Sustainability Linked Loan Principles Extend Green Finance

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The role of lenders in promoting sustainable development has received a helping hand with the issuance of the Sustainability Linked Loan Principles. The Principles provide a new industry standard for banks to incentivise borrowers looking to improve their sustainability performance, comply with environmental regulations or ensure long-term financial and operational stability. With this, lenders can also work toward their own goals for environmentally and socially responsible financing.

Sustainability Linked Loans and the Green Economy

Over the past few years, the international community has made great strides in producing guidelines and principles for lenders and investors to ensure that their financial contributions are compatible with the commitments made by states through agreements such as the Paris Accord and under the UN Sustainable Development Goals.

The Loan Market Association (LMA), the Asia Pacific Loan Market Association (APLMA) and the Loan Syndicated and Trading Association (LSTA) have now released the Sustainability Linked Loan Principles (the "**Principles**").[1] This is a critical development that will provide a means for lenders to incentivise borrowers to improve their overall sustainability performance and facilitate the transition towards sustainable business operations. The Principles follow the Green Loan Principles published in 2018 by the LMA and APLMA (see White & Case Client Alert March 2018). Together, they align strategic thinking on how financial institutions can be at the forefront of financing sustainable development.

Under the Principles, for a loan (or other instrument such as bonding lines, guarantee lines or letters of credit) to qualify as sustainability-linked, a borrower's performance is measured against pre-agreed Sustainability Performance Targets ("**SPTs**") that are specific to each financing and may include metrics such as key performance indicators or external ratings. SPTs should be "ambitious and meaningful to the borrower's business" as sustainability-linked financing solutions are designed to result in positive change through the use of financing incentives. An indicative list of SPTs is provided in Appendix 1 of the Principles, and includes energy efficiency, water consumption, affordable housing, sustainable farming and ESG assessment.

Positive performance against the SPTs may be directly linked to more favourable terms such as reducing the cost of a borrower's loan and, at the same time, this contributes to the environmental and social priorities of the lender. In addition to providing a tool for borrowers to improve their sustainability outlook on a company-wide basis, this can lead to long-term operational efficiencies, talent retention and positive reputational impacts.

1 The Sustainability Linked Loan Principles were issued by the Loan Market Association together with the Asia Pacific Loan Market Association and the Loan Syndicated and Trading Association on 20 March 2019, and may be found at https://www.lma.eu.com/application/files/8015/5307/4231/LMA_Sustainability_Linked_Loan_Principles.pdf.

Components of the Sustainability Linked Loan Principles

There are four core components to the Principles: linkage with borrower environmental, social and governance (ESG) or corporate social responsibility (CSR) strategies, establishing sustainability targets, reporting information and reviewing achievement. Although the Principles are not prescriptive, they aim to present a minimum standard of corporate engagement.

Relationship to Borrower's ESG/CSR

The Principles require borrowers of sustainability-linked loans to communicate their sustainability objectives, and show how these align with the SPTs, including with any sustainability standards or certifications they have obtained or seek to obtain.

Measuring the Sustainability of the Borrower

The Principles require borrowers and lenders to negotiate and set SPTs over the lifetime of a loan. SPTs may be based on a borrower's internal global sustainability strategy, or against an external third party rating criteria, and should be benchmarked against recent performance. Most importantly, performance against the pre-determined SPTs should be linked to the terms of the loan.

As a condition precedent to the loan becoming available, parties are encouraged to use independent assessors to determine if the appropriate SPTs are being applied.

Reporting

Transparency remains a hallmark of the developing sustainable finance markets. This is reflected in one of the most important components of the Principles – reporting. Borrowers must maintain up to date information concerning their compliance with the SPTs and it is recommended that the information is provided to financial institutions participating in the loan, at least once a year.

Where appropriate, borrowers are also encouraged to publish information relating to their SPTs, including in respect of the assessment methodology and assumptions. Information could be publicly disclosed in annual reports but, if appropriate, it may be shared only between the lender and borrower.

Independent Review

The Principles recommend that the state of a borrower's compliance in meeting its SPTs is reviewed by an independent third party, especially if information relating to SPTs is not intended to be made publicly available. Financial institutions lending to publicly-traded companies may, depending on the SPTs agreed, rely on publicly available disclosures to determine compliance with SPTs.

Where independent verification is sought, the Principles recommend it be done annually and using a qualified external reviewer, agreed by the lender and the borrower.

If no external review of SPTs will be undertaken, the Principles recommend that the borrower demonstrates or develops internal expertise to do so. Evidence for such should be thoroughly documented and provided to the lenders and, where appropriate, a description of internal expertise should be made publicly available.

Future of Sustainability Linked Loans

Solutions for extending the environmental and social license to operate have reached the boardrooms of banks and businesses. It is now common ground that financial institutions have a role to play in achieving sustainable development globally. The Sustainability Linked Loan Principles set an international baseline for determining how financing can facilitate positive corporate performance. From here, measurable growth in financing for sustainable development can be achieved.

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