European Leveraged Finance Association

ICMA International Capital Market Association

High Yield Sustainability-Linked Bonds

Practical Recommendations

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May 2023

Introduction

There has been a steady increase in issuance of sustainability-linked bonds by borrowers rated sub-investment grade (high yield). In order to maintain robust standards, the European Leveraged Finance Association (ELFA) have partnered with the support of the International Capital Market Association (ICMA) to create this set of practical recommendations for the high yield market in line with ICMA's Sustainability-Linked Bond Principles (SLBP).

A Sustainability-Linked Bond (SLB) is a performance-based debt instrument designed to encourage the issuer to achieve sustainable outcomes and/or to support the issuer's contribution to sustainable development. An SLB issuer uses material, core and quantifiable key performance indicators (KPIs) to assess and benchmark impacts and calibrate improvements in its sustainability performance targets (SPTs) by a given date.

Issuing an SLB makes issuers accountable for their sustainability targets and trajectories and allow issuers to demonstrate a commitment to sustainability. However, market participants are cognizant of the importance of enhancing integrity through the choice and target observation date of KPIs and/or the ambition of the SPTs, how meaningful any incentives established are, and the need to promote strong standards and transparency for these debt instruments.

Whilst the Sustainability-Linked Bond Principles (SLBP) and the subsequently released SLBP Related Questions apply to any type of bond instrument, including sub-investment grade bonds, some of the unique features of these instruments warrant specific consideration and market guidance for the sub-investment grade segment. This set of recommendations provides practical guidance on applying the SLBP to high yield bonds containing the features of an SLB (high yield SLBs). High yield bonds possess distinct characteristics compared to investment grade bonds, which this document seeks to address, including typically:

- Redemption provisions;
- Covenant provisions;
- Shorter tenor; and
- Higher representation of private companies (not publicly listed), which has implications for disclosure and reporting.

For the avoidance of doubt, high yield SLBs are not an asset class of their own.

They are high yield bonds to which the SLB label has been applied, as per the ICMA's SLBP. This document is designed to address the specific needs of the sub-investment grade bond market in respect of these core components where bond characteristics or market practice depart from the investment grade bond market. As such, it should be read alongside the SLBP. For clarity, high yield SLBs should be aligned with the five core components of the SLBP.

Whilst all recommendations below stemmed from feedback based on high yield SLBs with features prevalent in the high yield market, we note three specific recommendations that govern issuer/bond characteristics that also have a potential overlap with investment grade securities/issuers. Therefore, please find a table format clarifying these recommendations and the relevant applicable markets.

Recommendation	Applicable to all markets (IG & HY)	Practical recommendations for HY markets
1	✓	
2		✓
3		✓
4	✓	
5		✓
6		✓
7	✓	
8		✓
9		✓
10		✓
Appendix		✓

1. General recommendations on process and disclosure

Process

Points for Recommendation 1:
In line with the SLBP's intent to promote accountability in the issuer's sustainability strategy, issuers should ensure that KPIs and SPTs are selected within the context of publicly available sustainability strategy which comes as the foundation of the SLB structure. Only then should a discussion take place about which sustainable debt instrument fits that strategy. A concrete demonstration of the issuer's work on its sustainability strategy would be to report the identified KPI metrics on a regular basis, starting well ahead of any SLB issuance and thereby making available past data as recommended by SLBP (3 years of past performance where feasible).

Recommendation 1
Issuers are encouraged to take the following path prior to issuing a high yield SLB:

1) set sustainability strategy with all material KPIs identified and related short-, mid- and long-term trajectories;

2) identify ambitious SPTs that go beyond business-as-usual;

3) identify intermediate observation date to the set SPT(s) when necessary;

4) align key sustainability milestones and the contemplated bond characteristics (tenor, non-call period, etc).

Disclosure

Points for Recommendation 2:
The SLBP recommend that issuers communicate clearly to investors the rationale and process according to which the KPIs have been selected and how the KPIs fit into their sustainability strategy.

In the high yield market, issuers sometimes disclose key information underpinning KPIs and SPTs disparately within different documents or on the issuer's website, making it difficult and time-consuming for market participants to analyse this information in the short timeframe available during the marketing phase of the deal.

Recommendation 2
To increase transparency, the SLBP recommended information under Selection of KPIs and the level of SPTs should be clearly communicated to investors at least in the Offering Memorandum and investor presentation, as well as in the commonly published Sustainability-Linked Bond Framework.

Points for Recommendation 3:
The commercial terms relating to SPTs, including the structure of the coupon and the call price if SPTs are not met, are often disclosed inconsistently across different high yield SLBs, making it difficult for market participants to locate this information. Issuers are encouraged to include all of the information presented in the high yield SLB Disclosure Table[1] clearly in the Offering Memorandum if feasible, and in the investor presentation.

Recommendation 3
Issuers are encouraged to disclose at marketing of the high yield SLB the information on high yield SLB characteristics included in the high yield SLB Disclosure Table.

Points for Recommendation 4:
Issuance of an SLB is demonstrative of the issuer's commitment to ESG. Even though smaller, private or non-European high yield issuers will not necessarily be required to report ESG data up to the standard of publicly listed European companies, issuers are encouraged to report in line with applicable regulatory standards and/or international voluntary disclosure guidance. This will support investors' analysis of the SPTs.

Recommendation 4
Issuers are encouraged to disclose broader ESG data that is in line with applicable regulatory standards and/or international voluntary disclosure guidance applicable to market participants where the HY SLB is issued. For example, issuers targeting European investors are encouraged to disclose ESG data required under these regulations (e.g., data required for the PAIs under the EU SFDR, EU Taxonomy).

2. Calibration of SPTs

Target Observation Date

Points for Recommendation 5:
Key differences in bond characteristics between investment grade bonds and high yield bonds are the generally shorter tenor and redemption schedule. Where an issuer seeks to establish a long term SPT (e.g., 2030/2040/2050), it is recommended that interim SPTs representing milestone achievements should occur before the expiry of the non-call period and redemption schedule of the bond thus ensuring materiality of the SLB.

Recommendation 5
It is recommended that issuers set the target observation date/payment of penalty date before the call date. However, in case the call date is applied before the target observation date occurs, then the call price should reflect an assumption that the target has not been met.

[1] See Appendix 1: Disclosure Table

Points for Recommendation 6:
As recommended by the SLBP, issuers often demonstrate alignment with recognised sustainability goals, such as the Paris Agreement, through third party verification (e.g., Science Based Targets initiative approved targets). External verification should be provided where feasible for interim targets that have been interpolated from on a long-term scale (e.g., in line with net zero by 2050) and explicitly stated in the framework to ensure ambition and alignment with industry best practice.

Recommendation 6
Issuers are encouraged to seek verification and/or external review of the ambition and alignment with industry best-practice for interim targets derived from long-term targets, especially if based on verified long-term targets.

3. Bond Characteristics

Coupon variation

Points for Recommendation 7:
As stated in the SLBP, "the potential variation of the coupon is the most common example, but it is also possible to consider the variation of other SLB's financial and/or structural characteristics. Further, the SLBP recommend that trigger event(s) lead to a meaningful and commensurate variation in the financial and/or structural bond characteristics relative to the issuer's original bond."[2] Investors may consider the meaningfulness of the adjustment offered in the context of the issuer's overall cost of borrowing and to evaluate SLB structures with a particular focus on comparable issuers/issuances in the same region and/or currency.

Recommendation 7
Issuers are encouraged to demonstrate the commensurate and meaningful nature of the coupon variation to investors. Issuers are also encouraged to disclose their rationale for considering the economic value associated with the incentive mechanism to be meaningful and commensurate in the context of their funding program.

Issuers may further wish to demonstrate a relationship between SLB issuance amounts, the funding needs associated with the achievement of the selected sustainability performance targets, and the change in financial characteristics of their SLB issuance and/or program.

Call Price

Points for Recommendation 8:
Redemption provisions in high yield bonds provide issuers with the option to redeem the debt in advance of the maturity date (through the exercise of the calls). Applied to SLBs, this could create a risk that the coupon step up applies only for a limited amount of time before redemption or does not apply if SPT observation date comes later than the expiry of a non-call period. Hence, the SLB impact may rely mainly on the call price step up.

If there is no call price step up or if it is too low, this would allow the bond to be redeemed by the issuer at the same or a very similar price to the issuer's conventional bond before reaching the date for calculating an SPT, even if the issuer is not on track to meet its SPTs, whilst simultaneously benefitting from the SLB label.

According to the SLBP, SLBs "incentivise the issuer's achievement…through KPIs and SPTs." When the bond's financial characteristics do not differ materially from a non-ESG/conventional bond, this incentive is no longer present. Issuers should ensure the structure of any SLB requires their performance against at least one SPT be evaluated, prior to the bond becoming callable at the issuer's option at a pre-determined price.

One way to ensure that the call price is commensurate and meaningful in relation to the coupon variation would be to capitalise and pay the coupon change as though the bond had remained outstanding to maturity if it fails to achieve the relevant SPT(s) at the time of redemption.

Recommendation 8
As with the coupon variation, issuers are encouraged to demonstrate to investors that the change in call price is commensurate and meaningful with reference to the issuer's overall cost of borrowing and to comparable issuers/issuances in the same region and/or currency.

[2] https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/sustainability-linked-bond-principles-slbp/

4. Reporting

Points for Recommendation 9:
As stated in the SLBP, "this reporting should be published regularly, at least annually, and in any case for any date/period relevant for assessing the SPT performance leading to a potential adjustment of the SLB's financial and/or structural characteristics."[3]

As KPIs are a key feature of the high yield SLB, reporting on them should be a contractual requirement in the same way that disclosure of financial information is a contractual requirement in high yield bond indentures. Based on recently observed market practices, the absence of reporting is a trigger event activating the coupon variation. Alternatively, failure to provide KPI reporting may, in some cases, lead to an Event of Default following a negotiated grace period, as is standard for failure to comply with reporting requirements in a high yield bond.

Recommendation 9
Contractual annual reporting of up-to-date information on the performance of the selected KPIs is recommended with the activation of the trigger event in case of lack of reporting at the observation dates of the SPTs.

Points for Recommendation 10:
This reporting should not be a one-line item deeply imbedded in a sustainability report or in an annual or quarterly report published after unaudited financials are presented to investors. Rather, such reporting should be comprehensive, clear, and easy to find, even if it is part of the issuer's sustainability or annual reporting. Further, issuers should provide a detailed methodology showing progress on the KPI, including any clear impact from material changes to the business (e.g., M&A).

Recommendation 10
Issuers are recommended to disclose the KPIs and the performance against the SPTs reporting in a timely manner with clarity and substance. Issuers are encouraged to publicly and clearly present the reporting in investors' quarterly/annual presentations.

[3] https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/sustainability-linked-bond-principles-slbp/

APPENDIX: Diclosure Table

Click here to download the table for Excel

High Yield Sustainability-Linked Bond Feature	Answer from Issuer	Example Answers / Notes
Issuer		// [...]
Sustainability-Linked Notes Option		// Yes or No answer
Type of Bond Structural Feature		// Step up of coupon
Bond Structure Change		// +[xx]bps of step up
KPI		// Absolute Greenhouse gas emissions Scope 1 and 2 reduction
SPT		"// SPT 1.1 Reduce absolute scope 1 GHG emissions [...]% by 2025 from a 2021 base year SPT 1.2 Reduce absolute scope 2 GHG emissions [...]% by 2025 from a 2021 base year"
SPT Trigger		// Failure to achieve SPT 1.1 AND SPT 1.2 will trigger a [xx]bps step up in coupon. i.e. achievement on just SPT 1.1 will trigger coupon change
SPT Observation Date		// December 31, 2025
Coupon Variation Date		// June 30, 2026 step up in coupon if either targets are missed
Optional Redemption Dates		"// [..], 2026 [..], 2027 [..], 2028 and thereafter"
Redemption Price with SPTs achieved		"// [..], 2026 [xx]% of final coupon [..], 2027 [xx]% of final coupon [..], 2028 and thereafter 100.00%"
Redemption Prices without SPTs achieved		"// [..], 2026 [xx]% of final coupon [..], 2027 [xx]% of final coupon [..], 2028 and thereafter 100.00%"
Baseline year		// 2021
Baseline		// [...] tCO_2
Target year		// SPT 1.1 and 1.2 target year 2025;
Target performance		// [...] tCO_2 in 2025
Long term target		// Absolute Greenhouse gas emissions Scope 1 and 2 reduction [...]% by 2030

High Yield Sustainability-Linked Bond Feature	Answer from Issuer	Example Answers / Notes
Scope / Perimeter		"// This KPI includes the absolute scope 1 (direct emissions from own activities) and the absolute scope 2 (indirect emissions from the consumption of purchased electricity, heat and stream) GHG emissions of industrial, Research & Development and tertiary sites. It includes all scope 1 and 2 emissions in the GHG inventory, in line with the GHG Protocol Corporate Standard. Carbon offsets are not included in the calculation. The scope of activities considered is the same as the one used and disclosed in the Corporate Social Responsibility chapter of the Issuer's annual report."
Rationale		// The rationale for the KPI, and the ESG strategy itself, should include a clear explanation of how the issuer determined what the most material ESG issues are for the firm, .e.g. stakeholder surveys, materiality frameworks such as SASB, etc. Rationale should ideally include a link to the issuer's long-term sustainability targets.
Methodology		// Calculation of scope 1 and 2 GHG emissions is based on a GHG inventory reporting procedure in line with the recommendations of the Greenhouse Gas (GHG) Protocol.
Alignment with Science-Based Target Standards		// Where science-based target standard exist for the theme addressed by the SPT, details on whether the target aligns with these or not (and which ones it aligns with if so); if such standards don't yet exist, then N/A

High Yield Sustainability-Linked Bond Feature	Answer from Issuer	Example Answers / Notes
Second Party Opinion		"// Any independent accounting or appraisal firm or other independent expert of internationally recognized standing appointed by the Issuer, in each case with the expertise necessary to perform the functions required to be performed by such firm or expert in order to determine if the Sustainability Performance Target has been met. // Insert link to the SPO"
SLB Framework		// Insert link to the SLB Framework

About the European Leveraged Finance Association:
ELFA is a professional trade association comprised of European leveraged finance investors from over 60 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its investor community by promoting transparency and facilitating engagement among European leveraged finance market participants. For more information please visit ELFA's website: www.elfainvestors.com.

About the International Capital Market Association:
For over 50 years ICMA and its members have worked together to promote the development of the international capital and securities markets, pioneering the rules, principles and recommendations which have laid the foundations for their successful operation.

In pursuit of its objectives, ICMA brings together members from all segments of the wholesale and retail debt securities markets, through regional and sectoral member committees, and focuses on a comprehensive range of market practice and regulatory issues which impact all aspects of international market functioning. ICMA prioritises three core fixed income market areas – primary, secondary, repo and collateral: with two cross-cutting themes of sustainable finance and FinTech.

For more information visit: www.icmagroup.org and follow us on Linkedin

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