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How Does My Business Qualify for a Sustainability-Linked Loan?

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In case you missed it, Part 1 in our ESG series introduced environmental, social, and governance (ESG), considered its impact on the structured finance markets, and considered the implications of the COVID-19 pandemic on ESG. Part 2 considered green loans, the 'Green Loan Principles', and the relevance of green loans to your business. Our next advisory will focus on the sustainability-linked bond market.

What Are Sustainability-Linked Loans?

As evidence that the global regulatory environment and investor preferences are changing, and that there is increased recognition that investments in well-governed entities that create a positive social and environmental impact are growing in prominence, last year the Loan Markets Association, Asia Pacific Loan Market Association, and Loan Syndications and Trading Association launched the Sustainability Linked Loan Principles (SLLP). The SLLP were designed to provide ESG criteria for loan products. Readers may also have seen the term 'positive-incentive loan' used, though this term has largely been replaced.

Since the launch of the SLLP, throughout the structured finance markets there are an increasing number of SLLs emerging. The SLLP defines green loans as 'any types of loan instruments and/or contingent facilities (such as bonding lines, guarantee lines or letters of credit) which incentivise the borrower's achievement of ambitious, predetermined sustainability performance objectives. The borrower's sustainability performance is measured using sustainability performance targets (SPTs), which include key performance indicators, external ratings and/or equivalent metrics and which measure improvements in the borrower's sustainability profile.'

In other words, the focus of an SLL is on incentivising the borrower's efforts to improve its sustainability profile by aligning loan terms and key performance indicators to the borrower's performance against flexible, mutually agreed, material and ambitious, predetermined sustainability performance targets (SPTs). Use of proceeds is not a key determinant in the categorisation of an SLL, as opposed to green loans where the fundamental determinant is the utilisation of the loan for 'green projects' – for example, building solar or wind farms or investing in new green technologies.[1]

[1] For a nonexhaustive list of green projects under the Green Loan Principles, see our previous advisory, 'How Does My Business Qualify for a Green Loan?'

SPTs could be:

- Internal and bespoke to your company.
- External and set against your ESG performance in relation to peers, as determined by an external reviewer.
- A combination of both.

An SLL can be any type of loan financing, such as a term loan, revolving credit facility, or any other type of facility, as long as there is an economic impact on the terms of the loan tied to your achievement of (or failure to meet) the predetermined SPTs.

And it seems COVID-19 has not slowed the push towards SLLs. On 5 May 2020, the Loan Markets Association, Asia Pacific Loan Market Association, and Loan Syndications and Trading Association jointly published the 'Guidance on Sustainability Linked Loan Principles'.

Why Should My Business Enter into a Sustainability-Linked Loan?

There are a number of advantages for both borrowers and lenders in entering into SLLs. First and foremost, it could provide an opportunity for borrowers and lenders that do not operate in traditional 'green' projects to do so, but recognising that SLL proceeds do not need to be allocated exclusively (or indeed at all) to green projects.

The SLLP suggests the following nonexhaustive list:

- Building stronger, values-based relationships with stakeholders.
- Positive impact on reputation and credibility.
- Incorporating environmental, social, and governance performance into lenders' credit assessment.
- Enhancing a borrower's ambitions on ESG performance.
- Engaging lenders to incentivise and support material sustainability improvements by actively directing capital towards borrowers implementing robust sustainability strategies.
- Showing commitment to achieve sustainability goals with a correlated economic impact.
- Promoting sustainable long-term growth and profitability.
- Increased ability to attract and retain staff who see sustainable development goals contribution as an important part of their personal and working lives.

Taking up an SLL also makes sound economic sense because, if SPTs are met, the borrower is rewarded with a reduced interest rate on its SLL.

How Does My Business Qualify? The 4 Core Components

In order to qualify for an SLL, your business will need to comply with the '4 Core Components':

1. *Relationship to borrower's overall sustainability strategy*

You should be able to link your proposed SLL to your company's overarching corporate social responsibility/ environment, social, and governance strategy. An SLL can be made to any company that has a sustainability strategy, and it will reward that company for achieving the goals set out in that strategy. If, however, the minimum level of the SPTs are not met, or levels previously achieved are not maintained, then the incentive ceases to be awarded from that point and, in many cases, may be subject to a financial disincentive, such as a margin premium. In many cases this penalty is donated to charity by the lender. SPTs should be suitably meaningful, measurable, core to the overall business, externally verifiable, and able to be benchmarked.

2. *Target setting*

Your company must set the parameters of its sustainability goals for the purposes of the SLL, for example a reduction in CO_2 emissions or greater gender diversity in your workforce, so that it can be awarded or penalised through the SLL's variable interest rate. The SLLP include a nonexhaustive table of potential SPTs that could be used.

The relevant SPTs will be negotiated with your lenders and should apply for the term of the SLL. Significant input will be required during the negotiation phase to select the correct sustainability metrics and set the SPTs – your company as borrower will need to be able to show that the chosen metrics are meaningful (i.e., core to your business) and that the SPTs are ambitious.

Methodologies for selection of SPTs can include utilising:

- ESG metrics and targets included in your company's sustainability strategies and policies.
- External analysis to establish sector-specific ESG criteria and best-practice performance.
- Verified industry metrics reported against frameworks, with verification or evaluation by civil society organisations or external reviewers.

3. *Reporting*

You will need to maintain up-to-date information about your company's adherence to the selected SPTs during the term of the SLL, and it is recommended that such information be provided to your lenders at least once a year.

Currently there is no globally accepted methodology for reporting on SPTs. The methodology will be determined based on the chosen SPTs and the nature of your business. You may be required to confirm that there has been no change in the calculation methodology, and if there has been a change, your lenders will assess the impact of the change. You could make reporting methodology available upon the achievement of the SPTs or on agreed reporting dates, either directly to the lenders or as part of your overall corporate sustainability reporting. When possible, reporting should be made public.

4. *Review*

If possible, your performance in meeting SPTs should be periodically reviewed by an independent third party, and that independent verification should be done annually by a qualified external reviewer. If no external review of SPTs is undertaken, you should demonstrate or develop an internal capacity to self-review meaningfully.

Avoid Sustainability Washing!

'Sustainability washing' describes situations when claims on sustainable credentials, in order to secure an SLL, are misleading or inaccurate. This can occur in two ways:

1. *Through sustainability performance targets that are not sufficiently ambitious or meaningful* – the SLLP are drafted to give a clear framework of the processes to be followed to maintain the integrity of your SLL. In particular, the SLLP set out guidelines to ensure that targets are ambitious and meaningful and tied to sustainability improvement over a predetermined performance benchmark on a predefined timeline.

2. *Through inaccurate monitoring, measuring, and disclosing of borrower performance against sustainability performance targets* – we can all can take steps to avoid sustainability washing by ensuring close adherence to the four core components (made publicly available when appropriate) and obtaining an external review at the outset of the facility (when appropriate), with a view to being as open and transparent as possible.

Recent Developments in Europe

Siemens Energy's €3 billion SLL linked to ESG criteria

On 24 August, Siemens Gas and Power GmbH & Co. KG closed a €3 billion sustainability-linked syndicated multicurrency revolving credit facility with an international consortium of banks. The loan amounts, whose interest rate is also linked to sustainability criteria, can be drawn in various currencies. The deal also incorporates a swingline option of €1 billion for funds that can be drawn on very short notice. The financing costs are linked to the fulfilment of defined key performance indicators referring to environmental, social, and corporate governance criteria, which help to reduce the emission of greenhouse gases (CO_2 equivalent) and lost time injury frequency rate (LTIFR).

Klaveness Combination Carriers – First Norwegian SLL

In July, Norwegian shipbuilder Klaveness Combination Carriers secured a $60 million sustainability-linked term loan and revolving credit facility for the financing of two vessels currently under construction, with delivery scheduled in 2021.

This is believed to be the first Norwegian SLL, with the credit margin adjusted based on Klaveness's sustainability performance as defined by the company's ability to meet its goal of reducing CO_2 emissions per ton of transported cargo per nautical mile and reducing absolute CO_2 emissions per vessel.

ista's €1.85 billion SLL with a consortium of banks

On 17 August, the German energy provider ista announced a new SLL of up to €1.85 billion. The term of the loan is five years, including an extension option of up to two years. The lenders are a total of 11 banks. The variable interest rates under the SLL are linked to the fulfilment of sustainability targets. These will include CO_2 emissions per employee and the further expansion of the digital service infrastructure, which should be as resource-efficient as possible. If ista achieves the agreed sustainability targets, it can reduce the credit margin, and the margin increases if the targets are not met. These sustainability key performance indicators will be externally audited.

The Future of SLLs

We previously discussed the concept of the 'ESG acid test'. Once the COVID-19 crisis has passed, the practice of investing in companies that conform to ESG standards will undoubtedly continue to grow. We believe COVID-19 presents an opportunity for investors with ESG mandates to take a deep dive into the track record of a company ahead of its capital allocation decisions. This means that the actions of companies during the COVID-19 crisis may act as an acid test. Entering into an SLL would be a good sign that your company is trying to make a positive ESG impact.

The SLL market arguably has lower entry barriers than the green loan market due to the absence of restrictions on the use of the SLL proceeds. It is open to all companies regardless of size, and therefore we recommend considering whether such a loan would be of interest to your company in the 'new normal', especially for companies looking to transition their business post-COVID-19 to operate more sustainably. Furthermore, SLL principles are having an impact not just on the loan markets but are also spreading into the bond market in the form of sustainability-linked bonds that appeal to emerging market companies reacting to the global regulatory environment that continues to push for the sustainability profiles of these companies to become more visible and to be held accountable based on their results and governance. We will look deeper at the sustainability linked bond market in our next advisory.

Alston & Bird is one of the first firms to activate a multidisciplinary ESG Advisory Group made up of lawyers across several practice groups to assist boards of directors and managers of public companies in understanding the evolving ESG landscape.

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