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ESG Alert

What Is a Sustainability-Linked Loan, and Should My Company Get One?

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Under pressure from shareholder groups, investors and customers, you might already have "green initiatives" in your business plan, and you probably have already identified risks related to climate change and other social and environmental factors. Is there a way to cash in on what you are already doing by accessing the growing market for sustainability-linked loans (sometimes referred to as ESG-linked loans)? Here we will refer to these loans as sustainability-linked loans or SLLs.

What is a sustainability-linked loan? Is it the same as a "green loan"?

A "green loan" is structured like a typical loan, the only difference being that the proceeds of a green loan must be used for specific environmental or sustainability initiatives. In contrast, a sustainability-linked loan can be used for any general business purpose but provides the borrower with better pricing if it meets certain sustainability performance metrics. Because there is more flexibility regarding use of proceeds, these SLLs are more accessible to most companies than green loans, particularly for companies that are already tracking and accounting for Environmental, Social and Governance (ESG) criteria. As a result, together with increased political and investor focus on green initiatives, the market for these loans is skyrocketing. Bloomberg News recently reported that in the U.S. market, $52 billion worth of sustainability-linked loans were funded between January 1 and May 21 of this year, which represents nearly a three-times increase of all such loans funded in 2020. Experts expect the SLL market to only grow from here.

How are ESG metrics measured in sustainability-linked loans, and is it expensive to comply?

From a documentation perspective, sustainability-linked loan agreements can be drafted with only small differences from a traditional credit agreement. The key feature of an SLL is that certain specified ESG metrics reduce the borrower's interest rate margin (in the same way that some credit agreements allow for the reduction in margin as the borrower's leverage ratio decreases). There are also additional reporting requirements, typically including the delivery of a sustainability report to the lenders on an annual basis detailing the company's performance with respect to the selected ESG key performance indicators.

With respect to tracking the ESG metrics, while there are still many independent agencies offering ESG rating services, the market leader is the Sustainability Accounting Standards Board (SASB). The Loan Syndications & Trading Association (LSTA), which is the loan market trade organization, has adopted the SASB metrics into its ESG due diligence request list, which it recommends all investors solicit in connection with any loan origination process. The SASB standards are narrowly tailored to a borrower's industry, highlighting key ESG performance indicators that are reliably quantifiable and externally verifiable. SASB has created an accessible and user-friendly "materiality map" that sets out the particular key ESG performance indicators for any given business. Because the metrics are specific to the industry and easily quantifiable, these are often key performance indicators that companies are already tracking for purposes of preparing annual reports, lender presentations or perhaps even sustainability self-reports. Ideally, borrowers can leverage the data they are already collecting to improve pricing on their sustainability-linked loans.

The LSTA's latest guidance recommends that SLLs include third-party input on the selection of the ESG key performance indicators and also third-party monitoring and verification of those key performance indicators. While this approach potentially increases associated costs, the standardization of requirements and the use of an expert promise to increase efficiency in loan documentation and ongoing loan administration. An added benefit for some borrowers will be that this approach aligns the loan market with the sustainability-linked bond market monitoring requirements, making it easier for a company to refinance from one market to the other.

If my company doesn't get a sustainability-linked loan, do we have to worry about ESG disclosure?

As SLLs are becoming more common, investors are more often expecting ESG disclosure in connection with traditional credit facilities. As mentioned above, the LSTA has prepared a form ESG due diligence questionnaire (ESG DDQ) that it recommends investors require borrowers to complete and provide to the public-side data room in connection with any origination due diligence process. The ESG DDQ asks the company about its ESG-related policies and procedures and links to the SASB "materiality map". Increasingly, investors are viewing ESG risk as a material consideration in their overall credit analysis for any borrower in any industry. Borrowers can therefore expect to see diligence requests related to ESG whether or not they are tapping into the sustainability loan market.

Also, credit ratings firms are beginning to take ESG risk into account in their ratings process. Recently, ratings firms have adjusted their ratings of several oil and gas companies based on climate risk to the business. Credit downgrades can increase an issuer's cost of borrowing.

Given this reality, it might be a good time to explore accessing this growing source for additional debt financing.

For more information on this topic, please contact Anne Seymour, Tom Draper, Malcolm Henderson or another member of the Debt Finance or ESG groups.

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