CSF Center for Sustainable Finance India

Sustainability Linked Bonds and Transition Bonds

DEMYSTIFYING GREEN FINANCING INSTRUMENTS

As appreciation of the urgency of climate change grows, several innovative financial instruments have been developed and deployed to raise capital for action, including green bonds, transition bonds, and sustainability-linked bonds (SLBs). However, confusion remains about the basic concepts of these instruments and the differences between them. This piece focuses on demystifying two such instruments: sustainability-linked bonds (SLBs) and transition bonds.

WHAT ARE SLBS AND TRANSITION BONDS?

Sustainability-linked Bonds

SLBs largely function like traditional bonds, with the additional feature of sustainability-related key performance indicators (KPIs), such as reducing carbon emissions or improving social metrics. If issuers do not meet these KPIs, which are laid out upon the issuance of SLBs, they pay a higher interest rate. They are, therefore, incentivized to meet their targets in order to avoid higher interest payments.

Transition Bonds

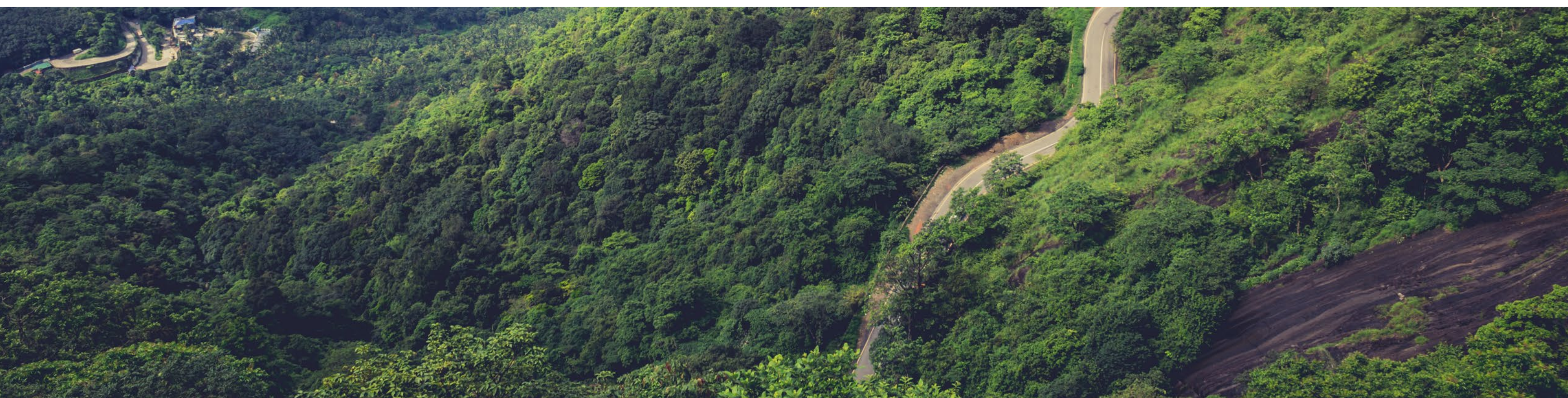
Transition bonds are issued to raise long-term capital for high-emissions industries to transition to less carbon-intensive operations. These bonds fund the issuers to become less carbon-intensive over the long term, though not necessarily to become completely green. Regulators also ask the issuers to disclose transition plans, including plans to cut emissions, implementation plans, and use of technology.

While the proceeds of transition bonds are used for a specific decarbonization-focused project, SLBs are targeted at certain sustainability outcomes from the project or corporation.

ARE THEY SUPPORTING CLIMATE ACTIONS?

Both SLBs and transition bonds can provide crucial financing for hard-to-decarbonize companies to transition to low-carbon practices, enabling the shift towards a more sustainable economy. They are also designed to foster transparency and responsible corporate behavior.

However, both of these bond types carry the potential for greenwashing. Given that transition bonds do not require companies to reach net zero, they can enable those in high-carbon industries to sustain their operations with only marginal emissions reductions. In the case of SLBs, if an issuer sets KPIs that are easy to achieve these targets may have been achieved under a business-as-usual scenario. These scenarios run contrary to the goal of achieving net zero as quickly as possible.



WHAT IS THE STATUS OF EACH INSTRUMENT?

SLBs are more commonly used than transition bonds. From 2019 to the end of 2023, a total of USD 253 billion was issued through SLBs globally, compared to USD 15 billion for transition bonds over the same period[1]. Investors may prefer SLBs over transition bonds due to the lack of clarity and consensus on the definition and concept of transition bonds compared to SLBs, which are based on meeting well-defined, forward-looking, and measurable KPIs.

SLBs and Transition Bonds in India

Several Indian energy-industry corporations, including JSW Steel, Ultratech Cement, and Adani Electricity Mumbai, have issued SLBs, while none has issued a transition bond to date. All of Indian companies' SLBs have been issued in overseas markets and in US dollars.

India's securities regulator, the Securities and Exchange Board of India (SEBI), does not have any guidelines for the issuance of SLBs but provided guidelines on transition bonds in 2023. As a subcategory of green bonds, transition bonds must meet all of SEBI's compliance requirements for green bonds, as well as some additional requirements.

WAY FORWARD

Despite all the controversies and limitations of SLBs and transition bonds, they can be powerful financial instruments to channel capital for the green transition. With some further refinement in design, disclosure, favorable regulations, and enabling environment, they can mobilize massive amounts of capital for the industrial sector that can reduce carbon emissions significantly, but gradually, over a long time. Transition bonds require more clarity (e.g. type of technologies for various sectors eligible for transition finance) and consensus on their definition and concept to make them transparent and universally accepted. On the other hand, there is a need to raise the ambition of SLB KPIs to make them a more impactful instrument. Given that India's green transition is facing financial and social challenges, the development of SLBs for domestic markets would nudge Indian companies to use SLBs to raise debt capital for carbon mitigations while addressing social challenges. SEBI can issue guidelines on SLBs like green and transition bonds.

READING LIST

1. ICMA (2024). Transition Finance in the Debt Capital Market. https://www.icmagroup.org/assets/Transition-Finance-in-the-Debt-Capital-Market-paper-ICMA-14022024.pdf
2. OECD (2023). Mechanisms to Prevent Carbon Lock-in in Transition Finance. https://www.oecd-ilibrary.org/environment/mechanisms-to-prevent-carbon-lock-in-in-transition-finance_d5c49358-en
3. Shrimali, G. (2022). Transition Bond Frameworks: Goals, Issues, and Guiding Principles. Stanford University. https://sfi.stanford.edu/sites/sfi/files/media/file/transition_bond_frameworks-_goals_issues_and_guiding_principles_0_0_0_0.pdf
4. World Bank (2023). Structural Loopholes in Sustainability-Linked Bonds. https://documents1.worldbank.org/curated/en/099237410062223046/pdf/IDU0e099a50307f86045a80b33201d0b7057cedf.pdf

1 https://www.spglobal.com/esg/insights/featured/special-editorial/global-sustainable-bonds-2023-issuance-to-exceed-900-billion

The Clarifying Concepts series provides short explanations of foundational ideas and terminology in sustainable finance to help professionals from different fields navigate emerging issues.

It is produced by the Center for Sustainable Finance (CSF), a knowledge and net-working hub which aims to accelerate India's financial sector towards a more sustainable future. CSF is managed by Climate Policy Initiative (CPI).