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Analysing Sustainability-Linked Bonds

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This paper examines the novel phenomenon of sustainability-linked bonds (SLBs). This bond coupon is contingent on the issuer achieving a predetermined sustainability performance target which can mainly be classified as social, economic, or governance objectives. In this context, this paper seeks to explore the case study of India, examining, through a timeline analysis, some major milestones for the growth of SLBs in India. The Paper highlights that the potential of SLBs to promote issuers' climate transitions crucially depends on a common understanding of eligible economic activities and material performance indicators, the use of science-based targets as best practice, the ability of borrowers to dispel concerns about greenwashing risk, and bond characteristics that set meaningful incentives for issuers to improve their carbon performance. Finally, the paper also calls attention to the previous growth of SLBs and their expected progress in the next few years. The paper concludes by telling us the reforms that are needed in the sector and ways of improving this device to ultimately increase sustainability.

Keywords: ESG, sustainability-linked bonds, India's SLB, greenwashing.

INTRODUCTION

'Sustainability' means the ability to maintain something at the same level. In environmental terms, it would mean the ability to avoid the depletion of resources, to maintain enough resources for the younger generation, and looking at the larger picture, it means maintaining an ecological balance. Today, the concept of sustainability is important, and thus there is a need to

develop instruments to promote sustainability, one of which is the new theory of sustainable bonds.

Sustainability Linked Bonds (*hereinafter 'SLB'*) characteristics vary depending on whether one has achieved environmental, social, or governance (ESG) objectives.¹ A sustainability-linked bond (SLB) is a borrowing instrument where financial and structural characteristics are based on whether the issuer achieves sustainability or ESG metrics within a given timeframe.² In case one does not meet their climate goals or objectives, then the interest of investors in the coupon also increases, meaning one has to shell out more money from their pockets as a penalty for not meeting the target as decided earlier. The concept of SLB is extremely clever and it is a medium for actually implementing what one has thought. It does not stop at only developing an emotional conscience but helps in actually working towards those values. It helps people be responsible for their beliefs about reducing harm to the environment.

SLB TARGETS

ESG Objectives: ESG objectives are any environmental, social, or governance objective that the issuer decides to fulfill for the achievement of targets set by the SLBs. These objectives are the ones that the corporation works towards, and they underline the broader vision that the issuer has. Some ESG targets are reducing business greenhouse gas emissions, increasing workplace diversity, investing in sustainable energy, providing transparent financial practices, and so on. Such goals also relate to the overall business and ethical standards that the issuer has decided to maintain in the long run.

SLB Principles: SLB targets mainly climate objectives, the failure of which leads to an increase in the coupon rate. The SLBs are measured through Key Performance Indicators (KPIs) and assessed through Sustainability Performance Targets (SPT). The International Capital Market

¹ 'Sustainability-Linked Bond Principles Voluntary Process Guidelines June 2020' (ICMA, June 2020) <<https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/June-2020/Sustainability-Linked-Bond-Principles-June-2020-171120.pdf>> accessed 28 July 2023

² 'What are sustainability linked bonds and how can they support the net-zero transition?' (World Economic Forum, 11 November 2022) <<https://www.weforum.org/agenda/2022/11/cop27-sustainability-linked-bonds-net-zero-transition>> accessed 28 July 2023

Association has published the Sustainability Linked Bond Principles having 5 components³ as mentioned hereunder –

- Selection of Key Performance Indicators (KPIs);
- Calibration of Sustainability Performance Targets (SPTs);
- Bond Characteristics;
- Reporting;
- Verification.

The KPIs should relate to the core business and sustainability objectives of the company and should address the relevant ESG challenges. These indicators should be relevant to the overall strategy be measurable and verifiable and be able to be benchmarked. Indicators should be chosen based on whether they can correctly and practically be used as targets. Issuers are encouraged to select targets that they have already included in their statements or business strategies earlier so that it is measurable and can be easily quantified and checked to see whether the effort of the issuer is getting materialized towards achieving those ESG objectives. The KPIs should mention the scope, the calculation methodology, and the general industry standard.

SPTs are determined as per KPIs and there can be multiple SPTs per KPI. The SPTs indicate the level of ambition that the issuer has. They should represent a material improvement and should go beyond the 'business as usual trajectory, should be measurable and be able to be compared, be consistent with the overall strategy, and should also indicate a timeline⁴. The SPTs should relate to the issuer's performance over some time, and the performance of the issuer's peers and should also be about the current happenings and goals about the scientific principles and what has to be achieved. For example, the issuer has to keep in mind the target that the country or the world wants to achieve, such as limiting global warming to well below 2, preferably 1.5 degrees Celsius, compared to pre-industrial levels by 2050. The goals set by the governments, global bodies, and agreements entered into with other countries by the governments should be kept in mind while determining the SPTs.

³ Sustainability-Linked Bond Principles Voluntary Process Guidelines June 2020 (n 1)

⁴ *Ibid*

The issuer should disclose the timeline for target achievement, the baseline or reference point, how such an SPT is to be achieved, and any factors that are out of the issuer's direct control and may affect the performance and achievement of SPTs. The issuer can also assign an outside agency to check its progress against the timelines and goals set so that there is no prejudice in case of an employee of the issuer conducting the same examination. The external reviewers can check the ambition set by the company, what is practically and realistically possible, whether the benchmarks set can be met, the method of measurement of achievement, and so on, to judge the correct position the company is in in terms of realizing its ESG goals. In case no external help is taken, the issuer should develop its standard to ensure that they are on track for the achievement of its ESG goals, taking into account the various internal processes that may be required to judge achievement and the ability of the staff of the issuer.

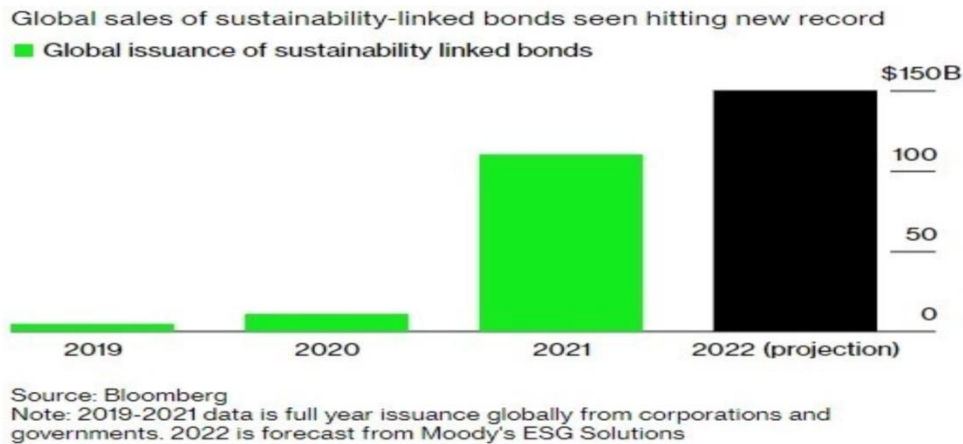
The conceptual basis of an SLB depends on the bond characteristics, which change with the non-achievement of ESG goals. The issuer should take into account exceptional events, including changes in the regulatory environment, that could impact the calculation of KPIs and SPTs. Issuers should also publish and keep readily available data on the performance of KPIs, the performance against the SPTs, or any other information to enable investors to check the progress and ensure compliance. Some examples of disclosures that the issuers should make are the rationale of SLB, description, and definition of KPIs and SPTs, calculation methodologies, the process of review, the verification and assurance report, and so on.

Issuers should also seek external verification of their performance, which ensures that there is a second level of check. An auditor or an environmental consultant can review the same, and the verification should be published to ensure that investors know and the credibility of the issuer is maintained and reinforced. This post-issuance verification is as necessary as issuance verification and helps strengthen integrity and reliability.

GROWTH TRAJECTORY OF SLBs

Magnitude and Reasons for Growth of SLBs: *SLBs grew at an exponential rate in the year 2020.*⁵

They offer several advantages over green or social bonds. The proceeds of green bonds can only be used for those specific green objectives whereas the proceeds from SLPs can be used for any corporate activity. Another disadvantage of green bonds is that it requires heavy capital expenditure on renewable energy, green buildings, etc. and thus it makes it difficult for issuers sometimes to issue those bonds. *The reasons above sparked a boom in the SLB market in the year 2020 and the same is represented via the image below-*



(image source⁶)

What is greenwashing and why is it a risk?: *Greenwashing is defined as when a company pretends to be environmentally conscious for marketing purposes only or to show the same to potential investors or clients to gain their trust, but in reality, it isn't making any notable progress or meeting any substantial green targets.*⁷ Because an issuer can define his own goal or his ESGs there is a good scope of manipulation of goals to represent that one has bigger goals but in reality, they must be reaping lesser results and enabling lesser impact on the environment. Investors also take advantage of the reputation of the said bonds because it helps them take advantage of the fame of the bonds without making any effort to push the investors to set more challenging and demanding goals.

⁵ What are sustainability linked bonds and how can they support the net-zero transition? (n 2)

⁶ *Ibid*

⁷ *Ibid*

WHAT REFORMS ARE NEEDED?

The market for SLBs needs reforms that can help improve the ESG targets overall. The market needs a scheme regarding the use of funds, which ensures that funds are used for green initiatives. Currently, funds can be used for any corporate objectives, unlike green bonds where funds can only be used for green objectives as specified earlier. KPIs also need to be monitored to check whether they are making any meaningful climate impact. They should be made keeping in mind the desired outcome and ensuring that the objectives set are logical and capable of making a change and achieving higher targets.

Increased transparency regarding agreements and more disclosures would ensure that compliance is maintained, as there is more public pressure to ensure that good ESG targets are set and the same is achieved. Public pressure and reputation help kindle compliance against these ESG targets and give meaning to the concept of sustainability-linked bonds.

INDIA'S SLBs

India witnessed its first issue of a Sustainability-Linked Bond ('SLB') by UltraTech Cement. Ultratech Cement, India's largest producer of grey cement, white cement, and ready mix concrete, has successfully raised US \$400 million in the form of sustainability-linked bonds.⁸

Under a sustainability Performance target, the company aims to reduce 22% of carbon emissions for every ton of cementitious material it produces by March 31, 2030, from the level of March 2017. Failure to do so would invite a penalty on the USD 400 million issuances by increasing the bond coupon rate from 2.80% to 3.55% per annum.⁹ The listing is a reaffirmation of Ultra-tech's commitment to grow its business sustainably. The Company's sustainability-linked fundraising exercise received an overwhelming response, with an over-subscription of more than seven times, a first in the Indian economy. The Company intends to use the proceeds from these bonds to refinance existing rupee-denominated debt, ongoing capital expenditure requirements, and general corporate purposes. Achieving vague goals requires intensive capital funding. The bond

⁸ 'SUSTAINABILITY' (UltraTech Cement) <<https://www.ultratechcement.com/about-us/sustainability/sustainability>> accessed 28 July 2023

⁹ *Ibid*

market allows companies to raise capital at fixed rates, which can be tapped into whenever needed.

Adani Electricity Mumbai issued a \$300-million 10-year sustainability-linked bond. The sustainability performance target here is linked to the company achieving at least 60% renewable power in its procurement mix by the end of fiscal 2027. A reduction in greenhouse gas emissions by 60% by the end of fiscal 2029, compared to FY19 is another target. If Adani Electricity fails to achieve these it would lead to a 0.15% increase in the rate of interest every year.¹⁰

A company issuing SLBs targets future improvements in predetermined key performance indicators (KPIs) and sustainability performance targets (SPTs). The KPIs are derived from the United Nations' 17 Sustainable Development Goals (for example, to increase the amount of renewable energy used by a company). Around the world, the issuance of sustainable bonds (SLBs) has been growing since 2019 but in India, they were used to raise debt for the first time in the year 2021.¹¹

CONCLUSION

SLBs and green bonds both aim to contribute to environmental sustainability through financing but they approach it in slightly different ways. Green bonds directly finance specific environmentally friendly projects, while SLBs are focused on achieving sustainability objectives through pre-defined KPIs and SPTs. However, SLBs provide more opportunities for companies to finance sustainable practices in a more general sense, rather than a specific green project. Although the SLB market is still developing, it has great potential to grow and become a significant player in the sustainable finance universe. The growth of the SLB market will also expand the sustainable finance market and contribute to a more sustainable world.

¹⁰ 'Adani Transmission's Entity Adani Electricity Mumbai Is First In India's Energy Sector To Issue Sustainability Linked Bonds' (*Adani Electricity*, 24 July 2021) <<https://www.adanitransmission.com/newsroom/media-releases/Adani-Electricity-Mumbai-is-First-in-Indias-Energy-Sector-to-Issue-Sustainability-Linked-Bonds>> accessed 03 August 2023

¹¹ Sustainability-Linked Bond Principles Voluntary Process Guidelines June 2020 (n 1)

The introduction of SLB has confirmed the need for a bond instrument linked to an issuer's sustainability strategy and ambitious, credible targets, including those connected to climate transition. SLBs add to the existing options in ESG Finance, such as green, blue, social, and sustainable bonds, diversifying both issuer and investor choice and promoting sustainability across all industries. A greater variety of issuers can participate in the sustainable finance market because SLBs focus on sustainable outcomes rather than solely on sustainable expenditure. As more issuers enter the SLB market, more issuers will set and achieve their SPTs, promoting greater ambition among new issuers to push for meaningful targets. Overall, SLBs are a valuable addition to the suite of ESG finance products, offering a practical tool to encourage an issuer's sustainability agenda and attract outcome-focused investors.