IIGCC

Net Zero Bondholder Stewardship: The Potential for Unlabelled Debt

Contents

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Introduction

The updated Net Zero Investment Framework (NZIF 2.0) outlines two key objectives of a net zero strategy for investors:

- **Transitioning investment portfolios** in a way that is consistent with the mitigation goals of the Paris Agreement, focusing on real economy decarbonisation; and
- **Increasing investment** in the range of climate solutions to enable the transition.

NZIF recognises that investors have a range of levers at their disposal to contribute to real economy decarbonisation. NZIF focuses on 'asset alignment' as the premise through which investors can pursue real economy emission reductions, based on its multi-criteria and maturity scale[1].

Corporate debt will be critical to transitioning investment portfolios, increasing investment in climate solutions and ultimately financing the net zero transition. For corporate fixed income, NZIF 2.0 recommends two alignment targets:

1. Asset alignment target: A 5-year target for increasing the % of AUM in material sectors that are 'aligning' or 'aligned' to a net zero pathway, or 'achieving net zero'.
2. Engagement threshold target: A minimum proportion of financed emissions are assessed as 'achieving' or 'aligned' to a net zero pathway, or are subject to engagement.

As the engagement threshold target suggests, investor stewardship can play an instrumental role in moving companies along the NZIF alignment maturity scale. To support bondholders in this effort, IIGCC published A Critical Element: Net Zero Bondholder Stewardship Guidance – Engaging with Corporate Debt Issuers in 2023. The guidance offers a detailed breakdown of the challenges and opportunities facing net zero stewardship for bondholders and provides a five-step toolkit for implementing effective bondholder stewardship.

NZIF 2.0 further encourages bondholders to "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"[2]. In 2024, IIGCC published Net Zero Bondholder Stewardship: Engaging Labelled Debt Guidance, exploring the particularities of engaging on green and sustainability-linked bonds (SLBs) to link financing and net zero commitments.

While labelled debt provides an opportunity to directly link financing to transition outcomes in the real economy, a holistic and multi-pronged approach to net zero debt financing across all bond formats and frameworks is imperative for an economy-wide net zero transition. Not all assets contribute equally to delivering the transition – finance that helps decarbonise emissions-intensive or 'hard-to-abate' sectors typically accelerates the transition more than finance provided to lower-impact sectors. And despite the rapid growth of labelled debt, labelled green bonds still play a limited role in carbon-intensive sectors: "as of June 2023, the outstanding labelled green bonds only represented 7% of the total debt in carbon-intensive sectors", mainly concentrated in "electric utilities and autos, where the low-carbon transition is most advanced"[3]. The Net Zero Bondholder Stewardship: Engaging Labelled Debt Guidance notes that instruments such as SLBs may help overcome this dynamic. Nonetheless, the majority of debt issued by carbon-intensive sectors is likely to remain unlabelled.

Unlocking the net zero potential of unlabelled bonds may therefore be a large opportunity for fixed income investors aligning with the net zero transition. It is critical that the financing ecosystem is equipped to integrate net zero actions, accountability mechanisms and stewardship into unlabelled debt as part of the effort to create real economy emissions reductions.

This discussion paper – *Unlocking the Net Zero Potential of Unlabelled Debt* - summarises the key lessons from the 2023 Net Zero Bondholder Stewardship Guidance and looks to begin discussion on how to unlock the net zero potential of unlabelled debt. This may be achieved through existing opportunities to strengthen bondholder stewardship and by standardising the integration of net zero factors into unlabelled debt.

[1] IIGCC, NZIF 2.0, p. 20

[2] Ibid. pg. 27.

[3] LSEG, Tracing carbon-intensive debt, p. 14.

Lessons from the IIGCC Net Zero Bondholder Stewardship Guidance

Recognising the potential of corporate debt in financing the net zero transition, IIGCC published its Net Zero Bondholder Stewardship Guidance in 2023. This outlined debt-specific considerations for each of the five steps set out in IIGCC's Net Zero Stewardship Toolkit.

Five Steps for Stewardship

Portfolio Analysis

Undertake portfolio analysis, set portfolio alignment goals and develop a stewardship prioritisation framework

Net Zero Objectives

Set net zero alignment criteria, alignment levels and time bound engagement objectives

Engagement

Develop an engagement strategy for priority companies

Voting

Baseline engagement and voting policy approach

Transparency and Alignment

Asset owner and manager alignment, engagement and transparency

Key Lessons

- Engagement across the financing lifecycle
- Responsible allocation of capital
- Collaborative engagement
- Engagement across the ecosystem

Engagement Across the Financing Lifecycle

- Prioritise engagements based on debt-specific criteria (for instance, leverage and near-term refinancing profile).
- Take a long-term outlook to engagement that extends beyond specific bond maturity dates, recognising opportunities for refinancing.
- Adopt different engagement approaches across the financing lifecycle, recognising differing opportunities.

Responsible Allocation of Capital

- Integrate bondholder stewardship into the investment decision making process, recognising the importance of capital allocation decisions on the primary market.
- Communicate investment decisions to issuers, including how changes in practice would return influence relative preference.

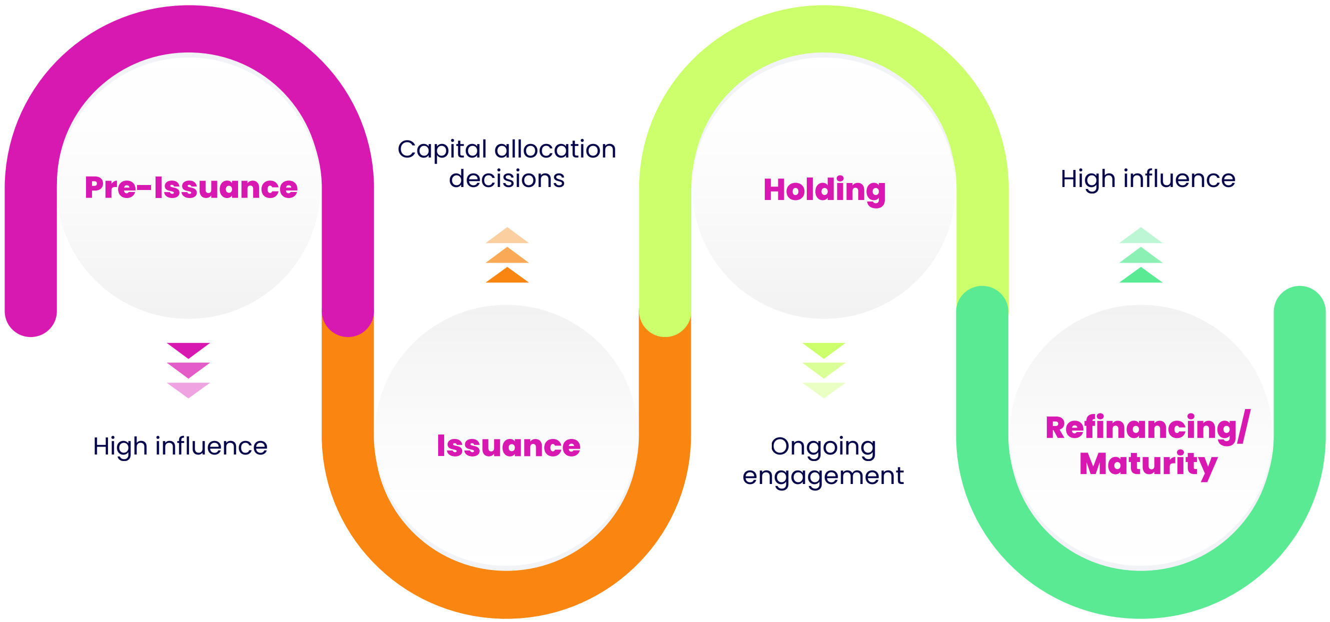
Collaborative Engagement

- Where applicable, engage as a bondholder on a collaborative basis through existing collaborative engagements, such as CA100+ or NZEI.
- Engage as bondholders collaboratively on climate concerns.

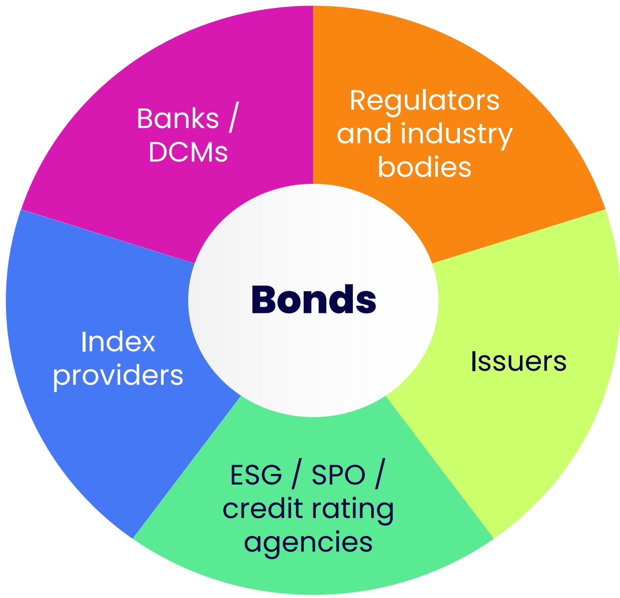
Ecosystem Engagement

- Engage across the bond markets ecosystem, including regulators, banks, second party opinion providers (SPOs) , credit rating agencies, index providers and debt syndicates, to share climate expectations.

Engagement across the financing cycle



Engagement across the ecosystem



Aligning Unlabelled Debt with the Net Zero Transition – A Discussion

This section raises questions for how unlabelled debt can more effectively contribute to reducing real world emissions and support the net zero transition.

Engaging Unlabelled Debt – Opportunities and Challenges

One of the greatest challenges for financing the net zero transition resides with the hard-to-abate industries. As climate and net zero transition plans and the related financing becomes more mainstream, unlabelled bonds provide a large set of opportunities for investors and issuers, especially in hard-to-abate sectors, to steer the transition. It is therefore critical that the financing ecosystem is adequately equipped to successfully integrate climate and net zero commitments, accountability mechanisms and stewardship into unlabelled debt to capitalise on the opportunity to ensure the transition affects real world emission reductions.

There are challenges to achieving this. These range from weak legal and financial accountability mechanisms to a lack of disclosure, poor alignment between the use of proceeds to the climate transition, and the still nascent use of climate and net zero covenants in documentation across all bond formats and frameworks, to name a few.

But, there are also opportunities for simple developments in disclosure to improve the links between unlabelled issuances and the net zero transition. These include climate and net zero transition plan disclosure, transparency on transition finance strategy and planning, use of proceeds, debt issuance/revenue aligned to green projects or activities, and taxonomy alignment disclosure where applicable. This level of transparency can provide the tools investors need to appropriately assess credibility of the issuer's transition and efforts to improve capital allocation to support the climate and net zero transition. There may also be opportunities for further disclosure around the use of proceeds for unlabelled debt and the nascent use of climate covenants in bond documentation.

Questions

1 **How can unlabelled debt support the net zero transition?**

2 **What are the obstacles to unlabelled debt supporting the net zero transition?**

3 **What are the key opportunities for unlabelled debt to support the net zero transition?**

Net Zero Covenants

IIGCC's Bondholder Stewardship Guidance notes that covenants linked to climate, sustainability and related disclosures have been used in GSS+ issuances but are still not part of mainstream bond structures. There may be opportunities to link covenants for unlabelled debt to the issuer's transition plan and climate commitments.

Questions

1 **What role can climate-related covenants take in unlabelled debt? What form would climate-related covenants take?**

2 **How can investors incentivise companies to insert covenants into unlabelled debt linked to sector best practise?**

3 **Where companies have public net zero commitments or targets (i.e. SBTi approved targets), how can these be incorporated into bond covenants?**

Case Study – Railpen: Incorporating Climate into Debt Covenants

Covenants are legally enforceable rules that borrowers and lenders agree upon at new issuance. Covenants can clearly outline what issuers are required to do (affirmative covenants) and what they are prohibited from doing (negative covenants). Bond covenants linked to climate, sustainability and related disclosures have been used in GSS+ issuances but are still not part of mainstream bond structures or linked to the issuer's transition plan framework at the entity level.

Railpen has undertaken work on expanding the covenants currently being used in the high yield bond market. This is proposed at the issuer level to align with and supplement the work done by ICMA on ESG covenants in the SLB space.

Examples include:

1. **Reporting Covenants** – Historically used to provide access to financial information. With climate being a major financial risk, reporting covenants could be amended to incorporate climate reporting with KPI's linked to the issuer's transition plan. This may be particularly important for holders of "144A" bonds not registered by the SEC or required to file financials on the EDGAR system.
2. **Investment Covenants** – A key risk for investors is issuers making investments that materially impact the volatility and default risk of their bonds. There are several provisions in conventional credit agreements to protect lenders against risky investments. This includes an Investment Covenant, which involves restrictions on permitted acquisitions, asset sales, and sale/leasebacks, with carve-outs for "permitted investments". For issuers committed to decarbonisation, this could be replicated to prohibit investments in high emissions businesses with transition risks which are not aligned with the issuer's overall stated climate transition strategy. For such issuers, where the use of proceeds is defined as "General Corporate Purposes", restrictions on investing in new fossil fuel developments could be a sensible way forward.
3. **Line of Business Covenants** – This covenant can be used to limit an issuer's future scope of business while offering stakeholders protection on an issuer's approach to proactively managing material risks. Without such a covenant, an issuer can change its management policy or strategic direction from its core business to riskier undertakings with higher earnings volatility or even to a new sector entirely different from what bondholders had evaluated when making their investment decision. The Line of Business Covenant can be amended linking it to the issuer's climate transition plan to include restrictions on new emissions intensive lines of business.
4. **Uncapped Debt-Financed Capex** – This is the amount of debt-financed capital expenditures that the issuer can undertake uncapped. By introducing caps on non-green capital expenditure, this covenant can potentially be linked to an issuer's climate transition plan and provide a broad steer to its capital allocation strategy.

By incorporating these covenants with regular alignment assessments, bondholders can ensure effective use of their capital to track, align and steward issuers to their climate and net zero goals.

Assessing Issuances

Both IIGCC's Bondholder Stewardship and Engaging Labelled Debt guidance explore the importance of understanding links between debt issuances and the entity-level transition plan/climate targets.

IIGCC encourages issuers of unlabelled bonds to articulate how unlabelled financing contributes to the entity-level transition plan or climate targets.

Investors can engage to understand the planned expenditure of proceeds for all unlabelled bond issuances and not just green bonds with strict use of proceeds – providing a clear link between capital raised and capital expenditure. To date, investors have generally provided issuers with the flexibility to issue bonds for general corporate purposes (GCP). GCP has historically included all activities relevant to the operational, financial and expansion strategy of the business including M&A and shareholder returns. While investors will continue to provide this flexible capital, additional disclosure on the intended use of these proceeds and any taxonomy aligned activities they may apply to, may be beneficial.

A core component of issuer transition plans is the decarbonisation strategy and corresponding capital allocation decisions. Under the UK Transition Plan Taskforce (TPT) framework, issuers are expected to disclose "information about how the entity is resourcing, and plans to resource, the current and planned activities set out in its transition plan"[3]. This will in turn provide bondholders with transparency around an issuer's capex towards transition activities and the trend and trajectory over time, potentially enabling investors to link unlabelled debt financing with capex plans.

Alongside bonds issuing under the EU Green Bond Standards, the European Commission have also proposed a voluntary pre-issuance and post-issuance disclosure regime for bonds marketed as environmentally sustainable and/or sustainability-linked[4]. Disclosure intends to capture how bond proceeds contribute to the issuer's climate transition plan, or how bond proceeds are expected to contribute to the issuer's Taxonomy alignment, where relevant.

Questions

1 **How can issuers demonstrate alignment between unlabelled bond financing and entity-level transition plans?**

2 **To what extent can bond durations for unlabelled debt be connected to capital investment cycles, decarbonisation targets and transition finance planning by issuers?**

3 **What role does disclosure regulation have in linking unlabelled debt issuances with entity-level transition plans?**

4 **Where a company has issued labelled debt, how does an investor ensure any subsequent unlabelled debt issuance is complementary and aligning to the overall debt stack?**

5 **To what extent would investors be supportive of further use of proceeds disclosures on unlabelled debt?**

6 **Would it help to define a category of unlabelled bonds which may not meet the ICMA Principles, but derive at least 70% of their revenue from activities identified in ICMA's use of proceeds categories?**

[4] Transition Plan Taskforce, Disclosure Framework.

[5] European Comission, The European green bond standard - Supporting the transition

Engaging Beyond CO_2

The net zero transition will require activities beyond those aimed at reducing CO_2 emissions. IIGCC's Addressing methane emissions from fossil fuel operations paper identifies methane emissions as a "major risk to companies in the oil & gas and coal industries, and their investors", noting that "there is no version of a credible energy transition plan that does not drastically reduce methane emissions from fossil fuel operations by 2030".

Methane has emerged as a key topic at COP28, followed by a proliferation of methane commitments. The IIGCC paper aims to support investor engagement on methane.

To date, finance for abatement activity has not flowed proportionately to sectors with the highest abatement potential due to limitations in the GSS+ frameworks and structures, with difficulty in demonstrating credible emissions reductions. There is hope for the future with reporting and verification propelled by regulation, paired with technology cost reductions and secular tailwinds all beginning to materialise.

Engagement on methane can include development of standard criteria for abatement for the oil and gas industry backed by strong scientific research and evidence in line with the IEA's Net-Zero Emissions scenario[5]. Overall, the engagement provides a strong opportunity for the ecosystem of issuers, investors, and structuring agents to credibly participate in transactions and structures aligned with technical and scientific consensus, providing the much-needed scalability to finance methane emissions abatement in the real economy.

The Methane Abatement Financing Taskforce (MAFT) is one such initiative that brings together technical experts, issuers, investors, lenders and climate initiatives to devise more effective debt solutions. In the context of this discussion paper, MAFT raises interesting questions about what covenant principles linked to methane emission reductions looks like.

Engaging the Ecosystem for Unlabelled Debt

The IIGCC Net Zero Bondholder Stewardship Guidance emphasises the value of bondholders engaging across the ecosystem to enhance credibility, integrity and ambition of unlabelled debt. The need for engagement with the bondholder ecosystem is exactly the same across all forms of debt. The participants include the regulators, policymakers, banks (and their respective debt units including lending desks, structuring desks, and both labelled and unlabelled debt capital markets teams), ratings agencies, and third party SPOs.

Investors are also encouraged to improve engagement with regulators on the development of accountability mechanisms including climate and net zero transition plan disclosures for all unlabelled bonds, and encourage discussions on climate-related covenants and KPIs in unlabelled issuances as well. As per current regulatory disclosure requirements, issuer disclosure already encompasses a number of aspects that are relevant for bondholders and can be levers for bondholder stewardship. IIGCC recommends the development of tools that aggregate these disclosures in a bondholder-relevant fashion.

Questions

1 **How can the wider debt ecosystem incentivise creating stronger links between unlabelled debt and an issuer's net zero commitments.**

2 **What role can the rating agencies play in more credibly building transition risk into credit ratings for unlabelled debt?**

3 **Debt issuance timelines remain short, making it challenging to facilitate a dialogue between the issuer, the arranger and the investor. How can the ecosystem be more effective in assessing an issuer's transition status and integrating climate disclosure and covenants in new issuances in a timely manner?**

[6] IEA, Net Zero Emissions by 2050 Scenario (NZE).

Leveraging current disclosure

Examples of existing global sustainability disclosure requirements

Reporting type	Corporate Sustainability Reporting	Green/Transition Taxonomies	Methane Emissions Disclosures	Debt-Specific Requirements
Reporting level	Company-level	Activity-level	Company-level limits and fines on methane	Activity-level
Examples	ISSB and TCFD-aligned rules, CSRD, SEC Climate Disclosure Rule, China Standards	EU Taxonomy, EU-China, Common Ground Taxonomy, Singapore-Asia Taxonomy	IRA Methane Emissions Red'n Program, EPA O&G Methane Rule, EU Methane Regulation OGMP Requirements	EU Green Bond Standard, ESMA Guidance on Prospectus Sustainability disclosures
Key disclosures required (bondholder relevant disclosures highlighted)	General disclosures • Governance, strategy, risk management, and metrics & targets disclosures on sustainability-related risks and opportunities Transition plans • **Financing strategy** • **Capital Structure and Issuance Strategy** • **Labelled/Unlabelled Debt Issuance Plans**	• **Green and Transition-related Revenues** • **Green and Transition-related Capex and Opex** • **% of Green Capex for the year from the specific issuance**	Different approaches: EU Methane Regulation • Limit emissions in O&G production and imports **(e.g. max intensity & targets)** OGMP Requirements • **Methane deduction targets (intensity or absolute)** • **Report methane emissions from all assets in implementation plan** Inflation Reduction Act (IRA) • Waste Emissions Charge for emissions >25,000 metric tons	EU Green Bond Standard Reg to introduce voluntary reporting templates for unlabelled bonds, including: • **Intended allocation to taxonomy aligned activities** • **Intended allocation to non-taxonomy aligned activities** • **Environmental impact** • **Link to transition plans** • **Link to Taxonomy KPIs**

Existing sustainability disclosures (both mandatory and voluntary) offer significant potential to leverage and integrate into a standardised bondholder disclosure template

Leveraging current disclosure into a Bondholder template

Bondholder disclosure template

Principal Disclosure	**Reporting type** i.e. Disclosure, Metrics and Targets
• Financing Strategy • Capital Structure and Issuance Strategy • Labelled/Unlabelled Debt Issuance Plans • Methane Emissions Reduction Program and Implementation Plan as submitted to OGMP/EU	• Intended allocation from the issuer to taxonomy aligned and non-taxonomy aligned activities • Green and/or Transition-related Revenues • Green and/or Transition-related Capex • Green and/or Transition-related Opex • Intended % of the specific issuance proceeds to be used for Green and/or Transition-related Capex for the year • Methane Emissions from operated and non-operated assets • Methane reduction targets (intensity or absolute) • Link to Taxonomy KPIs

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