APG Guidance on Sustainability-Linked Bonds

Financing the transition in a meaningful way

As a leading, long-term responsible investor, APG advocates responsible, sustainable growth in the sustainable finance market. We are committed to increasing our investments that contribute to our clients' objectives for ESG incorporation and thematic investment. APG actively engages with market participants and stakeholders to enhance sustainable growth. In 2020 we provided guidance for Covid response bonds. In 2018, 2019, and 2020 we hosted Roundtable events on green and social bonds with institutional investors, capital market underwriters, and other green bond stakeholders.

Recently, a new sustainable finance instrument came to the market – Sustainability-Linked Bonds (SLBs). These bonds differ from labeled use-of-proceeds (UOP) bonds by linking the bond's coupon payment to the achievement of a predetermined sustainability target (e.g. emissions reduction). As a large global investor in green, social, and sustainability bonds (GSS), we feel SLBs provide an opportunity to expand the ESG-themed debt market to new sectors and are well suited to address transition challenges. As with the GSS market, it is critical to uphold the integrity of the SLB market, especially in its early stages.

In this document we set out our expectations of SLB issuers to ensure that these bonds are structured with the aim of achieving transition goals, thus safeguarding the market's credibility. As we recognize this is a nascent market and want to encourage innovation to address some of the potential challenges, our guidelines do not address every aspect of SLBs. They are meant to serve as a starting point for baseline expectations and further discussion.

Overview and rationale for investing in SLBs

SLB overview

Sustainability-Linked Bonds are any type of bond instrument whose financial and/or structural characteristics can vary depending on whether the issuer achieves predefined sustainability/ ESG objectives. Issuers commit explicitly (including in the bond documentation) to future improvements in sustainability outcome(s) within a predefined timeline.

APG believes SLBs are well suited to address transition challenges, particularly for companies that do not have sufficient capital for use-of-proceeds (UOP) bonds and for sectors with business models where labeled UOP issuance might be viewed as controversial. Therefore, we believe this instrument should be prioritized for carbon-intensive sectors where transition is required to access capital markets over the long term. Our preference is for issuers to use SLBs to signal transition objectives, as opposed to issuing labeled "Transition Bonds." We believe the lack of consensus on how to define a "Transition" label introduces unnecessary confusion in the market, whereas SLBs can more efficiently promote and quantify transition, with an added accountability mechanism.

We have been developing examples of KPIs for specific sectors where SLB issuance is desirable because of transition needs, and we will continue to engage with counterparts and stakeholders as the market evolves to help define standards. Risk, return, and portfolio considerations will of course always apply when considering SLBs.

Why invest in SLBs?

- Our clients are actively investing in energy transition, digitalization, biodiversity, and the circular economy. SLBs provide an opportunity to directly invest in these transition themes.
- Our clients have ambitious targets to invest in Sustainable Development Investments (SDIs), investments that contribute to the Sustainable Development Goals. Although the SLB structure itself does not automatically lead to an SDI classification, SLB issuers demonstrating a commitment to increasing their contribution to the SDGs could be classified as an SDI over time.
- The SLB market provides us with an opportunity to enhance bondholder engagement, particularly with sectors or issuers in transition.

Guidelines

Alignment with ICMA's [Sustainability-Linked Bond Principles] is the starting point for APG's expectations of SLB issuers:

- KPIs should be material – we are focused on KPIs that align with APG's investment philosophy and consider both financial materiality and meaningful impact.
- The Sustainability Performance Targets (SPTs) should be ambitious:
    - They need to show a significant improvement from the most recent measurement year, not just a prior base year – the degree of performance improvement against current levels matters more than a comparison with the baseline year.
    - They can represent a milestone as part of a longer-term commitment (e.g. aim of net zero emissions by 2050 with interim targets for 2025).
    - We prefer alignment with science-based targets for issues and sectors where this is relevant.
- Accountability and reporting are key – consistent with ICMA guidelines, we expect externally-verified reporting of KPIs and impact at least annually, even after targets have been achieved.

Bond characteristics

- Trigger event:
    - We have a strong preference for coupon adjustment and are not inclined to accept philanthropic payments – since we view SLBs as an agreement between investors and issuers, interests should be aligned, with coupon adjustment providing greater accountability.
    - The coupon step-up should be at least 25bps but may be larger if transition progress is not sufficient – as the market evolves, we will consider different levels of coupon adjustment to ensure the accountability mechanism remains credible, tangible, and impactful.
    - We are not in favor of a coupon step-down if a target is first missed and then achieved at a later point during the life of the bond – we view the target as a commitment by the issuer and not something a company should be rewarded for explicitly, although successful transition could lead to lower cost of capital naturally over time. We recognize the step-down feature has been accepted in the Sustainability-Linked Loan market, but do not believe this should be incorporated in Sustainability-Linked corporate bonds at this time.
- Structural features:
    - For callable high yield bonds, the KPI measurement date should be before the first call date. We are also open to the concept of SLBs being called before the measurement date, provided a certain degree of progress toward the SPT has been achieved.
    - To ensure accountability, if a bond is called prior to maturity and the SPT was not achieved, there should be a mechanism to compensate bondholders for the incremental coupon payment over the remaining years until maturity.
    - Multiple KPIs/SPTs are acceptable, with a preference for no more than three, if this creates a better way to reflect transition and all demonstrate strong ambition/materiality.
    - Splitting a 25bps coupon penalty across three KPIs is similarly acceptable, but we would expect this to be accompanied by more ambitious targets and see this an area for continued engagement with market stakeholders.
    - We prefer a single KPI measurement date if the bond tenor is 10 years or less, while longer duration bonds should aim for several SPTs (i.e. an SPT at year 5 and year 15 for a 30-year bond). For sectors in which the transition is the most challenging, we expect to see progress at an earlier stage.
    - Interim targets and coupon step-ups are preferred to a single larger coupon step-up closer to maturity – this makes the impact of missing an SPT more tangible over a longer period. Best practice would be for each milestone SPT to have a minimum 25bps coupon trigger.
- Other expectations:
    - We require a clear, detailed framework demonstrating alignment with the SLB Principles.

- We have a strong preference for a second-party opinion.
- A sustainability-focused roadshow and other pre-deal marketing of the SLB structure are encouraged.
- We encourage issuers who have already issued an SLB to use SLBs as the instrument of choice for future funding.
- Mergers & Acquisitions or asset sales can be a means to achieve sustainability targets, but after a major transformational deal we expect issuers to provide a market update or consultation on how sustainability targets will evolve.
- Independent auditor verification is required, along with a verified track record for the KPI.
- For emissions-based SPTs, we prefer absolute reductions, but recognize that intensity-based measurements may be a suitable intermediate indicator for certain sectors – both could be acceptable if they capture the appropriate transition impact. However, as absolute reduction helps us move toward the long-term goal of carbon neutrality by 2050, this is the preferred option.
- We believe it is more difficult to use social KPIs in SLBs, but if they are truly meaningful targets, such as significant improvement in supply chain standards, they could work well. In most other cases, social expenditures may be better served in a social or sustainability bond.

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