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UK Regulator Raises Concerns over the Sustainability-Linked Loans Market, Including Potential Greenwashing

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On June 29, 2023, the Financial Conduct Authority, the UK’s financial markets regulator, released a summary of its concerns over the market for sustainability-linked loans (SLLs). Responding to concerns that banks overstate the extent to which they participate in green financing or otherwise have a positive ESG impact, in May 2023 the FCA began conducting interviews with banks and borrowers about the transparency of ESG-related loans. Following completion of engagement with stakeholders, the FCA **published a letter** addressed to the heads of ESG/Sustainable Finance at certain banks and companies, in which it raised concerns regarding SLLs, including potential greenwashing.

SLLs are loans that incentivize borrowers to achieve pre-determined ESG-related targets, principally by linking the interest rate margin of the loan to ESG-related targets: when borrowers do not meet their stated goals, they pay higher interest rates. SLLs are part of a broader market for sustainable debt, which can also include green bonds, green loans, sustainability-linked bonds (SLBs), sustainability bonds, and social bonds. SLLs are different from “green loans” in that they can be utilized for general commercial purposes and need not be used to finance green assets or projects, provided businesses meet the sustainability targets mandated in the loan documents.

The FCA probe focused on whether these loan transactions have “low quality” sustainability clauses—that is, whether the sustainability targets are intentionally easy to meet. In some cases, sustainability targets for financings are not made public, in contrast to public corporate ESG goals. Another area of concern for the FCA is so-called “sleeping” SLLs—loans that are identified as SLLs before any sustainability-related targets have been defined or go into effect.

In other words, the loans are labelled as SLLs and may have some core elements of the SLL structure including potential interest rate adjustment, but do not define, at least at origination, the sustainability performance targets. While the parties may memorialize the intention to agree on the performance targets at some point, having this intention in the initial agreement is not sufficient to classify the instrument as an SLL, according to principles and guidance issued by the Loan Market Association (LMA), the Loan Syndications and Trading Association (LSTA) and the Asia Pacific Loan Market Association (APLMA).

The FCA raised two principal areas of concern in its letter:

1. Credibility, market integrity and greenwashing concerns

One of the primary concerns with SLLs is the possibility of greenwashing. In the context of SLLs, the FCA expressed concern that borrowers could manipulate their ESG-related goals, i.e., the sustainable performance targets (SPTs) and key performance indicators (KPIs) of the loan, to project a positive image, without genuine efforts to achieve meaningful sustainability outcomes (possibly by setting targets that are too easily met). The FCA points out that concerns from market intelligence received in early 2023 includes suggestions of “low ambition and poor design in some SLLs.”

To address greenwashing risk, the FCA is advising that borrowers should align their SPTs and KPIs with their published climate transition plans. To the extent a company has adopted one, such as those proposed by the Transition Plan Taskforce framework, these plans serve as comprehensive roadmaps outlining a company's journey toward sustainability. By closely linking SPTs and KPIs to these tangible plans, borrowers can demonstrate their commitment to sustainable practices, building credibility among investors and stakeholders.

2. Conflicts of interest and weak incentives to issue SLLs

Despite the potential benefits of SLLs, the FCA observed that some borrowers might find the incentives to issue SLLs inadequate. Small savings on margins may be overshadowed by the costs and negotiation time with lenders, especially for smaller firms. Additionally, the fear of scrutiny over specifying SPTs and KPIs may discourage borrowers from embracing sustainability-linked financing. On the other hand, banks may prioritize relationships over a borrower's sustainability credentials, potentially affecting the decision to participate in SLLs. Additionally, the SLL Principles (SLLP) and related guidance (SLLP Guidance) issued by the LMA, LSTA and APLMA require annual external verification of a borrower's compliance with SPTs and KPIs, which is likely be a significant cost and time burden for mid-market borrowers.

Taking the Temperature: For companies and financial institutions alike, accusations of greenwashing are a mounting concern, from regulatory, litigation and reputational perspectives. The UK's FCA is not the only regulatory body concerned with combatting greenwashing in the sustainable finance market. In February, the LMA, LSTA and APLMA published updates to the SLLP and SLLP Guidance, and in May the LMA [released model provisions](#) for SLLs.

[As we have reported previously](#), SLLs are one of the fastest growing segments of the sustainable finance market, with originations holding steady in 2022 in the U.S. and

Europe, despite some market challenges. However, concerns around greenwashing, market integrity, and conflicting interests must be addressed to realize their true potential. Financial institutions and companies should consider the FCA's observations and incorporate them as applicable into their transition finance strategies. While the FCA is not yet regulating the SLLs market, it has been and will continue to monitor the sustainable finance market as part of its wider work of supporting the development of a robust transition finance ecosystem.