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# SUSTAINABLE LENDING— A GUIDE FOR 2021 AND BEYOND

BY AMARA GOSSIN, VICE PRESIDENT, BARCLAYS BANK PLC  
AND ROBERT J. LEWIS, PARTNER, SIDLEY AUSTIN LLP



2021 promises much progress in the world of sustainable finance. Interest in sustainable finance is exploding, which is stimulating rapid developments while at the same time creating a somewhat fragmented and possibly overwhelming landscape to participants.

This article focuses on sustainable lending—a distinct sub-category of sustainable finance that aims to accomplish environmental, social or governance (ESG)<sup>1</sup> ends concurrently with more traditional lending purposes. We identify the key drivers and considerations for sustainable lending, to allow market participants to successfully navigate the fast-changing topography. In so doing, we hope to inspire the industry to make sustainable loans ambitious, consistent, meaningful and ubiquitous.

First, we describe the two products in the market: green loans and sustainability linked loans. Second, we describe the principal relevant market constituencies and their interest in sustainable finance in general and sustainable

lending in particular. Third, we explore the fundamental characteristic of sustainable loans: sustainability. Finally, we look at specific drafting and diligence items that market participants should consider to ensure the integrity of sustainable loans. We use climate change mitigation as our primary example because it is a relatively well-developed and cross-cutting sustainability objective,<sup>2</sup> but the principles are relevant to any sustainability objective.

## I. OVERVIEW OF GREEN LOANS AND SUSTAINABILITY LINKED LOANS

The loan market has two dedicated sustainability products: green loans and sustainability-linked loans. While there is no current regulation of sustainability-themed loans as such in the United States, the market has broadly adopted voluntary principles promulgated by the LSTA, LMA and APLMA for each product: the [Green Loan Principles](#) and the [Sustainability-Linked Loan Principles](#).

Green loans and sustainability-linked loans both have the characteristics of a standard loan product, but with a sustainable feature added. Specifically, green loans are loans the proceeds of which are expressly designated for a use that is determined to be “sustainable” (to date, the green loan product only contemplates environmental sustainability objectives, but we expect that will soon broaden to include other ESG objectives). Sustainability-linked loans are not determined by their use of proceeds; rather, their sustainability characteristics are determined with reference to specific sustainability-related business ambition(s) incentivized by the debt instrument (usually through a pricing adjustment). Thus, while green loans aim to achieve one or more specific sustainable project objectives, sustainability-linked loans, when crafted in a meaningful manner, aim to incentivize the long-term pursuit of sustainability objectives in borrowers.

In both cases, the loan products have counterparts in the capital markets—namely, green, social or sustainability bonds, and sustainability-linked bonds—and the industry principles are purposely aligned.<sup>3</sup>

<sup>1</sup> For purposes of this article, the focus is primarily environmental sustainability. However, as noted, a “sustainable” finance product may also or alternatively address objectives related to the social and governance aspects of ESG. Many use “ESG finance” and “sustainable finance” interchangeably. In this article we use “sustainable” because it is more consistent with the international frameworks cited below.

<sup>2</sup> As Justin Worland has eloquently put it, “If a storm destroys a school, students can’t learn. If the sugarcane crops are flooded, farmers lose their jobs. If sea levels rise too much, entire communities disappear... That will come one way or another. Every country will be combatting climate change for the foreseeable future.” See Justin Worland, “2020 is Our Last, Best Chance to Save the Planet”, Time Magazine (July 9, 2020).

<sup>3</sup> See “[LSTA Green Loan Principles](#)”, Loan Syndications & Trading Association (May 2020) and “[Sustainable Finance—FAQs](#)”, Loan Syndications & Trading Association (July 2019).

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Below we compare certain characteristics of these two loan and bond products to better illustrate their use in the market.

	Green or Sustainable Loans/Bonds	Sustainability-Linked Loans (SLLs)/Bonds
<b>MARKET DEBUT?</b>	The first green bond was issued by the World Bank in 2008 and was dedicated to financing projects that addressed climate concerns. <sup>4</sup>	The first SLL was issued by Philips in 2017 and was designed to incentivize an improvement in a sustainability score provided by a third party sustainability ratings agency. <sup>5</sup>
<b>WHO PROVIDES THE CREDIT?</b>	Capital or financial markets participants looking to invest in accordance with specific mandates.	Capital or financial markets participants seeking to improve the sustainability characteristics of their investment portfolios or invest in accordance with specific impact mandates while maintaining a diversified asset base.
<b>WHAT IS IT FOR?</b>	Allocation of capital to projects identified as “eligible” in accordance with specified investment principles. Useful for channeling capital to sustainable projects. May not necessarily alter the sustainability profile of a borrower/issuer.	Usually general corporate purposes. Incentivizes improvement in selected “eligible” sustainability-related practices that are core to the borrower/ issuer’s business through adjustments in lending terms (typically pricing).
<b>WHAT DOES IT MEASURE?</b>	The use of capital for well-selected sustainability-related projects through careful tracking and proceeds management.	A borrower’s/issuer’s sustainability performance using “performance targets” established via transparent and regular reporting.



<sup>4</sup> “From Evolution to Revolution: 10 Years of Green Bonds”, The World Bank (November 27, 2018).

<sup>5</sup> “Philips Couples Sustainability Performance to Interest Rate of Its New EUR 1 Billion Revolving Credit Facility”, Koninklijke Philips N.V. (April 19, 2017).



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The two sets of relevant loan principles are summarized in the below chart.

Green Loan Principles	Sustainability-Linked Loan Principles
<p><b>Use of proceeds:</b> Proceeds must be used for eligible “Green Projects” described in the finance documents.</p>	<p><b>Relationship to the borrower’s overall corporate social responsibility strategy:</b> Any borrower of an SLL should have sustainability objectives, or key performance indicators (KPI), that are core to its business and align with the performance targets set out in the loan documentation.</p>
<p><b>Process for project evaluation and selection:</b> Borrower must clearly communicate (a) its environmental sustainability objectives, (b) how it selects eligible projects for application of loan proceeds and (c) how it manages material environmental risks related to the Green Project. Borrowers are encouraged to contextualize the project evaluation and selection process within their wider business environmental sustainability objectives.</p>	<p><b>Target setting:</b> The targets for the KPIs chosen should be ambitious and meaningful in relation to the borrower’s business.</p>
<p><b>Management of proceeds:</b> Loan proceeds must be tracked to provide transparency on use in accordance with facility terms.</p>	<p>N/A—proceeds may be used for any purpose.</p>
<p><b>Reporting:</b> The borrower should be able to provide to credit providers up-to-date information relating to the use of loan proceeds, including where possible a breakdown by project.</p> <p>The borrower should also report on the expected impact of the funded Green Projects, including quantitative performance measures where possible.</p>	<p><b>Reporting:</b> The borrower should be able to provide up-to-date information relating to the selected KPIs and, where possible, should publicly report on the KPIs.</p>
<p><b>Review:</b> External review is recommended in appropriate cases. Parties can determine the extent and nature of the review—for example, an external party could review the borrower’s proposed process for project evaluation and selection against an external standard, or against the borrower’s own standards; or an external reviewer could review the borrower’s report of expected environmental sustainability impacts of the funded projects.</p> <p>In contrast to the bond market, because loans are traditionally relationship-driven the Green Loan Principles recognize that borrowers can self-certify their green loans if they have appropriate internal expertise (which should be well-documented).</p>	<p><b>Review:</b> Where no public review or audit is undertaken, it is strongly recommended that a borrower receive a third party review of the selected KPIs 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.</p>

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## II. MARKET CONSTITUENCIES

Sustainable lending is attractive to many constituencies. It combines a shared set of public and private goals: economic risk reduction, opportunity realization and the mitigation of systemic sustainability challenges. Recognition of the mutuality of corporate and social objectives is becoming widespread; for example, in the prominence of “stakeholder capitalism”, as expressed in statements like the Business Roundtable’s 2019 “[Statement on the Purpose of a Corporation](#)”, in which several hundred CEOs of America’s leading businesses agreed that “all stakeholders” are essential and corporate purpose includes delivery of value “for the future success of our companies, our communities and our country”, and the statement by the [World Economic Forum’s January 2020 Annual Meeting](#) in Davos that stakeholder capitalism is essential “to overcome income inequality, societal division and the climate crisis.”

Through sustainable finance, the financial sector shows its commitment to use the capital raising and capital allocation power of finance to enable and accelerate sustainable development—that is, development that “meets the needs of the present without compromising the ability of future generations to meet their own needs.”<sup>6</sup>

This signaling is important to communities, customers, employees and others included within stakeholder capitalism. But it is also critical to more traditional finance constituencies for traditional financial reasons. The market’s appetite for sustainable loans is driven by deficiencies in existing products that lead to the following three broad areas of concern or interest:

- Mitigation of specific economic risks to financial returns that arise from inattention to sustainability (for example, exposures of mortgage loans to flood risk or agricultural investments to drought);
- Development of economic opportunities created by sustainability challenges (for example, providing for flood protection or increasing drought resilience); and
- Avoiding contribution to systemic sustainability challenges (for example, refraining from investments in activities or sectors that contribute to increasing flood or drought risk).

Done well, sustainable loans respond to each of these concerns, by allowing credit providers to shift their portfolios towards lower risk investments that are positioned for long-term value and by allowing borrowers to shift their business practices to do the same. Every market constituency has clearly stated its appetite for this shift. Below are some examples of actions by key constituencies that demonstrate the appeal of sustainable lending:

**A. Investors.** Whether to better understand their risk exposure, to seek better returns,<sup>7</sup> to meet an explicit sustainability impact mandate, or because they cannot invest away from the systemic risks that sustainability issues create,<sup>8</sup> investors have long been leaders in developing sustainable finance. Through the Principles for Responsible Investment (PRI), over 3,000 investors, including many of the world’s largest, have committed to integrating sustainability into their decision-making.<sup>9</sup> Similarly, more than 360 investors, including Blackrock among other significant market actors, with over \$34 trillion in assets under management, support [ClimateAction 100+](#), an investor engagement initiative with commitments among other things “to take action to reduce greenhouse gas emissions across the value chain in line with the overarching goals of the Paris Agreement.” Investors’ taste for sustainability in their portfolios will continue to grow and refine.

**B. Regulators.** Not surprisingly, regulators have also been attentive to the development of sustainable finance. For financial institutions, central banks have made clear that it is essential to understand and reduce climate risk exposure. For example, the Central Banks and Supervisors Network for Greening the Financial System (NGFS) encourages central banks to implement climate stress testing and prudential guidance,<sup>10</sup> which many have begun to consider or do.<sup>11</sup> In the US, the Board of Governors of the Federal Reserve System [joined](#) the NGFS in December 2020 after recognizing in its November 2020 Financial Stability Report that climate change “is likely to increase financial stability risks” and that it is likely to be a material risk that banks must monitor.<sup>12</sup> A September 2020 report by the Climate-Related Market Risk Subcommittee of the Commodity Futures and Trading Commission (CFTC) Market Risk

<sup>6</sup> “[Report of the World Commission on Environment and Development: Our Common Future](#)”, United Nations World Commission on Environment and Development (March 20, 1987).

<sup>7</sup> Robert G. Eccles and Svetlana Klimenko, “[The Investor Revolution](#)” Harvard Business Review (May-June 2019).

<sup>8</sup> Ibid.

<sup>9</sup> “[Principles for Responsible Investment, PRI Growth 2006-2020](#)”, Principles for Responsible Investment.

<sup>10</sup> The NGFS is a voluntary coalition of 54 central banks and supervisors, including the regulators of over ¾ of the global systemically important banks. See NGFS, “[A Call for Action: Climate Change as a Source of Financial Risk](#)” (April 2019).

<sup>11</sup> See “[Climate-Related Financial Risks: A Survey on Current Initiatives](#)”, Bank for International Settlements (April 2020).

<sup>12</sup> “[Financial Stability Report](#)”, Board of Governors of the Federal Reserve System (November 2020).



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Advisory Committee urged “urgent and decisive” regulatory action to address climate risk.<sup>13</sup> For financial institutions regulated by the New York State Department of Financial Services, which is an NGFS member, the regulator sent a letter to “commence a dialogue” on such questions.<sup>14</sup> To date, this regulatory discussion has been aimed at facilitating, rather than restricting, sustainable finance, and we expect such facilitation to continue. In addition, although bank loans are not securities, initiatives in the securities markets will influence the bank loan market, and securities regulators are increasingly emphasizing the importance of robust, consistent and transparent disclosure of sustainability risks and activities to better inform investment decisions.<sup>15</sup>

**C. Credit Providers.** Banks around the world have begun to set ambitious climate goals. The [Principles for Responsible Banking](#) (PRB), launched in late 2019 as the banking-side counterpart to the PRI, has over 190 members who have committed to aligning their business activities with society’s goals as expressed in, among other places, the Paris Agreement. The world’s leading banks are putting more specificity behind those commitments by setting out their plans for aligning their portfolios with the goals of the Paris Agreement and achieving net zero emissions by 2050.<sup>16</sup>

**D. Ratings Agencies.** All of the major ratings agencies, including Fitch, S&P Global and Moody’s, have committed to incorporating ESG criteria into credit ratings and analysis in a systemic and transparent way.<sup>17</sup> They have also grown their sustainability expertise with acquisitions of specialist sustainability ratings agencies—for example, S&P Global acquired RobecoSAM’s ESG ratings business, Moody’s owns a majority interest in Vigeo Eiris, and Morningstar owns Sustainalytics. The relevance of these and other specialist sustainability ratings resources will grow as investors increasingly demand third party ratings and as sustainability-focused financial products increasingly require independent opinions that assess issuer ESG quality, the alignment of an issuance with the relevant themed principles and the sustainability quality of the projects financed.

**E. Companies.** America’s business community is similarly focused on sustainable finance. Issuance of sustainable financial instruments—across green/social loans and bonds and sustainable loans and bonds—reached nearly \$360 billion for the first nine months of 2020—an almost 100% increase from 2019 totals.<sup>18</sup> In terms of climate change ambition, thousands of such businesses (as well as other U.S. sub-national actors, including municipalities and investors) have signed the [declaration](#) of We Are Still In, pledging to “support climate action to meet the goals of the Paris Agreement,” irrespective of the U.S. federal government’s commitment to doing so. Many have already put forward ambitious plans for meeting those commitments. From Microsoft’s [plan](#) to be carbon negative by 2030, to Walmart’s [Project Gigaton](#) plan to avoid one gigaton of greenhouse gases from its supply chain by 2030, business leaders have recognized the importance of assessing and mitigating environmental risks in their business.

In this context, borrowers and credit providers are particularly well-matched. Because relationship-based credit providers in the loan market bring a deeper understanding and commitment to a borrower’s business strategy and development, they are able to simultaneously promote the borrower’s sustainability objectives and their own internal targets. Indeed, sustainable lending should be an intimate financial means to achieve both parties’ sustainability objectives. These joint efforts will also promote the development of new sustainable finance products, including sustainable securitization structures (which will require a thoughtful melding of the sustainability mandates of the bond markets and the loan markets) and sustainable derivatives products.<sup>19</sup>

In addition, in a competitive market, the benefits of a consistent presentation of a borrower’s sustainability profile for comparison against that of competitors will help to ensure successful placement of the borrower’s debt issuances, which will benefit both the borrower and its credit providers. This incentive to satisfy their multiple constituencies’ sustainability requirements will operate

<sup>13</sup> “Managing Climate Risk in the U.S. Financial System: Report of the Climate-Related Market Risk Subcommittee, Market Risk Advisory Committee of the U.S. Commodity Futures Trading Commission”, U.S. Commodity Futures Trade Commission (September 9, 2020).

<sup>14</sup> “Letter to Chief Executive Officers or Equivalents of New York State Regulated Financial Institutions Re: Climate Change and Financial Risks”, New York State Department of Financial Services (October 29, 2020).

<sup>15</sup> “Sustainable Finance and the Role of Securities Regulators and IOSCO: Final Report”, The Board of the International Organization of Securities Commissions, Report FR04/2020 (April 2020).

<sup>16</sup> Major banks in the U.S. market that have committed to such targets in principle include [Barclays](#), [JPMorgan Chase](#) and [Morgan Stanley](#), among others.

<sup>17</sup> See “[ESG in credit risk and ratings statement](#)” Principles for Responsible Investment.

<sup>18</sup> “[Sustainable Finance Market Continues 2020 Growth](#)”, Refinitiv (November 11, 2020).

<sup>19</sup> For example, the market saw a cross-currency swap whose interest payments were tied to parties’ achievement of sustainability targets in the underlying instruments. See Anna Hirtenstein “[JPMorgan Currency Deal Highlights Finance’s Green Shift](#)”, The Wall Street Journal (October 26, 2020).

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to make borrowers themselves a leading driver for the promotion of consistency and transparency in meaningful sustainability disclosure.

### III. DEFINING SUSTAINABILITY

The primary component of a sustainable loan is sustainability. Because different actors will have different objectives and needs, the adoption of a singular definition of “sustainability” for financial products is unhelpful. Nevertheless, identifying acceptable parameters or themes is fundamental to the success of sustainable finance. In particular, the parties must be clear about (1) the defined sustainability objective, (2) the contribution of the activity being financed or incentivized to achieving such objective, and (3) an evaluation of any significant negative impacts that may undermine the sustainability determination.

The international community has recognized challenges to continuing to meet both the needs of the present and the future and that action must be taken to meet these challenges. This is expressed in the following three international agreements, which offer a robust set of sustainability benchmarks: (1) the 2030 Agenda for Sustainable Development<sup>20</sup> (which sets out 17 Sustainable Development Goals—a comprehensive set of sustainability objectives), (2) the Paris Agreement<sup>21</sup> (which provides

specificity around addressing climate change and low carbon development), and (3) the Sendai Framework for Disaster Risk Reduction<sup>22</sup> (the “UN Agreements”). The Paris Agreement in particular also expresses a scientific consensus around mitigating the profound economic costs and disruption that environmental change will, if left unaddressed, bring to the world’s economies and societies.

The UN Agreements establish sustainability objectives and initiated the inertial movement of national governments towards achieving those objectives. But the UN Agreements do not include the technical criteria pursuant to which credit providers and borrowers can evaluate the contribution of any particular loan or activity to achieving those objectives nor of any potential harm that such loan or activity may incidentally cause. Extending credit to a wind farm that will more efficiently power fossil fuel extraction may lower greenhouse gas emissions, but can the private sector participants in that transaction designate that credit as sustainable? Similarly, a wind farm that displaces coal powered supply to a utility may seem an obvious candidate for the label. But what if the wind farm is built in an environmentally sensitive area?

Today’s leaders in establishing technical criteria for sustainability designation include supranational bodies, national or sub-national governments, and private actors, such as industry groups, independent ESG rating firms, self-initiating issuers, and even credit providers. And while there has been significant effort made to establish classification protocols for financial instruments, the breadth of the participants has ensured that no single system dominates. To give a small sample of these types of technical standards, one long-standing private resource is the Climate Bonds Initiative (CBI) with its [Climate Bonds Taxonomy](#)<sup>23</sup> (which, despite the title, applies to loans as well). More recently, in the public sector, the European Union passed into law the [EU Taxonomy Regulation](#),<sup>24</sup>



<sup>20</sup> See [United Nations General Assembly Resolution A/RES/70/1](#) at paragraph 53 (September 25, 2015).

<sup>21</sup> The [Paris Agreement](#) is the latest global agreement reached under the auspices of the [UN Framework Convention on Climate Change](#) (UNFCCC), which was agreed in 1992 and committed to the world to limiting anthropogenic temperature rise and among other things required annual meetings of its signatory parties to further its objectives.

<sup>22</sup> [Sendai Framework for Disaster Risk Reduction 2015-2030](#).

<sup>23</sup> CBI provides its taxonomy for use “by any entity looking to identify which assets and activities, and associated financial instruments, are compatible with a 2-degree trajectory.” See “[Climate Bonds Taxonomy](#)”. CBI also provides a certification scheme that can be used to certify Green Loans (but not SLLs, due to their unspecified use of proceeds).

<sup>24</sup> [Regulation \(EU\) 2020/852](#) of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending [Regulation \(EU\) 2019/2088](#) (the “EU Taxonomy Regulation”).



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which outlines six environmental objectives for an economic activity to be environmentally sustainable, and requires that a qualifying activity must make a “substantial contribution” to at least one of these six objectives, and not cause “significant harm” to any of the others.<sup>25</sup> Limited drafts of technical standards for conducting this evaluation have already been proposed, but remain subject to discussion. This dual set of objectives—substantial contribution and “do no significant harm”—should become one of the cornerstones of the future development of the sustainable finance market, but market participants should brace themselves for continued competition on technical standard setting.

Although there is therefore currently no single, widely-adopted criteria for making sustainability determinations, credit providers and borrowers can use these taxonomies or specialist providers’ expertise (as the parties determine is appropriate) to identify the loan’s sustainability objective (or set of objectives), together with the loan’s contribution toward achieving that objective, and to measure the successful avoidance of significant ancillary harm. The parties should ensure transparency and consistency in the loan process so that the sustainability characteristics that led to the designation of such sustainable loan are readily apparent to the participants and can be explained to third parties. In this way, consistent minimum parameters and themes will apply to sustainable loans, notwithstanding a broad market application of the product.

#### IV. ADDITIONAL DRAFTING AND DILIGENCE CONSIDERATIONS

##### 1. Identify the Purpose

A first step in the successful crafting of a sustainable finance product is the identification of the meaningful sustainability objectives to be achieved. This determination should be made with reference to the three motivators discussed in Part II (economic risk reduction, opportunity recognition and the avoidance of contribution to systemic sustainability challenges). This determination will often not be straightforward.

Consider a green loan that finances a wind farm that will contribute to a sustainability objective of

increasing renewable power generation. The specifics of that contribution will vary depending upon the broader context. A wind farm that powers increased fossil fuel extraction will have a different profile to one that displaces a large amount of existing fossil fuel-powered generation. Furthermore, if the wind farm represents a small portion of an otherwise fossil fuel-focused portfolio, and does not represent a meaningful transitional movement to sustainably-sourced generation, the loan is unlikely to alter either the borrower’s or (if they are looking to the borrower’s overall credit profile for repayment) the credit providers’ exposure to climate related risk.

Regulatory developments may offer additional rationales for sustainable loans. While still speculative as of the date of this article, a game-changing development for sustainable lending would be a regulatory attribution of reduced capital charges accruing to loans structured to achieve meaningful sustainability objectives (or, conversely, a capital surcharge on loans that are especially exposed to climate risk).<sup>26</sup> Perhaps indicative of such regulatory acceptance in the future, the ECB announced in September 2020 that, commencing in January 2021, certain sustainability-linked bonds will be eligible as central bank collateral and also potentially eligible as assets for the purposes of its asset purchase program and pandemic emergency purchase program, subject to compliance with program-specific eligibility criteria. Credit providers who wish to have their loans qualify will need to be familiar with the program requirements.

##### 2. Align with Latest Best Practices

As described above, the field of sustainable finance is developing quickly, and best practices are continuing to emerge. As such, credit providers and borrowers should be willing to update their sustainable loan documentation as sustainability standards evolve. For example, a sustainability-linked loan may incentivize a sustainable transition objective that initially represents a Paris-aligned best practice. However, if the pace of transition is later determined to be too slow, it may be appropriate for the parties to amend the documentation to incentivize a more ambitious timeline.

<sup>25</sup> The EU Taxonomy Regulation sets out the criteria for “substantial contribution” and “significant harm” for each of the objectives. For example, a loan to a wind farm could be classified as environmentally sustainable under the current proposed screening criteria under the EU Taxonomy Regulation if it meets all of the criteria for Production of Electricity from Wind Power at Annex A, including the screening criteria to ensure that it is not significantly harming the achievement of any other sustainability goals.

<sup>26</sup> Action 8 of the EU’s Action Plan: Financing Sustainable Growth in 2018 was to explore this possibility, and since then the European Parliament and Council have mandated the European Banking Authority to “(1) [i]dentify the principles and methodologies for the inclusion of ESG risks in the review and evaluation performed by supervisors, and (2) [e]xplore the prudential soundness of introducing a more risk sensitive treatment of “green asset” (so called green supporting factor).” The idea was hinted at in the EU’s Green Deal announcement: “Third, climate and environmental risks will be managed and integrated into the financial system. This means better integrating such risks into the EU prudential framework and assessing the suitability of the existing capital requirements for green assets.” See “COMMUNICATION FROM THE COMMISSION: The European Green Deal”, European Commission (November 12, 2019).



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As discussed in Part II, a tremendous advantage to sustainable loans as a whole is the intimate relationship between credit providers and borrowers that allows this sort of iterative change. The parties should engage in regular dialogue about the adequacy of the loan to achieving the identified sustainability objectives.

### 3. Public Disclosure of Sustainability Targets and Progress

Unlike public securities markets, the loan markets are largely non-public. Even for public companies, the only documentation related to a sustainable loan that may become public is the credit agreement. Although a publicly filed credit agreement will reveal the metrics and targets chosen, such disclosure will be lacking any context. A borrower that sets meaningful and ambitious targets may require some additional disclosure describing any differences between the aspirational targets established in their loan documents for purposes of more favorable financing terms and any other strategic targets the borrower otherwise may have publicly disclosed. Similarly, companies should carefully consider the level of detail they provide on both the sustainability metrics selected and the targets set and where those are best disclosed (i.e., in securities filings or elsewhere, such as in self-published sustainability/ ESG reports or frameworks on their websites).

### 4. Elements of a Good Green Loan

Green loans are designed to finance eligible “Green Projects”. Thus, the sustainability value of a green loan lies in the project’s selection and in the rigor applied to ensure that the loan’s proceeds are used for that purpose. The following are some key considerations credit providers and borrowers should take into account in making these decisions, in addition to the basic features described above.

#### ■ PROJECT SELECTION.

- **Identification:** A project may be pure green or transition-focused.<sup>27</sup> In either case, best practice would ensure that the project is identified in accordance with the principles set out above—i.e., that it achieves a recognized sustainability objective in accordance with a credible taxonomy and does not cause incidental, significant harm.
- **Use of Proceeds:** There are two ways in which the use of proceeds may be mandated in green loan documentation. The specific project or projects may be identified in the use of proceeds covenant. Alternatively, if proceeds are meant to be used for

sustainable projects identified over time, the borrower can instead provide a “framework” that explains how the borrower will identify such projects, and the use of proceeds covenant will require the borrower to select projects in accordance with that framework. In general, the borrower would not seek credit providers’ approval for each project as it is entered into. Credit providers should, however, receive updates on project status and use of proceeds with other financial performance reporting (typically monthly or quarterly).

- **Consequence of Breach.** Whereas in the bond market there is currently no covenant default if an issuer fails to use the bond proceeds in accordance with the use of proceeds framework described in the securities offering materials, the loan market is more prescriptive. Thus, although the green loan principles do not require this, a best practice is to tie an event of default to a breach of the “green” use of proceeds covenant. The close relationship between credit providers and borrowers, and the loan market’s receptivity to loan document modifications (unlike bond indenture modifications) to meet the changing needs of credit providers and borrowers encourages the inclusion of a specific default tied to use of proceeds. Indeed, changed economic conditions or specific project developments may necessitate amendments. For example, in 2020 COVID may have interfered with a borrower’s ability to apply a green loan’s proceeds to specified sustainable projects and we would expect that in such a case credit providers would have provided a temporary amendment or waiver to allow otherwise ineligible uses of proceeds, with the requirement that when circumstances permit the proceeds would again be used only for eligible projects.

#### ■ ALIGNMENT WITH BORROWER’S BUSINESS STRATEGY.

While a borrower’s business strategy is not always as directly relevant to green loans as it is for sustainability-linked loans, it brings itself to bear in two ways.

- For pure green loans, there may be reputational risk to credit providers if the borrower’s overall sustainability profile is dubious.
- For transition-focused green loans, an understanding of how the project fits into and assists with the borrower’s broader sustainability strategy is critical to ensuring the appropriate application of the label. For example, if no clear and credible path exists for the borrower’s transition to a business model aligned with

<sup>27</sup> We note that neither of these categories is entirely clear-cut, but in general in the context of climate change “green” projects are those that are already sufficiently low-carbon that they do not need to change to be consistent with a future zero carbon world, and “transition” projects are those that are not yet sufficiently low-carbon, but for which there is a clear and credible plan according to which they will lower their carbon within a timeframe that can meet the goals of the Paris Agreement.





the Paris Agreement targets, the application of the sustainability label may be inappropriate.

#### ■ ACCURATE REPORTING.

Borrowers should provide annual reports to credit providers that cover (1) the use of proceeds, including the Green Projects financed, a description on how and why they qualified as eligible projects and the amounts allocated to each project, and (2) if possible, the ongoing and expected environmental impact of the projects. Where the projects financed are transitional, the environmental impact reporting should reflect alignment with the pathway agreed at the initial documentation phase, or, if appropriate, the parties should agree to an update to that pathway. As with the use of proceeds covenant, the loan documentation should reflect a default if the borrower breaches the reporting covenant.

#### ■ INDEPENDENT REVIEW OF REPORTING.

Third parties can provide valuable expertise prior to entering into the loan documentation (e.g., a review of the project selection framework or of the alignment of the loan with the Green Loan Principles), especially in cases where the projects financed are transitional or where the borrower does not have demonstrated internal expertise to confirm that the loan, and in particular the projects that it finances, aligns with the selected taxonomy. Whether ongoing third party is necessary will depend upon the complexity of the project selection process as well as the borrower's expertise.

#### 5. Elements of a Good Sustainability-Linked Loan

The allure of a sustainability-linked loan rests on its ability to incentivize a genuine transition in the borrower's business to improved sustainability

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practices. To achieve that improvement, credit providers and borrowers must focus on the metrics, or key performance indicators (KPIs), to measure and set meaningful goals for improving those KPIs. Below are some key considerations for credit providers and borrowers in making these decisions.

#### ■ KPI SELECTION.

Each KPI must be (i) core to the borrower's business, and (ii) a demonstrable marker of sustainability in that business. For example, renewable energy generated may be a meaningful KPI for a utility but may not be as meaningful for a retailer that generates its own power on-site. In general, these KPIs should be identified in connection with sustainability materiality assessments that form part of the borrower's broader risk assessment and strategy development programs.

- In some cases, multiple KPIs may present a more holistic reflection of the borrower's sustainability profile. In such cases, however, each KPI should reflect the qualities set out here. In addition, the parties should be thoughtful about the value of each sustainability objective reflected in the KPIs, and ensure that each KPI is clearly tied to a relevant objective.
- As an alternative to a borrower-generated KPI, third party sustainability ratings, rather than a business-related metric, may be an appropriate choice for a KPI in certain circumstances. However, the use of third party ratings may have limitations. Parties should give careful consideration to the independence of the rating provider, the transparency of the rating provider's methodologies, the rating provider's substantive credentials for providing ratings to similar companies, and should address in the loan documentation the protocols if the rating provider's methodology changes or the rating ceases to be available.
- Each KPI should reflect a sustainability indicator that the borrower has reported on in a consistent and measurable manner for some time or can adapt to reflect consistently and measurability over time. Any changes in reporting over time should be clear and accounted for in the documentation to ensure an apples to apples comparison. For example, a metric of renewable power generation over time that excludes hydropower in early years but later includes hydropower would not accurately reflect a change in the borrower's sustainability profile over time, even if the parties agree that hydropower qualifies for inclusion.
- No KPI should be a "business as usual" metric. It is not appropriate to apply the sustainability label to

something that is a standard business practice. For example, workplace reuse and recycle programs for common office waste may achieve sustainability objectives, but are also ubiquitous, and therefore should not need to be incentivized by special loan features.

#### ■ ESTABLISH A CLEAR INITIAL BENCHMARK.

Each initial KPI is a benchmark and must accurately reflect the current state of the borrower's business. The parties should mutually agree to, and expressly state, both the qualitative description of the benchmark KPI and the initial quantitative measurement of that KPI. It must be easily identifiable to all parties. Setting such an initial benchmark KPI may require deciding whether to use an average of that metric over a recent period or a single-year benchmark.

#### ■ ESTABLISH AND INCENTIVIZE AMBITIOUS TARGETS.

Once the parties select an appropriate KPI, the loan documentation should ensure that the transition being rewarded is sufficiently ambitious and incentivized.

- **Target Improvement over Benchmark.** The targeted improvements in performance of the KPI should be aligned with a mutually-agreed, and science-based quantification of meaningful improvement (such as the Paris Agreement). This may require escalating targets over the life of the facility and, as discussed above, may require recalibration over time to remain aligned with scientific best practices.
- **Pricing Incentive.** The carrot-and-stick approach is a best practice. A borrower should be incentivized to both improve on the KPI, but also to avoid any regression in the chosen metric. A bilateral economic incentive would reflect that the achievement of the sustainability performance target gives rise to a pricing or other benefit, while regression results in a pricing or other penalty. Consider also whether a sustainability pricing modification should apply to interest rate margins and facility costs throughout the facility structure or, as has more often been the case in the U.S. to date, only to drawn amounts under the facility.
- **Ensure Accurate Reporting.** Accurate and reliable reporting of a borrower's performance of its sustainability targets is paramount. Creditors must receive borrower-certified reports at least annually, customarily with the borrower's annual financial compliance certificate. The reliability of such certifications materially improves when the borrower includes information that is either publicly filed and subject to securities laws, or verified by third parties (noting again the use of third parties is not without limitations).

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- **Reviewing the Reports.** Pre-closing engagement with a third party to assess the ambitious nature of both the KPI and the targeted improvements (e.g., whether sufficiently aligned with the Paris Agreement) is likely helpful. Ongoing third party assessment of the sustainability performance metric is particularly helpful when the selected KPI is relatively complicated.
- **Inaccurate Reporting.** In the event that a borrower's sustainability reporting is determined to be inaccurate, and as a consequence the borrower improperly obtained the benefit of lower pricing, the loan documentation should provide that the borrower must 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.

disagreement in the markets that sustainable finance, and in particular for this article, sustainable loans, are integral to market participants' success. Sustainable lending mitigates economic risk that arises from inattention to sustainability objectives, provides valuable new economic opportunities and avoids exacerbating systemic sustainability challenges. With an increasing number of global financial institutions committing to the goals of the Paris Agreement, including an increasing number of "net zero by 2050" pledges by leading banks, future lending should embed sustainability in the ordinary course. The market appetite for green loans and sustainability-linked loans is an important step in that direction. ■

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## ■ CONCLUSION

The complaint that sustainable finance is an "alphabet soup" and a confusing morass obscures its crucial and urgent purpose. Indeed, there is more agreement than

950+

TOTAL ATTORNEYS

15

OFFICES WORLDWIDE

300

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