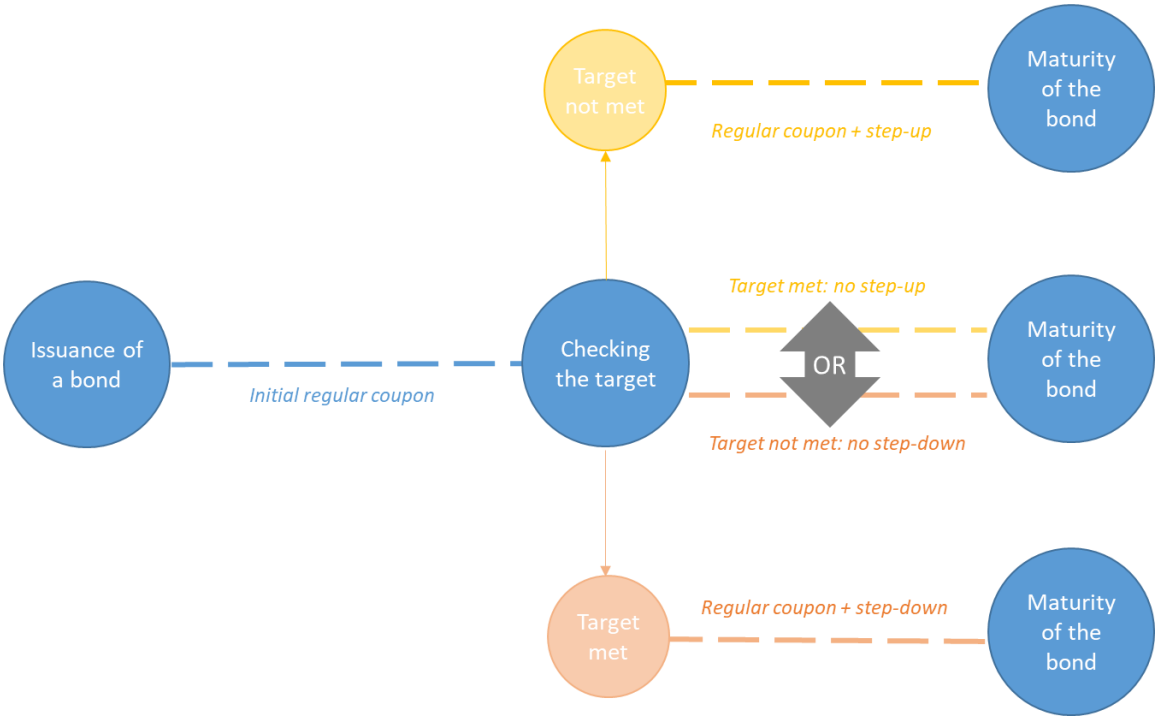
Sustainability-linked bonds, an effective tool for decarbonisation?

By Pauline Bacos and Naelle Verniest

Sustainability-linked bonds (SLBs) have an innovative format that links the bond's coupon to the achievement of environmental, social or governance targets. Many SLBs now include targets for reducing greenhouse gas emissions. However, this mechanism must impose greater constraints on issuers in order to become a real decarbonisation tool.

Chart 1: Mechanisms of SLBs



Source: Banque de France

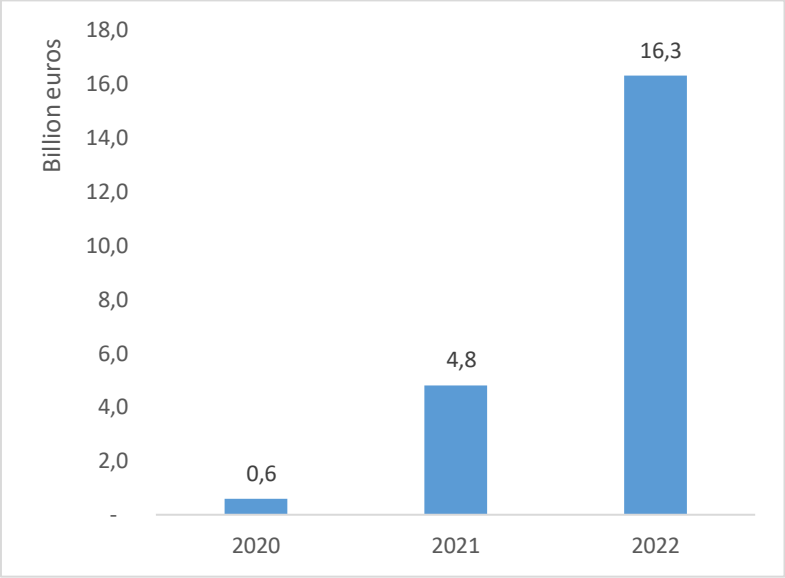
Note: A step-up is a coupon increase applied if an environmental, social and governance (ESG) target is not achieved. A step-down is a coupon decrease applied if an ESG target is achieved. These mechanisms are defined at issuance.

SLBs, an increasingly widespread instrument

Sustainability-linked bonds (SLBs) are bonds with an environmental, social or governance (ESG) constraint for the issuer. At issuance, the issuer defines one or more ESG targets, whose achievement is checked at a specific date, using indicators also chosen by the issuer. Reaching or missing the target changes the bond's features. Where a step-up coupon is defined at issuance, the coupon will increase in the event of a missed target and remain unchanged if the target is reached. When a step-down coupon is defined, the coupon will decline if the target is achieved, and will not change if it is not. More rarely, the SLB mechanism may combine a step-up and a step-down, or consist of a payment of a premium to bondholders at maturity if the target is missed.

SLBs have grown significantly in the European ESG bond market since their emergence in late 2019 (see Chart 2), benefiting from a catch-up effect with green bonds.

Chart 2: Volumes of SLBs issued in EUR billion (1st quarter)



Source: Bloomberg

Since 1 January 2021, environmental SLBs have been eligible as collateral for the Eurosystem and for the corporate sector purchase programme (CSPP). The Eurosystem showed its support for innovations in sustainable finance with this decision.

SLB issuers, mainly corporates, link their financial and ESG commitments

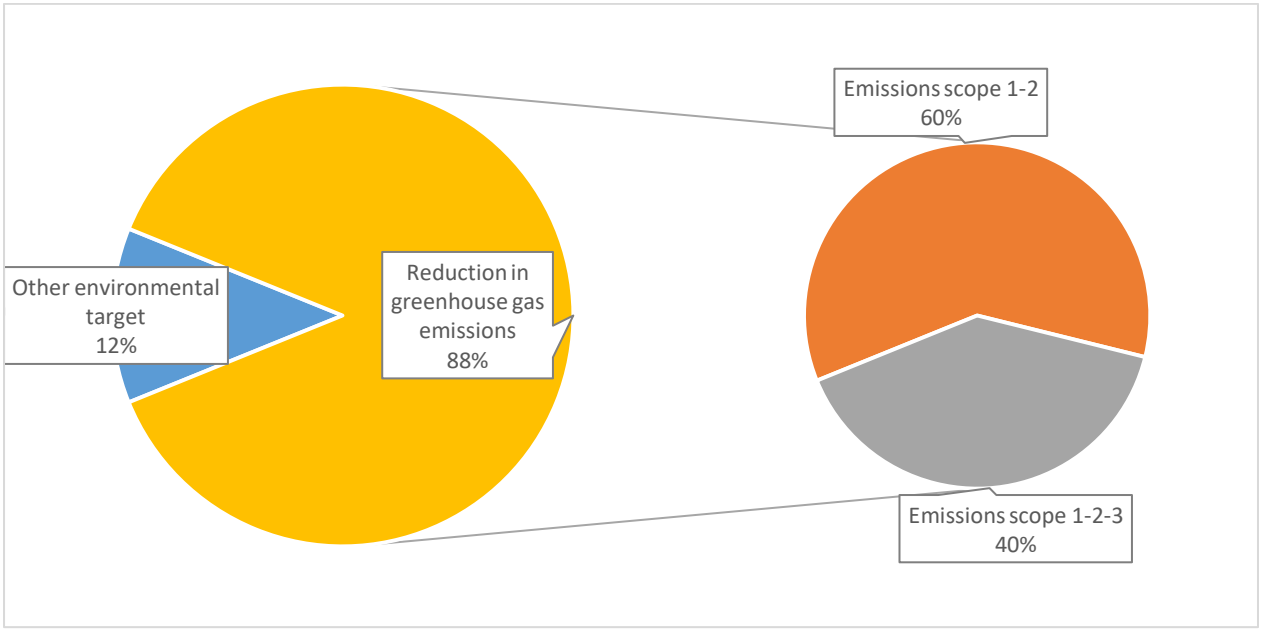
Non-financial corporations are the main issuers of SLBs, which give them access to a specialised investor base that generates significant demand. Since January 2020, 90% of SLBs, in value terms, have been issued by corporates.

The utilities sector (water, gas and electricity supply) is the largest issuer of SLBs, accounting for 21% of issuances since 2020. Some diversification has nevertheless been observed, with strong growth in SLB issuance in sectors such as telecommunications, agri-food and health.

In the ESG markets, the SLB format is an attractive alternative to green bonds (Descombes, Kergadallan and Le, 2022) for issuers. It can be used to finance any type of investment, with ESG commitments at the level of the issuer or its group, whereas green bonds are strictly for financing "green" assets. As a result, SLBs allow issuers with no "green" assets to finance to issue ESG debt. These two bond formats s are complementary and some issues combine the two, by linking their coupon to a target while allocating their funds to "green" assets.

A great majority of SLBs issued by non-financial corporations have environmental targets, and specifically targets linked to greenhouse gas (GHG) emissions. As of 19 August 2022, 88% of environmental SLBs eligible as collateral for the Eurosystem have had a GHG reduction target (see Chart 3), with a slight majority in a narrow scope (see next paragraph).

Chart 3: Targets of eligible SLBs (in numbers)



Source: Financial documentation of SLBs

Note: Scope 1-2 represents the issuer's direct greenhouse gas emissions. Scope 3 represents its indirect emissions.

Do SLBs really improve corporates' climate performance?

Economic actors must adapt to climate change, which implies a commitment to decarbonise their activities. With this in mind, the climate performance of companies can be defined by their volume of GHG emissions and/or by their commitment to a GHG reduction trajectory. Emissions are classified by scope: Scope 1 covers a company's direct emissions from sources it owns or controls. Scope 2 covers emissions resulting from a company's use of electricity, heat or steam. Scope 3 covers other indirect emissions, upstream or downstream of the production cycle. Not all economic activities are equally affected by this need for adaptation and some sectors have to make significant efforts to achieve it. The lack of adaptation generates financial risks over time (Boissinot, Clerc and Dees, 2021).

In this matter, the environmentally-targeted SLB mechanism signals the commitment of the issuer to reduce its GHG emissions, by linking it to financial commitments. However, the relevance and ambition of the targets are difficult to assess and the level of financial penalties for not meeting the targets is generally low. For example, indirect GHG emissions (Scope 3) are sometimes missing from the climate targets of SLB issuers in sectors where Scope 3 emissions are significant. In addition, the most common level of SLB step-up (i.e. premium to be paid to investors in the event of missing the target) averages 25 basis points (0.25%), compared to 125 basis points (1.25%) for a step-up linked to the change in the issuer's credit rating, which is common in the market. Lastly, any early repayment clause weakens the constraint created by the mechanism (Kölbel and Lambillon, 2022).

Against this backdrop, the ESG markets do not values SLBs in the same way. Most SLBs do not seem to have a significant premium (equivalent to a “greenium” for green bonds) over conventional bonds (Mirova 2022). SLB issues with a higher level of step-up or step-down nevertheless seem to benefit from a premium from investors (Kölbel and Lambillon, 2022). SLBs exist in a variety of forms and are sometimes difficult to value on the markets, as they are the result of tailor-made choices made by each issuer.

To address these limitations, the International Capital Market Association (ICMA) recently listed 300 standardised ESG targets for SLBs, by sector of activity. The ICMA provides benchmarks for issuers to calibrate their targets and recommends adopting targets based on Scope 1, 2 and 3 emissions for most sectors. In addition, the European Commission announced in July 2021 its plans to develop a label for SLBs. These initiatives are likely to consolidate issuances in the SLB format and to improve target relevance assessment over time.

For the most polluting sectors, the European project to achieve carbon neutrality by 2050 creates more effective decarbonisation mechanisms, notably with emission quotas and carbon markets to which applies to a growing number of economic actors. In this respect, the choice of the SLB format to issue debt is an additional sign of commitment by corporates to the transition.