Net Zero Bondholder Stewardship: Engaging Labelled Debt Guidance

Contents

Acknowledgements

The development of this paper has been led by Laith Cahill at IIGCC. We are grateful to the IIGCC Bondholder Stewardship working group members, including co-chairs Chandra Gopinathan, Railpen, and Sarah Peasey, Neuberger Berman.

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Introduction

With an estimated $275tn of investment needed to limit warming to 1.5°C between now and 2050[1], companies will require financing to decarbonise their business models and activities, and scale climate solutions in line with global net zero goals[2]. Meeting the ambitions of the Paris Agreement will therefore require capital flows that intentionally facilitate decarbonisation in line with the IEA Net Zero Emissions by 2050 Scenario[3].

Bondholders, as providers of primary market capital, have an opportunity to help steer the transition. This potential was explored in IIGCC's Net Zero Bondholder Stewardship Guidance in 2023, which built on the Net Zero Investment Framework (NZIF) and IIGCC's Net Zero Stewardship Toolkit to provide corporate bondholders with a foundational framework to enhance their climate stewardship practices across labelled and unlabelled debt.

The Guidance identified labelled bonds as potentially powerful tools for aligning financing with a 1.5°C-scenario transition. This is reflected in NZIF 2.0's call for investors to engage with issuers on the "potential use of covenants and verified labelled bonds (e.g. GSS+ issuances) as mechanisms to ensure alignment criteria are met during the lifetime of the bond"[4]. Through 2024, the Climate Action 100+ companies are expected to refinance over €470bn[5].

Labelled bonds provide investors with an opportunity to tie fresh capital to Paris-aligned climate targets and activities[6] in line with their own commitments to decarbonise real world emissions. However, even with rapid growth in issuance, GSS+ bonds only account for 5% of total issuance volume[7], and the growth in sustainability-linked bonds has plateaued.

This paper advances the IIGCC Net Zero Bondholder Stewardship Guidance by taking a more granular approach to stewardship and engagement for labelled debt, in particular green and sustainability-linked bonds, and seeks to:

1. Promote best practices for aligning labelled bonds with the net zero transition.
2. Explore approaches to engaging on labelled bonds.

Unlabelled Debt

This paper focuses on labelled bonds and the opportunities for net zero bondholder stewardship they provide. Unlabelled debt also provides an important opportunity to finance the transition. For more on unlabelled debt, please see the IIGCC Net Zero Bondholder Stewardship Guidance and Unlocking the Net Zero Potential of Unlabelled Debt Discussion Paper.

1 Swiss Re, Over USD 270 trillion in climate investments needed to meet 2050 net-zero targets.
2 GFANZ, Scaling Transition Finance and Real-Economy Decarbonisation.
3 C. Wilson, B. Caldecott, Breaking the Bond: Primary Markets and Carbon-Intensive Financing.
4 IIGCC, NZIF 2.0.
5 A. Hoepner, F. Schneider, Exit vs Voice vs Denial of (Re)Entry.
6 *Ibid*.
7 Climate Bonds Initiative, Green Bonds Hit Lifetime Total of $2.5tn.

Focus

GSS+ bonds provide an opportunity to tie costs of capital and refinancing to key themes, including the net zero transition. This paper primarily focuses on green and sustainability-linked bonds which can be used to finance transition-related projects and underline a transition strategy respectively.

Green bonds are "any type [of bond] where the proceeds or an equivalent amount will be exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible Green Projects"[8].

Sustainability-linked bonds (SLBs) provide forward-looking, general-purpose financing linked to sustainability performance where "the financial and/or structural characteristics can vary depending on whether the issuer achieves predefined sustainability/ESG objectives"[9]. Typically, SLBs tie performance on sustainability to the coupon rate through a step-up coupon if targets are not met.

Defining Eligible Green Projects

Climate Bonds Initiative

The Climate Bonds Initiative (CBI) is an international organisation working to mobilise global capital for climate action. CBI's Climate Bonds Taxonomy provides a science-based guide to climate-aligned assets and projects, on a sector-by-sector basis.

ICMA

The International Capital Market Association (ICMA) works to promote the development of international capital and securities markets. ICMA's Green Bond Principles (GBP) provides an indicative list of the most commonly used types of projects which are supported or expected to be supported by the green bond market.

EU Green Bond Standard

The EU Green Bond Standard seeks to be the 'gold standard' for green bonds[10]. The voluntary standard "requires that all bond net proceeds are allocated in alignment with the EU taxonomy"[11].

ASEAN Green Bond Standard

The ASEAN Green Bond Standards helps facilitate ASEAN capital markets to tap green finance opportunities. The Standards build on the ICMA GBP and aim to "provide more specific guidance on how the GBP are to be applied across ASEAN in order for green bonds to be labelled as ASEAN Green Bonds"[12].

[8] ICMA, Green Bond Principles.
[9] ICMA, Sustainability-Linked Bond Principles.
[10] Latham & Watkins, The European Green Bond Standard – The New Green Bond Gold Standard.
[11] *Ibid*.
[12] ACMF, ASEAN Green Bond Standards.

Opportunities

As explored in the IIGCC Net Zero Bondholder Stewardship Guidance, the existence of GSS+ instruments means bondholders can take a targeted approach to capital allocation: financing green projects (e.g. through green use of proceeds (UOP) bonds) or issuances with sustainability targets (e.g. through SLBs).

Green bonds have been widely used by sovereigns and corporates and, where aligned with best practice (i.e. Green Bond Principles), have been found to serve as a credible signal of an issuer's commitment toward the environment, improved disclosures and reduced emissions[13].

Proceeds from green bonds typically finance or refinance projects/activities that contribute to environmental objectives such as climate change mitigation and adaptation. Green bonds can help investors quantify green lending and their contributions to successful green capital deployment for green activities, projects and climate solutions in a taxonomy-aligned manner.

Meanwhile SLBs can create a link between an issuance and the issuer's overall approach to the transition, creating financial incentives to meet their stated commitments, while attempting to recognise the link between costs of capital and climate related financial risk.

SLBs have potential to provide net zero-aligned financing in sectors which currently lack sufficient eligible projects for green bond issuances, namely in the critical hard-to-abate or carbon-intensive sectors[14]. However, to date, SLBs have had less traction than expected in hard-to-abate and carbon-intensive sectors, as well as emerging markets.

Nevertheless, SLBs have been found to "reach broader sectors, with broader ratings, and a contrasting regional breakdown" to green bonds[15], providing investors with the potential for increased portfolio diversification.

Labelled Debt and Engagement

Labelled debt's characteristics can also help investors overcome some of the obstacles to bondholder stewardship identified in IIGCC's Net Zero Bondholder Stewardship Guidance. Investors have reported increased opportunities for climate engagement on new issuances of SLBs or green bonds compared to conventional issuances. Issuers have been more receptive to (and even actively seek) input from investors and are keen to understand climate best practices.

This is particularly the case for first-time issuers. In 2023, around two-thirds of SLB issuers were first-time issuers[16]. Institutional investors can play an influential role in shaping the bond characteristics for these new issuers, engaging to share best practice, investor expectations and pushing for nuanced, ambitious KPIs and material penalties/incentives.

Further opportunities have been complemented by quality engagements, through increased access provided by issuers. As the link between the issuance and climate is integral to the issuance, issuers may be more likely to include colleagues with sustainability expertise in meetings, providing investors with an opportunity to discuss sustainability concerns with teams that may otherwise typically sit outside bond-specific conversations.

Other ways that labelled bonds have helped bondholders overcome challenges include:

Challenge	Labelled Debt
Lack of climate disclosures in bond documentation	• Links between issuance and climate strategy • Additional disclosure and climate reporting post-issuance
Short pre-issuance timelines	• Longer issuer roadshows • Post-issuance reporting • Ongoing engagement on performance against targets/use of proceeds.
Perception and Access	• Links between net zero strategy and issuances opens door to cross-cutting discussions with issuers' sustainability and finance teams.

[13] C Flammer, Corporate Green Bonds.

[14] Anthropocene Fixed Income Institute, Chemicals Sector: Synthesising Impact with SLBs.

[15] Anthropocene Fixed Income Institute, SLBs: Complementary, My Dear Investor.

[16] Environmental Finance, Taking the Pulse of the Sustainable Bond Market.

Challenges

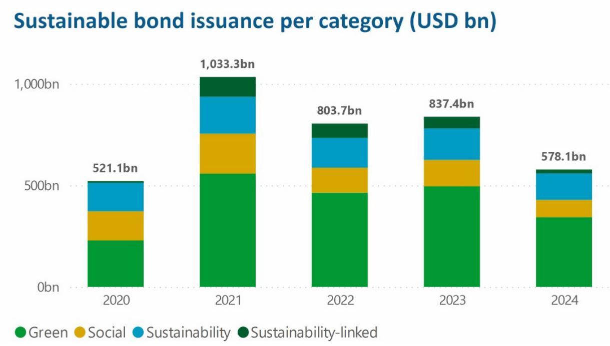
The market for GSS+ bonds has displayed rapid growth in recent years. By Q3 2023, Climate Bonds Initiative (CBI) reported cumulative volume of more than $4tn of GSS+ debt in alignment with its methodologies, with a further $12bn in unscreened transition bonds[17]. GSS+ bonds now account for 5% of total issuance volume[18]. This has been driven by investor appetite, policy support in some jurisdictions and a growing awareness of the benefits to investors and issuers of the instruments[19].

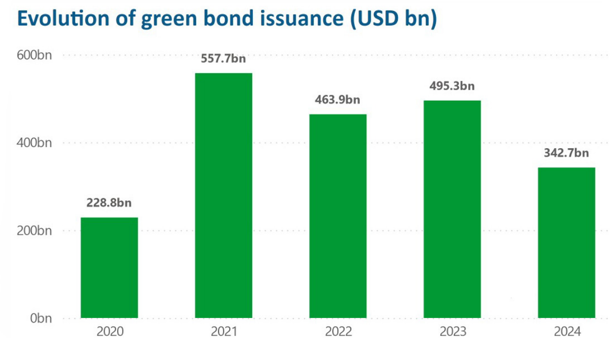
However, the overall picture of rapid growth has been clouded by stagnation in recent years. SLBs in particular are beset by concerns over impact and credibility. These concerns are linked to potentially unambitious targets and scepticism about step-ups being sufficiently material enough to incentivise change. Finally, emerging and frontier markets, as well as hard-to-abate sectors have all been underrepresented in SLBs – where they were expected to have potential as a source of sustainability-aligned financing.

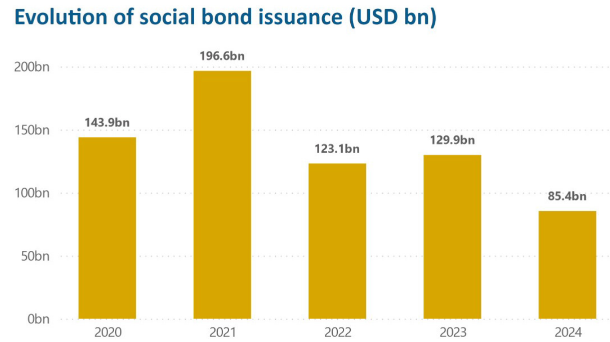
SLBs have substantial room for improvement: CBI found that 86% of SLBs are not aligned with climate best practice[20]. Moody's identifies a gap in quality between use of proceeds and sustainability-linked instruments: while 90% of UOP frameworks or instruments receive an excellent or very good rating from Moody's Second Party Opinion assessment framework, only 56% of SLB frameworks or instruments fall into those top two brackets[21]. Finally, there is uncertainty in the market about whether SLBs are a suitable investment for Article 9 fixed income funds[22].

SLB issuance volumes were down 22% in 2023 and Moody's expects SLB volumes to decline further in 2024, both in absolute terms and as a share of total sustainable bond issuance[23]. However, several developments suggested improving trends in terms of market practices, which may lead to a rebound in enthusiasm for the instrument. CBI noted that in 2023 "improved market-based guidance has contributed to an increase in climate ambition and can provide the cornerstone of deal credibility"[24]. ICMA found "a positive trend in the integrity of the SLB market as measured by reported controversies and SBTi alignment"[25]. Several SLB's have missed their targets, demonstrating that targets may have been more ambitious than initially expected.

For green bonds, the market is more developed. However, concerns have been raised about their ability to support hard-to-abate sectors to transition, where there may not be sufficient eligible projects for green bond issuances. Other challenges relating to carbon footprinting, poor quality and irregular impact reporting and lookback periods that threaten the additionality of green bonds have also all been identified as concerns.







Courtesy of ICMA Sustainable Bond Market Data, via LuxSE's LGX DataHub

[17] Climate Bonds Initiative – Green Bonds Hit Lifetime Total of $2.5tn.

[18] *Ibid.*

[19] Grantham Research Institute on Climate Change and the Environment – Mobilising Global Debt Markets for a Just Transition.

[20] Climate Bonds Initiative – 86% of SLBs Not Aligned with Climate Best Practice.

[21] Environmental Finance, Taking the Pulse of the Sustainable Bond Market.

[22] Nordsip, Are SLBs the Right Shade of Green for Article 9 Funds. For a further consideration of SLB's place in Article 9 Funds, see AFII's Sustainability-Linked Bond Handbook pg. 71.

[23] Environmental Finance, Taking the Pulse of the Sustainable Bond Market.

[24] CBI, 86% of SLB market not aligned with international climate goals, but improvement noticeable in 2023.

[25] ICMA, Market integrity and greenwashing risks in sustainable finance.

Engaging on Labelled Debt

Institutional investors can work with issuers to overcome challenges and shape labelled debt financing that aligns or supports alignment with net zero, pushing for clear accountability mechanisms, climate disclosures, ambitious KPIs and targets, credible covenants and structures, and greater additionality, in the financing and refinancing of debt.

NZIF Engagement Actions for Listed Corporate Fixed Income[26]

- **Engage issuers to secure agreement to alignment criteria and climate solutions activities including the potential use of covenants and verified labelled bonds (e.g. GSS+ issuances) as mechanisms to ensure alignment criteria are met during the lifetime of the bond.**
- Commence engagement well in advance of the issuance process itself and continue engagement across the financing lifecycle.
- Set clear expectations for companies in relation to net zero alignment criteria and climate solutions activities that should be demonstrated to secure financing.
- Assess how issuances are aligned with the net zero objectives and targets of the issuer.

Engaging and Assessing Issuers

The IIGCC Net Zero Bondholder Stewardship Guidance recommends a strategic, holistic and long-term approach to bondholder stewardship. Understanding bondholder stewardship as an issuer focused activity, rather than issuance, can help extend engagement beyond individual issuance maturity dates, with a view to enhancing the focus on managing and mitigating long-term climate related financial risks and concentrating on alignment between the issuer's bond financing strategy and transition plan.

This approach prioritises issuer level net zero commitments and actions, even when engaging on labelled debt. A GSS+ label may not sufficiently protect a bondholder from an issuer's wider capital structure and overall activities, including those that may be misaligned to the net zero transition. While the integrity, credibility and ambition of individual issuances is an important topic for engagement, this approach uses these conversations as a springboard for engagement on how the issuer is moving along NZIF's maturity scale. As CBI states: "SLBs are only as powerful as the entity's underlying transition plan".

The additionality of an issuance to decarbonising the issuer and wider economy may be missed otherwise. For instance, assessments of green bonds that primarily focus on the use of proceeds potentially risk isolating the assessment of the bond from the wider strategy of the company. This can lead to greenwashing or ineffectual financing, where UOP bonds finance 'green' projects which are not fundamentally addressing the emissions and/or transition risks of the company, nor providing wider climate solutions. Accordingly, ICMA's Green Bond Principles encourages issuers to position information on projects selected "within the context of the issuer's overarching objectives, strategy, policy and/or processes relating to environmental sustainability"[27].

Other benefits to this issuer-centric approach to engaging on labelled debt include:

- **Universal Approach to Labelled and Unlabelled Debt** – An issuer-centric approach creates consistency across stewardship on labelled and unlabelled debt which prioritises the sustainability performance of the entity and real-economy. This consistency enhances the likelihood of engagement being effective and supports investor stewardship and financing of the transition across assets.
- **Long-Term Thinking** – Fixed income investors typically tend to apply a duration lens to their approach to long-term systemic risks. An issuer-centric approach is better geared to the long-term thinking needed for the net zero transition. Unlike a duration constrained view of climate transition risks, an issuer-centric approach provides a holistic understanding of the strategic direction and credibility of the issuer's climate transition planning activities and capital allocation. This allows a credit investor to better understand whether the issuer provides sustainable long-term exposure, factoring in opportunities for refinancing too.
- **Applicability to Climate Related Financial Risk** – Understanding the issuer's climate strategy allows investors to better link the issuance objectives to financially material areas for the business, establishing a clearer de-risking pathway for the issuer's operations through the issuance.
- **Holistic Approach to Sustainability** – Ultimately, an issuer-centric approach facilitates a holistic view of an issuer's sustainability opportunities and risks, including those impacted by net zero activities (for instance, biodiversity or just transition). It also provides a broader view of the company's historical approach to disclosures and actions.
- **Leveraging Multi-Asset Stewardship –** Taking an issuer-first view allows capital providers to leverage holdings across the issuer capital structure held across portfolios, strategies and time horizons, including equity holdings where applicable.

[26] IIGCC, NZIF 2.0.

[27] ICMA, Green Bond Principles.

Case Study: Aviva Investors

Aviva Investors took an issuer-centric approach to its Climate Engagement Escalation Programme (CEEP). Launched in 2021, the programme focused on 30 systemically important carbon emitters around the world.

At launch, the programme targeted significant global polluters in the oil and gas, metals and mining and utilities sectors, requiring them to deliver net-zero Scope 3 emissions by 2050 and establish robust transition roadmaps. While relevant and well-designed ESG-labelled issuance from these emitters were considered positive, the engagement asks were thoroughly focused on the issuer level, with asks on integrating climate roadmaps into corporate strategy, including near-term transition targets and, importantly, evidencing effective board oversight and alignment of management pay/incentives, among others.

Ultimately, this approach to engagement presents two key questions:

- Is the issuer level transition plan robust?
- Do labelled debt issuances align with and support the issuer's transition plan?

NZIF Alignment Maturity Scale		i) Not aligned	ii) Committed to aligning	iii) Aligning towards a NZ pathway	iv) Aligned to a NZ pathway	v) Achieving NZ
NZ Corporate alignment criteria						
	At, or close to, net zero emissions					■
3	Emissions performance*				■	
6	Capital allocation alignment				■	
5	Decarbonisation strategy			■		
4	Disclosure*			■		
2	Targets*			■		
1	Ambition		■			
■	Additional criteria a company must meet to move to that alignment category					

*Alignment criteria that lower companies need to meet

Is the issuer level transition plan robust?

Transition plans are critical to all forms of bondholder stewardship and act as an "enabler of transition finance by providing a basis for both issuers and investors to propose and evaluate strategies, actions and investment"[28]. The activities, projects and targets included in labelled debt should ideally flow from the issuer's transition plan. Activities, projects and targets should move the issuer along the NZIF Alignment Maturity Scale[29].

For more on the assessment of corporate transition plans, please see IIGCC's Investor Expectations of Corporate Transition Plans: From A to Zero.

Do labelled debt issuances align with and support the issuer's transition plan?

IIGCC's Net Zero Bondholder Stewardship Guidance emphasises the importance of bondholders understanding how an issuer's debt strategy supports the delivery of their corporate strategy and transition plan.

Issuers are encouraged to demonstrate alignment between the transition plan and their financing strategy. In the case of labelled debt, investors want to understand how targets and UOP included in the bond link to, and support, the wider transition plan. This helps investors ensure that an issuer's debt strategy is in line with its overall transition plan and enables financing for projects and activities that mitigate long-term climate related financial risk.

[28] ICMA, Transition Finance in the Debt Capital Market.
[29] IIGCC, Investor Expectations of Transition Plans, p. 21.

Case Study: Articulating an Approach to Labelled Debt

Volvo has publicly disclosed its aim for "all our outstanding debt to be linked to the Green Financing Framework or in sustainability-linked format by 2025"[30].

PIMCO encourages first time SLB issuers to articulate how SLBs are expected to feature in their future financing strategy. Issuers with multiple net zero debt instruments are encouraged to provide an aggregated dashboard of key information for all outstanding net zero debt instruments on their website[31]. For instance, aggregated SLB data would include observation dates, targets, and step-ups of all outstanding SLBs.

The EU Green Bond Standard's optional disclosure regime will include pre-issuance and post-issuance disclosure templates, including information on the allocation of bond proceeds to taxonomy aligned activities. These are expected to be developed by the European Commission by December 2024. The templates are also expected to be relevant for SLBs, with requirements to include the rationale, level of ambition and materiality of the relevant KPIs and a description of the bond structure. Once published, investors can engage issuers to help standardise reporting pre- and post-issuance.

IIGCC Recommendation: IIGCC encourages issuers of green and labelled bonds to issue factsheets (including in existing reporting, such as impact allocation reports) which detail and provide transparency over how those bonds contribute to the entity-level transition plan[32].

Issuers may want to consider how their approach to debt financing can augment individual issuances, creating a financing strategy that works in harmony to support their transition plan. For instance, green bonds and SLBs may also be issued on a complementary basis.

For example, if an issuer were to seek financing through a green bond. A green bond does not require the borrower to make any sustainability improvements, beyond the project itself. The issuer could complement its green bond with the subsequent issuance of an SLB with entity-level targets, helping investors to understand how the projects financed by the green bond are situated within its broader net zero strategy.

The Anthropocene Fixed Income Institute (AFII) notes that this "complementary" approach allows use of proceeds focused investors to contribute capital to specific projects, while SLB investors ensure overall targets are met, with benefits "to stakeholders across the capital structure"[33].

Complementary approaches may be formalised through nascent 'green SLBs'. These hybrid sustainable debt instruments combine the use of proceeds nature of green bonds with the holistic, issuer-level KPIs and targets of a sustainability-linked bond[34]. A green SLB can help demonstrate how the use of proceeds will impact the issuer's broader sustainability goals, overcoming greenwashing concerns and potentially creating "more impactful and more intentional" net zero debt financing instruments[35].

Case Study: Verbund AG's Green Sustainability-Linked Bond

Verbund AG, Austria's largest electricity provider, placed the world's first Green and Sustainability-Linked Bond in 2021.

Verbund AG noted that in addition to being a UOP bond in line with the EU Taxonomy and the inclusion of issuer level KPIs, the issuance had a "strong preference for sustainable investors according to a transparent criterion during bookbuilding"[36].

The proceeds were earmarked to finance a hydropower plant in Germany and grid projects in Austria, with sustainability performance targets (SPTs) related to the issuer's new renewable energy and transformer capacity.

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[30] Environmental Finance, Germany Raises €3bn from New Green Bond.

[31] PIMCO, Best Practice Guidance for Corporate Sustainable Bond Issuance.

[32] IIGCC, Investing in Climate Solutions: Listed Equity and Corporate Fixed Income.

[33] Anthropocene Fixed Income Institute, Sovereign SLB: An Option for Japan's Transition.

[34] Environmental Finance, Combining Sustainability-Linked and Green Bonds Would be More Impactful.

[35] IEEFA, Issuers of Sustainability-Linked Bonds Could Step Up Efforts to Enhance Investor Confidence.

[36] Verbund, Green Finance – Reaching the Energy Transition Together with Investors.

Engaging Pre-Issuance

As with bondholder stewardship more generally, pre-issuance is the primary opportunity for bondholders to engage with issuers. Engaging prior to issuance of labelled debt is "critical for bond investors seeking to set expectations for issuers and upcoming issuances, setting clear expectations on delivery to secure financing. Pre-issuance is typically the most fruitful period for investors in terms of engagement, with relatively strong management access, at roadshows or otherwise, and potential for extended collective engagement with syndicates and lead managers"[37].

In addition to engaging on issuer level commitments and actions, outlined above, labelled debt provides bondholders with additional opportunities to engage on sustainability frameworks and issuance-level targets and characteristics.

Bond Frameworks

Companies seeking to issue GSS+ bonds typically publish bond frameworks, separate from the bond prospectus[38]. While approaches to GSS+ frameworks differ, they typically "explain how the issuer intends to align its green, social or sustainability bond issuance with the [ICMA] Principles. Frameworks might also contain information related to the issuer's sustainability strategy".

Financing Framework Case Study: SSE

SSE published a revised Sustainability Financing Framework in 2023. The revised Framework combines its previous Green Bond Framework and Sustainability-Linked Bond Framework, providing investors with a single overview of the company's approach to sustainability financing. This provides "a more holistic approach" that helps ensure "that investors contribute to SSE's achievement of its strategic Business Goals".

The Framework summarises SSE's net zero transition plan, including its SBTi carbon targets and provides a rationale for establishing a financing framework before setting out its approach to green bonds and SLBs in line with the ICMA principles.

Case Study: Insight Investment Engagement on Bond Frameworks

Background: Insight Investment initiated an engagement with a Latin American ethanol producer because the issuer's green bond framework was rated "Red" under Insight's impact bond assessment framework, meaning Insight was unable to invest in the issuance in funds with sustainability characteristics.

Engagement: Insight used the engagement as an opportunity to provide feedback on the issuer's framework and decarbonisation strategy, which would help to strengthen the issuer's green bond rating under their assessment framework. On the issuer's green bond framework, Insight suggested that additional detail should be provided on several items, including:

- The expected split between refinancing vs. financing and opex vs. capex
- How projects are robustly and independently evaluated, selected, and monitored including any exclusions or management of ESG risks throughout the process
- Any minimum levels/thresholds for use of proceeds categories and whether they are aligned with any official or market-based taxonomies

Insight also flagged areas of the company's transition plan which could be enhanced as this forms part of Insight's impact bond assessment framework. The issuer provides limited detail on their strategy for carbon emissions reduction. To strengthen their climate action strategy, we encouraged the issuer to set a medium-term carbon emissions reduction target along with a plan for how this would be achieved, providing several peer examples as guidance.

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[37] IIGCC, Net Zero Bondholder Stewardship Guidance.

[38] Although frameworks are typically separate from the prospectus, in the UK, the FCA's Primary Market Bulletin 41 notes that "where bond frameworks form part a communication that relates to an offer or admission of securities, they are likely to be advertisements for the purposes of the prospectus regime, so must comply with the Prospectus Regulation and the Prospectus RTS Regulation.

Pre-issuance engagement on frameworks allows investors to have an early say on the issuer's approach to net zero debt financing, leading to potential improvements across the issuer's future GSS+ issuances.

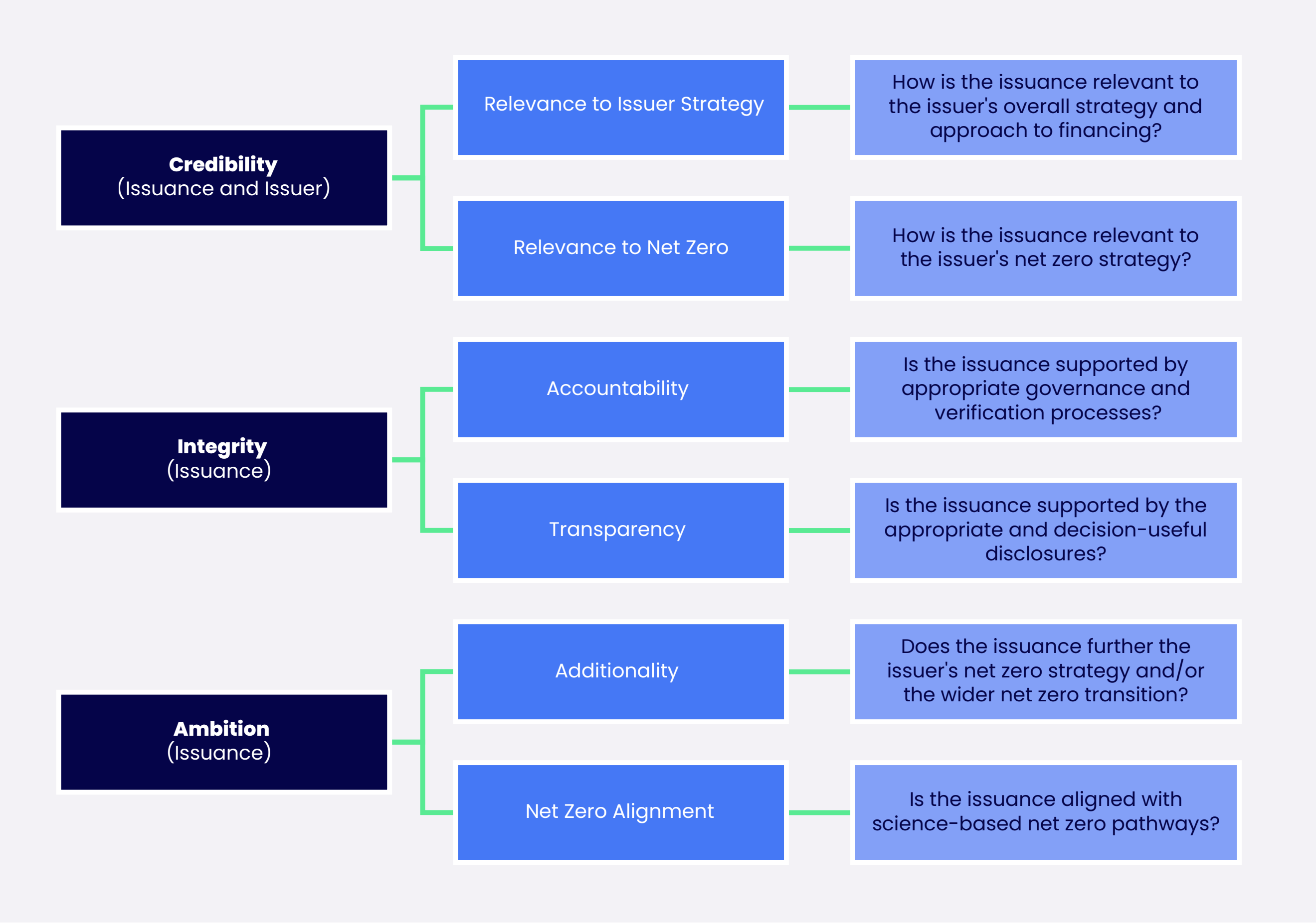
Issuance Targets and Characteristics

Investors can engage on the credibility, integrity and ambition of individual issuances.

Credibility assesses the intentionality, validity and relevance of the issuance to the issuer's broader strategy, including its net zero commitments. Along with ensuring that the issuance is green on a standalone basis this also entails ensuring alignment with the issuer's overall transition plan and strategy.

Integrity focuses on transparency and accountability, determining the processes and management systems governing the proceeds, mitigating risks, and the approach to reporting.

Ambition covers the extent of the environmental benefits generated by the issuer's use of proceeds (for a green bond) or sustainability targets (for an SLB). Ambition evaluates the transformative power of the stated objective and action of the debt issuance, its additionality, including its contribution to climate solutions[39] that could impact on the wider transition, and the issuance's alignment with the issuer's transition and sectoral net zero pathways.



[39] IIGCC, Investing in Climate Solutions.

ICMA's Green Bond Principles (GBP), Sustainability Bond Guidelines and Sustainability-Linked Bond Principles (SLBP) provide clear guidance for issuers seeking to issue GSS+ bonds.

For green bonds, issuers are also encouraged to use the voluntary EU Green Bonds Standard, which can also be used by issuers from outside the EU.

Information on issuances is not always readily available and is often missing key metrics: ICMA's Harmonised Framework for Impact Reporting, which forms part of the GBP, includes sector-specific impact reporting metrics according to the 10 eligible green project categories in the GBP. IIGCC recommends that four key pieces of information should be available for a given issuance:

1. Is there a "lookback" period for deemed "Eligible Green Projects" they already paid for?
2. Have issuers committed to fully allocating the proceeds within a certain timeframe?
3. Are the targets ambitious enough?
4. Does the issuance include Principle Adverse Impact (PAI) indicators, where appropriate?

For SLBs, investors can use the Climate Bonds Initiative's SLB best practice checklist to inform issuance-level engagements and AFII's Sustainability-Linked Bond Handbook, as well as European Leveraged Finance Association's (ELFA) and ICMA's Practical Recommendations for High-Yield Sustainability-Linked Bonds. CBI's checklist covers recommendations on:

- Overall disclosure
- GHG targets and alignment with the SLB database
- Target and trigger dates
- KPI selection
- Call options and legal clauses
- Post-issuance reporting
- Transition plans and links with issuance
- Assurance

As well as these, further work is required to improve the materiality of step-up coupons. Coupon step-ups should be "commensurate and meaningful relative to the issuer's original bond financial characteristics"[40]. However, the vast majority of SLBs are issued with a generic step up of 25 basis points (bps). The financial materiality of this step up will vary by issuer, impacting the incentive to meet targets.

For investors, step-ups need to balance materiality and credit risk: large enough to incentivise the issuer to meet its targets and hedge against additional risks created by failure to do so, and not so material as to put undue pressure on the cashflow of the business.

Case Study: PIMCO

Background: A US based CReal Estate Investment Trust (REIT) issued a sustainability bond in 2020. Disclosure practices fell short of best practice, including no impact report until two years after issuance or second party opinion.

Engagement: PIMCO engaged the company to share expectations for impact reporting and ICMA guidance to publish annually. The company failed to publish any impact reports two years into the three-year maturity and did not respond to engagement for a timeline.

PIMCO escalated engagement, speaking to the company's treasury team several times, highlighting to the company that it would consider the bond program misaligned with ICMA principles and failing to align with industry standard environmental standards (including TCFD and SASB).

Progress: The company published an allocation report and obtained a second party opinion for the program, including impact metrics. The conclusion triggered a re-evaluation of the position for specific funds subject to ESG guidelines. PIMCO plans to continue engaging the issuer on best practices including more ambitious eligibility criteria and metrics.

[40] ICMA, Sustainability-Linked Bond Principles.

Potential Options for More Material Step Up Coupons		
Approach	**Methodology**	**Rationale**
Scaling to the Size of the Company[41] (Federated Hermes)	Step-up based on percentage of EBITDA of the issuer. Step-up also considers the *pro rata* share that the SLB represents in the debt capital structure.	Appropriately align the step-up to the scale of the company.
Net Present Value	Issuers articulate the net present value of potential step ups on future cost of debt in the bond prospectus.	The Net Present Value (NPV) allows investors to normalise the number of potential payments (adjusting for disparities in the spacing of the target date and maturity date), the amount of the step up and put it in perspective of the bond credit rating/spread and tenor. This NPV should be gradually increasing proportionally with the credit spread (which is then linked to the sector, rating and maturity).
Greenback SLBs[42]	AFII recommends an option perspective, referred to as a 'greenback SLB': where the expected pay-out of the step structure is at least one dollar (one percentage point) in absolute risk-discounted value, with an assumed 50% step probability".	Greenback SLBs aim to help create more ambitious, material and standardised issuances. This is expected to result in higher coupon step-ups, lower initial costs-of-capital for issuers and "more defined sustainability hedging characteristics for investors".
Number of SLBs[43]	Barclays recommends that investor should focus on the number of SLBs outstanding from the issuer, and any commitments for SLBs to form a significant portion of the future capital debt stack: having many SLBs, "particularly when focused on a small number of material KPIs with a broad spectrum of observation dates, would provide more economic incentive to an issuer to meet its ESG target".	The materiality, or otherwise, of the step-up coupon is also impacted by whether the issuer has issued a single GSS+ bond or multiple bonds, and the extent to which the KPIs overlap. An issuer with multiple SLBs, tied to the same or similar KPIs, will suffer a more material penalty for failure to meet targets than an issuer with a single SLB.
Scale to Performance	Step-up coupons scale to degree of underperformance against emissions targets.	Examples of this exist within vanilla bond issuance, where step-ups in the coupon are tied to credit ratings, with the severity of the rating downgrade tied to more punitive coupon step-ups.

Alignment of executive and issuer financing incentives

One way to increase the credibility of SLB targets is to integrate them into executive remuneration, aligning senior management incentives with the issuer's financing incentives and wider business strategy and transition plan.

IIGCC's Net Zero Voting Guidance explores how incorporating climate metrics into executive remuneration helps ensure executives are incentivised to deliver on the climate strategy[44]. For SLBs, reflecting material SPTs/KPIs in management remuneration can increase accountability for achieving the targets and demonstrate alignment across the company.

Shareholder votes on executive remuneration may provide additional governance structures for multi-asset investors to utilise in their engagement where appropriate.

[41] See Federated Hermes, Do Sustainability-linked bonds have a step-up problem?

[42] See Anthropocene Fixed Income Institute, Greenback: SLBs: An Impact Standardisation Proposal.

[43] See Environmental Finance, SLB step-ups a long way from being financially punitive, says Barclays.

[44] For more on broader investor expectations for climate remuneration, please see the IIGCC Net Zero Voting guidance.

Engaging Post-Issuance

Labelled debt may provide more opportunities for engagement post-issuance. This is because the terms of the bond, including ongoing impact assessments and reporting, provide additional leverage points for post-issuance interactions. For instance, the defined assessment points for SLB's may help to motivate engagement, with opportunities to discuss performance in the period relevant to assess SPT performance which will lead to potential adjustments in the financial or structural characteristics of the bond.

Investors can engage with the issuer to better understand gaps between the intended decarbonisation/impact set out in the KPIs and the actual contribution/progress. Or to further understand green bond impact reports. This engagement should take place on an ongoing basis to understand progress towards targets, and not just at the observation date.

For instance, the majority of SLBs also have a single observation date. However, a challenge for the transition is the non-linear nature of progress towards decarbonisation goals. This is particularly true in sectors which hinge on technology shifts or other extrinsic levers to achieve the transition. Where issuers use a single observation date in their SLB, investors can engage for additional disclosures/information on interim non-binding flight path targets, with reference to external science-based pathways where possible. This will help investors better understand how progress is being made towards the targets and what progress is expected to look like over the life of the bond.

Where targets are not met, investors will want to consider:

- Ongoing assessment of the issuer's overall net zero alignment
- Ongoing assessment of the issuer's disclosures (both sustainability and otherwise)
- How is the issuer performing against entity-level short/medium term targets?
- Is failure to meet targets the result of external factors or poor execution by the issuer?
- What capital allocation decisions is the issuer making? Are these in line with the transition plan?

This allows investors to understand the net zero trajectory of the issuer and its management of climate related financial risk as a whole, which may be positive to its credit risk, even where SPT's are not met – see Enel case study.

Case Study: Enel

Enel is a major issuer of SLBs: issuing senior bonds only in SLB format, with a large percentage of total debt outstanding comprising SLBs.

In April 2024, Enel's 2023 Sustainability Report confirmed that the issuer had not achieved its Scope 1 emissions intensity targets, triggering coupon step-ups on 10 outstanding SLBs.

Research from Barclay's suggests that pressure on the bonds is unlikely because Enel "remains committed to its targets, is being transparent and accessible to investors, and its target performance was impacted by events outside its control"[45].

While the 2023 target linked to the SLB was missed, Enel reaffirmed its commitment to targets in the short, medium and long-term and had reduced Scope 1 emissions intensity by c.30% compared to 2022 and continues to make progress. The ambitious targets of the SLBs provided a valued hedge for investors and little sell-off due to the issuer's continued sustainability commitments and robust transition plan[46].

Case Study Tikehau Capital Post-Issuance Engagement

An issuer's SLB can sometimes be an opening for post-issuance engagement and the beginning of a net zero journey.

Background: In 2021, Reno Di Medici, an Italian cardboard manufacturer, issued its first SLB. The SLB included three KPIs, including a 30% reduction in Scope 1&2 emissions by 2030 (compared to a 2020 baseline) and included some elements of best practice: variable remuneration for Reno Di Medici's management was connected to the SLB KPIs. However, the targets were not aligned with a 1.5°C scenario.

Engagement: Tikehau Capital used its SLB holdings as a springboard to engage with the company on improving its overall climate targets. This included raising it on annual results calls, which typically focused on financial aspects.

Progress: In 2023, Reno Di Medici refinanced their SLB with revised and more climate ambitious targets. For Tikehau Capital, the SLB structure provided an additional opportunity to engage with the company on its climate targets.

[45] Environmental Finance, Enel SLB Target Miss 'Unlikely' to Trigger Forced Selling, says Barclays.

[46] AFII, Enel returns to the SLB market: per angusta ad augusta.

Engaging the Ecosystem

The IIGCC Net Zero Bondholder Stewardship Guidance emphasises the value of bondholders engaging the broader ecosystem to enhance the credibility, integrity and ambition of labelled debt.

Policymakers

The labelled debt market is currently characterised by a patchwork of regulation (mainly in the EU) and voluntary principles. Investors can play a critical role in working with regulators and policymakers to enshrine best practices for labelled bonds into regulation.

Improving labelled debt as a transition instrument starts with improving the provision and quality of issuer transition plans. IIGCC's Expectations of Policymakers on Corporate Sustainability Disclosures calls on sustainability disclosure frameworks to "include requirements for disclosure of robust, science-based transition plans"[47]. Harmonised mandatory transition plan requirements across jurisdictions would help investors understand the net zero alignment of bond issuers, in both the labelled and unlabelled market.

Investors can also engage on issuance-level regulations and frameworks. For instance, in the UK in 2023, the FCA published a series of engagement papers which included a proposal to require additional disclosure obligations for labelled debt, creating greater links between the prospectus and the bond framework[48]. IIGCC also responded to the Transition Market Finance Review, outlining the role labelled debt has to play in the transition, and the need for clear and standardised criteria for evaluating the performance of transition projects and activities funded through labelled instruments.

Investors may also wish to engage with other policymakers to replicate the EU Green Bonds Standard in jurisdiction-appropriate manner. IIGCC's policy working groups can provide a platform for investors to engage in collective advocacy in support of well-designed sustainable finance regulation. Platform-based stakeholder initiatives also provide an opportunity for engagement, such as the EU Sustainable Finance Platform and related stakeholder request mechanisms[49].

Other Ecosystem Participants

Engagement with other ecosystem participants also gives investors the opportunity to enhance the bond ecosystem. Conversations on best practices limited to issuer/investor exchanges overlook the role of Second Party Opinion (SPO) providers, Bank Debt Capital Market teams (DCMs) and others in structuring bonds, or the potential to elicit input from these critical players.

Investors have noted that some bank DCMs have had a positive influence in helping issuers to develop green bond frameworks, with some structuring agents more willing to push for ambitious targets and KPIs.

Potential DCM engagement opportunities on labelled bonds includes:

- **Pre-Issuance Reverse Enquiry** – DCMs also conduct reverse enquiry on labelled debt, providing investors with an opportunity to share their interests and explore the 'art of the possible'. This is a valuable opportunity to set out expectations for preferred issuances in the future.
- **Post-Issuance Feedback** – DCMs engage with investors post-issuance to gather feedback on recently issued instruments. This review of structures and disclosures helps inform future issuances.

Engagement is a two-way street and can be as much a learning exercise as a request. Other ecosystem participants are constantly furthering best practice in their own right. Engagement with other ecosystem participants can help investors understand trends within the market and emerging best practices.

[47] IIGCC, Expectations of Policymakers on Corporate Sustainability Disclosures.

[48] FCA, Engagement Paper 4: Non-Equity Securities.

[49] European Commission, Platform on Sustainable Finance.

Case Study: Engaging for Sector-Appropriate Labelled Debt – Federated Hermes

Background - Federated Hermes engaged with a global investment bank on structuring SLBs for financial institutions. While Federated Hermes generally have a favourable view towards SLBs in the corporate space, they have some concerns regarding the suitability of this structure for financials. This is especially the case for European banks due to MREL regulations[50] as SLBs can be seen to create an incentive to redeem bonds early if banks expect to miss their sustainability targets.

Engagement - Federated Hermes provided an example of an alternative UOP structure but the proceeds themselves are channelled towards sustainability-linked loans for borrowers. Federated Hermes also provided feedback to the investment bank on a specific Sustainability-Linked Financing Framework it had recently helped develop for an issuer. Federated Hermes emphasised that targets must be material and relevant to the company's core business activities. In this case, Federated Hermes stated its preference for certain targets within the issuer's existing framework, including sustainable lending and gender diversity in management positions.

Case Studies Engaging Syndicates and Underwriters

Insight Investment

Insight Investment engages with several syndicate sustainable capital market teams to outline their expectations in terms of best practice for impact issuance, so the banks can feed this back to their clients.

Insight maintains regular dialogue with the syndicate sustainable capital market teams and provides feedback on impact bond deals to promote a high quality, credible impact bond market. Insight also uses these opportunities to get oversight on innovations, market trends and upcoming supply from the syndicate banks. This is achieved through a number of formats, including roundtables, annual update meetings and conferences.

Specific examples of recent engagement with syndicates includes advocating for greater disclosure and transparency on issuers performance against the PAI indicators when issuing an impact bond and the carbon footprint of projects being financed by green bonds.

APG Asset Management

APG Asset Management has been hosting an annual Green Bond roundtable in New York for institutional investors and underwriters since 2018. Participants exchange views on the obstacles to corporate issuance and how they could help to overcome them. The first roundtable identified obstacles to the growth of GSS+ issuances in the US and potential solutions. The findings and recommendations from the 2018 discussion can be found here.

Conclusion

Labelled debt provides investors with an opportunity to condition financing on net zero aligned use of proceeds or sustainability targets. Labelled debt can also provide additional opportunities for investors to engage with issuers on their net zero commitments and activities.

[50] SRB, MREL.

Appendix - Assessment Framework with Examples

Below are examples of SLB issuances from three issuers broadly reviewed and compared based on the Net Zero Debt Model Assessment Framework. Company A stacks up the closest to best practices for SLB issuance followed by B and finally C. The assessments are preliminary and can vary based on investor views on Credibility, Integrity and Ambition, based on suggested use of the Net Zero Debt Model Assessment Framework.

Net Zero Debt Model Assessment Framework

Theme	Topic	Checklist	Company A	Company B	Company C
Credibility					
Strategy	**Net Zero Strategy**	Comprehensive, net zero aligned Scope 1, 2 and 3 emissions targets and a credible strategy to deliver those targets	YES	YES	NO
		Cumulative benchmark divergence metric score			
		NZIF alignment maturity scale? (i.e. Not aligned, Committed to aligning, Aligning, Aligned, Achieving net zero)	ALIGNING	COMMITTED	NOT ALIGNED
	Financing Strategy	Has the issuer described how the issuance is aligned with its wider financing strategy?	YES	NO	NO
		Proportion of total debt outstanding is in climate-related GSS+ bonds	HIGH	MEDIUM	LOW
Relevance	**Of Issuance**	Issuer provided a clear rationale for the issuance	YES	NO	NO
		Is the issuance appropriate to the sector?	YES	YES	NO
	Of Targets	Are targets aligned to the issuer's net zero strategy?	YES	YES	YES
		Are targets relevant and material to the sector, jurisdiction and issuer?	YES	YES	NO
		Are targets quantitative and comparable?	YES	YES	NO
Integrity					
Accountability	**Governance**	Identified who is responsible for the monitoring and provision of impact reporting?	YES	NO	NO
		Issuer approach to disclosures, financial and non-financial, considered in line with best practice? TCFD and ISSB-aligned	YES	NO	NO
		Are targets related to executive remuneration KPIs?	YES	NO	NO
	Post-Issuance	Issuance subject to independent assurance of both annual allocation and impact?	YES	YES	NO
		Approach to explaining recalibration of KPI's/SPT's where appropriate?	YES	YES	NO
Transparency	**Pre-Issuance**	Issuance aligned with the ICMA Principles?	YES	NO	NO
		Issuance been certified by the Climate Bonds Initiative?			
		Framework reviewed by a recognized SPO? And framework/SPO assessment and periodic review published on issuer webpage?	YES	YES	YES
		Are targets being benchmarked using external references? Are methodologies and historical datasets provided?	YES	NO	NO
		Estimated share of financing new assets versus refinancing existing assets, plus look-back period for existing assets?	YES	NO	NO
	Post-Issuance	Is the issuer committed to report at least annually for the life of the bond on:	YES	NO	NO
		• Allocation of proceeds	YES	NO	NO
		• Impact reporting (including SDG contributions and social co-benefits for green assets)	YES	NO	NO
Ambition					
	Materiality	Alignment between the timing of financial mechanism and the SPT's? (e.g. step up at least maturity minus 1yr)	YES	YES	NO
		Are targets suitably ambitious and aligned with sectoral science-based pathways?	YES	NO	NO
		Do targets include material Scope 3 emissions?	YES	NO	NO
		Are financial penalties (i.e. coupon step ups):	YES	NO	NO
		• Suitably ambitious to incentivise delivery of the targets	YES	NO	NO
		• Linked to the credit quality of the issuer	YES	NO	NO
		• Linked to the overall cost of debt for the issuer	YES	NO	NO
		• Linked to the extent of alignment between the issuer and issuance on climate goals and performance?	YES	NO	NO
		What percentage of the proceeds contribute to climate solutions?	HIGH	MEDIUM	LOW
		Are the use of proceeds aligned with a 'taxonomy-plus' approach?	YES	NO	NO
	Wider Impact	Disclosed relevant Principle Adverse Indicators (PAI)	YES	NO	NO
		Disclosed or committed to disclose impact of projects/targets on wider themes (i.e. Just Transition/SDG Commitments)?	YES	NO	NO
Engagement and Other Considerations					

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