INSIGHTS

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The Corporate & Securities Law Advisor

Editor-in-Chief
AMY L. GOODMAN
301-908-0938
agoodman16@verizon.net

Co-Editor
BROC ROMANEK
broc.romanek@gmail.com

EDITORIAL ADVISORY BOARD

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EDITORIAL OFFICE
28 Liberty Street,
New York, NY 10005
212-771-0600

Wolters Kluwer
Richard Rubin, Publisher
James Orefice, Managing Editor

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Green and Sustainability-Linked Loans: What Companies Need to Know

There are a variety of loan principles and frameworks that guide how a loan can qualify as sustainability-linked or "green."

By David Miles and Jecolia Horn

Many companies have been focused on environmental, sustainability and governance (ESG) matters for some time, and rightly so. However, those that have not are having to catch up quickly. There is, as yet, no general legal requirement for companies to set and/or achieve ESG-related goals. However, for many shareholders and other stakeholders it is no longer sufficient for a company to demonstrate profitability, that profitability must come alongside the achievement of ESG-related goals.

That is the case whatever sector(s) the company operates in. Indeed, many companies are learning that achievement of ESG-related goals can help drive profitability or, at the very least, maintain or increase market share. One only has to look at the number of brands linking their products to the achievement of green and sustainability goals in their TV advertising campaigns to see that such things are now a key factor in how a company is perceived by the public.

The Rise in Green and Sustainability-Linked Loans

While advertising is used to raise consumer awareness of an entities' ESG commitments, one way in which to raise awareness of those commitments to the market is through the terms on which that entity borrows or lends money. Loans made specifically to finance "green" projects have been a core product in the project finance world for years. However, what is new is the creation of a direct link between the pricing of a loan and the borrower's achievement of sustainability goals and the requirement to enshrine rigorous reporting requirements into the loan documentation.

Both company borrowers and their lenders have identified advantages to including green or sustainability-related provisions in their loan documentation. Company borrowers across all sectors see it as a tangible way of demonstrating their commitment to achieving ESG-related goals (effectively, in the case of sustainability-linked loans, putting their money where their mouth is).

In parallel, it is becoming more common for lenders to be subject to their own ESG-related targets (including around the ESG commitments of the entities to whom they are lending). Lenders also increasingly view a borrower prepared to commit to achieving defined ESG-related goals as one with the sort of governance to likely make it a better credit risk.

As a result, there has seen an exponential increase in green and, particularly sustainability-linked, loans recently. By way of example, while still lagging behind volumes in the European markets, data from Bloomberg has the amount of debt advanced under sustainability-linked loans originated in the US markets at about US$52 billion in the period January to the end of May of this year, a 292 percent increase on volumes across the whole of 2020.

The GLP and SLLP

To assist this market trend of linking ESG matters to loan terms, the leading bodies for participants in the EMEA, United States and Asia Pacific loan markets (the Loan Market Association (LMA), the Loans Syndications and Trading Association (LSTA) and

David Miles *is a partner, and* **Jecolia Horn** *is an associate, of Covington & Burling LLP.*

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the Asia Pacific Loan Market Association (APLMA), respectively) have jointly published the Green Loan Principles (GLP)[1] and the Sustainability-Linked Loan Principles (SLLP).[2] The LMA/LSTA/APLMA also have produced accompanying guidance notes, notes on best practice and glossaries to assist in the implementation of these principles.[3]

While it is possible for a single loan instrument to satisfy the requirements of both the GLP and the SLLP, it would be more typical for a loan instrument to adhere to either the GLP or the SLLP, given the differences in the two sets of principles. It is therefore important to be aware of these differences when considering whether a GLP or SLLP-compliant lending arrangement is right for a particular situation or borrower.

Green Loans

Under the GLP, green loans are loans where the proceeds are applied specifically towards underlying "Green Projects." What amounts to a "Green Project" is set out in Annex 1 of the Green Loan Principles (GLP), but examples include the financing of renewable energy, water or wastewater management and waste-to-energy projects. While the GLP have been designed to be applied to both term and revolving facilities, as alluded to above, the loan instruments that are most likely to satisfy the purpose clause requirements of the GLP are traditional project financings.

However, the GLP have wider requirements than just the purpose of the loan. The documentation for a green loan must also include reporting undertakings (often subject to third party audit) to ensure the ongoing "green" credentials of the financed asset.

There are no direct economic implications for either borrower or lender to a loan being classified as a green loan. Rather, a green loan classification opens up access to the liquidity provided by the increased number of creditors with a mandate to build a portfolio conforming to green principles.

Sustainability-Linked Loans

In contrast, under the SLLP, the proceeds of sustainability-linked loans can be applied for (within reason) any purpose. The focus of the SLLP is on measuring whether a borrower achieves certain agreed "sustainability performance targets" (SPTs), which are measured periodically, often by third parties, by reference to agreed key performance indicators.

Common SPTs include reducing CO_2 emissions, regeneration of production waste or increasing female and ethnic minority diversity percentages amongst employees, but can vary widely depending on the particular borrower and its business. The borrower's performance against the SPTs then results in a direct economic implication, typically in the form of a deduction or increase in the margin element of the loan interest rate.

The variety of SPTs that can be included in the loan documentation makes sustainability-linked loans applicable to companies operating in any sector, not just those active in sectors that are typically seen as being "green."

Documenting Green and Sustainability-Linked Loans

The provisions mentioned above for both green loans and sustainability-linked loans (together with related reporting requirements and events of default for material non-compliance with SPTs) are included in a borrower's loan documentation, alongside typical terms appropriate for that particular borrower. While the market is not yet mature enough for recognized "standardized" drafting to have evolved, the UK's Chancery Lane Project has produced some useful template language for both green loans[4] and sustainability-linked loans.[5]

It is too early to say whether sustainability-linked terms will follow the path taken by Foreign Account Tax Compliance Act (FATCA) and sanctions compliance over the past decade and become enshrined in the laundry list of "market standard" provisions

typically included in loan agreements across all sectors and product lines. However, the increase in loans complying with the GLP and SLLP is certainly likely to continue, for the reasons set out at the beginning of this article.

"Greenwashing" and Taxonomies

As mentioned above, there is, as yet, no general legal requirement for companies to set and/or achieve ESG-related goals. Similarly, there is no clear legal framework by which a company's ESG goals and achievements are benchmarked. The GLP and SLLP are extremely helpful, but they are guidance only and auditing of compliance with the GLP and SLLP can be subjective. This has given rise to concerns around so-called "greenwashing."

This is where a company exaggerates or invents its ESG credentials, or intentionally sets itself too easily achievable ESG goals, in order to attract investment, improve its market or consumer perception or obtain favorable loan pricing. Impact of this phenomenon in the loan markets can hopefully be addressed through the growing expertise of lenders and the use of third-party consultants to initially set and then audit a borrower's compliance with the ESG components of loan documentation.

It also is an issue that governments and regulators are alive to. In part to tackle greenwashing, the European Union has brought in a Green Taxonomy which seeks to define what a green investment looks like. The United Kingdom is planning to introduce its own version in 2022.

The obvious repercussion is that, if the implementation of different taxonomies becomes a trend, many companies may find themselves subject to multiple requirements across different jurisdictions in which they operate. A single global taxonomy framework, or a system of mutual recognition, would undoubtedly go some way to addressing this potential issue. However, until then, navigating taxonomies looks set to be an increasingly complex aspect of a company's approach to ESG generally and specifically the terms of any ESG-linked loans that it incurs.

Conclusion

It is increasingly likely that all companies will need to be familiar with at least the SLLP and related legal and market developments over the coming years, for the purposes of negotiating their loan terms. If nothing else, it will make a refreshing change from the focus on LIBOR transition, discussions of which have dominated the loan markets for the last several years.

Notes

1. *https://www.lma.eu.com/application/files/9716/1304/3740/Green_Loan_Principles_Feb2021_V04.pdf.*
2. *https://www.lma.eu.com/application/files/6816/2668/7155/Sustainability_Linked_Loan_Principles._V09.pdf.*
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