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Market View

The merits and mechanics of sustainability-linked bonds

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At a glance

Sustainability-linked bonds (SLBs) are issued by companies to demonstrate their commitment to sustainability targets.

Where targets are not met on time, bondholders are compensated.

This approach keeps companies accountable to sustainability targets and maintains investor confidence.

Sustainability-linked bonds, or SLBs, were designed to bring accountability into sustainable finance by linking an issuer's borrowing costs to pre-agreed sustainability targets. If those targets are met, payments continue as planned; if not, investors are typically compensated through a higher coupon¹. This creates a contractual connection between a company's sustainability strategy and its cost of debt.

A recent example comes from Repsol, the Spanish integrated energy company spanning oil and gas production, refining, chemicals, power generation and retail supply. Repsol issued a €650 million sustainability-linked bond in 2021 with an initial coupon of 0.375% and a maturity date of July 2029. As part of the bond's structure, the coupon was tied to Repsol meeting pre-agreed sustainability targets. Following the most recent assessment of these targets, the coupon has increased or 'stepped up' by 0.25% from 6 July 2026, rising from 0.375% to 0.625% for interest periods commencing on and after that date.

For investors, this represents a real-world test of a market designed to link financing costs to sustainability commitments, keep companies accountable and compensate bondholders when agreed targets are not met on time. For Repsol, the outcome reflects both meaningful progress on its emissions intensity and a decision to honour the original spirit of the bond agreement by applying the coupon step-up, even after updating its calculation methodology.

What happened with Repsol's SLB?

Repsol was among the first of the large oil and gas companies to commit to net zero emissions by 2050. Its SLB framework uses the Carbon Intensity Indicator (CII) to track progress. CII measures the amount of greenhouse gas emissions generated for each unit of energy produced or sold, allowing investors to assess whether the company is reducing the emissions associated with its activities over time.

Repsol set a 2025 target equivalent to a 12% reduction in CII. Its June 2026 notice reported a 16.3% reduction, although this used an updated method for calculating CII introduced in 2024. Whilst positive to see a reduction, Repsol ultimately reassessed its SLB because when using the previous calculation method – the original one in place when the bond was issued – the reduction would have been 11%, below the 12% target.

Repsol considers the updated calculation method consistent with the bond conditions, but in

recognition of investor expectations, it will voluntarily comply with the obligations that would follow if it had not met the targets. For bondholders, the outcome is unchanged: the coupon steps up by 0.25%.

This case illustrates how measurement approaches can evolve, impact SLB outcomes and prompt issuers to respond constructively to maintain investor confidence.

Why the SLB market matters

SLBs grew rapidly after the publication of the International Capital Market Association's Sustainability-Linked Bond Principles in 2020. Issuance accelerated through 2020 and 2021, when companies were under pressure to demonstrate credible climate transition plans, showing investors how they intended to reduce their environmental impact over time. Investors were also looking for financial products that linked capital markets to measurable sustainability outcomes, such as cutting greenhouse gas emissions or improving energy efficiency.

Their appeal was particularly clear for companies without a large or immediate pool of eligible green assets to finance. Proceeds from green (or blue) bonds are allocated to clearly defined projects, whereas SLBs can usually be used for general corporate purposes. By linking borrowing costs to company-level sustainability targets, SLBs address this gap, giving issuers access to sustainable finance and investors a measurable framework for assessing progress.

Since then, new issuance has slowed. Investors have become more selective, particularly where targets appear insufficiently ambitious, where the date on which performance is tested is too remote, or where the financial penalty for missing a target is considered too small to influence corporate behaviour. Nevertheless, the market remains relevant because a substantial volume of SLBs issued during the 2020-2021 peak are still outstanding and are now approaching the point at which sustainability targets must be formally assessed.

What it means for investors

For holders of Repsol's July 2029 bond, the immediate implication is higher income. The coupon has risen from 0.375% to 0.625%, adding €1.625 million of annual interest across the €650 million issue as the higher rate now applies.

The increase in the interest rate is not large in the context of Repsol's overall finances, but it confirms that SLB penalties can be enforceable and that even disputed targets can translate into better economics for bondholders.

What comes next?

Attention will now turn to other SLBs with upcoming test dates. Repsol itself has another SLB outstanding: its 0.875% July 2033 bond. That issue is linked to a longer-dated carbon intensity target, with a 2030 test date and a potential 0.375% coupon step-up if the relevant target is not met.

The market is entering a period when many SLBs issued in 2020 and 2021 will be tested. Enel Group, the Italian electricity and gas manufacturer and distributor, has already provided one prominent example of coupon step-ups, after the company did not meet its 2023 emissions intensity target, leading to a 0.25% coupon step-up on ten of its outstanding bonds. Other issuers across utilities, consumer goods, real estate and industrials will face similar scrutiny in the coming years.

This is a healthy development for the asset class. The credibility of SLBs rests on targets being measurable, reporting being transparent and consequences being enforced when targets are missed – helping reassure investors that sustainability commitments have meaningful financial consequences rather than being purely voluntary.

In Enel's case, the company reported a significant change in its energy mix, increasing electricity generated from zero-emissions sources from 45% in 2015 to 83% by 2024. Enel specifically credited sustainable finance instruments with helping to accelerate this transition.

For investors, this is the central appeal of the SLB structure. Capital can be directed towards companies with stated transition objectives, while also creating a financial incentive for those objectives to be delivered on time. The transparency required by SLBs also gives investors a clearer basis to monitor progress and engage with issuers.

The step-up on Repsol's 2029 bond is therefore more than a single coupon adjustment. It shows that sustainability-linked finance can encourage better environmental outcomes while helping to protect investor economics when delivery is slower or more complex than anticipated, illustrating how these structures are intended to align financial and sustainability objectives.

Like all corporate bonds, SLBs also carry investment risks. A coupon step-up increases the interest paid to investors if specified sustainability targets are missed, but it does not remove the risk that the issuer could experience financial difficulties or that the market value of the bond could fall before maturity. Investors should consider both the sustainability features and the issuer's overall credit quality when assessing these securities.

[1] The interest rate paid by the issuer to bondholders

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Ugnius manages direct fixed income portfolios across a variety of mandates with a particular focus on credit products. He is a voting member on the Fixed Income Committee. Prior to joining LGT, Ugnius worked as a credit analyst at MUFG where he was responsible for assessing credit risk on corporate finance transactions. Ugnius is a CFA Charterholder.

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