abrdn Position Statement – Sustainability-Linked Bonds

July 2024

Definition and history of Sustainability Linked Bonds

Sustainability Linked Bonds (SLBs) are fixed income instruments where the financial characteristics are tied to Sustainability Performance Targets (SPTs). SPTs are linked to Key Performance Indicators (KPIs) within a given timeframe. If issuers meet these targets, they may trigger benefits (i.e. reduced coupons); if they miss, they may trigger penalties (i.e. a coupon step up). SLBs are one type of sustainable debt, another type are Green, Social or Sustainable (GSS) bonds which are 'use of proceeds' bonds, meaning that the funds raised are ringfenced or earmarked for particular sustainability focussed projects. Our position on GSSs is detailed on our Sustainable Investing webpage. Conversely SLBs have no restrictions on projects funded, and therefore SLBs can be used by issuers who don't have sufficient capital expenditures connected to sustainability projects but want to tap into the sustainable debt market.

The first SLB was issued in 2019 and thus far SLBs have been a popular mechanism for hard-to-abate sectors such as Industrials and Materials. Sustainability linked instruments allow issuers to highlight their green and/or social commitments. Additionally, the issuer can be held accountable to their sustainability strategy and targets by investors, lenders, and the public.

The International Capital Markets Association (ICMA) has established the **Sustainability-Linked Bond Principles**. These guidelines cover the selection of KPIs; calibration of SPTs; bond characteristics, reporting and verification. ICMA has also published a **Illustrative KPIs Registry** which provides example KPIs.

What is abrdn's view of Sustainability Linked Bonds?

Principally, SLBs offer an innovative way for hard-to-abate issuers or those without green or social assets, to access capital from ESG investors. SLBs are particularly useful for issuers with smaller capital structures that might struggle to identify enough green or social investment projects. The private credit market typically has smaller deals for companies with long lead times, therefore investors can negotiate sustainability targets as part of the structure. So in the private credit space, SLBs are a common mechanism for us to explicitly link our financing to the improvement of a company's ESG credentials.

Within public credit, where we do not often have the ability to negotiate the ambition and quality of SPTs, we find wide variation in the quality of SLBs. In some cases, the ambition is lacking and the structure diminishes the materiality of the financial penalty. However, recently some companies have missed targets, suggesting that the level of ambition is increasing. Therefore the market is increasing viewing SLBs positively and participants are beginning to identify mispriced bonds that are likely to miss targets trigger the step up.

What are the challenges associated with SLBs?

At abrdn, we have identified several challenges with SLBs:

Variation in metrics: Although ICMA's **Illustrative KPIs Registry** is a useful tool for issuers, we still find wide variation in the metrics used. Therefore, KPIs and SBTs are typically unique to each issuer and limit comparability between issuers. The ICMA principles also requires that the SPTs are 'meaningful'. This requires the SPTs to be relevant to the core business, yet so far there is no market consensus on what 'meaningful' looks like.

Variation in ambition: The ICMA guidelines state that SPTs should be 'ambitious' and 'beyond a business-as-usual trajectory'. However, the level of ambition varies greatly between issuers and many of the targets set are weak. For example, there have been instances where issuers have fulfilled the SPT before issuing the bond. Likewise in many cases, the issuer is already on track to achieve the SPT by the specified date, so the issuance of an SLB does not further enhance the issuer's ESG ambition.

Structure: We are particularly concerned about the structure of SLBs. There is limited consensus across markets on what a meaningful and acceptable penalty looks like, which can also vary depending on the overall structure of the bond. Moreover, in many cases, the coupon variation only applies to the final year of the SLB's life, making the present-value impact of the potential financial cost even less significant. Callable bonds also require extra due diligence: there are examples of SLBs that are callable before the first observation date. Therefore, there may be no financial penalty for not achieving the SPT.

Greenwashing: With such flexibility around SLB standards, inevitably issuers and investors are exposed to risks of greenwashing – where an issuer overstates or misrepresents its green credentials. There are no restrictions on how the proceeds can be spent, so purchasing SLBs could expose investors to funding projects that are inconsistent with Net Zero and other environmental or social objectives. Additionally, the SPTs and associated penalties are typically not included in bond covenants, unlike other bond features.

What is abrdn's approach to SLBs?

For the reasons above, we have developed an internally consistent SLB evaluation framework. This approach ensures a minimum level of consistency in our SLB evaluation and enables us to distinguish between stronger conviction/high quality SLBs versus controversial/lower quality ones. This framework for assessing SLBs is in addition to our fundamental credit and ESG research of the issuer.

We recognise that the SLB borrowing mechanism can be a real incentive for issuers to achieve ambitious, material ESG targets if these challenges are overcome. However, for SLBs to be a meaningful mechanism for sustainable investing, there needs to be greater sophistication and nuance in assessing SLBs. As an overarching approach, SLBs should not be assessed in isolation. We believe that bottom-up assessment of issuers and their overall sustainability strategies is crucial in discerning the quality of an SLB.

As examples, we consider if an issuer is undertaking substantive changes to transform its business, as opposed to benefitting from business-as-usual changes. We also assess if the costs of failing to meet SPTs are significant, immaterial, or can they be avoided.

At abrdn we encourage issuers to:

- Assess KPIs on multiple dates that span most, if not all, of a bond's life.
- Make greater use of interim milestones to track progress on meeting KPIs over time.
- Create financial penalties that reflect a higher proportion of the original borrowing cost.
- Not use call features that allow the issuer to circumvent the costs of failing to meet KPIs.

Despite our conceptual concerns regarding the structure of SLBs, we invest in SLBs because we believe that investors need to take a holistic approach ESG investing. **At abrdn, we consider the issuance and the complexity around sustainability linked labels in tandem with the ESG creditability of the issuer.** We consider all factors that could influence a SLB's performance, including ESG and fundamental aspects.

Therefore, even if we do not think that the KPI penalty is financially material for the issuer, we may still purchase the issuer if we are comfortable with the overall ESG profile and credit attractiveness. In such cases, we will engage with the issuer and/or structuring teams to provide feedback and share our views on the quality of the SLB.

For the public credit space, where there is more uniformity in SLBs, we have developed the following assessment to identify credible SLBs.

Does the issuer meet minimum credit and ESG standards?

It is important that the credit profile of the issuer is attractive regardless of the KPIs and SPTs promoted by the bond. If the issuer is rated a sell by the Credit Analyst, it is unlikely that we would consider purchasing a SLB from that issuer and we would not pursue the issue in question. We take into account the ESG view of the issuer using our proprietary Fixed Income ESG Risk Rating framework and our ESG House Score to ensure that the issuer meets minimum standards. For sovereigns, we take into account our proprietary ESGP score, where "P" stands for politics.

We expect the issuer to demonstrate that SLB financing is part of its overall strategy and sustainability effort. The issuance of a SLB is not a substitute for a long term sustainability strategy. We also focus on governance, as we believe that well managed issuers will have the ability to execute a sustainability strategy.

Alignment with Sustainability Linked Bond principles

When considering an issuer's sustainability linked financing framework, we look for alignment to ICMA's SLB Principles and any other market-recognised region-specific standards. We consider whether the selected KPIs are material to the issuer's core sustainability and business strategy. The SPTs should be ambitious, representing a material improvement beyond a business as usual trajectory. Disclosures on target setting should make clear reference to the observation date and the trigger event.

Structure

We pay particular attention to the structure of SLBs. We expect the coupon rate to be a significant percentage of the original coupon rate. We also expect that the step up should apply for the majority of the bond's life. We are cautious of callable SLBs that give the issuer an option to redeem the bonds early and avoid paying a financial penalty.

External review

To ensure that the sustainability linked financing framework relevant to the bond issuance is credible, we expect a pre-issuance external review to have been carried out. This may include: second-party opinion, verification, certification or a rating. Self-labelled bonds need further investigation. Post-issuance verification is also necessary to audit the data an issuer publishes regrading performance against each SBT.

Does the SLB meet 'Do No Significant Harm' criteria?

Finally, we consider the potential negative, material externalities associated with the issuer. Unlike GSS bonds, there are no ring-fenced projects associated with the bond to assess. Therefore, holistically we consider the issuer's overall sustainability profile and ESG risk management.

Conclusion

Our approach to assessing SLBs ensures a minimum level of consistency in our evaluation and enables us to distinguish between stronger, high quality SLBs versus lower quality ones. However, it is important that this assessment is considered as part of the overall credit and ESG evaluation process of the issuer and bond.

Important Information

Investment involves risk. The value of investments and the income from them can go down as well as up and your clients may get back less than the amount invested.

The information in this document is not for general circulation and should not be considered an offer, or solicitation, to deal in any funds. The information is provided on a general basis for information purposes only, and is not to be relied on as investment, legal, tax or other advice, as it does not take into account the investment objectives, financial situation or particular needs of any specific investor.

Any research or analysis used to derive, or in relation to, the information herein has been procured by abrdn for its own use, and may have been acted on for its own purpose. The information herein, including any opinions or forecasts have been obtained from or is based on sources believed by abrdn to be reliable, but abrdn does not warrant the accuracy, adequacy or completeness of the same, and expressly disclaims liability for any errors or omissions. As such, any person acting upon or in reliance of these materials does so entirely at his or her own risk. Past performance is not necessarily indicative of future performance. Any projections or other forward-looking statements regarding future events or performance of countries, markets or companies are not necessarily indicative of, and may differ from, actual events or results. No warranty whatsoever is given and no liability whatsoever is accepted by abrdn, for any loss, arising directly or indirectly, as a result of any action or omission made in reliance of any information, opinion or projection made in this document.

The information herein shall not be disclosed, used or disseminated, in whole or part, and shall not be reproduced, copied or made available to others.

abrdn reserves the right to make changes and corrections to the information, including any opinions or forecasts expressed herein at any time, without notice.

This communication constitutes marketing, and is available in the following countries/regions and issued by the respective abrdn group members detailed below. abrdn group comprises abrdn plc and its subsidiaries:
(entities as at 14 June 2024)

United Kingdom (UK)

abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated in the UK by the Financial Conduct Authority.

Europe[1], Middle East and Africa

[1] In EU/EEA for Professional Investors, in Switzerland for Qualified Investors - not authorised for distribution to retail investors in these regions.

Belgium, Cyprus, Denmark, Finland, France, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, and Sweden: Produced by abrdn Investment Management Limited which is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL and authorised and regulated by the Financial Conduct Authority in the UK. Unless otherwise indicated, this content refers only to the market views, analysis and investment capabilities of the foregoing entity as at the date of publication. Issued by abrdn Investments Ireland Limited. Registered in Republic of Ireland (Company No.621721) at 2-4 Merrion Row, Dublin D02 WP23. Regulated by the Central Bank of Ireland. Austria, Germany: abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated by the Financial Conduct Authority in the UK. **Switzerland**: abrdn Investments Switzerland AG. Registered in Switzerland (CHE-114.943.983) at Schweizergasse 14, 8001 Zürich. **Abu Dhabi Global Market ("ADGM")**: abrdn Investments Middle East Limited, Cloud Suite 205, 15th floor, Al Sarab Tower, Abu Dhabi Global Market Square, Al Maryah Island, P.O. Box 764605, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. For Professional Clients and Market Counterparties only. **South Africa**: abrdn Investments Limited ("abrdnIL"). Registered in Scotland (SC108419) at 1 George Street, Edinburgh EH2 2LL. abrdnIL is not a registered Financial Service Provider and is exempt from the Financial Advisory And Intermediary Services Act, 2002. abrdnIL operates in South Africa under an exemption granted by the Financial Sector Conduct Authority (FSCA FAIS Notice 3 of 2022) and can render financial services to the classes of clients specified therein.

Asia-Pacific

Australia and New Zealand: abrdn Oceania Pty Ltd (ABN 35 666 571 268) is a Corporate Authorised Representative (CAR No. 001304153) of AFSL Holders MSC Advisory Pty Ltd, ACN 607 459 441, AFSL No. 480649 and Melbourne Securities Corporation Limited, ACN 160 326 545, AFSL No. 428289. In New Zealand, this material is provided for information purposes only. It is intended only for wholesale investors as defined in the Financial Markets Conduct Act (New Zealand). **Hong Kong**: abrdn Hong Kong Limited. This material has not been reviewed by the Securities and Futures Commission. **Japan**: abrdn Japan Limited Financial Instruments Firm: Kanto Local Finance Bureau (Kinsho) No.320 Membership: Japan Investment Advisers Association, The Investment Trusts Association, Type II Financial Instruments Firms Association. **Malaysia**: abrdn Malaysia Sdn Bhd, Company Number: 200501013266 (690313-D). This material has not been reviewed by the Securities Commission of Malaysia. **Thailand**: Aberdeen Asset Management (Thailand) Limited. **Singapore**: abrdn Asia Limited, Registration Number 199105448E.

Americas

Brazil: abrdn Brasil Investimentos Ltda. is an entity duly registered with the Comissão de Valores Mobiliários (CVM) as an investment manager. **Canada**: abrdn is the registered marketing name in Canada for the following entities: abrdn Canada Limited, abrdn Inc, abrdn Investments Luxembourg S.A., and abrdn Alternative Funds Limited. abrdn Canada Limited is registered as a Portfolio Manager and Exempt Market Dealer in all provinces and territories of Canada as well as an Investment Fund Manager in the provinces of Ontario, Quebec, and Newfoundland and Labrador. **United States**: abrdn is the marketing name for the following affiliated, registered investment advisers: abrdn Inc., abrdn Investments Ltd., abrdn Asia Limited, abrdn ETFs Advisors LLC.