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Sustainable finance:
Key considerations for loan documents

1. Introduction

As regulators, shareholders, investors and wider society increasingly focus their attention on ESG matters, they have crept up the boardroom agenda of large companies and financial institutions and are now firmly in the spotlight on financing transactions.

With many organisations regularly reporting formally on sustainability, many companies and lenders are also looking to find ways to enhance both their financial and reputational position with investors and customers by capitalising on the current focus on ESG. Even with economies around the world currently focused on the fall-out from Covid-19, ESG has remained a key focus. Indeed it is a widely held view that the pandemic is highlighting the need for a wholesale rethink of the values and wider purpose of business and finance.

As governments globally consider how to meet their net zero carbon goals, and with speculation around the introduction of increased regulatory impetus to encourage sustainable finance, ESG is expected to remain at the top of the boardroom agenda for the foreseeable future.

ESG factors are an increasingly common feature of the loan market. The European corporate lending market was the first to see the introduction of ESG and sustainable loans, but more recently the concepts have spread to other loan products, including leveraged finance, REF and fund finance, as well as appearing in all the major financial markets around the globe. They are likely to become a standard feature of many loan products – so much so that in the near future there may no longer be a discernible distinction between sustainable and traditional investing.

2. What are green and sustainability linked loans?

ESG loans generally fall into two categories (although hybrids are possible):

(1) green loans; and

(2) sustainability linked loans (sometimes also referred to as an "ESG linked loan" or a "KPI linked loan").

"Green loans" developed out of the long established "green bond" market, and essentially they represent a loan that is to be applied for the sole purpose of a specific environmental project/impact.

"Sustainability linked loans" are loans which contain a feature whereby the performance of the borrower is measured against certain external ESG metrics/KPIs, with that performance triggering certain outcomes (usually an adjustment to the margin).

The volume of green loans has grown steadily, however the product is inherently constrained by the availability of suitable green projects that can be the subject of the relevant financing (though it should be noted that APAC has seen higher levels of growth of this product). A recent example of a green loan is the USD300 million loan provided to Indorama Ventures Public Company Limited, which is intended to fund the construction of plastic recycling capacity and thereby help reduce marine plastic pollution (which, slightly confusingly, means that it can also be referred to as a "Blue Loan", as its focus was on the marine environment).

However it is sustainability linked loans that have seen explosive growth over the last few years. The use of a pricing mechanism that is linked to an external set of metrics is a relatively easy feature to incorporate into a working capital loan facility. There is no need for it to be part of an underlying environmental financing, so it can be made available to almost any borrower. It is also equally suitable for inclusion in a revolving loan as it is for a term loan. Accordingly it is the corporate lending market that has seen these metrics become a well-established and increasingly standard feature of loan documentation. More recently sustainability linked loans have started to become established in new product areas, with the expectation that this trend will only continue.

Support for both green loans and sustainability linked loans is provided by the Green Loan Principles (**GLP**) and the Sustainability Linked Loan Principles (**SLLP**), which are global principles published jointly by the Loan Market Association (the **LMA**), the Asia Pacific Loan Market Association (the **APLMA**) and the Loan Syndication and Trading Association (the **LSTA**). The GLP came first (in March 2018), setting out a voluntary framework for the provision of term loan financing to companies which would use the money for one or more specific "green" projects. The LMA, APLMA and LSTA later jointly published guidance to assist with the interpretation of the GLP.

The ESG loan market was given a further boost with the publication of the more flexible SLLP in 2019, which described the expected framework whereby companies could raise ESG-linked finance without a specific "green" project to fund.

The overriding aim of a sustainability linked loan is to encourage borrowers to improve their ESG or sustainability performance by being rewarded financially for complying with relevant targets. As with the GLP, the LMA, APLMA and LSTA jointly published guidance to provide further clarity on the SLLP and have recently published guidance aimed specifically at real estate finance and leveraged finance transactions.

3. How is a sustainability linked loan documented?

There are currently no market standard terms (or LMA standard wording) for ESG/sustainability linked or green loans, but there are some common features in the way ESG factors are incorporated into loan documents.

This note concentrates on sustainability linked loans, given their popularity and almost universal application. The main elements that are incorporated into sustainability linked loans are set out below.

Margin adjustment

– The most common way of encouraging a borrower to improve its ESG, sustainability and/or CSR profile is a pricing incentive (usually a margin ratchet). In more recent deals, this pricing adjustment tends to be structured on a two-way basis, so that a failure to comply with the relevant targets by the borrower may also result in an increase in the margin.

– The mechanics for this are straightforward and similar to a margin ratchet based on financial ratios.

– Typically the margin adjustment is relatively small – with adjustments of 5bp upwards or downwards being relatively common in corporate loans – but may be greater in other types of lending transactions, particularly where the opening margin is higher.

What ESG target to measure?

– The borrower's ESG performance is tested by way of key performance indicators (**KPIs**) measuring its progress towards agreed sustainability performance targets (**SPTs**) at regular intervals during the life of the loan.

– The SLLP state that SPTs should be ambitious. Traditional environmental targets are common (examples being the reduction of greenhouse gas emissions and energy consumption, water quality targets, increasing the use of recycled materials, compliance with modern insulation standards and bio-diversity targets), but ESG objectives are often much wider than that (provided they are meaningful and relevant to the business of the borrower).

  Examples of non-environmental SPTs include:

  – number of female managers

  – staff training

  – payment of the London living wage

  – reducing internal food waste

  – reducing accident rates

  The SLLP set out a list of common SPTs. The SPTs are capable of being adapted to suit a particular borrower and the sector in which it operates, so there is scope for the parties involved to think creatively in identifying suitable targets.

– Often (but not always) more than one SPT is selected. KPIs and SPTs are frequently negotiated on behalf of the syndicate by a Sustainability Co-ordinator or Sustainability Structuring Agent.

Some sustainability linked loans will not refer to specific SPTs but instead will be determined by reference to a company's overall sustainability score as awarded by a third party sustainability rating firm (an **External Review Provider**).

Reporting and verification

- There is currently no standard or universal measurement methodology for ESG criteria and KPIs are specific to each borrower. This may change over time and especially as new regulations are introduced, with the EU taxonomy for sustainable activities expected to have a particular impact in this regard. KPIs can be objective measures (such as amount of CO_2 produced) or can be ESG Scores or ESG Ratings provided by an External Review Provider.
- Certification requirements depend heavily upon the nature of the KPI. KPIs can either be self-certified by the borrower (within a compliance certificate) or certified by an External Review Provider. It should be noted that the SLLP recommends that a borrower seek external review of its performance against its SPTs, though ultimately it needs to be considered on a deal-by-deal basis.
- External review and certification are more common where the underlying data on which the KPI is based is not publicly available. Even if a KPI is self-certified, an external review is sometimes required as a condition precedent (to assure lenders that the borrower's methodology is robust) or an external review and certification may be required if the borrower changes its reporting methodology during the life of the loan. As always, a strong borrower may be better able to resist external review and verification.
- The borrower does not usually represent that the information delivered to the agent and/or External Review Provider is accurate.

Consideration needs to be given to the impact of material corporate events on the borrower (eg major acquisitions or disposals) and how KPIs might need to be revised to take account of such events. Third party input into the adjustment of the KPIs in those circumstances may be required.

What happens if the borrower fails to meet its SPTs or deliver KPI reports?

- Normally the only consequence is that the highest margin applies; there is generally no Event of Default or drawstop that would arise as a consequence of a borrower's non-compliance with the relevant SPTs. Sustainability linked loans are sometimes criticised for this lack of "teeth", though the counter-argument is that a corporate borrower would be highly reluctant to risk a default on their core loan financing that might be due to events that are partly outside their control, and they would also be discouraged from setting ambitious SPTs if the consequence of non-compliance was an event of default.

Emerging features – talking points

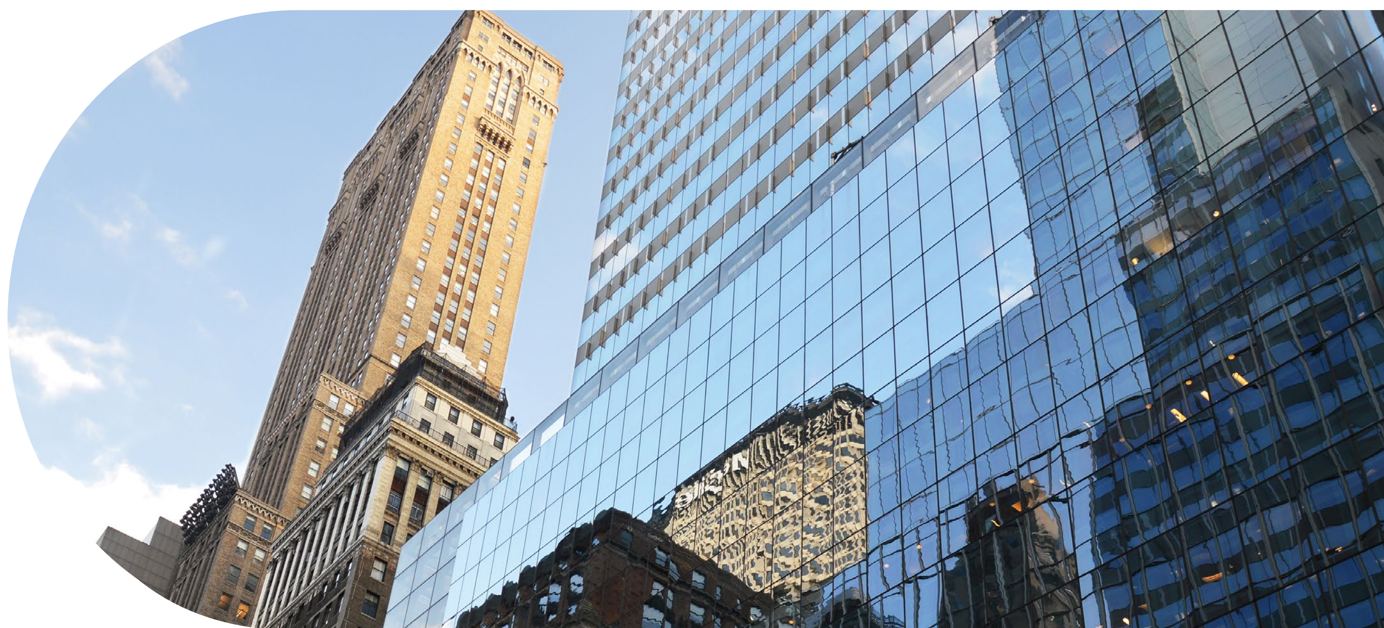
- **Charitable donations** – Primarily to avoid negative publicity from being seen to profit from meeting (and/or failing to meet) sustainability objectives, the borrower may agree to donate an amount equivalent to any margin reduction to charity and/or lenders agree to donate an equivalent to any margin increase to charity.
- **Sustainability payments** – In some cases, the amount equivalent to the margin reduction is not paid to charities, with the borrower agreeing instead to direct it towards its own sustainability objectives.
- **Significant or severe controversy events** – In a small number of recent deals, if there is a significant event with an adverse ESG impact (sometimes called an "ESG Event" or "ESG Controversy") that is categorised as high or severe (or equivalent), any margin adjustment will not apply even if the required KPIs (which may be unrelated to the event) are complied with. Ultimately, this is an anti-embarrassment clause for the lenders and borrower, and seeks to reduce the risk of green-washing.
- **Borrower's choice whether to comply with ESG provisions** – it is becoming more common for the borrower to elect whether or not to deliver evidence of its progress towards its SPTs – usually the only consequence of opting out is that there is no margin adjustment.

- **Role of ESG/Sustainability Co-ordinator** – the role of the lender(s) who undertake the ESG/Sustainability Co-ordinator role is becoming the subject of more attention in documentation. Lenders are becoming more aware of the potential liability, whether legal or reputational, that could attach to this role. An obvious concern would be where a lender helps structure a set of SPTs for a given loan and it is subsequently revealed that the underlying information was flawed or manipulated in some way. Accordingly it is becoming more standard for some protective language to be added to documents to recognise this, though the scope of those protections still varies and may depend on the particular detail of a transaction.

Other resources

The LMA has also published the following:

- Green and Sustainable Lending Glossary of terms
- Guide for Company Advisers to ESG Disclosure in Leveraged Finance Transactions (published together with ELFA)



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