Clients&FriendsMemo

Unlocking Sustainability-Linked Loans

4 May 2023

Cadwalader recently hosted a breakfast discussion with the Loan Market Association ("**LMA**") and **LSTA** with the aim of "Unlocking Sustainability-Linked Loans". During the session, Cadwalader partner Sukhvir Basran was joined by the LMA's Gemma Lawrence-Pardew and the LSTA's Tess Virmani in a conversation addressing some of the most frequently asked questions raised by market participants in respect of sustainability-linked loans ("**SLLs**").

The discussion was particularly timely given the updates to the Sustainability-Linked Loan Principles ("**SLLP**") and related guidance ("**SLLP Guidance**") published by the LMA, LSTA and Asia Pacific Loan Market Association ("**APLMA**") on 23 February 2023. In addition, the LSTA also published their "*Drafting Guidance for Sustainability-Linked Loans*" ("**LSTA Drafting Guidance**") with the LMA's drafting guidance for sustainability-linked loans ("**LMA SLL Rider**") published on 4 May 2023. As a result, attendees were provided a fantastic opportunity to strengthen their understanding of the practical considerations relating to the structuring and operation of SLLs.

This memo summarises the views and practical insights shared by Sukhvir, Gemma and Tess during this session.

Click here to listen to the breakfast discussion.

What are the main drivers behind the growth of the SLL product?

SLLs have proved to be resilient despite tough market conditions that saw an overall drop in loan originations. SLLs remain the fastest growing segment of the sustainable loan market with originations holding steady in 2022 in the US and Europe. This continued growth underlines the importance of SLLs as a tool for sustainable development, including in the US (which lacks the same regulatory drivers seen in Europe).

Demand for and interest in SLLs comes from a range of stakeholders and is also driven by developments in the sustainable finance sector generally. International goals such as the UN SDGs, Paris Agreement and, following Brexit, the UK's commitment to "net zero" have all increased awareness of sustainability issues. As a result, businesses and consumers alike have acted as catalysts for growth in sustainable finance products.

Regulation and risk management also play an important part In Europe, increased ESG-related regulation, the potential for adverse media scrutiny of sustainability activity and litigation risk have also added to the demand for and pressure on SLL products. Whilst the US currently lacks the

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same regulatory pressure, increased awareness and interest by borrowers and investors were nevertheless primary driving factors for SLLs in Q4 of 2021 and throughout 2022.

The inherent flexibility of the SLL product itself is also a key driver for its continued uptake by the market. Unlike green loans and social loans (both use of proceeds loan products), SLLs are borrower-focused, sector agnostic and can be used for a range of corporate purposes. In effect, a borrower whose business is not suited to investment in standalone 'green' or 'social' assets is able to structure a bespoke SLL catered specifically to its business. This makes SLLs ideal for transition financing and for those corporates without a clear environmental or social agenda. In the US, where project and infrastructure loans are less common, this flexibility is a particularly important and useful factor.

SLLs are also increasingly favoured for the transparency they offer to lenders, borrowers and sponsors alike. The requirement under the SLLP to deliver regular reporting on KPIs and sustainability performance targets ("**SPTs**") means that lenders have much better access to a borrower's ESG information.

The SLLP and SLLP Guidance have been updated a number of times since they were originally published in 2019. What is the reason for the most recent updates?

The first thing to note here is that the trade associations themselves do not drive changes to the SLLP – changes are driven by the market itself. This is a fast-moving area and the trade associations receive frequent comments and suggested updates to the SLLP and SLLP Guidance from market participants. These are collated and considered on an on-going basis with the need to balance important considerations such as providing certainty to the market (i.e. avoiding frequent and unnecessary amendments to the SLLP and SLLP Guidance), ensuring that the SLLP and SLLP Guidance reflect recent market developments whilst also staying true to the relevant core principles. At the same time, the associations try to ensure that the documents remain aligned with International Capital Markets Association's 'Sustainability-Linked Bond Principles' ("**SLBP**") (as far as possible given the different debt products), as this gives issuers the flexibility to elect between structuring their sustainability-linked financings as a loan or as a bond without duplicating the structuring work required from a sustainability perspective.

With this in mind, the LMA, LSTA and APLMA typically aim to publish annual updates to the SLLP and SLLP Guidance, although they are continually monitoring the market to identify changes in market trends throughout the year.

What substantive changes have been made in the most recent iteration of the SLLP and SLLP Guidance?

Whilst the redline appears extensive, there have not been any substantive changes to this year's version of the SLLP and SLLP Guidance when compared to, for example, the 2021 editions (when verification requirements over the life of the loan were added). In essence, the core requirements remain the same and the approach to the structure of an SLL hasn't changed.

The majority of the changes have focused on expanding upon the core requirements in the SLLP Guidance and also ensuring alignment with the SLBP. So, for example, whereas previous versions of the SLLP and SLLP Guidance have focused on SLLs in the form of syndicated and bank debt, both documents have now been amended to clarify that a broader array of financial instruments can (subject to compliance with the principles of the SLLP) be structured as an SLL. In a similar vein, the SLLP and SLLP Guidance have been amended to ensure their continued alignment with the SLBP.

How are the SLLP and SLLP Guidance intended to be referred to and used? Should market participants refer to just the SLLP, or both the SLLP and the SLLP Guidance?

Market participants should view the SLLP as the heart of the SLL framework. The SLLP Guidance elaborates upon the core principles of the SLLP, and should be viewed as a guide for practitioners in their application.

The content of the SLLP Guidance is informed by questions that the associations have received from market participants and the market consensus that has developed on the various issues on which the guidance touches. The SLLP Guidance is also deliberately pitched at a sufficiently high level that the market should be able to innovate and develop different SLL structures within the overarching principles of the SLLP by considering each transaction on a case-by-case basis. This means that the SLLP Guidance is not (and is not intended to be) exhaustive or prescriptive. Market participants should be aware that potential transactions could fall within the SLLP but may not necessarily be specifically covered in the SLLP Guidance. If this is the case, this does not preclude the relevant instrument from being structured as an SLL.

The revised SLLP are expressed to apply only to those transactions that complete after 9 March 2023. If parties were in the process of structuring an SLL on that date, but that transaction had not yet completed, how is that transaction affected by the changes to the SLLP?

The underlying principles contained in the SLLP have not changed. If a transaction has been structured in a way that does not comply with the revised SLLP, then it is unlikely that it will have complied with the previous edition of the SLLP.

Previous LMA publications suggest that a borrower does not need to have a sustainability strategy in order to put in place an SLL, but that having an existing sustainability strategy is helpful for a borrower looking to structure an SLL. Is an existing sustainability strategy an absolute requirement for an SLL and, if not, what does the borrower need?

The aim of the SLLP and SLLP Guidance is to make SLLs accessible to as broad a range of potential borrowers as possible. However, market participants should understand that an SLL is not a strategy or goal in itself, but rather a finance product that can be used by borrowers to align their financing sources with their wider sustainability plan. Companies that have a sustainability strategy (even if it is not yet incorporated into business strategy) typically tend to have more historic sustainability performance data which can be utilised for target setting and ongoing performance monitoring. Although this historic data may not be perfect, the process of data collection and target setting is imperative to the establishment of SPTs and ongoing monitoring of an SLL. In any event, in order to structure an SLL, a borrower will need to identify which issues are material to it, its sector and its jurisdiction, in order to establish appropriate key performance indicators and SPTs.

In the absence of an existing sustainability strategy, parties structuring an SLL will require more time to evaluate the sustainability performance and objectives of the borrower in order to structure that SLL appropriately. If a borrower does not have the time to complete this evaluation, then an SLL may be the wrong financing instrument for it at that stage.

Where a borrower faces challenges in structuring an SLL, the development of 'ESG linked' loans (loans which include an ESG-linked ratchet but do not comply with the

SLLP) have been seen as a compromise position. Are these ESG-linked loans the solution for borrowers that cannot put in place an SLL?

The associations consider that 'ESG-linked' loans or "interim loans" are causing confusion and there are concerns that they are financing tools that provide the economic benefits of an ESG-linked ratchet without the sustainability benefits associated with SLLs. The loans could attract green-washing challenges as a result, and could also potentially disincentivise sustainable impact; once a borrower has an ESG-linked loan in place, there may be no further incentive for the borrower to put in place a fully compliant SLL.

Early collaboration and engagement between lenders, sponsors and borrowers is to be encouraged so that the information and analysis required to structure loans as SLLs can be undertaken in a timely and efficient way.

Do the costs relating to structuring an SLL (particularly those relating to mandatory verification) create a barrier for the mid-market?

The associations acknowledge that the costs associated with data collection, analysis and annual verification can unwind the economics of the SLL ratchet. However, if borrowers self-certify their sustainability performance without verification whilst bond issuers remain subject to third-party verification requirements, there is an inconsistency across the market. Whilst SLLs are not regulated, they do and will continue to attract interest from regulators. In addition, permitting borrowers to 'mark their own homework', the results of which could lead to a margin discount, creates a conflict of interest and could call into question the integrity of the product.

The SLLP will always require external verification unless a borrower can be completely transparent in other ways. If a borrower were to depart from the core principles of the SLLP and continue to market the relevant loan as sustainability-linked, it would need to be able to clearly communicate to lenders, investors and the public its rationale for doing so. If the borrower were to market the loan under another label (rather than as a 'sustainability-linked' loan) because it cannot meet the core principles of the SLLP, this raises greenwashing concerns and may give rise to negative publicity that borrowers should be willing and able to manage.

To date SLLs have largely been the preserve of the syndicated and bank debt markets, how do you see the SLLP being applied in the private debt market?

The associations are of the view that there should be no difference in the criteria applied for SLL structures in private credit loans vis-a-vis syndicated loans and market participants should continue to support the origination of loans that comply with the SLLP in order to preserve the integrity of SLLs as a product. However, the associations also acknowledge that ESG in the private credit market is relatively nascent and the market should be patient to those in the private credit space that are new to SLLs. It is likely that as the private credit market becomes more familiar with the SLL product more loans will be structured as SLL adhering to the core components set out in the SLLP

Do KPIs and SPTs need to be in place at signing in order for a loan to be classified, referred to or otherwise reported as an SLL?

Yes. There is no deviation from this.

Is it possible to use a borrower's ESG rating as a KPI, and can that be the sole KPI for a borrower for the purposes of an SLL?

There has been declining support in both the US and Europe for the use of ESG ratings as KPIs for the purposes of an SLL. Whilst an ESG rating KPI could be a good starting point for SMEs or businesses without an established sustainability strategy, it would be surprising to see a sophisticated borrower using a KPI linked to an ESG rating.

What is the right number of KPIs?

There is no 'right number' of KPIs; it is very much a matter of quality over quantity when it comes to KPI setting. That said, borrowers in the US and European markets typically have at least three KPIs, which suggests that borrowers are generally comfortable with having more than one KPI.

How important is it to reference ESG standards and benchmarks when determining the scope and parameters of KPIs and SPTs? Is there a difference in attitudes between the US and European markets with respect to this subject?

The updated SLLP and SLLP Guidance contain significantly more detail in respect of ESG standards. It is important that, where relevant and available, the parties use ESG standards to define the scope, parameters and criteria of a given KPI. The LSTA Drafting Guidance includes references to ESG standards as the LSTA considers these helpful where the relevant financing instrument includes features such as a rendezvous clause or the ability to amend 'into' an SLL in future. Similarly, the LMA views the use of ESG standards and benchmarks as a useful tool in assessing the relevance of a particular borrower's KPIs and SPTs. Some ESG standards are based in science and therefore the use of ESG standards and benchmarks improves the transparency of a borrower's sustainability objectives and reporting, and improves the integrity of the SLL product. They can also be used to assist the analysis and understanding of 'Social' related KPIs.

Are KPIs still primarily focussed on the 'Environmental' element within "ESG"?

In both the US and European markets, the majority of SLL borrowers' KPIs are concerned with environmental factors (in particular, greenhouse gas emissions). In the United Kingdom this emphasis is influenced by regulatory pressures, with the Transition Plan Taskforce continuing to promote climate-related disclosures and the Financial Conduct Authority looking to incorporate similar disclosure obligations within the UK Listing Rules.

Given the flexibility of the SLL product, however, it would be unfortunate if it became used as a very narrow tool for meeting greenhouse gas or climate transition objectives only, rather than taking a more holistic view of ESG factors and sustainability improvement.

With regard to the 'social' element of ESG, there has been a reluctance from borrowers (particularly in the US) to adopt social SLL structures due to concerns about their ability to execute a social SLL appropriately. Whilst there is significant interest in this area, the lack of a scientific basis for setting and monitoring social KPIs and performance targets has led to hesitance from borrowers in putting in place these types of SLL structures. Understanding the intersectionality of E, S and G issues and factors is critical to addressing the complexity of issues however (for example, the unintended consequences resulting from electric batteries (with mining for lithium being one of them)). Market participants should note the increasing number of tools and resources available for considering "S" and "G" KPIs.

Do SPTs need to be set at a level above a minimum standard prescribed by regulations in order to be sufficiently ambitious for the purposes of the SLLP?

Although the level of ambition of a particular SPT will need to be assessed on a case-by-case basis, compliance with regulatory standards should, as a general rule, be considered 'business as usual'. Any SPT should therefore be set at a level above that regulatory standard in order to be considered sufficiently ambitious for the purposes of the SLLP.

How are the terms of a financing instrument meant to address a borrower's breach of SLL-specific provisions? In most cases, a breach of these provisions will only result in an upwards adjustment to the margin. Is this enough to incentivise borrowers to comply with the SLL provisions?

The margin ratchet, in isolation, is not enough to change borrowers' sustainability behaviour. If the borrower's only incentive for putting in place the SLL is a financial one, this is at odds with the nature and goals of the SLL product.

The ratchet does, however, add more "teeth" to a borrower's sustainability plans, as well as a level of required transparency when a borrower achieves or fails to achieve a target.

Unlike the US, the European market has evolved to address a borrower's non-compliance with SLL-specific provisions. Whilst (as is the case in the US) a breach of these provisions is 'ringfenced' from the rest of the financing instrument and will not trigger a default, the European market has adopted a concept of declassification in an attempt to address circumstances in which the relevant financing instrument ceases to comply with the requirements of the SLLP. Where declassification occurs, the borrower will need to cease publicising the relevant instrument as sustainability-linked. Failure to comply with the post-declassification publicity undertakings could result in a default under the relevant instrument. In the US, most credit agreements entered into in 2022 did not use the term "declassification"; however, there have been some instances where the concept of declassification has been incorporated.

Did the LMA and LSTA have any discussions with their respective committee members regarding a borrower's failure to comply with SLL-specific provisions triggering a default? Is this something that we could see the market adopt in future?

Some market participants argue breaches of SLL-specific provisions should trigger a default under the relevant financing instrument. However, the European and US markets have not yet reached that point. The development of the declassification concept in the European market is an additional consequence however for the time being, the focus is on the margin ratchet to perform the function of incentivising borrowers' compliance with the SLL-specific provisions.

As sustainability-related disclosure and reporting requirements become more extensive, the market is likely to see stronger consequences for failure to comply with SLL-specific provisions. In the meantime, market participants should appreciate that where a borrower is required to make sustainability-related disclosures under the reporting obligations applicable to it under general law, a breach of those reporting obligations would likely be regulated by the existing (non-SLL specific) provisions of the financing instrument and could, in principle, trigger a default.

Will the LMA SLL Rider include the ability for borrowers to apply amounts payable under the sustainability-linked margin ratchet towards 'ESG Projects' in lieu of paying additional interest to lenders?

No. Whilst this was a feature previously included by the market, this has now fallen away. From a borrower's perspective there is little incentive to comply with the SLL provisions, and to meet its SPTs, if the consequence of non-performance is simply that the borrower must invest an agreed amount into a specific ESG-related project.

The core principles of the SLLP include reporting and verification of a borrower's sustainability performance. What information is a borrower required to provide as part of its reporting and verification obligations, and what form should this information take?

The reporting requirements for an SLL are the same in Europe as they are in the US. A pricing or sustainability compliance certificate should be delivered at regular intervals (typically annually), certifying the borrower's performance in relation to each KPI and SPT. That certificate is delivered together with the sustainability information produced by the borrower supporting the certification of its sustainability performance, and a separate verification report produced by an external reviewer that verifies the borrower's own sustainability certifications.

Market participants should note that the borrower can provide the annual sustainability information in a number of ways provided that the KPIs are covered by such information. The intention is not to duplicate information that is already prepared and readily available.

The content of the verification report, and level of verification provided by the relevant external reviewer can vary between transactions. The nature of the KPI itself may dictate the level of verification that the external reviewer is able to provide.

How are the LMA and LSTA dealing with consequences resulting from 'ESG controversies' in their respective drafting guidance?

The analysis and impact of ESG controversies are heavily context-dependent and complex. The LSTA decided not to include it in the LSTA Drafting Guidance and the LMA SLL Rider will also not refer to ESG controversies to avoid indicating that it should be included and considered in every single transaction. This is therefore something that should therefore be considered on a case-by-case basis.

Should the provisions of an SLL include a general ESG-related information undertaking? If so, how granular should this undertaking be?

The SLLP and SLLP Guidance indicate that the borrower needs to deliver the information required by the finance parties to assess the borrower's performance in relation to the agreed KPIs. The LSTA Drafting Guidance and the LMA SLL Rider will not contemplate more extensive information undertakings. This is a fast-moving area and it would be impossible to cover all potential ESG-related information in these undertakings. For now, the information undertakings in the primary documentation are considered to be adequate for this purpose.

What is the role of an ESG consultant on an SLL, and is this different from an external reviewer who conducts regular verification of the borrower's sustainability performance?

An 'external reviewer' is an independent third-party reviewer that must be engaged by a borrower to verify its sustainability performance at the agreed reporting intervals, as per the SLLP. 'ESG

consultants' are separate third parties that a borrower may (but is not obliged to) engage to provide advice in relation to the structuring of an SLL and a borrower's sustainability strategy. This advice may extend to the provision of a 'second party opinion' that the borrower's financing instrument complies with the SLLP. Market participants should note that an external reviewer is not required to be involved in the initial structuring of an SLL; however, it is recommended where appropriate.

An external reviewer is only required to provide verification in respect of a borrower's sustainability performance, not assurance. Requiring assurance in respect of a borrower's performance risks limiting the range of potential external reviewers to auditors, which can have cost implications for borrowers.

The associations appreciate that the cost involved in appointing external reviewers is one of the biggest barriers to SMEs and mid-market borrowers accessing the SLL product, but this is something that they have not yet found a solution for. Borrowers should engage with potential external reviewers at the outset of structuring of an SLL to ensure that they understand the potential costs involved in appointing the reviewer.

What is the role of the Sustainability Coordinator for the purposes of the LMA SLL Rider?

The LMA SLL Rider contemplates that the role of a 'sustainability coordinator' will be limited to a pre-origination role, and that the sustainability coordinator will not be a party to the relevant financing instrument. Whilst the LMA appreciates that the role of the sustainability coordinator is rapidly evolving, sufficient market consensus will not have formed prior to publication of the LMA SLL Rider.

How have the LMA and LSTA approached SLL-related amendments in their respective drafting guidance?

With respect to sustainability-related amendments generally, the US market has moved past unanimous consent and now requires 'Required Lender' consent to such amendments. The US market has also shown a desire to find a responsible way to amend an instrument into an SLL post-closing (generally termed a 'sleeping SLL') to cater for potential timing issues with structuring an SLL at signing/closing. The LSTA Drafting Guidance therefore leaves open the possibility that users can amend a loan into an SLL post-closing, provided that lenders are provided with appropriate diligence materials to ensure that the loan will comply with the SLLP. However, the ability to amend a loan into an SLL post-closing should be subject to a 'sunset' period of no more than one year, and should only be used in exceptional circumstances. The associations are united in the view that 'sleeping SLLs' should not become standard practice within the market, and wish to emphasise that a financing instrument will only be classified as a 'sustainability-linked loan' at signing if it adheres to the SLLP at that time.

With regard to the approach taken to SLL-related amendments in the European market, the LMA is still in the process of consulting with its committee members on the LMA SLL Rider and is not willing to commit to a particular view on SLL-related amendments at this stage.

What work do the LMA and LSTA have in their respective pipelines for 2023?

The LSTA and LMA are looking at whether their existing external review guidance needs to be updated. The LSTA also plans to produce a practice note on fund finance and how SLLs can be used in fund financing facilities, which is an area of development that the LSTA has observed

(particularly in the private equity market). However, the LSTA's major focus for 2023 is on the ESG-integrated disclosure project; an industry-wide collaboration working towards the development of a global baseline of ESG information. The LSTA's work in this area will focus on educating market participants about the project and encouraging increased usage of the disclosure template that the project has generated.

In Europe, the LMA's priorities for 2023 include:

- Creating a mandate letter for the sustainability coordinator role. This is a document that the LSTA has already produced for the US market, and which has helped clarify market participants' thinking about the sustainability coordinator's role.
- Working with the other associations to update the existing external review guidance.
- Producing guidance on sustainability 'frameworks' (such as social loan frameworks and green loan frameworks) to explain what these terms mean in practice.
- Working with the other associations to establish whether they can publish guidance clarifying the 'greenwashing' concept and its usage in the market.
- Developing sector-specific case studies to explain how SLLs may be applied in the context of specific sectors within the finance market (for example, trade finance, aviation finance, etc.).
- Continuing engagement with the LMA's Pan-African ESG Think Tank; working with the LMA's African membership to understand the application of sustainability-linked financing products to their borrowing base and the specific considerations relevant to the African market.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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