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New Guidelines Boost Sustainability-Linked Lending

By **Aaron Adams and Yair Galil** (March 27, 2019, 4:09 PM EDT)

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Sustainability-linked loans, a fast-growing loan product introduced in the United States last year, got a significant boost last week with the promulgation of the Sustainability Linked Loan Principles, or SLLPs, by the leading syndicated lending industry associations.[1] The SLLPs establish a voluntary framework for designing and negotiating sustainability-linked loans, in order to assure the integrity of the asset class and promote its development.

The sustainable lending asset class took a step forward with the publication of the SLLAs by the top three global syndicated lending industry associations. The Loan Syndications and Trading Association, the Loan Market Association and the Asia Pacific Loan Market Association promulgated the SLLPs as a voluntary framework representing “the next step in collaboratively developing global standards for sustainable lending.”[2]

A type of loan product that has taken root in Europe over the past few years and arrived in 2018 in the United States, “sustainability-linked loans” are loans that have certain of their terms, most typically the pricing, tied to sustainability performance targets — such as the borrower’s use of renewable energy or its environmental, social and governance, or ESG, score as evaluated by a third party rating agency. This is distinct from traditional “green finance,” in which the proceeds of the financing are earmarked for specific green projects; in most instances, sustainability-linked loans are used for general corporate purposes.

In order to meet their objective of facilitating and supporting environmentally and socially sustainable economic activity and growth — and to provide appropriate assurances to investors, regulators and other stakeholders — sustainability-linked loans must tie their incentives — such as reduced pricing — to sustainability performance targets (1) that are “ambitious and meaningful to the borrower’s business” and (2) that represent some improvement relative to the performance baseline. The SLLPs’ goal is “to promote the development and preserve the integrity of the sustainability linked loan product" by setting out a framework of voluntary recommended guidelines, to be applied on a case-by-case basis by market participants, in order to secure these sustainability benefits.

Core Components for Sustainability-Linked Loans

The SLLPs outline four core components for sustainability-linked loans:

1. Relationship to Borrower's Overall Corporate Social Responsibility Strategy

The borrower should align the loan's sustainability performance targets with its overall sustainability objectives, as set forth in its corporate social responsibility, or CSR, strategy and communicate clearly to the lenders how the performance targets incentivized by the loan fit within those overall objectives.

2. Target Setting — Measuring the Sustainability of the Borrower

Appropriate — and appropriately ambitious — performance targets need to be negotiated between the borrower and the lender group for each transaction. The performance targets can be internal — tracking metrics such as energy efficiency, water consumption, sustainable sourcing and recycling, among others — or external — assessed by independent service providers against external rating criteria. Appendix 1 of the SLLPs provides an indicative list of common categories of sustainability performance targets, but different, customized performance targets may be appropriate for specific transactions.

In some cases, it may be helpful to seek an expert third party's opinion in developing suitable metrics and performance targets. It is important that the targets be meaningful and apply over the life of the loan, to incentivize ongoing positive change.

3. Reporting

Borrowers should maintain up to date information relating to their performance targets, whether those targets are internally or externally scored. The SLLPs recommend that such information be provided to the lender group at least once a year, and preferably also made publicly available.

4. Review

Validation of the borrower's performance is imperative. However, the need for external review is to be negotiated on a case-by-case basis. Where the information relating to the performance target is not made publicly available or otherwise accompanied by an audit statement, external review of the borrower's performance is strongly recommended and the SLLPs recommend that such review be performed on an annual basis at least. By contrast, where the borrower is a public company that includes information on its sustainability performance metrics in its public disclosures, the need for additional third-party validation is less pressing, though such validation may still be desirable.

Green finance, and sustainability-linked loans, are on an upward trajectory. LPC saw almost $60 billion globally in green and sustainability-linked loans in 2018, quadrupling the volume recorded in 2017.[3] 2018 was also the year that sustainability-linked loans were first seen in the United States, with two loans that adopted internal sustainability performance metrics. Earlier this month, Xylem Inc. became the first U.S. company to issue a sustainability-linked loan with an external performance target — a comprehensive ESG score assessed by Sustainalytics, an expert third party provider of ESG ratings.

The publication of the SLLPs represents another milestone in the development of this loan product, providing market participants with an important framework to guide expectations, inform market practice and enhance the integrity of the asset class.

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[1] https://www.lma.eu.com/application/files/8015/5307/4231/LMA_Sustainability_Linked_Loan_Principles.pdf

[2] See LSTA's Week in Review, March 22, 2019.

[3] See LSTA's Week in Review, Feb. 1, 2019.