Sustainability-linked Loans:

UNPACKING SUSTAINABILITY LINKED LOANS, ESG CONSIDERATIONS AND THE RISK OF ESG-WASHING

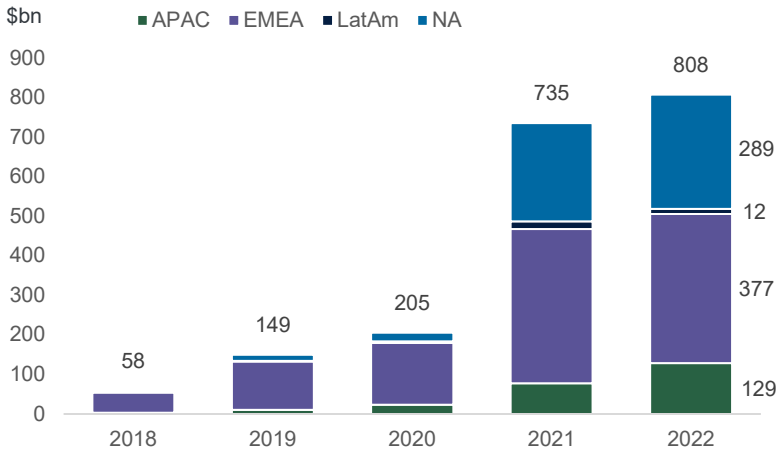
March 2, 2023

Overview of Sustainability-linked Loans (SLLs)

Overview

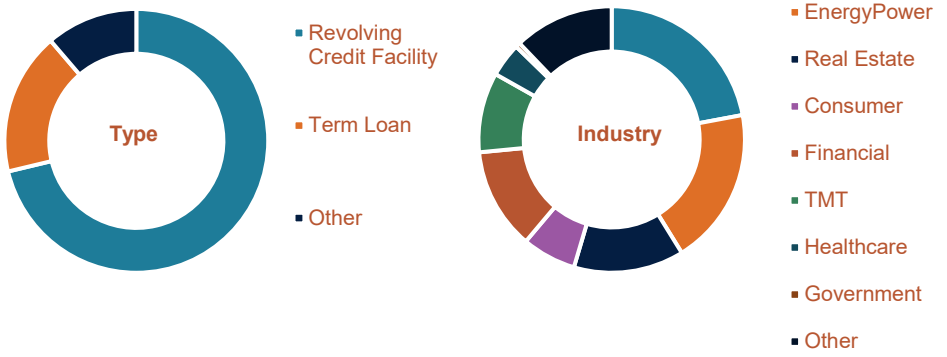
- Sustainability-linked Loans are a relatively new but well-entrenched product in the global debt markets
  - As of year-end 2022, there were nearly $2 trillion of SLLs outstanding
  - The margin and facility fee can move up or down based on the borrower's performance toward pre-defined ESG Key Performance Indicators (KPIs)
  - SLLs do not have a designated use of proceeds, making them a flexible financing tool that also contributes to the sustainability strategy of the borrower
- However, borrowers should be mindful of certain potential risks associated with SLLs, among them reputational considerations
- The Sustainability-linked Loan Principles (SLLP) were designed to promote the development and preserve the integrity of the product by providing guidelines which describe the characteristics of these loans and recommended market practice. The SLLP provide that:
  - KPIs should be core, material, and relevant to the borrower
  - Sustainability Performance Targets (SPTs) should be ambitious, representing a material improvement beyond "Business as Usual"

Global SLL volume



Source: Refinitiv as of January 4, 2023

SLL type and sectors breakdown (through 2022)



Source: Refinitiv as of January 10, 2023
*other includes Assed Based Loan, Islamic loan, reserve based, and bridge

Most SLLs are written into documentation at closing; an amendment mechanic has also developed, but should not be considered equivalent

	Sustainability-linked Loans	"Sleeping"
Description	• Loan instrument with potential for pricing adjustment up or down depending on progress toward defined ESG metrics	• Loan instrument with potential to add KPIs later (within 12 months) with a majority lender vote

Requirements	• Determine core, material, relevant KPIs and ambitious targets
	  ◦ Typically at least one environmental metric anchors the deal
	  ◦ Social metrics are increasingly included as well when relevant
	• Incorporate SLL mechanics in loan documents
	• ESG-focused lender presentation
	• Annual reporting to lenders including external review/audit
		• Incorporate mechanism in loan documents to allow for the addition of KPIs at a later date with a majority lender vote
		• Potential pricing adjustments are agreed in advance
		• Incorporate KPIs and targets post-close

Benefits	• Demonstrate commitment to sustainability • Contractual interest expense savings if targets are hit	• Prepare for simple addition of KPIs at a later date • Appropriate where a company has begun a sustainability program, but is not ready for an SLL structure immediately at closing
Considerations	• Reputational risk if KPIs and targets are not sufficiently ambitious • Contractual interest expense penalty if targets are missed • Ongoing reporting requirement	• May be viewed as only a half-step • **Should not be called "Sustainability-linked" until KPIs are added**
Margin Adjustments	• Interest expense adjustments typically available following first annual reporting	• Interest expense adjustments do not go into effect until KPIs are added to the facility

Benefits and considerations of a Sustainability-Linked Loans

Benefits

Highlights Environmental and / or Social Priorities

Demonstrates clear commitment to company's long-term sustainability initiatives

Positive Public Perception and Shareholder / Stakeholder Approval

Favorable messaging enhances customer, shareholder, and stakeholder goodwill and aligns with public interest in ESG

Cost of Funds

Potential to adjust pricing grid based on performance towards metrics

Lender Friendly (when properly structured)

Banks embrace the opportunity to participate in well-structured ESG-related financings

Considerations

Strength of Metrics

Important to select metrics that are viewed as credible by the ESG community

Ability to Meet Metrics

Important to select metrics that are ambitious and can be reasonably achieved

Work Streams

Some additional lender communication and modifications to existing credit agreement; ongoing tracking and assurance from auditor and associated cost

The five pillars of the LSTA's Sustainability-linked Loan Principles

1 Pillar 1: Selection of KPIs	2 Pillar 2: Calibration of SPTs	3 Pillar 3: Loan characteristics	4 Pillar 4: Reporting	5 Pillar 5: Verification
• Credibility of the SLL will rest on the selection of the KPI(s) • KPIs must be: (i) material to the borrower's core sustainability and business strategy; and (ii) measurable or quantifiable on a consistent methodological basis; and (iii) able to be benchmarked (as much as possible to an external reference)	• SPTs should be ambitious and represent a material improvement both beyond a BAU trajectory and regulatory required targets … and be based on a combination of benchmarking approaches: (i) the borrower's own performance over time (minimum of 3 years is recommended); (ii) the borrower's peers and comparable, or versus current industry or sector standards; and/or (iii) reference to science	• A key characteristic of a SLL is that an economic outcome is linked to whether the selected predefined SPT(s) are met • The margin under the relevant loan agreement will often be reduced where the borrower satisfies a pre-determined SPT as measured by the pre-determined KPIs and vice versa… the ratchet may include a neutral bracket in which no margin adjustment applies	• Borrowers should, at least once per annum, provide the lenders participating in the loan with: (i) up-to-date information to monitor the performance of the SPTs and to determine that the SPTs remain ambitious and relevant to the borrower's business; and (ii) a sustainability confirmation statement with verification report attached	• Borrowers must obtain independent and external verification against each SPT for each KPI • Should be conducted by a qualified external reviewer with relevant expertise (i.e., auditor (limited or reasonable assurance), environmental consultant and/or independent ratings agency) • Verification must be shared with the lender in a timely manner, and where appropriate, be made publicly available

Source: Sustainability-Linked Loan Principles, February 2023

KPIS IN A SUSTAINABILITY LINKED INSTRUMENT SHOULD BE MATERIAL AND CREDIBLE WITH AMBITIOUS TARGETS

Materiality

- Issues captured by the chosen KPIs are the ones that have the **greatest impact on the relevant activity, strategic orientation and the borrower's operational and financial performance**
- Issues captured by the KPIs have the **highest impact on the environment and/or society**
- A borrower should seek to benchmark its KPIs by undertaking a **materiality assessment** of itself and its industry
  - Growing number of organizations are performing these assessments in accordance with ESG reporting frameworks such as GRI, SASB, TCFD and ICMA'S Illustrative KPI Registry

Credibility

- **Clear definitions** of each KPI
  - Applicable scope
  - **How the target is linked to the borrower's sustainability strategy**
  - Any baseline being used
  - **What the KPI is being benchmarked against**
  - The calculation methodology

Ambition

- Borrowers can use **industry initiatives and standards to ensure that selected KPIs are ambitious**
  - Such standards include, but are not limited to, the Science Based Targets initiative and the Transition Pathway Initiative
  - These help **provide an indication of a borrower's ambition relative to their industry sector**
  - SPTs should not be set lower than the performance historically achieved by the borrower
- Best practice is for **SPTs to be updated so that they are never less ambitious than those publicly announced**

Source: Guidance on Sustainability-Linked Loan Principles, February 2023

Sustainability-Linked Loan Financing Roadmap

	Process items for the borrower	Role of Sustainability Structuring Agent ("SSA")
1	• **Finalize decision** to establish a Sustainability-Linked Loan and **engage Sustainability Structuring Agent**	

2	• Work with lines of business and internal sustainability division to **determine meaningful 'KPI(s)'** and annual targets	• **Provide market color on proposed KPIs and targets**
		  ◦ Important to select metrics that are material and ambitious
		  ◦ Share the latest trends in SLLs and comparable borrower KPIs

3	• **Engage third party assurance provider** ◦ *Helpful to engage assurance provider once KPIs are finalized – baseline should be assured ahead of close*	• **Support the borrower in its selection of and coordination with third party assurance provider**

4	• **Create** short lender presentation; **integrate** sustainability elements into credit agreement	• **Assist borrower with lender presentation and engage with legal counsel as they draft credit agreement**
		  ◦ Provide market color and assist borrower in identifying and analyzing issues important to lenders based on recent precedents and by reference to the SLLP
		  ◦ Facilitate dialogue between the borrower and lenders
		  ◦ Review and comment on any post-close marketing materials

5	• **Report KPI performance** to lenders, providing details of underlying methodology and assumptions when possible
	  ◦ *Annual reporting requirements commence one-year post close*
		• **The Sustainability Structuring Agent usually does not have a post-closing role**
		  ◦ The Administrative Agent implements the pricing adjustments agreed in the credit agreement as certified by the borrower in its KPI performance reporting

Key topics on the 2023 SEC ESG regulatory agenda

Topic	Expected timing	What to expect
Climate Risk Disclosure	*1Q (Final rule)*	• Aims to standardize climate risk disclosures, including financial statement disclosure, GHG emissions, and 10-K disclosure around governance, business strategy, and climate risk management • The final rule may contain changes from the proposed text, such as: (1) moving scope 1 + 2 disclosure outside the 10-K, (2) delaying or entirely removing scope 3 disclosure, (3) reworking the proposed financial statement line-item disclosure on climate-related impacts, and (4) delaying implementation timelines given the delay in finalizing the rulemaking
Enhanced ESG Disclosures by Investment Advisers and Investment Companies	2H *(Final rule)*	• Aims to adopt requirements for investment companies and investment advisers related to environmental, social and governance (ESG) factors, including ESG claims and related disclosures. • The proposed amendments seek to require enhanced disclosure of ESG issues to clients and shareholders. If adopted in the proposed form, the proposed amendments would require registered investment advisers, certain advisers that are exempt from registration, registered investment companies, and business development companies, to provide additional information regarding their ESG investment practices.
Human Capital Management	2Q *(Proposed rule)*	• The proposal is expected to require more prescriptive disclosure of workforce-related metrics • Key areas of required disclosure may include, among others: (1) workforce diversity (e.g., EEO-1 data); (2) number of part-time vs. full-time employees; (3) turnover rates; (4) employee compensation; and (5) whether the company has a defined benefit or defined contribution retirement plan
Corporate Board Diversity	2H *(Proposed rule)*	• Aims to enhance disclosures about the diversity of board members and nominees • May consider adopting board diversity rules similar to Nasdaq (have at least two diverse directors including at least one woman and at least one member of an underrepresented community), although ultimately unclear given the Nasdaq rule is being challenged in court

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SEC Enforcement and Private Actions

SEC Climate and ESG Task Force (2022-23)

- Three credited enforcement actions against investment managers, process related
- Two credited actions against issuers, tying ESG-related failures to disclosures
  - International mining company relating to environmental compliance and safety program disclosures after a dam collapse
  - Software/gaming company relating to human resources risk disclosures after “toxic culture” complaints
- None to-date relating to SLLs

SEC “Whistleblower Complaint” (2023)

- Deforestation and climate-focused NGO filed a complaint under the SEC’s whistleblower program challenging an international meat processor’s sustainability-linked bonds
- Two claims (per their press release; they have not released the complaint)
  - The issuer allegedly based the bond offerings on its commitment to achieve net zero emissions by 2040, but it excluded ‘Scope 3’ supply chain emissions, which allegedly comprise 97% of its carbon footprint
  - The issuer did not include disclosures regarding deforestation in its supply chain, allegedly providing incomplete information for investors to evaluate its net-zero claims
- The issuer has responded that:
  - The issuing documents clearly and accurately disclosed that Scope 3 emissions were out of scope
  - The company is channeling substantial resources toward sustainability
  - There is no widely-accepted measure for Scope 3 emissions (but the Company is working to reduce them).
- SEC will determine whether to open an investigation. The process takes substantial time and – unlike civil litigation – is not public. If the SEC declines to pursue the matter, there will be no announcement (unless the issuer does so).