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Sustainability-linked bonds complement and bolster the sustainable finance market

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Sustainability-linked bonds have the potential to entice issuers, diversify economic options available to investors, and encourage outcome-focused sustainable finance, argue **Aaron Franklin, Paul Davies, Ignacio Domínguez and Kristina Wyatt**

In September 2019, Italian power generation company Enel opened up the market for a new sustainable finance product — bonds with interest rate adjustments related to sustainability performance targets. This new product has considerable potential to bring more issuers into sustainable finance, allow more financings to incorporate sustainability, and create investable assets for a greater portion of the investing community.

What happened?

The interest rate applicable to Enel's 'SDG–linked bond' (referring to the UN Sustainable Development Goals) was subject to a potential one-time 25-basis-point increase if less than 55% of Enel's total power generation capacity comes from renewable power facilities as of 31 December 2021. This feature broke new ground in sustainable finance.

Historically, sustainable finance was the province of equity investors that screened their investment choices based on companies' environmental, social, and governance (ESG) characteristics. For instance, investing in renewable power would be favored, and investing in businesses with perceived negative social characteristics would be less desirable.

In 2007, sustainable finance opened up to debt finance with the first green bond issuances. Green bonds are bonds like any other, but with an express connection between the financing and underlying environmentally-friendly business activities. This generally takes the form of stating that 100% of the net proceeds of a bond offering will be allocated to projects meeting certain criteria. For instance, the bond issuer will disclose that it intends to allocate the proceeds to renewable power generation projects.

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Green bonds focusing on environmentally-friendly spending remain the standard bearer but the same approach can be applied to other labels reflecting other sustainability priorities. For example, social bonds connect to activities with social benefits, and sustainability bonds attach to activities with both environmental and social benefits, to name just two. The market for sustainable finance bonds grew from nearly non-existent to surpassing $200 billion (equivalent) in new issuances in the first 10 months of 2019.

In 2017, a separate debt-based approach to sustainable finance emerged, with the first credit facility with an interest rate margin linked to sustainability performance ratings or targets. This approach differed from the green bonds approach in that the connection between financing and sustainability did not depend on the use of proceeds, which could be used for general purposes, but rather on an interest rate linkage. For instance, the borrower and its lenders could agree that the interest rate will increase or decrease by five basis points, depending on whether the borrower improves its third-party sustainability grade. This approach deviates from green bonds and other activity-based sustainable financings that do not typically include any sustainability-specific contractual terms. This approach is most common among revolving borrowing facilities, which are typically a much smaller, shorter-term part of a company's capitalisation relative to bonds, and for which lenders are predominantly banks.

Enel's SDG-linked bond applied the interest rate linkage feature common in revolving borrowing facilities to a widely-distributed bond (albeit with a more significant adjustment). Combining the two predominant debt-based sustainable finance approaches may seem like a natural evolution, but this new product is greater than the sum of its parts.

The benefits of sustainability-linked bonds

Sustainability-linked bonds complement and bolster the existing sustainable finance market by bringing more issuers into sustainable finance, diversifying economic options available to investors, and allowing for more outcome-focused sustainable finance. Rather than replacing or negating the value of the green bond market, sustainability-linked bonds are one of the "50 shades of green" required to develop a robust and mature market for investments with sustainability characteristics, to borrow a phrase from Bank of England Governor Mark Carney.

Sustainability-linked bonds will facilitate more issuers participating in sustainable finance by overcoming one of the main obstacles to issuing a green bond. Many issuers are unable to issue a green bond (or other type of activity-based sustainable finance product) because they cannot identify sufficient expenditures on business activities connected to sustainability. To be attractive to investors, bonds generally need to be issued in minimum aggregate principal amounts above $250 million (equivalent).

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This minimum threshold assures investors that a sufficiently liquid market for the sale of the bonds will develop in the event the investor wishes to cash out. But even among companies that have the need and capability to issue bonds in such amounts, finding $250 million in specifically sustainable expenditures is often challenging. The minimum liquidity threshold therefore excludes a large fraction of the bond issuing world, including many issuers working to transition their business model to a more sustainable foundation.

Sustainability-linked bonds overcome this obstacle because they rely on a different way of connecting the financing to sustainability. Whereas green bonds look at how the proceeds will be used and do not involve contractual changes related to sustainability, sustainability-linked bonds do not restrict how the proceeds will be used, but link one of the key terms of the transaction — the interest rate — to sustainability performance targets. So issuers with lower levels of sustainability spending requirements, including those at the beginning of their sustainability transition and those for which their sustainability improvements will come from divestments, can be part of the sustainable finance bond market.

More issuers participating in the sustainable finance bond market means more issuers setting and hitting sustainability performance targets, which should be set at appropriately meaningful levels of ambition. More issuers also mean more sustainable finance bond issuers signaling to the bondholder universe that they care about sustainability, thereby opening up a channel for investor engagement on sustainability related topics. More engagement means more opportunities for issuers to understand and react to the topics bondholders find most relevant about that issuer's impact on the world. The more companies that participate in sustainable finance, the more the rest of the business world will notice and consider whether to join in. For all the remarkable growth, a relatively small fraction of bond issuers have issued green bonds or other sustainable finance products.

Not only do sustainability-linked bonds help bring more issuers to the sustainable finance bond market, they also have the potential to open up sustainable finance bonds to more investors. A greater diversity of sustainable finance bond issuers, including smaller companies with higher-yielding debt (for the reasons mentioned above), means investors will have more sustainable investment options. The green bond market has so far been dominated by investment-grade issuers, leaving investors searching for different opportunities without a foothold. More fundamentally, by incorporating potential interest rate adjustments, sustainability-linked bonds offer investors a different economic proposition (unlike green bonds, which are contractually identical to their non-green analogues). Some investors may want downside protection in case a target is not met, as is the case for Enel's bond. Other investors may want to offer better terms in exchange for an issuer meeting its targets. Investors will inevitably have diverse preferences for what constitutes more attractive terms, and sustainability-linked bonds open up a new field for innovation and value creation.

Finally, some investors or companies may prefer sustainability-linked bonds' focus on outcomes (as opposed to spending). Measuring outcomes is more straightforward as compared to sustainable business activity spending, and issuers have access to longstanding methodologies such as the World Resources Institute Greenhouse Gas

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Protocol. A focus on outcomes is also more easily aligned with frameworks such as the UN SDGs. Issuers and investors likely would agree that achieving sustainability performance targets with the least amount of spending possible would be most advantageous. Just as many green bonds are generally supported by a third-party opinion on the credibility of the sustainability characteristics of the bonds, sustainability-linked bonds could be supported by a third-party opinion on the credibility of the selected sustainability performance targets.

What sustainability-linked bonds suggest about the future of sustainable finance
There has naturally been robust debate on how sustainability-linked bonds fit within the sustainable finance bond universe. Investors spent many years learning how to deal with green bonds, including development of third-party ratings systems, indices, and internal expertise. Sustainability-linked bonds do not fit neatly within investment criteria that are focused on how the proceeds are used.

In time, however, the sustainable finance market will benefit from increasing prominence of sustainability-linked bonds as a complementary product, through more issuers and more diverse options for investors. The market has already seen evolutions such as transition bonds and SDG bonds. Another potential product could be "green-striped" bonds, in which a green bond structure is applied, except the issuer specifies only a certain portion of the proceeds as to be applied to eligible projects. By solving the minimum liquidity threshold problem, green-striped bonds could have similar benefits as sustainability-linked bonds in terms of diversifying issuer participation.

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Some investors will not see value in sustainability-linked bonds, just as some investors will not see value in green bonds. Differences in opinion among investors are inevitable as investor financial and sustainability preferences are far from uniform.
But by bringing more issuers into sustainable finance, diversifying economic options available to investors, and allowing for more outcome-focused sustainable finance, sustainability-linked bonds have potential to meet the demands of even more issuers and investors. And for the market overall, that is a good thing.

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**Latham & Watkins represented the initial purchasers in respect of Enel's SDG-linked bond.*

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