are not immune from accusations of greenwashing. Concern here arises from (i) whether the KPIs have relevance to the wider community beyond the issuer's business, (ii) whether the SPTs are sufficiently ambitious, and (iii) whether the structural/pricing changes upon reaching (or failing to reach) an SPT are sufficiently material to drive the issuer's continued adherence to its ESG programme and the achievement of the results which underpin the SPT.

Neither the failure to meet an SPT nor the failure to report on whether the SPT has been achieved results in an event of default under an SLB. It is important to be aware that the consequence of such failures in SLBs are customarily limited to the application of the structural or pricing change (often a coupon step-up), that results from the SPT not being met.

As the complexity of SPT Triggers develops, care will also need to be taken by issuers to ensure that relevant corporate events that might require an adjustment to either the SPT or the methodology of KPI calculation are anticipated, considered and provided for at the time of issuance, similar to the way that convertible bonds contemplate conversion price adjustment. Complexity of SPT Triggers may also increase the time and costs of KPI reporting obligations.

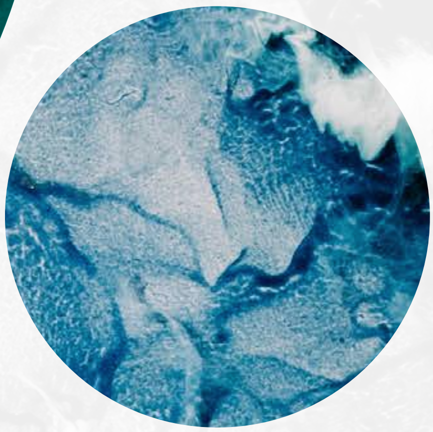
Opportunities for further developments

Regulatory encouragement for SLBs: From 1 January 2021, bonds with coupons linked to SPTs are potentially eligible as ECB collateral, and thus also potentially eligible for purchase pursuant to the ECB's asset purchase programmes, including the Pandemic Emergency Purchase Programme. Previously, SLBs would have been ineligible if they had a coupon step-up/down feature. The ECB will now consider an SLB with a coupon step-up/down feature potentially eligible for collateral purposes if the coupon change is linked to a performance target referring to one or more of the environmental objectives set out in Regulation (EU) 2020/852 (the EU Taxonomy Regulation) and/or to one or more of the United Nation's Sustainable Development Goals relating to climate change or environmental degradation.

Expansion into sustainability-linked commercial paper: After pioneering SLBs, Enel has also played a leading role in the expansion of sustainability-linked concepts into commercial paper programmes. While the first ESG commercial paper programme established by Rabobank in 2018 relies on Rabobank's ESG Leader classification based on Sustainalytics' independent assessment of Rabobank's overall ESG performance, Enel has taken a different tack, trying to square the circle between commercial paper being a short-term instrument and ESG agendas usually requiring a long-term horizon to work towards SPTs. Enel has adopted an SPT for renewable energy installed capacity (60%), which it aims to achieve by 31 December 2022. This SPT is not limited to the ECP programme, but is included in Enel's sterling-denominated SLB issued in 2020. It is also notable that the SPT represents a greater ambition than that included in Enel's initial SLB in 2019 (55% renewable energy installed capacity by 31 December 2021), demonstrating how an SPT can be used to drive continued improvement in ESG performance. If the SPT is not met, there is no impact on the financial characteristics of the outstanding commercial paper. However, Enel will no longer be able to issue commercial paper labelled as sustainability-linked ("SDG 7 (Affordable and Clean Energy) Target Notes") off the programme. In addition, once the date for the SPT Trigger assessment has passed, Enel will no longer be able to issue commercial paper labelled sustainability-linked, with the implication being that to issue sustainability-linked commercial paper once more, Enel will need to supplement or update its commercial paper programme, setting a new and further more ambitious future SPT to work towards. Thus, although not an SLB, an approach to a sustainable commercial paper programme such as Enel's does appear well matched to the SLB concepts of target setting, measurement against such target, and demonstrating continual improvement on KPIs and the promotion of an ESG agenda across a business.

Scope for future innovative development: While the SLB market remains in its infancy, similar features have been present in the loan market for some time, and ESG and sustainability are becoming a core part of government and corporate issuer long-term strategies. The flexibility offered by SLBs to use proceeds for general corporate purposes, while aligning the KPIs and SPTs with the issuer's long-term ESG strategy, provides a real opportunity for issuers to define what is meaningful for their own transition towards decarbonisation, sustainability and being socially responsible, and to publicly communicate their ambitions through the terms of their public bond issuances.

If you want to discuss Sustainability-Linked Bonds, or any other issues in the debt capital markets, please feel free to contact any of the Dentons Debt Capital Market team.



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