EVERSHEDS SUTHERLAND

Shining a light on green loans and sustainability linked loans

Overview of the key features

Part 2: Sustainability Linked Loans

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As highlighted in ***Part 1 – Green Loans – Overview of the key features*** of our two part briefing, the key distinction between a green loan and a sustainability linked loan is the use of proceeds. The proceeds of a sustainability linked loan may be used for general corporate purposes whilst the proceeds of a green loan must be used for a specific "green project".

In the table below, we examine the '*Sustainability Linked Loan Principle*s' and the accompanying '*Guidance on the Sustainability Linked Loan Principles'* as published by the Loan Market Association.

Sustainability Linked Loans	
What is a sustainability linked loan?	A sustainability linked loan is any loan instrument and/or contingent facility (such as a bonding line, guarantee line or letter of credit) which incentivises a borrower's achievement of ambitious, predetermined sustainability performance objectives. The '*Guidance on the Sustainability Linked Loan Principles'* clarifies that any entity that may borrow in the loan market may borrow a sustainability linked loan provided that it is aligned with the four core components of a sustainability linked loan which we highlight below.
Is a borrower required to use the loan proceeds for a specific purpose?	There is no specific requirement for use of proceeds. A sustainability linked loan could be used for a borrower's general corporate purposes.
Is pricing impacted by a borrower's performance?	The hallmark of a sustainability linked loan is that a borrower's performance against predetermined sustainability objectives affects the interest rate, incentivising improved sustainability performance over time. The Sustainability Linked Loan Principles set out a non-exhaustive list of 10 common categories of objectives, including reduced greenhouse gas emissions, reduced water consumption and the amount of renewable energy generated or used by a borrower. Common categories of objectives include: a. energy efficiency; b. greenhouse gas emissions; c. renewable energy; d. water consumption; e. affordable housing; f. sustainable sourcing; g. circular economy; h. sustainable farming and food; i. biodiversity; and j. global environmental, social and governance ("**ESG**") assessment. Two-way pricing mechanisms have been introduced on certain deals whereby a price reduction applies if the sustainability targets are achieved by a borrower and a price increase applies where a borrower fails to achieve all or some of its key sustainability targets.

What are the core components of a sustainability linked loan?	To satisfy the Sustainability Linked Loan Principles, a sustainability linked loan must comply with the following four components:
	1. <u>Relationship to a Borrower's Overall Sustainability Strategy</u> A sustainability linked loan is intended to complement, enhance and support a borrower's existing overall sustainability strategy. Accordingly, sustainability performance targets will differ on a case by case basis depending on the business of that particular borrower and its strategy.
	2. <u>Target Setting – Measuring the Sustainability of a Borrower</u> Sustainability performance targets should be ambitious (i.e. should go beyond what a borrower would have achieved in its ordinary course of business) and meaningful (i.e. core to a borrower's business). The relevant metrics and sustainability performance targets are negotiated and set between a borrower and a lender. The targets can be internal and bespoke to a borrower's business and/or external and set against a borrower's ESG performance in relation to its peers as determined by an external reviewer. Examples of certain methodology for selecting the sustainability performance targets include: (a) ESG metrics and targets included in a borrower's sustainability strategy and/or policies; (b) external analysis to establish sector-specific ESG criteria and best practice; and/or (c) verified industry metrics reported against certain frameworks with verification or evaluation by a third party who will determine whether such targets are ambitious for that particular borrower and that borrower's industry.
	3. <u>Reporting</u> There is no standard methodology for reporting on sustainability performance targets. The methodology will be determined by a borrower's chosen sustainability performance targets. A borrower should maintain and keep readily available up to date information relating to its sustainability performance targets. Such information should be provided to a lender at least once a year. Where possible a borrower should be encouraged to publicly report information relating to its sustainability performance targets. This information will usually be included in a borrower's annual report or its sustainability report.

	4. <u>Review</u> The requirement for an external review is generally agreed between a borrower and a lender. If information relating to a borrower's sustainability performance targets is not public, a borrower is recommended to seek an external review of its performance against its sustainability performance targets. Where an external review is sought this should be independently verified by a qualified external reviewer, such as an auditor, environmental consultant and/or independent ratings agency at least once a year.
Should any additional representations and warranties be included in a facility agreement?	A borrower should be under an obligation to represent the accuracy of any reporting.
Should any additional information undertakings/covenants be included in a facility agreement?	Information undertakings/covenants relevant to a borrower's sustainability performance targets should be clearly identifiable in a facility agreement.
Should any additional events of default be included in a facility agreement?	A borrower and a lender should consider whether or not a failure by a borrower to accurately report on its sustainability performance targets or meet its sustainability performance targets will trigger an event of default under a facility agreement.

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