Sustainable investing for all

How SLB Principles meet companies halfway with sustainability targets

Green and Social Bonds are now the hottest trend in the finance industry. To counter the critics' allegations of too little transparency and possible greenwashing, a few steps still need to be taken to enhance the credibility of these bonds. But when this is achieved, they are believed to shape the future of the entire finance world. As we saw in our recent article 'Investing without remorse', Green and Social Bonds cover all the groundbreaking investments regarding eco-friendliness and social impact. But not all companies are ready to kick off sustainability-only projects or turn to 100% sustainable business operations just yet. Sustainability-linked Bonds meet these companies halfway by giving them green light if they achieve certain targets to enhance their sustainability.

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The Sustainability-Linked Bond Principles

The Sustainability-linked Bond Principles are part of the International Capital Market Association's (ICMA) framework, the basis for sustainable investment activities worldwide with its array of rules, standards and codes of conduct.

While under **Green Bond Principles (GBP)**, **Social Bond Principles (SBP)** and **Sustainability Bond Guidelines (SBG)** bond proceeds are dedicated to financing eligible projects, under the **Sustainability-Linked Bond Principles (SLBP)**, proceeds are primarily used for the general purposes of an issuer in pursuit of Sustainably-linked KPIs and Sustainability Performance Targets (SPTs).

SLBPs are forward-looking performance-based instruments with which the issuer explicitly commits (in bond documentation) to meeting certain improvements in sustainability within a predefined timeline. Hence, financial and structural characteristics of the bond are contingent upon the issuers' ability to achieve predefined sustainability objectives within the set timeline. SLBPs make for a reliable ESG instrument, as issuers can be held explicitly liable. In this context, underwriters can help moving the market towards more structure and disclosures facilitating credible transactions.

SLBPs require clear and transparent processes, and commitments, not just for a bond's classification but also for potential investors or underwriters. The principles emphasize transparency, accuracy and integrity of disclosed and reported information. A bond combining **SLBPs** and the use of proceeds features should apply guidance for both types of bonds.

The subsequent five core components demonstrate how bonds align with SLB principles:

1. Selection of KPIs

With regards to sustainability, the issuer is advised to use KPIs to measure developments, but the number of KPIs chosen should be limited as it depicts transparency and thus, credibility. They should clearly address relevant socio-ecological and governance challenges within the issuer's sector and be directly subject to management supervision. Encouraging issuers to use sustainability KPIs is easy, as they significantly contribute to the sustainability and business strategy of the issuer.

The KPIs must fulfill the following criteria: They should be credible, historically comparable and relate to the issuer's overall business. Furthermore, the KPIs must be of strategic significance to the issuer's operations and easily comparable to benchmarks. Internal and external sustainability KPIs ought to be distinguishable from one another and finally, externally verifiability and transparency would prove to investors the clear rationale and process disclosure on how the KPIs have been selected.

2. Calibration of Sustainability Performance Targets (SPTs)

One or more SPTs should be defined per KPI to show the level of ambition the issuer is ready to commit to and should clearly reflect an intended improvement of the KPI. Ideally the SPT should have an external reference as a respective benchmark. A timeline must be defined, at the latest by the time the bond is issued.

To set targets, issuers should include their own historical performance with a minimum of three years and have a track record on the selected KPI with forward-looking guidance. Targets can include official objectives like regional or international carbon budgets and net zero goals. Disclosure on target setting should make clear reference to the time frame for the target achievement, including triggering events and frequency of SPT measurements. A verified reference curve can help to visualize KPI improvement targets and the reasoning for their use.

3. Bond Characteristics

The bonds' financial and structural characteristics vary depending on whether or not the selected KPIs realized the predefined SPTs. Here, the SLB documentation will have to specify trigger events. The most frequently varying element of the SLB depending on the issuer's performance in reaching SPTs is the coupon but there are other financial or structural SLB attributes. These variations should be pronounced enough to easily differentiate from the original fixed income instrument.

4. Reporting

Issuers should disclose subsequent information on a regular basis:

- Current information on the performance of chosen KPIs
- Computation of KPIs development compared to SPTs and their impact on financial and structural attributes of the bond
- All information allowing investors to monitor SPT changes and claims
- All updates on the SPTs and related KPI/ESG governance
- Everything crucial to the analysis of KPIs and SPTs

5. Verification

The issuers are encouraged to appoint external auditors to review the bond documentation and contractual stipulations' alignment with the five core components. The external auditors should have the competencies and expertise to assess the relevance, robustness, credibility and reasoning for choosing SPTs and benchmarks. The issuers should also have their documentation verified for each significant change and build their own internal auditing expertise and departments. This verification should be made publicly available and take place at least once a year with additional verifications on any date that is relevant for SPT performance leading to a potential adjustment of the SLB. While pre-issuance review is optional, post-issuance verification is a necessary element of the SLBP.

Examples for Sustainability Linked Bonds

When we think about sustainability, we try not to think about oil and gas companies, but due to the importance they still have in the global economy, it would be wise to also incentivize them to enhance the sustainability of their operations. Governed by its new SLB Financing Framework, this is what Eni S.p.A. is doing now. As the first major Oil and Gas company it issues a Sustainability-Linked Bond of EUR 1 billion, and a 7-year maturity. The Sustainability Performance Targets (SPTs) it sets include to increase installed renewable energy capacity to at least 5 GW by the end of 2025 (compared to 0.3 GW in 2020) and halving its net greenhouse gas emissions of upstream activities to at least 7.4 million tons by the end of 2024 compared to 2018. Seeing such a positive reaction to this deal, Eni S.p.A. hopes to encourage other players in this type of industry to follow suit.

The Spanish oil company REPSOL, one of the ten largest private oil companies in the world, is also relying on SLBs to reach its goal of becoming a net zero emissions company by 2050. By launching a sustainable financing framework, it attempts to ensure a smooth energy transition process. It is the first company of its industry to have an overarching framework which includes **Use of Proceeds Green Bonds** that are aimed at financing specific projects, but also **Sustainability-linked Bonds** that cover the company's sustainability commitments. The SPTs for REPSOL include a monitoring and fulfillment of key sustainability objectives like a limit to CO2 emissions per unit of energy produced, as a verifiable indicator. This approach should offer flexibility and transparency in the issuance.

We here at FORRS know that in some industries it is very cumbersome or impossible to switch to 100% sustainable operations, but with SLBs there is still a good chance to attract investments by pledging to reach certain sustainability targets. We can accompany you with technical and managerial support for the specification of suitable projects for SLBs. For a successful certification process later on, the devil as always lies in the details. This is why we also support you in the verification process for these bonds.

In the next article we'll take a look at Climate Bonds, which set themselves apart from the types of bonds that we have covered already as they only financing climate change mitigation or adaptation projects.

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