

INSIGHTS

Is the "S" in ESG Poised for a Breakout Year in 2022 for Sustainability-Linked Loans?

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If last year was any indication, 2022 may be another record-setting year for the sustainable syndicated loan market. According to financial data provider Refinitiv, new issuances of sustainability-linked loans ("SLLs") climbed to \$717 billion in 2021, an increase of more than 300 percent year-over-year from 2020. As appetite for sustainability-linked credit facilities grows, lenders should also be prepared to address the evolving requirements of borrowers in this market. Traditionally, SLLs have been aligned more toward the environmental component of a borrower's Environmental, Social, and Governance (ESG) strategy; however, as borrowers carve out more space for non-environmental goals in their ESG strategies, SLLs are now increasingly incorporating social goals as well, either on a stand-alone basis, or in addition to environmental (and/or governance) goals.

For the uninitiated, sustainability-linked loans are a type of loan instrument designed to incentivize borrowers to achieve certain predetermined environmentally and/or socially sustainable objectives. A distinguishing feature of an SLL is that a particular economic outcome, usually a reduction (or increase) in the loan's pricing, is made contingent upon the borrower's satisfaction of (or failure to satisfy) sustainability performance targets (SPTs) that correspond to certain predetermined key performance indicators (KPIs). Unlike green loans, SLLs do not require the loan proceeds to be used for a green or sustainability-related project, and may be used to fund any general corporate purpose.

The growing interest among borrowers in the social aspects of ESG comes as diversity and inclusion (D&I) initiatives have gained wider acceptance and workers are increasingly returning to the office, making employee health and safety a renewed corporate priority. As a partial reflection of this trend, in April 2021, private equity firm Blackrock amended its \$4.4 billion revolving credit facility, introducing a sustainability-linked pricing mechanism that references three separate KPIs, two of which (Black, African American, Hispanic and Latino Employment Rate and Female Leadership Rate) are socially-oriented. In the ensuing months, we have also seen more and more borrowers, including the following, incorporate one or more social KPIs into their SLLs:

- The Southern Company (Diverse Supplier Spend);
- American Campus Communities Operating Partnership LP (Diversity Employment Rate, Diversity Director Rate);

- HP Inc. (Percentage of Black and African Americans among US-based Executives);
- Autodesk, Inc. (Women in Technical Roles); and
- Enerplus (Average 3-year Lost Time Injury Frequency rate).

Choosing KPIs

When incorporating social-oriented KPIs into an SLL, lenders and borrowers will generally establish KPIs that are bespoke to the borrower. This approach provides lenders and borrowers with added flexibility to ensure the loan's sustainability provisions closely conform to the Sustainability Linked Loan Principles (SLLP).¹ KPIs that adhere closest to the SLLP will be both core to the borrower's business, relevant to the sustainability challenges confronting the borrower's industry, and capable of being benchmarked.

Importantly, the loan's KPIs should also be linked in some fashion to the ESG strategy of the borrower or its parent. A review of an organization's ESG materiality assessment can provide a basis for lenders to evaluate which sustainability topics (whether environmental, social, or governance oriented) are most important to a borrower's business and its stakeholders. Lenders should be wary of establishing KPIs that have not been previously documented by the borrower or otherwise established as an internal company priority. An SLL containing KPIs lacking demonstrable connection to a borrower's business or policies can raise questions of so-called "sustainability-washing," which poses a reputational risk to all parties of the loan.

Alternatively, lenders and borrowers may also choose to adopt a KPI that references a sustainability rating issued by an independent ESG rating agency, such as MSCI, Sustainalytics, or V.E (formerly known as Vigeo Eiris). Using their own internal methodologies, ESG rating agencies will calculate a borrower's sustainability performance relative to that of the borrower's industry peers. The use of such a rating agency can also have the benefit of lending an additional aura of credibility to a firm's ESG reporting, as ESG rating agencies will normalize scores within a given sector, providing additional context to investors.

Calibrating SPTs

In accordance with the SLLP, borrowers should have significant input in developing the SPTs, which must remain ambitious throughout the loan's term. SPTs, including for social KPIs, may be based on one or more benchmarking approaches, including an assessment of the borrower's own performance over a period of time, a comparison of a borrower's performance relative to that of its peers, or by reference to other systematic, science-based proxies, including targets that may already be set on the national, regional, or international level. SPTs should not be set at lower levels, or on a slower trajectory, than any other related targets that may have already been set by the borrower in internal strategies or elsewhere.

Generally, SPTs will be structured to target an improvement of a borrower's own performance under the relevant metrics. To ensure that these SPTs remain ambitious, lenders and borrowers can elect to incorporate a moving baseline. Using this methodology, each year, the borrower's performance from the prior year is incorporated into the SPT and will require a set degree of improvement over that baseline from the prior year to meet the SPT.

Verification

Pursuant to the May 2021 release of the SLLP, lenders and borrowers are now required to

obtain verification from an independent and external reviewer as to a borrower's performance against all SPTs. This review must occur at least once a year and is frequently performed by the borrower's financial auditor, but any qualified external reviewer with the requisite experience, such as an external consultant or ESG ratings agency, can perform the review. The reviewer's verification is typically issued in the form of an independent audit or assurance statement that is provided where the borrower reports its performance, often in its financial statements or ESG reporting documents.

Outlook

As the SLL market continues to mature, it is likely more changes to market standards await borrowers and lenders. As borrowers continue to refine their ESG strategies to incorporate more social and governance issues, it is likely they will seek to harness the reputational benefits of doing so by including more KPIs related to those issues in their SLL packages. Additionally, with the growing number of SLL issuances, "sustainability washing" will remain an ongoing concern in the market. The May 2021 revisions to the SLLP established the verification requirement, in part, to head off "sustainability washing" and preserve the integrity of the SLL product. In light of these risks, lenders and borrowers would be well advised to incorporate additional flexibility into their loan documents, particularly with respect to the rights to modify and adjust sustainability targets as well as requirements related to reporting and verification.

1. The Sustainability Linked Loan Principles are a set of high-level market standards designed to promote the development of sustainable loans published by the Loan Market Association (LMA), the Asia Pacific Loan Market Association (APLMA) and the Loan Syndications and Trading Association (LSTA).