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ESG – Recent Developments in Global Sustainable Finance

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With an intense focus on sustainability by governments, companies, investors and financial intermediaries, environmental, social and governance ("ESG") principles are more important than ever. The explosion of net-zero emissions commitments from companies and countries in an effort to slow global warming under the Paris Agreement are being met by a rapid rise in sustainable debt financings from US$160 billion in 2019 to US$750 billion in 2020 to over US$2 trillion in the first five months of 2021 alone, according to Bloomberg.[1] Lenders are working with domestic and multinational borrowers in industries as diverse as water, aviation, and food and beverages to incorporate innovative debt financing terms. This article will provide an overview of the principle guidance approved by loan market associations and will discuss some of the mechanisms for using credit pricing to incentivize sustainable behavior.

Sustainable Lending Guidance Overview

The Sustainability Linked Loan Principles and Guidance Notes ("SLLPs") that were jointly published by the Loan Market Association, Asia Pacific Loan Market Association and the Loan Syndications and Trading Association in 2019 and updated in May 2021 are shaping deal structures and documentation around the world. There are two methods through which a company may tap into the "green" loan market. One method is a *green loan* (a "GL"), which is a type of loan instrument made available to finance a green project in categories including renewable energy, energy efficiency, pollution prevention and control, climate change adaptation, green buildings, and other related categories. A GL must follow a clear frame work consisting of four components:

1. The use of proceeds for a specific green project reflecting the utilization of the loan proceeds;
2. The process for project evaluation and selection;
3. The management of proceeds that will be tracked by the borrower to maintain transparency; and
4. The reporting process by which the borrower will keep developments on the project readily available.

GLs can be incorporated into a variety of types of loan instruments, including both term loans and revolving credit facilities.

The second method instead has a broader applicability and is called a *sustainability-linked loan* ("SLL"). An SLL, which is the primary focus of this article, utilizes a behavior-based model by setting performance targets within a company's debt instrument. This type of loan facility, which originated in European loan markets, has exponentially gained popularity around the world since the pandemic. For example, in the U.S. markets, coinciding with a green policy push by President Joe Biden, ESG loans are booming in the U.S. markets alongside greater awareness of social justice.[2] Instead of specifying the use of the loan proceeds, an SLL looks to incentive the improvement of a borrower's general sustainability profile by achieving predetermined and ambitious sustainability performance targets ("SPTs"). SPTs are measured and monitored throughout the life of the loan utilizing predefined key performance indicators ("KPIs"). Once these SPTs are met, the company will be rewarded with a reduced pricing to their credit facility. In the alternative, if the SPTs are not met, the borrower may face increased interest rate spreads. Though an event of default will not be triggered under the loan agreement, a company could face reputational scrutiny from its investors or its product users who are eager to invest in ESG-friendly businesses and utilize ESG-friendly products.

Staying Sustainable Throughout the Life of A Loan

For an SLL, one of the lead or arranging banks on the deal will serve as the "sustainability coordinator" or the "sustainability structuring agent" for the lender group to determine and monitor the SPTs throughout the life of the loan. SPTs should be:

1. Internal and bespoke to the borrower's business;
2. External and set against a borrower's ESG performance over time—with a minimum measurement period of three years (if possible)—in relation to its peers, as determined by an external reviewer;
3. Set by reference to the science or to country-specific, regional, or international targets; or
4. A combination of any of these.[3]

The loan documents will then incentivize a company to achieve these metrics by offering an interest rate pricing reduction, which is typically adjusted once per year. The pricing grid related to the SPTs can be agreed at the origination of the loan or through an amendment after the initial closing.[4]

Examples of SPTs include environmental targets such as reduction in emissions, water usage, use of renewable energy, and carbon. Social and governance targets have also been implemented into debt instruments, providing reduced margin pricing for improving the quality of personnel training, providing enhanced safety for team members and even reducing the risk of data security breaches. No matter the type or category of target selected, the SPTs should represent an ambitious and meaningful goal for the borrower. Industry guidance on SLLs recommend increased diligence on and cooperation with borrowers to determine appropriate "stretch" goals to ensure that achievement of the goals will have an impact. In addition to leveraging a borrower's own understanding and perspective of its industry and its own performance, the guidance further recommends consulting with third-party sources, such as the Sustainability Accounting Standards Boards or similar ESG rating agencies.

With the assistance of the sustainability coordinator, KPIs are set to track the borrower's SPTs. KPIs may include external ratings or equivalent metrics, and they vary depending on sector and geography. These KPIs ought to be easily benchmarked by reference to regulatory standards, industry standards, or international agreements such as the Paris Agreement. The mechanism for measuring the borrower's improvement can be either by an absolute value or as a percentage change. Borrowers are required to report at least on an annual basis to the sustainability coordinator to verify that the borrower is meeting its SPTs. For any SSL, it is important for the parties to include key performance metrics in the loan agreement, with clear ratchets and targets, to facilitate the syndication of the loan facility. In May 2021, the SLLPs were revised to impose an additional requirement on borrowers that they must obtain "independent and external verification" of their performance level of each SPT for each KPI.[5] This means that an auditor or a qualified external reviewer with relevant expertise must verify that the borrowers are meeting their performance targets. Publication of the performance is recommended so that investors are receiving transparent data and information. However, some borrowers may choose to keep this information private.

It is important to note that there may be consequences in the debt instrument for failing to meet SPTs. For example, the margin adjustments may award a five basis points reduction when all SPTs are met, but the margin adjustment may increase by a comparable amount if no SPTs are achieved during the reporting period. Even though the failure to meet an SPT would not directly result in an "Event of Default," in some situations, failure to timely report or the reporting of inaccurate SPT information may result in a breach of a borrower's reporting covenants and therefore give rise to an "Event of Default."

Conclusion

These types of "green" loans currently provide unique, creative, and functional strategies for a company to make environmentally conscious decisions, while also generating favorable economic terms and goodwill for its investors and potential lenders. The benefits of incorporating sustainability into a company's platform are endless: stronger, value-based relationships with investors; positive impact on reputation and creditability; enhanced ambitions on ESG performance; economic impacts that actively direct capital to investors while implementing robust sustainability strategies; a visible commitment to sustainability, long term growth, and profitability; and an increased ability to attract and retain staff who see ESG contribution as an important part of their personal and professional lives. Companies should take advantage of this trending opportunity to reach long-term sustainability while reducing interest margins.

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1. See, The Sustainable Debt Market Is All Grown Up - Bloomberg.
2. See, US Sustainability Linked Loans.
3. Sustainability Linked Loan Principles (SLLP) - LSTA.
4. BNP Paribas Closes Sustainability-Linked Syndicated Credit (globenewswire.com).
5. Sustainability Linked Loan Principles (SLLP) - LSTA.

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