EVERSHEDS SUTHERLAND

Striving for a sustainable future

Recent updates to the Sustainability Linked Loan Principles

The consideration of environmental, social and governance (**ESG**) factors by corporate borrowers, investors and lenders has continued on a steady upward trajectory over the last number of years. Despite the impact of the COVID-19 pandemic, that positive movement shows no sign of abating. In fact, there has been an acceleration of an awareness of, and desire to implement, ESG principles by market participants.

The recent publication by the LMA and other related trade associations of a further set of updates to the Sustainability Linked Loan principles and guidance (the "**SLLPs**") presents an opportunity to reflect on the current status of this increasingly important area in the finance world.

What is a Sustainability Linked Loan ("SLL")?

As highlighted in our previous briefing available here, a SLL is any loan or contingent facility (such as a guarantee line or letter of credit) which incentivises a borrower's achievement of ambitious, predetermined sustainability performance targets ("**SPTs**") which are measured against a set of agreed key performance indicators ("**KPIs**"). The borrower's performance against those SPTs affects the interest rate applicable to the underlying facility, either in a positive or negative manner, consequently incentivising improved sustainability performance over time.

What changes are contained in the updated SLLPs?

The SLLPs have been updated as follows:

1. Selection of KPIs

The credibility of the SLL marketplace is contingent upon the selection of KPIs which are seen to be plausible. In order to achieve this, the selected KPIs must be material to the borrower's sustainability and business strategy and also relate to ESG challenges which are pertinent to the sector within which the borrower operates.

The SLLPs stipulate that KPIs should be:

- relevant, core and material to the borrower's overall business, and of high strategic significance to the borrower's current and/or future operations;
- measurable or quantifiable on a consistent methodological basis; and
- able to be benchmarked, i.e. as much as possible using an external reference or definitions to facilitate the assessment of the SPT's level of ambition.

2. Benchmarking KPIs

Further clarity has been provided as to what is required in order to properly benchmark KPIs. As part of that process, borrowers and lenders should be cognisant of goals and objectives set out in widely recognised international agreements such as the UNFCCC Climate Agreement, ratified in 2016 (more commonly known as the Paris Agreement), the UN Sustainable Development Goals published in 2015 and relevant industry standards which should be included in the benchmarking process in order to maintain their veracity.

The KPIs must be clearly defined and the borrower must specify how the target is linked to its overall sustainability or ESG strategy and set out its calculation methodology in a transparent manner.

3. Calibration of SPTs

The SLLPs have to date accentuated the importance of choosing SPTs and related KPIs which are both ambitious and suitably meaningful to the borrower's overall business.

In order to assist lenders with their evaluation process when it comes to the setting of appropriate SPTs, there is an expectation that the borrower's historical performance relating to the proposed SPTs will have been disclosed through previous annual reports or sustainability reports of the borrower. Ideally, this information should be available for at least the previous three years. However, there is an awareness that the lack of such information should not be a barrier to new entrants to SLL arrangements.

Borrowers are expected to communicate the rationale for choosing its KPIs and outline the motivating factors for the SPTs. This will require the borrower to set out its level of ambition, the consistency of the SPTs with its overall strategy, its benchmarking approach and how it intends to achieve the SPTs.

Borrowers are also encouraged to:

- set clear timelines for the achievement of their SPTs;
- use a baseline or science based reference point as the basis for measuring the improvement of KPIs; and
- specify how they intend to achieve their SPTs through identifying the key actions to be implemented.

There is likely to be increased third party involvement in the structuring of SLLs going forward with a "*Sustainability Coordinator*" or a "*Sustainability Structuring Agent*" advising the relevant parties on the negotiation of KPIs and calibration of the SPTs.

4. Reporting

The transparent reporting of up to date information to lenders on the current progress relating to, and the continued relevance of, the SPTs is a continued central feature of SLLs.

Further clarity has been provided on the following points which should be borne in mind when documenting the level of reporting required for a SLL:

- the metrics for the reporting requirements should be clearly set out in the facility agreement and reporting by the borrower should be required at least annually over the life of the loan
- Information undertakings relevant to the SPTs should be clearly identifiable in the facility agreement (for example, the delivery of a copy of the borrower's sustainability report to the lenders on an annual basis over the life of the loan); and
- the borrower should be under an obligation to formally represent the accuracy of any reporting in the facility agreement.

5. Verification

Most reporting will be prepared on an annual basis and once completed, the lender will utilise the content of the external review to appraise the borrower's performance against the SPT and KPIs which have been set.

This is a considerable change to the current reporting mechanism applicable to SLLs and would be participants should be mindful that third party rather than internal verification is now an essential aspect of SLL. The costs and timing implications of that third party involvement should therefore be factored into the process.

Prior to the recent revisions to the SLLPs, the recommendation to borrowers was that they may consider seeking independent and external verification of their performance against their SPTs and achievement of each KPI.

That is no longer the case and the revised SLLPs envisage that borrowers must obtain independent and external verification by a qualified external reviewer with an appropriate and relevant level of expertise, such as an auditor, environmental consultant or a representative of an independent ratings agency.

Conclusion

The evolution of the SLLPs is not surprising with the influx of private equity investment coinciding with an increased focus on ensuring that SPTs and KPIs continue to be transparent and readily measurable. Lenders can now also avail of a strengthening of the reporting and verification process through the call for the use of specialist third party advisors in both the setting of SPTs and the measuring process over the life of a loan.

While sustainability linked loans are relatively new to Northern Ireland, given developments in the global financial market, we expect to see them becoming more of a feature in the Northern Irish market. Given our experiences in this area globally, we have the expertise to assist clients navigate this area.

If you would like to discuss any aspect of this area further please get in contact with Damian McElholm or your usual Eversheds Sutherland contact.

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