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Focus on... Sustainability Linked Loans

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Sustainability linked loans ('SLLs') are loans where a proportion of the interest rate is linked to the borrower's ability to meet sustainability targets. They can help to bolster a company's existing ESG strategy, regardless of how advanced it is. Such loans are not new, but they are evolving. On 23 February 2023, the LMA published revised versions of the Sustainability-Linked Loan Principles ('SLLPs') and the accompanying guidance. The revised versions are intended to reflect market developments and ensure that these publications continue to promote the development and integrity of SLLs.

From 9 March 2023 any new loan, or extension or refinance of an existing loan will need to comply with the new principles to be classified as a SLL. All transactions completed prior to 9 March 2023 will still be reviewed in light of the principles in force at the time they were signed.

What is an SLL?

SLLs incentivise borrowers to accelerate their ESG performance by setting sustainability performance targets ('SPTs'). A borrower's progress is then measured against key performance indicators ('KPIs').

If a borrower reaches their SPTs there is a loan price adjustment - margin rates are decreased. Borrowers are not required to use the loan proceeds for specifically green initiatives. This is the key difference between SLLs and green loans. This means that obtaining an SLL can therefore help companies to future proof themselves and assist with current financing needs.

Key changes

- SPTs to be 'beyond regulatory required targets'
  The SLLPs build on the existing benchmark: 'beyond business as usual', (which remains in force) and state that the SPTs should never be less than a publicly announced target. Both provisions help to ensure that SPTs are robust. To avoid accusations of greenwashing, SPTs must also remain 'relevant and ambitious throughout the life of the loan.'
- Engagement of lender group
  Lenders must make their own assessment of SPTs – lenders must satisfy themselves that proposed SPTs are material and ambitious. The SLLPs stress that lenders cannot rely on sustainability coordinators whose role is to provide 'market colour'.

- **Margin ratchet**
  The SLLPs, informed by market practice, now include a two-way margin ratchet, which will go down if targets are met and up if they are not. The potential increase if targets are missed is new.
- **Labelling**
  SPTs must be agreed in advance before a loan can be labelled an SLL. The SLLPs do not comment on when KPIs should be set. However, as SPTs and KPIs work together, the SLLPs effectively extend to both.
- **Independent verification**
  During the term of the loan, borrowers must obtain independent external verification of their performance against each SPT for each KPI, which will be reviewed by the lender. It is important to note that while much of the SLLPs is subjective, external verification is compulsory and must be carried out by a qualified external reviewer.

What's next?

To assist new entrants, the LMA is currently drafting an SLL rider, which is expected to contain a set of clauses and drafting options for SLLs. These are likely to be very broad brush given the nature of the market but will provide a useful starting point for negotiations. We await the clauses eagerly and hope to provide further comment on this in the future.