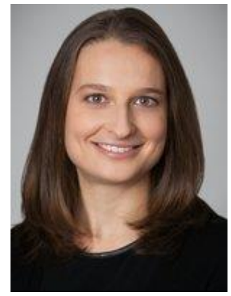
Considerations For Structuring Sustainability-Linked Loans

By **Amara Gossin and Bob Lewis** (November 25, 2019)



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Sustainability-themed debt instruments represent one response of the financial community to the need to channel capital toward facilitating a carbon transition.

Since green bonds debuted in 2012, the types and numbers of these instruments have grown. Sustainability-linked loans are one of the newest entrants to the market, first appearing in April 2017 with a loan to Royal Philips NV. They have become mainstream following the publication of the Sustainability-Linked Loan Principles[1] in March by the respective loan industry bodies in the U.S., U.K. and Asia Pacific: the Loan Syndications and Trading Association, the Loan Market Association, and the Asia Pacific Loan Market Association.

What is a sustainability-linked loan?

A sustainability-linked loan is a loan or similar facility that includes an economic incentive for the borrower to achieve certain defined sustainability performance targets, for example, increasing the percentage of power generated by a utility from renewable sources, or increasing the certified-sustainable space operated by a real estate operator.

This incentive typically takes the form of a secondary pricing mechanism that adjusts pricing up or down depending upon the borrower's performance of the sustainability targets. Aside from that pricing incentive, a sustainability-linked loan is largely identical to any other loan product or contingent facility and may be used for any purpose, including general corporate purposes.

In contrast, a green bond, green loan or similar sustainability-themed debt instrument focuses on the proceeds of the debt being used for sustainable purposes.

The four components of a sustainability-linked loan set out in the Sustainability Linked Loan Principles are:

1. Relationship to the borrower's overall corporate social responsibility strategy: Any borrower of a sustainability-linked loan should have sustainability objectives that are core to its business and align with the performance targets set out in the loan documentation.

2. Target setting – measuring the sustainability of the borrower: The sustainability objectives chosen should be ambitious and meaningful in relation to the borrower's business.

3. Reporting: The borrower should be able to provide up-to-date information relating to its performance, and where possible, publicly report on its performance.

4. Review: Where no public review or audit is undertaken, it is strongly recommended that a borrower receive a third-party review of its performance against the documented targets. If no third-party review is available, the borrower should have the internal expertise necessary

to validate its reporting of its performance.

Why would a borrower want a sustainability-linked loan?

Companies are increasingly focused on integrating sustainability considerations into their core business, whether because of strategic decisions or in response to pressure from investors, regulators, employees, customers, local communities or other stakeholders.

Sustainability-linked loans allow companies to demonstrate their commitment to achieving key sustainability-related performance targets by tying loan pricing to their achievement. This sends a powerful message of alignment across a company's core business, contrasting this integration to the historic treatment of sustainability as the purview of a single team or business area.

At the same time, by linking the incentive to pricing rather than a more damaging event of default, the company can set ambitious targets without significant contractual risk. In addition, achievement of the sustainability targets results in a pricing benefit.

Why would a lender want to provide a sustainability-linked loan?

To date, sustainability-linked loans have been made in relationship-based revolving credit facilities. In these cases, lenders expect a long-term working relationship with the borrower. Helping the borrower to achieve its sustainability-related business targets is an important part of that relationship.

These loans are also responsive to stakeholders' demands that lenders be well positioned to address the economic impact of environmental change on their loan portfolio. The more lenders encourage clients to consider and prepare for these economic costs, the stronger the lenders' portfolios are likely to be in the face of it.

What drafting considerations should be taken into account when creating a sustainability-linked loan?

Metric Alignment With Borrower's Business

The value of the sustainability-linked loan rests on its ability to incentivize a genuine transition in the borrower's business to more sustainable practices. So the chosen sustainability metric must be (1) core to the borrower's business, and (2) a demonstrable marker of sustainability in that business.

For example, renewable energy generated is a good metric for a utility, but would not be appropriate to a retailer that also happened to generate its own power on-site. In some cases, a sustainability-linked loan is tied to a sustainability rating supplied by a third-party ratings provider. A lender should carefully consider the benefits and pitfalls of using a third-party sustainability metric.

Establishing an Ambitious Target

Once an appropriate metric has been selected, there are a number of drafting decisions to be made in order to ensure that the transition being rewarded is sufficiently ambitious:

- Description of initial benchmark: The benchmark against which improvement is measured must accurately reflect the current state of the business and must be easily identifiable to all parties. This may mean, for example, that an average of performance over some recent period of time is used instead of a single-year benchmark.

- Target improvement over benchmark: Consider whether an escalating target over the several years of the facility may be more appropriate than a single static during the life of the facility.

- Pricing incentive: Best practice is to include a bilateral economic incentive — i.e., achievement of the sustainability performance target results in a pricing or other benefit, while regression of performance results in a pricing or other penalty. Consider whether a pricing incentive should apply to interest rates across the facility, or as has more often been the case in the U.S. to date, only to drawn amounts under the facility.

Ensuring Accurate Reporting

To ensure accurate and reliable reporting of a borrower's performance of its sustainability targets, creditors must receive at least annual reports, which, when they are provided by the borrower, should be certified by the borrower in its annual compliance certificate.

These certifications will be most reliable where they include information that is either publicly filed and subject to securities laws or verified by third parties. Where a third-party sustainability rating is used, however, borrowers will have little control over the frequency or quality of the rating, which should be reflected in the documentation.

Reviewing the Reports

Third-party review is likely to be most helpful in cases where the selected sustainability performance metric is relatively complicated. In cases where the metric is simple to calculate from the borrower's disclosures and the disclosures themselves are reliable, third-party review may not be particularly beneficial.

Where reports are found to be inaccurate, however, a best drafting practice is to ensure that the borrower does not retain the benefit of any improperly obtained lower pricing and must instead retroactively repay amounts that would have been payable but for the inaccuracy.

Whether such inaccuracy gives rise to an event of default under the agreement has typically been left to an interpretation of the standard reporting representations and covenants.

Conclusion

Proper drafting and structuring of sustainability-linked economic incentives into general-purpose loan documentation can have a material impact on both the borrower's and its creditor's environmental, social and governance objectives.

If done well, the structure can be straightforward from a legal perspective. Moreover, such financings facilitate the integration of sustainability metrics with business metrics and can send a powerful message to both the borrower's and creditor's stakeholders.

Done poorly, sustainability-linked mechanisms may risk opening borrowers or lenders to charges of so-called green-washing for seeking the public relations benefits of a purportedly greener type of loan without attendant meaningful business change.

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[1] https://www.lma.eu.com/application/files/8015/5307/4231/LMA_Sustainability_Linked_Loan_Principles.pdf.