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SUSTAINABILITY-LINKED LOANS - MAINSTREAM BUT NOT "STANDARD"

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In the final month of 2021, it seems a misnomer to talk about the "sustainability-linked loan market", to suggest it is separate to the mainstream loan market. Sustainability-linked or "ESG" loans (which link pricing to the attainment of certain ESG targets) are on offer to most corporates and the majority of 2021 working capital facilities for larger UK corporates were sustainability-linked loans (SLLs).

As ESG features become the norm in corporate lending, certain terms will inevitably become more settled and this is already evident in some areas. However, there remain a number of variables and further, each SLL is, to some extent, unique. There is a goal within the "ESG" acronym for almost every type of business. KPI targets vary widely, in particular, in terms of how individual outputs are achieved.

Our final briefing of 2021 summarises some of the emerging trends we have observed and the key areas where SLL terms are still developing.

KPIs - E, S and G

Environmental KPIs remain the focus for most companies, specifically, KPIs related to reductions in emissions, although the range of environmental KPIs is starting to develop. Others that have gained in popularity include improvements in water efficiency and/or energy efficiency, growth in the sustainable part of a business and becoming or remaining a member of certain climate and environmental initiatives or indices such as the UN PRI and Dow Jones Sustainability World Index.

We have seen some social KPIs relating to the percentage of women in leadership positions in the organisation, but in general, KPIs focussing on "S" and "G" are still relatively few. Practice will begin to emerge as use of the Social Loans Principles develops and social projects become more widespread.

The KPIs are the crux of the ESG terms. They typically require discussion and, depending on what they are and whether lenders have seen KPIs of that type before, detailed discussion may be required regarding the manner in which the business seeks to achieve the relevant targets. It is this bespoke aspect of the KPIs that makes it important for treasury teams to take the lead in appropriately setting ESG terms. In many cases, it will be necessary to provide lenders with a clear view on how their businesses' ESG strategy should be documented, measured and reported for financing purposes.

Adjustments to KPIs

SLLs often contain a mechanism for the ongoing review and adjustment of KPIs and targets to make sure they continue to be fit for purpose, but there is no standard practice in terms of how the adjustment mechanism operates.

The thinking behind these provisions, from a lender perspective, is that KPI targets should remain ambitious. In some deals, this is achieved by providing for a year on year ramp-up, rather than a baseline target which would enable the borrower to maintain the margin reduction over the life of the deal. Some lenders seek rights to instigate a review of KPIs if they believe an adjustment or replacement of the KPIs or related targets is necessary or desirable.

The borrower may also wish to maintain ambitious targets, but also will wish to maintain the flexibility to adjust KPIs and targets over time as the business'

ESG strategy (and the science behind it) evolves, so their perspective is slightly different. Some borrowers may therefore also seek specific rights to review KPIs and targets.

In syndicated deals, there may be a debate about whether any proposed adjustments are subject to all Lender or Majority Lender consent. More recently, a consensus seems to be emerging that this is Majority Lender matter. The appropriate threshold will, in part, depend on the size of the lender group and the circumstances giving rise to the amendment/replacement.

KPIs TBC

Some corporate SLLs this year have been completed without any KPIs being specified. The loan agreements include ESG mechanics (the margin adjustment and reporting provisions) but the KPIs and targets that bring those mechanics into operation are left to be agreed at a later date.

These deals, and whether it is possible, at the outset, to categorise them as SLLs, has been somewhat controversial, against a backdrop of concerns about standards in the ESG market and greenwashing. However, provided lenders have appropriate rights to approve KPIs and related reporting mechanisms before the ESG mechanics go live (in the same way as would be the case were they agreed at the outset), this approach can be viewed as a practical solution for a borrower which is not quite ready to set KPIs, but wants to take the first step on the ESG journey. Given we are moving at some speed towards a market where virtually all loans may have ESG features, there are good reasons to attempt to future-proof a three to five year deal.

Pricing of SSLs

If the borrower meets its KPI targets, the consequence is a price adjustment. The impact on Margin on meeting the KPI targets is, in most cases, 2.5bps, going up to 5bps in some instances. ESG terms are consistent in relation to the consequences of a failure to meet a KPI target, in that it does not result in a Default or Event of Default. However, it is increasingly the case that the Margin ratchet is two-way ie the Margin increases by 2.5bps if the borrower does not meet its KPI targets (and some lenders are starting to propose other consequences too, see further below).

The operation of the ratchet varies in SLLs involving more than one KPI target. In some deals, the ratchet may be cumulative (i.e. per KPI). In others, more than one or all of the targets may need to be met for the ratchet to apply. For example, if there are three KPI targets, should the margin decrease by 1.25bps where two out of three KPI targets have been met; should there be a decrease of 2.5bps per KPI or no adjustment unless all three KPI targets are met.

“Pay-away”

A topic that has generated a lot of interest is so-called “pay-away”, where the benefit of any Margin reduction/increase on an SLL is directed to a sustainable purpose. While there may be sound conceptual arguments in favour of “pay-away” (is it appropriate for either party to benefit commercially from failure/achievement of ESG targets), this can be challenging to implement.

For example, if the borrower undertakes to apply the amount of any margin adjustment (up, down or both) to a sustainable purpose, a process for verification needs to be agreed in the same way as in relation to the KPI targets themselves. Donating the amount to an agreed charity may be one solution, although in syndicated deals, achieving lender consensus on the appropriate cause may be an issue.

Reporting and Verification

ESG reporting mechanisms have become reasonably settled. In almost all cases, the borrower reports on the KPIs by delivering to the Lender/Agent a Sustainability Compliance Certificate at the same time it delivers its annual reports. The certificate is typically required to be signed by one or two directors, similar to the usual process for financial covenants Compliance Certificate.

The main debate is around verification, specifically, whether the borrower is able to self-certify compliance with KPI targets or whether external verification is required, and if so, of what type. Early ESG loans typically relied on self-certification. However, the LMA’s Sustainability Linked Loan Principles were updated in May 2021 to require external review by environmental or other

consultants, auditors or ESG ratings agencies, which has led to external review and verification becoming the subject of increasing focus. Third-party verification usually takes the form of a limited assurance report or verification statement in respect of any information contained in the annual report or financial statements (depending on where the borrower reports on the KPIs) relating to the KPIs or targets, or the company's wider sustainability strategy.

There appear to be a range of views among lenders, and the LMA and its sister loan market trade organisations are considering what further guidance can be provided to the loan market on external review and verification to assist with decision making. From a documentation perspective, it is helpful if the agreement provides some flexibility as to who provides the review/verification, given that practice continues to develop, rather than a specified name eg an "internationally recognised sustainability inspection and certification entity or an independent third party/auditor.

ESG ratings

ESG ratings are relatively new and only provided by a handful of agencies. They are available in relation to the business as a whole or, depending on what sector a company is in, for a certain aspect of its business such as its investment portfolio. Providers include S&P, Sustainalytics and MSCI. There has been some concern about the robustness of such ratings, for example, whether the metrics underpinning the rating are too limited (for instance, they only focus on the company's environmental credentials and not its social or governance credentials) and the credibility and independence of the rating agencies.

While some lenders have clearly looked at them in some detail and are comfortable to use them in SLLs as a metric for the pricing adjustment, others seem more reluctant, in which case borrowers are needing to work quite hard to illustrate why they have chosen to obtain such ratings. Nonetheless, ESG ratings are being used and can be useful to borrowers which do not have access to an ESG analysis and reporting department internally. They can also be useful where the long-term nature of a company's internal targets are difficult to reconcile with the requirement to meet short term KPIs within the context of SLLs.

In SLLs employing ESG ratings, there has been some discussion around whether further verification is required, which borrowers might view as overkill, given the ratings have an external source. However, it seems to be increasingly accepted that the ESG rating, having been obtained from an external provider, is sufficient.

The use of ESG ratings may be facilitated if the agencies become the subject of closer regulatory focus. The UK Government 's policy document Greening Finance: A Roadmap to Sustainable Investing states it is considering bringing ESG ratings firms into the scope of FCA regulation and authorisation.

"Declassification"

"Declassification" is a concept that has developed more recently. It refers to a provision that describes the circumstances in which a loan will cease to be classified as an SLL, and the ESG mechanics (and potential pricing advantage) will fall away. These might include factors largely within the borrower's control, such as misreporting or failure to report, plus sometimes, the lenders' belief that that the KPIs no longer comply with the LMA's Sustainability Linked Loan Principles. The concept stems from the desire to avoid greenwashing and lenders' internal reporting requirements (particularly where they have targets for deploying capital towards sustainable finance).

Declassification is a hot topic in green loans and use of proceeds products where, if a borrower is in persistent breach of reporting obligations, a lender cannot verify how funds are used and may consider itself quite exposed to greenwashing claims. It perhaps seems less fundamental in SLLPs where the proceeds are used for unrelated purposes and where margin increases typically apply in the event of the borrower's breach or failure to report. Given the declassification could have significant reputational and even economic consequences for the borrower (for example in terms of its share price), borrowers are therefore typically seeking to resist such provisions, or at least ensure that the bar for declassification is set at an appropriate level.

Declassification provisions are by no means standard in SLLs, and whether they are raised at all by lenders may be a relationship point (as well as linked to lenders' internal reporting requirements as

noted above). Proposals along these lines have tended to crop up in more broadly syndicated deals, where perhaps there is a wider lender group and their individual policies on SLLs need to be considered. If declassification provisions are on the table, there is likely to be a quite detailed discussion about the circumstances in which declassification would be triggered and strong resistance from borrowers to automatic declassification (ie without a grace period and/or a consultation process to determine whether the issues can be resolved).

ESG in 2022

SLL volumes expanded very quickly this year (doubling in EMEA from 2020 to 2021). This has afforded lenders and borrowers an opportunity to better understand and develop the product in a number of ways, providing a firmer basis from which to build during 2022. This should mean that some of the moving aspects – including a wider variety of KPIs and sources and processes for external review and verification - will become better understood. A key priority for borrowers during this "develop and build" period (in terms of KPI targets and the SLL product itself) will be to maintain as much flexibility as possible to alter and adjust targets and reporting requirements as further information and learning comes to light.

The continuing flow of new information, reports, consultations and regulation around ESG and green finance suggests we can expect further evolution in SLLs and ESG/green finance products more generally. One of the announcements at COP 26, for example, was the development of new requirements in terms of sustainability disclosure standards for financial institutions, and as this framework develops, this could have knock-on effects in terms of ESG products offered to customers and the applicable terms. While the wheels are turning swiftly, there remains ground to be broken in ESG and green finance (the role of derivatives in sustainable finance being just one example), and it will be some time before the menu of financing products has matured fully to suit a sustainable agenda.

Wishing all of our clients and contacts a peaceful festive season and a Happy New Year. Slaughter and May's financing practice has chosen the Woodland Trust for our charity donation for 2021.

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