



# **SUSTAINABILITY-LINKED BONDS: HOW TO MAKE THEM WORK IN DEVELOPING COUNTRIES, AND HOW DONORS CAN HELP**

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# Abstract

This report provides an overview of developments, challenges and opportunities in the new sustainability-linked bond market, with a spotlight on public sector issuances in the wake of the first two sovereigns entering this space in 2022. Building on insights from extensive consultations with experts and stakeholders as well as data provided by the Luxembourg Stock Exchange via the LGX DataHub, the report highlights how tailored and well-timed donor engagement can facilitate market growth. It outlines six constraints that are preventing this market from reaching scale in developing countries and corresponding ways that donor support can help overcome these.

# Foreword

This report is part of a broader series on green, social, sustainability and sustainability-linked (GSSS) bonds. Within the GSSS bond group, there are broadly two sub-categories of bonds which differ based on their underlying mechanisms: green, social and sustainability (GSS) bonds, and sustainability-linked bonds (SLBs). The most recent OECD reports in the GSSS bond series have therefore looked at these sub-categories separately. This series was initiated in response to a request from the Group of Twenty (G20) Development Working Group, under Italy's Presidency, for Italy's Cassa Depositi e Prestiti and the OECD to analyse the GSSS bond market in developing countries.

The first report in the series, *Scaling up green, social, sustainability and sustainability-linked bond issuances in developing countries* (2021), assessed the potential of the GSSS bond market to contribute to financing the Sustainable Development Goals, as well as highlighting gaps, challenges and possible policy actions.

The subsequent OECD report, *Green, social, sustainability and sustainability-linked bonds in developing countries: How can donors support public sector issuances?* (2022), drew on the strong evidence base of data provided by the Luxembourg Stock Exchange via the LGX DataHub to provide concrete recommendations on how donors can support public sector actors to tap into the potential of GSSS bonds.

The 2023 report, *Green, social and sustainability bonds in developing countries: The case for increased donor co-ordination*, recognised the particularities of green, social and sustainability (GSS) bonds as use-of-proceeds debt instruments and therefore focused on this subset of GSSS bonds. Building further on LGX DataHub data as well as extensive consultations with stakeholders, it explored how increased donor co-ordination can support GSS bond issuances in developing countries. It also highlighted five major policy areas – investment, insurance, (market)-infrastructure, issuance and impact – in “the Five Is” framework for donors to support the growth of this market.

This new report explores sustainability-linked bonds (SLBs), instruments whose structural and/or financial characteristics change according to whether issuers meet predefined sustainability objectives. A particular focus is on public sector issuances. The report provides an overview of market developments since the first SLB issuance in 2019 (using LGX DataHub data) and outlines six challenges to the scaling of the market as well as corresponding areas of donor support to address these.

The analysis also demonstrates the complementarity of SLBs and GSS bonds. Together with the preceding report on GSS bonds, it stresses that issuers should not have to choose between GSS bonds and SLBs but rather can use the two instruments in accordance with their ultimate financing needs.

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# Abbreviations and acronyms

<b>ADB</b>	Asian Development Bank
<b>AFII</b>	Anthropocene Fixed Income Institute
<b>ASCOR</b>	Assessing Sovereign Climate-related Opportunities and Risks
<b>BRD</b>	Development Bank of Rwanda
<b>DAC</b>	Development Assistance Committee (OECD)
<b>DFI</b>	Development finance institution
<b>ECB</b>	European Central Bank
<b>EU</b>	European Union
<b>ESG</b>	Environmental, social and governance
<b>GHG</b>	Greenhouse gas
<b>GSS</b>	Green, social and sustainability
<b>GSSS</b>	Green, social, sustainability and sustainability-linked
<b>ICMA</b>	International Capital Market Association
<b>IDA</b>	International Development Association
<b>IDB</b>	Inter-American Development Bank
<b>IFC</b>	International Finance Corporation
<b>IMF</b>	International Monetary Fund
<b>KPI</b>	Key performance indicator
<b>LGX</b>	Luxembourg Green Exchange
<b>MDB</b>	Multilateral development bank
<b>NAP</b>	National adaptation plan
<b>NDC</b>	Nationally determined contribution
<b>ODA</b>	Official development assistance
<b>SDG</b>	Sustainable Development Goal
<b>SLB</b>	Sustainability-linked bond
<b>SLBPs</b>	Sustainability-Linked Bond Principles (ICMA)
<b>SPO</b>	Second party opinion
<b>SPT</b>	Sustainability performance target
<b>SSDH</b>	Sustainability-linked Sovereign Debt Hub



# Executive summary

Current levels of financing are insufficient to meet the annual SDG financing gap in developing countries, estimated at USD 3.9 trillion (OECD, 2022<sup>[1]</sup>). Official development assistance (ODA) remains fundamental in financing sustainable development – and indeed rose to an all-time high in 2022 (OECD, 2024<sup>[2]</sup>) – but is not enough to cover the sizeable and growing needs placed on the development system. Mobilising more private investments, in particular those with the size and duration needed for sustainable development, will be crucial in developing countries. Capital markets can play an important role in opening up vast pools of untapped commercial capital.

Financial instruments such as green, social and sustainability (GSS) and sustainability-linked bonds (SLBs) – which link scale with impact – are important intermediation tools between capital markets and sustainability needs. Previous OECD work has focused on the particularities of GSS bonds as use-of-proceeds instruments with underlying green, social or sustainable assets (OECD, 2023<sup>[3]</sup>). This report focuses on SLBs as forward-looking instruments with changing structural and/or financial characteristics depending on whether issuers meet predefined sustainability objectives. They therefore hold significant potential for areas such as biodiversity, climate change adaptation and social development – which have strong financing needs but typically lack pipelines of sizeable and bankable assets necessary to use GSS bonds. Since they do not require underlying assets, SLBs can be backed by an issuer's entire balance sheet and can therefore be issued at high values and with longer tenors than GSS bonds. They can also be linked to existing sustainability pledges – such as the Nationally Determined Contributions – and thus increase their credibility and issuers' accountability.

The SLB market grew spectacularly following the first issuance in 2019, and has been marked by more volatility in recent years. Yet issuances from developing countries, which have the greatest financing needs, account for a small share of the total SLB market – and appear to be decreasing. Between 2021 and 2022, the share of SLBs from issuers in ODA-eligible countries as a percentage of the total issued amount decreased from 13% to 5%. At the same time, despite the first sovereigns entering the SLB market as issuers in 2022, public sector issuances remain extremely rare – accounting for just 2% of total issued value. This stresses the need to scale up the SLB market in developing countries and increase issuances from public sector actors.

In an increasingly complex macroeconomic context, members of the OECD Development Assistance Committee (DAC), referred to hereafter as donors, have an important role to play in supporting the SLB market, including with blended finance instruments. At the same time, SLBs and GSS bonds remain debt instruments at their core: they are not a one-size-fits-all solution. Before supporting an issuance, donors must carefully evaluate the broader macroeconomic environment, the institutional setting and whether issuers have room to take on more debt. The choice between complementary instruments – such as SLBs, GSS bonds and other types of financing – must therefore be made based on the instruments' respective characteristics, but also on those of the issuer.

Where SLBs are deemed appropriate, targeted and co-ordinated efforts by the donor community can be crucial in fostering more widespread usage in developing countries, and more specifically by public sector issuers. The nascent stage of the SLB market provides donors with a unique opportunity to leverage their

comparative advantages, co-ordinate on the types of support they provide, and align on their priorities from the onset. This can then go a long way in avoiding fragmentation and ensuring the evolution of a rigorous and credible market.

Donors have an important role to play in intermediating between (i) the interest of investors towards sustainable investment, (ii) financial innovation in capital markets, and (iii) the sustainable development ambitions of low- and middle-income countries. This report identifies six bottlenecks which currently limit the relevance and impact of SLBs, and ultimately hamper the market's growth in both developed and developing countries. To overcome these bottlenecks, the report provides policy advice in the following corresponding areas of donor support:

1. Provide technical assistance to narrow capacity and co-ordination gaps between stakeholders.
2. Encourage the development and use of locally adapted SLB guidelines and Principles that value sustainability.
3. Assist in choosing ambitious, material and harmonised key performance indicators (KPIs) and sustainability performance targets (SPTs).
4. Strengthen data capacities in partner countries to enable credible SLBs.
5. Advise on how to enhance the robustness of bond characteristics that incentivise sustainability.
6. Enable transactions to scale the market in developing countries.

These areas of donor support include more granular recommendations applicable to all types of SLB issuers in developing countries. In response to the extremely low level of public sector issuances to date – and the potential that these could hold for advancing sustainable development – specific recommendations pertaining to public sector issuers are also provided.

# **1 Sustainability-linked bonds (SLBs) hold significant potential to finance sustainable development and climate transition pathways**

Recent overlapping and global crises – the COVID-19 pandemic, Russia’s war of aggression against Ukraine, climate change and others – have put increasing pressure on financing for the Sustainable Development Goals (SDGs). The annual SDG financing gap is estimated to be USD 3.9 trillion, and it is expected to increase by USD 400 billion per year between 2020 and 2025 (OECD, 2022<sup>[1]</sup>). There is therefore an urgent need to scale up all sources of finance for sustainable development as well as critical climate goals. Developing countries have particularly acute financing needs. Yet, private investors have allocated only a small portion of their assets in these economies. This is due to several reasons, among them: high real and perceived risks, mandate requirements, limited currency transferability, and regulatory constraints (OECD, 2023<sup>[3]</sup>).

In this context, green, social, sustainability and sustainability-linked (GSSS) bonds have great potential to alleviate the ever-growing shortfall in finance for sustainable development and climate goals, particularly in developing countries. The newest of these GSSS bonds are sustainability-linked bonds (SLBs), for which the market in developing countries and globally remains underdeveloped despite their many advantages. To date, issuances have been concentrated in developed countries and issued by corporates rather than public sector actors. Scaling the use of this instrument will require addressing a number of bottlenecks in developing countries, which are both market-related and tied to bond fundamentals more specifically. This report identifies six specific areas where donor support can contribute to overcoming these bottlenecks. Given the extremely low level of public sector issuances to-date – and the potential that these could hold for driving sustainable development – the recommendations applicable to all types of SLB issuers will be complemented by messages that pertain to public sector issuances in particular. Public sector entities are also usually the main counterparts of donors in their development co-operation programmes and projects, making them a natural partner to work with for the scaling of the SLB market.

Debt markets hold seemingly infinite potential for private finance mobilisation due to their size: the global bond market stands at approximately USD 128.3 trillion (ICMA, 2020<sup>[4]</sup>). Bonds provide long-term, stable debt financing and are therefore strongly attractive for investors (Browne, Sundstrom and Shar, 2023<sup>[5]</sup>). The stated aim of GSSS bonds, more specifically, is to align financial returns with sustainable and development outcomes. With the growing interest in impact and SDG-aligned investing, GSSS bonds can be of importance to both impact investors and more traditional institutional investors. In addition, such bonds are a way for developing country issuers to tap into a new, deep pool of capital while also signalling their commitment towards sustainability.

The challenging global market conditions in 2022 resulted in a 16% drop in total fixed income issuances over the previous year. During the same period, GSSS bond issuances fell by 13%. Despite GSSS bonds

having outperformed the broader bond market, it was the first-ever annual decline in this asset class (IFC - Amundi, 2023<sup>[6]</sup>). The most recent S&P outlook for the GSSS bond market, published in September 2023, predicted GSSS bond issuance would continue to outpace that of traditional bonds for the remainder of the year and reach its highest-ever share of global bond issuance (S&P Global Ratings, 2023<sup>[7]</sup>). Still, in the face of growing concerns about green and SDG-washing related to these instruments as well as a backlash against environmental, social and governance (ESG) investments more broadly (Economist Intelligence Unit, 2023<sup>[8]</sup>), strong efforts are needed to ensure that the GSSS bond market unlocks its full potential to support the mobilisation of finance for sustainable development and climate transition pathways. At the same time, the same factors stifling traditional bond issuances – including rising interest rates and recession risks in key regions such as Europe and North America – could also result in decreased GSSS bond issuances (S&P Global Ratings, 2023<sup>[7]</sup>).

GSSS bonds fall into two complementary categories. (Box 1.1 presents the definitions used throughout this report.) Green, social and sustainability (GSS) bonds are use-of-proceeds instruments, meaning issuers commit to using the proceeds to (re-)finance specific projects considered to have a positive environmental and/or social impact. The proceeds of SLBs, on the other hand, can be used for general purposes and hence are more fungible. The structural and/or financial characteristics of SLBs change depending on whether issuers meet predefined sustainability objectives. **GSS bonds and SLBs are complementary: issuers should not have to choose only either one or the other but rather use both instruments based on their ultimate financing needs.**

OECD policy work has focused on different parts of the GSSS bond market starting with the role of OECD Development Assistance Committee (DAC) members (hereafter, donors) in scaling up GSSS bond issuances in developing countries as well as public sector issuances of these instruments (Demebele, Schwarz and Horrocks, 2021<sup>[9]</sup>; OECD, 2022<sup>[10]</sup>). Another recent report zeroes in on the particularities of GSS bonds as use-of-proceeds debt instruments and calls for increased donor co-ordination to support this category of bonds (OECD, 2023<sup>[3]</sup>). This report, while recognising the complementarity of GSS bonds and SLBs, turns the focus on the latter category and on the role of donors in increasing issuances in developing countries.

As is the case with the GSS bond market, development of the SLB market faces challenges. With the first SLB issued as recently as 2019<sup>1</sup> – and the first sovereign issuance taking place in 2022 (Box 1.2) – donors and development finance institutions (DFIs) have not extensively supported SLBs to date or themselves issued SLBs. Although this may be due to the nascent nature of the instrument, this dynamic starkly contrasts the one in the GSS bond market, where donors have played a more active role. Indeed, the World Bank and the European Investment Bank were the first issuers of green bonds and, more broadly, donors' interest in project deliverables makes use-of-proceeds instruments particularly attractive. Nonetheless, even without directly entering the market by issuing SLBs, donors and their DFIs have a key role to play in supporting not only the development of the SLB market but also SLB issuers themselves.

The findings and recommendations of this report are based on the data provided by the Luxembourg Stock Exchange via the LGX DataHub (Box 2.1 provides more details) as well as extensive consultations with stakeholders from the GSSS bond ecosystem including donor institutions, multilateral and national development banks, bond issuers, private sector players, and industry experts. This report also builds on existing literature, SLB market analysis and case studies although, given the novelty of SLBs, these remain limited at the time of writing.

### Box 1.1. Definitions used throughout this report

**Public sector bonds** refer to bonds issued by sovereign, sub-sovereign and agency actors to finance spending programmes, cover interests due or repay old debts. As with other types of bonds, a public sector bond promises to pay the buyer periodic interest or coupons and repay the face value on the maturity date. The rating of the bond is associated with the creditworthiness of the sovereign.

**Sustainability-linked bonds** are bonds “for which the financial and/or structural characteristics can vary depending on whether the issuer achieved predefined sustainability/ESG objectives” (ICMA, 2023<sup>[11]</sup>). As such, they are forward-looking performance-based instruments where issuers commit to future improvements in sustainability outcomes within a determined period (ICMA, 2023<sup>[11]</sup>). Table 1.1 provides a non-exhaustive list of some of the most common types of financial and/or structural characteristics associated with SLBs.

**Key performance indicators (KPIs)** are “quantifiable metrics used to measure the performance of selected indicators” (ICMA, 2023<sup>[11]</sup>). The many potential KPIs include, for example, total greenhouse gas emissions per capita, or children in employment (% of children aged 7-14).

**Sustainability performance targets (SPTs)** are “measurable improvements in KPIs on to which issuers commit to a predefined timeline” (ICMA, 2023<sup>[11]</sup>). When possible, these should be specified in existing climate or sustainability policies or pledges. They should also be ambitious.

While KPIs and SPTs are closely related, they are two distinct components and should be treated as such. SPTs represent the target and thus the level of ambition of the bond, while KPIs represent the corresponding metric(s). The quality of KPIs depends on whether the chosen metric is relevant and material for the operations and sustainability impact of the issuer and whether the performance against this indicator can be and is measured in a credible way. Although it should be fundamental for issuers to disclose both KPIs and SPTs, these components are in practice not always within the contractual obligation of the bond itself.

**Green, social and sustainability bonds** differ from SLBs in that they have a use-of-proceed mechanism with a focus on activities or assets with a sustainable purpose. GSS bonds are beyond the scope of this report, but have been the focus of previous OECD publications, for instance (OECD, 2023<sup>[3]</sup>).

Box Source: ICMA (2023<sup>[11]</sup>), *Sustainability-Linked Bond Principles Voluntary Process Guidelines*, <https://www.icmagroup.org/assets/documents/Sustainable-finance/2023-updates/Sustainability-Linked-Bond-Principles-June-2023-220623.pdf>; (OECD, 2023<sup>[3]</sup>), *Green, Social and Sustainability Bonds in Developing Countries: The Case for Increased Donor Co-ordination*, <https://www.oecd.org/dac/green-social-sustainability-bonds-developing-countries-donor-co-ordination.pdf>.

### Table 1.1. Types of financial and/or structural characteristics associated with SLBs

This table outlines the types of financial and/or structural characteristics that can be associated with SLBs alongside some examples. As of 2023, the majority of SLB issuances have involved a step-up. Changes to other structural characteristics or other non-financial penalties are not precluded by the ICMA Sustainability-Linked Bond Principles, but can have some limitations such as increasing the overall complexity of the bond.

Coupon step-up	If the issuer does not meet its predetermined sustainability targets by the target observation date, subsequent interest payments will be increased by a predetermined penalty amount (usually quoted in basis points). <i>The Chilean sovereign SLB issuance is characterised by a coupon step-up (see Box 1.2).</i>
Coupon step-down	If the issuer meets its predetermined sustainability targets by the target observation date, subsequent interest payments will be decreased by a predetermined amount (usually quoted in basis points).

	<i>The Uruguay sovereign SLB issuance combines both a step-up and step-down (Box 1.2), while the recent Development Bank of Rwanda SLB (Box 2.2) has a coupon step-down only.</i>
Redemption premium	If the issuer does not meet its predetermined sustainability targets by the target observation date, the issuer will have to pay a predetermined premium on the bond's redemption price at the time of redemption (usually quoted in percentage).
Donation	If the issuer does not meet its predetermined sustainability targets by the target observation date, an amount equal to a predetermined percentage of the bond's issuance will be donated to a foundation or organisation of the issuer's choice.
Early redemption	If the issuer does not meet its predetermined sustainability targets by the target observation date, the bond will be redeemed early at a predetermined redemption price.
Purchase carbon emission credits	If the issuer does not meet its predetermined sustainability targets by the target observation date, the issuer will purchase carbon offsets for an amount equivalent to a predetermined percentage of the aggregate principal amount of the bonds.
Emerging characteristics	One example is introduction of a penalty fee if the issuer fails to deliver the Sustainability Certificate and/or the Limited Assurance Report. <i>The recent Development Bank of Rwanda SLB (see Box 2.2) introduced this type of penalty.</i>

Table Source: Adapted from UI Haq and Doumbia (2023<sup>[12]</sup>), "Structural loopholes in sustainability-linked bonds", <https://documents1.worldbank.org/curated/en/099237410062223046/pdf/IDU0e099a50307f86045a80b33201d0b7057cedf.pdf>; ICMA (2023<sup>[13]</sup>), *Sustainability-Linked Bond Principles Related Questions*, <https://www.icmagroup.org/assets/documents/Sustainable-finance/2023-updates/SLB-QA-2023-Sept-250923.pdf>.

## 1.1. Sustainability-linked bonds are powerful instruments for accelerating progress towards sustainability targets

SLBs are a forward-looking performance-based instrument in that issuers explicitly commit to future improvements in sustainability outcomes with a predefined timeline. Proceeds raised through SLBs do not have to be directly used for green or social assets or projects. But they crucially relate to the performance of certain sustainability KPIs in achieving predefined SPTs, as elaborated in Box 1.1. It is important that the chosen SPTs be ambitious enough to encourage issuers to go beyond business as usual.

In September 2019, the Italian energy group Enel issued the world's first SLB.<sup>1</sup> The global SLB market initially experienced very significant growth that peaked in 2021, before momentum slowed in 2022 (Figure 2.1). That year, SLB issuances accounted for 9.4% of all GSSS bond issuances, down from the high of 11.2% in 2021. Initial figures for the first quarter (Q1) of 2023 suggest that the market was picking up again, although the latest September 2023 S&P outlook projected SLB issuances in 2023 would not reach 2022 levels and would continue to lag the levels of other bond types (S&P Global Ratings, 2023<sup>[7]</sup>).

Two further trends can be identified within the global SLB market. **First, the SLB market is highly concentrated in developed markets despite the greater sustainable financing need of developing countries.** In 2021, issuers from official development assistance (ODA)-eligible countries accounted for 13% of the total issued amount of SLBs, and their share dropped to 5% in 2022, indicating that SLB issuances are largely not occurring in the countries that have the greatest financing needs and could benefit most from these instruments. Among their clear advantages for developing countries, SLBs – unlike GSS bonds – do not rely on a pipeline of bankable projects, which developing countries often lack. Untying the instrument from a specific use of proceeds also means that SLBs can be used by a wider range of entities that want to demonstrate to debt capital markets their commitment to sustainability outcomes. Further, debt markets enable developing countries to access both local and foreign currency funds. Due to their ability to reward and incentivise sustainability performance, SLBs therefore complement the suite of financing tools used to meet developing countries' sustainable development and climate objectives.

**A second identifiable trend is that the SLB market is dominated by corporate issuers, which make up 98% of issuances to date, despite the many advantages of SLBs for public sector issuers.** In

2022, sovereigns entered the SLB market as issuers for the first time: Chile issued the first sovereign SLB in March and Uruguay followed suit in October (Box 1.2). In both cases, the bonds' KPIs were in line with the goals of the countries' nationally determined contribution (NDCs) in the context of the Paris Agreement. In June 2023, Chile issued another SLB with a gender KPI – the first sovereign bond to incorporate social targets and also the first issuance in euros (Bruni and Lewis, 2023<sup>[14]</sup>).

Despite the low number of sovereign, sub-sovereign and agency (or public sector) SLB issuances to date, the instrument holds significant potential for such issuers. Public sector issuers broadly use traditional bonds (also referred to as vanilla bonds throughout this report) to raise capital to carry out basic services of government such as education and transport as well as for other sovereign responsibilities such as helping economies transition towards sustainable pathways. Public sector issuers can therefore complement the use of vanilla bonds with SLBs and GSSS bonds more broadly. Aside from mobilising investors, SLBs also signal the credibility of a sovereign's commitments towards the SDGs and the Paris Agreement, particularly as sovereigns are typically the actors primarily responsible for the implementation of these goals. SLBs are often seen as an intermediary step in the transition to full-fledged SDG and Paris Agreement alignment in the financing profile of an issuer that may not have enough projects initially for a GSS bond tied to assets having green, social or sustainability objectives. For sovereigns, SLBs are also highly relevant for areas such as biodiversity, climate change adaptation and social outcomes, which have strong financing needs but lack bankable assets and therefore are harder to finance with GSS bonds. Finally, public sector SLBs may be particularly important in markets with low or no SLB issuance numbers as they can have a market-building, trickle-down effect and set benchmarks for other actors to follow, although evidence for this is lacking (OECD, 2024<sup>[15]</sup>).

It is important to acknowledge that public sector actors were also very slow to enter the GSS bond space; the first sovereign to issue a green bond was Poland, and then nearly a decade after the birth of the market (Rowntree, Richardson and Iritz, 2023<sup>[16]</sup>). In this light, then, the fact that two sovereigns issued SLBs when the market was less than four years old can be seen as promising for future issuances. Sovereigns' interest in the broader GSSS bond space has been growing, and 2023 was the biggest year on record for sovereign issuances of such instruments (Rowntree, Richardson and Iritz, 2023<sup>[16]</sup>). At the same time, it is important to note that SLBs, like GSS bonds, are essentially debt instruments and may not be appropriate for all issuers and should not be viewed as a one-size-fits-all solution. Issuing bonds – let alone more complex instruments such as GSS bonds and SLBs – requires significant capacity, which some entities in developing countries may lack. Broader considerations with regard to countries' macro fundamentals and overall risk setting are also relevant, and debt sustainability concerns need to be carefully evaluated (OECD, 2023<sup>[3]</sup>).

The starting point of this report, then, is to explore how donors can support SLB issuances from developing country issuers – including both public sector and corporate. Given the extremely low level of public sector issuances to-date – and the potential that these could hold for driving sustainable development – the recommendations applicable to all types of SLB issuers will be complemented by messages that pertain to public sector issuances in particular.

## Box 1.2. Sovereign SLB issuances: Chile and Uruguay

### Chile: The world's first sovereign SLB issuer – coupon step-up linked to the NDC and to gender equality

In February 2022, Chile issued the world's first sovereign SLB. Its stated purpose was to “leverage ambitious timelines to achieve strong sustainable outcomes that are relevant, core and material to Chile and the Chilean people” (Public Debt Office of the Ministry of Finance of Chile, 2023<sup>[17]</sup>). Chile built on its previous GSS issuances, with the aim to inspire other sovereigns and corporates to do the same (Public Debt Office of the Ministry of Finance of Chile, 2023<sup>[17]</sup>). Its SLB, which matures in 2042, raised USD 2 billion and achieved very high and diversified investor demand of USD 8.1 billion (GFL - Green Finance for Latin America and the Caribbean, 2022<sup>[18]</sup>).

The SLB has two KPIs that, alongside the associated SPTs, are in line with the environmental objectives set in Chile's updated NDC. The bond has an associated coupon step-up, which “raises the coupon by 12.5 basis points per KPI, from 4.34% per annum at issuance to 4.59% if both KPIs underperform the SPT at the penalty event date” (Kulenkampff and Pipan, 2023<sup>[19]</sup>).

In 2023, Chile added a third KPI to its SLB Framework, focused on gender equality and women's empowerment. In June of that year, Chile issued a USD 3 billion multi-currency package of SLBs composed of a USD 1.15 billion 12-year SLB, a USD 1.1 billion 30-year SLB, and a EUR 750 million 11-year SLB (Table 1.2). Not only was this the first sovereign SLB to incorporate social targets, but it was also the first sovereign SLB in euros (Bruni and Lewis, 2023<sup>[14]</sup>). This bond also has an associated coupon step-up.

**Table 1.2. Characteristics of the 2023 Chile Sustainability-linked Bond Framework**

KPI	Associated SPT	Observation date	Structural and/or financial characteristic(s)
1. Greenhouse gas emissions (GHG) per year, measured in metric tonnes of CO <sub>2</sub> equivalent (MtCO <sub>2e</sub> )	Achieve GHG emissions of 95 MtCO <sub>2e</sub> by 2030	31 December 2030	Chile will link the bond's financial characteristics to the achievement of the SPTs, such as a coupon step-up or a premium payment in case an SPT, including an intermediate SPT, is not met at the target observation date. In the event that more than one SPT is not met, the premium paid will be cumulative
	Achieve a maximum of 1 100 MtCO <sub>2e</sub> between 2020 and 2030	31 December 2030	
2. Non-conventional renewable energy (NCRE) generation as the percentage generated in the national electric system, measured in megawatt hours (MWh)	Achieve 50% electric generation derived from NCRE sources by 2028	31 December 2028	
	Achieve 60% electric generation derived from NCRE sources by 2032	31 December 2032	
3. Percentage of women in board member positions at companies that report to Chile's Financial Market Commission (CMF)	Achieve at least 40% of women representation in boards of directors at companies that report to the CMF by 2031	31 December 2031	

Source: Public Debt Office of the Ministry of Finance of Chile, (2023<sup>[17]</sup>), *Chile's Sustainability Linked Bond Framework: June 2023*, <https://www.hacienda.cl/english/work-areas/international-finance/public-debt-office/esg-bonds/sustainability-linked-bonds/chile-s-slb-framework-june-2023-version>; Sustainalytics (2023<sup>[20]</sup>), *Second-Party Opinion: Chile's Sustainability-linked Bond Framework*, <https://www.hacienda.cl/english/work-areas/international-finance/public-debt-office/esg-bonds/sustainability-linked-bonds/second-party-opinion-sustainalytics-2023->



### Uruguay: The first sovereign SLB with both a coupon step-up and step-down mechanism

In October 2022, Uruguay issued the world's second sovereign SLB and pioneered an alternative approach by implementing a two-way pricing structure. The bond, maturing in 2034, received high investor demand of USD 3.96 billion, greatly exceeding the USD 1.5 billion size of the bond (IDB, 2022<sup>[21]</sup>).

The Uruguay SLB has two KPIs. Together with the associated SPTs, these link “the country's cost of capital to the achievement of its climate and nature-based goals under the Paris Agreement” (Ministry of Economy and Finance of Uruguay, 2022<sup>[22]</sup>). The two KPIs are linked not only to a coupon step-up but also to a step-down if Chile overperforms its targets (Table 1.3). The coupon step-up and step-down are symmetrical, of 15 basis points (Kulenkampff and Pipan, 2023<sup>[19]</sup>).

**Table 1.3. Characteristics of the Uruguay 2022 SLB**

KPI	Associated SPT	Observation date	Structural and/or financial characteristic(s)	
Reduction of aggregate gross GHG emissions (in CO <sub>2</sub> equivalent) per real gross domestic product unit with respect to reference year 1990 (in %)	NDC commitment: Achieve at least 50% reduction in GHG emissions intensity by 2025 from the 1990 reference year	2025	A one-time coupon step-up will occur if Uruguay fails to achieve its NDC commitment by 2025	No change in the coupon will occur if Uruguay meets its NDC commitments but falls short of exceeding the overperformance targets (i.e., when the performance of both KPIs falls on or in between the two targets outlined in their respective SPTs).
	Outperformance compared to NDC commitment: Achieve more than 52% reduction in GHG emissions intensity by 2025 from the 1990 reference year		A one-time coupon step-down will occur if Uruguay overperforms on its NDC commitment by 2025	
Maintenance of native forest area (in hectares) with respect to reference year 2012 (in %)	NDC commitment: Maintain at least 100% of the native forest area compared with reference year 2012	2025	A one-time coupon step-up will occur if Uruguay fails to achieve its NDC commitment by 2025	
	Outperformance compared to NDC commitment: Achieve an increase higher than 3% of the native forest area compared with reference year 2012		A one-time coupon step-down will occur if Uruguay overperforms on its NDC commitment by 2025	

Source: Ministry of Economy and Finance of Uruguay, (2022<sup>[22]</sup>), *Uruguay's Sovereign Sustainability-linked Bond (SSLB) Framework: For Sustainability-Linked Bonds Focused on Climate and Nature-Based Targets*, [https://www.mef.gub.uy/innovaportal/file/30690/20/uruguay\\_sslb\\_framework\\_2.pdf](https://www.mef.gub.uy/innovaportal/file/30690/20/uruguay_sslb_framework_2.pdf).

Source: Public Debt Office of the Ministry of Finance of Chile, (2023<sup>[17]</sup>), *Chile's Sustainability-linked Bond Framework: June 2023*, <https://www.hacienda.cl/english/work-areas/international-finance/public-debt-office/esg-bonds/sustainability-linked-bonds/chile-s-slb-framework-june-2023-version>; Sustainalytics (2023<sup>[20]</sup>), *Second-Party Opinion: Chile's Sustainability-linked Bond Framework*, <https://www.hacienda.cl/english/work-areas/international-finance/public-debt-office/esg-bonds/sustainability-linked-bonds/second-party-opinion-sustainalytics-2023->; GFL – Green Finance for Latin America and the Caribbean (2022<sup>[18]</sup>), “Chile becomes the first country in the world to issue a Sustainability Linked Bond”, <https://greenfinancelac.org/resources/news/chile-becomes-the-first-country-in-the-world-to-issue-a-sustainability-bond/#:~:text=The%20placement%20of%20the%20new,investor%20but%20also%20by%20geography>; Kulenkampff and Pipan (2023<sup>[19]</sup>), *More for Less – Scaling Sustainability-linked Sovereign Debt*, [https://uploads-ssl.webflow.com/63060e56769e33ff323efef0/642aea97be3a5f2695089149\\_MoreForLess.pdf](https://uploads-ssl.webflow.com/63060e56769e33ff323efef0/642aea97be3a5f2695089149_MoreForLess.pdf); Bruni and Lewis (2023<sup>[14]</sup>), “Chile opens sovereign SLBs to euros and social KPIs”, <https://www.ifre.com/story/3993906/chile-opens-sovereign-slbs-to-euros-and-social-kpis-m3cqrnvxnp>; IDB (2022<sup>[21]</sup>), “Uruguay issued global sustainability-linked bond, with IDB support”, <https://www.iadb.org/en/news/uruguay-issues-global-sustainability-linked-bond-idb-support>; Ministry of Economy and Finance of Uruguay, (2022<sup>[22]</sup>), *Uruguay's Sovereign Sustainability-linked Bond (SSLB) Framework: For Sustainability-Linked Bonds Focused on Climate and Nature-Based Targets*, [https://www.mef.gub.uy/innovaportal/file/30690/20/uruguay\\_sslb\\_framework\\_2.pdf](https://www.mef.gub.uy/innovaportal/file/30690/20/uruguay_sslb_framework_2.pdf).

## 1.2 Different factors determine investor appetite for SLBs

**From the investors' perspective, the evolving SLB market has significant potential to support the development of sustainable finance markets by broadening their range of available options.** When seeking investment opportunities, investors look at the broader bond market and then potentially at thematic bonds such as GSS bonds and SLBs. Investors are drawn to GSSS bonds for many reasons: to achieve ESG impact, contribute to the development of this market, diversify their portfolios, and reflect the direct interests of their stakeholders (The World Bank, 2022<sup>[23]</sup>). Consultations with international investors suggest that SLBs in particular are perceived as advancing the development of sustainability investment options. Investors appreciate the fact that these bonds are more flexible, incentivise positive sustainability outcomes, and can, as discussed in section two, exceed the issuance size and typically have longer tenors than GSS bonds.

Moreover, SLBs can be designed in a way that mitigates climate transition risks, which are increasingly shaping investor decisions. Public commitments made by major investors and asset owners, for instance in the context of the United Nations-convened Glasgow Financial Alliance for Net Zero, known as GFANZ, suggest that there is clear momentum to align portfolio allocation with net-zero targets. While climate transition risks weigh less heavily on the asset quality of sovereign issuers than on that of corporate bond issuers, sovereign bond portfolios are also increasingly covered by sustainability objectives in investor mandates. SLBs are ideally suited to integrate these objectives through KPIs and SPTs that reflect the issuer's path to net zero.

### Box 1.3. The role of credit fundamentals for investors in GSSS bonds

Investing in developing country market debt offers potentially higher returns for private sector investors due to the greater level of risk associated with investing in such rapidly growing and sometimes politically unstable countries (FT Adviser, 2023<sup>[24]</sup>).

Rating agencies play an important role in determining the risk of bonds, with sovereign risk ranging from very safe (US Treasury bonds) to moderately risky (investment grade) and highly speculative (high-yield bonds, also known as junk bonds). A significant number of developing countries fall under this high-yield category. Before investing in a sovereign bond issuance, the private investor will, among other factors, undertake due diligence on the interest rate risk and inflation. GSSS bonds will typically add another level of complexity for investors, involving, for example, an assessment of the ambitiousness of the KPIs and SPTs for SLBs. Moreover, investments in developing countries will have additional credit risks. Examples of such risks include:

- Debt default risk – A sovereign cannot or will not pay back its debt. Bondholders do not receive their scheduled interest payments during a default and often do not receive the full principal either.
- Political risk – Political instability is common in developing nations since governance systems tend to be immature.
- Liquidity risk – Developing country market debt securities may be difficult to buy and sell quickly because the market is more limited than developed markets.
- Currency risk – Investment returns may be affected by changes in the value of both the US dollar and emerging market currency.

Based on such considerations, the private sector will bid a price at auction that it believes captures the risk and return elements of the sovereign issuer's bonds. Ultimately, a sovereign issuer with a high credit rating will pay a lower interest rate than one with a low credit rating. Investors who purchase

bonds with low credit ratings, however, can potentially earn higher returns but must bear the additional risk of default by the bond issuer.

Source: FT Adviser (2023<sup>[24]</sup>), "The role of emerging market bonds right now", <https://www.ftadviser.com/investments/2023/03/02/the-role-of-emerging-market-bonds-right-now/>.

An issuer's credit fundamentals are also critical to investment decisions, especially for public sector issuances (see (The World Bank, 2022<sup>[23]</sup>) and Box 1.3). In regions with a large number of countries with low credit ratings, such as sub-Saharan Africa, these can have a significant impact on regional investment allocations. Relatedly, the overall health of the domestic market can also impact investment decisions. At the same time, the SLB market is still in its infancy and therefore remains the subject of intense investor scrutiny. For example, during consultations, some investors indicated they will not purchase SLBs due to greenwashing or transparency concerns as well as the potentially variable nature of investment returns. Some also prefer the transparency of use-of-proceeds bonds and have mandates that do not allow for SLBs (Sustainability-linked Sovereign Debt Hub, 2023<sup>[25]</sup>).

Section two provides an analysis of SLB issuance trends, illustrating the market's rapid growth and development since its inception in 2019 to Q1 2023. While underscoring the enormous potential of SLBs, the analysis also points to some limitations in the market, especially regarding the limited opportunities for developing country issuers despite the bond market's significant size, traditionally low cost and longer-term financing characteristics. This analysis can provide useful orientation to help donors understand the current dynamics and find entry points to put SLBs at the service of the international sustainable development and climate agendas.

# 2 Market overview: The SLB market is concentrated in developed markets and driven by corporate issuances

As discussed in section one, sustainability-linked bonds (SLBs) have rapidly gained traction among issuers and investors, despite being a relatively new segment of the bond market. This section presents a more granular analysis of trends in the market using data provided by the Luxembourg Stock Exchange and its proprietary tool the LGX DataHub (Box 2.1).

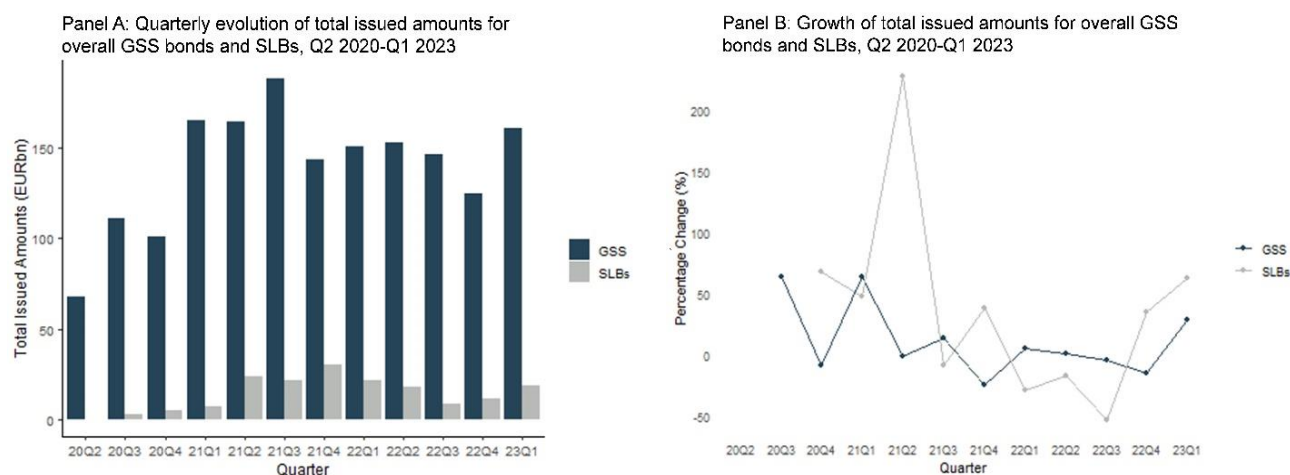
## 2.1 The SLB market in terms of volume and number of issuances has been volatile since inception

**In the first years after SLBs were introduced to the market in 2019, issuance volumes grew rapidly,** reaching a peak level of just over EUR 30 billion in Q4 2021 (Figure 2.1, Panel A). Compared with green, social and sustainability (GSS) bonds, however, overall issuance volumes remain relatively small. In Quarter one of 2023, for example, SLBs made up 10.4% of issued amounts in the total green, social, sustainability and sustainability-linked (GSSS) market (GSS bonds and SLBs). On average, however, the annual percentage growth in SLB issuance volumes from 2020 to 2022 was more than six times bigger than that for GSS issuance volumes in the same period.

**Volatility is more pronounced for the global SLB market than for GSS bonds.** The growth momentum in the global SLB market slowed in 2022, although it rose again in 2023 (Figure 2.1, Panel B). While a similar pattern was observed in the overall bond market and the GSS bond market (OECD, 2023<sup>[3]</sup>), the decline in SLB issuances was more pronounced. This can partly be explained by the relatively nascent stage of the SLB market. Another explanation could be hesitation on the part of investors due to the lack of clear and credible key performance indicators (KPIs) and sustainability performance targets (SPTs). These and other bottlenecks to SLB market development are discussed in greater detail in section three. By the same token, the pick-up in growth of SLB issuances in the first quarter of 2023 could signal that the instruments are gaining credibility (for example, thanks to pre-issuance external reviews based on an SLB framework) and/or are becoming more relevant and convenient for issuers.

**Figure 2.1. After a slowdown in 2022, SLB issuances picked up again in the first quarter of 2023**

Quarterly evolution of total issued amounts for overall GSS bonds and SLBs (Panel A, left side) and their respective growth, Q2 2020-Q1 2023 (Panel B, right side)



Source: Authors' calculations based on LGX DataHub data.

### Box 2.1. LGX DataHub descriptive statistics

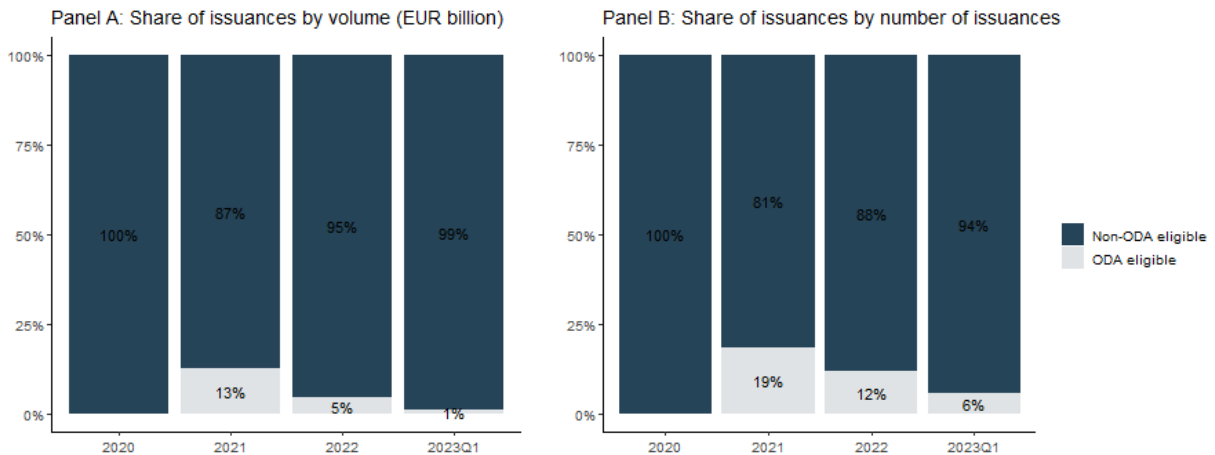
The Luxembourg Green Exchange (LGX), part of the Luxembourg Stock Exchange, is dedicated to sustainable finance with the aim of reorienting capital towards sustainable investments. The LGX DataHub, referenced throughout this report, provides users with granular and structured pre- and post-issuance data on listed GSSS bonds. It is a tool that enables investors and asset managers to compare different products and their characteristics. This transparency also helps drive expectations and harmonisation regarding impact reporting. This report uses the dataset from LGX DataHub as of July 2023 with the following scope:

- a total of 426 SLB issuances
- a timeframe of June 2020 to March 2023
- a total of 273 issuers
- developing countries are countries eligible for official development assistance (ODA) per the DAC List of ODA-eligible countries as of March 2023 (in this analysis, the People's Republic of China is not included as ODA-eligible unless specified)
- types of issuers are corporates; financial institutions; and sovereigns, sub-sovereign and agencies (SSA)
- data on GSS bonds covers the same time period and a total of 8,440 issuances.

### Issuances from ODA-eligible countries account for a relatively small share of the total SLB market.<sup>2</sup>

The imbalance between advanced and ODA-eligible markets appears to be increasing. As shown in Figure 2.2, the share of SLBs from issuers in ODA-eligible countries as a percentage of the total issued amount decreased from 13% in 2021 to 5% in 2022; the share dropped to just 1% in Q1 2023. In terms of number of issuances, a similar downward trend was observed, whereby issuances from ODA-eligible countries accounted for 19% in 2021 but fell to 12% in 2022 and 6% in Q1 2023.

**Figure 2.2. The share of SLBs from issuers in ODA-eligible countries is small and decreasing**



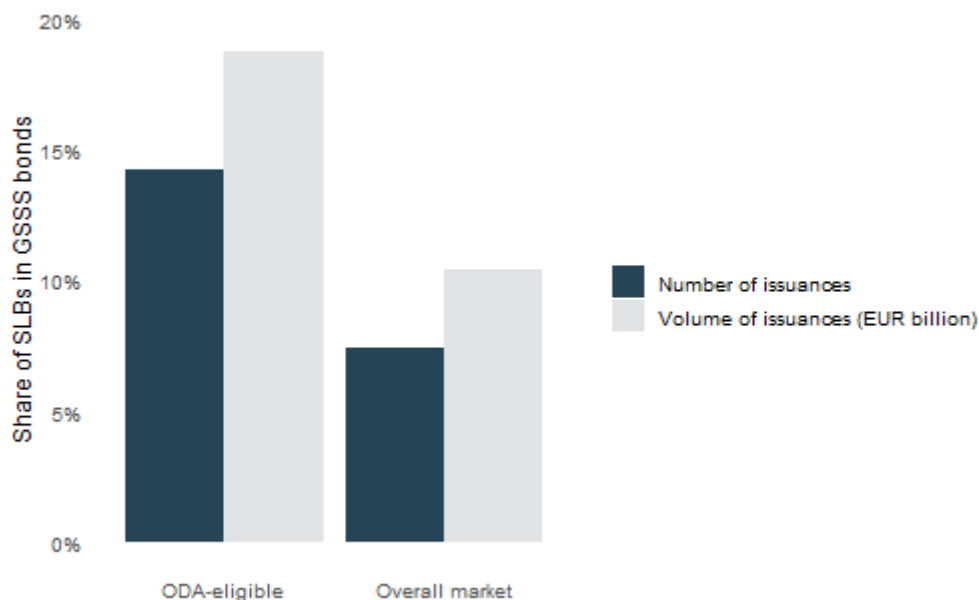
Note: The ODA-eligible group in this figure does not include China.

Source: Authors' calculations based on LGX DataHub data.

Among ODA-eligible countries,<sup>3</sup> SLB issuances are highly concentrated in a handful of larger, upper middle-income markets. Among SLBs from issuers in ODA-eligible countries, Brazil, India and Mexico together account for about 80% of total issuances (in EUR billion), while the rest of issuers in Costa Rica, Dominican Republic, Indonesia, Malaysia, Peru, South Africa, Thailand and Türkiye together account for the remaining 20%.

**However, SLBs consistently account for a larger share of total GSSS bond issuances in ODA-eligible countries than in the overall market.** As indicated in Figure 2.3, in 2021 and 2022, SLBs accounted for 14% of the total number of GSSS bonds issued and 19% of issued value in ODA-eligible countries. This compares to shares of 7% and 10%, respectively, in advanced markets. These figures suggest that ODA-eligible country issuers make relatively more use of SLBs compared with other types of GSSS bonds. This can be due to multiple reasons – including the more limited pipelines of bankable assets or capital-intensive projects in these settings.

**Figure 2.3. SLBs represent a bigger share of GSSS bonds issued in developing countries than of those issued in the overall SLB market**

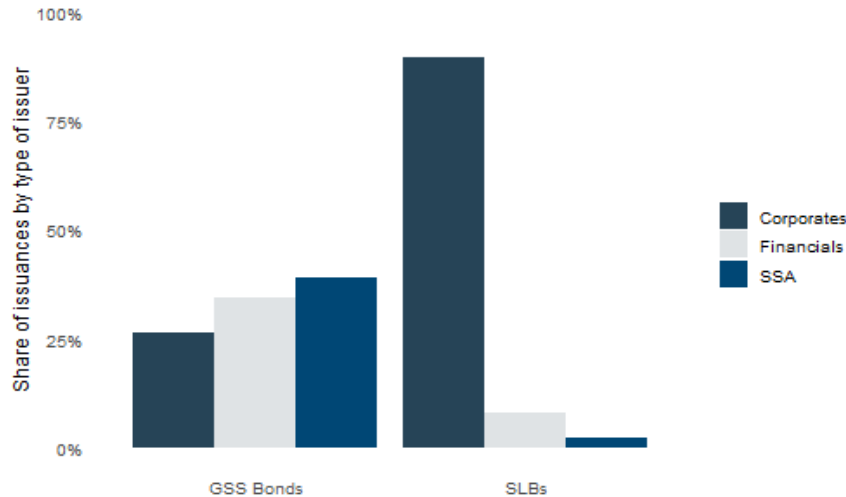


Note: The ODA-eligible group does not include China. The overall market includes ODA-eligible and non-ODA-eligible markets. Value of issuances refers to the amount issued in EUR billion, while number of issuances refers to the count of issuances without distinction by size.  
Source: Authors' calculation based on LGX DataHub data.

**Most of the SLB issuances in ODA-eligible markets are corporate bonds, as they are in advanced markets** (Figure 2.4). From Q1 2020 through Q3 2023, corporate issuers represented approximately 90% of all SLB issuances, and 98% of issuances when financial company issuers are included. Public sector (sovereign, sub-sovereign and agency, SSA) issuances accounted for just 2% of total issued value.<sup>4</sup> There are only a few transactions, among them the recent SLB issuance by the Development Bank of Rwanda (BRD) (Box 2.2), where a sovereign or local government or other public sector agencies made use of SLBs.

### Figure 2.4. SLBs are predominantly issued by corporates rather than public sector entities

Share of GSSS bonds and SLBs by ODA-eligible country issuers, by type of issuer over Q1 2020 to Q3 2023



Note: SSA = Sovereigns, Supranational and Agencies.

Source: Authors' calculations based on LGX DataHub data.

#### Box 2.2. The Development Bank of Rwanda's sustainability-linked bond

In September 2023, the Development Bank of Rwanda (BRD) launched its first SLB with a seven-year tenor and a target size of Rwandan Franc (FRW) 30 billion (equivalent to USD 24.8 million). The bond was oversubscribed and well received by investors and allows the BRD to diversify its funding away from government sources. Issued in local currency, the SLB also reduces risks related to foreign exchange fluctuations.

Crucially, the bond benefitted from an innovative credit enhancement mechanism from World Bank International Development Association (IDA) funds. The government of Rwanda used IDA funds to collateralise the bond, thereby reducing the risk for investors and lowering the cost of borrowing. It was the first time that IDA financing has been used to leverage private capital. While this was vital to this issuance and drove private capital mobilisation, it is expected that the BRD's strong balance sheet and credit rating will, in time, allow it to issue without credit enhancement. Beyond this, the SLB is the first of its kind in many other areas as well: the first SLB issuance by a national development bank globally, the first SLB issuance in East Africa and the first-ever bond issuance by the BRD. As such, the 2023 SLB not only contributes to local capital market development but also has a demonstration effect for other potential issuers including the Rwandan government itself and corporates.

The BRD's issuance is innovative also in the structure. Instead of having a symmetric step-up and step-down (as is the case in the Uruguay SLB) or a simple step-up (as in Chile's), it has a step-down only structure, which positively incentivises the borrower to set meaningful targets. The SLB's KPIs are aligned with Rwanda's sustainable development objectives (contained in its Vision 2050 strategy). They also focus specifically on improving environmental, social and governance systems and practices in partner financial institutions; increasing funding to women-led projects from 15 to 30 percent of the



BRD's portfolio; and financing 13,000 affordable housing units by 2028. Depending on the number of targets the BRD meets, the coupon payments will decrease by between 0 and 40 basis points.

Consultations conducted with the BRD ahead of its issuance highlighted the importance of this issuance, with the BRD acting as a vehicle for innovation for the Rwandan market and also the wider region. The consultations also showed some of the challenges the bank faced including preparing an issuance in a market that lacks guidelines for both GSSS bonds and sustainable finance more broadly and setting appropriate KPIs and SPTs.

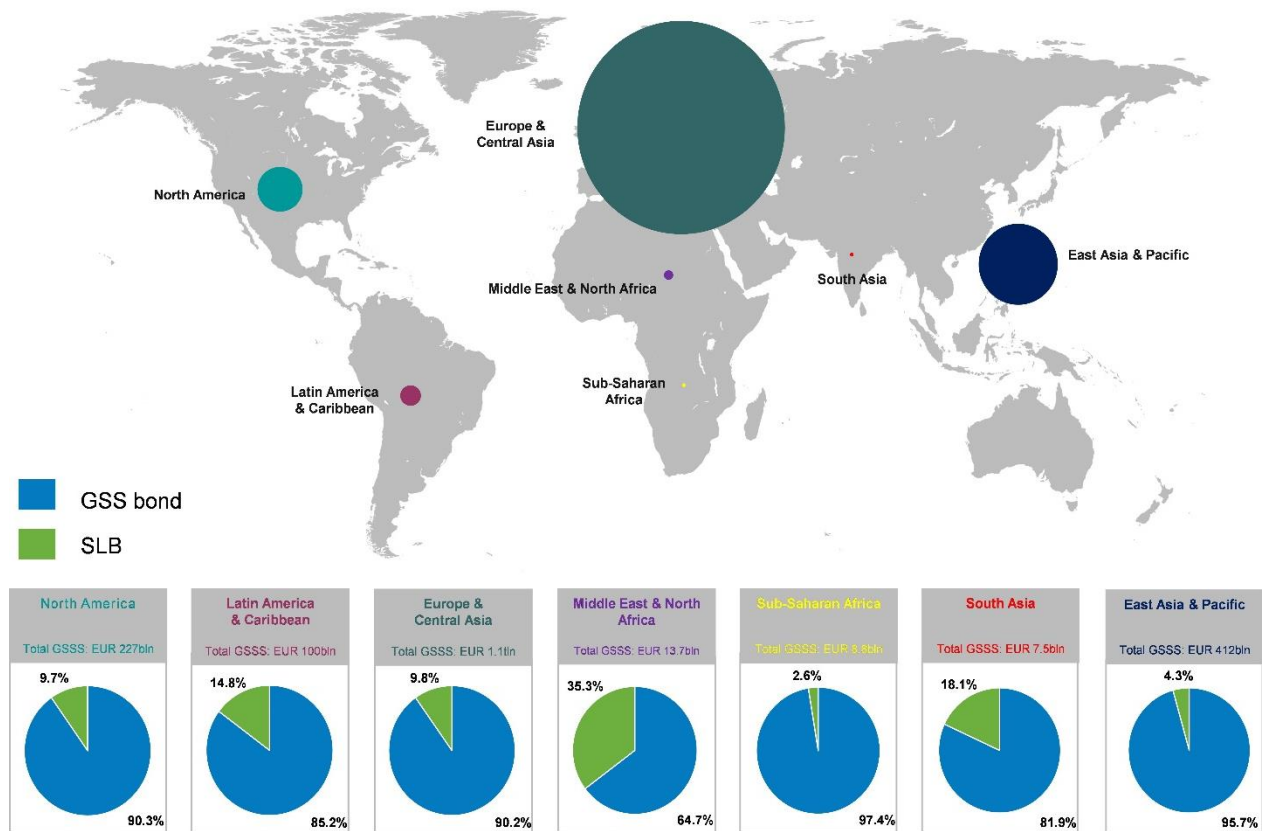
Source: The World Bank (2023<sup>[26]</sup>), *Rwanda Issues First-Ever Sustainability-Linked Bond (SLB) Backed by World Bank's Innovative Financial Structure*, <https://thedocs.worldbank.org/en/doc/743272cfbb73c6a9a1e97ecfadb2d58-0340012023/original/Case-Study-Rwanda-SLB.pdf>; Development Bank of Rwanda (2023<sup>[27]</sup>), *Sustainability-Linked Bond*, <https://www.brd.rw/sustainability-linked-bond/>; Alatabani, Verma and Navarro (2023<sup>[28]</sup>), "How Rwanda's inaugural Sustainability-Linked Bond broke new ground in leveraging private capital", <https://blogs.worldbank.org/psd/how-rwandas-inaugural-sustainability-linked-bond-broke-new-ground-leveraging-private-capital>.

**There is also significant disparity in terms of SLB issuance volumes across and between regions.**

Figure 2.5 shows the share of SLB issuances in overall GSSS bond issuances, by region. GSSS bond issuances, unsurprisingly, are highly concentrated in regions with the deepest and most liquid bond markets. In fact, the two regions with the highest value of GSSS bond issuances are Europe & Central Asia and East Asia & Pacific, which account for 60% and 22% of all global GSSS bond issuances from 2020 to Q1 2023, respectively. SLBs made up only a small share of GSSS bond issuances in most regions, although their shares were higher in regions with relatively more ODA-eligible countries and upper middle-income countries. For instance, SLBs accounted for 9.8% of total GSSS bonds in Europe and Central Asia but 14.8% in Latin America and the Caribbean; 35.3% in the Middle East and North Africa; and 18.1% in South Asia.

It is also clear that regions with the greatest financing needs are not taking sufficient advantage of SLBs relative to GSSS bonds, although it should be noted that the GSSS bond market is much larger and more established than the developing SLB market. SLBs accounted for only 2.6% of Sub-Saharan Africa's GSSS bond issuances, for example. Moreover, GSSS bond issuances were 125 times greater in the Europe and Central Asia region than in sub-Saharan Africa, while SLB issuances were a staggering 481 times bigger in Europe and Central Asia than in sub-Saharan Africa. Such limited prevalence of SLB issuances in the overall GSSS bond market highlights how their potential for financing sustainable development is not yet being tapped across most regions.

Figure 2.5. GSSS bond volumes differ significantly by region, SLBs generally accounting for only a small share (2020-Q1 2023)

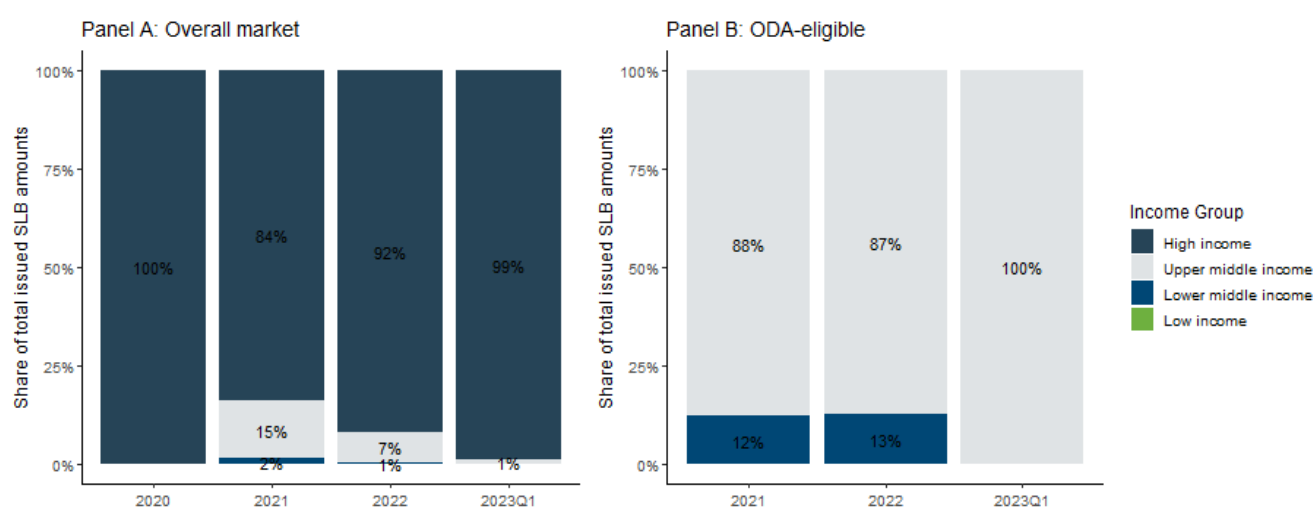


Note: The GSS bond market is much larger and more established than the developing SLB market. The figure covers only the period since the first SLB issuance (2020 to Q1 2023). The circles representing total volumes of GSSS bond issuances for each region are scaled relative to each other.

Source: Authors' calculations based on LGX DataHub data.

**The split of SLB issuances according to country income group is closely related to the regional split.** Panels A and B in Figure 2.6 illustrate the evolution of SLB issuances according to the income level of the issuer's country. Panel A, representing overall market issuances (in EUR billion), shows that high-income countries account for the bulk of the total issuance value. Among issuances from ODA-eligible countries, issuers of the majority of SLBs (in EUR billion) were from upper middle-income countries and, to a lesser degree, lower middle-income countries. Both sides of the figure suggest that those countries with the highest need of financing for sustainable development are not using SLBs. With the BRD's inaugural SLB issuance in September 2023, Rwanda became the first low-income country to enter the SLB space (The World Bank, 2023<sup>[26]</sup>).

**Figure 2.6. SLB issuers are concentrated in high-income countries while the few issuers in ODA-eligible countries are mainly in upper middle-income countries**



Note: The ODA-eligible group does not include China.  
Source: Authors' calculations based on LGX DataHub data.

**For the period of Q2 2020 to Q1 2023, a substantial majority (93%) of the SLBs issued globally were issued in hard currencies.**<sup>5</sup> However, for SLBs from issuers in ODA-eligible countries, local currency issuances accounted for 17% of total issued value.<sup>6</sup> Issuers can gain from issuing debt in local currency as it eliminates the need to manage foreign exchange fluctuations and allows for better alignment between the currency of financing and revenue streams. In contrast to SLBs, local currency issuances make up approximately 15% of the overall GSS bond market (in EUR billion) and surpass 40% for GSS bonds from issuers in ODA-eligible countries. Such disparity in local currency issuances in favour of GSS bonds compared with the SLB market might be attributed to the instrument's novelty and sophistication, suggesting that local investors and issuers require more familiarity and understanding before they are willing to enter this space.

## 2.2 Actors across the SLB ecosystem are setting best practices

The novelty of SLBs as a financial instrument means that best practices, expectations and regulations are still under development. For this reason, initiatives by local and regional actors as well as practices adopted by issuers themselves play the important role of setting precedents for other issuers to follow.

### **Regulation: soft and binding**

At the international level, the International Capital Market Association (ICMA) has been at the forefront of developing best practices for all types of issuers in terms of structuring features and disclosure and reporting for use-of-proceeds bonds as well as SLBs. The ICMA Sustainability-Linked Bond Principles (ICMA SLBPs) are designed to "drive the provision of information needed to increase capital allocation to such financial products" (ICMA, 2023<sup>[11]</sup>). The ICMA SLBPs have five core components: (i) selection of KPIs, (ii) calibration of SPTs, (iii) bond characteristics, (iv) reporting and (v) verification. These evolve together with the market and in June 2023 were adapted to accommodate all types of issuers including sovereigns. ICMA has also published accompanying guidance documents including a list of questions and answers and an Illustrative KPIs Registry that includes high-level recommendations and illustrative

examples, including for sovereign issuers specifically, to guide the selection of KPIs for SLBs<sup>7</sup> (ICMA, 2023<sub>[29]</sub>). It is important to note that the ICMA SLBPs are neither mandatory nor enforceable; adherence to the Principles by issuers is voluntary. Still, experts and investors alike have pointed to the fact that not following the SLBPs— for example by failing to undergo annual verification or to report on the bond – may cause investors to lose trust in the issuer. This can make it difficult for the issuer to raise additional funding in the future (de Calonje and de la Orden, 2022<sub>[30]</sub>). The reputational cost in this sense may be more damaging than other types of penalties embedded in the bond itself, such as coupon step-ups, and therefore incentivise issuers to adhere to best practices. Indeed, as argued by Lindner and Chung in a paper for the International Monetary Fund, the ICMA SLBPs have “effectively become a precondition for sovereign issuances” (2023<sub>[31]</sub>).

There are a number of other noteworthy international initiatives. In an especially significant step, the European Central Bank (ECB) started accepting SLBs as collateral as of January 2021. The ECB is prescriptive as to the SLBs it accepts, specifying that they must be linked to a target that refers to environmental objectives set out in the European Union (EU) Taxonomy or to SDGs specifically relating to climate change or environmental degradation (European Central Bank, 2020<sub>[32]</sub>). This demonstrates the increasingly important role of central banks in supporting innovation in sustainable finance and sends a clear message of support for SLBs to the market. At the same time, hurdles remain within the EU. For example, experts interviewed for this report pointed to the lack of clarity in the current EU Sustainable Finance Disclosure Regulation regarding whether SLBs can qualify as Article 9 funds (that should be invested 100% in sustainable investments).

As yet, there are fewer Standards for SLBs than for the more established green bond market (e.g. the EU Green Bond Standard). The Association of Southeast Asian Nations (ASEAN) stands out in this regard, having developed in 2022 the Sustainability-Linked Bond Standard, which complements the ICMA SLBPs with specific guidance for the ASEAN region. The aim is to provide certainty to investors that bonds labelled as ASEAN SLBs have met uniform standards and to provide market best practice to guide issuers (ASEAN Capital Markets Forum, 2022<sub>[33]</sub>). In consultations conducted for this report, it was acknowledged that more regional Standards are needed to develop and strengthen the credibility of the SLB market and address greenwashing concerns that can arise if the market is left unregulated. At the same time, some expressed appreciation for the current freedom from regulatory scrutiny as it leaves space for the market to adapt and continue innovating rather than being unduly constrained prematurely.

More broadly, developments with regard to sustainability-linked finance also impact the SLB market. For example, a review of sustainability-linked loans by the United Kingdom’s Financial Conduct Authority (FCA) found two principal areas of concern: (i) credibility, market integrity and greenwashing concerns and (ii) conflicts of interest and weak incentives to issue sustainability-linked loans (Financial Conduct Authority, 2023<sub>[34]</sub>). These concerns may also be relevant for other sustainability-linked financial instruments. With respect to SLBs, the FCA is also considering asking issuers for additional information – such as how the KPIs and SPTs fit within their wider sustainability and business strategy – as part of the required investor materials (Financial Conduct Authority, 2023<sub>[35]</sub>). These are promising signs that regulators at the national level will increase scrutiny around SLBs – and could have implications for the global SLB market as well as developing countries issuing on exchanges in other jurisdictions.

At the same time, donors are also expanding their capacity and expertise in sustainability-linked finance via other instruments. In November 2023, for example, the World Bank approved an innovative USD 350 million sustainability-linked loan for Uruguay that links the financing conditions to environmental targets by cutting loan interest rates if ambitious emission reductions are achieved (World Bank, 2023<sub>[36]</sub>). Learnings and best practices developed in the use of sustainability-linked loans will naturally be applied to SLBs and vice versa.

### ***Issuers: corporate and public sector***

As the market continues to grow and develop, it is important to consider the ways in which issuer practices have created a precedent for other issuers and consequently also impacted the perception of the market. To date, corporates have been particularly influential due to the lack of established Standards, guidelines and regulation, and the fact that corporates and financials have issued the vast majority (98%) of SLBs. As such, the activities of corporates affect the overall market. Indeed, certain SLB issuer practices have resulted in accusations of greenwashing that impact the credibility of these instruments and the broader development of the SLB market (Bryan, 2023<sup>[37]</sup>; See, 2023<sup>[38]</sup>). The case of Sembcorp Industries, a Singapore-based energy and urban development company discussed in greater detail in section three, is an indicative example of the issuer taking advantage of the structure of the bond without placing sustainability objectives at the core. By selling one of its subsidiaries, Sembcorp Industries was able to achieve its SPT without making real efforts to cut its emissions (Box 2.3).

While public sector SLB issuances remain very limited to date, each does play a role in shaping the market as countries' domestic practices and decisions can trickle down to the market more broadly. Chile, for example, was already very active in the green bond space and built on its established green bond Framework – as well as the ICMA SLBs – to develop an SLB Framework (Public Debt Office of the Ministry of Finance of Chile, 2023<sup>[17]</sup>). Its practice will undoubtedly set the precedent for the format, structure and process for issuance that will be followed by other sovereigns, and indeed Chile is actively involved in knowledge sharing within the Latin American and Caribbean region. Similarly, Uruguay's recent sovereign issuance, featuring both a step-up and step-down structure, is now recognised as the trendsetter for future public sector issuances (Box 1.2). More broadly, public sector actors can also test new formats that others may then use. Helsingborg in Sweden, for example, was the first city to issue an SLB, which is linked to its yearly emission reduction efforts. Such decentralised issuances can be a way to link local outcomes – which investors may view as more tangible – with financing while also allowing the government to increase its influence over areas that are beyond its direct control (Nasdaq, 2022<sup>[39]</sup>).

### Box 2.3. Sembcorp Industries: Divesting to achieve sustainability performance targets

The case of Sembcorp Industries exemplifies how issuers can use financial engineering to achieve a sustainability performance target (SPT) without expending significant effort to actually make progress towards that target. This example also highlights the weakness of some SLB structures at a time when the broader market still lacks standardised and locally adapted guidelines or expectations.

Sembcorp Industries is a Singapore-based energy and urban development company and an issuer of SLBs. In September 2022, the company announced plans to sell two of its coal-fired plants to an Omani-led private consortium. While the details of the transaction are beyond the scope of this analysis, it has been heavily criticised, with one critic accusing it of having been “engineered to get out of paying SLB step-ups” (Cripps and Jenkins, 2022<sup>[40]</sup>). Indeed, the sale helped Sembcorp meet its decarbonisation targets without any real emissions reductions taking place since the emissions from the two coal plants will only be shifted from Sembcorp Industries to the new owners.

It is important to note that while the Sembcorp case is significant, it cannot be generalised and should not serve to tarnish all SLB issuers. Still, it must be taken seriously as it has implications for policy makers and issuers of SLBs. SPTs need to be properly calibrated, especially for issuers in the energy or utility sectors. Otherwise, issuers may choose to sell their assets rather than decommission them or adapt them to make real reductions in emissions, in order to avoid the structural and/or financial changes associated with the SLB. Agreeing on how to treat assets that used to be part of an issuer’s portfolio is therefore crucial – and particularly relevant given the importance that SLBs can have in hard-to-abate sectors. The updated questions and answers document accompanying the ICMA SLBPs provides guidance in this area, noting that issuers can “achieve targets via acquisitions or divestments ... under conditions or (gradual) phase in/phase out” (ICMA, 2023<sup>[13]</sup>). At the same time, in the case of Sembcorp Industries, the fact that investors had limited legal options to claim a coupon step-up further undermines the credibility of the SLB as an instrument that drives truly sustainable actions. Legal guardrails and enforcement mechanisms are therefore needed to protect investors and ensure that they can hold issuers to account for their behaviour.

Source: Cripps and Jenkins (2022<sup>[40]</sup>), “Investors urged to vote against Sembcorp coal plant deal”, <https://www.environmental-finance.com/content/news/sembcorp-coal-plant-deal-highlights-slb-weaknesses-claims-afii.html>; Erlandsson and Rimaud, CFA (2022<sup>[41]</sup>), *Sembcorp: “Carbon footprint arbitrage of a lifetime”*, [https://img1.wsimg.com/blobby/go/946d6aac-e6cc-430a-8898-520cf90f5d3e/AFII\\_Sembcorp\\_061122-819d41d.pdf](https://img1.wsimg.com/blobby/go/946d6aac-e6cc-430a-8898-520cf90f5d3e/AFII_Sembcorp_061122-819d41d.pdf); See (2023<sup>[38]</sup>), “Sustainability-linked bonds and how to use them credibly”, <https://www.eco-business.com/news/sustainability-linked-bonds-and-how-to-use-them-credibly/>; ICMA (2023<sup>[13]</sup>), *Sustainability-linked Bond Principles Related Questions*, <https://www.icmagroup.org/assets/documents/Sustainable-finance/2023-updates/SLB-QA-2023-Sept-250923.pdf>.

# 3 Bottlenecks hinder the growth and potential of the sustainability-linked bond market, particularly in developing countries

If sustainability-linked bonds (SLBs) are to reach their potential, especially in developing countries that are most in need of increased financing for sustainable development and climate goals, the market must overcome bottlenecks that currently hamper its growth. These bottlenecks limit the relevance and impact of SLBs in both developed and developing countries. In turn, they impact public sector issuances as well – although the focus of this section is on all issuer types, since the market is currently dominated by corporates.

This section discusses six bottlenecks that hinder development of the SLB market:

1. Local capital market development and stakeholder co-ordination are lacking.
2. Locally adapted SLB guidelines and Principles are missing, leading to instrument misuse.
3. Chosen key performance indicators (KPIs) and sustainability performance targets (SPTs) are immaterial, difficult to compare and not sufficiently ambitious.
4. Data to monitor KPIs and SPTs are of poor quality and limited in availability.
5. Financial incentives embedded in bond characteristics outweigh sustainability incentives.
6. A slowdown in overall SLB market momentum risks locking out developing countries.

As discussed in section two, SLBs are now largely concentrated in developed markets and driven by corporate issuers. Growing imbalances between advanced and emerging markets could further fragment the SLB market and slow its growth. In particular, the bottlenecks can heighten concerns about greenwashing, social washing and Sustainable Development Goal (SDG) washing. These also can undermine the credibility and impact of the SLB market and thereby lower investor interest. Although the latest International Capital Market Association (ICMA) analysis finds a clear declining trend in the number of controversies related to SLBs (ICMA, 2023<sup>[42]</sup>), these concerns remain real for stakeholders in the bond ecosystem (Bryan, 2023<sup>[37]</sup>). Indeed, since SLB bond proceeds are fungible and not restricted to specific uses, these concerns also may prove to be an even bigger issue for SLBs than they are for GSS bonds (Ul Haq and Doumbia, 2023<sup>[12]</sup>).

Building on the overview of current trends in the SLB market presented in section two, this section discusses each of these six general bottlenecks and their implications. Sections four and five take the discussion further, looking closely at how donors can support SLB market development by addressing each of these bottlenecks.

## **1. Local capital market development and stakeholder co-ordination are lacking**

The novelty of SLBs means that developing countries often lack local capacity and experience regarding these instruments. Bond issuances also rely on financial systems, local capital market development and co-ordination among different relevant stakeholders – fundamental building blocks for the creation of SLB markets that are credible, accountable and harmonised. Often, these too are lacking.

**A certain degree of financial sector and local capital market development is needed for SLB issuances and before SLB guidelines can be established.** There is no single blueprint for capital market development, which will depend on specific country conditions and context. However, a sustainable and well-functioning capital market requires macroeconomic stability, a certain level of development of the financial sector, and a robust legal and institutional environment, according to a primer for policy makers from the World Bank Group (2020<sup>[43]</sup>). As these interlinked preconditions are an important starting point for any type of bond issuance (Infographic 4.1), bond issuance may not be appropriate in all countries at any given point in time. Moreover, even after a degree of capital market development has been achieved, other considerations specific to bond issuance come into play. Indeed, numerous financial organisations and domestic institutions are required for bond issuances – including a stock exchange, trading platform, fiduciaries, credit risk assessment agencies, among others (OECD, 2023<sup>[3]</sup>). In consultations, the Development Bank of Rwanda also cited the challenges of preparing an SLB issuance in a market that lacked guidelines not only for SLBs but also for GSS bonds and sustainable finance more broadly (Box 2.2). Support from the World Bank was fundamental in putting these in place.

**Strong co-ordination among stakeholders is also essential.** The issuance of an SLB and the creation of associated guidelines and regulations require significant co-ordination among the many ministries, public agencies and stakeholders involved throughout the lifecycle of an SLB (Kulenkampff and Pipan, 2023<sup>[19]</sup>). Sovereign SLB issuers interviewed for this report stated that fostering the inter-agency and inter-ministerial co-ordination required to agree on the bond Framework and the KPIs was one of their main challenges as there were no established co-operation channels across ministries, agencies and government departments. Research has also pointed to other intra-governmental co-ordination failures – such as information silos, which make data sharing more challenging (Kulenkampff and Pipan, 2023<sup>[19]</sup>). Communication for peer learning with external stakeholders – such as investors, donors and other issuers – is also important and often lacking.

## **2. Locally adapted SLB guidelines and Principles are missing, leading to instrument misuse**

Like the underlying capital market development and stakeholder co-ordination, policies and guidelines specific to SLBs are often lacking. The ICMA Sustainability-Linked Bond Principles (SLBPs) constitute another basic starting point for the creation of SLB markets that have integrity, are accountable and inspire trust.

**There is a need for the ICMA SLBPs to be adapted to local contexts.** Clear guidelines for applying the ICMA SLBPs in different jurisdictions are necessary to reflect different contexts, create local ownership, and thereby help build credibility among local and international investors (OECD, 2023<sup>[3]</sup>). Locally adapted ICMA SLBPs should reflect not only the context but also the expectations of different countries. For example, what is considered appropriate in terms of SPTs, KPIs, and data and reporting expectations for a developed country may naturally be different for a developing country context. There are many reasons for this including the fact that technical, financial and human resource constraints can limit the capacity of issuers in different contexts to collect and report on data with the same granularity. There will also be variations in the ability of the public sector to play an active role in creating sustainable finance regulation and monitoring its implementation (OECD, 2023<sup>[3]</sup>). As such, a key challenge is finding the right balance



between developing regulatory clarity in developing countries but not overburdening these countries with overly ambitious expectations.

Investors and issuers alike orient themselves by these different guidelines, Principles and Standards<sup>8</sup>, and their absence can lead to fragmentation of the approaches taken by issuers in different sectors and markets. For investors, lack of locally adapted guidelines and Principles hampers comparability and familiarity, and thus limits confidence and cross-border investment flows. For issuers, the burden of having to operate in an environment lacking clear expectations can disincentivise issuance altogether. Locally adapted ICMA SLBPs are necessary in developed and developing countries alike. Indeed, no SLB Standard or guidance currently exists in Europe, the region with the greatest volume of issuances, although there are calls to adapt the EU Green Bond Standard for SLBs (Lehmann and Martins, 2023<sup>[44]</sup>).

**The lack of locally adapted Principles or Standards can lead to issuers misusing SLBs, which can result in greenwashing accusations that tarnish the SLB market.** This is especially relevant given that SLBs are versatile thanks to their fungibility, which makes them particularly attractive for so-called “hard-to-abate” or traditionally dirty industries that lack large green projects or assets but have nevertheless set climate or sustainability targets (Lehmann and Martins, 2023<sup>[44]</sup>). As such, SLBs hold significant potential for a whole-of-economy, cross-sectoral transition (OECD, 2023<sup>[45]</sup>). However, the practices adopted by issuers from high-emitting sectors are not always consistent in practice with ambitions to transform a company and adhere to a credible low-emission pathway (OECD, 2023<sup>[45]</sup>). This is exemplified by the Sembcorp Industries example presented in Box 2.3. At the same time, externally verified ex-ante, interim and post-issuance reporting may be lacking – and this is essential for monitoring how issuers are performing against their predetermined SPTs (OECD, 2023<sup>[45]</sup>). Indeed, ICMA reports that controversies around SLB issuances persist, although with a clear declining trend (ICMA, 2023<sup>[42]</sup>).

Local Principles, policies and regulations are therefore fundamental to set expectations for issuers, investors and donors alike and to counter greenwashing or SDG-washing. For donors and investors, these are particularly important when it comes to issuers in high-emitting industries as they could otherwise be accused of supporting questionable entities and their environmentally and socially detrimental activities. At the same time, the use of sustainable finance instruments in high-emitting industries means that they may have more significant impact given the greater potential for sustainability-related improvements that exist in these industries. For investors and donors, supporting these types of issuances – provided they follow strong Principles and guidelines – may therefore even be viewed as preferable to issuances from other sectors.

### ***3. Chosen key performance indicators (KPIs) and sustainability performance targets (SPTs) are immaterial, difficult to compare and not sufficiently ambitious***

Finding the right balance between feasibility and ambitiousness of KPIs and SPTs is the litmus test for the successful further development of the SLB market. Investors choosing to invest in an SLB search for KPIs and SPTs that they deem ambitious enough and relevant to the issuer – particularly given the numerous greenwashing accusations tied to the SLB market and concerns regarding the robustness of issuers’ chosen KPIs (Bryan, 2023<sup>[37]</sup>). Similarly, issuers will aim to set KPIs and SPTs that they deem achievable while also seeking to demonstrate a level of ambition to reassure investors.

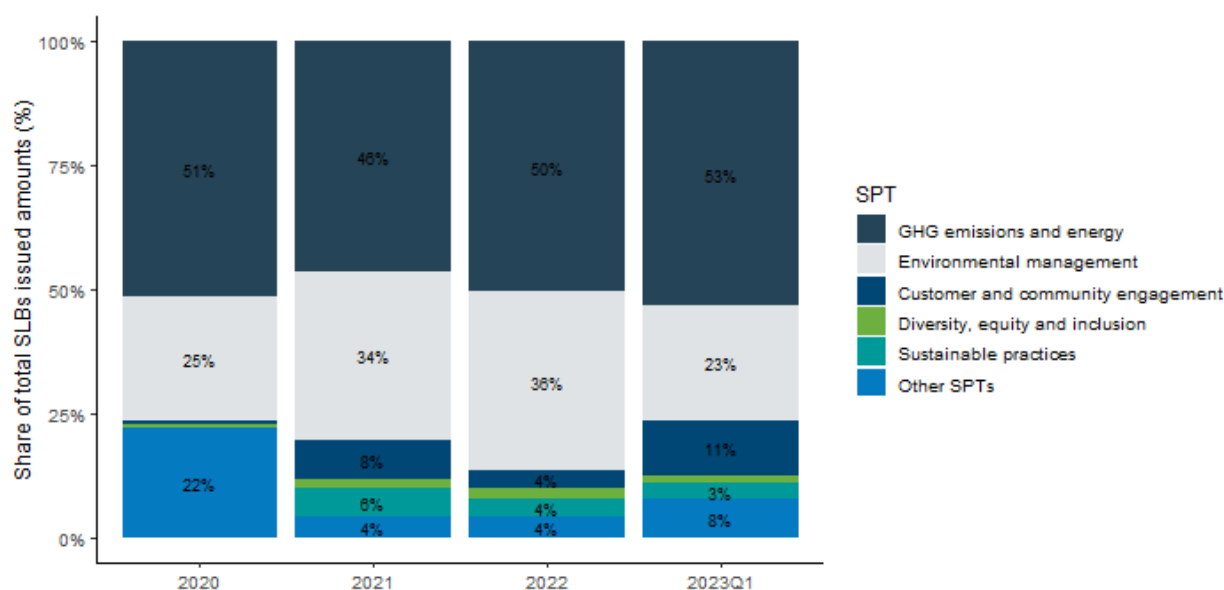
**Experts have warned about the lack of materiality and insufficient ambition of KPIs and SPTs** (European Securities and Markets Authority, 2023<sup>[46]</sup>; ICMA, 2023<sup>[42]</sup>). A key advantage of SLBs is that they can be used by a broad range of issuers to enforce their sustainability commitments. In practice, however, the level of ambition of KPIs and SPTs, especially for corporate issuances, is often disappointingly low (Climate Bonds Initiative, 2023<sup>[47]</sup>; OECD, 2023<sup>[45]</sup>). For example, according to Climate Bonds Initiative, the majority (84%) of oil and gas companies’ SLB issuances do not encompass scope 3 emissions<sup>9</sup> (2023<sup>[47]</sup>). This is shocking, given that scope 3 emissions can account for an estimated 80-95% of these companies’ total carbon emissions (Wood Mackenzie, 2022<sup>[48]</sup>). In addition, some issuers of

sustainability-linked instruments selected immaterial KPIs that have little relevance to the companies' core business (ICMA, 2023<sup>[42]</sup>). The German medical diagnostics company amedes Group, for example, attempted unsuccessfully to go to the market with a loan linked to KPIs related to the percentage of electric vehicles in its fleet and employee accident rates (Furness, 2021<sup>[49]</sup>). These types of behaviours naturally raise questions about the honesty of issuers' sustainability intentions.

**The comparability of bonds due to their different KPIs and SPTs is another aspect of this bottleneck hindering SLB market growth.** In deciding whether to invest in one bond over another, an investor will seek to compare their respective KPIs and SPTs. This can be very difficult if the chosen indicators and targets relate to completely different sectors or focus on metrics that are not directly comparable (e.g. one related to the percentage of seats held by women in the national parliament and another to the percentage of total territorial protected area) (Ghosh, Nwanna and Cliquet, 2021<sup>[50]</sup>). Indeed, a survey of major institutional sovereign debt asset managers found that 90% reported that they view the standardisation of KPIs as relevant (Sustainability-linked Sovereign Debt Hub, 2023<sup>[25]</sup>). The sheer number of indicators and targets can also make comparison extremely difficult. Out of the 426 individual SLB issuances analysed from the LGX DataHub for this report, for instance, 298 distinct SPTs were identified. Comparison is then made even more challenging by the fact that individual issuances will also differ in their chosen structural or financial characteristics as well as in the number of KPIs and SPTs. The fact that there is no common expectation regarding the format or content of SLB pre-issuance frameworks and post-issuance reporting also limits comparability.

As illustrated in Figure 3.1, most SLBs issued to date have SPTs related to greenhouse gas (GHG) emissions and energy; in 2023, this was the case for 53% of issuances. An advantage of emissions-related targets is that they can be aligned with internationally endorsed goals and standards such as the Paris Agreement and the International Energy Agency net-zero scenarios. Environmental, social and governance (ESG) ratings are often used as an alternative to climate-related KPIs but they have limitations, including diverging and evolving methodologies and scales and a degree of subjectivity that results in a low level of standardisation across markets<sup>10</sup> (NGFS, 2022<sup>[51]</sup>; ICMA, 2023<sup>[42]</sup>). Finally, issuers and donors may be equally interested in measuring and incentivising social outcomes – such as public health improvement and women's empowerment – but to do so will require more qualitative or idiosyncratic metrics. A very small percentage of SPTs relate to the ICMA's sustainability theme of diversity, equity and inclusion.

**Figure 3.1. Most SLBs target environmental and climate objectives, with targets for social outcomes much less common**



Note: SPTs are categorised according to the ICMA sustainability themes as presented in ICMA (2023<sup>[29]</sup>), Illustrative KPIs Registry, <https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/sustainability-linked-bond-principles-slb/>. Source: Authors' calculations based on LGX DataHub data.

#### **4. Data to monitor KPIs and SPTs are of poor quality and limited in availability**

There are very significant variations in what issuers in different country contexts are able to measure, with the result that issuers have a limited number of potential KPIs to choose from. Given that the availability of accurate and timely data is essential to being able to issue an SLB, and also underpins the SLB's credibility in the form of reporting (Infographic 4.1), this is a significant barrier to the scaling of the market (Sustainability-linked Sovereign Debt Hub, 2023<sup>[25]</sup>). The variations are due to many reasons including discrepancies in data availability, technology constraints, and limitations in human and financial resources (Kulenkampff and Pipan, 2023<sup>[19]</sup>). Indeed, fewer than half of low-income and lower middle-income countries are able to produce data on even a third of the SDG indicators. Relatedly, data challenges including "the paucity of data, incompatible and incomparable formats, and lack of adequate institutional capacities in national statistics offices" are cited as major impediments to achieving the SDGs (International Institute for Sustainable Development, 2023<sup>[52]</sup>).

**Data measurement practices are particularly underdeveloped in some areas**, making it hard to target these using SLBs. Unfortunately, these are also areas where SLBs could offer the greatest potential – such as biodiversity, climate change adaptation and social outcomes – since they lack an underlying pipeline of assets and therefore cannot be financed with use-of-proceeds bonds. According to UN Women for example (2023<sup>[53]</sup>), data are lacking for 80% of the indicators for gender equality across the SDGs. Similarly, available indicators may cover only a narrow aspect of the broader issue. For example, an indicator that looks at the number of female corporate board members may not reflect the working conditions and remuneration of women in the general workforce or the impact of the issuers' operations on female customers. Such limitations are also linked to the general gaps in data on gender.

**Monitoring and tracking of SPTs rely on self-reporting and are not necessarily audited.** The ICMA SLBPs call for issuers to seek an independent and external verification of their performance against each SPT, and urge that a verification assurance report for this be published at least annually (ICMA, 2023<sup>[11]</sup>;

ICMA, 2023<sup>[13]</sup>). Still, while such verification is the recommended market best practice, all issuers may not actually follow it. Reporting may also not necessarily be audited, particularly for historical data as part of the baseline. According to Moody's, few SLBs with climate-related SPTs directly reference science-based measurement criteria (Ghosh, Nwanna and Cliquet, 2021<sup>[50]</sup>). Relatedly, a recent study for King's Business School in London found that the GHG Protocol – the most common and widely respected basis of GHG accounting and reporting – leaves room for gaming in the calculation of GHG emissions. Since the GHG Protocol is not prescriptive enough, the authors concluded that issuers using KPIs related to SLBs are able to produce calculations that maximise their desired outcomes (Aikman et al., 2023<sup>[54]</sup>). As a consequence, issuers' reporting of their performance against the targets may not be reliable, and indeed calls have been made to improve transparency in the SLB market (Eurosif, 2022<sup>[55]</sup>).

**For sovereign issuers, an underlying challenge is to find data that reflect outcomes directly influenced by government policies and actions.** Often social outcomes, in health or education for example, correlate with economic indicators such as gross domestic product growth, and it is difficult to isolate the effect of specific policies targeting those outcomes. For example, the government of Chile is exploring the issuance of SLBs with KPIs linked to education policy outcomes but has found it challenging to identify relevant data demonstrating a direct relationship. More broadly, sovereigns may face challenges selecting KPIs and SPTs. Since they respond to much broader constituencies than corporate issuers, public sector actors may be criticised for prioritising one area – or KPI – over another. Sovereigns also need to exercise care to pick indicators that accommodate changes in political administrations (Giráldez and Fontana, 2022<sup>[56]</sup>).

### **5. Financial incentives embedded in bond characteristics outweigh sustainability incentives**

One of the key benefits of SLBs compared with GSS bonds is the commitment enforcement whereby changing financial and/or structural characteristics create a direct link between financial outcomes and sustainability. This creates a strong incentive for issuers to meet their stated sustainability commitments. However, structural loopholes mean that this relationship can be weakened – either voluntarily or involuntarily as issuers seek to navigate a new market with relatively little guidance. These loopholes in turn pose significant challenges to the credibility of SLBs as sustainable instruments.

This is especially true for SLBs with coupon step-ups, which make up the majority of SLBs. In 2022, for example, 83% of overall market issuances had a coupon step-up. In ODA-eligible countries, this figure rises to 94%. Three structural loopholes are especially common for SLBs. While it is important to acknowledge that the novelty of the market means that the implications of these are yet to be fully studied and understood, it is clear that these loopholes can pose significant credibility challenges. The three are as follows:

- **Setting late target dates.**<sup>11</sup> The ICMA SLBPs recommend a target observation date that is “appropriate for the financial instrument selection” and also the inclusion of an intermediate observation date (ICMA, 2023<sup>[13]</sup>). A World Bank study looking at all SLB issuances up to the end of 2021 found that in practice, issuers using step-up penalties are more likely to benefit from a later target date as it minimises the total penalty payout. SLBs with step-ups were found to have a target date that was set later by a period of 21% of the bond's tenor relative to other SLBs (UI Haq and Doumbia, 2023<sup>[12]</sup>). As such, issuers of SLBs with coupon step-ups succeed in minimising the penalties imposed on them. This approach could therefore impact the effectiveness of the instrument and the issuers' incentives to meet their sustainability targets – with important consequences on the future credibility of the SLB market. Indeed, a structure with a small penalty imposed towards the end of the life of the bond risks rendering this penalty financially immaterial. This may then move SLBs towards becoming a kind of instrument that has to be booked as an

instrument with embedded options or derivatives, which then may have different capital and accounting treatment to a vanilla bond.

- **Calling a bond before maturity.**<sup>12</sup> UI Haq and Doumbia (2023<sup>[12]</sup>) also found that SLBs with step-ups set the first call date close to the target date, thus minimising potential penalties. A recent study by the Anthropocene Fixed Income Institute, however, suggests otherwise; it found little quantitative evidence on excess callability in SLBs (Erlandsson and Korangi, 2023<sup>[57]</sup>). Such contradictory findings may increase stakeholders' caution when it comes to SLBs.
- **Setting low penalties.** The majority of SLBs issued to date have a step-up coupon of 25 basis points. Yet there is no underlying rationale for this figure, which has prompted skepticism and concern from the sustainable finance industry (Furness, 2021<sup>[49]</sup>; UI Haq and Doumbia, 2023<sup>[12]</sup>). Although this tendency towards 25 basis points may simply be a reflection of the relative immaturity of the market, it is fundamental for more complex bond characteristics to develop as the market evolves – for example with less ambitious targets corresponding to higher coupon step-ups. Kölbl and Lambillon (2022<sup>[58]</sup>) found that the savings resulting from the greenium (or SLB premium) that issuers benefit from often exceed the penalties they must pay if they fail to meet the targets. As such, issuers may be gaming the system to benefit from the green wave in price while ultimately not paying for it. The greenium that issuers can benefit from should therefore be tied to established KPIs and SPTs. Consultations for this report indicated that in the case of sovereign issuances in emerging markets, institutional investors consider penalties that are too high to be too detrimental to countries that may already be struggling with debt repayment. The reputational risk in the case of non-performance – with possible follow-up consequences of lower ESG scores or more difficult access to market for the future – was discussed as being sufficiently penalising.

**Finally, the absence of legal enforceability of SLBs widens the scope for greenwashing.** Experts consulted for this report raised this concern, and other critics have also cited what one called a “lack of legal rights or remedies for the investor in relation to the sustainability-linked promises of the issuer” (See, 2023<sup>[38]</sup>). While the ICMA SLBPs provide important guidance in this area, adherence to these is voluntary. The example of Semcorp's SLB (Box 2.3) shows how investors may have little legal recourse to claim a coupon step-up once the target observation date is reached. While this example is crucial and illustrative, it cannot be generalised, nor should it be taken as reflecting the experience of all issuers. Still, the Semcorp case raises concerns with regard to greenwashing. Furthermore, as SLBs start attracting more traditional or non-sustainable investors, they will open up extremely vast pools of capital. This would be a positive development, but it is also important to consider that these types of investors are less likely to strictly scrutinise the sustainability of the bonds or of their issuers. Other actors – such as external reviewers and donors that support issuances – must therefore play a critical role in ensuring that SLBs are designed with sustainable impact at their core.

## **6. A slowdown in overall SLB market momentum risks locking out developing countries**

Despite the potential of SLBs in mobilising resources to finance sustainable development, the SLB market momentum has slowed recently (Figure 2.1), calling into question the future of the market. This is, in many ways, a product of the other barriers identified throughout this section: it risks, however, impacting developing countries the most – which have the greatest financing needs and could benefit the most from this instrument.

**Macroeconomic trends exacerbate an already challenging environment for financing sustainable development and decrease investor demand towards developing countries.** In the decade preceding the COVID-19 pandemic, successive shocks led to a deterioration in the fiscal position of many developing countries. Since the pandemic, many other factors – including higher borrowing costs and rising food and energy costs due to multiple crises – have further eroded developing countries' capacity to invest in the SDGs (OECD, 2023<sup>[59]</sup>). The lower credit ratings of developing country issuers mean that they struggle to

access the international bond market at a time when risk-averse institutional investors are also less likely to look towards developing countries. Investors already wary of SLBs are likely to be even more cautious about now investing both in a developing country context and in this instrument type. The pressures are not only on the SLB market – and indeed higher global interest rates, more restrictive funding conditions and increasing geopolitical risks also contributed to the first-ever decline in GSSS bond issuances in 2022 (IFC - Amundi, 2023<sup>[6]</sup>). While the GSSS bond market, and SLBs within it, seems to have picked up again in 2023, the global environment remains challenging, especially for developing countries. Another factor in the market slowdown is that institutional investors' own corporate investment policies often filter developing countries out of investment decisions, which throws up additional impediments when these countries seek financing (OECD, 2021<sup>[60]</sup>). Research has found that even institutional investors with ESG strategies for their capital allocation risk directing capital away from emerging and frontier markets (Mobilist, 2022<sup>[61]</sup>).

**Debt sustainability concerns in developing countries are an additional constraint, especially for public sector issuances.** An increasing number of countries have secured International Monetary Fund staff-level agreements for relief programmes to meet their financing needs (World Bank, 2023<sup>[62]</sup>). Supporting SLB issuances in countries that may subsequently face a debt crisis can be seen as adding to – rather than addressing – debt problems. Moreover, in an environment of rising borrowing costs, the transaction costs associated with SLBs can increase the financing costs of debt as issuing an SLB involves complex co-ordination and preparation as well as external verification and monitoring of KPIs and SPTs.

At the same time, debt levels have been rising. The total debt service as a share of the export of goods, services and primary income for low-income countries, for example, increased from 4.1% in 2012 to 16.8% in 2021. For middle-income countries, the share rose from 8.6% in 2012 to 13.7% in 2021 (World Bank, 2023<sup>[63]</sup>). Global events – including the lingering effects of the COVID-19 pandemic and the consequences of Russia's war of aggression against Ukraine – are likely to have sharply increased these trends since 2021. Concerns around debt sustainability are especially relevant given that a Moody's study has found that roughly 35% of SLB issuances up to Q1 2021 were from issuers with a non-investment grade rating category (Ghosh, Nwanna and Cliquet, 2021<sup>[50]</sup>), although where debt is sustainable, donors could in certain circumstances help issuers potentially improve credit ratings and thus allow access to more cost-effective capital. The issuance of sovereign SLBs is therefore neither suitable nor recommended for all country contexts; as shown in Infographic 4.1, an evaluation of public debt levels should be the first step in considering whether to issue (or support the issuance of) a sovereign SLB.

# 4 Donor engagement is critical to support the sustainability-linked bond market

Co-ordinated and ambitious interventions are crucial to address the bottlenecks discussed in section three and to unleash the full potential of sustainability-linked bonds (SLBs) to mobilise financing for the achievement of the sustainable development and climate goals. This is why donor engagement is so critical at this early stage of market development. Donors have limited financing capacity to support bond market developments, but their involvement in a transaction can have an important signalling effect. This plays a critical role as new sustainable markets are being developed and clear expectations are being established by donors.

Donor engagement in the SLB space is therefore relevant for different issuer types and at different phases of market development. The considerations outlined in this section are therefore pertinent to all types of SLB issuers. However, a particular focus is given to public sector actors – in line with the report’s focus on public sector issuances and the fact that these entities are typically the main counterparts to donors in their development co-operation activities. At times, this section takes a narrower focus on sovereigns to reflect the approach taken by rating agencies.

## 4.1 Why donors should consider supporting SLBs

SLBs offer issuers several advantages over other instruments, making them powerful tools that can play a critical role in mobilising finance for the mounting climate and sustainable development challenges faced by developing countries. This section focuses on some of the key differences between SLBs and labelled green, social and sustainability (GSS) bonds that are especially salient to issuers but also donors. These are: (i) commitment enforcement, (ii) versatility, (iii) scalability and (iv) cost reduction potential (

Figure 4.1). In addition, and for public sector issuers in particular, SLBs can enhance the credibility of their climate and sustainability pledges; offer them a financing means that is often more compatible with their budgetary frameworks than GSS bonds; help them raise more finance by broadening the potential investor base; and potentially enhance their creditworthiness.

This is not to say that there is necessarily a choice to be made between GSS bonds and SLBs. As mentioned, these instruments should be viewed as complementary rather than mutually exclusive – and issuers should choose to use both instruments based on their ultimate financing needs. While this section focuses on the advantages of SLBs in particular, GSS bonds also have characteristics which make them attractive and advantageous to issuers and investors alike. Crucially, the underlying use-of-proceeds mechanisms allows for greater transparency on what the funds are used for.

Issuers can use SLB and GSS bonds separately, and in this context, weighing out the comparative benefits and disadvantages can help guide them towards which instrument to use. Alternatively, it is also possible to combining SLBs and GSS bonds into one structure – for example, proceeds from an SLB issuance can

be used for green projects.<sup>13</sup> As issuers decide whether SLBs or GSS bonds are most appropriate for their financing needs, donors can provide instrumental advice and support. In doing so, donors can base their support on a cost-benefit analysis of where scarce development resources can be used most effectively.

Figure 4.1. SLBs offer a set of distinct advantages to issuers over GSS bonds



### ***(i) Commitment enforcement***

By ensuring that it is in the issuers' financial interest to meet their sustainability targets, SLBs can incentivise transformation and behavioural change. Moreover, as they incorporate clear performance metrics to hold issuers accountable, they also can bolster the credibility of the issuer's sustainability ambitions in the eyes of both investors and other stakeholders. Section 3.1 describes the industry practices and challenges that threaten to undermine this key advantage.

SLBs create a link between sustainability outcomes and the financial and/or structural characteristics of the bonds. Investors in GSS bonds, on the other hand, have visibility on where the bond proceeds actually go but lack a direct means of enforcing issuers' sustainability commitments (OECD, 2023<sup>[3]</sup>). Failure to use proceeds in the way initially set out in the issuer's GSS bond Framework might result in significant reputational damage, yet normally it does not constitute an event of default nor would it give the bondholder the option to accelerate repayment or demand other remedies (Doran and Tanner, 2019<sup>[64]</sup>). A detailed review of 150 public sector green bonds found that these bonds promise little or nothing that would be legally enforceable (Bolton et al., 2022<sup>[65]</sup>). By contrast, SLBs reset the structural and/or financial characteristics of the bond if the issuer fails to meet a specific target. At certain dates, sustainability outcomes are evaluated and, depending on the result, pre-agreed penalties or rewards are triggered. As described in section two, failure to meet the target leads in most cases to a step-up or raising of the bond coupon that the issuer pays to the investor. As elaborated in section three, the change in bond characteristics lacks legal enforceability. At least in theory, however, terms can be set to reflect the investor's ambition, and penalties can be made large enough to discipline the issuer (Lehmann and Martins, 2023<sup>[44]</sup>) but also reward them when SLB targets are met.

For sovereign issuers, SLBs can then enhance the accountability and credibility of government's climate and nature as well as social pledges by establishing clear performance metrics and financial incentives to achieve them.

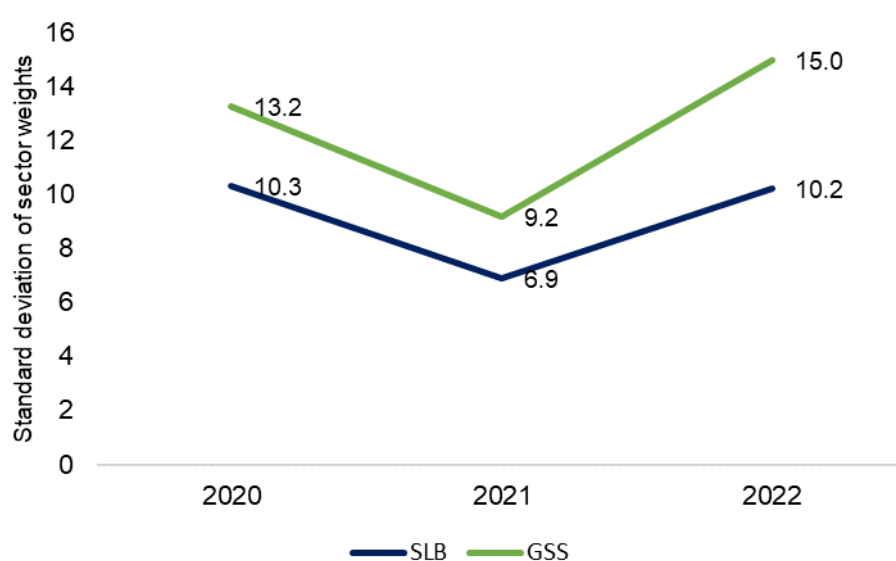
### ***(ii) Versatility***

SLBs provide a wider spectrum of opportunities to finance, support and engage with issuers' efforts to transition to a low-carbon and sustainable pathway. Issuers have the freedom to choose a strategy for achieving their sustainability targets that best aligns with their individual needs and objectives. This flexibility can also allow for more agility in a changing external environment. For example, SLBs do not lock in capital expenditures towards a specific type of technology, leaving room to accommodate technological advances and innovations (Rimaud, 2023<sup>[66]</sup>).



SLBs therefore can be used by a broader range of issuers, including in sectors where explicitly green, social and sustainability assets are rare. The average standard deviation of the share of sub-sectors represented in new SLB issuances between 2020 and 2022 was 9.1 compared to 12.5 for GSS bond issuances (Figure 4.2), signalling that SLB issuances are more evenly distributed across sectors than are GSS bonds. A study by Moody's also found the SLB market to be more diversified, both in terms of industry and with regard to the credit segment of the issuer. The study also estimated that roughly 35% of SLB issuances (between Q2 2020 and Q1 2021) fall within the non-investment grade category, whereas issuers with weaker credit ratings have played a much less active role in the GSS bond space (Ghosh, Nwanna and Cliquet, 2021<sup>[50]</sup>).

**Figure 4.2. The sectors represented in bond issuances in the SLB market tend to be more evenly distributed compared to the GSS market**



Note: The subsectors represented are categorised into communications, consumer discretionary, consumer staples, energy, healthcare, industrials, materials, technology, utilities

Source: Authors' calculations based on LGX Data Hub data

For sovereign issuers, one benefit of SLBs is that they are compatible with the budgetary frameworks of many countries that restrict or prohibit earmarking of proceeds, which can be an impediment to GSS bond issuance (Kulenkampff and Pipan, 2023<sup>[19]</sup>). As most of the public expenditure financed by sovereign bonds is not tied to specific sustainability objectives, the potential of sovereign debt financing via GSS bonds is limited. SLBs, however, can be used to cover a much wider range of a government's financial expenditures, although this should, in particular, not contribute to unsustainable debt levels.

Moreover, key performance indicators (KPIs) can be adapted to a variety of areas, such as biodiversity and adaptation, where it is typically more difficult to identify a pipeline of bankable assets that are of direct relevance to sustainability objectives. In the context of adaptation, SLBs provide flexibility as the impacts of climate change and new possible adaptation solutions develop – and it is important to monitor the potential that SLBs hold in this respect and possibly modify them to fit this purpose (OECD, 2023<sup>[67]</sup>). Calls have also been made to explore the potential of SLBs for biodiversity – for example by setting KPIs related to this, and developing reporting practices that allow for an assessment of biodiversity impact (Gursoy, 2023<sup>[68]</sup>). A promising example is Uruguay's sovereign SLB, which introduces nature-based targets including one KPI linked to the maintenance of the country's native forest area (Box 1.2 in section one).

The International Capital Market Association's (ICMA) Illustrative KPIs Registry includes close to 300 KPIs across 9 sustainability themes – among them biodiversity, circular economy, water and diversity. SLBs could also be used for debt relief or restructuring (Kulenkampff and Pipan, 2023<sup>[19]</sup>), although caution should be used in judging whether this use is appropriate given the country and issuer's context and would not lead to risks of sustainability washing.

### **(iii) Scalability**

By way of their flexibility, SLBs open the door to a broader range of sectors, as reflected in the high level of diversification of the SLB market (see Figure 4.2). Global SLB coverage includes companies from across traditional sectors seen in the use-of-proceeds market (e.g. electric utilities) as well as from consumer staples, materials and health care. Industries with a high reliance on fossil fuels such as transport and particularly the aviation sectors (e.g. airports) – which traditionally have few opportunities to tap into sustainable finance – are suitable candidates for SLB issuances. These sectors are often important drivers of economic growth in low- and middle-income countries.<sup>14</sup>

Their reach gives SLBs the potential to drive transformative change. SLBs offer issuers the opportunity to make use of sustainable finance instruments even if they do not currently have a pipeline of bankable sustainable projects. The focus of an SLB can thus be on an issuer's long-term trajectory and achievement of more sustainable outcomes in the future. Investors can accompany and reward issuers in their transition to a more sustainable model, with the SLB serving an incentive for issuers to restructure operations in alignment with their long-term sustainability ambitions. SLBs also can include KPIs that cover entire operations and expenditures rather than a more narrowly defined field of the operations. KPIs for corporate issuers, moreover, can include impacts beyond their own businesses such as the potential impacts on suppliers and clients along the value chain. For sovereign issuers, SLBs can capture sustainability outcomes that involve complex interactions and linkages across policy areas.

These features make SLBs highly scalable. According to Kulenkampff and Pipan (2023<sup>[19]</sup>), the SLB market size could grow to between USD 250 billion and USD 400 billion by 2030 in emerging markets and developing economies alone. Since there is no need to have an underlying pipeline of relevant assets, SLBs can be issued at much larger amounts than use-of-proceed bonds. In advanced markets and those eligible for official development assistance (ODA), the average size of SLBs is EUR 400 million, greater than that of green, social and sustainability bonds, which average EUR 278 million, EUR 303 million and EUR 358 million, respectively. This is also true for sovereign bonds. Chile's first sovereign SLB, issued in March 2022 with a tenor of 20 years, was issued in the amount of USD 2 billion (Box 1.2). Its first green bond issuance, by contrast, was smaller at USD 1.4 billion (Climate Bonds Initiative, 2023<sup>[69]</sup>).

With greater involvement of sovereigns in the SLB space, which typically issue large-size bonds, the difference in average size is likely to increase in the future. For many developing country issuers, this presents an important advantage. Smaller issuers that do not have a sizeable pipeline of green, social, or sustainability assets to justify the issuance of GSS bonds could still make use of SLBs since these instruments are backed by the issuer's entire balance sheet rather than a subset of assets.

Interviews conducted for this report also indicate that larger-sized bond issuances also bring in a wider and deeper investor base, which can benefit pricing since a potential greenium is based on having multiple bids at issuance to compress pricing. An issuance above USD 1 billion can help lower the issuer's coupon payments (Climate Bonds Initiative, 2022<sup>[70]</sup>) as this will attract a larger pool of bond investors, ultimately providing cheaper financing for the issuer. Since SLBs are not tied to underlying assets, they can be more frequently issued, potentially creating a pipeline with the corresponding development of in-house expertise on the private sector side. Ensuring a steady deal flow can help the market evolve and continue to expand at a fast pace.

#### ***(iv) Cost reduction potential***

Compared with vanilla bonds, green, social, sustainability and sustainability-linked (GSSS) bonds help lower borrowing costs by unlocking new sources of capital. They can also provide better access to credit by helping issuers tap into deeper and more liquid pools of investors that are motivated by environmental, social and governance aims in addition to financial returns. SLBs are then appealing to investors for additional reasons – including their potentially larger size and longer tenor, the fact that they are not tied to the local political cycle, and the enforceability that comes if they are tied to existing sustainability pledges.

At the same time, however, issuing GSSS bonds entails higher costs than vanilla bonds. This is due to many reasons, including second party opinions and other services required for issuance as well as reporting obligations. Comparing GSS bonds and SLBs, an IMF study suggests that the hypothetical costs of an inaugural sovereign issuance are quite similar (Lindner and Chung, 2023<sup>[31]</sup>). Actual costs can differ markedly, however, depending on numerous factors including a country's specific situation, the complexity of an issuance and the availability of local expertise. Indeed, differing views emerged in consultations undertaken for this report over which are more costly: SLBs or GSS bonds. In this regard, an SLB issuance can involve fewer transactions costs and constraints since underlying assets do not have to be identified and tied to the bond. At the same time, it may entail significant efforts to setting appropriate KPIs and SPTs. Both bond types also require post-issuance reporting. Overall, the different factors driving these costs are likely to be more pronounced in developing countries.

Moreover, sustainability commitments, if followed through, will translate into future resilience to climate and nature shocks, which in the medium- to long-term can be reflected in investors' risk assessments and bond valuations, giving issuers the advantage of a "sustainability premium".<sup>15</sup> Other positive spill-over effects include the fact that issuance requires a high degree of inter-ministerial co-ordination, as well as robust data management and measurement practices relating to KPIs and SPTs. This, in turn, can create the impetus for policy alignment and benefit broader macroeconomic policy making (Sustainability-linked Sovereign Debt Hub, 2023<sup>[71]</sup>).

The Sustainability-linked Sovereign Debt Hub (SSDH) presents a conceptual approach that sets out how a well-targeted and effective use of SLBs could help to mitigate debt sustainability risks for sovereign issuers.<sup>16</sup> It refers to a "virtuous circle" – whereby SLBs (i) reward positive sustainability outcomes through reduced cost of capital, (ii) incentivise resilient investments that lower sovereign risks, which ultimately could (iii) create fiscal space to support greater public spending (Kulenkampff and Pipan, 2023<sup>[19]</sup>).

## **4.2. Donor support can be a game changer for the SLB market**

Despite the urgent need to mobilise and align financing for the achievement of the sustainable development and climate goals, the SLB market is unlikely to scale to its potential, especially in developing countries, without co-ordinated and ambitious interventions. This is why donor engagement is so critical at this early stage of market development. Donors have limited financing capacity to support bond market developments but their involvement in a transaction can have an important signalling effect. This is critical as new sustainable markets are being developed and clear expectations are being established by donors.

**By their very nature, SLBs are well aligned with donor priorities.** With the increasing number of funding commitments, such as the USD 100 billion annual climate finance goal and the Kunming-Montreal Biodiversity Framework, donors are under pressure to find suitable programmes and instruments to support developing countries' endeavours to meet the SDGs and climate objectives. Donors also are increasingly looking for ways to use scarce development resources to mobilise private finance from commercial investors – by working with sustainable finance instruments and through blended finance structures or instruments. SLBs are ideally suited in this regard as they offer commercially viable and

investable options to channel funds into sustainability outcomes, with clear metrics to measure and track progress.

**Donors have significant comparative advantages that can underpin their support to facilitate and accelerate the growth of SLB markets in developing countries.** The financial markets in OECD countries, including investor preferences and regulatory developments, will ultimately have a role in determining SLB reporting and evidence (for example, credible KPI data measurement). It is therefore critical that bilateral donors engage and exchange with financial regulators in their jurisdictions on best practices and identify those that could be transferred to a developing country context. In addition, as the providers of ODA and upholders of transparency and impact in development finance, multilateral development banks (MDBs) and bilateral donors can advise on and help refine reporting standards and transparency requirements, and provide capacity building on impact measurement and management. For issuances they support, donors also can help identify and develop metrics and indicators that are relevant for development and sustainability standards. The comparative advantages of multilateral and bilateral actors in the SLB market are discussed in Box 4.1.

**Donors are better versed in developing country contexts and more familiar with countries' financing needs and debt levels than are financial regulators and investors in advanced markets.** As such, they are ideally situated to bridge gaps between stakeholders in the financial sectors of their own countries and their counterparts in developing countries. Donors often have long-standing partnerships with developing country actors that have vast experience in developing capacities and advising on capital market and financing skills. Likewise, donors often work with the debt and public financial management divisions of Ministries of Finance and state-owned enterprises, which are key stakeholders in the promotion of sovereign or public SLB markets in developing countries. Based on these relationships, donors are aware of the capacity constraints and needs of these potential issuers and are best placed to help address some of the bottlenecks in their access to the SLB market. Donors are also aware of debt levels and the strains and complications that debt defaults can produce and therefore are familiar with the context that needs to be considered before issuing bonds.

Based on their experience with blended finance instruments to mobilise investments, donors also have co-operated on financing, for instance through the use of guarantees (EDFI, 2022<sup>[72]</sup>), and are well versed in delivering transactions based on each donor's risk profile. They can replicate these co-financing arrangements to enable market-shaping SLB transactions.

**Moreover, donors can call on an established set of tools to help accompany SLB issuers from the initial pre-issuance stages to ex-post reporting.** On a practical level, this means they can foster connections among different types of market players such as regulators, standard setters, issuers and investors. Thus, they are ideally placed to enable market co-ordination, which is critically lacking in the SLB market.

#### Box 4.1. How multilateral and bilateral actors' comparative advantages play out differently in the SLB market

Multilateral Development Banks (MDBs) have so far been the most visibly active in supporting GSS bonds and SLB issuances. As providers of technical and blended finance support and active participants in the market (for example as anchor investors), MDBs have been involved in a significant number of transactions. For example, the Inter-American Development Bank (IDB) has supported many transactions in Latin America, a region at the forefront of public sector SLB issuance. Both the World Bank and the IDB have also been involved in supporting the creation of Standards, including as part of the ICMA working group addressing approaches to standardisation.

The SLB market requires different support and donor involvement than the GSS bond market since SLBs give rise to potentially larger issuances with long tenors. Blended finance approaches that provide a credit uplift, for example, may be less effective on very sizeable SLB issuances than on smaller GSS bond issuances. The World Bank's involvement in the Development Bank of Rwanda's SLB issuance in September 2023 (Box 2.2) may be a suitable opportunity to test the market and provide an issuance that can be scaled at the sovereign level.

MDBs also have considerable flexibility in using donor funds and establishing financial entities such as trust funds that can allow for longer-term donor participation in SLB issuances. These are particularly suitable for donor payments, for example in the coupon step-up or step-down of the bond, and could address obstacles in issuing SLBs in developing countries. Donor feedback suggests this coupon payment is an area where donors could make a considerable difference, without requiring significant exposure. However, each SLB issuance should be tested to determine where donor participation can be most effective.

Bilateral donors' support to the GSS bond and SLB markets appears less mainstreamed. Like MDBs, some bilateral development finance institutions, among them Germany's KfW and France's Proparco, issue GSS bonds. These institutions use GSS bonds to fund their own balance sheets and subsequent activities, which translates into market awareness and potentially relevant transactions at the developing country level. However, the active engagement of bilateral donors in both markets remains somewhat limited and uncoordinated.

There is great demand from developing country issuers for bilateral donors to become more active as providers of credit enhancement for GSS bonds, the 'Insurance' part of the Five Is policy framework (OECD, 2023<sup>[3]</sup>). However, incentives must also be in place for these bilateral donors – particularly around ODA-eligibility for mobilisation, strengthening of reporting and harmonisation of development impact, as agreed at the November 2023 DAC High Level Meeting (OECD, 2023<sup>[73]</sup>). For example, bilateral donors' funding models are generally not set up to make contingent payments to cover the step-down on a bond to reward the issuer for the successful achievement of an SPT. Under their budgeting frameworks, bilateral donors tend to prefer to make fixed and certain payments. This limits their flexibility in supporting SLB issuances, especially if the bond has a long tenor and as a result greater reporting requirements.

Given such constraints, donor support may need to target particular elements of the market. Bilateral donors are well placed to provide long-term capacity development both prior to and after issuance (such as for KPIs and SPT reporting) and to work not only with their own financial regulators but also with local investors who typically purchase bonds, such as pension funds. A case can also be made for several bilateral donors to pool their resources together, including through trust funds administered by MDBs, to set up facilities that provide credit enhancements for multiple bonds from different issuers as well as cover other costs such as reviewing and monitoring fees. Such facilities can be structured to receive fixed amounts of donor resources and make contingent payments that are triggered by the successful achievement of SPTs. In this collaborative way, donors could support SLBs at a scale that a single donor could not achieve, which would have transformative impact on the overall SLB market.

### 4.3 Towards a guiding framework for donor interventions

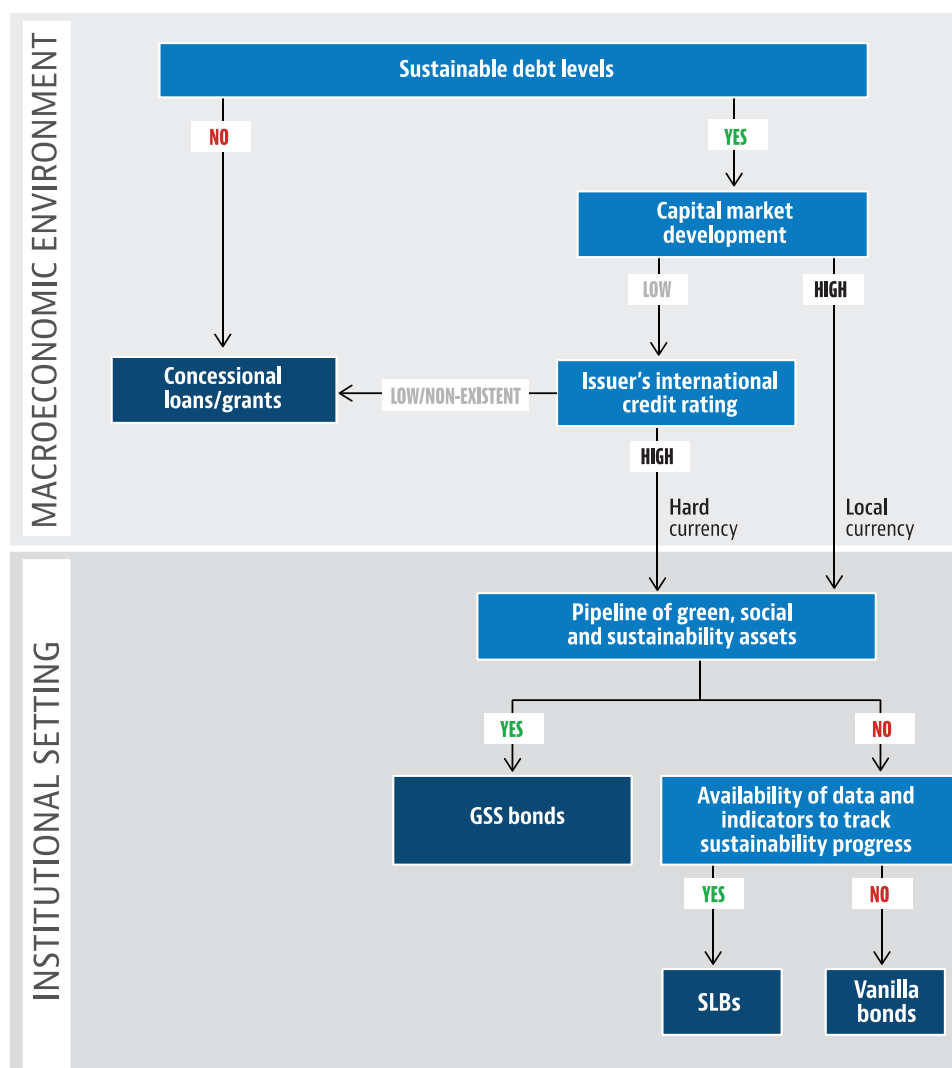
SLBs have great potential in terms of financing sustainable development and dovetail with donor priorities and areas of expertise. Yet, donors have so far been hesitant to support SLBs. The bond market is not a typical source of development finance, especially considering that the GSS bond market is still developing and SLBs at an even earlier stage. Donors therefore face a significant number of risks, opportunities and constraints. The scarcity of ODA resources, for one, necessitates a balanced approach that takes into

account the costs and benefits of any intervention related to SLB issuances. At the same time, if donors do not get involved and thus reassure the market, there is a risk that the SLB market will fail to establish itself as a useful funding tool for developing economies since the prevalence of greenwashing will erode market credibility and therefore investor interest.

A number of factors can guide donors' decisions as to whether and how to support both private and public sector SLB issuances. Infographic 4.1 illustrates some of the criteria that donors can consider in selecting the most suitable type of intervention for promoting sustainable finance in their partner countries, focusing especially on choosing between SLBs and GSS bonds based on their respective advantages. The message is not that support for SLBs and GSS bonds should be mutually exclusive. As underlined throughout the report, the experience of having issued GSS bonds can be helpful in expediting the process of SLB issuances and vice versa, as some of the technical requirements and procedures for issuing both GSS bonds and SLBs are the same. For example, GSS bonds and SLBs need greater co-ordination across government, particularly between the Ministry of Finance and the Ministry of the Environment. Once an issuer goes through the process of using international frameworks such as the ICMA Principles and engaging with second party opinion providers for a GSS bond or SLB, that knowledge is established in the Debt Management Office, facilitating repeat issuances.

The infographic decision tree, covering both the macroeconomic environment and institutional setting, is meant to inform donors about the kinds of circumstances in which SLBs can be an appropriate instrument, justifying the use of development resources. It can help identify situations in which the use of SLBs can most suitably address development and financing needs in terms of magnitude and nature. Rather than providing an exhaustive list of criteria, the decision tree provides illustrative factors that donors can consider before providing this support. The criteria are related to the macroeconomic environment as well as institutional setting of the issuer, both of which shape the choice of bond type. The sequencing presented in the decision tree is not prescriptive, as the factors will be assessed and weighed in an iterative process and depending on the particular context of a donor programme or project.

**Infographic 4.1. Decision tree to guide the choice of sustainable finance instruments and whether donor support is most appropriate for SLBs, GSS bonds and/or vanilla bonds**



Note: The different bond types are not mutually exclusive. Rather, issuers can use them individually or in a complementary manner.

### **Macroeconomic environment**

**Debt sustainability concerns.** Typically, support for SLBs should presuppose that the issuers have room to take on more debt. Donors will therefore avoid promoting SLBs and GSS bonds in countries that suffer from an unsustainable debt burden.

Concern over debt sustainability is growing as tightening conditions in global financial markets lead to higher interest rates, both generally and in particular in developing countries. Developing countries' average interest cost on external borrowing is three times higher than that of developed countries (Spiegel and Schwank, 2022<sup>[74]</sup>). Developing countries are therefore exposed to higher financing costs, particularly hard currency issuance, when rates move unfavourably. These can put additional pressure on general issuance and deter testing of new funding approaches, including SLBs.

However, even where countries' existing debt is at unsustainable levels, there might be a case for using SLBs. One view is that by incentivising sustainability-oriented policies and investments, SLBs could help

to bring about better sustainability outcomes and contribute to better public debt management (Volz, 2023<sup>[75]</sup>; Sustainability-linked Sovereign Debt Hub, 2023<sup>[71]</sup>). SLBs could complement climate-related debt clauses, which allow developing country governments to defer debt repayments in the event of severe climate shocks or natural disasters. As discussed, SLBs could in certain cases also be used for debt relief and restructuring. They could be issued at a lower coupon rate than existing debt, possibly under a substantial donor guarantee, and the proceeds can then be used to buy back existing debt in a debt swap. In 2021, for instance, Belize signed a debt-for-nature swap with the environmental organisation 'The Nature Conservancy' (TNC) that reduced the country's external debt by a striking 10 percent of gross domestic product (GDP). Under the agreement, a TNC subsidiary lent funds to Belize to buy back a USD 553 million sovereign bond—the government's entire stock of external commercial debt, equivalent to 30% of GDP—at a discounted price of 55 cents per US dollar. It financed this by issuing USD 364 million in so-called blue bonds<sup>17</sup> that were guaranteed by the US International Development Finance Corporation (Owen, 2022<sup>[76]</sup>). In theory, the arrangement could also have used an SLB. For an SLB intervention to be justifiable, however, other conditions such as relatively high levels of capital market development alongside the availability of data and indicators to design rigorous and relevant KPIs, would ideally be present.

**Capital market development.** In countries at early stages of capital market development and with low credit ratings, paving the way for a commercially viable SLB transaction would involve costly efforts on both the issuer and donor side. These might divert resources away from development priorities, which could be catered to in more cost-efficient ways. At early stages, donors might want to prioritise supplying direct finance through loans and grants while laying the groundwork for future bond issuances, for example through technical assistance for capital market development and sovereign debt management capacities. As a first step towards the use of sustainability-linked debt, the use of a sustainability-linked loan or privately placed SLB could also be considered.

**Market fragmentation.** More broadly, there is also a need to ensure that SLBs are used in conjunction with established debt raising approaches and that SLBs – or any other GSSS bonds – do not fragment the issuer programme and create related market and debt management inefficiencies. As such, the debt issuance structure, debt management, market dynamics, and bond issuance strategy all become key factors to consider.

**Hard versus local currency.** The development of local currency bond markets helps mitigate currency risk and therefore increase country's financial resilience. At the same time, it is crucial to broader capital market development (International Monetary Fund & The World Bank, 2021<sup>[77]</sup>). Particularly in the current complex macroeconomic context, supporting local currency bond issuances – where possible – should be a priority. For SLBs, this is especially important given that, as discussed in section two, the substantial majority (93%) of SLB issuances globally have so far been issued in hard currencies. Still, in developing countries, a number of reasons can make it challenging to issue bonds in local currencies. If the level of local capital development is low, a case can still be made for issuing bonds in hard currencies. The decision hinges on the existing debt profile of the issuer and capacities to manage foreign-denominated debt alongside the currency risks this involves. Depending on the credit rating of the issuer, some form of credit enhancement may be needed.

To inform the choice between local and hard currency bonds, donors can also help assess if, given the local investor base, there is enough room to accommodate new issuances in the local market. For sovereign and other public sector issuances in particular, there is a risk that promoting more local currency public debt will crowd out commercial debt, which can hamper the development of the overall financing landscape in a partner country. Under these circumstances, hard currency issuances in international markets can be a more suitable option. Investor appetite for, and familiarity with, sustainable finance can also be a factor to consider. In countries where the local investor appetite for GSS bonds or SLBs is low, the additional cost of issuing these products in local currency compared with that of vanilla bonds may not be justifiable unless for reasons of investor education and long-term market development. If the benefits of familiarising local investors, regulators and issuers with sustainable finance products are factored in,



however, there can indeed be a powerful argument to be made in favour of supporting local currency issuances.

The type of revenue of the issuer can also be considered. For example, if an issuer such as a state-owned enterprise has US dollar-denominated export revenues, hard currency SLBs would be a suitable option. For an issuer with only local currency revenue such as tax revenues, the currency risks might be larger.

### ***Institutional setting***

While the decision to support a bond issuance at all hinges on macroeconomic factors, it is the institutional setting that shapes the choice between GSS bonds, SLBs or some combination of the two.

**Pipeline of green, social and sustainability assets.** Where there is a well-developed pipeline of bankable assets directly relevant to a sustainability objective that the partner country and donor want to pursue, opting for use-of-proceeds bonds will be an effective choice. However, where it is more difficult to identify bankable projects, donors can encourage and promote the use of SLBs. In the transport sector, for example, where issuers may not yet have deployed clean technologies or have assets qualifying as green, donors can support the issuance of SLBs on the condition that issuers reduce their greenhouse gas emissions and explore clean technologies.

For sovereign and other public sector issuers, donors can help assess if the legal framework allows for the separate budgeting of green and social projects and if there are sufficient expenditure items that would be eligible under a GSS bond framework to back up a standalone bond issuance. GSS bonds would be suitable if such conditions are met or can be achieved in a reasonable timeframe, but in their absence, an SLB would be the more viable option. As discussed, SLBs are possibly more suitable for sustainability themes such as biodiversity and adaptation for which it may be more difficult to identify bankable assets. However, a major challenge is the absence of long baselines for the types of KPIs that could be used for these purposes. It could also be difficult to identify a broad enough investor base for such bonds, given that investors would need to be willing to study and familiarise themselves with the instrument to understand and assess the KPIs and SPTs related to relatively niche areas.

**Availability of data and indicators to track sustainability progress.** Data availability and the presence of indicators to track progress can also signal to donors that the use of SLBs is appropriate. In particular, the existence of internationally agreed targets, such as on climate and biodiversity, can ensure that the bond issuance contributes to a widely endorsed goal and that progress towards this goal can be measured in a comparable way. For sovereign borrowers, the World Bank's Sovereign ESG Data Portal provides a list of indicators that could be used as KPIs for SLBs linked to various sustainability themes such as climate risk and resilience, nature capital management, energy use, security and food security (World Bank, 2023<sup>[78]</sup>). Naturally, nationally determined contributions are a suitable framework in which to anchor climate-related KPIs, as demonstrated in the case of the SLB issuances of both Chile and Uruguay. KPIs can also be developed to accommodate the specific objectives and development context of individual issuers, as demonstrated in the Development Bank of Rwanda's recent issuance. Donors can help develop these indicators and collect and monitor relevant data. Such support would complement other measures through which donors can support SLB issuances in their partner countries. These measures are elaborated in section five.

# 5 Recommendations for donors to more effectively support sustainability-linked bond issuances in developing countries, with a view to public sector issuances

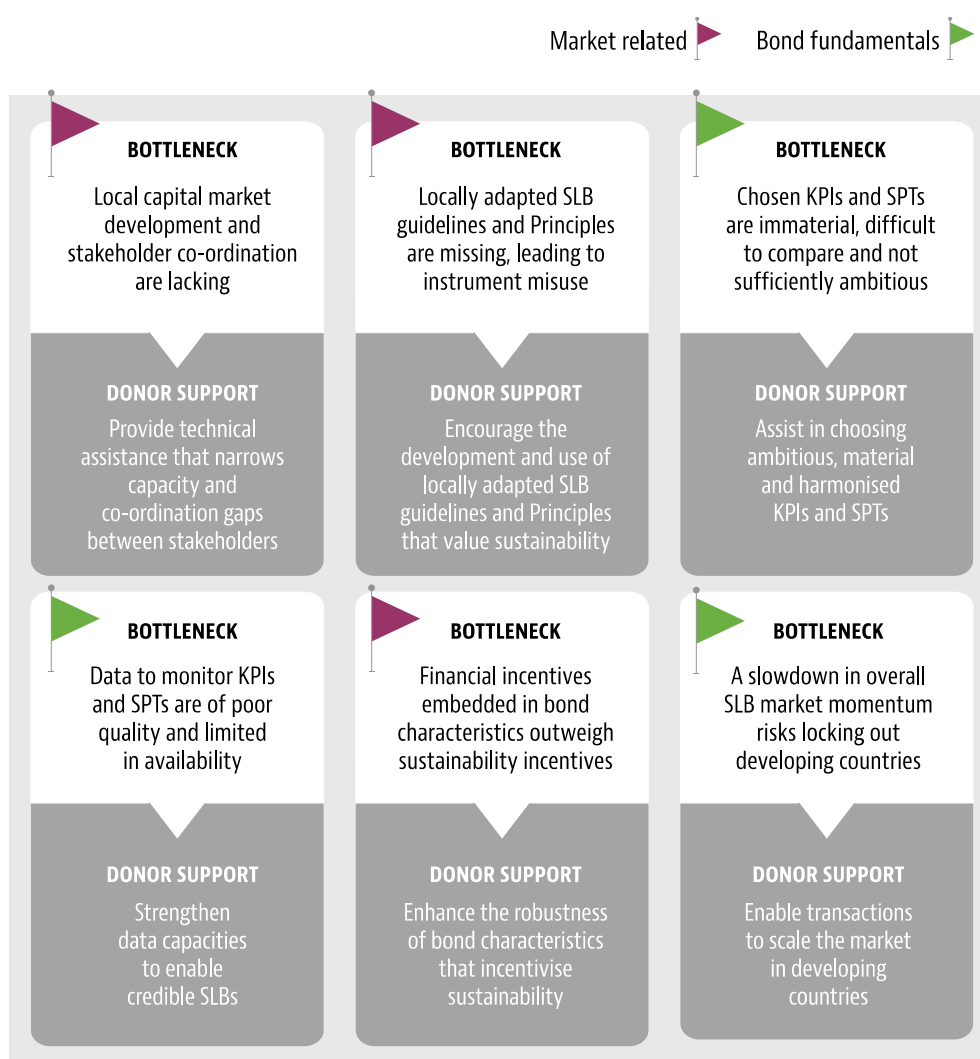
Donors can, and should, play an instrumental role in scaling the sustainability-linked bond (SLB) market, in particular in developing countries. This section outlines six areas of donor support that correspond to the six bottlenecks to market development discussed in section three. These areas are also in line the “Five Is” framework on the major policy areas in which donors can support the growth of the green, social and sustainability (GSS) bond market: investment, insurance, (market)-infrastructure, issuance and impact (OECD, 2023<sub>[3]</sub>). The recommendations set out in this section, while not specifically categorised according to the “Five Is”, do relate to and reflect all policy areas within that framework.

This section presents recommendations for donors to address the six bottlenecks to market development identified in section three. To help overcome these barriers and thus scale SLB issuances in developing countries, donor support should:

1. Provide technical assistance that narrows capacity and co-ordination gaps between stakeholders
2. Encourage the development and use of locally adapted SLB guidelines and Principles that value sustainability
3. Assist in choosing ambitious, material and harmonised key performance indicators (KPIs) and sustainability performance targets (SPTs)
4. Strengthen data capacities to enable credible SLBs
5. Enhance the robustness of bond characteristics that incentivise sustainability
6. Enable transactions to scale the market in developing countries.

Infographic 5.1 shows the relationship between the six bottlenecks and corresponding areas of recommended donor support, which are relevant to all types of SLB issuers. As discussed, however, there is a particular need – and potential – to scale up public sector issuances. Within each area of donor support, then, additional considerations pertaining specifically to public sector issuances are presented. Table 5.1, at the end of this section, also provides an overview of the six areas of donor support and corresponding recommendations.

## Infographic 5.1. How donors can address the bottlenecks that prevent the SLB market from scaling in developing countries



### 1. Provide technical assistance that narrows capacity and co-ordination gaps between stakeholders

As discussed, the issuance of an SLB requires extensive local capacity regarding the instrument as well as internal and external co-ordination among stakeholders. These elements are often lacking in developing countries – preventing them from tapping into the nascent SLB market. Such capacity and co-ordination gaps also lead to a highly fragmented market, creating confusion for issuers and investors alike.

**First, donors can build up organisational capacity in key domestic institutions and financial organisations to enable capital market development.** While donors cannot influence the whole range of actors involved in the creation of a functional bond market, they can adapt their approaches to the level of capital market development and ensure that key actors necessary for a GSS bond or SLB issuance are in place (OECD, 2023<sup>[3]</sup>). The World Bank Group, for example, provides tailor-made support to the development of local capital markets that includes both advisory services (e.g. policy advice on strengthening the legal and regulatory framework for capital markets) and transaction interventions (for specific projects that catalyse market development) (Carvajal et al., 2020<sup>[43]</sup>). Relating more specifically to preparing a market for SLB issuances, donors can provide targeted capacity development on this

instrument for government and relevant private sector participants. Ministries of Finance and Debt Management Offices are particularly important as they often set the national guidelines and Frameworks for bond issuance and in turn provide training for local issuers as well. The Swiss State Secretariat for Economic Affairs (SECO), for example, has been supporting the World Bank Government Debt and Risk Management Program for middle-income countries with annual workshops focused on enabling debt management offices to overcome challenges to access markets and shape market infrastructure. Capacity development should notably also be addressed to financial authorities in charge of approving the prospectus or equivalent pre-issuance legal documentation.

Donors can also focus on increasing the technical know-how and awareness of potential issuers – both public and corporate – around SLBs. In this regard, existing platforms and programmes can be leveraged. For example, the World Bank, through its Sustainable Finance and ESG Advisory Services, facilitates the development of GSS bond markets in emerging economies through pre- and post-issuance technical assistance, including through developing bond Frameworks and helping issuers meet reporting expectations (The World Bank, 2023<sup>[79]</sup>). The scope of such advisory services could be expanded to also cover SLBs. Other noteworthy initiatives include the Luxembourg Stock Exchange's LGX Academy, which provides certified courses on different areas of sustainable finance, and the International Capital Market Association's (ICMA) sustainable finance courses (ICMA, 2023<sup>[80]</sup>).

**Donors can encourage improved co-ordination among stakeholders at both the local and donor level.** Peer learning and exchange are important ways to build up local organisational capacity. The Inter-American Development Bank (IDB), for example, provides a platform for Chile and Uruguay to share their experiences in issuing sovereign SLBs with other actors within the Latin America and Caribbean region. The Sustainability-linked Sovereign Debt Hub (SSDH) can also serve as a crucial knowledge transfer platform (Kulenkampff and Pipan, 2023<sup>[19]</sup>). Greater co-ordination is also needed among donors themselves. Indeed, there are few instances where different donors work together to provide technical assistance for potential and existing issuers of GSS bonds in developing countries (OECD, 2023<sup>[3]</sup>). Donors' own reporting standards and requirements often vary, and the technical assistance on sustainable finance is often adapted to donor needs and templates rather than those of recipients. The lack of co-ordination exacerbates fragmentation in the SLB market overall and in developing countries in particular. Any harmonisation of expectations and requirements must crucially involve not only donors themselves, but also developing country stakeholders and private bond investors as well as standard-setting bodies such as ICMA. Working together, donors can also better accompany issuers across the whole SLB issuance process and make best use of their individual comparative advantages. Indeed, an important step to drive harmonisation and co-ordination around SLBs and advance the SLB market would be to create a global platform for sharing best practices and conducting research. This could be linked to existing initiatives, such as the SSDH.

For public sector issuances in particular, the following considerations are relevant for donor support:

- **Target capacity building and technical assistance towards Ministries of Finance and Debt Management Offices.** Empowering these actors with a solid technical understanding can help them develop a strategy for further issuances (Lindner and Chung, 2023<sup>[31]</sup>). Such understanding can then trickle down to other domestic actors such as sub-sovereigns.
- **Provide technical assistance to co-ordinate the efforts of different internal stakeholders involved in structuring public sector SLBs and preparing the market** (Kulenkampff and Pipan, 2023<sup>[19]</sup>). Studies have pointed to the importance of having an inter-agency co-ordinating body that can oversee all activities related to public sector SLB issuances (Lindner and Chung, 2023<sup>[31]</sup>). Although it will be costly to put such processes in place and overcome related bureaucratic barriers, the costs can be amortised over subsequent issuances – and will benefit the local sustainable finance ecosystem more broadly. Donors can therefore support the development of an inter-agency committee to oversee debt management office and fiscal co-ordination, and manage investor

communications. In consultations, Chile (though not a donor recipient), stressed the importance of this type of support. Experts interviewed for this report also noted that bilateral technical assistance providers are often especially well placed to support public sector issuers in multi-stakeholder processes as they tend to have long-term in-country presence and are regarded as more impartial compared to development banks.

- **More indirectly, donors can aim to sponsor holistic programmes and policies that involve inter-ministerial co-ordination and dialogue** – creating incentives for ministries to work together. Establishing co-ordination mechanisms would serve to lower entry barriers for potential SLB issuers as the necessary inter-ministerial connections would already be in place.

## ***2. Encourage the development and use of locally adapted SLB guidelines and Principles that value sustainability***

The initial rapid growth of the SLB market profited, to some extent, from the absence of regulations that might have unduly constrained early activities. Presently, however, there is a need for local guidelines – which must crucially remain harmonised and interoperable among each other. The ICMA Sustainability-Linked Bond Principles (ICMA SLBPs) provide a de facto global standard for issuers, but these must be adapted to different country contexts and complemented by the development of local external reviewers. Locally adapted guidelines and Principles are essential to preventing certain actors from misusing SLBs, which can lead to greenwashing accusations such as those that currently tarnish the market's reputation and threaten its growth.

**Donors can support the development of SLB guidelines, Frameworks and Principles that reflect market best practice and are also adapted to local realities.** This support can take the form of working directly with developing countries to develop localised guidelines and Frameworks (United Nations, Inter-agency Task Force on Financing for Development, 2023<sup>[81]</sup>). Currently, only a few technical assistance programmes focus on developing the necessary sustainable finance infrastructure for SLBs. However, there are initiatives in the GSS bond space that can be expanded to also cover SLBs. One of these is the International Finance Corporation's Green Bond Technical Assistance Program,<sup>18</sup> which was launched to foster the supply of emerging market green bonds, for example by disseminating the ICMA Green Bond Principles and supporting relevant policy development (IFC, 2023<sup>[82]</sup>). The World Bank Treasury, through the Bank's Sustainable Finance and ESG Advisory Services, has also provided technical assistance to a range of actors to develop green bond Standards, regulations and Frameworks (The World Bank, 2023<sup>[79]</sup>).

While donors should consider expanding such technical assistance programmes to SLBs as well, this type of support in itself can also indirectly prepare actors to undertake SLB issuances. In consultations, Chile officials reported that their prior use-of-proceeds bonds issuances facilitated the launch of Chile's SLB programme. Nevertheless, as illustrated in Infographic 4.1, a GSS bond issuance should by no means be seen as a precondition for entering the SLB space. Indeed, both Uruguay and the Development Bank of Rwanda (BRD) issued SLBs without having previously issued GSS bonds – underscoring the importance of tailoring donor support to the context and realities of different issuers. Overall, once local Principles and guidelines have been developed, donors should consider pairing other forms of support with expectations that issuers follow these. In addition and given that no SLBs have yet reached maturity, it would be prudent to regularly update all types of guidance and to learn from exemplary SLB issuances (such as the sovereign issuances of Chile and Uruguay).

**Concurrently, donors can support the development of local external reviewers and certify their approaches.** External reviewers who are familiar with country contexts play a key role in ensuring the credibility and effectiveness of SLBs and ensuring that developmental impact is at the core of the issuers' intentions. ICMA identifies four types of external reviews: second party opinion (SPO), verification, certification, and bond scoring or rating (ICMA, 2022<sup>[83]</sup>). Post-issuance verification is an especially necessary element of the ICMA SLBPs, which call for an external reviewer to verify the issuer's

performance against each SPT for the different KPIs at least once a year (ICMA, 2023<sup>[111]</sup>). This is a fundamental step as it leads to the potential adjustment of the bond's structural and/or financial characteristics (e.g. a coupon step-up if the SPT is not satisfied). Still, this can be a costly process for bond issuers (OECD, 2023<sup>[3]</sup>) – and even more so for SLB issuances that will rely on technical and timely data to demonstrate progress towards the SPT. For this reason, particularly in developing country contexts, donors should support the training of local external reviewers, who offer the dual advantage of deeper understanding of local realities and services at a lower costs than their international counterparts (OECD, 2023<sup>[3]</sup>; Flugge, Mok and Stewart, 2021<sup>[84]</sup>). In doing so, donors must crucially first align on the codes of practice and the guidelines they expect external reviewers to follow. The Asian Development Bank is particularly active in this space, offering training programmes for local SPO providers to build an enabling environment for the issuance of use-of-proceed bonds and SLBs in the Asia region.

Of all the areas of donor support discussed in this report, the development of locally adapted SLB guidelines and Principles will require the greatest co-ordination with public sector actors. The Ministry of Finance, the Financial Services Authority and others will naturally need to be involved in this process. As such, the recommendations outlined above are likely to significantly and directly facilitate public sector issuances as well. In addition to these, however, the following consideration is also important for public sector issuances specifically:

- **Ensure that external reviewers are shielded from undue political pressure.** The perception that any form of external review is subject to political influence will undermine investor confidence, with damaging effects on broader market development. In providing technical assistance, donors can thus advise governments on regulatory and governance measures to safeguard the political independence of external reviewers.

### ***3. Assist in choosing ambitious, material and harmonised key performance indicators (KPIs) and sustainability performance targets (SPTs)***

Ambitious, material and harmonised KPIs and SPTs are the cornerstone of a strong SLB and a credible market more broadly. Yet experts have warned that issuers too often choose KPIs and SPTs that lack materiality and ambition. At the same time, it is difficult to find the right balance between what investors need – i.e. KPIs and SPTs that they deem ambitious enough and relevant to the issuer – and what issuers themselves want – i.e. KPIs and SPTs that they deem achievable. Even when this balance is found, bonds will have different KPIs and SPTs, as well as different underlying structural and/or financial characteristics, which makes comparability challenging.

**Donors can support the building of local or regional KPI registries, taking into account that what issuers are able to measure may differ across country contexts.** For example, while emissions reduction may be a relevant objective in developed countries, it may be more appropriate for SLBs in developing countries to target social or adaptation outcomes as well as nature conservation. As in other areas of possible donor action, existing efforts in the GSS bond space can be leveraged and expanded to include SLBs. An example is the IDB's Green Bond Transparency Platform. Praised for its contributions to the harmonisation of KPIs and GSS bond reporting in the Latin America and the Caribbean region, the platform could be expanded to include SLBs (Vasa, Vartanyan and Netto, n.d.<sup>[85]</sup>; OECD, 2023<sup>[3]</sup>). A new global SLB platform for sharing best practices and fostering greater co-ordination, as suggested in the first section of this section, could also serve to help maintain and update KPIs. To encourage harmonisation and credibility of SLBs, donors could link their support, wherever possible, to the expectation that issuers of SLBs set KPIs from existing registries. At the same time, donors should co-ordinate among themselves as to their expectations on KPIs. An independent international body could also be established to endorse chosen KPIs to give them greater legitimacy (Flugge, Mok and Stewart, 2021<sup>[84]</sup>).

**Donors can then provide guidance to issuers in selecting KPIs.** The ICMA SLBPs should be the starting point in assessing the suitability of KPIs. They specify that KPIs should be relevant, core and

material as well as measurable, externally verifiable and able to be benchmarked (ICMA, 2023<sup>[11]</sup>). As stressed in consultations for this report, a bottom-up approach to KPIs is needed, given the variations in what different issuers are able to measure. This can ensure that KPIs are set based on what issuers will realistically be able to report on. A market sounding then can be conducted to determine whether the SLB would be something investors are interested in.

Donors should therefore use their technical expertise and internal know-how on impact measurement and sustainability-linked instruments to help issuers select KPIs, assess their suitability, and then communicate this with investors. For example, the IFC supports the issuers it works with in the selection of KPIs via materiality assessments and target benchmarking (de Calonje and de la Orden, 2022<sup>[30]</sup>). Similarly, the World Bank calls for KPIs based on benchmarks – where performance is assessed relative to a benchmark model – rather than KPIs based on outcomes – where performance is measured only using the indicator of interest.<sup>19</sup> As much as possible, donors should also support the use of KPIs based on benchmarks as this filters out changes resulting from factors beyond an issuer’s control (Stewart et al., 2022<sup>[86]</sup>; Wang et al., 2023<sup>[87]</sup>). While these KPIs are more complex to set and understand, they are crucial to SLB market credibility as they counter greenwashing claims and questions about additionality. They further help ensure that issuers are punished or rewarded only for the events they actually did influence, thus reassuring investors about the level of ambition of chosen KPIs (in the form of SPTs). As such, they monitor the actual impact of issuers (Stewart et al., 2022<sup>[86]</sup>). It is worth noting that identifying such performance-based indicators is particularly challenging for sovereigns as so many factors are beyond a government’s control (Flugge, Mok and Stewart, 2021<sup>[84]</sup>).

**Finally, donors can help issuers choose a level of ambition – expressed in the form of SPTs – that is both reachable and benchmarked.** The ICMA SLBPs state that SPTs should be ambitious and based on a benchmark and also specifies what this means by this for sovereign issuers (ICMA, 2023<sup>[11]</sup>; ICMA, 2023<sup>[13]</sup>). Building on these Principles, the World Bank has developed the Feasibility-Ambitiousness, or FAB, Matrix – which aims to give more structure to an issuer’s target-setting exercise by gauging targets within both feasibility and ambitiousness dimensions (Box 5.1). This is a useful tool that both issuers and donors that are supporting issuers should actively use.

For public sector issuances in particular, the following considerations are relevant for donor support:

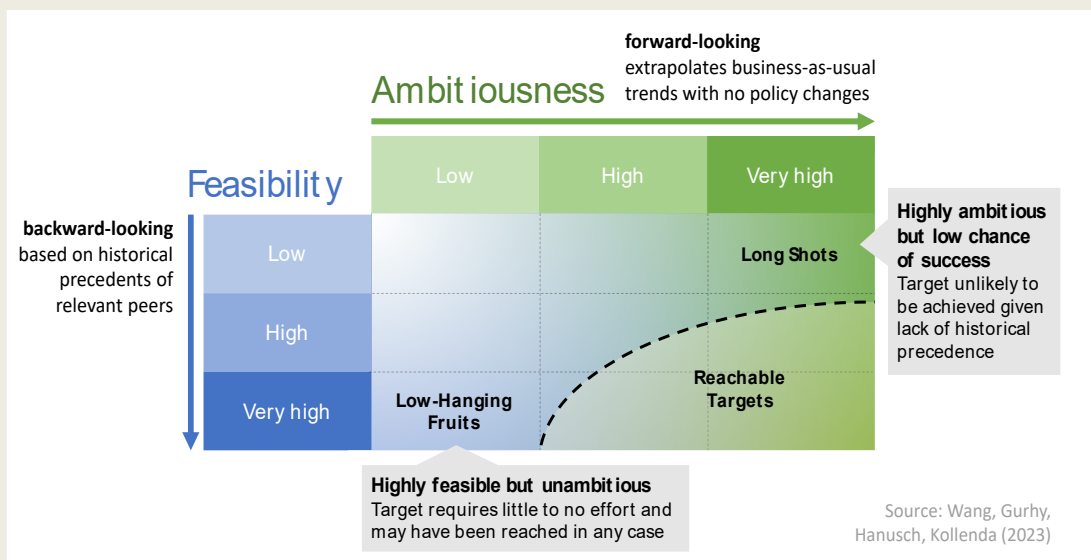
- **Identify and agree on a set of KPIs that can be used by sovereign SLB issuers.** This benefits issuers and investors alike – for example by reducing the burden of choice for debt management teams, creating a sense of familiarity for investors and thus facilitating comparability, and increasing market harmonisation more broadly. Indeed, the Development Bank of Rwanda cites KPI setting as one of the greatest challenges it faced in developing its first SLB (Box 2.2). ICMA’s Illustrative KPIs Registry is an important initiative in this area. In June 2023, the registry was updated to include additional KPIs for sovereign issuers (ICMA, 2023<sup>[29]</sup>). Key multilateral donors such as the IDB and the World Bank are involved in this process, shaping the selection of potential KPIs based on their expertise and familiarity with sovereign borrowers’ sustainability objectives. The World Bank Group, in another significant initiative, has also published a list of potential KPIs for sovereign SLBs (Flugge, Mok and Stewart, 2021<sup>[84]</sup>). A platform similar to the SSDH could be used to agree on and endorse KPIs for sovereign issuers.
- **Target capacity building and technical assistance towards the development and implementation of international sustainability commitments, and then support issuers in setting SPTs that link to these commitments.** Investors have expressed a preference for KPIs that are tied to existing metrics – such as those of the Science Based Targets initiative or to countries’ own nationally determined contributions (NDCs) or national adaptation plans (NAPs) (See, 2023<sup>[38]</sup>). While this may not always be appropriate for issuers and indeed the importance of setting bottom-up KPIs has been previously noted, donor support can nonetheless focus on the development and implementation of NDCs, NAPs and other internationally recognised targets. This

can lay important groundwork for possible SLB issuances that are tied to these national commitments. Indeed, a key success factor of the sovereign SLB issuances of both Chile and Uruguay was the presence of well-defined and ambitious NDCs, which provided credible KPIs and SPTs for the country’s respective bonds (Box 1.2). For sovereigns in particular, the World Bank is currently working towards integrating the FAB Matrix into its Sovereign ESG Data Portal as an open access tool (Wang et al., 2023<sup>[88]</sup>). This would equip investors with the tools to easily verify the level of ambition of the SLBs they are considering, thereby building investor confidence in the credibility of the sovereign SLB market and thus supporting its growth.

**Box 5.1. The World Bank Feasibility-AmBitiousness (FAB) Matrix: A reachable target is ambitious and feasible**

The setting and evaluation of SLB targets are usually done on a case-by-case basis and predominantly focus on their level of ambition. The FAB Matrix uses a quantitative framework to assess SLB targets and also introduces feasibility. Ambitiousness is a forward-looking notion, which projects the business as usual (BAU) scenario into the future. A target that is very much achievable under BAU without additional policy efforts is seen as unambitious. If the target is unlikely to be reached if BAU continues, on the other hand, it is regarded as ambitious. Feasibility is a backwards-looking concept that gauges a target by asking whether any other country in the past reached the target within a similar timeframe. If there is plenty of historical precedence, then the target is highly feasible, but if no other country has ever accomplished anything comparable then it is not feasible. Issuers need to balance both dimensions to avoid two types of targets. One is low-hanging fruit, meaning those that are highly feasible but not ambitious, would require little to no effort to achieve, and are likely have been realised without an SLB. Long shots are the other target to be avoided – that is, those that are highly ambitious but not feasible or look good on paper but are unlikely to translate into reality. Both extremes open the issuer and investor to the criticism of greenwashing. Instead, the FAB favours reachable targets that are ambitious and become increasingly feasible due to SLB funding.

**Figure 5.1. The World Bank FAB Matrix gives more structure to a target-setting exercise**



Source: Wang et al., (2023<sup>[88]</sup>), ‘Ambitious, yet feasible: Setting FAB targets for sustainable financing instruments’, <https://blogs.worldbank.org/psd/ambitious-yet-feasible-setting-fab-targets-sustainable-financing-instruments>



#### 4. Strengthen data capacities to enable credible SLBs

Data capacities and availability play a fundamental role in determining whether an issuer should enter the SLB space and whether it is appropriate for donors to support an SLB issuance (see also Infographic 4.1). Yet multiple bottlenecks exist – including variations in what different issuers are able to measure and the existence of areas where comparable data are particularly difficult to either obtain or attribute.

**There is significant room for donors to increase funding for data.** According to the PARIS21 PRESS2022 database, international support for data and statistics amounted to USD 542 million in 2020, a drop of nearly 16% – over USD 100 million – from 2019 levels. This was the biggest decline in funding since the start of the SDG era (PARIS21, 2022<sup>[89]</sup>). Traditional support for data and statistics has been characterised by a supply-driven, piecemeal approach that emphasises data needed by development co-operation providers for their monitoring, reporting and accountability rather than endogenous demand for data. Donors are therefore encouraged to take a demand-driven, holistic approach designed to strengthen the entire statistical system (OECD, 2017<sup>[90]</sup>). For example, the Systematic Observations Financing Facility is a United Nations multi-partner trust fund that aims to fill pertinent data gaps regarding weather and climate including by supporting countries, in particular least developed countries and small island developing states, to improve their data collection, processing and exchange efforts (OECD, 2023<sup>[67]</sup>). Such efforts, across different areas, will be fundamental to creating a strong foundation for issuing SLBs.

**Relatedly, donor technical assistance could be designed to complement broader efforts to enhance data capacities in partner countries.** In particular, donors should target their support towards national statistical agencies, which play a crucial role in creating trust in data and ensuring the integrity of the national statistical system. While building capacity to collect data is important, donor efforts must go beyond this to enable national statistical offices to “play an evolving and multifunctional role in the data ecosystem” (OECD, 2017<sup>[90]</sup>). The use of new enabling technologies (such as the Internet of Things and geographic information systems to capture data at source and in real time) can, where appropriate, also be explored as a means of improving access and availability of data (Kulenkampff and Pipan, 2023<sup>[19]</sup>). Technical assistance as well as grant finance can be important in developing the necessary data capacities and also improving compliance with donors’ expectations of data quality. These efforts, while not relating exclusively to SLBs, contribute to a strong enabling environment that in turn allows for local issuances. Donors already provide technical assistance for the production and management of specific data related to GSSS bond issuances, which are often aligned with donors’ own reporting requirements. To achieve more systemic effects that can create SLB market momentum, technical assistance related to the monitoring and reporting of corporate bonds would need to be better harmonised across donors and issuing entities and also anchored in macro-level efforts to boost data capacities at the national level.

For public sector issuances in particular, the following considerations are relevant for donor support:

- **Focus efforts on strengthening data that are already being collected and encourage issuers to set KPIs and SPTs based on these available data.** Governments already collect significant amounts of data. Wherever possible, rather than creating new data collection requirements, existing data should be leveraged. Donor efforts can therefore focus on improving the collection and processing of existing metrics, thus encouraging a bottom-up approach.
- **Increase investments in, and demand adherence to, international platforms on countries’ sustainability performance.** Issuers should be encouraged to collect and prepare data in line with the format required by existing databases established by respected third parties and then to choose their KPIs from these. Doing so would reduce the administrative budget for debt management teams and drive harmonisation. A number of existing datasets already have a specific focus on climate and nature-related objectives, according to a World Bank study (Flugge, Mok and Stewart, 2021<sup>[84]</sup>). The World Bank’s Sovereign ESG Data Portal is a good example of such a platform; it provides a user-friendly way for issuers, investors and other stakeholders to verify the ambition

and track record of sovereign SLB KPIs (World Bank, 2023<sup>[78]</sup>). Another important initiative in this space is the Assessing Sovereign Climate-Related Opportunities and Risks (ASCOR) Project, which will be the first publicly available, independent and open-source investor framework and database to assess the climate action and alignment of sovereigns (ASCOR, 2022<sup>[91]</sup>). Although not focusing on SLBs exclusively, ASCOR will narrow the data gap and enable investors to assess individual country approaches to addressing climate change. As such, it will offer potential to increase understanding of KPIs and SPTs.

### **5. Advise to enhance the robustness of bond characteristics that incentivise sustainability**

The credibility of SLBs is greatly weakened by issuers taking advantage of structural loopholes – such as setting late target dates, calling a bond before maturity and setting low penalties – that weaken the direct link between financial and sustainability outcomes.

**First, it is necessary for donors to continue supporting research to inform best practices regarding SLB characteristics.** Ideally, bond characteristics should reflect the specificities of (i) the issuer; (ii) the features of the transaction (e.g. tenor, call features, etc.); and (iii) the relative and absolute ambition of the SPTs (ICMA, 2023<sup>[13]</sup>). In a survey of major institutional sovereign debt asset managers, two-thirds of respondents supported the idea that the size of the coupon step-up and step-down should be correlated to the credit rating of the issuer (Sustainability-linked Sovereign Debt Hub, 2023<sup>[25]</sup>).

To date, however, there are few studies in this area and, as discussed, bonds tend to cluster around a coupon step-up of 25 basis points without an underlying rationale. Research by the Anthropocene Fixed Income Institute (AFII), however, is raising awareness of problematic practices that can undermine the sustainability impact of the SLB market, and offers innovative solutions to remedy such market distortion (Erlandsson and Richardson, 2023<sup>[92]</sup>; Mielnik and Erlandsson, 2022<sup>[93]</sup>). For example, AFII research suggests designing SLBs in a way that maximises incentives for sustainable behaviour. It also calls for SLB design to be as simple and harmonised as possible. Given the novelty and complexity of this instrument, doing so increases investor trust due to familiarity and amortises learning costs for issuers that can then use the same characteristics for repeat issuances (Stewart et al., 2023<sup>[94]</sup>). Another area that must be prioritised is the existence of the greenium in SLBs. A study by the Climate Bonds Initiative has found that SLBs, in some cases, can indeed help issuers achieve pricing benefits in the primary markets, although it is necessary to continue monitoring the pricing of SLBs as the market develops (Harrison, 2022<sup>[95]</sup>). More broadly, the pricing benefits of using SLBs rather than vanilla bonds in developing countries remain unclear. There are, of course, significant benefits to issuing GSSS bonds – including tapping a broader range of investors, accessing markets, and providing market signaling – but more evidence is needed on the specific pricing benefits of issuing SLBs.

**Donors should encourage issuers to follow these best practices via different forms of support.** For example, their support can be conditional on issuers following best practices on bond characteristics. Similarly, donors could also consider disengaging with an issuer should it be seen to be taking advantage of structural loopholes of SLBs. More directly, donors can enter the picture by covering the amount of the step-down, thereby rewarding the issuer for sustainability outcomes while guaranteeing the coupon levels for investors who are more financially motivated. Alternatively, donors can cover the difference between the step-down or step-up that issuers are ready to accept and that which investors find attractive enough. Consultations conducted for this report also revealed an openness from donors to cover the full costs of first-time SLB issuances – including costs related to external reviews, reporting and the transaction more broadly.

**The role of external reviewers could also be expanded to cover the structural and/or financial characteristics of SLBs.** Indeed, it would be highly relevant for SPOs to provide opinions on whether issuers are taking advantage of loopholes in structuring their SLBs; these would increase bond credibility

in the eyes of investors (Ul Haq and Doumbia, 2023<sup>[12]</sup>). When training local SPOs – which was included as a separate recommendation earlier in this section – donors could therefore include a focus on bond characteristics.

For public sector issuances in particular, the following considerations are relevant for donor support:

- **Focus research on the specificities of bond characteristics of sovereign SLBs.** For sovereigns, the costs of transitioning towards a national emissions pathway consistent with the Paris Agreement are so great that it is difficult to imagine a financial penalty high enough to create a material incentive for this (Cheng, Ehlers and Packer, 2022<sup>[96]</sup>). Still, penalties, and the related reputation costs of incurring these, must be high enough to incentivise sovereigns to meet their SPTs. In the case of step-downs, the issuer is rewarded if SPTs are successfully achieved. Yet there is some hesitation on the part of investors to embrace this structure as the step-down would trigger a lower return on their side. However, and especially for sovereign issuers, this structure can provide a suitable incentive that is politically more acceptable and easier to accommodate within existing budget frameworks. Governments can be more willing to enter into an agreement that rewards them for achieving targets rather than penalises them for failures.
- **Diversify the market through direct support to SLBs with innovative structural and/or financial characteristics.** The novelty of the SLB market means that there is still significant room for market innovation and testing of new bond structures. Issuers and investors alike may be more likely to consider an innovative bond structure if it is supported by a donor institution as a form of endorsement. The Development Bank of Rwanda's recent issuance, which has a step-down-only structure and was supported by the World Bank, can serve as an example.

## **6. Enable transactions to scale the market in developing countries**

As discussed, the slowdown in SLB market momentum stems from broader investor hesitance towards these instruments and overall market conditions as well as challenges inherent to the developing country context of issuers. Via direct investment into bonds and credit enhancement, donors can enable transactions and thus bring the market to scale in developing countries.

**First, donors can consider supporting the SLB market by investing in issuances in developing countries.** Through their participation, donors can boost investor confidence in the bond by providing a financial risk cushion and also due to their strict due diligence processes (OECD, 2023<sup>[3]</sup>). As such, first-loss blended finance is a strong signal of credibility – not only of the issuer but of the issuer's chosen KPIs and SPTs. Such investment is therefore fundamental to help build nascent SLB markets in developing countries. Equally crucial is that such interventions be designed in line with the OECD DAC Blended Finance Principles, with a particular focus on aiming towards long-term commercial sustainability as markets mature (OECD, 2020<sup>[97]</sup>). Once investor confidence is established in an SLB market, reliance on development finance and the level of concessionality should decrease.

**Donors should also consider scaling up guarantees for SLBs in those instances where these offer a more effective use of development finance than other instruments.** Guarantees have proven to be the most effective blended finance instruments for mobilising private finance (Garbacz, Vilalta and Moller, 2021<sup>[98]</sup>), and can therefore play an important role in scaling SLBs. In the context of SLBs, guarantees typically take the form of either a partial credit guarantee or a political risk guarantee. The former protects investors from non-repayment due to issues related to the issuer itself, while the latter is a form of insurance against government risks (including changes in laws or regulations, breach of contract, expropriation, war, or civil unrest) (OECD, 2023<sup>[3]</sup>). Most crucially, credit enhancement therefore transfers a portion of the risk to a third party – often a bilateral aid agency, DFI, MDB, specialised guarantee provider or private insurer – and as a result, makes the investment more attractive for investors. Indeed, the advantages of credit enhancement are many and significant: they lower the risk of investing in SLBs for investors, stimulate demand and crowd in private investors and, by extension, also lower the borrowing costs for issuers

(Kulenkampff and Pipan, 2023<sup>[19]</sup>; Willems and Zoltani, 2022<sup>[99]</sup>). Donors should therefore explore opportunities to make use of these instruments for SLBs, building on efforts that may already be underway with regard to use-of-proceeds bonds (OECD, 2023<sup>[3]</sup>). While credit enhancement is undoubtedly important for scaling the SLB market, however, it must be used carefully and in line with the OECD DAC Blended Finance Principle 2. This means that donors must develop their use of guarantees in a way that reflects context-specific factors while also being additional and market building and limiting concessionality (OECD, 2020<sup>[97]</sup>; OECD, 2023<sup>[3]</sup>).

**Donors need to increase their own institutional capacity to provide credit enhancement and explore opportunities to pool their capacities in this regard.** There is significant scope for donor institutions to develop their internal technical capacity on credit enhancement instruments. This can build on and complement equally needed efforts regarding use-of-proceeds bonds (OECD, 2023<sup>[3]</sup>). The SSDH can serve as a platform where different actors can share knowledge and experience on the use of credit enhancement tools for SLBs (Willems and Zoltani, 2022<sup>[99]</sup>). At the same time, particularly in sub-investment grade countries, a tangible credit uplift may exceed the capacity of an individual donor. There is therefore significant space for donor institutions to pool their capacities to bring transactions to scale. Bilateral DFIs, MDBs and specialised guarantee providers must therefore come together for the most effective use of credit enhancement instruments (OECD, 2023<sup>[3]</sup>; Willems and Zoltani, 2022<sup>[99]</sup>; Kulenkampff and Pipan, 2023<sup>[19]</sup>). Currently, however, the market for credit enhancement is highly fragmented; the SSDH can again serve as crucial platform where different stakeholders co-ordinate (Willems and Zoltani, 2022<sup>[99]</sup>).

For public sector issuances in particular, the following considerations are relevant for donor support:

- **Signal support for public sector SLB issuances through investment**, thus encouraging others to enter this space as issuers and investors. The European Bank for Reconstruction and Development (EBRD), for example, invested EUR 50 million in the EUR 650 million SLB issuance of Public Power Corporation, Greece's largest power producer and electricity supplier. In addition to serving as an endorsement of the issuer's ambitious sustainability and decarbonisation targets, the EBRD's investment also had a broader demonstration effect since this was the first SLB issuance in the EBRD region (Aristeidou, 2021<sup>[100]</sup>).
- **Expand the use of guarantees for sovereigns wishing to enter the SLB market.** Credit enhancement is not necessary for all sovereigns: Chile and Uruguay's SLB issuances, for example, received very significant investor interest even without this thanks to the countries' investment grade ratings and manageable public debt profiles (Kulenkampff and Pipan, 2023<sup>[19]</sup>). Still, credit enhancements can be crucial in helping provide a bond with a higher rating than would be possible in the absence of such enhancements – although they are not necessary for all sovereigns and should only be made available to official development assistance-eligible public sector actors. To date, however, examples of donors guaranteeing public sector SLBs have been very limited – possibly because of the limited number of such transactions to date. The BRD's SLB is a notable exception, where credit enhancement was provided via concessional International Development Association funds serving as a first-loss insurance for investment in the case of default (Box 2.2). Recent consultations undertaken by the SSDH found some interest from different development actors to enter this space (Willems and Zoltani, 2022<sup>[99]</sup>), and more may be interested in the future. Indeed, a promising initiative in this space was announced at the United Nations Climate Change Conference (COP28) in late 2023. This newly established Task Force on Sustainability-Linked Sovereign Financing for Nature and Climate brings together participating MDBs, DFIs and other development actors to boost co-operation around credit enhancement for sustainability-linked sovereign financing<sup>20</sup> (Climate Champions - United Nations Framework Convention on Climate Change, 2023<sup>[101]</sup>).

**Table 5.1. Recommendations for areas of donor support**

The following areas of donor support are identified as important to scaling the SLB market in developing countries, with targeted recommendations for all types of SLB issuances and public sector issuances more specifically.

Bottlenecks to scaling SLB market development	Areas of donor support	Recommendations		
			For all types of SLB issuances	Only for public sector SLB issuances
Local capital market development and stakeholder co-ordination are lacking	Provide technical assistance that narrows capacity and co-ordination gaps between stakeholders	Build up organisational capacity in key domestic institutions and financial organisations to enable capital market development	X	
		Encourage improved co-ordination among stakeholders at both local and donor level	X	
		Target capacity building and technical assistance towards Ministries of Finance and Debt Management Offices	X	
		Provide technical assistance to co-ordinate the efforts of different internal stakeholders involved in structuring public sector SLBs and preparing the market		X
		Sponsor holistic programmes and policies that involve inter-ministerial co-ordination and dialogue		X
Locally adapted SLB guidelines and Principles are missing, leading to instrument misuse	Encourage the development and use of locally adapted guidelines and Principles that value sustainability	Support the development of SLB guidelines, frameworks and Principles that reflect market best practice and are also adapted to local realities	X	
		Train and develop local external reviewers and certify their approaches	X	
		Ensure that external reviewers are shielded from undue political pressure		X
Chosen KPIs and SPTs are immaterial, difficult to compare and not sufficiently ambitious	Assist in choosing ambitious, material and harmonised KPIs and SPTs	Support the building of local or regional KPI registries	X	
		Guide issuers in selecting KPIs	X	
		Help issuers choose a level of ambition – expressed in the form of SPTs – that is both reachable and benchmarked	X	
		Identify and agree on a set of KPIs that can be used by sovereign SLB issuers		X
		Target capacity building and technical assistance towards the development and implementation of international sustainability commitments, then support issuers in setting SPTs that link to these commitments		X
Data to monitor KPIs and SPTs are of poor quality and limited in availability	Strengthen data capacities to enable credible SLBs	Increase funding for data	X	
		Design technical assistance to complement broader efforts to enhance data	X	

Bottlenecks to scaling SLB market development	Areas of donor support	Recommendations		
			For all types of SLB issuances	Only for public sector SLB issuances
		capacities in partner countries		
		Focus on strengthening data that are already being collected, and encourage issuers to set KPIs and SPTs based on these available data		X
		Increase investments in, and demand adherence to, international platforms on countries' sustainability performance		X
Financial incentives embedded in bond characteristics outweigh sustainability incentives	Advise to enhance the robustness of bond characteristics that incentivise sustainability	Continue supporting research to inform best practices regarding SLB characteristics	X	
		Encourage issuers to follow best practices via different forms of support – including disengagement and covering first-time issuance costs	X	
		Expand the role of external reviewers to cover the structural and/or financial characteristics of SLBs	X	
		Focus research on the specificities of bond characteristics of sovereign SLBs		X
		Diversify the market through direct support to SLBs with innovative structural and/or financial characteristics		X
A slowdown in overall SLB market momentum risks locking out developing countries	Enable transactions to scale the market in developing countries	Consider supporting the SLB market by investing in issuances in developing countries	X	
		Scale up guarantees for SLBs where these offer a more effective use of development finance than other instruments	X	
		Increase donors' own institutional capacity to provide credit enhancement and explore opportunities to pool their capacities in this regard	X	
		Signal support for public sector SLB issuances through direct investment	X	
		Expand the use of guarantees for sovereigns wishing to enter the SLB market.		X

# 6 Ways forward in donor support for sustainability-linked bond issuances in developing countries

Sustainability-linked bonds (SLBs) are relatively new instruments that hold significant potential to scale financing for sustainable development and climate transition pathways. They also offer several advantages to issuers looking to mobilise the private sector. Crucially, they are highly relevant for areas such as biodiversity, climate change adaptation and social outcomes – all of which have very strong financing needs but are hard to finance using green, social and sustainability (GSS) bonds. This is because these areas typically lack pipelines of sizeable and bankable assets that GSS bonds must, by definition, be used to finance. SLBs can instead incentivise issuers to set ambitious targets related to a range of sustainability themes and drive issuers – public and private alike – to meet these targets. They can also be linked to existing sustainability pledges, such as the Sustainable Development Goals (SDGs) and nationally determined contributions (NDCs) – therefore increasing their credibility and the accountability of issuers. The fact that SLBs do not require underlying assets also means that they can – at least in theory – be issued at much larger amounts and with longer tenors than their use-of-proceeds counterpart, since SLBs can be backed by an issuer’s entire balance sheet rather than a subset of physical assets. These factors, among others, contribute to making this relatively new and still-underutilised instrument attractive to issuers in developing countries and to investors.

Yet to date, issuances from developing countries account for a small part of the total SLB market – and appear to be decreasing. Between 2021 and 2022, the share of SLBs from issuers in official development assistance (ODA) -eligible countries as a percentage of the total issued amount decreased from 13% to 5%. This is a worrying trend given that these are the countries with the greatest financing needs and so the countries that could reap the greatest benefits from these instruments. At the same time, public sector issuances of SLBs – which offer a signal on the credibility of sovereign sustainability commitments or increase the ambition towards areas that cannot be financed via GSS bonds – are also extremely rare. They account for just 2% of total issued value.

## ***SLBs are one important tool among several complementary sustainable finance instruments***

There is therefore a need to scale up SLB issuances in developing countries and from public sector actors. This is not to say that SLBs are a one-size-fits-all solution; rather, they must be seen as part of a toolbox and therefore complementary to other sustainable finance instruments including GSS bonds. Crucially, both GSS bonds and SLBs remain debt instruments at their core. The debt sustainability of issuers, as well as other factors related to the macroeconomic environment and the institutional setting, must therefore be carefully weighed up prior to considering an issuance.

Donors have so far been hesitant to enter the SLB space, most likely due to the novelty of the instrument and the early stage of market development. Moreover, for political and budgetary considerations, donors

may prefer short-term wins and in particular physical projects that can be funded through grants and publicly announced by policy makers. The appeal of the short term and visibility of projects will remain a challenge to building the financial architecture needed to support the sustainable transition of developing countries. As emphasised throughout this report, this stresses the complementarity of different types of GSSS bonds – but also other types of financing. This includes grant-funding – which ensures visibility, compared to long-term debt funding that will typically be longer than the political cycle of both ODA-providers and recipients.

***Donors must seize the opportunity to scale developing country SLB issuances via targeted and co-ordinated support***

Where SLBs are deemed appropriate, targeted efforts by the donor community could go a long way in fostering more widespread usage in developing countries most broadly and by public sector issuers more specifically. In particular, this report identifies specific areas where donor support can make significant strides in scaling the market and outlines recommendations to overcome six main bottlenecks that now hinder the growth, relevance and potential of SLBs. While the recommendations are applicable to all types of SLB issuers, they are complemented by more targeted ones pertaining to public sector issuers in particular. This is in response to the extremely low level of public sector issuances to date – and the potential that these could hold for driving sustainable development. Public sector entities are also usually the main counterparts of donors in their development co-operation programmes and projects, making them a natural partner to work with for the scaling of the SLB market. The bottlenecks to scaling SLB market development and corresponding areas of donor support are summarised in Table 5.1.

In scaling the SLB market in developing countries, donors must act in a concerted and co-ordinated manner – aligning on priorities and leveraging their respective comparative advantages to move as a collective force in the face of a risk-return focused private sector. The donor community needs to focus on establishing reporting and transparency as the private sector will seek out the most appropriate market for its particular needs. The nascent stage of the SLB market provides a unique opportunity to do this from the onset. Donors must seize the moment.



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## Notes

<sup>1</sup> In September 2019, the Italian energy group Enel issued the world's first SLB with a value of USD 1.5 billion and a five-year maturity. The bond was greatly oversubscribed and was linked to a sustainability performance target relating to the company's renewable energy generation within its total installed capacity. For more information, see <https://www.spglobal.com/marketintelligence/en/news-insights/trending/fVsxYZY69uoZopKMVdc9DQ2..>

<sup>2</sup> When China is included as an ODA-eligible country, SLB issuances in ODA-eligible countries in 2022 account for 16% of the total volume of these instruments issued (rather than 13%) and 25% of the total number of issuances (rather than 19%).

<sup>3</sup> To date, public sector and corporate issuers in China have issued EUR 4.9 billion in SLBs, more than any ODA-eligible country.

<sup>4</sup> When China is included as an ODA-eligible country, the shares of SLBs issued by corporates rises to 80% and by financial services companies to 18%. The share of public sector issuances remains at 2%.

<sup>5</sup> Hard currencies are defined as the US dollar, euro, Japanese yen, United Kingdom pound, Swiss franc, Canadian dollar and Australian dollar.

<sup>6</sup> When China is included as an ODA-eligible country, the share of local currency issuances increases to 37%. This could reflect the government policy in China to promote the renminbi and the absorptive capacities of the domestic bond market in China.

<sup>7</sup> The Illustrative KPIs Registry, as of June 2023, includes 43 suggested sovereign KPIs across a range of sustainability themes. For example, under the theme of climate change, suggested potential KPIs relate to greenhouse gas emissions and energy. Other sustainability themes are diversity, equity and inclusion; biodiversity (including soil and/or land use); product governance (including safety and quality); air quality; working conditions (employee engagement, labour practices and labour rights); access and affordability; poverty and inequality; health; community and human rights; waste; access and affordability (including access to medicine); water (including oceans); and water, waste, access and affordability. See <https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/sustainability-linked-bond-principles-slb/>.

<sup>8</sup> Within the context of GSSS bonds, the terms Principles, Standards and guidelines are often used interchangeably. Throughout this report, these terms are always used together, without therefore necessitating distinction between them. While Principles are voluntary process guidelines for issuing green, social, sustainability or sustainability bonds – with the respective ICMA Principles globally recognised as market best practice – Standards typically go further than Principles by providing guidance that is specific to a regional or local context. For more information, see: <https://www.oecd.org/dac/green-social-sustainability-bonds-developing-countries-donor-co-ordination.pdf>

<sup>9</sup> Scope 3 emissions are indirect emissions that are not produced by the company itself but are emissions produced by customers using the company's products or by suppliers making products that the company uses. For more information, see <https://www.weforum.org/agenda/2022/09/scope-emissions-climate-greenhouse-business/>.

<sup>10</sup> Question 4.2.3 of the ICMA Sustainability-Linked Bond Principles Related Questions document) provides guidance on whether a third party ESG rating can serve as a KPI for an SLB. See

<https://www.icmagroup.org/assets/documents/Sustainable-finance/2022-updates/SLB-QA-CLEAN-and-FINAL-for-publication-2022-06-24-280622.pdf>.

<sup>11</sup> For SLBs with step-up penalties, setting a late target date is a way to minimise the total penalty as fewer coupon payments need to be made at the higher coupon rate. It also reduces the total penalties paid out over the lifetime of the bond.

<sup>12</sup> In this situation, the issuer calls an SLB bond before maturity, therefore paying a predetermined call price to bond holders and then no longer being liable for future coupon payments. This action can be used to evade potential penalties embedded in the bond Framework.

<sup>13</sup> One example is Verbund's EUR 500 million Green & Sustainability-linked Bond issued in 2021. It combines the features of use-of-proceeds bonds with a coupon step-up linked to company-wide sustainability goals. The proceeds of the bond will be used to finance a hydropower plant in Germany and grid projects in Austria. Details are available at <https://www.verbund.com/en-at/about-verbund/investor-relations/financing/green-finance>.

<sup>14</sup> A 2017 study for the World Bank that estimated the impacts of rail transport on agricultural production found that the shutdown of the Ethio-Djibouti railway line, for example, increased transportation costs to the port of Djibouti and significantly reduced agriculture production, and that a 10% increase in transportation costs was associated with a 2.8% decrease in agricultural production. For details, see [DOI: 10.1596/1813-9450-8174](https://doi.org/10.1596/1813-9450-8174).

<sup>15</sup> Data-based evidence on the actual presence of this premium is not yet established. There have been some cases of pricing tightening compared with original guidance, but whether there is this premium is hard to prove without a counterfactual.

<sup>16</sup> The SSDH is hosted by NatureFinance and supported by Switzerland's State Secretariat for Economic Affairs.

<sup>17</sup> The so-called blue bonds in the Belize transaction, however, were not blue use-of-proceeds bonds that would fall into the category of GSS bonds.

<sup>18</sup> The program was developed in partnership with SECO, the Swedish International Development Cooperation Agency and the Ministry of Finance of Luxembourg.

<sup>19</sup> According to a World Bank working paper, an example of an outcome-based KPI would be "annual avoided primary forest loss" in square kilometres (km<sup>2</sup>); an example of a benchmarked KPI would be "annual avoided primary forest loss in km<sup>2</sup> above the benchmark". The authors also show how benchmarked KPIs could be used to structure an SLB that would truly disincentivise deforestation in the Brazilian Amazon. See <http://documents.worldbank.org/curated/en/099354409042343013/IDU024051b5607a6f04cc809b4a0d926e299c521>.

<sup>20</sup> The Task Force participants are the Agence Française de Développement, Asian Development Bank, African Development Bank, European Investment Bank, Global Environment Facility, Green Climate Fund, IDB, and US States International Development Finance Corporation.