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SUSTAINABILITY LINKED LOANS – THE STAR PERFORMER OF THE LOAN MARKETS?

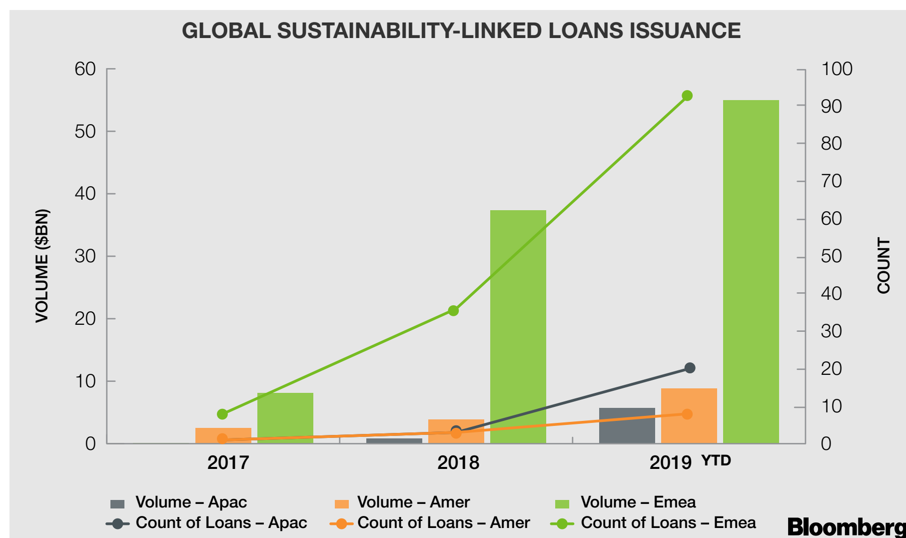
The growth of sustainability linked loans has been the success story of the European loan markets over the last 12 months. We explore what this means and how the market has developed.

Key issues

- Sustainability linked loans have grown rapidly
- Flexible use of proceeds make these loans attractive for companies keen to demonstrate compliance with environmental and social goals
- The loans market has innovated as ESG and sustainability awareness rises
- Pricing adjustments have become more sophisticated
- A wider range of sustainability metrics are being applied
- The robustness of testing varies

What is a sustainability linked loan?

Whilst the term "green loan" has for some time been used as a generic reference, two distinct products have emerged. A true "green loan" is one where the proceeds of such loan are utilised to finance a green purpose or project. The "sustainability linked loan" is a more recent development – there is no green use of proceeds requirement but the loan includes a pricing adjustment if the borrower achieves specified sustainable or ESG (environmental, social and governance) targets.



As you can see from the above data provided by Bloomberg, sustainability linked loans have achieved rapid growth in the last year.

Factors driving growth

- **Increase in legislation and non-legal recommendations** – almost every day our news and media outlets are reporting on the environmental risks to the planet and the public are becoming educated and engaged on a wide range of issues whether that is plastic in our oceans or the effects of climate change. Legislators and regulators have responded accordingly and there is a large body of EU and national

legislative and wider initiatives to respond to the three main goals of the Paris Agreement of 2015 (to re-orient capital flows towards sustainable investment, to manage the financial risks stemming from climate change, environmental degradation and social issues and to foster transparency). A discussion of all these initiatives is beyond the scope of this briefing but is an important factor driving growth in this area.

- **ESG issues rising to top of board agendas** – there is a perceived need to re-cast the economies of the future, not only to transition to low/zero carbon emissions but also to take into consideration a broader category of social goals. These issues are rising to the top of boardroom agendas for all stakeholders including borrowers, banks and asset managers. This is spurred on in part by the increasing risks that flow from an inadequate response to ESG issues (in terms of litigation risk, public opinion (including shareholder activism) and the legal and financial consequences of breaching new laws and recommendations in this area).
- **Flexibility** – a general corporate revolving facility can be a sustainability linked loan (because there is no use of proceeds restriction as compared to green loans) and this has greatly expanded the universe of borrowers attracted to this product. The loan markets have led the way here although it is interesting to note that Enel have recently issued the first sustainable bond using methodology similar to that used in sustainable loans.
- **Market standardisation** – whilst it is not possible to say there are standardised commercial terms for these transactions, the publication of the Sustainability Linked Loan Principles by the LMA, APLMA and LSTA in March 2019 has certainly helped to define this as a product. It has also given legitimacy by helping to prevent a proliferation of terms in loans that were called green but in reality were really little more than normal loans – a process that became known as "green washing".
- **Lower pricing** – the changes to pricing, certainly in the investment grade space where facilities are often undrawn, are not huge but nonetheless this is obviously an attractive feature for borrowers.

Pricing

Sustainability linked pricing adjustments have become more sophisticated.

- **Discount and premium** – some of the first sustainability linked loans only applied a discount ie the margin reduced if targets were met. However, most loans now apply a discount and a premium, whereby the margin increases if targets are missed. This may be on a sliding scale so the margin ratchets up as more targets are missed.
- **Adjustment** – at the time of writing pricing adjustments remain modest. Certainly for investment grade lending, 2.5 to 3bps is common. However, there are examples of larger redeterminations.
- **ESG benefit** – we have seen some loans require the sustainability premium to be paid into a borrower's specific ESG account where it may be used by the borrower but only for ESG purposes. The thinking here is that lenders should not benefit from a borrower's failure to meet sustainability targets. This provides an incentive for the borrower to consider other sustainable projects or ways of improving on its sustainability performance.

Borrowers typically have the right to opt-out of sustainability linked margin adjustments. We have also seen the right to opt-in at a future date. Additionally borrowers may be able to change KPIs if lenders consent (the voting threshold will need to be agreed and we have seen both all lender and majority lender consents).

Sustainability Metrics

The Sustainability Linked Loan Principles sets out a list of some common criteria but this is only a suggestion and we are seeing different metrics used in these loan facilities:

- **Bespoke key performance indicators ("KPIs")** – there has been a marked increase in entity specific KPIs. Borrowers have set their own targets linked to a wide range of ESG factors, in conjunction with sustainability coordinators (a bank or banks appointed to this role to establish sustainability targets with the borrower). We have seen KPIs dealing with carbon emissions (which are probably the most common), water usage, women on boards, fatalities in the workplace and sales of zero/low-calorie drinks. Often multiple KPIs will be tested.
- **ESG Scores** – we have seen deals where there is an overall ESG score provided by a third party rating agency either as a standalone test or combined with other KPIs.

As this market grows and becomes more sophisticated and as the number of rating agencies who are interested in this area also proliferates it seems likely this methodology will also evolve. Rating agencies have their own customised scoring methods and greater standardisation and transparency would be helpful, making it easier to compare companies. As the political agenda broadens to encompass a wider variety of environmental and social imperatives, it seems likely that the metrics looked at in financings will also diversify.

A pricing adjustment in relation to sustainability performance can be directly linked to the financial risks to the borrower's business of non-compliance with sustainability goals. It will be interesting to see if comparisons will start to be made between borrowers in the same sectors – and whether the required level of consistency of disclosure, testing and reporting will exist for that to happen.

Verification and Reporting

Verification and reporting requirements are key to the robustness of the testing process (and to avoid criticism of green washing) and we see a number of different approaches in the market:

- **Independent third party** – at one end of the spectrum, lenders may require independent audit and verification from specialist audit firms such as Sustainalytics or Vigeo Eiris. Acceptable firms can be pre-agreed at the start of the loan.
- **Borrower self-certification** – at the other end of the spectrum, lenders may simply receive self-certification from the borrower where it has the necessary internal methodologies and process, particularly where that borrower reports that information publicly.
- **Limited assurance** – lenders may benefit from an independent limited assurance report (ie nothing has come to the auditor's attention that suggests the information is not fairly stated or not prepared in accordance with established procedure).

It is worth noting that ESG criteria have long been applied in project finance – notably the Equator Principles which provide a framework for determining, assessing and managing environmental and social risk (but this is beyond the scope of this briefing).

Conclusion

The growth in sustainable financing has been a marked high note in a challenging market. This is particularly the case in the investment grade space and real estate financing and many commentators think this may also become a more prevalent feature of the leveraged loans market in the year ahead. Recently we have also seen the first capital call financing for a fund documented on this basis which is an interesting development. The ESG and sustainability agenda is centre stage around the world and it seems clear that the loans market will continue to innovate in structuring the terms of financings to play its part in this development.

Accelerating Growth of Sustainability Linked Loans and Financings

2014

Green Corporate Loan
July 2014, Sainsbury's announces 1st corporate "green" loan (Clifford Chance advised on this financing).

Green Bond Principles
June 2014, ICMA issues Green Bond Principles, voluntary process guidelines for the issue of Green Bonds to finance/refinance eligible green projects (updated regularly).

ESG Corporate Loan
April 2017, Unibail-Rodamco puts in place 1st of its kind green loan linking pricing to environmental performance (Clifford Chance advised on this financing).

Social Bond Principles and Sustainability Bond Guidelines
June 2017, ICMA issues voluntary process guidelines (updated 2018).

EU Sustainable Finance Action Plan
March 2018, EU Commission launches plan.

Green Loan Principles
March 2018, the LMA and APLMA issue Green Loan Principles, voluntary process guidelines for the issue of Green Loans to finance/refinance eligible green projects (updated December 2018).

ESG Leveraged Loan
May 2019, MasMovil announces first leveraged loan package incorporating ESG criteria (relating to the rcf and capex lines).

Sustainable/ESG Loans grow
Eg Gestamp announces ESG linked loan, 1st in automobile sector;
Schroders announces ESG linked loan, 1st by an asset manager;
Carrefour announces CSR linked facility, 1st in European retail;
DP World enters into sustainability loan in Islamic format
(Clifford Chance advised on all these financings).

Sustainability Linked Loan Principles
March 2019, the LMA and APLMA issue Sustainability Linked Loan Principles, voluntary guidelines for the issue of Sustainability Linked Loans which incentivize the borrower to achieve ambitious, meaningful, pre-determined sustainability performance objectives.

ESG Schuldschein
June 2019, Dürr announces world's 1st sustainability Schuldschein.

Sustainability Derivative
August 2019, the 1st sustainability improvement derivative is announced.

SDG Bond
September 2019, Enel announces general purpose bond with coupon linked to SDG (UN Sustainable Development Goals).

EU Sustainable Finance Taxonomy
October 2019, EU sustainable taxonomy regulation enters EU trilogue process.

Fund Financing
October 2019, Quadria Capital enters into sustainability improvement capital call facility, said to be 1st of its kind (Clifford Chance advised on this transaction).

Euro PP Note
October 2019, Bel Group raises new Euro PP notes with environmental and social criteria.

FCA Feedback Statement
October 2019, UK FCA outlines priority action relating to climate change and green finance.

2019

We have a number of other articles included in our publication **GROWING THE GREEN ECONOMY**: ADDRESSING THE SUSTAINABILITY CHALLENGES AND OPPORTUNITIES that look at developments in ESG and sustainable finance.

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