

# BLOG POST

## Leveraging SLBs to Advance Governments' Sustainability Agendas

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Sustainability-Linked Bonds (SLBs) are forward-looking performance-based financial instruments whose economic terms vary depending on whether the issuer achieves specific sustainability targets within a predefined time frame. The typical structure contemplates a coupon step up at a certain date if such targets are not met, and it has been observed that investors are willing to accept lower yields in return for this commitment. The SLB made its capital market debut in September 2019, when ENEL issued a US\$1.5 billion transaction in the US market that was oversubscribed by almost three times.[1]

To ensure transparency and credibility of SLBs, the International Capital Market Association (ICMA) developed the Sustainability-Linked Bond Principles (SLBP) shortly thereafter, providing voluntary guidelines and best practices for their issuance.[2] These principles emphasize the use of credible, material, measurable, and externally verifiable Key Performance Indicators (KPIs) that can be benchmarked to assess the rationale and the level of ambition of their corresponding Sustainability Performance Targets (SPTs). Since then the market grew rapidly, achieving total SLB volumes of USD\$226.6 billion at the close of Q1 2023.[3]

SLBs are still relatively underused by sovereigns. As of Q1 2023, SLBs accounted for only 1% of the cumulative GSS+ (green, social, sustainability and SLB) sovereign issuances, while green bonds represented 80%.[4] The only two sovereigns that have issued SLBs so far are located in Latin America (Chile and Uruguay).

Since its first issuance in May 2022, Chile has emerged as the frontrunner in sovereign SLB issuances. To date, Chile has raised over USD\$9 billion via sovereign SLBs.[5] Chile's first framework included two KPIs aligned with the country's Nationally Determined Contributions (NDCs) – reducing greenhouse gas emissions and transitioning to a more renewable electricity grid. The Ministry of Finance updated its Framework in 2023 to also include a social KPI relating to the percentage of women in board member positions at companies that report to the Comisión para el Mercado Financiero (CMF).[6]

Uruguay became the second sovereign SLB issuer with its debut USD\$1.5 billion issuance.[7] This transaction was an innovation in the market because the country introduced a two-way pricing structure, featuring a step-down coupon to incentivize environmental improvements and a step-up to penalize underperformance. Their KPIs are focused on reducing emissions and preserving native forest areas.[8] The issuance received a significant demand of USD\$3.96 billion[9], evidencing the increased interest in these instruments.

Chile and Uruguay's pioneering efforts demonstrate the role SLBs can play in advancing the transition to a net-zero future, serving as a source of inspiration for other countries as investors increasingly recognize that superior environmental and social performance can mitigate credit risk.[10]

Recent updates in the market point towards more growth in the sovereign SLB space. For example, the 2023 edition of the SLBPs has been modified to include specific guidelines for sovereign issuers[11], highlighting that KPIs must align with the country's economic, social, governance, and sustainable development policies. Regarding SPTs, the updated principles suggest that sovereign issuers disclose strategic national development plans or policies with a significant impact in the achievement of chosen targets. The SLBPs also underline that SPTs should be consistent with the country's sustainable development policies and should be comparable with other countries' targets. In the cases where quantitative data is not annually available, sovereign issuers are encouraged to disclose explanations regarding the evolution of KPIs.

Other governments have expressed interest in the SLB instrument. Senegal, for example, published their Sustainable Financing Framework in September this year. They are the first sovereign to publish a framework that combines use of proceeds (UOP) and sustainability-linked funding. The framework includes ten eligible UOP categories, seven of which are social and three environmental, with access to basic infrastructure and services, including education, as a priority area. Its two KPIs are related to educational completion rate at the primary level and access to electricity for rural populations.[12] The Framework was independently reviewed by Moody's ESG Solutions.[13]

## SOVEREIGN SLBs IN EMERGING MARKETS

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SLBs could be an interesting financing tool for sovereigns, especially in Emerging Markets (EM). EM countries are disproportionately exposed to the effects of climate change and socio-economic problems such as greater inequality and unemployment, low growth rates, and a lack of access to essential services.[14] Additionally, EM countries are affected by high financing costs.[15] Sovereign SLBs can be a solution for both problems, as they can be aligned with environmental and social goals, which represents an added and attractive value for ESG-focused investors; and they can benefit from reduced debt service expenses if SPTs are achieved.

Small sovereign issuers may lack large projects and the capacity to allocate the proceeds solely to green and/or social use of proceeds, so SLBs serve as a valuable complement to advance their sustainability agenda. In this way, EM sovereigns can leverage SLBs to access international capital markets for large-volume bonds.[16]

SLBs are also a valuable resource to address ESG objectives, as they can demonstrate the government's commitment to these priorities through public policies and assure a lasting impact not only on the sovereign balance sheet, but also in achieving the country's long term sustainability goals. Achieving SPTs requires governments to stay the course on sustainability over time, since these debt instruments may have maturities for 5, 10, 15 or even 30 years. This implies that targets need to be measured and achieved not only by the existing sovereign administration, but also by future ones.

Chile, a frequent issuer in the markets, has placed several SLBs with the same SPTs. As the amount of outstanding bonds builds up, the potential impact of a coupon step up increases, and therefore augments the incentive for the government to achieve sustainability targets. This dynamic, in turn, enhances the credibility of new SLB issuances attracting more investors and thus tightening new SLB pricing. In addition, increasing the commitment of the issuer having multiple triggers for the same KPI helps lower the cost of compliance of each transaction, as reporting requirements will be applied to multiple issuances. In summary, tapping the market frequently lowers deal-specific costs of the SLB and enhances the greenium of each deal.[17] The Chilean case as a best practice to implement sovereign SLBs could be emulated by other sovereigns in the EM.

## SLBs AS A COMPLEMENT TO GSS BONDS

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SAAlthough SLBs and GSS bonds differ in their approach, they can be highly complementary. GSS bonds are well suited to channel funds to government expenditures with positive environmental and social outcomes. Whereas SLBs grant issuers greater flexibility in terms of the use of proceeds, focusing on meeting predefined sustainability goals.

Sovereign issuers can use the UOP approach to finance specific programs that help drive the sustainability agenda. Meanwhile, SLBs allow governments to promote key policy issues. As mentioned before, targets set by one government can bind future governments to continue with these actions during the life of the instrument, allowing for a continuation of action across administrations.[18]



Studies have demonstrated various benefits of sovereign SLBs. Empirical evidence has shown that countries excelling in climate transition experience lower long-term government bond yields, implying investor willingness to support robust climate mitigation policies.[19] SLBs can therefore offer a promising complementary resource to enforce sustainability commitments. This way, the right combination of different types of thematic debt can amplify a country's engagement related to sustainable development. SLBs can also diversify the investor base by attracting foreign capital.[20]

Nonetheless, there are some challenges to be faced, largely because SLBs require historical data on sustainability-related KPIs, which may not be comparable from country to country. Therefore, it is difficult to measure the level of ambition of the SPTs, which becomes complicated due to the lack of relevant peers or international standards.

In this regard, there is a trend in the wider SLB market towards improving the quality of these instruments. For example, the World Bank curates and maintains an ESG data portal that allows for easy comparison between countries. This promotes the possibility of standardizing KPIs across countries to facilitate benchmarking. Achieving these improvements would contribute to further increase the use of SLBs by sovereign issuers, providing a complementary instrument that they can use to GSS bonds.

## SCALING PATHWAYS FOR SUSTAINABILITY-LINKED SOVEREIGN DEBT

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Multiple Development Finance Institutions (DFIs) including the World Bank, the European Bank for Reconstruction and Development (EBRD) and the Asian Infrastructure Investment Bank (AIIB) together with other International Organizations such as ICMA, and Climate Bonds Initiative (CBI) are establishing the Sustainability-Linked Sovereign Debt Hub (SSDH) to develop and scale performance-linked sovereign debt, which can positively impact economic, environmental, and social outcomes.

The SSDH aims to enhance sustainability risk management in sovereign debt markets, reduce the capital costs of sustainable investments and promote innovations to increase resilience to external shocks through technical guidance and the development of platforms, tools, relevant innovations, standards and regulations.[21] The hub's success will be evaluated based on increased issuance and quality of sustainability-linked sovereign debt. It aims for at least USD\$7.5 billion of new issuance and refinancing over a four year initial period globally.[22]

To scale the virtuous cycle created by the Sustainability-Linked Sovereign Debt (SLSD), the SSDH (see figure 1) outlines seven pathways: i) credit enhancement for stimulating demand; ii) integration of SLSD solutions into financing initiatives addressing climate, biodiversity, and disaster risk challenges; iii) standardization; iv) capacity building; v) enabling regulation and market development to stimulate the demand of SLSD instruments; vi) fiscal rules and frameworks that encourage the adoption of these instruments; and vii) nature market linkages[23] that can support performance in pursuit of nature-related goals.[24]

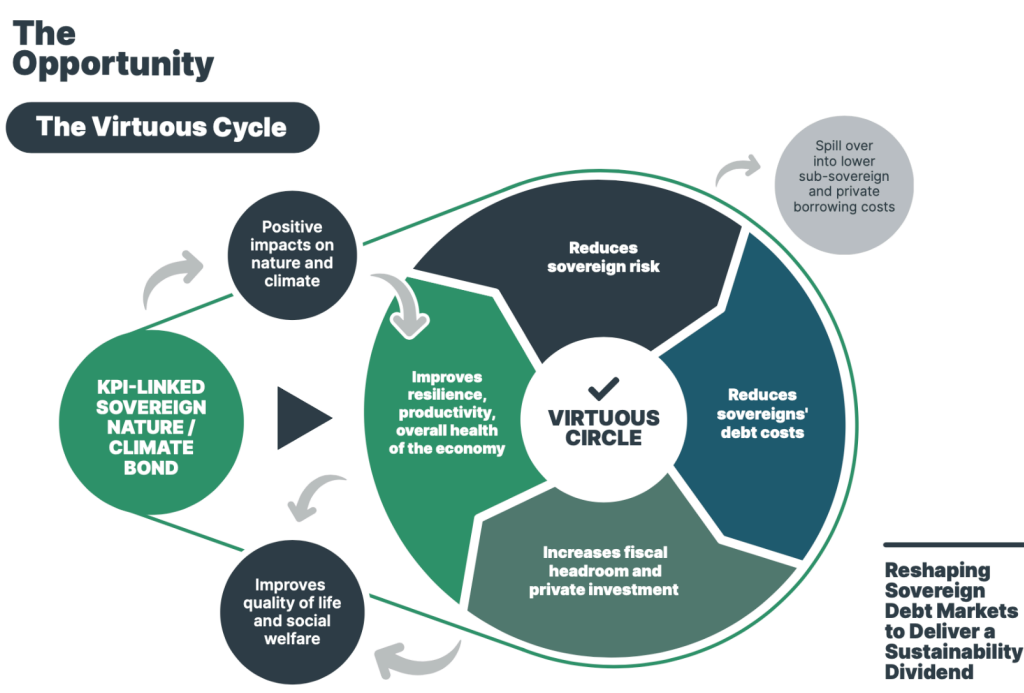


Figure 1. The Virtuous Cycle  
Source: Sustainability-Linked Sovereign Debt Hub

The emergence of sovereign SLBs and the efforts achieved so far indicate a path toward a transformation of debt markets, driven by initiatives such as the SSDH; however, more efforts are needed to stimulate demand and integrate these instruments into the sovereign issuers' sustainability strategies and policies for achieving 2030 Agenda goals.

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