

# INSIGHT: SUSTAINABILITY-LINKED BONDS

## SOME PRACTICAL CONSIDERATIONS FOR DOCUMENTING AND STRUCTURING TRANSACTIONS

Sustainability-linked bonds (“SLBs”) have fast become an important feature of the sustainable finance market. According to Climate Bonds Initiative, SLB issuance reached US\$76.3 billion in 2022<sup>1</sup> and we have seen an increasingly wide variety of corporate and sovereign issuers take advantage of the structure<sup>2</sup>.

Issuing a SLB can indicate an issuer’s commitment to sustainability principles and offer a practical alternative for those issuers without sufficient sustainable assets to take advantage of the sustainable “use of proceeds” structure. By embedding corporate commitments in their funding, SLBs can be particularly valuable to issuers that wish to demonstrate their commitment to their transition strategy away from carbon intensive business.

However, the market has not grown without incident or controversy. Some issuances have attracted accusations of “greenwashing” for a lack of ambition in their targets, the lack of meaningful consequences if a target is not met or where the structure of the SLB does not address the true sustainability challenges of their business. SLBs carry with them some particular considerations that should be kept in mind when structuring a transaction and preparing the relevant legal documents and marketing materials.

We take a look at some of these key points in this note.

### Sustainability-linked bonds – A (very) brief recap of the basics

SLBs are bonds where the financial and/or structural characteristics vary depending on whether or not predefined sustainability performance targets (“SPTs”), determined by reference to key sustainability performance indicators (“KPIs”), are met.

Unlike “green bonds”, there is no requirement that the proceeds be allocated to a sustainable project or purpose. The proceeds from an SLB may be used for general corporate purposes or, indeed, any other purpose.

The SLB market is based upon the International Capital Market Associations (“ICMA”) [Sustainability-Linked Bond Principles](#) (the “Principles”). In addition to the Principles, ICMA have produced a range of additional materials to assist the growth of the market and maintain market integrity, notably:

- a set of [Related Questions](#) providing guidance on common questions about SLBs (the “ICMA SLB Q&A”); and
- an [Illustrative KPI Registry](#), a set of high-level recommendations as well as illustrative examples to assist issuers with the selection of relevant and material KPIs.

## Some key points to think about when structuring and documenting SLBs

### 1. *Align the SLB terms and conditions with the SLB framework*

It is important to ensure that the issuer’s SLB framework - the document typically setting out its sustainability strategy, goals and objectives as well as the description of SPTs and KPIs - aligns with the terms and conditions of the SLBs.

Whilst this may seem obvious there can be a disparity between the way in which the framework, primarily a marketing document, and the terms and conditions, a legal document, are drafted. It is important to ensure consistency. This is particularly true where using detailed, technical language to describe the KPIs. By way of example, for greenhouse gas emissions targets, it is key that it is consistently clear whether Scope 1, 2 or 3 metrics are being applied in the KPI.

<sup>1</sup> See: [Green and other Labelled Bonds Held Market Share in 2022 Amidst Fall of Global Fixed-Income](#) | Climate Bonds Initiative

<sup>2</sup> Issuance by financial institutions has been limited owing to reservations expressed by regulators from a regulatory capital perspective. See, for example, para 187 et seq. of [European Banking Authority AT1 Report 24 June 2021](#).

## 2. **SLB specific risk factors and disclaimers**

Additional SLB specific risk factors and disclaimers should be included in the offering document to reflect SLB risks. For example, an issuer may elect to include disclaimers and risk factors which highlight some of the following points:

- » the bonds may not satisfy the sustainability objectives, policies or requirements of investors;
- » the bond proceeds may not be allocated towards a sustainable project or purpose;
- » the issuer may be able to exercise discretion in calculating the KPIs;
- » no assurance is given as to the suitability or reliability of any opinion, report or certification of any third party in connection with the offering of the bonds;
- » the legal and regulatory framework relating to SLBs is still evolving;
- » the issuer may fail to meet an SPT which would affect its cost of funding; and
- » the issuer may have the flexibility to recalculate the SPT or KPI in certain circumstances (see “*Be clear with your recalculation language*” below).

## 3. **Redemption provisions**

Redemption provisions should be drafted carefully in order to ensure that investors have a clear understanding of the redemption mechanics of an SLB, particularly where describing redemptions using a make-whole calculation. A study by Covenant Review in 2021<sup>3</sup>, found that in a sample of 14 SLBs surveyed, it was not clear in 6 of the examples whether the stepped-up interest rate was used in the calculation of the make-whole amount on the exercise of an optional call right by the issuer.

There is also growing consensus that, to avoid accusations that an issuer may have the ability to “avoid” its test date, optional issuer call rights should generally either not be permitted prior to a KPI test date or, where a such call right does exist, the call price should reflect an assumption that the SPTs have not been met, i.e. the step-up should automatically apply in the calculation of the redemption amounts.

## 4. **Failure to report need not be an event of default**

The terms and conditions of SLBs generally contain a contractual undertaking to report on the KPIs on at least an annual basis. Failure to comply with this undertaking would, subject to a short grace period, typically be an event of default in the terms of an SLB, unless failure to report on the KPIs is specifically carved out from the events of default. Those involved with structuring an SLB transaction should consider whether an event of default is the appropriate recourse in this circumstance, or if an alternative consequence, such as a coupon step-up, is more appropriate.

## 5. **Be clear with your recalculation language**

It is common for an issuer to include some flexibility or discretion over how KPIs are calculated and include an option to alter an SPT or the calculation of a KPI prior to maturity of the bond.

This makes sense as the calculation of the corporate sustainability targets on which KPIs are based may change over time (for example, evolving science may require an issuer to “rebase” the way it calculates a KPI, or M&A activity may change the corporate perimeter of the issuer group and require amendments to SPTs and KPIs to ensure they remain appropriate).

Whilst recalculation language is now accepted practice, it is nevertheless a right for the issuer to unilaterally amend one or more KPIs or SPTs and, if exercised, such right is likely to be subject to scrutiny. It is critical that the drafting of the recalculation mechanics in the terms and conditions of the bond is clear and unambiguous, and aligns with the company’s recalculation policy, which may also be documented elsewhere outside of the transaction documents.

Note, provisions to prevent the abuse of recalculation policies have been observed in the terms and conditions of recent SLBs requiring the issuer to: (i) act in good faith; (ii) make appropriate disclosures to bondholders on the exercise of a recalculation right; and (iii) have an external party verify that the new KPIs / SPTs maintain the same level of materiality and ambition.

<sup>3</sup> See Covenant Review - ESG: Make-Whole Ambiguity in Sustainability-Linked Bonds, November 4 2021

## 6. **Identify tax and accounting implications early on**

Any bond issuance which incorporates a coupon step-up, premium or other “structural” feature may give rise to particular withholding and/or stamp tax consideration. Whilst this is rarely a “gating item” for an SLB, a tax and accounting analysis early on in the transaction timetable can help to identify any potential adverse tax and/or accounting implications and avoid any delays to the transaction (or the need to redraft (which can be costly for an issuer)). For example, there is a need to consider how certain sustainability-linked financings should be treated from an accounting perspective and represented in the financial statements of an issuer (e.g. whether there is an embedded derivative in the terms of the instrument that requires separation in the accounts under IFRS 9).

## 7. **Exercise caution with ECB eligibility**

The European Central Bank (“ECB”) decision to accept certain SLBs as eligible collateral for Eurosystem credit operations was a welcome boost to the growth of the market<sup>4</sup>. However, not all SLBs are eligible, and issuances remain subject to compliance with all other eligibility criteria. The eligibility assessment is performed by the appropriate national central bank and, given its complexity, satisfaction of the relevant eligibility criteria cannot be guaranteed. Issuers should therefore avoid using statements in offering documents and marketing materials which confirm that their SLBs “will be” ECB eligible and, instead, opt for market standard statements which confirm that their SLBs are “intended to be” ECB eligible, subject to all relevant criteria of the ECB being met.

## 8. **Seek to ensure credibility of KPIs, SPTs and implications of failing to hit SPTs**

Issuers and their advisers should seek to ensure that the selection of KPIs and SPTs is credible. This is critical to avoid accusations of greenwashing that have affected certain SLBs.

By way of recap, under the Principles, in order for SPTs to be credible they should “represent a material improvement... and be beyond “Business as Usual”...where possible, compared to a benchmark or external reference...[and] consistent with the Issuer’s overall strategic sustainability/ESG strategy”.

KPIs should be “relevant, core and material...measurable...externally verifiable and able to be benchmarked...as much as possible using an external reference or definitions”.

Helpfully, in addition to the Principles, there is guidance in both the [ICMA SLB Q&A](#) and [Illustrative KPI registry](#) on how best to ensure credibility of KPIs and SPTs by reference to both existing market practice and sector specific standards.

The financial/structural consequences of failing to hit an SPT should be “meaningful relative to the Issuer’s original bond financial characteristics”.

There are no hard-and-fast rules around what constitutes “meaningful”. Clearly, this is a commercial rather than a legal consideration, but an assessment of current market trends may be insightful. In its recent [survey](#) of the SLB market, the European Securities and Markets Authority (“ESMA”) found that, in relation to coupon step-ups:

- of 182 surveyed SLBs issued by EEA-domiciled corporates, average step-ups varied between 14bps and 33bps per KPI, depending on the number of KPIs and targets used; and
- SLBs with multiple KPIs tend to face higher cumulative penalties, but this comes at the expense of a lower step-up per KPI. See figure 1 below.

<sup>4</sup> See: [FAQ on sustainability-linked bonds \(europa.eu\)](#)

ESMA also highlighted two trends that might lead to questions around credibility of targets that are worthy of consideration. First, step-up mechanisms that “kick in” too close to maturity and thereby diminish the number of step-up payments made by the issuer prior to maturity. Second, coupon step-ups that appear to be uncorrelated with the underlying coupon rate – the financial incentive to reach an SPT decreasing with the credit quality of the issuer. See Figure 2 below.

Figure 1

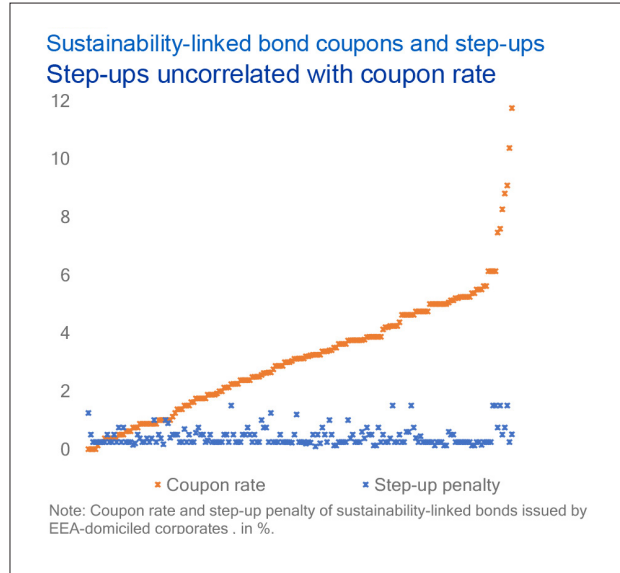
SLB coupon step-up  
Coupon step-ups vary substantially

	Average	Minimum	Maximum
1 KPI	33	10	150
2 KPI	25	10	75
3 KPI	14	5	40
≥4 KPI	21	18	30

Note: Average, minimum, and maximum coupon step-ups per KPI (in bps) used in 182 sustainability-linked bonds issued by EEA-domiciled corporate issuers.

Source: ESMA TRV Risk Monitor, 9 February 2023

Figure 2



**9. Manage your marketing material**

As on all bond transactions, the marketing material for an offering of SLBs must be consistent with the bond offering documentation. Market practice remains that, whilst the SLB framework is not incorporated by reference, material elements of the framework are disclosed in the bond offering document. It is therefore key to ensure that statements are accurately transcribed into the bond offering document from, and align with, the wording of the framework. Whilst other elements of the framework may not be included in the bond offering document investors will typically review both, and it is therefore important to ensure that statements made in the framework are appropriate and verifiable.

**10. Consider enhanced due diligence**

Given the additional scrutiny around SLBs, enhanced due diligence about the offering is important.

SLBs have attracted particular criticism in relation to both the materiality of the KPI and SPTs and other wider ESG controversies affecting the issuer or its group. It is important for all parties to consider the potential reputational issues, negative regulatory investigations and litigation risks that may arise in the event that an SLB is publicly criticised. Due diligence – focusing, for example, on how the framework was structured, the issuer’s assessment of materiality of its targets, and wider ESG controversies that may affect the issuer and its group - can be a helpful “insurance” tool in this regard. The Association for Financial Markets in Europe (AFME) have put together a helpful [High Yield ESG Due Diligence Questionnaire](#) that may provide a source of potential questions.

The above is a selection of just some of the many considerations for documenting and structuring SLB transactions. We are beginning to see a range of other innovations and developments in the market including the increased use of “sustainability co-ordinator” mandate letters, step-down instruments and mechanisms linked to non-cash penalties such as charitable donations and carbon credits. Please get in contact with any of your Mayer Brown contacts if you would like to discuss further.

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