THE PITFALLS ASSOCIATED WITH SUSTAINABILITY-LINKED BONDS

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With the publication last August of the Working Group I contribution to the Sixth Assessment Report of the Intergovernmental Panel on Climate Change (IPCC)[1] and its alarming findings on the advanced state of global warming, it is imperative that the financial and corporate sectors now join the efforts of other stakeholders and become vectors of a transition towards a net-zero world.

Leading the way in this regard and acting as a codifier of market practices, the International Capital Market Association (ICMA) in June 2020 published its Sustainability-Linked Bond Principles[2]. These principles supplement those previously published by ICMA regarding green bonds (Green Bond Principles) and social bonds (Social Bond Principles) and its guidelines applicable to sustainability bonds (Sustainability Bond Guidelines). According to ICMA, the purpose of sustainability-linked bonds (SLB) is to enhance the role that bond markets can play in financing and encouraging the social and environmental responsibility of corporate stakeholders, and thereby contributing to sustainability.

Since the publication of the Sustainability-Linked Bond Principles, $36 billion worth of bonds have been issued pursuant to this regime. The second quarter of 2021 saw a significant increase in both volume and value[3] of issues of this kind, which are particularly popular in Europe[4] and are now on the radar screen of Canadian bond issuers[5].

Contrary to green bonds, where all or part the proceeds from the offering must be used exclusively for financing or refinancing new and/or ongoing green projects[6], SLBs are debt instruments whose financial and/or structural characteristics may vary depending on whether Environmental and/or Social and/or Governance (ESG) goals selected by the issuer are met. This ability for the issuer to define its environmental goals allows a greater pool of issuers to have access to the sustainable bond market. In this sense, SLBs are seen as an even more effective and catalyzing means than green bonds to achieve a low-carbon, inclusive and sustainable economy. Free from the constraint of having to use the proceeds from the offering exclusively within the strictures of a project recognized as “green”, issuers of SLBs can use the proceeds to finance initiatives and projects that would not otherwise have been recognized as “green” but can nonetheless have a positive impact on sustainability. Were it not for SLBs, these initiatives and projects would never have been financed. In fact, whether green bonds actually increase the level of investment in "green" projects is open to discussion. Several green projects financed by green bonds would have come to fruition even if green bonds did not exist, as they were already part of the issuers' business plan or DNA, and related to their core business activity (renewable energy, recycling, green technology) and thus could have been financed by a "standard" bond issue[7].

SLBs, on the other hand, allow businesses in the primary sector (e.g. mining, petroleum and gas extraction), the secondary sector (e.g. pharmaceuticals, chemicals, steel and cement-making) and the tertiary sector (e.g. air, maritime and road transport) to access the sustainable investment market and thereby contribute to reducing the impact of these businesses on the environment, and particularly on global warming.

In the context of an SLB issue, the issuer expressly undertakes to make improvements in its sustainability-related results in accordance with a predefined timetable. SLBs are thus forward-looking performance-based instruments. Performance is measured by reference to Key Performance Indicators (KPIs) and is assessed against Sustainability Performance Targets (SPTs).

However, there are some pitfalls associated with SLBs. In no particular order of priority, they are: (1) lack of ambition associated with the selection of KPIs and the calibration of SPTs; (2) insufficient increase in the coupon rate associated with failure to achieve SPTs; (3) built-in loopholes in the bond structure, and (4) belated disclosure of the KPIs during the term of the bonds. We will examine each of these pitfalls in turn.

Selection of KPIs and calibration of SPTs

In its Sustainability-Linked Bond Principles, ICMA states that the issuer's performance in terms of sustainability is to be measured through KPIs that can be external or internal. This choice between external and internal KPIs can lead an "opportunistic" issuer to select only internal KPIs and thus focus the analysis of the impact and achievement of the SPTs on certain aspects of its operations rather than on the overall effect of its activities. For example, in March 2021, PT Japfa Comfeed Indonesia Tbk (Japfa), an Indonesian agro-food business, issued SLBs in the amount of US$350M with a five-year term[8]. Pursuant to the issue, Japfa undertook to install wastewater treatment equipment in eight of its slaughterhouses and one of its poultry hatcheries before December 23, 2024. The SPTs for the issue were calibrated based on the number of slaughterhouses and hatcheries outfitted with wastewater treatment equipment, whereas the KPI used was based on an annual measure of cubic meters of wastewater. Thus, Japfa may well be able to meet its SPTs without this translating into a significant and material reduction in the volume of its wastewater, as all it must do is install the wastewater treatment equipment without necessarily reducing the volume of its discharged wastewater. In addition, another troubling fact is the SPT benchmarking chosen by Japfa in relation to its overall sustainable development strategy. For in its 2019 report on corporate responsibility, Japfa did not even make the treatment of its waste water a priority. According to ICMA, "SPTs should be ambitious [and] represent a material improvement in the respective KPIs and be beyond a "Business as Usual" trajectory [and] where possible be compared to a benchmark or an external reference [and] be consistent with the issuer's overall strategic sustainability/ESG strategy". We believe that It is arguable whether or not Japfa meets this requirement.

Insufficient variation in the coupon rate associated with a failure to achieving SPTs

The Voluntary Process Guidelines for Issuing Sustainability-Linked Bonds published by ICMA recommend that the variation of the financial and/or structural characteristics of the bonds be commensurate and meaningful relative to the bonds' original financial characteristics. On the SLB market today, an increase in the coupon rate of 25 basis points appears to be the norm. In the current low-interest-rate environment, one can thus question the proportionality and disincentive effect of this increase in the interest rate, which represents merely 5% to 10% of the initial coupon rate. Combined with a modest SPT, this slight variation in the coupon rate may not incentivize management of the issuer to achieve its SPT.

Finally, external reviewers, or Second Party Opinion givers, thus far have not included an analysis of the proportionality and severity of the variation of characteristics of the SLB in their external assessments of the SLB and its framework.

In addition, we note that an excessive penalty could have the perverse consequence of attracting arbitrageurs as SLB investors, whose sole motivation would be to bet on the issuer's failure to meet its SPT, in order to profit from an increase in the coupon rate and thereby achieve a better ROI.

Built-in loopholes in the bond structure

SLB issuers generally include in the bond documentation an escape clause allowing for exclusion from the KPIs' and SLBs' assessment of certain exceptional events such as a material acquisition or a drastic change in the regulatory environment. Consequently, an uninformed SLB investor may be surprised to learn that the issuer in which it invested has suddenly acquired assets in the coal sector using the proceeds of the SLB issue, and that those assets, by virtue of the escape clause, are now excluded from the calculation of the KPI used to assess the SPT of the issuer even if such issuer undertook to reduce its carbon footprint. This investor will be all the more incredulous at not being able to profit from an increase in the coupon rate despite the acquisition of fossil fuel-related assets by the issuer that nevertheless met its SPT only because of the escape clause.

Belated disclosure of KPIs

ICMA recommends that SLB issuers publish, for the benefit of the investing public, up-to-date information on the performance of the selected KPIs, as well as a verification assurance report outlining the issuer's performance against the SPTs.

According to ICMA, these reports should be published regularly, at least once a year, and in any case for any date/period relevant for assessing SPT performance leading to a potential change in the coupon rate or other financial and/or structural characteristics of the SLB.

In practice, some SLB issuers do not adhere to this annual disclosure timetable and delay public disclosure of KPI-related information until relatively late in the bonds' tenure. This practice can have the effect of allowing an unscrupulous issuer to obtain and benefit from better financing conditions (often called "greenium") for a lengthy period before maturity without deploying the efforts of a committed SLB issuer in transforming its activities to achieve a greener and more sustainable economy.

The market has even seen some SLBs of junk bond issuers having a call date set before the date scheduled for an assessment of the SPT and a possible increase in the coupon rate resulting from the issuer failing to meet its sustainability performance targets.

To avoid this unwarranted situation, a change in the early redemption mechanism should be made in order to measure the performance of the KPIs, assess the SPTs and pay the adjusted coupon if failure to meet the SPT occurred on the early redemption date.

Conclusions

While the ideology underlying SLBs is sound and praiseworthy, an astute investor or ambitious issuer should pay close attention to the pitfalls outlined above in order to avoid suspicions of greenwashing that could damage the reputation and credibility of the investor and/or issuer and possibly lead to a meltdown of the SLB market. We believe in the medium term that this market will attract the scrutiny of market regulators who will tighten the application criteria for SLBs by insisting, for example, that KPIs be scientifically based and recognized as actually contributing to the reduction of GHG emissions.

To avoid these pitfalls and keep abreast of developments in the market for sustainable finance instruments, do not hesitate to contact a member of McMillan's ESG – Sustainable Finance team.

[1]Volume 1 of the Sixth Assessment Report, Intergovernmental Panel on Climate Change (IPCC), August 2021
[2] Sustainability-Linked Bond Principles, International Capital Market Association (ICMA), June 2020
[3] The value of SLB issues in the first quarter of 2021 is practically the same as the value of the SLB issues in all of 2020, and the value of SLB issues in the second quarter of 2021 is almost double that of those issued in 2020. Investment bank JP Morgan even predicts that the total value of SLB issues this year could be between $120 billion and $150 billion (see *Sustainability-linked bond market to swell up to $150 billion: JPMorgan ESG DCM head*, Reuters, March 22, 2021).
[4] More than half of all SLB issues have been in Europe. They have become even more popular since the

European Central Bank began accepting some SLBs as collateral and including certain SLBs in its asset purchase program. Such SLBs must align with the European Taxonomy or the UN's sustainable development goals.
[5] See the June 14, 2021 Sustainability-Linked Bond Framework of TELUS and the latter's subsequent issue on June 21, 2021 of SLBs worth CAD$750,000,000 with a 10-year term and a coupon rate of 2.85% and the June 17, 2021 Sustainability-Linked Bond Framework of Enbridge and its subsequent issue on June 21, 2021 of SLBs worth US$1,500,000,000 with a 12-year term and a coupon rate of 2.50%.
[6] Known as "Use of Proceeds Bonds" or "UoP Bonds"
[7] See in this regard "Shooting for the Moon in a Hot Air Balloon? Measuring How Green Bonds Contribute to Scaling Up Investments in Green Projects", Discussion Paper May 2018, A 2° Investing Initiative report by Stan Dupre, Taylor Posey, Tina Wang and Tricia Jamison.
[8] Prospectus

By Bruno Caron

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.