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GREEN AND SOCIAL LOAN PRINCIPLES UPDATED

WHAT HAS CHANGED?

The Green, Social and Sustainability-Linked Loan Principles (together the Loan Principles) specify the criteria that qualify a loan as green, social or sustainability-linked. Although closely adhered to in practice, they are not regulatory requirements – rather voluntary recommended guidelines aimed at protecting the integrity of the sustainable loan market. The Loan Principles are reviewed on a regular basis to keep pace with market practice and the evolution of sustainable loan products.

New versions of all of the Loan Principles and related guidance were published on 23 February 2023, reflecting the conclusions of the latest review. The updated material is available on the LMA's Sustainable Lending microsite. There are a significant number of changes, but many of the amendments simply expand and add colour to previous content or are aimed at aligning the drafting more closely to the text of ICMA's equivalent guidelines for the bond market.

This Briefing considers the key changes made to the Green Loan Principles (GLP) and Social Loan Principles (SLP), and their impact on current and future transactions. The updates to the Sustainability-Linked Loan Principles are addressed in a separate briefing.

Key points

Amendments have been made to every section of the GLP and SLP, each of which are considered in turn below. Key points include:

- **GLP/SLP more closely aligned with bond equivalents in places**: This reflects that products can be interlinked (e.g. used to refinance each other), as well as a desire for consistency across product markets. There are however a number of places where the loan and bond principles diverge, in recognition of the differences between the product markets. For example, in the approach to the use of green/social loan frameworks and the requirements for external review.

- **Guidance clarifies that the GLP/SLP are focussed on projects rather than borrowers:** The guidance accompanying the GLP/SLP (the **Guidance**) emphasises that the GLP/SLP are focussed on the eligibility of projects rather than the nature of the borrower – while also highlighting that borrowers will need to explain their overall strategy to lenders and broadly, that those in controversial industries will need to be more transparent.

- **Minimal changes to the substance of external review requirements**: External reviews (both pre- and post-origination) retain their status as recommendations. This reflects current practice in the green and social loan markets, where the necessity for an external review is considered on a case-by-case basis. Additional direction and guidance on the form and content of external reviews has, however, been added to the GLP/SLP and Guidance.

1. GREEN LOAN PRINCIPLES – WHAT HAS CHANGED?

Recast definition of a green loan

A newly recast definition of a green loan reads as follows:

> "Green loans are any type of loan instruments and/or contingent facilities (such as bonding lines, guarantee lines or letters of credit) made available exclusively to finance, re-finance or guarantee, in whole or in part, new and/or existing eligible Green Projects and which are aligned to the four core components of the GLP."

The substantive change is the addition of a reference to contingent facilities.

Application of the updated GLP

The updated version of the GLP includes an explicit grandfathering provision. Loans currently being negotiated can be labelled as "green" if aligned with the previous version of the GLP, provided they are completed before March 9 (two weeks from the date of publication of the updated GLP). All loans originated, extended or refinanced after March 9 must be aligned with the updated version.

The inclusion of this grandfathering provision highlights expectations that when an existing green loan is extended or refinanced, the extended/refinanced transaction may need to be reviewed in light of any intervening changes to the GLP. No view has been expressed on the position if a green loan is otherwise amended, or, if a green loan is extended pursuant to in-built extension options; it is assumed that in those circumstances the parties would take a practical approach.

Controversial industries and "pure play"

The sections of the Guidance that touch on green loans to those in controversial industries/involved in fossil fuel activities have been carefully reviewed. The broad approach taken in the relevant sections of the updated Guidance is to highlight that the GLP are focussed on the eligibility of projects rather than the nature of the borrower – while also highlighting that borrowers will need to explain their overall strategy to lenders and broadly, that those in controversial industries will need to be more transparent.

For example, rather than saying borrowers who are not yet aligned with the Paris agreement (i.e. on a path to net zero) can/cannot use green loans, the Guidance notes that green loans are focussed on eligible projects rather than the borrower itself and that the GLP require borrowers to communicate their environmental sustainability objectives overall. The Guidance also notes that many lenders will take into consideration the borrower's overall sustainability profile when evaluating green loans – and may require additional transparency "in the presence of controversial issues" from certain borrowers, including their transition strategy.

The Guidance makes the same point in response to the question of whether a green loan can be made to a borrower with low ESG ratings and/or exposure to controversial issues or sectors/technologies such as fossil fuel or nuclear energy (this is not an update; this question featured previously).

The previous version of the Guidance addressed whether a project associated with fossil fuel production (i.e. by improving energy efficiency or linked industrial processes) could qualify for a green loan. The answer suggested yes – subject to alignment with the GLP (which would be appropriate to confirm with an external reviewer) - noting that market participants would need to be mindful of their own lending criteria and environmental assessment standards. This has been deleted.

At the other end of the ESG spectrum, the Guidance confirms that "pure play" businesses who are exclusively focussed on the green economy can use green loans.

Refinancings of green projects

The guidance on refinancings of projects has been significantly expanded. It now addresses expectations with regards to lookback periods (and the possibility that lenders will differentiate between refinancing of capital projects and operating expenditures (where the lookback period may be shorter)). Other topics addressed include the possibility of refinancing a green loan before maturity, consecutive refinancings for long-dated green assets and the financing of assets pledged as collateral against another borrowing.

Core Component 1 - Use of Proceeds

Green Loan Frameworks

In addition to describing the use of the loan proceeds for green projects in the finance documents, the GLP now also state that the borrower should describe them in a green loan "framework" (if applicable).

This reference to green loan frameworks reflects the growing use and relevance of such frameworks in the loans context. Frameworks have not, however, been highlighted in the GLP in the same way as in the Green Bond Principles (**GBP**), reflecting differences in practice between the two product markets.

The GBP have recommended the use of frameworks as a transparency tool for some time. Although their use is not mandatory and the GBP do not prescribe their form or content in any detail, the GBP recommend that issuers explain the alignment of their green bond with the core components of the GBP in a green bond framework and/or legal documentation, within the context of the issuer's overarching sustainability strategy.

In the course of updating the GLP, there was a question of whether the GLP should be brought into line with the GBP in terms of this recommendation around the use of frameworks. While frameworks are relatively common among issuers of sustainable bonds and such issuers are increasingly extending their bond frameworks to address sustainable loans (which is logical from a consistency perspective if the issuer uses sustainable loan and bond products of the same type), it remains unusual for borrowers who do not access the capital markets to use a framework purely for loan products. It is perhaps for this reason that the GLP have not been updated to include an explicit recommendation with regards to the use of green loan frameworks in the same way as the GBP.

The updated GLP do, however, acknowledge that frameworks may be used to enhance transparency. Instead of a recommendation in the body of the GLP equivalent to that included in the GBP, a similar recommendation has instead been added to the Guidance. Pursuant to the Guidance, borrowers are now recommended to explain the alignment of their loan with the core components of the GLP in a green loan framework and/or legal documentation, as appropriate.

Categories of eligible Green Projects

The "high level, non-exhaustive" list of eligible green project categories in the GLP has been moved from its previous position in an appendix and aligned precisely with the GBP.

The substantive change is that the GLP now include an additional category - green technologies (such as carbon extraction technologies and energy storage systems).

A note has been added (tracking the GBP) that international and national taxonomy initiatives may be useful to borrowers in terms of what might be considered green and eligible by lenders (and borrowers are encouraged to provide lenders with information on alignment with taxonomies where appropriate).

The Guidance has also been updated to specifically note that carbon offsetting has not been envisaged in the GLP list of eligible projects.

Guidance on use of proceeds

The Guidance on the use of proceeds has been significantly expanded to address the possibility of green loan financing for intangible assets/expenditure (such as R&D), loans which meet both the GLP and SLP (to be labelled according to their prime focus), "theme loans" and confirmation that green loans do not have to be climate related.

The question on theme loans refers to the possibility that a borrower may have a more general green, social and sustainability-linked framework which allows proceeds to be allocated to one or several defined categories.

Core Component 2 - Process for Project Evaluation and Selection

The GLP have been updated to track the GBP requirement for downside reporting. In addition to the sustainability objectives of green projects and the process for determining their eligibility, borrowers should also communicate to lenders complementary information on the processes by which the borrower identifies and manages the environmental and social risks associated with the project. Borrowers are also encouraged to have a process in place to identify mitigants to known or potential material risks of negative social and/or environmental impacts from the project.

Again reflecting the GBP, borrowers are now also encouraged to provide information, if relevant, on the alignment of projects with official or market-based taxonomies and related eligibility criteria (in addition to disclosing any green standards or certifications as previously encouraged).

Core Component 3 – Management of Proceeds

The requirements around the management of proceeds have been made more robust. Management of proceeds should be attested to by the borrower in a formal internal process linked to the borrower's lending and investment operations for green projects (previously, borrowers were simply encouraged to establish an internal governance process to track the allocation of funds), and the borrower should make known to the lenders any intended types of temporary placement for the balance of unallocated proceeds.

The Guidance expands on the temporary placement of proceeds pending allocation, noting that borrowers should ensure that in selecting temporary investments, they do not damage the integrity of the green loan market.

The GLP stop short of requiring or even recommending the borrower's use of proceeds to be externally audited or reviewed, although such a recommendation has been included in the Guidance (see "Review" below).

It has also been clarified that a facility cannot be labelled green if it includes a green and non-green tranche – the green label applies only to the tranche aligned to the core components of the GLP – and that the proceeds can be managed per loan or on an aggregated portfolio basis.

Core Component 4 – Reporting

The substance of this core component has not changed. The Guidance has, however, been substantially expanded to address how borrowers should approach reporting on the impact of the loan proceeds.

In particular, the Guidance now covers the methodology for reporting on the impact of the loan proceeds (emphasising the use of qualitative performance indicators as well as quantitative performance measures where feasible, and signposting borrowers to market guidance such as ICMA's Harmonised Framework for Impact Reporting as a reference point), reporting impact for projects where the borrower has provided only partial financing, and the circumstances in which it may be appropriate to report on estimated rather than actual impact (i.e. where actual impact cannot be calculated until the assets are operational/project is completed).

Review

The section in the GLP on external reviews has been substantially reworked, although the substance remains largely unchanged with external review remaining a recommendation only. The previous recommendation for an external review "when appropriate" is now, however, more precisely articulated, with a distinction made between pre- and post-origination external review.

Pre-origination external review

The GLP now take a more directional approach to the involvement of external review providers pre-origination, recommending, where appropriate, that borrowers appoint an external review provider to assess alignment of the loan with the core components. This change brings the GLP into closer alignment with the GBP on this point.

In the context of green bonds, pre-issuance second party opinions, while not mandatory requirements of the GBP, are in practice considered a pre-issuance requirement and have become standard market practice. The updates to the GLP in this context could therefore be viewed as a strong indicator of the desired direction of travel for green loans.

In practice, it is anticipated that the need for a second party opinion in the loans context, where lenders are likely to have a more in-depth understanding of the borrower and its operations, will be considered on a case-by-case basis. In this regard, the GLP continue to note that some borrowers may have the expertise to self-certify alignment with the core components of the GLP (which expertise must be documented).

Post-origination external review

Unlike the GBP which recommend that the issuer's management of proceeds be supplemented by the use of an external auditor or other third party to verify the internal tracking and allocation of funds, the GLP do not include an equivalent recommendation although such a recommendation has been added to the Guidance.

It is not immediately clear why this recommendation for post-origination external review has been confined to the Guidance, in contrast to the recommendation for pre-origination external review, which appears in the body of the GLP. Whatever the reason, like pre-origination external review, external review post-origination remains recommended only.

On a separate note, the GLP no longer list out the different possible types of external review. Instead, borrowers are referred to the LMA's separate guidance document on external reviews for recommendations and explanations on the different types of external reviews.

Documentation

The Guidance has been expanded to include a much longer list of potential provisions to be considered for inclusion in green loan documentation. Additions include clauses relating to:

- disclosure: inclusion of express consent from the borrower for lenders to disclose the existence and the details of any green/ESG transaction for both internal reporting and external disclosure purposes;
- conditions precedent: inclusion of any conditions precedent required to confirm alignment of the green loan with the GLP and/or any other green conditions precedent;
- communication: inclusion of provisions around when the loan can be referred to as a green loan — these will typically state that the parties should hold the communication of the loan as a green loan until such time agreed between the parties, and/or, where there is a breach of the covenants under the facility agreement, the borrower should cease to refer to the facility as a green loan in any future communications;
- green loan coordinator: inclusion of provisions relating to the green loan coordinator where relevant (the Guidance cross-refers to the LMA's separate note on the role of the Sustainability Coordinator); and
- declassification: inclusion of provisions relating to when the loan might be declassified as a green loan.

The previous question in the Guidance addressing what constitutes a "green" breach has been deleted, perhaps reflecting that there remains no market consensus on this point.

2. SOCIAL LOAN PRINCIPLES - WHAT HAS CHANGED?

The updates to the SLP largely mirror those made to the GLP discussed above. In some places, the changes are, however, less extensive. This reflects the fact that the SLP and accompanying Guidance were published more recently than the GLP and accompanying Guidance. Certain of the changes made to the GLP on this occasion are therefore "catching up" changes to align with the more recently published SLP.

3. LOOKING AHEAD

The revised GLP and SLP provide greater clarity on a number of features and expectations in relation to green and social loans respectively. They remain, however, high level and deliberately loose, the loan trade associations having made a conscious effort to allow market participants a degree of flexibility in the context of a developing market. The Guidance provides additional colour and has, as explained above, been substantially expanded on in this round of updates, but for those entering the market for the first time, there are a number of questions that do not have prescribed answers.

Some of the open questions relate to the form and content of particular documentation terms. While the LMA is currently working to produce template drafting in the form of a rider for sustainability-linked loans, it remains to be seen whether standardised drafting will also be made available for "use of proceeds" loans in due course.

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