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Sustainability-linked loans: how “greenwashing” risk is mitigated in documentation

In this article Greg Brown considers two recent clauses that are increasingly being included in sustainability-linked loan documentation to provide lenders with protection from the risks of “green-washing”.

Key points

- It is increasingly common for sustainability-linked loans (SLL) documentation to include certain protective provisions that are intended to ensure that lenders do not find themselves party to an SLL that is flawed or deficient in some way.
- The first example is the inclusion of a “declassification” provision which describes the particular circumstances when a loan will cease to be classified as an SLL and, in turn, the parties agree to cease to publicise it as such.
- The second example is the “*rendez-vous*” clause which recognises the coming together of the parties to engage in a discussion with a view to addressing changes that affect the borrower or its business that render one or more of the borrower’s KPIs/SPTs as no longer being fit for purpose.
- There is a danger that the increased complexity of the clauses can undermine an attractive feature of an SLL – namely that it has historically been a relatively simple mechanic.

Sustainability-linked loans (SLLs) are loan facilities that contain a feature whereby the borrower’s performance is measured against certain ESG and/or sustainability linked metrics comprised of key performance indicators (KPIs) and sustainability performance targets (SPTs), and that performance may trigger certain economic outcomes – usually an adjustment to the margin that is payable by the borrower. By way of example, a borrower might agree to set SPTs which are linked to a reduction of its greenhouse gas emissions. If the borrower manages to meet those targets, then the lenders agree to reduce the pricing of the loan. Conversely, a failure to achieve those targets could result in the pricing being increased. The rationale for such provisions is that the terms of the SLL provide an incentive for the borrower to improve their ESG or sustainability performance.

SLLs have proved to be enormously popular in recent years, as the use of a pricing mechanism that is linked to an external set of metrics is a relatively simple feature to introduce into many types of loan instrument, and there is perceived reputational benefit for both borrowers and lenders if they are able to structure loan financings as SLLs.

It is common for borrowers and lenders to publicise particular loans as being “sustainability-linked loans”, as a way of demonstrating that all parties are meeting their individual sustainability strategies and also to demonstrate their commitment to ESG issues to their stakeholders.

Market practice and conventions have developed around the approach to SLLs, with key support provided by the Loan Market Association (LMA) and the Loan Syndication and Trading Association (LSTA), who have published various principles and guidance around how such loans should be structured. It is important to note however that SLLs are essentially an unregulated product, as there is no specific authority or body that is responsible for making the determination that a particular loan is to be classified as an SLL. The LMA and LSTA principles are valuable and provide important guidance to the market, but they represent non-binding recommendations and ultimately the SLL market is essentially selfpoliced, in as much as the market participants are themselves responsible for applying that guidance in a consistent fashion and ensuring that the SLL “label” is applied correctly.

Recent years have seen a growing awareness of the risks posed by "green-washing", being the practice of making misleading or unsubstantiated claims about the environmental or social benefits of a product. Many participants in the loan markets are increasingly alive to the risks posed by allowing loose or inconsistent standards in relation to SLLs, including the potential legal and/or reputational liability that might accrue to those lenders who either arrange or participate in such loans.

That awareness of "green-washing" risk is resulting in greater focus on the terms of the underlying loan documentation as to how that risk might be mitigated. It is increasingly common for SLL documentation to include certain protective provisions that are intended to ensure that lenders do not find themselves party to an SLL that is flawed or deficient in some way.

The first example of such a protection is the inclusion of a "declassification" provision. This is a consequence of the fact that, in the absence of any current specific regulatory guidance as to what constitutes an SLL, it is up to the parties themselves to agree to publicise a particular loan as an SLL. "Declassification" therefore describes the particular circumstances when a loan will cease to be classified as an SLL and, in turn, the parties agree to cease to publicise it as such.

Declassification is not usually triggered by the failure of a borrower to meet the particular SPTs set out in the loan agreement. Rather it is intended to apply either: (i) where the borrower has somehow failed to engage in the process required to allow those targets to be measured and tested (for example, if a borrower fails to provide the information that is required for those targets to be tested); or (ii) simply where it has become apparent that the loan agreement no longer meets the requirements of an SLL. The scope of the declassification provision can be the subject of negotiation, as borrowers will want to ensure that the threshold for such an event is set at an appropriate level and ideally is linked to objective criteria.

The effect of a declassification event is usually two-fold. First, the parties are prohibited from continuing to describe the relevant loan as an SLL. In some cases, this can also require the parties to go further and remove or update any prior public disclosures that may have described the loan as an SLL (for example, updating websites to correct or remove previous press releases). This can be an important right for the lenders, as it allows them to be publicly distanced from a loan that was previously described as an SLL, where there are now concerns that it no longer meets those criteria.

The second impact is that the declassification event usually "switches off" the sustainability mechanics in the loan agreement, so that any pricing adjustment mechanics (and other provisions) linked to the SPTs cease to apply.

The declassification clause therefore serves as a deterrent and a sanction for possible green-washing, as well as a safeguard for the lenders' reputation and regulatory compliance.

A further provision that is intended to ensure the ongoing integrity of an SLL is the so-called "*rendez vous*" clause. This provision recognises the fact that during the life of a loan facility there may be certain changes that affect the borrower and/or its business, or which relate to the benchmarks or ratings used in the underlying KPIs and SPTs, and which therefore mean that the SLL provisions need to be reviewed and potentially revised by the parties. It is referred to as a "*rendez vous*" clause to recognise the coming together of the parties to engage in a discussion with a view to addressing the underlying change.

The trigger for the *rendez vous* provision might relate to a change in underlying law or methodology that renders one or more of the KPIs/SPTs as no longer being fit for purpose. For example, if the parties have agreed to a particular KPI, but the scientific consensus around how that KPI should be measured has subsequently changed, then it makes sense that the parties look again at what was agreed to determine whether the provisions and/or the targets require updating in light of the latest generally accepted scientific position.

The trigger might also relate to a change in the borrower's own business, often as a consequence of a material disposal or acquisition undertaken by the borrower, that means that the original SPTs are no longer appropriate, and the relevant targets need to be adjusted to recognise the change.

In either case, the occurrence of such a trigger event results in a negotiation period between the borrower and lenders, when they will work together in good faith for a specified period to agree on appropriate revisions to the document to ensure that it is still in line with the expectations for an SLL. If, after the prescribed negotiation period, the parties have been unable to reach agreement then this is often deemed to be a "declassification event" (as described above), with the result that the loan ceases to be treated as an SLL from that point onwards.

The *rendez vous* clause therefore serves as a flexible and collaborative tool to ensure that the SPTs and KPIs remain aligned with the borrower's sustainability objectives and the prevailing market conditions, and to avoid the risk of green-washing by having SPTs that are either too easy or too hard to achieve.

The role of the "sustainability co-ordinator" in loan documentation is also attracting greater scrutiny. The sustainability co-ordinator will usually be one or more lenders who assist the borrower in setting the KPIs/SPTs for inclusion in the loan documentation. Many banks now have specialist sustainability teams with the expertise to work with companies on their sustainability strategies and to advise on the selection and appropriateness of the targets to be included in an SLL. The sustainability co-ordinator will sometimes be a party to the loan agreement and may also be named as such on the cover of the document.

Banks acting in the role of sustainability co-ordinator will usually expect the loan documentation to be clear as to the scope of their role and, in particular, to specify that they are acting on a non-reliance basis (ie the borrower and the wider lender group will be responsible for their own assessment of whether the SLL meets the appropriate requirements). It is rare for a sustainability co-ordinator to have any ongoing role that continues after the loan documents have been signed, meaning that their role is somewhat analogous to that of an arranger. SLL documentation will sometimes include further protective provisions that are intended to limit the potential liability of the sustainability co-ordinator, usually included alongside similar protective provisions that apply to the agent bank.

In the context of syndicated loans there may sometimes be a discussion as to whether changes to the SLL provisions should be subject to all lender approval, or the more customary majority lender approval. Some individual banks feel strongly that, to protect themselves from risks of green-washing claims, each lender in a syndicate should be required to consent to changes to, for example, the SPTs contained in the documentation. While this may be understandable, it nonetheless goes against the general principle of a syndicated loan which is that most amendments or waivers can be made by majority lender approval rather than requiring unanimity, and borrowers may be reluctant to see the entirety of the SLL provisions subject to all lender approval.

Finally, while the increased focus on protective provisions in SLL documentation is a reasonable position for lenders to take, given the desire to mitigate green-washing risk, there is a danger that the increased complexity can undermine an attractive feature of an SLL – namely that it has historically been a relatively simple mechanic to introduce into a loan agreement. As SLL mechanics become longer and more complicated (often absorbing more time and cost at the execution stage) there is a risk that they become less attractive to borrowers who are considering introducing these features into their loan facilities. The introduction of standardised drafting will help to address this concern. Given that there is no expectation that green-washing concerns will fall away, lenders will also continue to seek to include appropriate protections in their SLL documentation.

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Further reading

- The role of the sustainability coordinator in sustainability-linked loans (2021) 11 JIBFL 746.
- 2021: the year of the sustainability linked loan (2021) 10 JIBFL 675.
- Lexis+® UK: Practice Note: Green Loans.