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Environmental, Social, And Governance:

How Sustainability-Linked Debt Has Become A New Asset Class

April 28, 2021

Key Takeaways

- Global issuance of sustainability-linked debt instruments will likely surpass $200 billion this year, driven by ongoing sustainability-linked loan market growth and an acceleration in sustainability-linked bond issuance.
- Sustainability-linked instruments will broaden the universe of issuers who can obtain sustainable financing to those who may not have sufficient capital expenditures connected to sustainability projects, are at the beginning of their sustainability journeys, or are in transition and hard-to-abate sectors.
- Banks will also spur growth given their need to fulfill corporate objectives relating to the share of impact financing within their lending books.
- Companies will use sustainability-linked instruments to fund innovative environmental technologies and a broader range of social and governance key performance indicators (KPIs) will proliferate.
- The sustainability-linked concept will likely expand beyond the classic sustainability-linked loan or sustainability-linked bond structures into other instrument types including the newly developed sustainability-linked green bond that combines use of proceeds and sustainability-linked bond models.
- The need for transparency and effective sustainability-related disclosure practices to avoid "ESG-washing" is crucial to expanding the practice of linking loan and bond pricing to environmental, social, and governance (ESG) performance.

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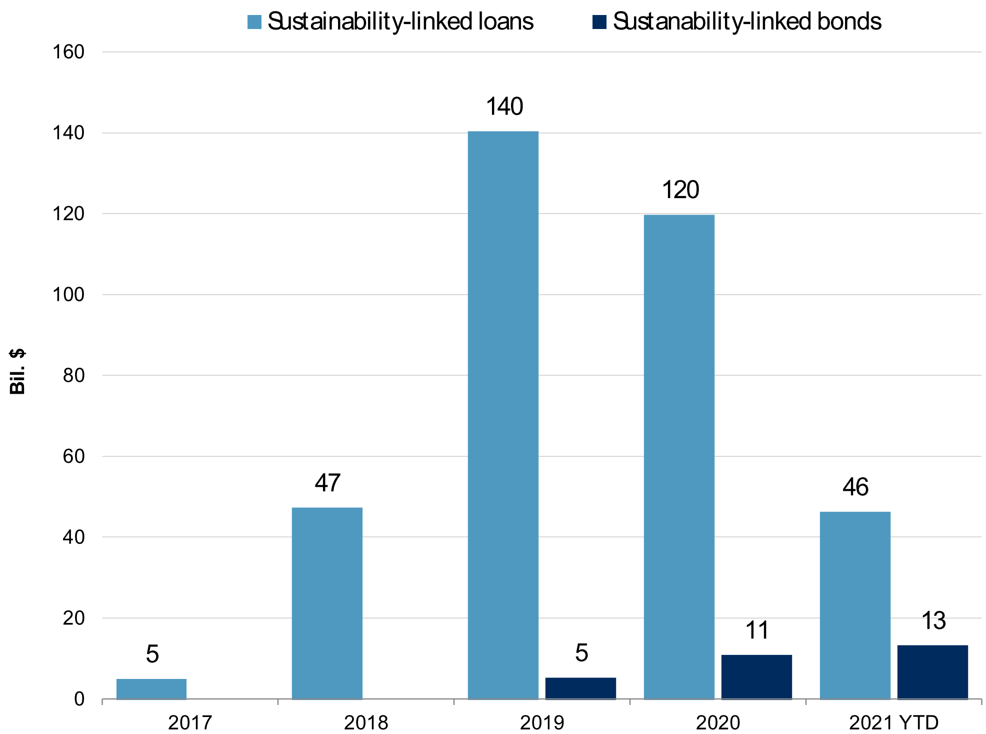
The issuance of sustainability-linked debt instruments--including sustainability-linked loans (SLLs) and sustainability-linked bonds (SLBs) is on the rise worldwide. S&P Global Ratings expects SLL and SLB issuance to surpass $200 billion this year. Total sustainability-linked debt issuance exceeded $130 billion in 2020, according to Bloomberg, up nearly 300% from 2018 levels (see chart 1).

Chart 1

Global Issuance Of Loans And Bonds Linked To Sustainability Performance Targets



Data through April 9, 2021. YTD--Year-to-date. Source: Bloomberg.

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In contrast to other types of sustainable debt instruments, including green, social, or sustainability bonds or loans, sustainability-linked instruments, aren't dependent on dedicating issuance proceeds to defined environmental or social projects. Instead, a borrower can apply the label to any type of loan or bond instrument that directly links funding costs to achieving predetermined sustainability performance targets (SPTs). The use of proceeds, which isn't usually identified when the loan or bond is issued, could be for any general corporate purpose.

Sustainability-Linked Debt Instruments Defined

Sustainability-linked loans are defined by the Loan Market Assn. (LMA), Asia Pacific Loan Market Assn. (APLMA), and Loan Syndications and Trading Assn. (LSTA) as any type of loan instruments and/or contingent facilities (such as bonding lines, guarantee lines, or letters of credit) which incentivize the borrower's achievement of ambitious, predetermined sustainability performance objectives.

Sustainability-linked bonds are defined by the International Capital Markets Assn. (ICMA) as any type of bond instruments for which the financial and/or structural characteristics can vary depending on whether the issuer achieves predefined sustainability/ESG objectives.

Given the greater flexibility in proceed use, sustainability-linked instruments have the potential to broaden the universe of issuers who can obtain sustainable financing. Issuers unable to issue a use of proceeds instrument (i.e., green, social, or sustainability bond or loan) because they don't have sufficient capital expenditures connected to sustainability projects could still tap the sustainable debt market. This includes companies in the consumer discretionary and health care sectors. It also includes smaller issuers that might lack the capacity to implement effective tracking or reporting practices required for use of proceeds instruments; issuers at the beginning of their sustainability journeys; and those in transition and hard-to-abate sectors such as industrials or materials (see charts 2a and 2b). Sustainability-linked instruments allow such issuers to highlight their green or social commitments and reinforce their sustainability strategy to investors, lenders, and the public.

Hard-To-Abate Sectors Including Industrials And Materials Are Far More Prominent In The SLB Market Than In The Green Bond Market

Chart 2a

Green Bond Issuance By Nonfinancial Corporate Sector (2020)

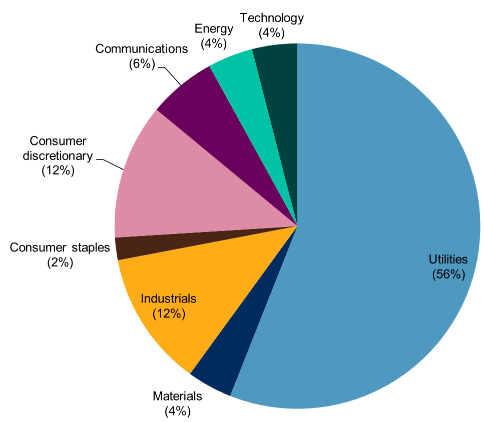

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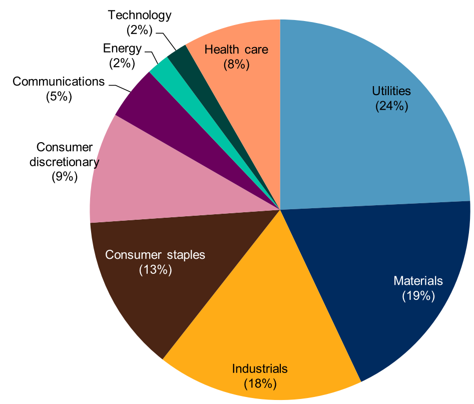
Chart 2b

Sustainability-Linked Bond Issuance By Nonfinancial Corporate Sector (2019-2020)



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Challenges And Risks Remain With The New Asset Class

Despite the innovative features and characteristics of sustainability-linked instruments, and the rapid surge in issuance over the past few years, key challenges for the sustainability-linked debt market still exist.

Challenges Facing Sustainability-Linked Debt Instruments

Proceed restrictions: There are no restrictions on how the capital raised can be spent, and no consistent tracking of proceed use. This could lead to proceeds funding projects that don't have a clear beneficial impact, increasing the risk of "ESG-washing."

Metric comparability: As the sustainability-linked instrument market is relatively new, there's no standard set of metrics by which to track issuer performance. The KPIs and SPTs are currently unique to each individual entity, which limits comparability of one set of SPTs or KPIs to another.

Metric relevance: Relevant KPIs may vary depending on an entity's industry, business model, geography, and sustainability trajectory. In some cases, metrics set by an issuer may not apply to a substantial enough share of its business.

Metric ambition: The KPIs and SPTs may not be overly ambitious or aggressive and may not demonstrate a significant improvement over an issuer's business-as-usual strategy.

Performance reliability: Issuer performance against set targets is also often self-reported, self-policed, and unaudited, so performance may not be reliably or consistently reported.

Financial penalty: In some cases, the financial penalty for failing to meet the predetermined targets may also not be material enough to encourage the entity to deliver on its goals or tracked frequently or reliably enough to ensure it's demonstrating significant sustainability performance improvements over the life of the instrument.

Global Standards And Principles Are Driving Best Practices

The need for transparency and effective sustainability-related disclosure practices to avoid ESG-washing is crucial to growing the practice of linking loan and bond pricing to ESG performance. In our opinion, "The Sustainability Linked Loan Principles" (SLLP), published by the LMA, APLMA, and LSTA in March 2019 and the Sustainability-Linked Bond Principles (SLBP) published by ICMA in June 2020 are key to promoting market discipline. These voluntary guidelines provide a standard set of best practices for issuance of sustainability-linked instruments (see Key Components of the SLLP and SLBP). While the SLLP and SLBP are largely similar, the SLBP promote greater transparency and requires post issuance verification of an issuer's performance against its targets be made publicly available. According to ICMA, this can consequently expose the issuer's strategy, goal-setting, and deliverables to the broader market, with the potential for a greater impact on the issuer's reputation. The LMA, APLMA, and LSTA are currently in the process of updating the SLLP to better align them with the SLBP; this should help ensure coherence and integration between the loan and bond markets.

Key Components Of The SLLP And SLBP

The SLLPs have four core components:

- Relationship to Borrower's Overall Sustainability Strategy: Communicating how a sustainability-linked loan product fits into the borrower's broader social responsibility strategy.
- Target Setting: Setting appropriately ambitious SPTs for each transaction.
- Reporting: Reporting practices on progress in meeting SPTs.
- Review: The value of using a third party to review and verify a borrower's performance against its SPTs.

The SLBPs have five core components:

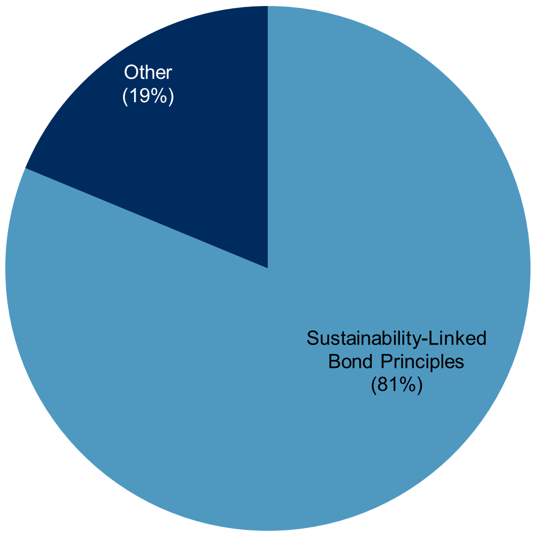
- Selection of KPIs: Selecting KPIs that are relevant, core, and material to the issuer's strategy, measurable or quantifiable, externally verifiable, and able to be benchmarked.
- Calibration of SPTs, which are set before or concurrently with the issuance of the bond and go beyond the issuer's business as usual trajectory.
- Bond characteristics: Disclosing the KPI and SPT definitions and calculation methodologies and the potential variation of the SLB's financial and/or structural characteristics.
- Reporting: Reporting practices on progress in meeting SPTs.
- Verification: The value of using a third party to review and verify an issuer's performance against its SPTs.

In addition, we believe new disclosure frameworks like the EU Green Taxonomy, which defines the economic activities that meet the climate change mitigation and adaptation objectives of the EU, will accelerate some degree of standardization over time, by applying a harmonized standard for what can be marketed as environmentally sustainable or green (see "The EU Green Taxonomy: What’s In A Name?," published Sept. 11, 2019).

Ultimately, we believe the sustainability-linked transition instrument market could grow rapidly as transparency and disclosure requirements become more comprehensive and robust. Over 80% of sustainability-linked bonds followed ICMA's SLBP in 2020 (see chart 3) and we expect this share will increase over time, enhancing market integrity and consistency and helping mitigate investor fears of ESG-washing in this rapidly evolving asset class.

Chart 3

The Majority Of SLBs Align With The SLBP
SLBs that followed SLBP in 2020



SLB--Sustainability-linked bond. ICMA--International Capital Markets Assn.
SLBP--Sustainability-Linked Bond Principles. Source: Environmental Finance.
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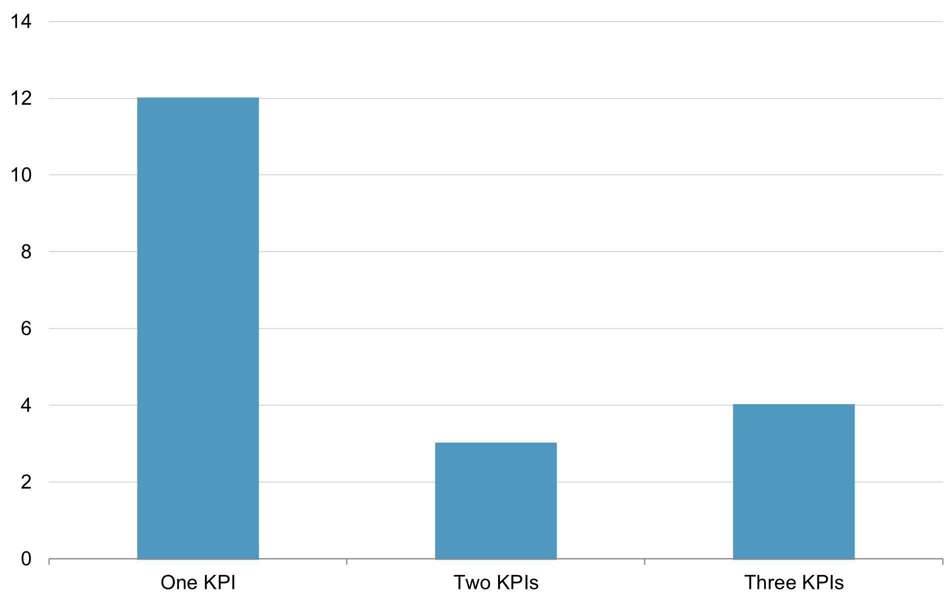
Sustainability-Performance Targets: Number And Complexity

In practice, SPTs can include any number of factors but are usually specific environmental, social, and/or governance KPIs that track improvements in a borrower's or issuer's sustainability profile. In some cases, an SPT could also be an overall ESG score assigned to the borrower or issuer from an external provider. The SPT approach adopted in the market varies largely by instrument type. Most SLLs are linked to more than one SPT or KPI (sometimes up to four or five) or to an overall ESG score or rating that captures a combination of ESG indicators. On the other hand, SLB KPIs are usually simpler in scope with one KPI being the most common structure (see chart 4).

Chart 4

The Majority Of SLBs Are Linked To Achievement Of A Single KPI
SLB count by number of KPIs, 2020-2021



Data is from a sample set of SLBs from ICMA's Sustainability Bond Database and is not exhaustive.
SLB--Sustainability-linked bond. KPI--Key performance indicator.
Sources: International Capital Markets Assn., S&P Global Ratings, issuer filings.
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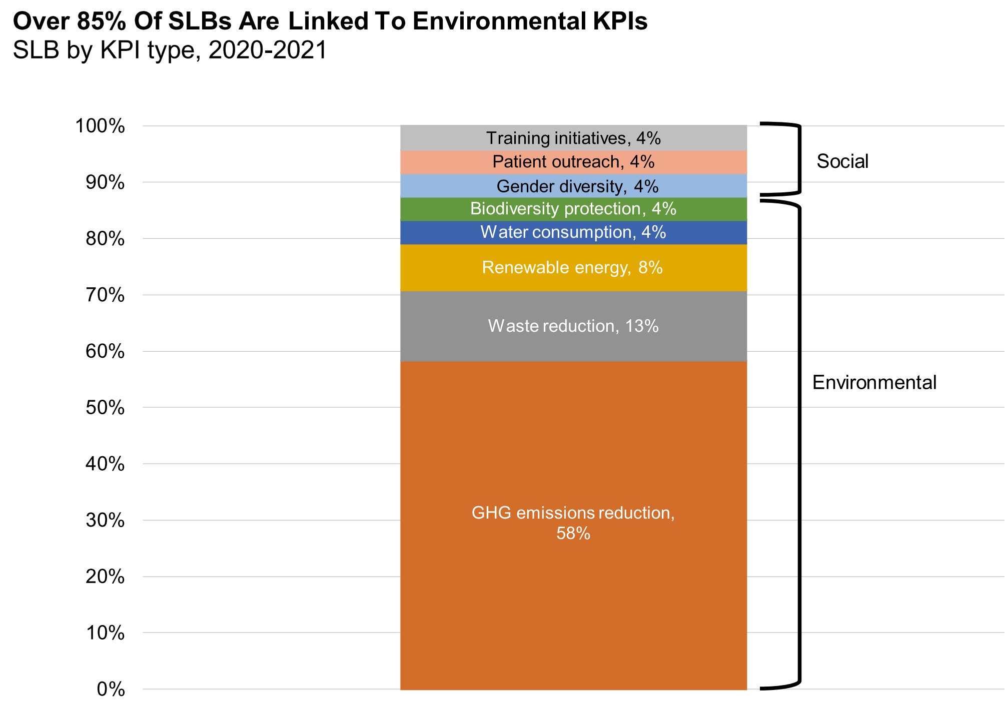
This distinction is largely attributable to the different market structures. SLLs are usually syndicated by a small group of banks with deep in-house expertise and sophistication. The increased level of interaction with these lenders makes it easier to track more complex SPTs on a frequent basis (i.e., annually). On the other hand, the investor pool for SLBs is often large and highly diversified. This increases demand for an SPT mechanism that is simpler and easier to track, with SPTs usually concentrated on specific environmental or social factors (see chart 5). The European Central Bank (ECB) for example, will only accept SLBs under its asset purchase program linked to SPTs with environmental objectives such as those relating to climate change or environmental degradation and doesn't consider improvements in ESG ratings or scores as acceptable SPTs. While the SLB market is still developing, we believe KPIs will remain limited in scope, and highly concentrated on environmental factors, at least for the next few years.

Chart 5



*GHG emissions refer to scopes 1, 2 , and 3. Data is from a sample set of SLBs from ICMA's Sustainability Bond Database and is not exhaustive. SLB--Sustainability-linked bond. KPI--Key performance indicator. ICMA--International Capital Markets Assn.

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Pricing Mechanisms: Financial And Structural Impacts

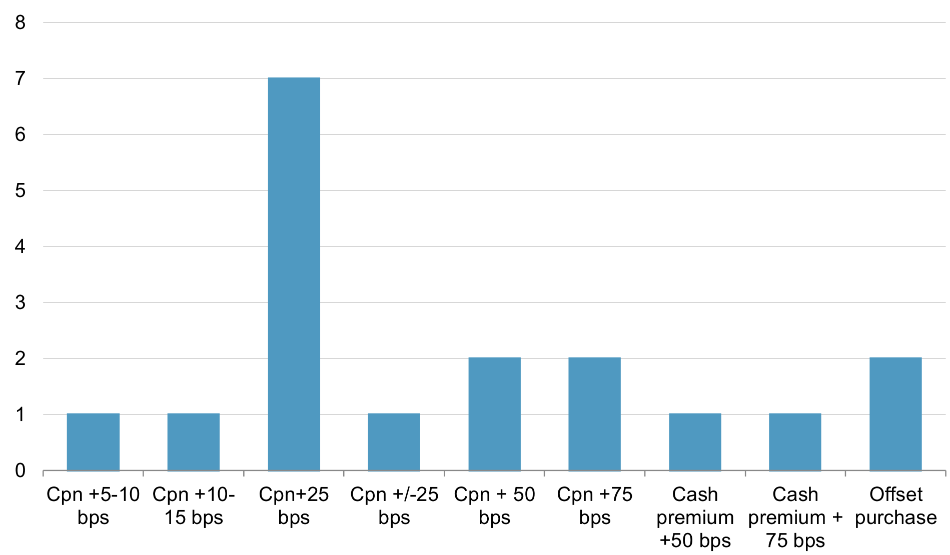
The cornerstone of a sustainability-linked instrument, according to ICMA, is that its financial and/or structural characteristics can vary depending on whether the predefined SPTs are achieved. Pricing adjustment mechanisms on sustainability-linked instruments operate in three primary ways: a benefit mechanism (one-way), a penalty mechanism (one-way), or a benefit and penalty mechanism (two-way). With a one-way benefit mechanism, an issuer will face a margin discount if it meets its predetermined SPTs but will face no penalty if it fails to do so. The alternative is true with a one-way penalty mechanism. On the other hand, with a two-way mechanism, the issuer will obtain a margin discount if it meets the predetermined SPTs or face a margin premium if it fails to do so.

Because the primary objective of sustainability-linked instruments is to provide incentives to entities to improve their sustainability performance, many instruments, specifically in the loan market, have historically adopted a two-way mechanism with an equal and opposite benefit or penalty if the company meets, or fails to meet, its performance targets. While the financial incentive for SLLs isn't usually disclosed, we understand it's often relatively small, typically in the range of 5% to 10% of the initial margin, capped at 15 basis points (bps). This is slightly different for the SLB market. In the bond market, most instruments have a one-way penalty mechanism with the most common one being a one-time 25 bps step-up if the targets aren't achieved in the specified time frame (see chart 6). So far, the only cases where SLBs have had a two-way mechanism are in the private-placement market. French elderly care and support group, Korian, and French utility, Albioma, were the first entities to issue sustainability-linked euro-denominated private placements, which applied two-way pricing mechanisms.

Chart 6

A 25 Basis Point Coupon Step-Up Remains The Most Common Debt Pricing Adjustment For SLBs

Debt pricing adjustment on SLBs, 2020-2021



Data is from a sample set of SLBs from ICMA's Sustainability Bond Database and is not exhaustive.

Cpn--Coupon. bps--Basis points. SLB--Sustainability-linked bond.

Source: International Capital Markets Assn., S&P Global Ratings, issuer bond filings.

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The diverse pricing structures are largely due to the difference in the public-facing nature of the loan and bond markets and the varying degrees of interaction between issuers and their stakeholders. Loan and private placement bond market participants often have more interaction with their lenders or investors, leading to increased scope for discussion about the conditions and mechanisms of the instruments. On the other hand, interaction with investors in the public bond market is fairly limited, which has led to many bonds having stricter and less frequent pricing adjustments. We also understand that since the bonds are listed and traded on a daily basis, a step-down approach to a bond coupon could create some pricing complexity, which may be hard to assess for investors at the time of issuance as well as over the life of the instrument.

Innovation in pricing structures has also increased in recent years, with new structures emerging that are related to, but somewhat different from, the step-up/step-down approach. For example, to avoid the potential reputational harm associated with profiting from a pricing adjustment, lenders or investors may agree to allocate an amount equivalent to a margin increase to specific ESG projects that help the issuer achieve its sustainability objectives. In addition, for instruments with a step-down mechanism, issuers may donate the margin reduction amount to an

ESG-related charity or nongovernmental government organization (NGO). In other cases, issuers or borrowers with greenhouse gas (GHG) emissions-related SPTs have also committed to purchase a specified amount of carbon offsets if they fail to meet their goals. In these scenarios, investors wouldn't receive a higher payment, but the issuer would be forced to increase its contributions to fund actions that foster sustainable development. We acknowledge, however, that such pricing structures may increase the risk of ESG-washing, particularly if the impact of the charitable contribution or carbon offset isn't closely aligned with the issuer's sustainability strategy.

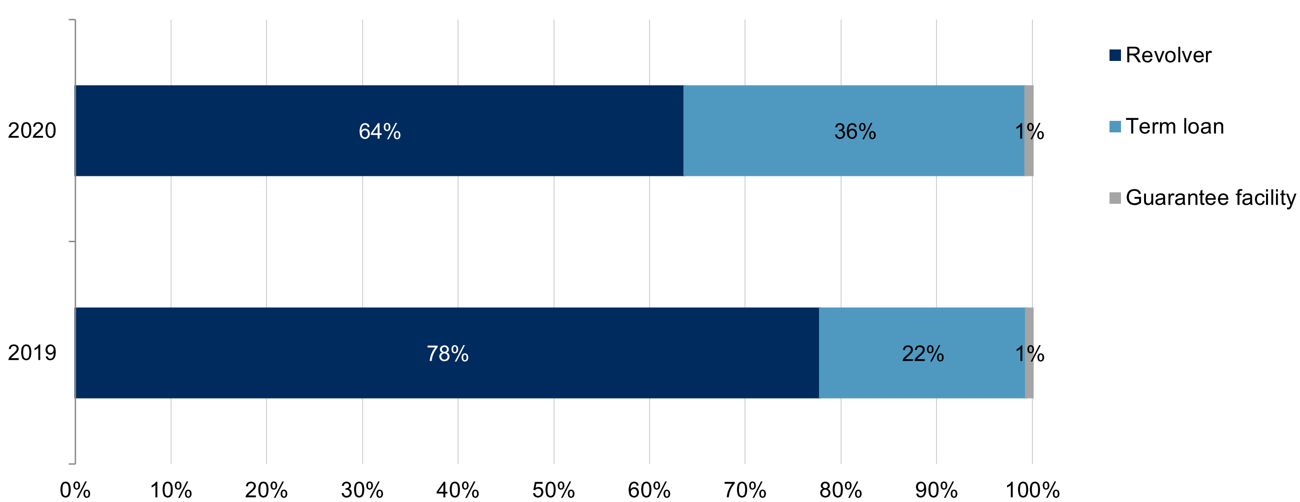
Sustainability-Linked Loans Have Taken Off

Since the first sustainability-linked loan was issued was by Dutch health care company, Phillips, in 2017--a $1.2 billion revolving credit facility (RCF) tied to an ESG rating provided by a third-party provider--the market has grown impressively (see "Why Linking Loans to Sustainability Performance Is Taking Off," published on Sept. 3, 2019). Despite a slowdown in SLL issuance in the first half of 2020, as issuer attention shifted toward financing short-term liquidity measures in response to the COVID-19 pandemic, it quickly rebounded in the second half of the year. Cumulative SLL issuance surpassed $300 billion in 2020, an over 6x increase from around $50 billion in 2018, according to BloombergNEF.

The majority of SLLs issued to date have been in the form of RCFs (see chart 7). RCFs are well suited for general corporate purpose use because they provide a borrower with the ability to periodically draw down and repay the loan when needed. However, a growing number of borrowers are linking sustainability objectives in a term loan format. We see this as a key market trend, because a margin adjustment on a drawn term loan increases accountability for the issuer in meeting its set SPTs.

Chart 7

The Term Loan Format Is Gaining Prominence In The SLL Market
SLL issuance by loan type



SLL--Sustainability-linked loan. Source: Bloomberg and S&P Global Ratings.

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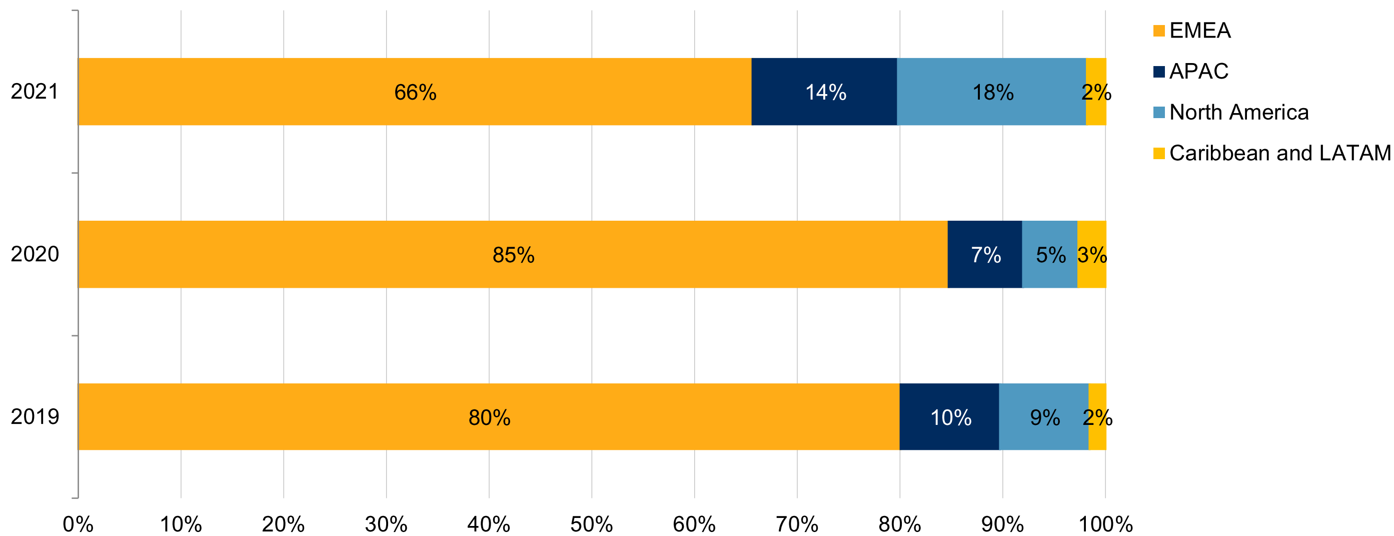
Europe leads in the issuance of sustainability-linked loans, with borrowers and lenders in the region pushing the envelope to link loans to ESG performance (see chart 8). For example, in the first quarter of 2021, Belgian-based alcohol beverage company, Anheuser Busch, and Italian utility, Enel, issued the two largest SLLs to date.

Interestingly, the EU Green Taxonomy, may accelerate the issuance of sustainability-linked debt in lieu of use of proceed instruments, as it narrows the list of environmental projects eligible for green-labelled financing in Europe. We also believe European banks have strong incentives to increase the share of sustainability-linked loans within their lending books given their need to fulfill corporate targets related to impact financing. We believe this is one of the key drivers for a marked acceleration of the sustainability-linked debt market in Europe.

Chart 8

European Borrowers Dominate The SLL Market Although Diversification By Region Continues To Grow

SLL issuance by region



SLL--Sustainability-linked loan. Data through April 9, 2021. Source: Bloomberg and S&P Global Ratings.

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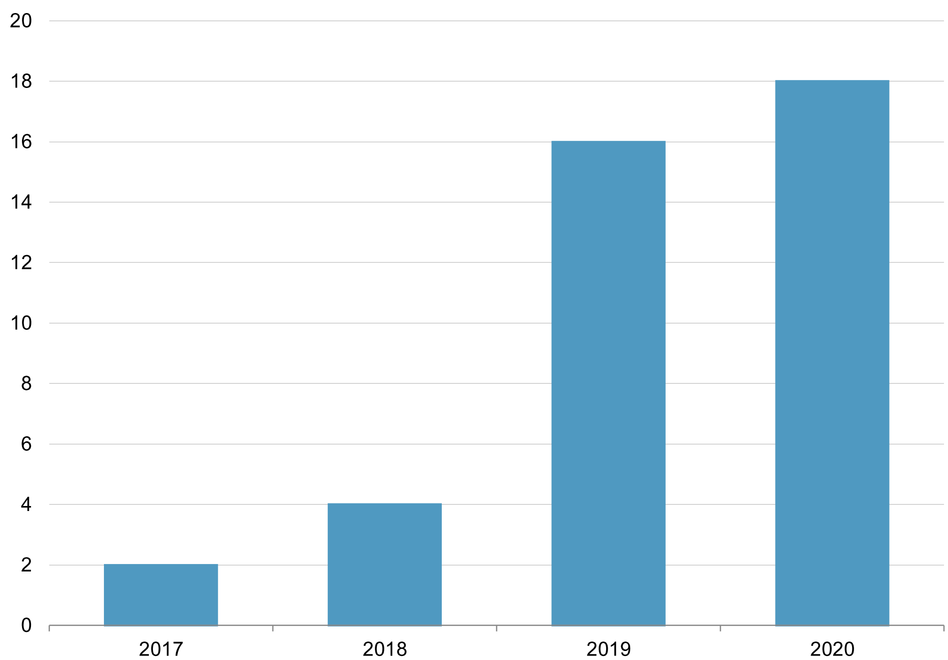
Growth in the SLL market, however, isn't coming from the EU alone. Issuers in the U.S. are becoming highly engaged in ESG with a growing number starting to link their loan financing to sustainability performance targets. CMS Energy became the first company to issue an SLL in the U.S. in June 2018, worth $1.5 billion, and tied to its clean energy goals. In February 2021, global private equity investment firm, The Carlyle Group, issued the largest sustainability-linked credit facility in the U.S. at $4.1 billion and the first-ever tied to a governance KPI of improving board diversity.

A growing number of borrowers in emerging market economies are also entering the sustainability-linked loan market. The market for sustainability-linked loans in Asia Pacific (excluding Japan) has steadily increased since 2017, according to Bloomberg, with 18 firms signing a total of $7.4 billion of SLLs in 2020, compared with 16 companies raising $7.5 billion in 2019 (see chart 9). Singaporean global commodities trader, Trafigura, issued one of the largest SLLs globally in March 2021, a $5.5 billion loan linked to reducing GHG emissions, responsible sourcing of metals, and expanding its renewable power portfolio.

Chart 9

More Firms In APAC Are Getting Sustainability-Linked Loans
No. of SLL borrowers in APAC, excluding Japan



SLL--Sustainability-linked loan. Source: Bloomberg.
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Sustainability-Linked Leveraged Loans

The size of the sustainability-linked leveraged loan market is still quite small compared to that of investment-grade loans. However, according to the European Leveraged Finance Association (ELFA) and the LMA, tightening regulations as well as widespread societal support for improved ESG practices, are driving increased investor demand for the incorporation of ESG factors in the leveraged finance markets. In July 2019, Spain's fourth-largest telecoms operator, Másmóvil, became the first leveraged loan borrower in Europe to include an ESG component in a leveraged loan package. Since then, interest in sustainability-linked leveraged loans has accelerated rapidly. In June 2020, for example, plastic packaging firm Logoplaste, created the first institutional term loan with interest payments linked to its ability to reduce carbon dioxide emissions across its operations. In addition, in January 2021, German wind turbine gearbox maker, Flender, announced a sustainability-linked term loan B to support its buyout by private equity firm, Carlyle. Half of any savings achieved on the loan will go to a climate-related charity, making it the first leveraged finance transaction to have a charity donation provision. Momentum for this has remained particularly strong in Europe where 13 high-yield issuers have issued sustainability-linked loans so far this year, compared to only two in 2020 according to data from LCD news, part of S&P Global Market Intelligence.

In January 2021, the ELFA and LMA jointly published the first set of guidance for structuring ESG factors into leveraged loan transactions (the "Guide"). The Guide outlines the current regulatory landscape, describes why there's such an urgent demand from investors for increased disclosure on ESG factors--particularly in the high yield market--and details best practices for borrowers to integrate ESG factors into offering documentation. We expect this additional guidance, along with the current momentum in the market, to drive further growth of the sustainability-linked leveraged loan market over the next few years.

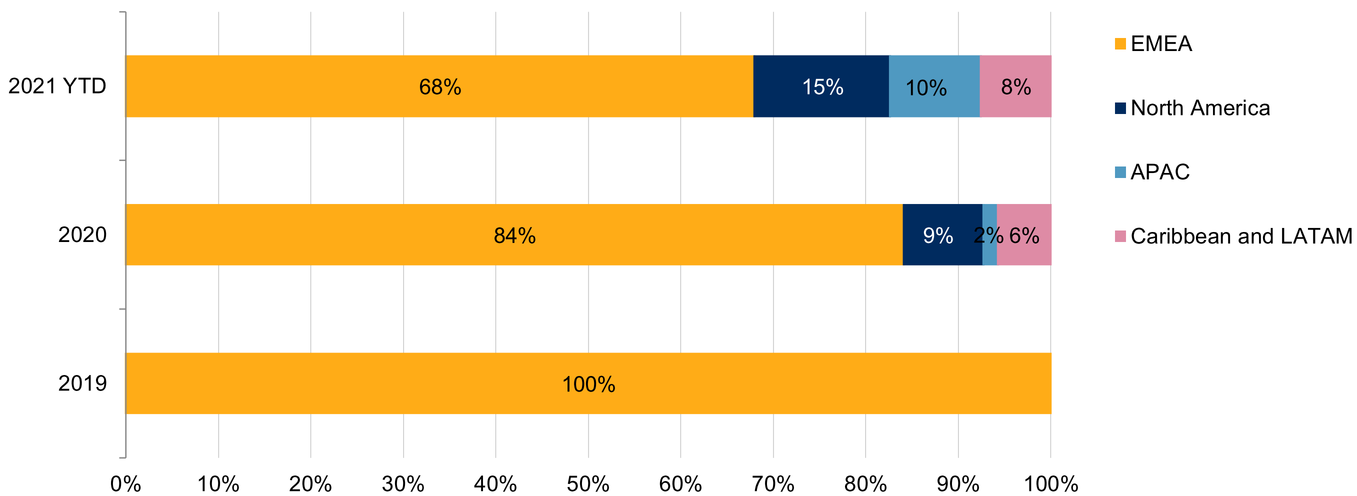
The Rise of Sustainability-Linked Bonds

The rapid growth of SLLs has provided for other linked-instruments to gain momentum, notably SLBs. Italian utility, Enel S.p.A, issued the first two SLBs in September and October of 2019 linked to its target of increasing renewable energy installed capacity. Enel's first SLB issuances marked a noteworthy innovation in the corporate bond market and have encouraged various other corporate market participants to follow suit. Recent SLB issuers include United Arab Emirates airline operator Etihad Airways, Brazilian paper and pulp firm Suzano, and Swiss pharmaceutical company Novartis.

Similar to the SLL market, the majority of SLB issuance is concentrated in Europe although it is rapidly diversifying (see chart 10). In December 2020, utility NRG Energy became the first company in North America to issue an SLB and in February 2021 UltraTech Cement became the first Indian issuer to tap the market.

Chart 10

The SLB Market Is Seeing Notable Momentum In North America and APAC
SLB issuance by region



SLB--Sustainability-linked bond. YTD--Year-to-date. Data through April 9, 2021. Sources: Bloomberg and S&P Global Ratings.
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We expect new issuers to seek out SLB financing over the coming year, particularly as market integrity and transparency efforts grow. For example, the ECB announced that starting in January 2021, it will accept sustainability-linked bonds as eligible collateral and also start buying them under its asset purchase programs, which should stimulate further growth in Europe and help establish best practices for the instrument. The London Stock Exchange (LSE) also recently introduced the ability for issuers to display SLBs on the Issuer Level Classification segment on its Sustainable Bond Market, provided they're issued in accordance with the SLBP. According to the LSE, this is crucial for investors and issuers, providing an additional layer of transparency as more businesses make sustainability central to their operations.

Sustainability-Linked Leveraged Bonds

U.S telecom company, Level 3 Financing, was the first high-yield issuer to tap the SLB market with a $900 million issuance in January 2021 tied to GHG emission reduction targets. It was soon followed by Brazilian paper producer, Klabin, with a $500 million issuance linked to reducing the consumption of natural resources, increasing the recycling of water and solid waste, and preserving biodiversity in the company's forest areas. We expect a growing number of entities to issue high yield bonds as they incorporate sustainability in their corporate strategies and investment decisions.

The Path Ahead

It's clear that a greater number of market participants will begin to use sustainability-linked instruments to align financial incentives with sustainability performance. However, we also expect the market will continue to devise new linked instruments and use of proceeds categories.

We believe sustainability-linked instruments will increasingly be used to fund innovative technologies such as those related to carbon capture or hydrogen as well as expand into less mature environmental categories such as climate change adaptation, biodiversity, or water use. We also believe a broader range of social and governance KPIs will proliferate, including those related to diversity and inclusion, particularly as social justice issues continue to dominate social, political, and economic agendas globally.

Furthermore, the sustainability-linked concept will likely expand beyond the classic SLL or SLB model into other instrument types. For example, the first sustainability-improvement derivative (SID) was introduced by Dutch oil and gas company, SBM Offshore, in August 2019, an interest rate swap deal that hedges the interest rate risk of financing the construction of one of SBM Offshore's floating production storage and off-loading facilities. Similar to a sustainability-linked loan, the SID's price is linked to SBM Offshore's independently assessed ESG performance, alongside trading risk, capital requirements, and profit, according to ING. In addition, in March 2021, U.S. utility, Schneider Electric, became the first company to issue a sustainability-linked convertible bond, introducing the sustainability-linked format into structured equity transactions. That said, the sustainability-linked hybrid bond market has so far been slower to develop (see "Sustainable Finance: Equity Content And Sustainability-Linked Hybrids," published Feb. 10, 2020). Over time, however, we expect there to be further innovation in linking sustainability performance to other capital market instruments.

A new category of sustainability-linked instruments, called sustainability-linked green bonds (SLGBs) has also emerged, which ties the use of proceeds model of a green bond with the performance-based structure of an SLB. The first SLGB was issued by Japanese construction company, Takamatsu, in March 2021. The company will use bond proceeds to fund the construction of a new energy-efficient building in Tokyo. The SLGB is also tied to Takamatsu's SDG revenue-contribution target. Austrian utility, Verbund quickly followed suit, issuing an SLGB to upgrade and expand a hydropower plant and expand the power grid in Austria. The coupon on the bond will rise if the company fails to meet two sustainability performance targets related to integrating renewable-energy generation into the grid. While only $690 million has been raised by the SLGB format to date, according to Environmental Finance, there are expectations that this structure will gain traction rapidly over the coming years, particularly as issuers look to better align their financing needs with their sustainability objectives. We don't expect sustainability-linked instruments to cannibalize use of proceeds instrument volume, and vice versa. Instead we see these two instrument types as complementary, enabling borrowers and issuers to leverage the different sustainable finance instruments to embed ESG into their overall business strategies.

Ultimately, we believe the sustainability-linked market is on the cusp of impressive growth, which may further spur sustainable business practices around the globe. We expect growth in these instruments will be global, accelerated by ambitious environmental commitments and the call for a greater focus on mitigating social risks. In our opinion, improved transparency and reporting practices are key to addressing the various challenges associated with the asset class and fostering credibility across the market.

The author would like to acknowledge the contribution of Lara MacLennan and other members of the Finn Partners team, as well as Nina Flitman of LCD News, a part of S&P Global Market Intelligence, to this research.

This report does not constitute a rating action.

Related Research

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- Sustainability in 2021: A Bird's-Eye View Of The Top Five ESG Topics, Jan. 28, 2021
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- Why Linking Loans To Sustainability Performance Is Taking Off, Sept. 3, 2019

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