

Sustainability-Linked Bonds: alternative steps

Josephine Richardson (*)

The Sustainability-Linked Bond (SLB) market has brought an innovation to the thematic bond market by allowing the proceeds to be used for general corporate purposes. The issuer is penalised (or rewarded) for meeting (or not meeting) its Sustainability Performance Targets (SPTs).¹

The most common structure involves an issuer paying an increased coupon payment to investors, a 'step-up',² when a target is missed. One criticism of this structure is a perceived lack of alignment between investors and issuers on sustainability objectives, with the investor seemingly benefiting from an issuer missing its targets.³

While we consider that the coupon pay-out should be viewed as a hedge for investors rather than a bonus payment,⁴ we note that the market is responding to this concern by developing alternative structures, where the step-up proceeds are used either as a donation to charity, or to purchase carbon credits or renewable attribution certificates. While these may have identical financial outcomes for the issuer, the SLB will be a different product for the investor.

In this note we analyse some example SLBs using these new structures, to evaluate their benefits for investors, issuers, and the broader market.

- **All SLBs have the potential to achieve lower financing spreads for issuers.** To maximise the benefit, targets need to be ambitious, and penalty payments must have value to investors.⁵
- **SLBs that pay a charitable donation in lieu of an interest penalty risk lower alignment with investor impact objectives.** Our case study highlights a lack of a clear link between the impact of the donation and the missed SPT. **Better communication of donation outcomes would strengthen this structure.**
- **SLBs that buy either carbon offsets or renewable energy certificates have the potential to offer investors more certain environmental outcomes.** Analysing three case studies suggests that the purchased credits are not commensurate with the missed targets, and often materially lower. **If the penalties were better calibrated, this structure could provide more value for investors, which could be reflected in pricing.**
- **Islamic finance, sustainability-linked hybrids, and bonds accounted for as 'hold-to-maturity'** are three scenarios where innovations have **potential to widen the investor base**, and this can support growth of the instrument class.

¹ SLBs sometimes have benefits for issuers if targets are achieved, but we focus on structures with a penalty.

² For details of the first bond paying a step-up please see "[One small step for Orlen, one giant leap for the SLB market](#)", AFII, 29 Nov 2022.

³ "[Sustainability bond market stumbles as investors get picky](#)", FT, 14 Feb 2023.

⁴ Please see "[Understanding dynamics between sustainable and traditional debt](#)", AFII, 26 Jan 2023.

⁵ For more details please see "[An option pricing approach for sustainability-lined bonds](#)", AFII, 8 Nov 2022s.

Traditional structures: option value

An SLB, when compared to a traditional green bond structure, has a fundamental route to potentially offering lower funding spreads for issuers. When an investor has a chance of receiving a benefit (traditionally an increased coupon) in the future, under a risk-neutral framework, they should accept a lower spread today.

The two factors to maximise this value are the probability of receiving the benefit (i.e., an ambitious target), and the value derived by the investor of the benefit. The SLB market is innovating new methods of delivering this value to investors and so, in this note, we consider the investor value of some of these new structures.

Receiving an increased coupon will always maximise the value to investors; they can choose to make a donation or buy offsets themselves if these were perfectly aligned with their impact objectives. All else being equal, a structure paying a coupon step-up will maximise the option value and offer the lowest funding spread to issuers.

Nevertheless, we are aware of new structures in the market, and want to dig deeper to analyse how they compare to traditional structures, where they are complementary, and how they may contribute to ongoing market development.

Charitable donation

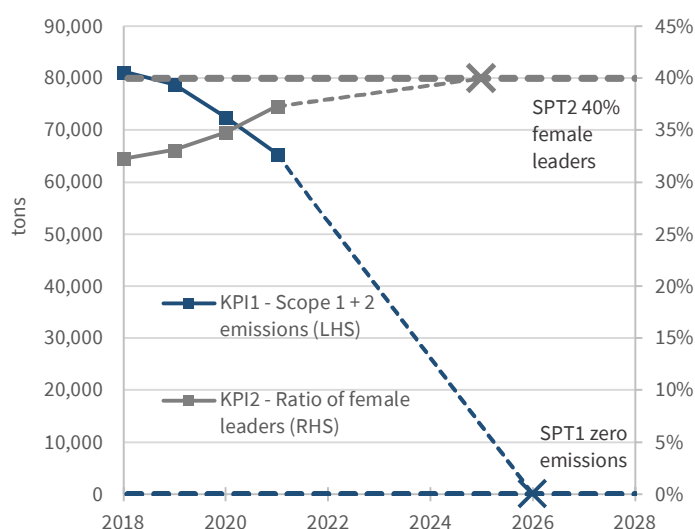
It is reported that 1.71%⁶ (estimated as \$2.1bn)⁷ of SLBs issued to Feb 2022 were structured to pay an equivalent charitable donation rather than a coupon pay-out, if the issuer misses its SPT. While this is a small percentage of the overall market, we do see growth in certain regions, such as Japan. We cover an example below, to understand the potential benefits or challenges of such a product.

Case study: SHISEI JPY0.45% 27s

In December 2022, Shiseido, the Japanese cosmetic company, issued JPY20bn of a 10y SLB (ISIN JP335160ANC1) where charity donations would be made in the event of missing either of two SPTs. The coupon paid was 0.45%, and the charitable donation would be 0.05% of notional for each missed SPT.

KPI1 is Scope 1 + 2 emissions, with a target of carbon neutrality by 2026, including emissions credits purchase.⁸

Figure 1. Shiseido historic KPIs and SPTs. Source, Shiseido.



⁶ “[The Economics of Sustainability Linked Bonds](#)”, ECGI, Sep 2022.

⁷ Estimated using 1.71% from reference note and all SLBs issued before 28 Feb 2022 sourced from Bloomberg.

⁸ The addition of emissions credits would seem to make it virtually guaranteed to achieve the target.

Reported figures for 2021 show emissions of 65,481t.⁹

KPI2 is the ratio of female leaders, with a target of 40%. Reported figures for 1 Jan 2022 show 37.3%.⁹

If either target is missed, “[there will be a] donation [...] to a public interest incorporated association, public interest incorporated foundation or international organisation working for environmental preservation, empowerment of women or gender equality.”⁹

While the penalty, 0.05% or 0.1%, may seem small, the bond has a very low standard coupon, with 4.5% of total cumulative interest. As a percentage of total cumulative interest, this would be equivalent to paying 0.25% in the final 20three years of a 10y bond with coupon 3.375%. This seems inline, or even slightly higher, than current SLB structures.

Observations

While the broad area of charitable donation is aligned with the SLB’s KPIs, there is no direct link between donation outcomes and sustainability performance. Compared to the specific objectives of the SLB, the outcomes of such a vague charitable donation do not seem aligned with investor objectives. A more compelling approach would be to disclose which charity will receive the penalty payment and what outcomes the donation will achieve. To strengthen the structure, the issuer could also commit to remediation plans to achieve the target at a later point in time.

Sustainable finance promotes using the scale of investment capital to achieve objectives that are not possible through philanthropy alone. We query the impact of having a relatively small charitable donation to atone for investment not achieving the desired sustainability outcome.

Purchased environmental results

i. Carbon offset purchases

Carbon credits are market-based instruments allowing one credit (equivalent to one metric ton of CO₂ or equivalent GHG reduced, avoided or removed in approved projects) to be cancelled in the voluntary or compliance carbon offset market by companies that cannot reduce their own emissions.¹⁰ While there have been questions raised on which type of projects can generate credible carbon credits,¹¹ the market allows companies to reduce their own emissions and claim lower net carbon emissions after the cancellation of purchased carbon credits. The price of carbon credit has fluctuated in the recent past.¹²

It is reported that 1.71% of SLBs issued to Feb 2022 were structured to include purchase of carbon offsets⁶ (the same proportion as for a charitable donation, five bonds in the analysis), i.e., still a relatively low but potentially growing percentage.

⁹ “[Sustainability-Linked Bond Framework 2022](#)”, Shiseido, accessed 25 Apr 2023.

¹⁰ “[Voluntary carbon markets: how they work, how they’re priced and who’s involved](#)”, S&P, 10 Jun 2021.

¹¹ “[Fear of greenwashing is ‘main barrier’ to corporate use of carbon credits](#)”, Responsible Investor, 16 Jan 2023.

¹² “[Global carbon pricing generates record \\$84 billion in revenue](#)”, World Bank, 24 May 2022.

Case study: KAJIMA JPY0.554% 28s

In March 2023, Kajima Corporation, a Japanese construction company, issued an JPY10bn SLB with a maturity of 5 years (ISIN JP321020AP39) where either charity donations would be made, or carbon credits would be purchased in the event of missing an SPT.

The KPIs referenced are its Scope 1 + 2 emissions and its Scope 3 GHG emissions, both with reduction targets in 2030 (although the SLB will observe an interim target at the end of 2027) compared to a baseline in 2021. A third KPI is the CDP Climate Change Score, with a target to remain scored at a Leadership Level. Historic levels for the first two KPIs are shown in Figure 2.¹³

Kajima has already issued other thematic bonds, including a JPY10bn 5-year 0.11% green bond in February 2020 and a JPY10bn 5-year 0.25% sustainability bond in March 2022,^{14,15} but this is its first SLB. Most of Kajima's emissions are released through its construction activities, for which construction material comes from concrete and steel products. Construction is considered a 'hard to abate' sector, and so using an SLB to offer a transparent commitment to decarbonising should be viewed very positively.

The coupon paid was 0.554% for five years, and the penalty is a maximum of 0.0625% of the notional, which is a slightly lower percentage of coupon than the SHISEI example above.

While this structure allows for charitable donation as an option, we have covered that idea above, and so explore further the impact of carbon credit purchases. (We note that having this choice in the structure weakens the environmental case for investors, as there is no guarantee that offsets would be purchased in the event of a missed target).

Figure 2. Kajima historic KPIs and SPTs. Source: AFII, Kajima.

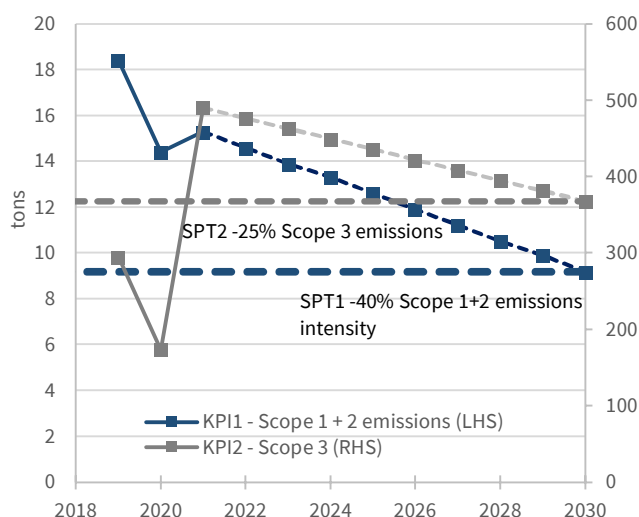


Table 1. Kajima's carbon credit purchase on a JPY 10bn notional. Source: AFII, Kajima.

KPI description	SPT	Penalty	Penalty (JPY)	Carbon offset (t)
Scope 1+2 intensity	4.4% annually to 2030.	0.025%	2,500,000	3,759
Scope 3 intensity	2.8% annually year to 2030.	0.025%	2,500,000	3,759
CDP Score	Leadership Level	0.0125%	1,250,000	1,880
			Total:	9,398

Using an average price of \$5/ton for carbon credits, we can convert this into the total amount of carbon credits to be purchased, which is equivalent to 9,398 tons of CO₂ (see Table 1).

¹³ "Second Party Option; Kajima SLB", R&I, 14 Feb 2023.

¹⁴ "Kajima Green Bonds", Kajima, accessed on 4 May 2023.

¹⁵ "Kajima Sustainability Bonds", Kajima, accessed on 4 May 2023.

Kajima Group's Scope 1 + 2 emissions were 191,000 tons and, for Scope 3, 6,750,000 tons on a non-consolidated basis.¹⁶ As such, the penalty on the SLB is equivalent to an offset corresponding to 5% of the firm's annual Scope 1 + 2 emissions.

Table 2 compares the emissions reduction from Kajima's targets with the potentially purchased offsets. The proposed purchased offsets are very small compared to the emission reduction expected at the initiation of the transaction. The outcome would be negligible and, as such, not credible.

This goes against the Sustainability-Linked Bond Principles, which aim for a high level of ambition.¹⁷

In addition, the type of carbon offsets that Kajima will be purchasing are: "J-credits that its customers have received based on the environmental value created by the work contracted to Kajima".¹⁸ This seems at odds with the ambitions of investors. There is also a potential conflict of interest in using the penalty payment to incentivise customers to contract with Kajima.

Case study: TOYOBO JPY 0.634% 28s

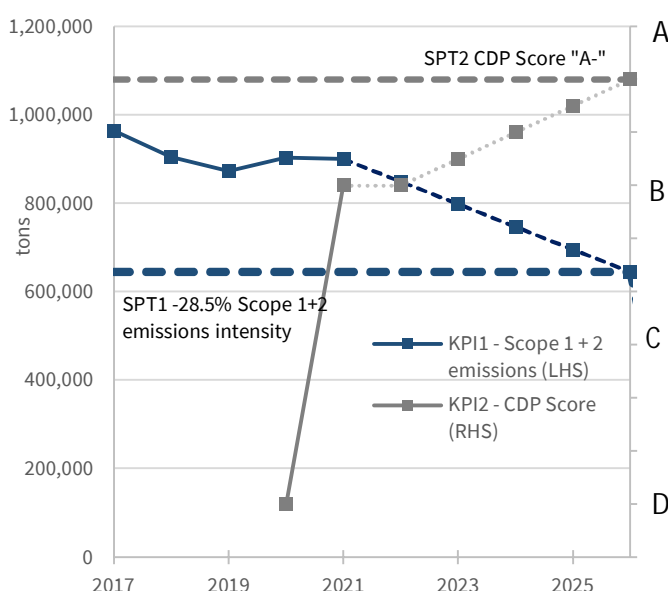
In March 2022, Toyobo, the Japanese retailer, issued a JPY20bn 5-year SLB (ISIN JP361980AP33) where charity donations would be made, or carbon credits purchased, in the event of missing an SPT. The KPIs referenced were Scope 1 + 2 GHG emissions to be reduced by 2027 compared to a baseline of 2021. This bond also referenced retaining a CDP Climate Change Score higher than A-.¹⁹ Historical values of the KPIs are shown in Figure 3.

Toyobo has already issued one thematic bond in the form of a JPY10bn 7-year 0.25% social bond in December 2021.²⁰

Table 2. Comparison of Kajima emissions reductions between SLB target and purchased offsets. Source: AFII, Kajima.

Year	Target Scope 1+2 Emissions	Target Scope 3 Emissions	Emissions reduction If target is achieved	Emission reduction from purchased offsets
2021	191,000	6,750,000		
2022	182,511	6,562,500	-195,989	
2023	174,022	6,375,000	-391,978	
2024	165,533	6,187,500	-587,967	
2025	157,044	6,000,000	-783,956	
2026	148,556	5,812,500	-979,944	
2027	140,067	5,625,000	-1,175,933	-9,398
Total:			-4,115,767	-9,398

Figure 3. Toyobo historic KPIs and SPTs. Source: AFII, Toyobo.



¹⁶ On a consolidated basis: Scope 1 + 2 emissions - 420,000 tons / Scope 3 - 10,330,000 tons. "[Sustainability Report 2022](#)", Kajima, accessed 4 May 2023.

¹⁷ "[Sustainability-Linked Bond Principles \(SLBP\)](#)", ICMA, accessed on 4 May 2023.

¹⁸ "[Kajima Second party opinion](#)", R&I, 14 Feb 2023.

¹⁹ "[Note of issuance of Sustainability-Linked Bonds](#)", Toyobo, 10 Feb 2023.

²⁰ "[Social Bonds](#)", Toyobo, accessed on 4 May 2023.

Table 4. Toyobo's carbon credit purchase on JPY20bn notional. Source: AFII, Toyobo.

KPI description	SPT	Penalty	JPY	Carbon offset (t)
Scope 1+2 intensity	28.5% by 2027	0.07%	14,000,000	21,053
CDP Score	A- or higher	0.03%	6,000,000	9,023
			Total:	30,075

The coupon paid was 0.634% and the penalty 0.10% of the notional. This penalty will be used to buy carbon offsets, unless they are unable to due to the occurrence of an inevitable matter,²¹ in which case it will donate to qualified charities.

Table 4 shows the calculation of carbon credits that can be purchased, using a price of \$5/ton. The total amount of carbon credits to be purchased are equivalent to 30,075 tons of CO₂. This compares with 900,000 tons of yearly GHG emissions, as per Toyobo's own disclosure.²² As such, the penalty on the SLB is equivalent to an offset corresponding to 3.3% of the firm's annual emissions.

Table 3 compares the emissions coming from the potential offset purchases with the reductions from the targets. The offsets are less than 10% of the emissions reductions coming from successfully achieving the targets of the SLB.

Table 3. Comparison of Toyobo emissions reductions between SLB target and purchased offsets. Source: AFII, Toyobo.

Year	Scope 1+2 Emissions	Emissions reduction If target is achieved	Emission reduction from purchased offsets
2021	902,000		
2022	900,000	-2,000	
2023	872,973	-29,027	
2024	845,946	-56,054	
2025	818,919	-83,081	
2026	791,892	-110,108	
2027	764,865	-137,135	-30,075
Total:		-417,405	-30,075

ii. Renewable energy certificates

A Renewable Energy Certificate (REC) is a tradeable instrument issued for any one megawatt-hour of electricity generated from renewable energy sources and transferred to the grid.²³ It is sometimes called an Energy Attribute Certificate (EAC).²⁴

There are ongoing questions on the usage of RECs, in that they can create selective emissions reporting.²⁵ Nevertheless, as with carbon offsets, they produce additional financial benefits for producers of renewable energy, and so they are important instruments in encouraging more investment in renewable energy production.

²¹ Example given is changes to provisions of the trading system.

²² "[Toyobo Group revises upward reduction target of greenhouse gas emissions](#)", Toyobo, accessed on 4 May 2023.

²³ "[Renewable energy certificates \(RECs\)](#)", EPA, accessed 4 May 2023.

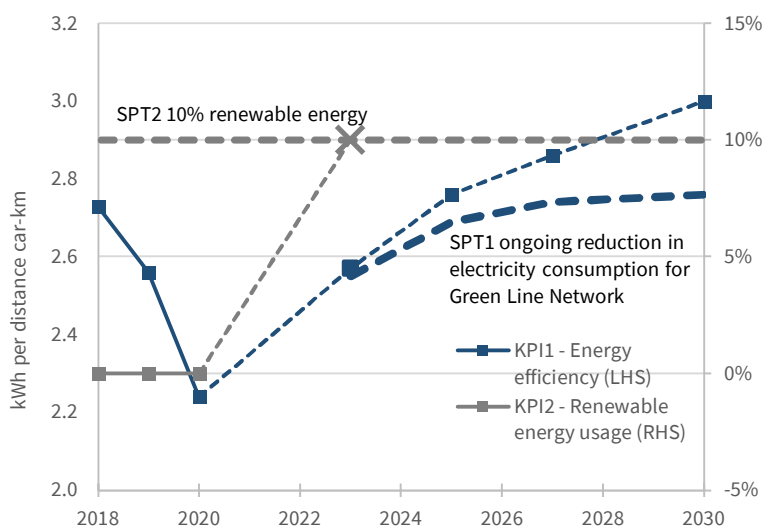
²⁴ "[What is an Energy Attribute Certificate – EAC](#)", Ecohz, accessed on 4 May 2023.

²⁵ Scope 2 emissions can be reported using either a "location-based" or "market-based" method.²⁵ The location-based method uses an average from grid production, while market-based allows a user to buy rights to renewable production. Where alternative methods are chosen for different users, this would lead to total Scope 2 emissions not equalling total usage when considering the whole grid. For more details please see "[Scope 3: Omission impossible](#)", LGIM, 24 Apr 2023.

Case study: BTSTB THB multi-tranche SLB

In November 2022, Thailand's BTS Group issued a THB20bn multi-tranche SLB, with a retail portion of THB13bn giving points under its loyalty scheme to commuters, and an institutional tranche of THB7bn. The coupons range from 2.95% for the 2-year to 4.7% for the 10-year tranches, with a 4.5- and a 7.5-year tranche as well (ISIN TH0221A34B06, TH0221B37509, TH0221A3A507, TH0221A3CB04).²⁶ The bonds are reported to have achieved a 20-25bps savings against conventional bonds. It received the "ESG Bond of the Year" Awards 2022 from IFR Asia.²⁷

Figure 4. BTS historic KPIs and SPTs. Source: AFII, BTS Sustainability Linked Finance Framework.



The two SPTs under this SLB are i) SPT1: the improvement in energy efficiency in the Green Line network (an elevated metro rail line in Bangkok) by 8% from business-as-usual (BAU) within nine years or by 2031, and ii) the production or procurement of electricity from renewable energy sources of at least 10% each year of the total electricity used in the operation of the Green Line network.^{28,29}

The second SPT should be considered alongside the domestic background, where Thailand, as a country, currently consumes 16.5% of its total energy from renewable sources and aims to reach 30% by 2037.³⁰ The specific SPT represents a new process for BTS to purchase RECs, procure or generate new renewable energy directly.

BTS has issued other thematic bonds in the past, including a green bond and a SLB.³¹ The first SLB issued in 2020 had a SPT as the total electricity consumption per car-km for the Green Line network, aiming for a reduction from BAU of 0.91% in FY2023/24, growing to 8% by FY2030/31, relative to a baseline measured in FY2018/19.

The new SLB does not include a coupon adjustment. If either SPT is missed, BTS will buy additional REC for the length of the bond.³²

²⁶ "ESG Bond: BTS Group's Bt20bn sustainability-linked bond", IFR, 10 Feb 2023.

²⁷ "BTS Group affirmed as sustainability leader with ESG Bond of the Year win at IFR Asia Awards 2022 in Singapore", BTS Group, 28 Apr 2023.

²⁸ "Sustainability-linked bond framework," BTS Group, Mar 2022.

²⁹ "BTS Group sets coupon range of 2.80%-4.70% per annum for its 4 tranches of SLB", BTS Group, 4 Nov 2022.

³⁰ "Thailand – Renewable Energy", International Trade Association, accessed on 4 May 2023.

³¹ "Green Bond", BTS, accessed on 4 May 2023.

³² "Thailand's first sustainability-linked bond for public offering", BTS Group, 20 Oct 2022.

Table 5 compares the MWh coming from renewable sources if targets are achieved compared to penalty RECs purchased. Prices of RECs have been volatile and vary by region; for this illustration we have used an average price of \$5/MWh.³³

Table 5. Comparison of BTS renewables energy usage SLB target and purchased RECs. Source: AFII, BTS. Annual energy usage of Green Line interpreted from graph in Sustainability-Lined Finance Framework.

ISIN	TH0221A34B06	TH0221B37509	TH0221A3A507	TH0221A3CB04
Maturity	2024	2027	2030	2032
Notional (THB)	4,091,200,000	4,951,800,000	1,716,800,000	2,240,200,000
Notional (USD)	120,944,054	146,385,112	50,752,042	66,224,792
Maximum coupon penalty	0.10%	0.10%	0.10%	0.10%
Penalty (USD)	120,944	146,385	50,752	66,225
MWh purchased	12,094	14,639	5,075	6,622

Estimated annual usage of Green Line (MWh)	Number of years	Total energy used (MWh)	Total REC bought (MWh)	REC proportion
158,000	10	1,580,000	76,861	4.9%

Observations

It is clearly important to assess the magnitude of the purchased impact in these structures; the examples we have considered have often delivered outcomes far smaller than the original targets. A stronger structure would include more significant environmental purchases, allowing the appropriate quantity of offsets or REC to be bought. This might cost more but that would better incentivise the issuer to achieve its targets.

From a structural point of view, purchasing carbon offsets, RECs or EACs where SLB targets are missed, creates effectively guaranteed environmental outcomes for investors. This can make such an SLB appear comparable to a green bond, where investment is made for known outcomes. However, the aim of SLBs is to raise capital to truly transition businesses and achieve organic sustainability improvements. Using carbon offsets, RECs or EACs will encourage overall investment in sustainability, but leaves the specific issuer's fundamental business unaffected. This may not necessarily be aligned with SLB investor objectives.

Investor structural considerations

So far, we have directly compared these new SLB structures to traditional step-up SLBs. Now we explore three alternative sources of investor demand, where traditional SLB structures may either be impossible or unattractive, which could attract new capital to the product.

i. Sukuk

Sukuk is the Arabic name for sharia-compliant bonds. Under Islamic law, interest payment is prohibited, and so sukuk instruments are typically structured as Special Purpose Vehicles (SPV),

³³ [“Record high certificates prices bring renewable energy buying in focus”](#), S&P Global, 1 Dec 2022.

representing ownership of real assets, so that sukuk holders can receive returns as a profit share or rent.³⁴

A natural extension is to consider a green sukuk, with proceeds typically ring-fenced for investments in renewable energy, which also addresses sharia concerns for protecting the environment. Despite recent growth of this product, it is reported there is significant unsatisfied demand.^{35,36}

While in theory, guidance on SLB sukuk doesn't preclude paying a coupon step-up,³⁷ we note that in the first SLB sukuk (as discussed below), an alternative step mechanism was chosen.

Case study: UNITYL \$2.394 25s

The first sustainability-linked sukuk (ISIN: XS2245508044) was issued by Etihad Airways in November 2020.³⁸ The KPI is emissions intensity of the entire fleet, with a target reduction of 17.8% by Dec 2024, measured against a 2017 baseline.

In the event of failing to achieve the targeted reduction, the issuer will purchase carbon offsets on an increasing scale depending on the extent to which the target is missed. We note that these carbon offset purchases are additional to any commitments already made under the Carbon Offset and Reduction Scheme for International Aviation (CORSIA), which commits airlines to offset total post-2020 absolute emissions.

The bond was only slightly oversubscribed, compared to reports of multiple oversubscriptions of green sukuk issuance in Malaysia and Indonesia,³⁸ but it did represent an innovation in the sukuk market as it was the first such issue in this market.

ii. Hybrids

Hybrid instruments are securities that possess elements of both debt and equity; bonds with specific elements bringing them closer to equity instruments are often considered hybrids.

Providing they fulfil relevant criteria, hybrid instruments are generally considered 50% equity instruments for accounting purposes on the part of the issuer, and therefore increase the equity ratio with a smaller impact on the level of debt. This can be especially attractive in sectors subject to regulation on minimum equity levels such as insurance and banking. They are also attractive in sectors that need to secure long-term funding for infrastructure projects, such as utilities and telecoms.

The equity treatment decision is controlled by rating agencies and is subject to review. Given hybrids pay significantly higher coupons to reflect both the usual subordination, and their perpetual nature, a reclassification can be very costly for issuers, as happened to Dong Energy immediately after issuance in 2013.³⁹ No guarantees of hybrid classification are given by rating agencies, and treatment is reviewed throughout the life of the instrument.

³⁴ "[Sukuk](#)", Wikipedia, accessed 4 May 2023.

³⁵ "[COP27: Islamic capital markets can take the lead](#)", Norton Rose Fulbright, Nov 2022.

³⁶ "[Green Sukuk](#)", Climate Bonds Initiative, accessed 4 May 2023.

³⁷ "[Sustainable Sukuk](#)", World Bank Group, Nov 2021.

³⁸ "[Etihad's \\$600 million sustainability-linked sukuk: the first of many things](#)", Natixis, 30 Nov 2020.

³⁹ "[Dong plans to keep things simple](#)", Global Capital Asia, 20 Sep 2013.

This potential reclassification incentivises issuers to be conservative in their structures, to have the most confidence in continued equity treatment.

Hybrids are typically perpetual bonds, with issuer calls after an initial ‘non-call’ period, which gives a minimum maturity for the security. Proximity and likelihood of calls are assessed to understand the permanence of the instrument, which is required for equity treatment. For example, in May 2017 S&P removed equity treatment from Veolia hybrid instruments after the CEO made a public statement around his intention to buy back the debt.⁴⁰

Step-up coupons are considered to impact the likelihood of a security being called, i.e., an issuer might call an instrument to avoid paying the step-up coupon. This is an identified limitation of non-hybrid SLBs, with guidance now given by ICMA that all step-ups should be paid prior to the bond being callable.⁴¹

In 2020 S&P published guidance that an increased interest cost would affect equity treatment, and this payment being made to a third party (i.e. a donation or offset purchase) would not affect that.⁴² The Japan Credit Rating Agency (JCR) have issued some guidance suggesting they will not interpret step-up coupons as influencing early-redemption probabilities, although more care may be needed when the changes in coupon are drastic.⁴³ This note refers to ‘contemplated’ issuance by Chugoku, although due to the private nature of loan financing, we have been unable to confirm the details of a sustainability-linked hybrid which may have been issued under this advice.

Even though only the magnitude of a penalty payment rather than the recipient (investors or offset purchases) should impact the perceived probability of being called, we have heard discussions that this is a structure being explored to facilitate issuance of SLB-hybrids, and we wait to see new structures as they develop.

Case study: ENELIM

Enel, the Italian utility, is the flagship issuer of SLBs.⁴⁴ Indeed, since its inaugural issuance in Sep 2019, all non-perpetual issuance has been using the SLB structure. Enel has made further press comments re-iterating its support of the product, coming from achieving a reduced funding cost.⁴⁵

Since the first SLB, Enel has issued €4.6bn in hybrids, with coupons between 1.375%-6.625%. Given the higher cost of this debt, it seems reasonable that Enel would explore a sustainability-linked product, if possible, to benefit from associated reduction in funding costs. We do not know why this is the case, but the fact that it has not, may be an example of the current challenges of issuing sustainability-linked hybrids using standard structures.

iii. Accounting treatment

Accounting guidance offers three potential classifications for debt securities, Held to Maturity (HTM), Available for Sale (AVS), and trading.

⁴⁰ “[Total’s hybrids equity credit under threat](#)”, Reuters, 13 Feb 2017.

⁴¹ “[ICMA cracks down on SLBs with new guidance on callables, materiality and KPIs](#)”, Responsible Investor, 28 Jun 2022.

⁴² “[Sustainable Finance: Equity Content And Sustainability-Linked Hybrids](#)”, S&P, 10 Feb 2020.

⁴³ “[Requirements for Equity Content for Sustainability-Linked Hybrid Financing](#)”, JCR, 5 Sep 2022.

⁴⁴ For a summary of issuance see “[Enel – A case study in transition finance using SLBs](#)”, AFII, 25 Jul 2022.

⁴⁵ “[New EU law increases companies’ risk of deforestation](#)”, FT Moral Money, 15 Feb 2023.

The classification is important as each has its own accounting treatment and related disclosure.⁴⁶ AVS, sometimes referred to as ‘fair-valued’, requires continuous re-valuation of the asset, which can create undesirable income volatility. HTM allows assets to be carried at par, unless impaired via a credit review process, which does not depend on market prices.

SLB structures can present complications for HTM classifications, due to the step-up coupon. It may be possible to treat the step-up coupon as an embedded derivative, and be accounted for separately, or the coupon may be sufficiently complicated to require re-classification of the entire asset.⁴⁷

Accounting treatment of assets can vary by investor and depends on local regulation and individual interpretation of guidance. There can be no SLB structure that guarantees a certain classification. We have heard from market participants that some HTM investors are unwilling to buy SLBs due to complications around the accounting treatment. It is reasonable to believe that effectively removing the coupon step, by converting it into an exogenous payment to a charity or carbon offset provider, would simplify the situation.

Observations

SLBs are still a relatively new product, and the investor base is growing. We have presented three ways in which alternative step structures may have the potential to widen the group of interested investors, and so could be supportive of overall growth in the product.

Conclusions

The SLB market is developing to consider alternative structures, where payments on missing SPTs take forms other than a coupon step-up.

For issuers to benefit from reduced funding spread, they need to maximise the option value of the structure, and this requires the penalty to have highest direct value to investors. A coupon step-up will maximise this, as investors have full choice in how to direct this benefit.

Some SLBs make a charitable donation. There are legitimate concerns around the lack of restrictions on eligible charities, and a stronger structure would be one where more information was given in advance.

Another structure is where environmental outcomes are bought with the penalty, either carbon offsets, renewable energy certification or energy attribution certificates. This has the potential to give investors a specific, quantifiable and reliable environmental outcome. In our examples, the purchases are not calibrated sufficiently well to establish the direct link between anticipated investment outcomes and missed targets. Clearer alignment between targeted objectives and performance outcomes would promote a more credible and enduring SLB structure.

We have also discussed three potential alternative scenarios where use of these alternative structures may widen investor bases, attracting capital which is otherwise unable or unwilling to invest in SLBs.

⁴⁶ “[3.3 Classification of debt securities](#)”, PWC, accessed 4 May 2023.

⁴⁷ See 13.11.11.1 of “[Life Sciences Industry Accounting Guide](#)”, Deloitte, Mar 2023.

These structures can be a way to make SLBs aligned with the principles of Islamic finance. They are a potential way to allow hybrid issuance to be sustainability-linked. They may also make it easier for investors to classify SLBs as HTM instruments for accountancy purposes.

For this reason, despite concerns that these alternative steps are not as impactful as paid coupon-steps, we are supportive of these structures. They have the potential to enable more capital to invest in SLBs and grow the market of a product that has the power to help accelerate the climate transition.

IMPORTANT DISCLAIMER:

This report is for information and educational purposes only. The Anthropocene Fixed Income Institute ('AFII') does not provide tax, legal, investment or accounting advice. This report is not intended to provide, and should not be relied on for, tax, legal, investment or accounting advice. Nothing in this report is intended as investment advice, as an offer or solicitation of an offer to buy or sell, or as a recommendation, endorsement, or sponsorship of any security, company, or fund. AFII is not responsible for any investment decision made by you. You are responsible for your own investment research and investment decisions. This report is not meant as a general guide to investing, nor as a source of any specific investment recommendation. Unless attributed to others, any opinions expressed are our current opinions only. Certain information presented may have been provided by third parties. AFII believes that such third-party information is reliable, and has checked public records to verify it wherever possible, but does not guarantee its accuracy, timeliness or completeness; and it is subject to change without notice.

Any reference to a company's creditworthiness or likelihood of positive or negative performance in the current or future market is purely observational and should not be taken as a recommendation or endorsement or critique of such company or security.

The Anthropocene Fixed Income Institute is a non-profit organization "to monitor, advocate for and influence the impact of the fixed income and bond markets in the age of human induced climate change." For more information about the Institute, please visit www.anthropocenefii.org or follow us using the hashtag #anthropocenefii.

AFII is not in any way associated with, nor are any of its directors, employees or advisors, any of the companies it references in its materials or reports and is not receiving compensation or consideration of any nature for its observations and/or insights.

