Can the Sustainability Linked Loan Deliver Lasting Change?

Henrietta Worthington and Victoria Judd*

As with most sectors, sustainability is a buzzword in the loan market. Sustainability linked loans are increasing in popularity, and the recently published Loan Market Association guidance on these loans provides market participants with greater clarity as to how to take advantage of these loans. The authors of this article discuss sustainability linked loans and the guidance.

As we emerge from the COVID-19 pandemic, there is increasing rhetoric surrounding the need to build back our systems better. This slogan focusses on seizing the opportunity to rebuild structures that meet ambitious environmental and sustainability targets across all industries and sectors, and this includes the loan market.

The growth of the sustainability linked loan ("SLL") market has snowballed over the past few years. From an SLL market worth $5 billion in 2017, according to Refinitiv, companies reportedly raised $163 billion of green and sustainability linked loans worldwide in 2019, and these loans appear to be gaining momentum.

Europe and the UK, in particular, have led the charge for this expanding market. The UK's Loan Market Association ("LMA") published its green loan ("GL") and SLL principles in 2018 and 2019 respectively. The LMA published updates to these principles and corresponding guidance ("SLL Guidance")[1] to provide greater clarity for lenders and borrowers looking to take advantage of this socially sustainable funding tool.

WHAT ARE SLLS?

SLLs have previously been referred by various other names, including environmental, social, and governance ("ESG") loans or key performance

---

* Henrietta Worthington is counsel at Pillsbury Winthrop Shaw Pittman LLP focusing her practice on domestic and cross-border debt financings, representing banks, funds and other financial institutions, sponsors and borrowers from various industries and countries. Victoria Judd, counsel at the firm, is a multispecialist financing lawyer who advises borrowers and financial institutions on a broad range of transactions, with a focus on energy finance and project development. Resident in the firm's London office, the authors may be reached at henrietta.worthington@pillsburylaw.com and victoria.judd@pillsburylaw.com, respectively.

[1] https://www.lma.eu.com/documents-guidelines/documents/category/green--sustainable-finance#document_index.

indicators ("KPI") loans. However, the LMA's SLL Guidance recommends that the term "SLL" becomes consistent and exclusively used in order to "build a common language and understanding in the market."

According to the LMA's SLL principles,[2] the aim of an SLL is to assist borrowers who want to improve their sustainability profiles by incentivizing "the borrower's achievement of ambitious, predetermined, sustainability performance objectives." These should not be confused with GLs, which are used to finance a specific green purpose. In contrast, the purpose of an SLL is not relevant to the availability of a loan. Instead, an SLL benefits from a pricing mechanism which is linked to certain predetermined sustainability performance metrics.

Broadly, a borrower will have access to cheaper funds where it is able to achieve prescribed sustainable or ESG "sustainability performance targets" ("SPTs"). Conversely, borrowers can expect prices to rise where they fail to hit their SPTs.

The LMA highlights four interrelating core components to an SLL, which are described in greater detail below:

- **Relationship to Borrower's Overall Sustainability Strategy**

  The emphasis on this pillar is that borrowers should have a clear sustainability strategy. This should then be reflected within the drafting of the SLL. As such, the SLL should support the sustainability strategy of the borrower rather than being the basis for its strategy.

  One of the benefits of an SLL is its flexibility, as it encourages market participants to develop their sustainability objectives based on that borrower's specific sustainability profile. This means that the SPTs (as further described below) can be bespoke and specific to a borrower or can be based on existing sustainability indices.

- **Target Setting—Measuring the Sustainability of the Borrower**

  The SLL mechanism works such that the borrower and lender will agree to what the LMA calls "ambitious and meaningful" SPTs and, where the borrower hits these targets throughout the life of the loan, it will benefit from advantages, such as a reduction in interest rates. The schedule to the LMA SLL principles sets out a list of common categories of SPTs. For example, an SPT could be related to energy efficiency, emissions, water consumption or ESG. The SPT list in the

[2] https://www.lma.eu.com/documents-guidelines/documents/category/green--sustainable-finance#document_index.

LMA SLL schedule is non-exhaustive, and other categories of SPTs or metrics may be considered where relevant or appropriate for a specific borrower.

The relevant metrics considered by the parties will depend on the borrower's profile and will be assessed by the parties on a case-by-case basis, with considerable input from the borrower or borrower group. Some SPTs are generic and will likely apply to most corporates, such as the "global ESG assessment." Alternatively, other SPTs may be more appropriate for specific businesses, for instance the 'affordable housing' category, which will likely be more applicable for property developers or borrowers in the real estate sector.

The LMA also provides examples as to how a borrower can improve on its SPTs. For example, the "global ESG assessment" metric looks at improvements in an ESG rating or achieving a recognized ESG certification; and the "circular economy" metric looks at an increase in recycling rates or use of recycled materials or supplies.

To the extent possible, the SPTs should be set by reference to available industry standards and initiatives, which will help benchmark ambitiousness of targets and eliminate the view that they represent business as usual. Any targets must be set with transparency and clearly documented. In longer-term transactions, flexibility may need to be included to allow for the targets to align with the business over the life of the loan.

- **Reporting**

  The reporting obligations will be embedded within the borrower's general reporting requirements under the loan agreement. Timing for delivery of reports and any external verification requirements will be determined on a case-by-case basis in discussion between the parties. However, the SLL Guidance requires annual reporting as a minimum and encourages public reporting. Borrowers are also urged to furnish lenders with "details of any underlying methodology and/or assumptions."

- **Review**

  The requirement for an external review process will also be determined on a case-by-case basis. Borrowers may consider seeking an independent external review prior to or after signing any SLL, in each case to assess meaningfulness, ambition and credibility of the SPTs. Where the borrower is a public company, lenders may be able to rely on publicly available information.

In some cases, an initial review may be sufficient, but in others a further review on any extension or issue of new loans may be appropriate, particularly if the SPTs which were previously set have already been achieved.

Borrowers should be aware that internal factors such as the availability of a dedicated sustainability team at the borrower and internal audit processes in relation to sustainability will be considered by any independent reviewer.

WHAT ARE THE BENEFITS OF SLLS?

In addition to their possible cost savings for compliant borrowers and sustainability impact, SLLs are proving extremely popular as a result of various ancillary benefits.

- *Protection from Sustainability Washing*—The LMA has put an emphasis on the importance of avoiding sustainability washing, which is where claims of sustainability credentials are misleading, inaccurate or inflated. By setting examples of SPTs and establishing some clear guidance, the LMA's intention is to avoid companies benefitting from the reputational benefits of SLLs without having ambitious sustainability targets in place.
- *EU Taxonomy Requirements*—The EU Taxonomy regulations will shortly come into force, and exact legal requirements are expected to be published by the end of 2020. These standardize terminology applicable to all financial products in the EU and will introduce obligations and objectives for any environmentally sustainable activities. Following the LMA guidance in respect of SLLs will give borrowers and lenders an early mover advantage in complying with the EU Taxonomy regulations.
- *Emerging Markets*—SLLs are of particular use for borrowers in emerging markets, where supranational funding institutions have long looked to make a more sustainable impact. SLLs are sufficiently flexible to allow parties to adapt them to fit a borrower's specific sustainability profile, and the pricing incentives can be leveraged by lenders to encourage borrowers to operate more sustainably.
- *Reputation*—SLLs may improve the reputation and credibility of a borrower—both internally and externally. In relation to the latter, participating in SLLs may help build strong, value-based relationships with new or existing stakeholders and aid in obtaining new investments

by illustrating the borrower's commitment to achieving sustainability goals. Similarly, reputational benefits are available for lenders participating in sustainable lending.

- *Credit Risk*—Reports suggest that ESG leading companies outperform their counterparts. During the COVID-19 pandemic, good governance and sustainable practices has been seen to have a materially positive impact[3] in the global markets. To the extent that improved ESG performance has a beneficial impact on the credit of the relevant borrower or borrower group, it is certainly a benefit for lenders from a risk perspective.
- *Longer Term Impact*—As compliance with the SPTs will be ongoing for the term of the SLL, an SLL imposes longer-term goals to improving economic, social and governance performance. Though failure to comply may not necessarily cause an event of default, there may be reputational damage, which will create a further compliance incentive for the borrower over the term of the SLL. The longer-term impact for the borrower may also be seen through the ability to attract and retain staff who see contributions to social and developmental goals as an important corporate value.

Ultimately, if more corporates consider how to enhance their ESG performance and lenders incorporate these values into their credit assessments, then material sustainability improvements can be made by driving capital towards borrowers who have more robust sustainability strategies.

---

[3] https://ignition.financial/esg-leaders-outperformance-covid-19/.