Markets Brief

DFSA Best Practice Guidelines on ESG Bonds

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Introduction

In this Markets Brief, we provide information about the DFSA's approach to the listing of environmental, social and governance (ESG) bonds. ESG bonds include bonds or sukuk labelled as green, social, sustainable, sustainability-linked, climate, climate adaptation, climate transition or with a similar label.

This Markets Brief contains voluntary best practice Guidelines (the Guidelines) for issuers seeking to raise funds for projects and assets, which could be classified as contributing to achieving ESG goals, and market practitioners. This may include those which are intended to address transition to a zero-carbon economy, adaptation to climate change, as well as all other ESG objectives.

Through this Markets Brief, we seek to promote consistency and uniformity of disclosures of ESG bonds and sukuk to aid investors to navigate and make well-informed investment decisions.

Terminology

Defined terms are identified in this Markets Brief by the capitalisation of the initial letter of a word or each word in a phrase. Terms not expressly defined in this Markets Brief are defined in the Glossary Module of the DFSA Rulebook (GLO).

ESG BOND GUIDELINES

General

When considering issuing ESG bonds in or from the DIFC, we suggest that issuers and market practitioners consider following an internationally-accepted and transparent set of standards, principles, or best practices.

Several voluntary standards have been developed in recent times. They include the International Capital Market Association (ICMA)'s Green Bond Principles, Social Bond Principles, Sustainability Bond Guidelines, and the Sustainability-Linked Bond Principles; the Climate Bonds Initiative (CBI)'s Climate Bonds Standard; and standards and guidelines that refer to or cover a specific region such as the Association of Southeast Asian Nations (ASEAN) or the European Union.

Whilst we are not endorsing any specific voluntary standards, we have set out the Guidelines that we would expect to be followed, and we encourage a high level of transparency that will provide investors with a deeper understanding of the ESG themes and practices. Our Guidelines set out in this Markets Brief are modelled to a large extent on the ICMA principles and guidelines, commonly used by the majority of the ESG bond issuers listed in the DIFC.

Taxonomies and definitions

The DFSA does not intend to prescribe when a bond may be labelled as either E, S, G or other and what can be considered as eligible for investors. The DFSA recognises that it remains a complex and continually developing area, particularly in a cross-border context.

It is currently addressed in bond issuances globally by a combination of definitions and taxonomies, appropriate disclosures, second party opinions and certification schemes.

For example, there exist several types of definitions and various national or regional taxonomies issued by industry-led standard providers or jurisdictions such as those by ICMA, CBI, the European Union or ASEAN. They aim to provide increased clarity to stakeholders and decision makers and set the path for an orderly approach to classifying ESG products. We encourage issuers and market practitioners to refer to such taxonomies and definitions in complying with ESG standards, whenever possible. Issuers and their advisers should ensure that the descriptions of bonds are not misleading or deceptive.

For the purposes of the definitions set out in the Annex to this Markets Brief, we have referred to the ICMA principles and guidelines, which are internationally accepted and widely used, including by the majority of the ESG bond issuers listed in the DIFC.

Use of proceeds

The proceeds raised through the issuance of ESG bonds must be allocated towards the projects as described and represented in the offering documents.

Project evaluation and selection disclosure process

The issuer of ESG bonds should clearly communicate to investors:

a. the objectives of the proposed project(s);
b. the process by which the issuer determines how the projects fit into a certain project category; and
c. complementary information on processes used to identify and manage the perceived ESG risks associated with the project(s).

Issuers are also encouraged to:

a. position the information set out above within the context of the issuer's overarching objectives, strategy, policy and/or processes relating to ESG;
b. provide information, if relevant, on the alignment of projects with official or market-based definitions or taxonomies, related eligibility criteria, including, if applicable, exclusion criteria; and disclose any ESG standards or certifications referenced in project selection; and
c. have a process in place to identify mitigants to known material risks of negative social and/or environmental impacts from the relevant project(s).

External review

We encourage a high level of transparency and recommend that an issuer's process for project evaluation and selection be supplemented by an external review, also referred to as a second party opinion. External certification and ratings may also be used to increase transparency and credibility.

Management of proceeds

The net proceeds of ESG bonds, or an amount equal to these net proceeds, should be credited to a sub-account or otherwise tracked by the issuer in an appropriate manner and attested by the issuer in a formal internal process linked to the issuer's operations for ESG projects.

So long as an ESG bond is outstanding, the balance of the tracked net proceeds should be periodically adjusted to match allocations to eligible projects made during that period.

To encourage a high level of transparency, we also recommend that an issuer's management of proceeds be supplemented by the appointment of an auditor, or other third party, to verify the internal tracking method and the allocation of funds from the ESG bond proceeds.

Reporting

Issuers should collect, and keep, readily available up to date information on the use of proceeds.

In the interest of transparency, it is recommended that this information is published annually and on a timely basis until full allocation and until the bond reaches maturity. It is recommended it is done more frequently in case of material developments affecting the flow of proceeds.

The annual report should include a list of the projects to which ESG bond proceeds have been allocated, as well as an appropriate description of the projects and the amounts allocated, and their expected impact.

The overall objective is to inform investors of progress, changes, or updates to an ESG bond.

ADDITIONAL GUIDELINES FOR SUSTAINABILITY-LINKED BONDS

Selection of Key Performance Indicators (KPIs)

For sustainability-linked bonds, the issuer's sustainability performance is measured based on using pre-defined KPIs.

The KPIs selected by the issuer and used in the sustainability-linked bond should be:

a. relevant, core and material to the issuer's overall business;
b. of high strategic significance to the issuer's current and/or future operations;
c. measurable or quantifiable on a consistent methodological basis;
d. capable of being externally verifiable; and
e. able to be benchmarked.

Selection of Sustainable Performance Targets (SPTs)

SPTs are measurable improvements in KPIs in respect of which issuers commit to a pre-defined timeline within which the SPTs are planned to be achieved. Each KPI should be linked to one or more SPTs.

Each SPT should:

a. represent a material improvement in the respective KPI;
b. be comparable to a benchmark or external reference;
c. be consistent with the issuer's overall ESG strategy; and
d. be determined on a pre-defined timeline.

Bond characteristics

The financial and structural characteristics of sustainability-linked bonds may vary depending on whether the selected KPIs reach (or do not reach) the pre-determined SPTs. For example, the issuer may state in the offering documents that if the selected KPIs do not reach the pre-defined SPTs, the coupon rate, or other financial or structural elements, may need to be adjusted.

Reporting

We encourage a high level of transparency for sustainability-linked bonds as the proceeds from their issuance are not ring-fenced to green, social or sustainable purposes exclusively.

Issuers are encouraged to publish on an annual basis, and keep readily available and easily accessible:

a. up-to-date information on the performance of the selected KPI(s), including baselines, where relevant;
b. a verification assurance report relative to the SPTs outlining the performance against the SPTs and the related impact, as well as timing of such impact, on the bond's financial and/or structural characteristics; and
c. any information enabling investors to monitor the level of ambition of the SPTs.

External review

In general, we believe and recommend that external reviews should be used to increase the credibility of sustainability-linked bonds.

At the issuance stage, we recommend that issuers appoint (an) external review provider(s) to confirm that bond KPIs and SPTs are in accordance with the best practice standards adopted in relation to the issuance of such bonds.

We also recommend that an issuer's ongoing management of its performance against each SPT for each KPI and any relevant adjustments be supplemented by the appointment of an auditor, or other third party, to verify that a proper process has been followed.

Similarly, it would increase the credibility of the issuer and likely stand it in good stead for future issuance if, post issuance, an audit or other third-party verification is carried out and published in respect of the issuer's performance against the stated SPTs and KPIs.

MISCELLANEOUS

Disclaimer

Please note that the contents of this Markets Brief are not intended to be Guidance as contemplated by the Regulatory Law 2004 and the contents should neither be interpreted, nor relied upon, as Guidance. You should refer to the DFSA Rulebook for Guidance or contact the DFSA if you require individual guidance.

Technical explanations given in this Markets Brief are for illustrative purposes and should not be considered or relied upon as legal advice. We recommend that independent advice is obtained if you are unsure about any aspect of the DFSA Markets regime, which may apply to you.

All issuers are reminded to ensure that information disclosed in a Prospectus or in any other document (such as a Financial Promotion or a market announcement) complies with legal requirements under DFSA-administered legislation. This includes ensuring that information disclosed in a Prospectus or in any other document is not misleading or deceptive.

Further information

The DFSA Markets team can be reached on markets@dfsa.ae or +971 4 362 1500. The DFSA will not advise a particular course of action or provide (legal) advice, but it is prudent to keep the DFSA informed of ongoing developments in relation to the Reporting Entity and any planned issuance.

Contact us

Visit the DFSA website www.dfsa.ae for:

- other editions of the Markets Brief;
- access to DFSA-administered legislation and the DFSA Rulebook, including a full text of the Markets Law 2012 and Markets Rules; and
- the Code of Market Conduct (in the Sourcebook Modules part of the DFSA website).

For enquiries:

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Feedback

We appreciate your feedback and welcome any suggestions that you may have. Please email us at markets@dfsa.ae.

ANNEX

Definitions based on ICMA principles and guidelines

Green bonds are any type of debt instrument where the proceeds will be exclusively applied to finance or re-finance projects with clear environmental benefits. Examples of project categories include renewable energy, energy efficiency, and pollution prevention and control. Different types of green bonds exist in the market.

Social bonds are any type of debt instrument where the proceeds are exclusively applied to finance or re-finance projects that directly aim to address or mitigate a specific social issue and/or seek to achieve positive social outcomes. Examples of project categories include providing and/or promoting affordable basic infrastructure, access to essential services, and affordable housing.

Sustainability bonds are any type of debt instrument where the proceeds will be exclusively applied to finance or re-finance green and social projects.

Sustainability-linked bonds are any type of debt instrument for which the financial and/or structural characteristics (i.e., coupon, maturity, repayment amount) can vary depending on whether the issuer achieves a set of pre-defined ESG/ sustainability-linked SPTs for pre-selected KPIs within a pre-defined timeline.

Note: The DFSA classifies a bond as a Debenture, see General Module (GEN) A2.2.1(b). A Debenture is an instrument creating or acknowledging indebtedness, whether it is secured or not (and subject to certain exclusions). Typically, a bond, debenture stock, loan stock, note and certain Islamic products (including “sukuk”) are regarded as Debentures. Therefore, the Guidelines apply to a sukuk in the same way as they apply to a bond.