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Sustainability-Linked Finance—
Mobilizing Capital for Sustainability in Emerging Markets

By Raquel de la Orden and Ignacio de Calonje

Sustainability-linked finance is designed to incentivize the borrower's achievement of environmental, social, or governance targets through pricing incentives. Launched in 2017, it has now become the fastest-growing sustainable finance instrument, with over $809 billion issued to date in sustainability-linked loans and bonds. Yet these instruments are still nascent in emerging markets, which represent only 5 percent of total issuance to date. This note shares examples of recent sustainability-linked financing, including several involving IFC in various roles, to highlight how investors can utilize these new instruments in emerging markets and mitigate greenwashing risks.

Sustainability-linked finance mobilizes capital to support the borrower's improved environmental, social, and governance performance. These financial instruments incentivize the pursuit of sustainability targets by tying pricing—usually through interest rates—to their achievement. Targets are typically related to corporate environmental, social, or governance (ESG) metrics. They should be ambitious and aligned with the firm's corporate sustainability strategy. Incentive structures can vary, including an increase (step-up) in the interest rate paid by the firm if the target is missed, a decrease (step-down) if the target is met, or both. The underlying instrument can be any financial product, including bonds, corporate loans, project finance loans, revolving credit facilities, derivatives, and others. The most popular instruments thus far have been corporate sustainability-linked loans (SLLs) and sustainability-linked bonds (SLBs). For example, Enel issued a five-year, $1.5 billion SLB in 2019 with a 25 basis point interest rate step-up linked to a target of 55 percent renewable installed capacity by 2021.[1]

Since their inception in 2017, over $809 billion of sustainability-linked financing has been brought to market, of which 85 percent was SLLs. The market reached new heights in 2021, when SLLs reached an annual issuance of $366 billion, or 181 percent above the 2020 volume of $130 billion. Most impressive were SLBs, the volume of which rose to $103 billion—i.e. 803 percent above 2020 figures; partly driven by the European Central Bank's (ECB) decision to accept SLBs as collateral for Eurosystem credit operations and monetary policy purchases, starting in 2021.[2]

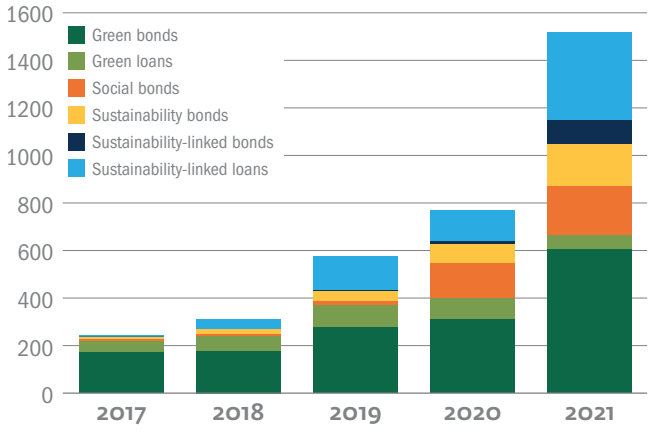

FIGURE 1 Sustainable Debt Annual Issuance, 2013–2021 ($ billion)

Source: BloombergNEF, Bloomberg L.P.

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There are examples of sustainability-linked financing across all industries. Of the $809 billion issued to date, 44 percent was from companies in the manufacturing, agriculture, and services sectors; 39 percent was from infrastructure companies, including energy, telecommunications, transport, mining, and water; and 17 percent was from financial institutions, including banks, insurance companies, government agencies, and others.

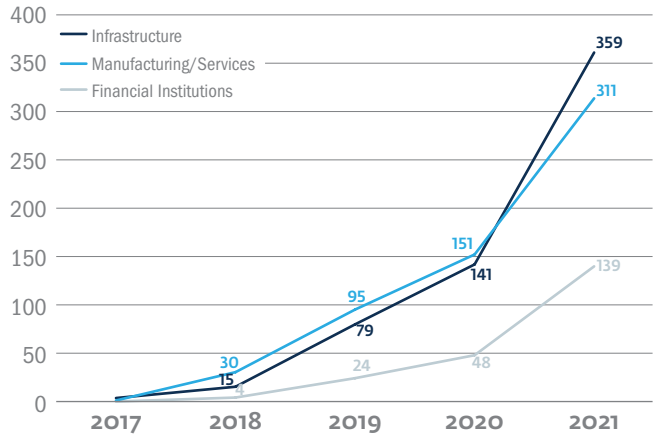

FIGURE 2 Cumulative Sustainability-Linked Financing by Sector, 2017–2021 ($ billion)

Source: BloombergNEF, Bloomberg L.P.

The rapid market growth of sustainability-linked financing across industries reflects the strong interest in these instruments by borrowers, investors, and regulators. Firstly, sustainability-linked finance allows borrowers to highlight sustainability commitments to their existing investor bases, while attracting a wider pool of investors interested in impact and sustainable investing. By doing so, companies may achieve a lower cost of capital, as well as an expanded and diversified investor base. These instruments also allow borrowers to better align their financial, operational, and sustainability objectives at a time when sustainability has become a strategic imperative for most companies, given broader climate and societal concerns. Secondly, investors can leverage sustainability-linked finance to adopt a "profit-with-purpose" business model. An increasing number of retail and institutional investors are making sustainability a core criterion in their investment decisions, driven by investee demand. In addition, good ESG performance may also enhance shareholder value, both in the short and long run, by increasing customer loyalty, lowering climate risks, increasing staff productivity, and other factors.[3] In fact, multiple financial institutions are incorporating ESG performance into their credit rating systems, reflecting the positive impact that ESG can have on portfolio quality. Finally, regulators are also keen to promote sustainability-linked finance as a tool to attract private investment toward government objectives under the 2030 Agenda.[4]

Growth in Emerging Markets

So far, emerging markets have accounted for just 5 percent of total sustainability-linked financing issuances.[5] The Europe and Central Asia and North America regions registered the highest debt volumes, with 54 percent and 31 percent of total issuances thus far, respectively, followed by East Asia (10 percent), Latin America (3 percent), and the Middle East and North Africa (1 percent).[6] As of December 2021, only $44 billion of all sustainability-linked debt issuance was in low- and middle-income countries.

Yet the market in developing countries is growing. In 2021, sustainability-linked financing in emerging markets saw a 327 percent increase compared to 2020 volumes. Mexico, China, Turkey, Russia, and Brazil led the way, with approximately 82 percent of total volumes in non-high-income countries. There are also select examples elsewhere, mostly in Asian countries such as India and Thailand. In Africa, as in the rest of Latin America, market activity remains limited thus far.

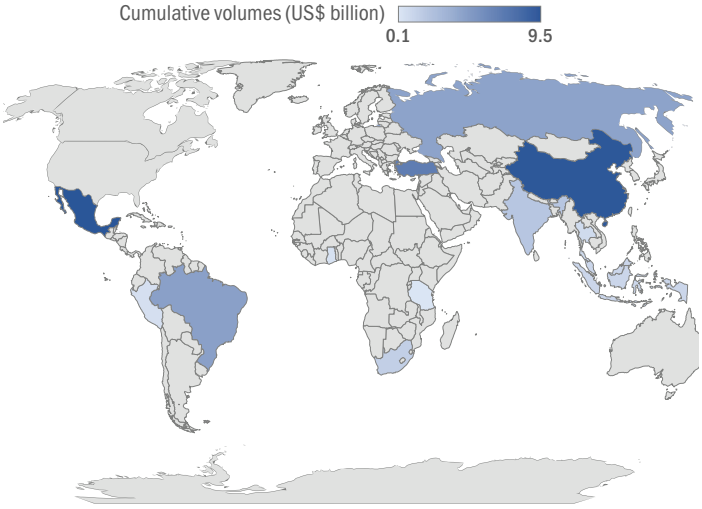

FIGURE 3 Cumulative Sustainability-Linked Financing in Emerging Markets, 2017–2021 ($ billion)

Source: BloombergNEF, Bloomberg L.P.

SLLs have been the most popular sustainability-linked instrument in emerging markets so far, but SLBs skyrocketed in 2021 in line with global trends. The first emerging market SLL was issued by Polat Energy, a wind power investor in Turkey, in August 2018. Since then, $25.2 billion of SLLs have been issued in low- and middle-income countries. Nearly two years later, in September 2020, Suzano, a Brazilian pulp and paper company, issued the first emerging market SLB. Despite the slow ramp-up, $18 billion was issued in 2021.

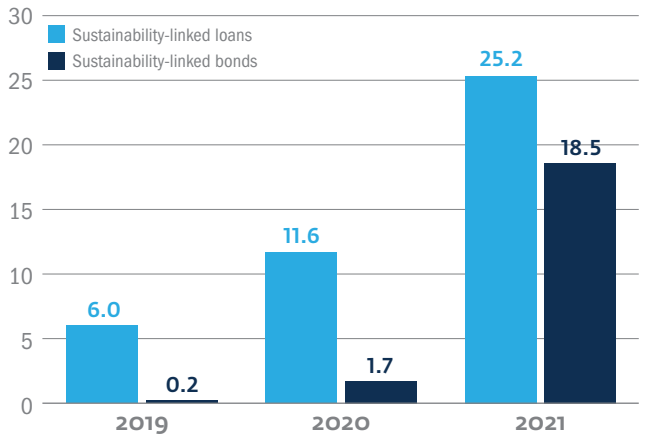

FIGURE 4 Cumulative Sustainability-Linked Issuance in Emerging Markets, 2018–2021 ($ billion)

Source: BloombergNEF, Bloomberg L.P.

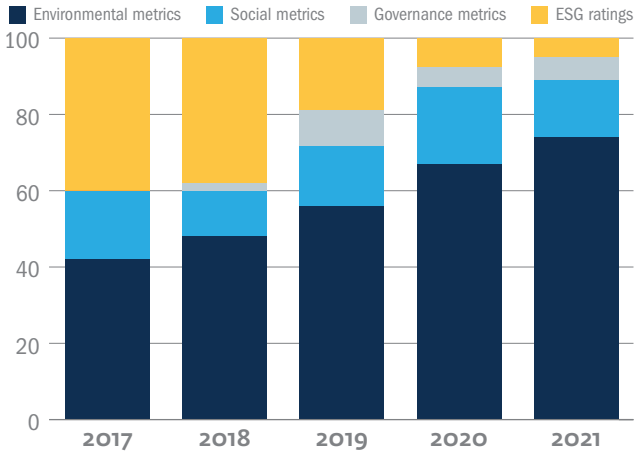

FIGURE 5 Evolution of Indicators in Sustainability-Linked Issuances, 2017–2021

Source: BloombergNEF, Bloomberg L.P.

Evolving Trends in Pricing, Metrics, and Instruments

Pricing structures are expected to evolve as the market for sustainability-linked financing matures. Ideally, the pricing step-up or step-down should be commensurate with the target's ambition and meaningful relative to the issuer's original financial characteristics. However, since the market is still relatively nascent, there has been little ex-ante variability in financial incentives so far. This is partially due to a lack of transparency around target ambitions, driven by the absence of harmonized sustainability disclosures. For SLBs, the market has typically opted for a 25 basis point step-up in the event that issuers fail to hit targets; and some issuers, particularly in emerging markets, have offered larger step-ups. For SLLs, there is typically a step-down of 5 to 10 percent of the initial margin if the target is met, which can also be combined with a step-up if the target is missed. However, beyond pricing penalties, missed targets could have broader consequences for a company, as they may indicate increased operational, financial, and reputational risk, which in turn could raise the company's cost of capital and reduce its ability to raise additional financing.

Corporate ESG metrics are the most popular sustainability indicator. Some 90 percent of sustainability-linked financing to date has used corporate ESG metrics for their targets. The remaining 10 percent were mainly third-party ESG ratings from agencies such as Sustainalytics, MSCI, and Vigeo Eiris. Since corporate ESG metrics are increasingly available to the public through annual sustainability reports, they have gradually become more popular than third-party ratings, which can be perceived as a black box, with a methodology owned by the score provider and beyond the issuer's direct control.

Most early debt issuances used carbon emission reduction metrics, but alternative social and environmental indicators are surging. Corporate environmental metrics were used in 67 percent of total issuances to date, with carbon emissions as the most popular option year after year. Until recently, corporate social and governance metrics, such as worker safety or women in management, were much less common. This tendency may have been partly influenced by the ECB which, for the moment at least, can only purchase sustainability-linked products with environmental targets, which may deter Eurozone companies from using social and governance metrics. Yet demand for more innovative indicators is growing as companies seek to leverage these instruments to address various sustainability priorities, with new metrics emerging around freshwater consumption, waste reduction, and workplace diversity.

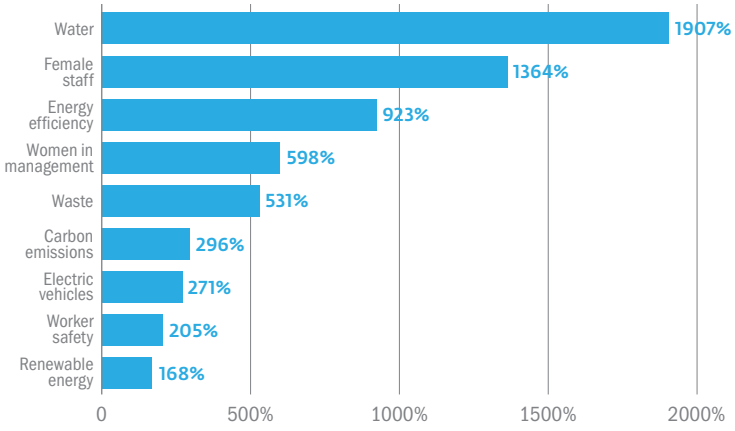

FIGURE 6 Annual Growth of Sustainability-Linked Financing by Corporate Metric in 2021

Source: BloombergNEF, Bloomberg L.P.

SLBs tend to have just one metric, while SLLs can have up to four or five.[7] This distinction is largely driven by different market structures. The SLB investor pool is often large and highly diversified, demanding pricing mechanisms that are simpler and easier to track. Conversely, SLLs are usually syndicated by a small group of banks with deep in-house expertise and sophistication, making it easier to track more complex structures with multiple metrics.

Material sustainability metrics should be linked to ambitious targets, as well as credible and meaningful action plans to achieve them. Contrary to other sustainable finance instruments (i.e., green, social, and sustainable), sustainability-linked loans and bonds generally have no constraints on the use of proceeds. In many cases, these products are used for general corporate purposes, where the borrower retains full discretion as to the allocation of capital. This is part of the reason that these instruments have grown so fast. However, it is important for companies to have credible action plans to achieve their sustainability targets, including an associated budget, whenever possible.

As a result, investors have been particularly keen to invest in "super green" structures, i.e., sustainability-linked instruments in which companies also commit to use the proceeds for green or social projects that will help them achieve their targets. An example is Verbund's €500 million SLB issued in March 2021.[8] The bond combined green use-of-proceeds with a coupon step-up linked to corporate targets on renewable energy. These types of instruments reassure investors about a company's commitment to meet its sustainability targets, and they fit into the investor's portfolio green allocation commitments.

The Role of Sustainability Coordinators

Targets are usually negotiated by one of the lenders under the role of sustainability coordinator. The "Sustainability-Linked Loan Principles"[9]—published by the Loan Market Association in March 2019 and updated in July 2021[10]—as well as the "Sustainability-Linked Bond Principles"[11]—published by the International Capital Markets Association in June 2020—aim to preserve the integrity of SLLs and SLBs by setting voluntary guidelines for market participants. The Sustainability-Linked Loan Principles recommend that targets are negotiated and set between the borrower and a single lender leading the group, i.e., the "sustainability coordinator." For SLBs, this role is normally performed by the underwriting bank.

Sustainability coordinators play an important role in ensuring targets are ambitious and fit for purpose. The facility's sustainability coordinator must ensure that (a) the underlying sustainability metric is material to the borrower's core business, e.g., a reduction in freshwater use might be relevant to a mining company but not to a wind power producer; and (b) the proposed target is ambitious, e.g., a 60 percent reduction in carbon emissions by 2030 might not be ambitious if it uses 2010 as baseline. To determine this, sustainability coordinators undertake a materiality assessment of the company's sustainability metrics and benchmark targets against the company's historical trajectory, typically looking back at least three years, and also against the company's industry peers. This analysis provides an indication of the target's ambitiousness, eliminates perceptions of "business-as-usual" improvements, and informs decisions on pricing incentives.

Second Opinion Providers provide an additional layer of credibility. Sustainability metrics and targets, as well as the scope and methodology, are captured in a "sustainability-linked financing framework." This document describes the rationale for prioritizing certain metrics over others, the justification behind proposed targets, the action plan that will support target achievement, and the reporting mechanism for selected metrics. The framework is validated by a Second Party Opinion (SPO), which will corroborate that targets are science-based and ambitious, consistent with the borrower's strategy, and within reasonable reach for the borrower. The SPO will also confirm the alignment of these instruments with the Sustainability-Linked Loan Principles and Sustainability-Linked Bond Principles.

Conclusion

Sustainability-linked finance is expected to continue growing and evolving over the next few years. Growth will be driven by rising public awareness of climate change risks and global inequalities; soaring appetite for impact investing, particularly from younger generations[15]; and enlarging public regulation on sustainable finance and ESG disclosure standards for companies, with the aim of aligning financial flows with governments' sustainability objectives and increasing transparency from the private sector.[16] As the sector matures, sustainability coordinators' support on impact measurement, along with additional client support in the design and execution of sustainability action plans, will become important for the success of these instruments in achieving their intended objectives.

BOX 1 IFC's Full-Cycle Offering for Sustainability-Linked Financing in Emerging Markets

As the largest development institution focused on the private sector in developing countries, IFC is well-positioned to support the scale-up of sustainability-linked financing in emerging markets. Driven by increasing private sector demand, and in support of the 2030 Agenda of its client countries, IFC has rolled out a comprehensive offering for sustainability-linked financing. It combines IFC's globally recognized expertise in sustainability and impact measurement, its deep understanding of local markets, its access to blended finance and financing in local currencies, and its funding for pre-investment work. IFC sees these instruments as an opportunity to elevate its client partnerships from the purely financial to long-term strategic engagements around their sustainability agendas.

IFC can successfully play the role of sustainability coordinator, leveraging internal know-how on impact measurement and sustainability. IFC has led the development of widely-used sustainability and impact metrics, including the HIPSO indicator set and Joint Impact Indicators.[12] In 2017, IFC developed an ex-ante impact assessment tool—the Anticipated Impact Measurement and Monitoring ("AIMM") system[13]—which scores project outcomes (i.e., stakeholder, economy-wide, and environmental effects) and catalytic or systemic effects on markets. In addition, IFC has in-house experts in sustainability and climate, which can lead the set-up of sustainability-linked finance frameworks and coordinate SPOs.

Sustainability coordinator activities are embedded in IFC's mandate for sustainability-linked financing. At no additional cost to clients, IFC assigns a sustainability coordinator to each transaction, composed of in-house experts from its climate business department and its advisory teams. Activities covered by the sustainability coordinator can vary depending on the project, but they generally include: (i) identifying corporate- or project-level metrics that are material to the borrower's business strategy; (ii) benchmarking proposed targets for each metric against the borrower's historical performance and industry peers to ensure ambitiousness; (iii) defining relevant reporting methodologies and external verification mechanisms for target compliance; (iv) structuring financial incentives that are commensurate with the target's ambition, drafting sustainability-linked financing frameworks whenever needed, and incorporating legal language in the documentation; and (v) assisting in the SPO of the sustainability-linked financing framework, if required. (See Example 1 in Annex for more information.)

In addition to the market-standard Sustainability Coordinator role, IFC can provide strategic and implementation support to assist companies in their broader sustainability objectives. Deploying a team of in-house experts and consultants, as well as financial resources on a case-by-case basis, IFC can provide two levels of support to clients. The first service is "strategic support" to assist clients in crafting or refining their sustainability strategy, so that it is comprehensive (e.g., not limited solely to carbon emissions), ambitious, and inclusive. Interventions can include net-zero pathways, climate resilience roadmaps, "Just Transition" plans,[14] community engagement plans, gender strategies, and others. The second service is "implementation support" to assist clients in implementing pre-identified sustainability initiatives or new technologies that will help them implement their sustainability strategies. This might include pre-feasibility studies to assess the commercial or technical viability of new decarbonization technologies (e.g., hydrogen, batteries, floating solar PV) for client operations, support in the implementation of community engagement or gender programs, and others. IFC can partially co-fund some of these activities or projects via its own funds or donor financing.

See Annex for more information on IFC's experience in sustainability-linked finance.

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Annex

Example 1 IFC as Sustainability Coordinator

IFC has experience acting as Sustainability Coordinator in emerging markets, both for SLLs and SLBs. In 2021 to date, IFC has committed close to $700 million in long-term finance in various sustainability-linked transactions across the globe. This includes (i) a $30 million super-green SLL to Turkish municipal water utility IZSU linked to gender equality;[17] (ii) a $56 million super-green SLL to Brazil's state-own water utility Corsan linked to reduced water distribution losses, which also benefited from additional co-funded advisory services;[18] (iii) an $85 million SLL to Thai cargo carrier Precious Shipping linked to reduced freshwater use;[19] and (v) a $500 million SLB to Pan-Asian energy provider Sembcorp Industries linked to GHG emissions reduction targets.[20]

Example 2 IFC Strategic / Implementation Support

IFC also has vast experience helping companies with their sustainability strategies. Relevant examples of this work include: (i) Nachtigal Hydro Power Company (Cameroon), where IFC provided $13 million in InfraVenture funds for project co-development, as well as advisory to improve local sourcing, community engagement, gender equality, and livelihood restitution; (ii) Medellin's smart city strategy (Colombia), where IFC Advisory helped develop an action plan to integrate the use of digital solutions and big data in the city; and (iii) Oyu Tolgoi (Mongolia), where IFC Advisory trained over 1,500 stakeholders on mining and groundwater management.

Example 3 IFC in a SLB: Sembcorp (Singapore)

This landmark deal was the first SLB by an energy company in Southeast Asia, and the region's largest such issue to date.

The investment comprised S$675 million ($500 million equivalent) that will be used for renewable energy projects and other sustainable assets. The bond included a 25-basis-point step-up linked to a corporate carbon intensity reduction target of 25 percent by 2025.

This SLB issuance was completed at a crucial stage of Sembcorp's strategic shift to transform itself into a leading sustainable solutions provider in Asia, in line with the company's roadmap to quadruple renewable generation capacity to 10 GW by 2025.

In addition to anchoring the issue, IFC helped Sembcorp review the sustainability-linked finance framework, including a materiality assessment for the selection of metrics, target benchmarking, implementation action plans, and reporting methodologies.

Example 4 IFC in a Super-Green SLL: Corsan (Brazil)

The investment consisted of a R$300 million ($60 million equivalent) green and sustainability-linked loan to support Corsan's water-loss program and energy efficiency improvements through network replacement and efficient electric pumps and hydrometers. The facility included a coupon step-down linked to Corsan's target of reducing water losses in distribution to less than 35 percent by 2024.

In addition to the standard Sustainability Coordinator services provided by IFC, this project benefited from additional advisory and funding support through the "Utilities for Climate" initiative.[21] This work is helping Corsan diagnose and plan priority locations and interventions for its objective to reduce water losses.

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