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Sustainability-linked bonds: nascent opportunities for ESG investing

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A new concept rather than just a new label

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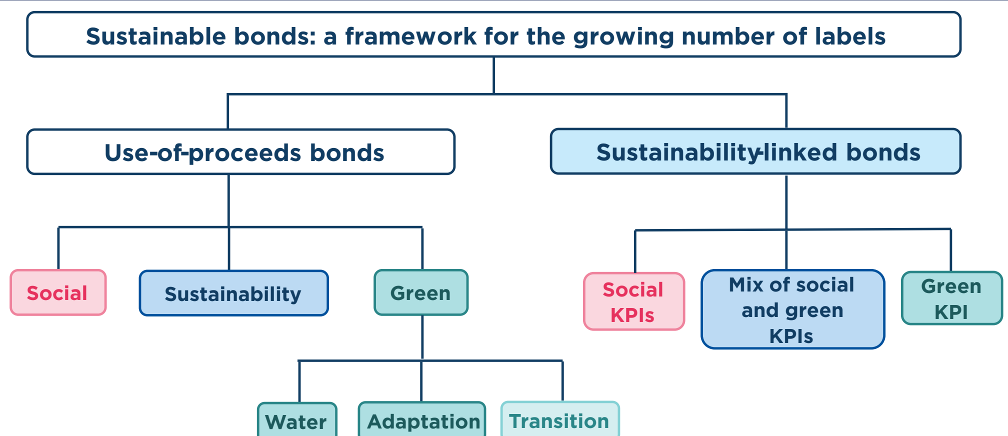
Since the creation of green bonds, many new labels have emerged, including social bonds, sustainability bonds, and recently transition bonds, not to mention water, blue or adaptation bonds. Despite the standardisation efforts led by the International Capital Markets Association (ICMA), creativity in self-labelling has increased the number of labels. Whereas the type of activities financed by these various bond labels differ, they are all anchored to the same initial concept and to a pledge by issuers that the proceeds will be dedicated to a **predetermined list of eligible projects**. These are 'use-of-proceeds' bonds.

A more radical development marked the end of 2019. With its self-labelled Sustainable Development Goals (SDG)-linked bond issued in September 2019, Enel -- the Italian energy company -- brought a fundamentally different format into the public bond space, introducing the first-ever sustainability-linked bond (SLB). Within such a format, the pledge made by the issuer is no longer on the use of proceeds: SLBs are indeed general- purpose corporate bonds. Rather, **the pledge is about achieving a quantitative sustainability target at the issuer level**. In addition, SLBs depart from the vanilla structure of use-of-proceeds bonds, as the financial features of the bond are linked to the (non-) achievement of the sustainability objective.

Figure 1. Mapping the galaxy of sustainable bonds



Source: Amundi as of 1 December 2020.

Glossary

- ***Water bonds,*** *or blue bonds, are green bonds that specifically aim to finance water-related projects;*
- ***Adaptation bonds,*** *or climate resilience bonds, are green bonds whose proceeds specifically finance climate-resilience projects; and*
- ***Transition bonds*** *aim to finance projects that can contribute to the energy transition but that may not be deemed eligible under green bond taxonomies.*

While this format is new to the public bond space, with issues from only three different issuers, it has already been thriving in the private debt space since 2018, with the amount of loans and revolving credit facilities incorporating sustainability covenants signed exceeding $250bn, according to BloombergNEF.

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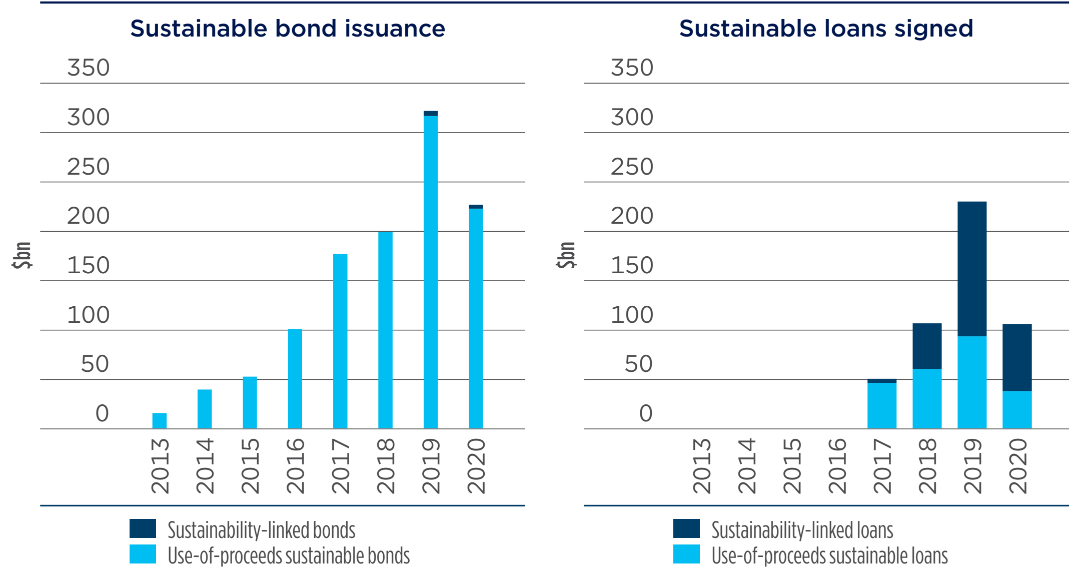
Figure 2. Trends in sustainable bond issuance and sustainable loans signed



Source: BloombergNEF, Amundi. Data as of 29 October 2020.

"The SLB format has the potential to become a complementary element in sustainable finance".

We believe this format could find its place in sustainable fixed income investing. However, to avoid the risk of misuse of this format, minimum standards and safeguards are needed, in our opinion. As the Covid-19 pandemic has accelerated the trend towards ESG investing, large asset managers with a proven ESG expertise and in-depth research capabilities will play a key role in driving these investments and providing suitable solutions that incorporate the most recent market trends.

Benefits of the SLB format

Green and social bonds provide investors with assurance and transparency that the projects financed by the bonds deliver positive societal impacts. We view the increasingly wide adoption of these formats as a clear positive, as it allows investors to engage with a growing number of issuers on their sustainable finance frameworks and sustainability strategies.

However, as the market is growing, the use-of-proceeds format has revealed some limitations, and in some cases, it was not fit for purpose. **We believe that the SLB format has the potential to fill some of these gaps and become a complementary element in sustainable finance**. SLBs complement green bonds in three ways:

"By setting a commitment at the issuer level, the SLB format has the benefit of providing confidence that the issuer not only has set quantitative ESG targets, but that it is firmly committed to reaching them".

- **A more flexible and inclusive format:** despite the growing sector diversification in the green bond space, the use-of-proceeds constraints attached to the format means those issuers that cannot legitimise a pool of eligible green assets large enough to issue a benchmark green bond are left out, either because they are too small, too early in their sustainability journey, or involved in asset-light businesses. The market has been trying to bypass some of these constraints and a number of corporates in the consumer sector have been pledging to allocate the proceeds of long-duration sustainability bonds to operating expenses, such as purchasing costs. This contradicts the idea that the green bond issuance potential of an issuer should grow along with its incremental efforts to increase the pool of eligible assets. The EU Green Bond Standard opposes this evolution, as bringing corporate operating expenses into the green bond space weakens this promise. The flexibility of the SLB format (General Corporate Purpose, choice in the ESG key performance indicator, KPI) would open an alternative sustainable funding option and better accommodate such issuers while avoiding weakening the foundations of the green bond concept.

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- **Assurance regarding the future improvement of the issuer's ESG performance:** the Green Bonds Principles (GBP) encourage issuers to explain the articulation between eligible projects with their wider sustainability strategies. However, the firm commitment remains at the project level. As part of their green-bond quality evaluation process, it is key for ESG analysts to check whether the funded projects will contribute to achieving wider environmental targets defined at the group level. On many occasions, clear and ambitious wide environmental targets were missing. **By setting a commitment at the issuer level, the SLB format has the benefit of providing confidence that not only the issuer has set quantitative ESG targets, but that it is firmly committed to reaching them.**
- **Protection against green default:** this confidence is further reinforced by the protection for investors provided by the coupon step-up should the issuer fail to fulfil its pledge. In the case of green bonds, investors do not have any protection. The coupon step-up creates an incentive for management to deliver on the ESG target and therefore aligns the interests of corporate managements and investors on the achievement of sustainability goals. The addition of green bonds as a funding tool has been challenged by some market observers. We do not share this thinking, as we believe green bonds have opened a door for fixed income investors to engage with issuers on their sustainability goals. **The SLB format nonetheless goes one step further by creating a direct financial incentive enshrined in the bond structure.**

We believe that SLBs can complement green bonds in the sustainable bonds market, as the former can be a better fit for a number of issuers, notably in asset-light corporate sectors. Finally, it is key to highlight that the two formats are not mutually exclusive. **Sustainability-linked green bonds would combine the strengths of the two formats,** allowing investors to have at the same time:

- A higher level of confidence regarding the future improvement of the sustainability performance of the issuer; and
- A strong level of transparency that the proceeds will finance projects that will contribute directly to achieving the sustainability target.

In the loan space, in June 2020, Italian renewable energy developer ERG turned an existing project finance agreement into a combined green and sustainability-linked loan. In addition, we consider that **the use of ESG KPIs for financial instruments will have a broader impact on ESG data development.** Both the clarification and quantification of ESG performance by companies and the management of ESG data will be beneficial to all and, more specifically, to investors, helping to support their confidence in ESG data.

Table 1. Main features of use-of-proceeds and sustainability-linked bonds

Format	Use-of-proceeds (UoP) bonds			Sustainability-linked bonds
	Green bonds	Social bonds	Sustainability bonds	
Key features				
UoP commitment	✓	✓	✓	×
Impact reporting	✓	✓	✓	?
Commitment regarding issuer's ESG performance	×	×	×	✓
Investor protection in case of green default	×	×	×	✓
Market size, $bn	$950bn	$90bn	$100bn	$10bn
Reference guidelines	ICMA GBP	ICMA SBP	ICMA SBG	ICMA SLBP
Examples of self-labelling	Blue bonds, water bonds, adaptation bonds, transition bonds, climate action bonds	Affordable housing bonds	SDG bonds	SDG-linked bonds
Applicability/sectors				
SSA	++	++	+++	+++
Financials	+++	++	+++	+++
Non-financials corporates	+	-	++	+++
Applicability/instruments				
Bonds (including covered and PP)	+++			++
Corporate hybrids	+++			+
Loans	+++			+++
ABS	+++			--
Convertibles	++			+++
Investor protection in case of green default	×	×	×	✓
Financial incentive for the issuer	×	×	×	✓

Source: Amundi as of 16 November 2020. Evaluation ranges from --- (totally incompatible) to +++ (perfectly compatible). UoP: use of proceeds. SSA: Sovereigns, Supranational and Agencies.

"We consider SLB as an opportunity for issuers to improve investor confidence in their ability to build sustainable businesses and achieve strategic sustainability targets through the introduction of a specific sustainability covenant".

An emerging concept that needs to be framed more fully

If one of the benefits of the format is its greater flexibility, nevertheless, it should be framed to avoid any misuse. In this context, a dedicated task force at the ICMA level led to the publication of the Sustainability-Linked Bond Principles (SLBP) in June 2020, the aim of which is to guide issuers when considering issuing in this format. We believe that the specific ESG KPIs retained should share the following common features:

"Long-term and buy-and-hold investors may be interested in investing in SLBs as they allow engagement with issuers on key ESG factors and the choosing of those issuers with a strong commitment to deliver positive impacts and to de-risk their portfolios from environmental and social risks".

- **Core to the strategy:** encompassing a large spectrum of group activities.
- **Straightforward:** a single KPI illustrative of a specific sustainability challenge is to be preferred to a composite index mixing several ESG KPIs related to different ESG issues, in our view.
- **Under management control:** we expect managements to have strong control over the achievement of te targets in order to limit the influence of external factors. Typically, we believe that external ESG ratings provided by agencies are not under management control, as methodologies can evolve over the lifetime of the bond.
- **Part of the management remuneration scorecard:** this could be a strong signal of alignment of interests.
- **Ambitious:** when compared to past achievements or peers' targets – and whenever possible – putting the target in the context of existing sector commitments or science-based targets. In any case, issuers should make a clear link between their target and the expected contribution to wider regional or global sustainability goals, such as the SDGs.
- **Based on a stable calculation methodology:** Availability of past performance is an advantage.
- **Audited** by an internationally recognised independent third party over the lifetime of the bond and whenever possible for at least the latest exercise before issuance of the bond to build confidence at the starting point.
- **Within a time horizon** that is relevant to corporate strategies and industrial planning.
- **Allowing monitoring:** we expect issuers to provide some guidance on the expected pathway to the target, along with the type of actions planned to reach it.

Pricing: the best case should be the base case

We believe that SLBs have to be priced in line with regular bonds from the same issuer with the same seniority. As such, **we consider SLBs to be an opportunity for issuers to improve investor confidence in their ability to build sustainable businesses and achieve strategic sustainability targets through the introduction of a specific sustainability covenant.**

Therefore, at time of issuance, **the best case should be the base case.** Pricing below the curve makes little sense for ESG investors, as this could be interpreted to mean investors would be anticipating a high default probability and they would expect to see a lower yield initially that will be offset by the higher coupon later on (**step-up activation**). For ESG investors, pricing the worst case would be contradict the investment philosophy of supporting issuers that do deliver on ambitious sustainability journeys.

Based on this perspective, the conditionality of SLBs (eg, a step-up) has to be seen as a protection or compensation in case of failure in reaching the KPIs. In such cases, investor confidence in the ability of top management to execute properly the sustainability strategy – if not the overall strategy – might be affected. **A direct consequence could be a widening of bond spreads and rising reputational risk for this kind of bond.** The impact might be felt along the entire issuer curve. **As such, we do not consider the financial compensation embedded in SLBs (eg, a step-up) as a potential additional return, but rather see it as protection.**

SLBs should not be seen as a tool to reduce an issuer's cost of debt in the short term, in our view. However, in the long term, we see potential positive impacts on the credit quality of those issuers whose management will have been able to demonstrate a strong track record in mitigating negative externalities and building businesses with positive contributions to the SDGs. **The integration of ESG risks and opportunities in the strategy can be seen as a guarantee of future competitiveness.**

The level of compensation is also a key parameter. When materialised by a coupon step-up, it depends both on the magnitude of the step-up (in basis points) and on how frequently the step-up could be activated over the lifetime of the bond. The challenge will be to find the right balance. On the one hand, the compensation should be costly enough to signal a high commitment from management to deliver on the announced

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sustainability targets, taking into account the level of ambition. On the other hand, the self-imposed penalty should not prevent the issuer from reinforcing its sustainability actions and investments in the future or weaken its credit quality. After all, targets may be missed by a tiny margin or by only a few years, not calling into question the overall sustainability direction of an issuer.

"The integration of ESG risks and opportunities in the strategy can be seen as a guarantee of future competitiveness".

On the investor side, in case of compensation through the bond cash flow (eg, coupon step-up), the latter should be large enough to compensate the investor who assumed the target as granted. If the ESG risk linked to the sustainability performance targets of the bond materialises, the bond – together with the entire curve – may suffer from a capital depreciation that requires compensation in some manner.

Finally, in some instances, issuers of sustainability-linked loans have chosen to pay the compensation to a third-party or to pay the amounts into a dedicated fund. Given such circumstances, it is important that investors keep a view on how these proceeds get used. In our opinion, the amounts related to the 'penalty' should eventually be reinvested in projects that will help the issuer to catch up on its sustainability goals.

Convenient covenants? SLBs in investor ESG strategies

Long-term and buy-and-hold investors may be interested in investing in SLBs as they allow engagement with issuers on key ESG factors and the choosing of those issuers with strong commitments to deliver positive impacts and to de-risk their portfolios from environmental and social risks. On the other hand, the integration of covenants in the structure of SLBs means that the format departs from vanilla bonds. **Due to this higher complexity, the format may not suit the strategies of some categories of investors.**

"From January 2021, bonds with coupon structures linked to environmental sustainability performance targets will become eligible as collateral for Euro system credit operations and also for the APP".

For instance, so far, the Euro system has not been allowed to purchase such bonds under its asset purchase programme (APP). However, this will change in January 2021, **as the ECB has** just announced **that bonds with coupon structures linked to environmental sustainability performance targets will become eligible as collateral for Euro system credit operations and also for the APP.** This is a positive signal for the SLB market. However, this might have unfortunate side-effects by pushing corporates in sectors where social issues dominate over environmental ones to opt for environmental targets when considering issuing an SLB in order to qualify under the APP. Therefore, it will be key that the EU progresses on its taxonomy of activities contributing to EU social goals and – in the longer run – extend the eligibility of SLBs to those with a social component.

In addition, the non-vanilla format of SLBs does not fit well within the investment policies attached to insurers' asset liability management as, by default, an SLB does not qualify as an SPPI (Solely Payment of Principal and Interest) security. However, SLBs could still be structured in a way that accommodates such investors. As discussed above, the covenant can be designed in a way that is financially neutral for the investor and where the compensation is rather paid to a third-party or specific fund. In addition, the qualification of an SLB as an SPPI security can still be retained in case of correlation between the ESG KPI of the SLB and the issuer's credit risk.

SLBs offer some potential for tailor-made approaches. For advanced ESG investors, private placements allow bilateral documentation and bespoke features (eg, step-up being replaced by a compensatory payment, or a jointly agreed ESG KPIs). This could depict a new way to implement engagement policies for bondholders. As the format emerges, usual trading and data platforms will need to adapt in order to ease the identification of SLBs and their sustainability covenants.

Case study 1: Enel and Novartis, the way forward

At the time of writing, four corporates have so far issued SLBs: **Enel**, the Italian utilities company; **Suzano**, the Brazilian pulp & paper company; **Novartis**, the Swiss pharmaceuticals company, and **Chanel**, the French luxury goods company, showing how the SLB format suits a high variety of sectors. We compare the features of the euro SLBs issued by Enel and Novartis, and assess them against our expectations. In our view, **they are well-structured**. In detail:

- Both selected ESG KPIs reflect the key sustainability challenges faced by the respective sectors -- namely, the low-carbon transition for electricity utilities and access to medicine for pharma groups, and how companies face these challenges. While Enel relies significantly on fossil fuels to generate electricity – coal accounted for 26% of the group energy mix in 2018 --- the company has a coal phase-out strategy and is a leading developer of renewable energies.
- The performance targets appear ambitious enough either when compared to past trends or to sector-specific science-based targets. For instance, Enel's CO_2 reduction target used for its 2034 SLB has been validated by the Science-Based Targets Initiative (SBTI) as aligned with the well-below 2°C goal.
- The calculation methodologies for the KPIs are clear and base-year data are audited, reinforcing investor confidence in the reported ESG data. For instance, Novartis had both its calculation methodology and 2019 performance data audited based on limited assurance procedures.

Table 2. Enel and Novartis SLBs, a comparison

Issuer	Enel	Enel	Novartis
Financial features			
Maturity	2024 and 2027	2034	2028
Size	2 x €1.00bn	€0.50bn	€1.85bn
Coupon, %	0.000% and 0.375%	1.125%	0.000%
Potential coupon step-up	25bps	25bps	25bps
Sustainability features			
Theme	Environmental	Environmental	Social
KPIs	Renewables in installed generation capacity, %	CO_2-intensity of power generation assets (g CO_2/kWh)	# of patients in low-income countries reached by Novartis' programmes, increase
Sustainability-performance targets	55% vs. 46% in 2018	125g CO_2/kWh vs 369 in 2018	At least 200% and 50%, respectively
Target date	2021	2030	2025
Amundi's expectations on ESG targets			
Core to sustainability strategy	Yes	Yes	Yes
Straightforward	Yes	Yes	Yes
Under management control	+++	++	+++
In remuneration scorecard	Indirectly (yes)	Yes	Yes
Ambitious	Acceleration	Aligned with well-below 2°C target (SBTi)	Acceleration
Clear calculation methodology	Yes	Yes	Yes
Audited	E&Y	E&Y	PWC
Relevant time horizon	+++	++	+++

Source: Amundi as of 16 November 2020. Evaluation ranges from --- (completely irrelevant) to +++ (completely relevant).

These bonds are good examples of KPIs and targets that are material, ambitious, under management control, and consistent with the company's overall strategy.

Case study 2: SLBs in private placements: room for tailor-made solutions, Fromageries Bel

A number of private placements have already used the sustainability-linked format (mostly *Schuldscheins*). A good example is the sustainability-linked euro private placement done by the French food company Fromageries Bel. As a bilateral instrument, euro private placements are based on tailor-made documentation based on a direct negotiation with the issuer. This allows for the inclusion of specific features, usually financial covenants. In the case of Fromageries Bel, sustainability/ESG covenants were included in addition to financial covenants.

Extract from Fromageries Bel's press release

"The environmental and social criteria concern two cornerstones of the company's strategy for sustainable development:

- *The deployment of a programme of concrete actions to favour a sustainable upstream dairy. In partnership with dairy producers in the ten farming basins where Bel procures its supplies, Bel has committed to deploying a programme of concrete actions from its global charter, co-signed developed jointly with the WWF France, to encourage notably best practices in the areas of animal welfare, pasture grasing and the use of sustainable and locally-produced animal feed.*
- *Cutting greenhouse gas emissions. Bel has committed to deploying an ambitious plan with annually-set targets through 2029."*

If the goals are not met, the company will pay a compensation amount, either to strengthen the failing criteria or to a specific NGO. Another specific feature of the documentation is a 'rendez-vous' clause on the upstream dairy criteria, meaning that there will be a discussion with the company during the life of the bonds to assess if the criteria remain consistent and if they need to be amended.

"SLBs do make sense and fit the long-term vision of an investor's responsible investment policy; they are complementary to the use-of-proceeds concept of green bonds".

Conclusions

To sum up, we believe that:

- **SLBs do make sense and fit the long-term vision of an investor's responsible investment policy.**
- **SLBs are complementary to the use-of-proceeds concept of green bonds.**
- **At issuance, the pricing of these instruments should not differ from conventional bonds, as the best case – that is, the achievement by the issuer of its ESG targets -- should be the base case.**

As the Covid-19 pandemic has accelerated the trend towards ESG investing, large asset managers with a proven ESG expertise and in-depth research capabilities will play a key role in driving these investments and providing suitable solutions that incorporate the most recent market trends. In this context, SLBs illustrate new opportunities for bond holders to ensure the integration of ESG criteria into the selection of bonds and issuers as well as provide additional ways to engage with companies. While at this stage the most advanced ESG fund investors can highlight the sustainable benefits of SLBs, standardisation will be key to ensuring their development and deployment by a multitude of investors.

Definitions

- **Asset purchase programme (APP):** A type of monetary policy wherein central banks purchase securities from the market to increase money supply and encourage lending and investment.
- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Correlation:** The degree of association between two or more variables; in finance, it is the degree to which assets or asset class prices have moved in relation to each other. Correlation is expressed by a correlation coefficient that ranges from -1 (always move in opposite direction) through 0 (absolutely independent) to 1 (always move in the same direction).
- **Diversification:** Diversification is a strategy that mixes a variety of investments within a portfolio in an attempt to limit exposure to any single asset or risk.
- **NGO:** Non-governmental organisation.
- **Quantitative easing (QE):** QE is a monetary policy instrument used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.
- **Spread:** The difference between two prices or interest rates.

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