LATHAM & WATKINS

Client Alert
Commentary

Latham & Watkins Environmental, Social & Governance and Sustainable Finance Practices

June 15, 2023 | Number 3122

Sovereign SLBs: Pioneered in Emerging Markets and Poised for Growth?

Chile and Uruguay are the world's first and only issuers of sovereign SLBs — instruments that present unique opportunities for sovereign finance.

In the last couple of years, many sovereign issuers have entered the sustainable finance market as a financing alternative. More will likely follow, including emerging market sovereigns. Sustainable finance offers various opportunities, including the ability to demonstrate a country's commitment to sustainability and increase its potential investor base. Certain ESG investors specifically look to emerging markets because they see sustainable finance as a chance to diversify their portfolio and create a significant ESG impact in historically underfunded regions.

Latin America is at the forefront of innovative sustainable finance transactions. The region is also home to two of the three "carbon-negative" countries in the world — Suriname and Panama[1] — and the potential for different ways to GSS+[2] financing instruments in the region is myriad. For example, in the private sector, a leading pulp and paper producer was one of the first SEC-registered sustainability-linked bonds (SLBs), and the Republic of Ecuador issued the world's first sovereign social bond with the net proceeds earmarked to finance domestic housing development showing that not only private sector companies but also sovereigns have taken to sustainable finance with gusto in the region.

Benefits of Sovereign Sustainable Finance

In addition to providing sustainability benefits, sovereign GSS+ financing can provide a commercial upside:[3] Sovereign GSS+ bonds may trade with a "greenium" at issuance or in secondary-market trading. Certain studies have revealed pricing effects of up to 15 basis points (bps) in secondary trading.[4] Sovereign GSS+ bonds can further help finance ministries increase their investor base by attracting foreign private sector capital; investors show increasing appetite for GSS+ financing instruments, with some funds investing in ESG products only. For example, Mexico's first SDG-aligned sovereign bond was 6.5 times oversubscribed, while the sovereign green sukuk bonds issued by Indonesia from 2018 to 2022 experienced higher investor demand compared to its conventional bonds. The order book of the below mentioned US$3 billion green bond issued by a "Quasi Sovereign" was eight times oversubscribed.

Furthermore, since GSS+ sovereign bonds often attract a larger investor base, they help emerging market sovereigns access international capital markets for large-volume bonds of more than US$500

Latham & Watkins operates worldwide as a limited liability partnership organized under the laws of the State of Delaware (USA) with affiliated limited liability partnerships conducting the practice in France, Hong Kong, Italy, Singapore, and the United Kingdom and as an affiliated partnership conducting the practice in Japan. Latham & Watkins operates in Israel through a limited liability company, in South Korea as a Foreign Legal Consultant Office, and in Saudi Arabia through a limited liability company. Under New York's Code of Professional Responsibility, portions of this communication contain attorney advertising. Prior results do not guarantee a similar outcome. Results depend upon a variety of factors unique to each representation. Please direct all inquiries regarding our conduct under New York's Disciplinary Rules to Latham & Watkins LLP, 1271 Avenue of the Americas, New York, NY 10020-1401, Phone: +1.212.906.1200. © Copyright 2023 Latham & Watkins. All Rights Reserved.

million; amounts that sovereigns may otherwise not be able to raise in their respective domestic market. For example, the majority of Chile's GSS+ bonds are denominated in international currencies. However, bonds in international currencies might expose emerging market sovereigns to currency risks.

Recent Landmark Transactions in Emerging Market Sovereign GSS+ Issuances

In 2022, we observed three "first of its kind" sovereign bond offerings all issued by emerging market sovereigns.

In the second half of 2022, an emerging market "Quasi Sovereign" issued a US$3 billion green bond, the first-ever green bond issued by a sovereign wealth fund and the first-ever 100-year century green bond issued by a sovereign wealth fund. The proceeds from the offering are earmarked to fund and facilitate the sovereign's plan to reduce its dependency on hydrocarbon energy sources and to fundamentally reorientate and diversify its economy toward sustainability. Another issuance of US$5.5 billion followed in early 2023.

In February 2022, Chile issued the world's first sovereign SLB, involving US$2 billion 4.340% sustainability-linked notes due 2042. According to certain sources, Chile's SLB was oversubscribed more than four times[5] and generated a greenium of approximately 10 bps.[6] The SLB sets two key performance indicators (KPIs): "absolute greenhouse gas (GHG) emissions"[7] and "non-conventional renewable energy,"[8] both following Chile's Nationally Determined Contribution (NDC) to the Paris Agreement. In case of non-compliance with an SPT, the coupon of the bond will increase by either 12.5 or 25 bps (up to but excluding the maturity date), depending on whether one[9] SPT has been achieved (12.5 bps) or none (25 bps).[10]

The second sovereign SLB Uruguay's issuance of approximately US$1.5 billion 5.750% sustainability-linked notes due 2034. Similar to Chile's SLB, Uruguay's SPTs have been calibrated in accordance with its NDC to the Paris Agreement. Uruguay's SLB contains GHG emissions reduction targets (expressed in CO2 equivalents per real gross domestic product (GDP) unit) as well as targets related to the preservation of Uruguay's native forest area.[11] The terms of Uruguay's SLB provide for both a step-up and step-down mechanism (15 bps per KPI),[12] which constitutes not only the first sovereign SLB with this feature but also one of the still relatively few SLBs with step-down mechanics.

Opportunities and Challenges

Sovereign sustainable finance is currently dominated by use-of-proceeds instruments. However, Chile's and Uruguay's SLBs led to a rethinking of sovereign sustainable bond issuances and generated an interest in, or at least an increased focus on, SLBs, particularly as attention on environmental and social issues continues to increase. Sovereign SLBs offer significant opportunities and challenges compared to other GSS+ bond types.

SLBs enable sovereigns to use the bond proceeds freely, unlike, for example, a green or social bond. Sovereign issuers, especially smaller nations, might not always have the capacity to allocate the proceeds solely to green and/or social projects. SLBs offer flexibility — while issuers can still invest in such projects, they can use the remainder amount of proceeds for other purposes and pursue the agreed upon SPTs using other levers available to them, such as regulation or further partnerships with the private sector. SLBs may become increasingly attractive as various jurisdictions, including in Latin America, begin to roll out their own sustainable taxonomies. Such regulatory frameworks can help direct further private capital toward achieving particular environmental and social goals.

Furthermore, as Uruguay's example above shows, coupon step-down features could incentivize issuers to achieve the instrument's SPTs, thereby saving taxpayers money. Recently, the International Capital Markets Association (ICMA) began to work on an update of its Sustainability-Linked Bond Principles for sovereigns to address their specific needs, suggesting the potential that ICMA sees for additional sovereign SLBs in the future.

However, investors may perceive sovereign SLBs as requiring a deeper commitment toward sustainability across the government compared to a green bond. Given the long maturities of sovereign bonds, SPTs set by one government will also bind future governments during the lifetime of the SLB. Furthermore, SLBs attract a lot of scrutiny, particularly regarding the selection of suitable KPIs and the degree of ambition of the SPTs, or how meaningful the financial penalty is in case of a coupon step-up (amount of the coupon step-up and step-up date).

Recently, non-sovereign SLB issuers have become subject to greenwashing allegations by either not accurately disclosing all information associated with their KPIs or not selecting suitably ambitious SPTs. For example, a number of corporate issuers have been criticized by excluding Scope 3 GHG emissions from their GHG emissions reduction SPT, even though the largest portion of their GHG footprint is generated outside of Scope 1 and 2. Assessing a corporate SPT's level of ambition is already difficult in certain cases, but even more so for sovereign issuers due to a lack of relevant peers or international standards. Sovereign SLB issuers may be able to address this problem by linking their SPTs to NDCs under international agreements, such as the Paris Agreement, particularly to the extent achieving such NDCs is non-binding under such agreements. However, because NDCs only reflect targets that a country has committed to achieve, they may still be vulnerable to criticisms regarding the level of ambition.

SLBs also tend to require more resources and time to structure. Not every sovereign will have historical data available that provides for a robust baseline against which the KPI can be tested. Finally, a lot of skepticism exists around the step-down feature and the associated incentive. However, debt management offices (DMOs) might otherwise hesitate to risk a coupon step-up and "waste" taxpayer money.

Conclusion

In the last couple of years, sovereigns in general, and emerging markets sovereigns in particular, have demonstrated a strong commitment to sustainable finance and innovation. SLBs come with unique upsides, particularly with the flexibility they offer sovereigns in the use of proceeds. However, they also face certain distinct challenges, particularly regarding greenwashing, the level of ambition of KPIs and SPTs, reporting capabilities and resources of sovereigns, as well as the robustness of sustainable financing frameworks. Sovereigns considering the issuance of a GSS+ bond will need to carefully consider these factors in selecting whether an SLB or a use-of-proceeds issuance best fits their circumstances and, if so, how to structure it to best manage the distinct risks and opportunities associated.

If you have questions about this Client Alert, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Edward R. Kempson
edward.kempson@lw.com
+971.4.704.6370
Dubai

Peter Neuböck
peter.neuboeck@lw.com
+44.20.7710.4608
London

Austin J. Pierce
austin.pierce@lw.com
+1.713.546.7561
Houston

You Might Also Be Interested In

Sustainability-Linked Bond Issuers Miss Sustainability Targets: 10 Takeaways

Experts' View: Developments in ESG/Sustainable Finance

Focus on Greenwashing: The Latest Regulatory Proposals in the EU and the UK

ESG and Sustainable Finance in the GCC Region

Client Alert is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the lawyer with whom you normally consult. The invitation to contact is not a solicitation for legal work under the laws of any jurisdiction in which Latham lawyers are not authorized to practice. A complete list of Latham's Client Alerts can be found at www.lw.com. If you wish to update your contact details or customize the information you receive from Latham, visit our subscriber page.

Endnotes

[1] World Population Review, Carbon-Negative Countries 2023, https://worldpopulationreview.com/country-rankings/carbon-negative-countries (May 4, 2023).

[2] "GSS+" bonds refers to green, social, sustainability and sustainability-linked bonds.

[3] For further information, see World Bank (2022), Sovereign Green, Social and Sustainability Bonds: Unlocking the Potential for Emerging Markets and Developing Economies. https://thedocs.worldbank.org/en/doc/4de3839b85c57eb958dd207fad132f8e-0340012022/original/WB-GSS-Bonds-Survey-Report.pdf (April 22, 2023).

[4] See Fn 2 above.

[5] Environmental Finance (March 3, 2022), Chile issues ground-breaking sovereign sustainability-linked bond, https://www.environmental-finance.com/content/news/chile-issues-ground-breaking-sovereign-sustainability-linked-bond.html (April 22, 2023).

[6] Environmental Finance (March 7, 2022), Chile sends "strong message" to sustainability-linked bond market, https://www.environmental-finance.com/content/analysis/chile-sends-strong-message-to-sustainability-linked-bond-market.html (April 22, 2023).

[7] The GHG emissions KPI encompasses emissions within its "National Greenhouse Gases Inventory" and is measured in accordance with the IPCC guidelines for national greenhouse gas inventories (2006). According to the country's sustainability-linked bond framework, this includes sectors such as energy, industrial processes and product use, agriculture, and waste, but excludes land use, land use change, and forestry.

[8] As a percentage of total generation in the National Electric System. Non-conventional renewable energy covers the country's energy grid and is measured by a database that the country's National Energy Commission has published.

[9] In the case of the GHG emissions reduction target, both sub-targets must be satisfied.

[10] Furthermore, the country's SLB contains a "most-favoured nations clause" which will adjust the SPTs under the current SLB toward any more ambitious SPT in any subsequent SLB issued by it — a feature that is uncommon in SLBs.

[11] The bond terms include four SPTs:

SPT 1a: achieve a reduction of at least 50% in GHG emissions intensity by 2025, compared to 1990 levels;

SPT 1b: achieve a reduction of more than 52% in GHG emissions intensity by 2025, compared to 1990 levels;

SPT 2a: maintain at least 100% of Native Forest Area compared to 2012 levels; and

SPT 2b: achieve an increase of more than 3% in the Native Forest Area compared to 2012 levels (i.e., more than 103% compared to 2012 levels).

[12] In case of non-compliance with SPT 1a or SPT 2a, the coupon will increase by 15 bps per KPI (up to but excluding the maturity date). In case of achievement of SPT 1b or SPT 2b, the coupon will decrease by 15 bps per KPI, also an uncommon feature in SLBs (up to but excluding the maturity date).