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SGX Group Shares Views on Addressing Concerns about Sustainability-linked Bonds with Enhanced Targets and Structure

Introduction

The Singapore Exchange ("**SGX Group**") identifies green, social and sustainability ("**GSS**") bonds listed on the SGX-ST that meet recognised standards as Sustainable Fixed Income instruments. However, SGX Group has not recognised a different class of sustainable debt, namely sustainability-linked bonds ("**SLBs**"), and this initiative is under review.

SLBs are a relatively new fund-raising instrument for issuers.[1] The issuer of an SLB ("**SLB issuer**") is required to set certain sustainability performance targets ("**SPTs**") which in turn affect the characteristics of the bond such as the coupon rate. The SLB issuer, in return, has unfettered use of the funds raised, unlike in the case of GSS bonds which proceeds can only be used for eligible green projects.

In its media release on "Addressing concern about sustainability-linked bonds with enhanced targets and structure" (27 September 2023), SGX Group observed that notwithstanding the flexibility in the use of funds, SLBs are not commonly issued, and one of the main reasons is the concern about credibility from fears of greenwashing. Given the pressing global need for financial support by companies and countries in the transition to Net Zero, particularly in Asia, there is a persuasive case to consider the use of SLBs as a form of transition finance, particularly for issuers operating in brown or hard-to-abate sectors. In this regard, SGX Group has addressed two key aspects for the broader adoption of SLBs: (1) credibility of the SPTs; and (2) the product structure. This Update outlines SGX Group's views on these two aspects, along with our comments.

Credible Sustainability Performance Targets (SPTs)

There has been criticism of some SLB issuers who have set SPTs "that are not material to their business, do not cover all material scopes of their carbon footprint, or are insufficiently ambitious". SGX Group suggested that SLB standards include a requirement that SPTs be developed by third-party experts using credible benchmarks, rather than by the issuers, such that market needs can be met. Borrowing from two leading market standards for SLBs, SGX Group further illustrated how credible sustainability performance targets can be set.

[1] To read more about the various types of sustainable financing instruments, please refer to our "Guide to Sustainable Financing in Southeast Asia".

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- ***Sustainability-Linked Bond Principles published by the International Capital Market Association ("ICMA")***

  SLB issuers that follow ICMA's Sustainability Linked Bond Principles must have key performance indicators ("**KPIs**") that are relevant, core and material to the issuer's business and benchmarked. SLB issuers can take guidance from ICMA's illustrative registry on KPIs that are material to each sector and the global benchmarks which issuers can refer to calibrate their targets. Adherence to the registry is strictly voluntary.

- ***Climate Bonds Sector Criteria and Climate Bonds Standard under the Climate Bonds Initiative ("CBI")***

  CBI has issued focused criteria for pivotal sectors, including hard-to-abate ones such as steel and cement production, for the purpose of eligibility screening for labelled bonds and loans. These Sector Criteria provide science-based benchmarks for each sector that are aligned with the Paris Agreement, specifically to a 1.5°C warming limit above pre-industrial levels and is co-developed with external technical experts and subjected to public consultation, including actors in that sector. For SLBs to attain the Climate Bonds Standard and Certification Scheme, issuers must meet the Sector Criteria and other requirements, such as disclosure. Bond issuers, governments, investors, and financial markets use this Scheme to prioritise investments which genuinely contribute to addressing climate change.[2]

Product Structure

SGX Group stated that there must be adequate levers to ensure that issuers are accountable for the targets they set. Gaps in the SLB product itself, which issuers may use to bypass penalties resultant from missed targets, were also highlighted.

- *Step-up model*. This is the most commonly adopted product mechanism. If the issuer misses one or more of its targets, the issuer pays bondholders a higher coupon (i.e., a coupon step-up). The predominant practice of setting coupon step-ups at 25 basis points (occurring in over 60% of SLBs) indicates that the bonds' original coupon and the issuers' credit quality or scale are not considered, which prompted the European Securities and Market Authority to suggest that SLB issuers may potentially be benefiting from a "free lunch" by reducing their cost of capital from the sustainability premium while limiting financial penalties for missing their target.

[2] Climate Bonds Standard.

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- *Call option mechanism, as identified in a study by the World Bank*.[3] For instance, SLBs are more likely to include call options than corporate green bonds or conventional corporate bonds. Issuers are permitted under these call options to redeem the SLB before the target observation date and escape potential penalties before they miss any target. Additionally, SLB issuers with step-up penalties tend to set later target dates for their SLBs, which suggests that they do this to minimise potential penalties for failure to meet outcomes.

SGX Group identified key safeguards currently available for issuers to deploy that can ringfence the gaps concerning the step-up model and the call option mechanism, which will in turn help issuers stem reputational risks in SLBs.

- ICMA encourages SLB issuers to set a target observation date and penalty payment date before the call date of the bond, and recommends issuers to set intermediate observation dates for the SPTs.

- CBI-issued Climate Bonds Standard imposes mandatory safeguards covering both financial and non-financial repercussions.

    - To qualify for certification, SLBs cannot mature or become callable before the date of the first interim target.
    - Interim SPTs must be set on a three-yearly basis for the term of the SLB and a five-yearly basis thereafter, up to the date the activity is intended to hit net zero emissions or 2050, whichever is sooner. Certification under the Climate Bonds Standard may be rescinded if SLB issuers do not meet their targets (and do not remedy the under-performance within the stipulated timeframe), or if SLB targets are reset at a lower level than those in place at the time of certification.

Safeguards

To sum up, SGX Group highlighted the need for safeguards to address investors' concerns (such as greenwashing risk and commensurate risk-reward factors). To this end, issuers should:

- Adhere to current market guidelines on SLBs;

- Appoint external reviewers to conduct a rigorous review against the SLB requirements pre- and post- issuance and disclose areas of non-compliance; and

- Consider adopting robust certification standards for their SLBs, for instance obtaining certification under the Climate Bonds Standard.

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[3] World Bank Group, "Structural Loopholes in Sustainability-Linked Bonds", October 2022.

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Our Comments

Transition planning is emerging as a crucial element in the whole-of-economy decarbonisation journey, particularly to improve the emissions performance in carbon-intensive activities, so as to avoid carbon lock-in and stranded assets. At the heart of it, financial instruments made for the purpose to finance such transition must be credible and meaningful so that financiers and issuers can make use of such instruments as a genuine pathway to address climate issues. The issues to consider when using such financial instruments may be complex and multi-faceted. Please reach out to our contact partners to start a conversation on what you should look out for.

Contacts

Debt Capital Markets

Lee Xin Mei
Head, Debt Capital Markets

T +65 6232 0618

xin.mei.lee@rajahtann.com

Cheryl Tan
Partner, Debt Capital Markets

T +65 6232 0177

cheryl.tan@rajahtann.com

Sustainability

Lee Weilin
Head, Sustainability
Partner, Banking & Finance

T +65 6232 0707

weilin.lee@rajahtann.com

Please feel free to also contact Knowledge Management at eOASIS@rajahtann.com

Regional Contacts

R&T SOK & HENG | *Cambodia*
R&T Sok & Heng Law Office
T +855 23 963 112 / 113
F +855 23 963 116
kh.rajahtannasia.com

RAJAH & TANN 立杰上海
SHANGHAI REPRESENTATIVE OFFICE | *China*
Rajah & Tann Singapore LLP
Shanghai Representative Office
T +86 21 6120 8818
F +86 21 6120 8820
cn.rajahtannasia.com

ASSEGAF HAMZAH & PARTNERS | *Indonesia*
Assegaf Hamzah & Partners

Jakarta Office
T +62 21 2555 7800
F +62 21 2555 7899

Surabaya Office
T +62 31 5116 4550
F +62 31 5116 4560
www.ahp.co.id

RAJAH & TANN | *Lao PDR*
Rajah & Tann (Laos) Co., Ltd.
T +856 21 454 239
F +856 21 285 261
la.rajahtannasia.com

CHRISTOPHER & LEE ONG | *Malaysia*
Christopher & Lee Ong
T +60 3 2273 1919
F +60 3 2273 8310
www.christopherleeong.com

RAJAH & TANN | *Myanmar*
Rajah & Tann Myanmar Company Limited
T +95 1 9345 343 / +95 1 9345 346
F +95 1 9345 348
mm.rajahtannasia.com

GATMAYTAN YAP PATACSIL
GUTIERREZ & PROTACIO (C&G LAW) | *Philippines*
Gatmaytan Yap Patacsil Gutierrez & Protacio (C&G Law)
T +632 8894 0377 to 79 / +632 8894 4931 to 32
F +632 8552 1977 to 78
www.cagatlaw.com

RAJAH & TANN | *Singapore*
Rajah & Tann Singapore LLP
T +65 6535 3600
sg.rajahtannasia.com

RAJAH & TANN | *Thailand*
R&T Asia (Thailand) Limited
T +66 2 656 1991
F +66 2 656 0833
th.rajahtannasia.com

RAJAH & TANN LCT LAWYERS | *Vietnam*
Rajah & Tann LCT Lawyers

Ho Chi Minh City Office
T +84 28 3821 2382 / +84 28 3821 2673
F +84 28 3520 8206

Hanoi Office
T +84 24 3267 6127
F +84 24 3267 6128
www.rajahtannlct.com

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