Sustainability-Linked Bonds: Linking Business Strategy with Sustainability

Executive Summary

- Sustainability-linked bonds are a new type of debt instrument in the ESG investing scene.
- The bonds' features can vary depending on whether the issuer achieves its **predefined sustainability objectives**.
- The proceeds deriving from sustainability-linked bonds are not restricted to specific projects and may be used for **general corporate purposes**.
- Sustainability-linked bonds complement the range of sustainable debt instruments, such as **green and social bonds**, but might also become an attractive alternative to standard corporate bonds.
- The Luxembourg Green Exchange (LGX), the world's leading platform for sustainable finance instruments, recently recognized sustainability-linked bonds.

The ambition of most global policy makers is clear: Make the world (and finance) more sustainable. How to get there, however, is a question not only governments need to answer. Investors and regulators demand sustainability, while issuers are in need of tools that combine their own business interests with their stakeholders'.

It is therefore exciting news for issuers that there is a new type of bond entering the sustainable investment scene: Sustainability-linked bonds are very much like an ordinary bond, but with the upside of being also sustainable. How does that work?

Sustainability-linked bonds can be used to **finance general corporate purposes**. Unlike green, social and sustainability bonds, they are not use-of-proceeds bonds. Issuers remain flexible with the allocation of the funds and the choice of their projects or portfolios.

What is sustainable about them? Continuing an idea that is already prevalent among sustainability-linked loans, the features of sustainability-linked bonds are **linked to predetermined sustainability metrics**, such as carbon emissions. The issuer will be rewarded if it meets the targets. If it fails to meet them, the investor profits, for example, from a higher interest rate.

I. The Sustainability-Linked Bond Principles

In June 2020, the International Capital Market Association (ICMA) published their Sustainability-Linked Bonds Principles (**SLBP**)[1] to provide guidance to market participants. The SLBP have five core components:

1. Selection of Key Performance Indicators (KPIs)

Issuers shall commit to sustainability KPIs that are:

- credible, relevant and material to the issuers' overall business and of high strategic significance;
- measurable or quantifiable on a consistent and methodological basis;
- externally verifiable; and
- able to be benchmarked.

The KPIs are not limited to greenhouse gas emissions, but can include all types of internal and external sustainability KPIs, e.g. reducing water waste or energy consumption or improving access of low-income regions to key resources such as medicine, water or education.

[1] Available here: https://www.icmagroup.org/green-social-and-sustainability-bonds/

2. Calibration of Sustainability Performance Targets

On the basis of the selected KPIs, the issuer is expected to commit to sustainability performance targets (SPTs). The SPTs shall be **ambitious**, i.e. constitute a material improvement and not just a continuation of "business as usual". In addition, SPTs must be:

- consistent with the issuer's overall ESG strategy;
- determined on a predefined timeline which is set in advance; and
- comparable to a benchmark or an external reference, where possible.

The SPTs shall be based on a combination of **benchmarking** approaches:

- the issuer's own performance over time (the issuer's track record of the past three years as well as forward-looking guidance are recommended),
- the issuer's peers (e.g. best-in-class approach, sector standards); and
- reference to science or official targets such as the Paris Agreement or the UN Sustainable Development Goals.

The SLBP provide further details on the specific **disclosures** the SPTs should refer to. It is strongly recommended, but not mandatory, to appoint an external review provider at issuance confirming the alignment of the bond with the five core components of the SLBP.

3. Bond Characteristics

The key component of a sustainability-linked bond is that the bond's financial and/or structural characteristics can vary depending on whether the selected KPIs reach the predefined SPTs (or not). A change of the coupon is one option, but not the only one. The main requirement is that the variation of the bond characteristic is **meaningful** relative to the original financial characteristics and is included in the bond documentation at issuance.

Investors that do not want to profit from a failure to meet sustainability targets can, among others, commit such gains to ESG-specific purposes.

4. Reporting

Issuers should publish and keep readily available:

- up-to-date information on the performance of the KPIs;
- a verification report outlining the performance of the SPTs and the related impact on the bond's characteristic; and
- in general any information enabling investors to monitor the level of ambition and progression of the SPTs.

The reports shall be published at least annually. The reporting can be included in the standard reports of the issuer, e.g. its annual accounts or sustainability reports.

5. Verification

Issuers are required to seek independent external verification of their performance against the SPTs by a qualified external reviewer with relevant expertise, e.g. an auditor or an environmental consultant. The verification is mandatory at least once a year and in any case for any period where the performance can lead to a trigger event adjusting the bond characteristics. The verification of the performance should be made publicly available. This post-issuance verification is mandatory, unlike the pre-issuance external review which is only recommended but might become a *de facto* requirement of the market.

II. Main Benefits

While green, social and sustainability bonds already have a track-record of success; sustainability-linked bonds have the potential to become the most important sustainable bond instrument. Key advantages include:

- Flexibility on the use of proceeds

  Sustainability-linked bonds can be used for general corporate purposes. Issuers can allocate the proceeds with greater flexibility where they need it the most, regardless whether the so financed assets qualify as green or sustainable.

- Focus on success

  Issuers are measured by performance. Improving KPIs to reach specific targets is a commercial goal that issuers are highly familiar with. As a result, it is easier for them to implement the SPTs in their already existing performance-based tools and policies (e.g., management incentive schemes, reporting, auditing). Measuring concrete sustainability performance is also beneficial to the investors and the overall strategic goal of sustainability: reporting focuses more on performance and the accountability of the issuer is ensured.

- Addressing more issuers and more issues

  Not every sustainability issue can be solved by dedicated projects. Often, it is the overall process, e.g. an issuer's supply chain, which is detrimental to an important sustainability goal. By focusing on the issuer rather than the specific projects, sustainability-linked bonds encourage corporations to improve their sustainability strategically. Issuers are free to define the sustainability targets that are most material to them. They can align their sustainability strategy with a bond instrument that further incentivizes them, but remain free to adapt their approach of implementation at their own discretion and, as a result, maybe more efficiently.

III. Luxembourg's Role

As a leading financial hub in Europe, Luxembourg continues to devote its efforts to sustainability in general and sustainable finance in particular. The Luxembourg Green Exchange (LGX), highly regarded in the global sustainable investment scene and a key player in Luxembourg, recently added the SLBP as an **eligible classification** for bonds displayed on the LGX.

IV. Conclusion

Sustainability-linked bonds are the first performance-based bond instrument in sustainable finance. They offer issuers greater flexibility by allowing the use of proceeds for general corporate purposes. By encouraging issuers to define their sustainability performance metrics, sustainability-linked bonds have the potential to truly drive corporate strategies towards sustainability.

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