HERBERT SMITH FREEHILLS

SUSTAINABILITY LINKED LOANS

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Legal Briefings – By **Elliot Beard and Kristen Roberts**

Our take on the development of ESG and debt financing

This is the second in a series of articles looking at the development of ESG in debt financing (the first can be found here). In this article, we address the topic of sustainability-linked loans. Before delving into the detail and trends of that, we will briefly discuss the difference between sustainability-linked loans and green-lending. In subsequent articles in this series, we will look at the development of ESG and green debt in the USPP, DCM and securitisation markets.

Sustainability-linked loans have much broader application than green-lending (lending which is put in place to be used for a specific 'green' purpose). Typically, sustainability-linked loans can be used for any general corporate purpose, are sector agnostic and often focus as much on the societal and governance aspects of ESG as they do on the environmental.

THE DEVELOPMENT OF SUSTAINABILITY LINKED LOANS

On the loans side, the LMA, APLMA and LSTA have jointly produced the Sustainability-Linked Loan Principles. These are a set of high-level market standards to promote the development and integrity of sustainable loans by encouraging consistency of approach while recognising the need for flexibility across sectors. In practice, however, the sustainability terms of a financing are focussed on the corporate's own ESG framework and targets, not least because the principles are weighted towards just environmental factors. Discussions with lenders on ESG are typically held in that specific context rather than by reference to the above principles but it is certainly the case that ESG advisors and co-ordinators will have regard to those principles in advising on the sustainability-linked features of a financing.

ESG FRAMEWORK AND MONITORING SUSTAINABILITY PERFORMANCE TARGETS

Corporate sustainability-linked loans will typically rely upon the borrower's existing ESG framework as reported in the borrower's audited financial statements. This approach considerably simplifies not only agreeing the sustainability related provisions of the loan agreement but also the ongoing reporting against the sustainability performance targets ("**SPTs**"). This also avoids the need for on-going monitoring of SPTs by a lender or other third party. There is a large and growing industry of SPT advisers and monitoring bodies who borrowers are calling upon to support them in verifying SPT performance. This is then reflected in the audited financial statements rather than separate reporting to the lenders.

STRUCTURE OF SUSTAINABILITY-LINKED LOANS

Sustainability-linked loans are usually structured as a revolving credit facility for general corporate purposes, with a small incremental pricing benefit to the borrower for meeting certain sustainability targets. The objectives broadly fall into two categories:

1. the requirement for the borrower and its lenders to set ambitious and meaningful core SPTs for the borrower to meet which fit in with the borrower's own broader sustainability objectives; and
2. the need for transparency in determining whether those SPTs have been met through both the borrower's reporting obligations and objective SPTs.

From a documentary standpoint, there are no standard market templates for sustainability-linked financings. However, a number of key trends have developed in the market and the time spent in a transaction on the sustainability-linked aspects tends to be in agreeing the SPTs themselves rather than the documentation of them.

KEY PERFORMANCE INDICATORS

The borrower's sustainability performance is typically measured using specific SPTs which measure improvements in the borrower's sustainability goals (rather than a more generic ESG score). These must be genuine, rigorous and measurable targets to avoid the risk of "greenwashing" (i.e. the setting of targets which if met would not reflect material improvements beyond current performance). Borrowers can expect lenders to test how demanding the SPTs are and to insist that the SPTs are focussed on material incremental improvements beyond the current baseline. Given this:

- it is usual to select sustainability goals which are already reported on in the annual consolidated audited accounts of the borrower/its parent;

- environmental related SPTs which are set at a level which is no more than “slightly better than last year” are likely to be challenged by lenders. From a policy and reputational perspective, lenders are understandably focussed on avoiding the risk of being associated with greenwashing; and
- it is common for a borrower entering into its debut sustainability-linked loan to appoint a lender as ESG co-ordinator. It is advisable for discussions with the ESG co-ordinator to start early in any financing process. That co-ordinator assists the borrower in:
    - setting the SPTs themselves and the projected target performance (which will typically be derived from the corporate’s ESG framework);
    - agreeing the sustainability-linked provisions to be included in the facility agreement; and
    - liaising with the syndicate lenders and supporting the borrower in answering the syndicate’s sustainability related queries.

NUMBER AND TYPES OF SPTS

We commonly see three SPTs agreed for sustainability-linked loans (sometimes more depending on the borrower’s ESG framework (e.g., five)). Examples of recently agreed SPTs include:

- reducing greenhouse gas emissions;
- percentage of women in senior management positions;
- employee training on:

  - diversity;
  - anti-harassment; and
  - culture;
- provision of education services;
- utilisation of more energy/water efficient processes or machinery;
- utilisation of renewable energy;
- reducing workplace injuries;
- creating a “do the right thing” corporate culture; and
- promoting new innovations.

When drafting SPTs, it is important to be clear on the mechanism for measurement of the borrower’s improvement, for example, whether the improvement should be defined as a change in the absolute value of the metric, or as a percentage change.

SPT PERFORMANCE REPORTING TO LENDERS

Reporting to lenders will commonly take the form of a sustainability certificate which sets out target and actual SPT performance which is delivered with the annual consolidated audited accounts of the borrower/its parent and financial covenant compliance certificate. The sustainability certificate will also set out the margin adjustment (if any) which applies as a result of that performance. To the extent that the SPTs form part of the audited financial statements, separate testing/reporting by a finance party/third party ESG advisor is typically not necessary.

FUTURE PROOFING

SPTs may cease to be as relevant over time, and parties may need to consider amendments to them, particularly for facilities that have longer maturities or extension options. Some facilities include obligations to negotiate in good faith to amend SPT targets that were applicable after a certain amount of time.

Borrowers should also consider the potential impact on SPTs of any changes to their business. Facilities can define the conditions under which the borrower may be permitted to update its SPTs to maintain alignment with its business and sustainability commitments, for example, in the context of significant M&A activity, extraordinary events or changes in the regulatory environment. This is to ensure that the SPTs are no more or less demanding than they would have been but for such event in the same way that facility agreements contain similar provisions to reverse the effect of accounting changes on financial covenants. To date, this type of future-proofing has been very limited but is something which we expect to see more of over time.

If third party ESG ratings are used, borrowers should be aware of the potential for rating agencies to change their rating methodologies, which Sustainalytics did last year. In such a circumstance, facilities should contain provisions to enable the parties to revise and agree changes to any affected SPTs.

CONSEQUENCES OF FAILURE TO MEET SPTS

The failure to meet any or all SPTs will not be an event of default nor will the failure to deliver an SPT certificate. This will be explicit in the facility agreement (although note that misrepresenting SPT information may well constitute a breach). The only direct consequence of meeting or failing to meet SPTs or to deliver an SPT certificate will be an adjustment to the margin. This would take effect shortly after delivery of the SPT certificate or the last day after which an SPT certificate should be delivered respectively.

It is typical to see “two-way” margin adjustments depending upon the number of SPTs met. Whilst a matter for negotiation one common formulation is:

3 SPTs met: margin reduced by 2.5bps

1-2 SPTs met: no margin adjustment

0 SPTs met or no certificate delivered: margin increased by 2.5bps

PRESCRIPTIVE PAYMENT PROVISIONS

It is also becoming more common for a regime to be included which requires the amounts represented by the pricing changes on the loan to be applied in a specified manner (and not simply kept by the bank or borrower). For example, the borrower could agree to donate margin savings to charity or to re-invest them towards meeting the SPTs or its other ESG goals. The approach of lenders to the application of increased margin has been varied. For some, the perception of benefitting from a failure to meet the SPTs has meant that either the lenders have (i) agreed to pay those increased amounts to charity or (ii) allowed the borrower to retain the increased margin provided that it is applied towards meeting the SPTs or other ESG goals (provided that that is incremental expenditure). Alternatively, and more commonly, the facility agreement does not regulate how the lenders will apply that increased margin.

CONCLUSION

The growth of sustainable business practices and their financing is widely seen as a key element to the economic recovery from the CoVid-19 pandemic. Whilst the near-term economic benefits of adopting sustainability provisions in corporate loans may be marginal given the upfront work and ongoing monitoring (particularly for undrawn stand-by RCFs), the broader economic, regulatory and investor drivers mean that, for many, sustainability-linked loans will fast become the norm. This is a theme we will pick up on in our 8th Annual Corporate Debt and Treasury Report which will be published in the Spring.

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KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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