A&L Goodbody

ESG & SUSTAINABILITY

Sustainability-linked loans
- the evolution, the benefits, and the concerns

A sustainability-linked loan (**SLL**) is a loan where the economic outcome is linked to the sustainability performance of the borrower.

SLLs aim to support the key role that credit markets can play in encouraging and incentivising borrowers to contribute to sustainability (from an environmental and/or social and/or governance (**ESG**) perspective).

This article looks at the reasons why SLLs have become more popular in recent years, their key properties as well as some concerns that have been raised.

11 MIN READ

What is a sustainability linked-loan?

Any type of loan instrument and/or contingent facility (such as guarantee facility or letter of credit facility) can be structured as a SLL. Such loans incentivise borrowers through the economic characteristics of the loan varying depending on whether the borrower achieves agreed sustainability performance goals or not. The borrower's sustainability performance is measured by applying predefined sustainability performance targets (**SPTs**) to predefined key performance indicators (**KPIs**).

Evolution of SLLs

Market standards

In March 2019, the loan industry bodies in Europe, the US, and the Asia Pacific (i.e. the Loan Market Association (**LMA**), the Loan Syndications and Trading Association (**LSTA**), and the Asia Pacific Loan Market Association (**APLMA**)) published the Sustainability-Linked Loan Principles (the **SLLPs**). While several SLL transactions closed in Europe pre-publication of the SLLPs, their publication helped accelerate the growth of the SLL market. The SLLPs were updated further in May 2021 and February 2023.

The SLLPs are voluntary recommended guidelines that aim to promote the development of SLLs and have provided the loan markets across Europe, the US and Asia Pacific with a common framework setting out the core components which a loan needs to have for it to be categorised as a SLL.

The SLLPs set out the following five core components that a loan must meet to be categorised as a SLL:

- **Selection of KPIs** –The borrower's sustainability performance over the term of the loan is to be measured by using one or more sustainability KPIs. The credibility of a SLL is dependent on the selection of proper KPIs.

  The KPIs must be (i) relevant and material to the borrower's overall business and its sustainability strategy (ii) measurable and quantifiable by using consistent calculation methodologies (iii) capable of being benchmarked against relevant industry standards and/or industry peers.

  Examples of KPIs include (i) the extent of the borrower's reliance on renewable energy (ii) reductions in the borrower's greenhouse gas emissions (iii) the diversity of the borrower's workforce, management team, and / or board of directors (iv) a borrower's contribution to affordable housing.
- **Calibration of SPTs** – The process of calculating the SPT per KPI is vitally important as they form the basis of the borrower's obligations in the facility agreement.

The SLLPs sets out several criteria in relation to the selection of SPTs, including (i) they should represent a material improvement in the KPIs and go beyond both what the borrower would achieve anyway in a "business as usual" scenario and what it is already required to achieve by regulation (ii) setting them at such a level that they remain ambitious and relevant throughout the term of the loan (iii) being based on a combination of benchmarking approaches (i.e. the borrower's past performance, the performance of peers in the industry, and science-based reference points).

The SLLPs recommend that the borrower seeks input from an external party to determine the relevance, robustness, and reliability of the selected KPIs, the rationale and level of ambition of the proposed SPTs, the relevance and reliability of the selected benchmarks, and the credibility of the strategy outlined by the borrower to achieve them.

We typically see three or four KPIs and related SPTs agreed for SLLs (occasionally more, depending on the borrower's approach to sustainability). While the model provisions (referred to below) contemplate four KPIs, that is for illustrative purposes only and is not a recommendation that four KPIs be included in each SLL.

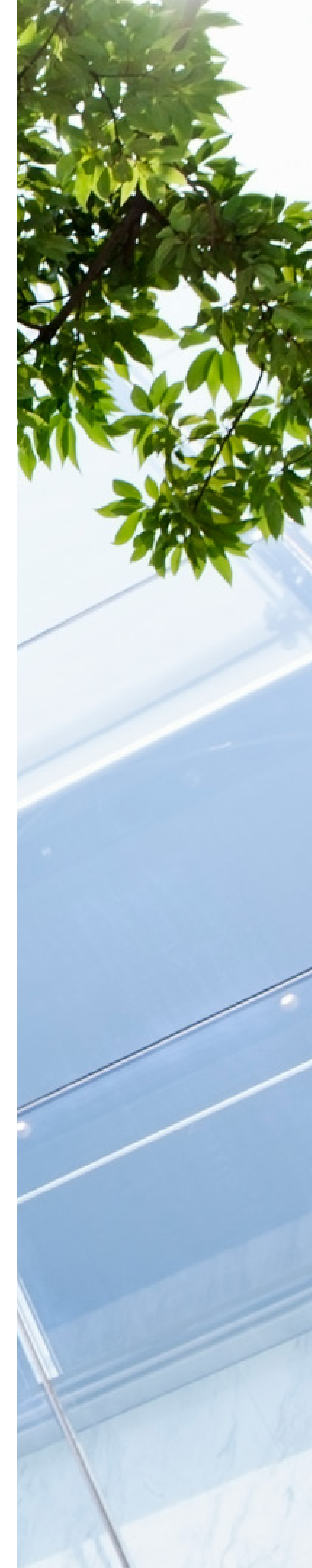
- **Loan characteristics** – A key characteristic of a SLL product is that an economic outcome is linked to whether the selected SPTs are met. This is typically done by the interest margin being reduced or increased by an agreed amount depending on how many SPTs were met within the relevant reference period.
- **Reporting** – A borrower should, at least once per annum, provide the lenders with (i) up-to-date information to enable them to monitor the performance of the SPTs and determine if the SPTs remains ambitious and relevant to the borrower's business (ii) a sustainability confirmation certificate together with a verification report outlining the performance against the SPTs for the relevant year and the related impact on the loan's economic characteristic (e.g. the margin increase or reduction).
- **Verification** – A borrower must obtain independent external verification of its performance against each SPT for every relevant period that leads to a potential adjustment of the loan's economic characteristics. The verification should be carried out by one or more independent external experts, such as an environmental consultant, an auditing firm or ratings agency.

Model clauses for SLLs

Until recently, there has been no standard drafting available for SLL provisions in loan agreements. This has resulted in a wide variety of approaches to the drafting of SLL provisions being taken in the market. However, in May 2023, the LMA published the first set of draft model provisions for SLLs (the **model provisions**). The model provisions are designed to be inserted into the LMA's Senior Multicurrency Term and Revolving Facilities Agreement for Leveraged Acquisition Finance Transactions (Senior/Mezzanine) but can also be adapted for use with the LMA's other recommended forms of facility agreements.

The key aspects of the model provisions include the following:

- **Margin adjustment** – the model provisions modify the standard definition of "margin" in the facility agreement by stating that the level of the margin is subject to adjustment in accordance with a new clause entitled "sustainability margin adjustment". The parties have the flexibility to agree on the number of SPTs and the mechanics of the margin adjustment, (including assigning different weightings to different SPTs). The margin adjustment is based on how many SPTs



are met during a reference period. The parties can also agree to a one-way margin adjustment (i.e. a reduction only) or a two-way margin adjustment (i.e. one which can also increase where the borrower does not meet an agreed number of SPTs). It is also typical for the margin adjustment to be applicable to any commitment fees.

- **Provision of information** – the model provisions set out requirements for the provision of Sustainability Information, Sustainability Compliance Certificates, Sustainability Reports and Verification Reports. These are to allow for the reporting, testing and verification of the borrower's performance against the SPTs and ultimately determining the margin adjustment.
- **Sustainability amendment event** – if a "sustainability amendment event" occurs, then the borrower must notify the facility agent and propose sustainability amendments to any of the impacted KPIs, SPTs or calculation methodologies in order to remove or take into account the impact of the event. The parties must then enter into negotiations with a view to agreeing any such amendments. "Sustainability amendment event" is defined to include a merger, an acquisition or a disposal of an asset or business by the borrower which could reasonably be expected to impact any of the KPIs or SPTs. If amendments cannot be agreed by an agreed deadline, the lenders have the ability to declassify the loan (see below).
- **Declassification event** – the model provisions contain a concept of "declassification event" which allows the lenders to declassify the loan as a SLL. Once it is declassified, then the sustainability margin adjustment will no longer apply, and the borrower can no longer market or describe the loan as a SLL. In the model provisions only a failure to agree on sustainability amendments within a specified period after the occurrence of a sustainability amendment event is included as a declassification event. The remaining events on the list are left blank; therefore, giving the flexibility to include additional events on a case-by-case basis. These could include: (i) a persistent failure by the borrower to meet SPTs and/or (ii) a breach of certain sustainability provisions (e.g. requirement to provide reporting) that is not cured within a particular timeframe.

- **Sustainability breach** – a "sustainability breach" is a breach of one of the sustainability provisions in the facility agreement. In accordance with market practice, under the model provisions a sustainability breach does not result in an event of default (**EOD**). Instead, either the margin reduction is not applied (in a one-way margin ratchet), or there is a margin increase (in a two-way margin ratchet). However, lenders may want to consider on a case-by-case basis whether a sustainability breach could be sufficiently serious and/or persistent such that it should trigger an EOD.

The publication of the model provisions was a welcome development for the SLL market as it is expected to promote further consistency and standardisation, and reduce time spent on negotiating SLL clauses. The model provisions also provide enough flexibility for borrowers and lenders to customise them as required for each transaction. However, as noted above, there is a wide variety of approaches being taken in the market and some loan agreements include more comprehensive provisions than those contained in the model provisions; as a result, there remains scope for negotiation and divergence from the model provisions.

The Benefits

Reputation - the "green halo"

There is considerable reputational benefit for both borrowers and lenders when a SLL deal is announced as it demonstrates to the public, investors, and other stakeholders that they are taking steps to address sustainability concerns. This benefit is more pronounced when the SLL is the largest or the first one in a particular industry or country, or if it is highly ambitious in its SPTs.

Nevertheless, both borrowers and lenders need to be mindful of, and take steps to mitigate, any potential risks for greenwashing allegations to be levied against them throughout the term of the loan as this will reduce any "green halo" benefit that they received when the SLL deal was first announced.

Interest rate margin

The key characteristic of a SLL is that an economic outcome is linked to whether the selected SPTs are met.

Although the possibility for the interest rate margin and/or commitment fees to reduce may pique the interest of borrowers initially in a SLL, it is generally not the primary motivation for the borrower's decision to go ahead with a SLL given that the potential reduction in the interest rate margin and/or commitment fee is normally only a few basis points.

Helping lenders achieve their commitments and obligations

Many banks and financial institutions have made public ESG commitments as well as signing up to certain alliances and frameworks to support them in achieving credible science-based and net zero targets, including the Glasgow Financial Alliance for Net-Zero (**GFANZ**), and the Net Zero Banking Alliance (**NZBA**). In addition to these alliances, banks and financial institutions need to comply with a number of ESG-related regulatory requirements. These include Pillar 3 disclosures (which require European banks to provide information on their green asset ratio, and this ratio also measures the extent to which banks' activities are aligned with the EU Taxonomy Regulation). Therefore, banks and financial institutions have an incentive to encourage their borrowers to avail of SLLs as it will help them achieve their own sustainability commitments and improve their ESG disclosures.

More accessible than green loans or social loans

SLLs have much broader application than green loans or social loans. Green loans and social loans require a borrower to use the loan proceeds towards eligible green or social projects. In contrast, SLLs can be used for any general corporate purpose, are applicable to every sector and can focus as much on the social and governance aspects of ESG as on the environmental aspects.

Therefore, this considerably widens the potential market for sustainable finance by allowing borrowers who are not in conventional "green" industries, or who do not have eligible green or social projects to finance, the possibility of accessing sustainable finance.

Standardisation

The growth of SLLs was accelerated when the LMA, LSTA and APLMA jointly published the SLLPs. The SLLPs brought a structure to the market and gave clear guidance on the minimum standards for a loan to gain the SLL label. Although still relatively new, we would expect the publication of the model provisions will continue this acceleration.

The Concerns

While there are many factors contributing to the popularity of SLLs, parties need to be mindful of the pitfalls and concerns around SLLs, some of which are outlined below.

Greenwashing

SLLs are essentially an unregulated product. While the SLLPs provide valuable guidance to the market, they are non-binding recommendations and do not have the force of law. In addition, there is no authority or supervisory body that has oversight or approval on the determination as to whether a loan is compliant with the SLLPs. Therefore, there is a risk that borrowers and lenders could label a loan as a SLL without satisfying all the core components of the SLLPs.

Labelling a loan as a SLL without adhering to the SLLPs could amount to greenwashing, as well as undermining the integrity of the SLL market. Borrowers and lenders who engage in greenwashing could open themselves up to regulatory scrutiny and litigation risk.

The increased awareness of greenwashing has resulted in the addition of certain protective provisions to facility agreements which are intended to ensure that lenders do not find themselves party to a SLL that is deficient in some way. As noted above, the LMA introduced "declassification event" and "sustainability amendment event" concepts into the model provisions to address some of those concerns.

Costs

When the SLL product was first introduced, the interest margin adjustment was normally downwards only. However, in more recent years, a two-way interest margin adjustment has become much more common. This means that if the borrower does not achieve the pre-agreed SPTs, then it can end up paying a higher interest rate.

In addition, borrowers will have to incur costs in obtaining the services of external ESG advisors (e.g. for a pre-signing second party opinion or KPI/SPT assessment, or as part of the verification report that needs to be appended to the borrower's sustainability confirmation certificate).

The possibility of paying a higher interest rate, coupled with the costs that the borrower will have to incur, may negate the benefits of the SLL product in the view of some borrowers, and in particular SMEs who may have more limited cash resources to put towards sustainability initiatives.

Potential for lenders to benefit from non-compliance

Where a two-way interest margin adjustment is built into a SLL, a situation can arise where a lender benefits financially where a borrower does not meet its ESG targets. A perception that a lender is gaining more profit as a direct result of the borrower producing excessive greenhouse gas emissions could be of concern for a lender from a reputational and PR perspective.

To address this potential negative perception, we increasingly see clauses in SLLs which provide that any increase in interest payments as a result of the margin adjustment are to be applied by the borrower towards a particular green project or to a specific charity.

Virtue signalling

There are some commentators who argue that the SLL market does not adequately address the climate emergency we are facing or go far enough in sufficiently contributing to efforts to achieve the goals of the Paris Agreement or the UN's Sustainable Development Goals, and therefore amount to virtue signalling by both borrowers and lenders.

On the other hand, supporters of SLLs take the view that any increased focus on ESG and sustainability is to be welcomed and that SLLs are an important way of encouraging companies to develop and maintain sustainability strategies and focus on their sustainability performance.

Conclusion

With ESG increasingly taking a central position in the business strategies of many companies, the use of the SLL product as an important sustainable and transition financing tool by borrowers in a variety of industries will continue to grow.

To maintain the integrity of the SLL market, lenders and borrowers need to make sure the SPTs continue to be ambitious as the market develops, and that the SLLs they enter are not vulnerable to any risks of greenwashing allegations during the term of the SLL.

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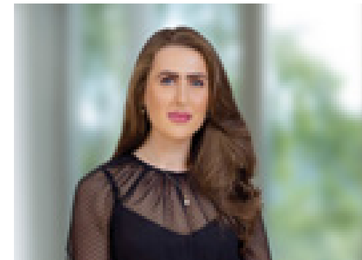

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