Guidance on Green Loan Principles and Guidance on Sustainability Linked Loan Principles

Finance Alert

Environmental Alert

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By: Glenn A. Reitman

Sustainable finance is clearly becoming an important part of the US finance market. The LSTA, LMA and APLMA in the US established their Sustainable Finance Working Group and tasked it with the maintenance of their Green Loan Principles (GLP) and Sustainability Linked Loan Principles (SLLP). The GLP and SLLP were published in 2018 and 2019, respectively. On February 3, 2020, the LSTA distributed an ESG Due Diligence Questionnaire (ESG DDQ). The ESG DDQ is intended to "be completed by the borrower during the due diligence phase of the loan origination process." Recently, on May 5, 2020, the LSTA, together with LMA and APLMA published Guidance on Green Loan Principles (G-GLP) and Guidance on Sustainability Linked Loan Principles (G-SLLP). These guidelines are considered to be framework and intended to be flexible in order to adapt to the development and growth of sustainability linked loans. Although Green Loans and Sustainability Linked Loans are similar in goal,[1] they are different financial products and should be viewed accordingly.

Green Loan Principles

At the core of a Green Loan is the principle that the loan proceeds will be used for "Green Projects." The Green

Loan Principles provide a laundry list of categories eligible for Green Projects, but that list is not considered exhaustive.[2] There are four core components of a Green Loan according to the GLP:

- Use of proceeds
- Process for project evaluation and selection
- Management of proceeds
- Reporting

Use of proceeds

As first discussed above, the "fundamental determinant" of a green loan is that the loan proceeds are used for Green Projects.[3] The Green Projects should be appropriately described in the finance documents (and marketing materials). Additionally, the G-GLP provides guidance that borrower should be prepared to provide and keep available, up to date information on the use of proceeds. The G-GLP indicates that annual reporting of updates (or when there is a materials event) is appropriate. The G-GLP provides for what type of information should be provided:

- List of the Green Projects to which the green loan proceeds have been allocated and the basis on which they have been designated Green Projects
- A brief description of the projects
- The amounts allocated and
- The expected environmental impact, if possible.

The G-GLP notes that the borrower and lender(s) may agree that the information provided should be reviewed by an external reviewer and that additional reporting on use of proceeds is appropriate.

Process for project evaluation and selection

The GLP suggests that borrowers are encouraged to position the information within the context of their overarching objectives, strategy, policy and/or processes relating to environmental sustainability. Ultimately, lenders will have developed criteria and policies. The G-GLP recognizes current international and national initiatives to produce taxonomies[4] in an effort to provide independent standards for projects and ensure comparability. However, until such time as there is consensus on developed taxonomies, the stakeholders (borrower, investor, lenders) may have different strategies and objectives that will need to be in conformity in order for the borrower to administer the Green Project and the Green Loan.

It is interesting to note that the G-GLP suggests that proceeds used to improve energy efficiency on projects associated with fossil fuel production or industrial processes linked to fossil fuel production are potentially eligible, as long as the loan funding such projects is aligned with the four components of the GLP and the borrower has committed to an ambitious decarbonatization pathway reasonably aligned to the Paris Agreement. [5] Further, since the focus of a Green Loan is on projects, as opposed to an overall ESG[6] rating of a borrower, it is possible that a borrower with a low ESG rating can obtain a Green Loan. However, the G-GLP suggests that additional reporting and scrutiny may be required for such borrowers.

Management of proceeds

The GLP suggests that borrowers should dedicate a separate account that can be tracked by borrowers to maintain transparency and promote integrity of the product. Borrower are encouraged to establish internal governance processes to track the allocation of funds towards Green Projects.

Reporting

Reporting is one of the most important characteristics of a Green Loan, as it is with any loan. Internally prepared information will be the main data aggregator for the status of a Green Project; however, a standard of review of such information will need be developed. In finance, external review of information is appropriate, although the GLPs do not rule out self-certification by borrowers.[7] Both borrowers and lenders seek consultant review in order to verify information provided by the borrower or otherwise audited.

The following are suggested standards in the GLP:

- ***Consultant review*** – advice from consultants and/or institutions with recognized experience in environmental sustainability or other aspects of the administration of the Green Loan (i.e., second party opinions).
- ***Verification*** – independent verification of a borrower's Green Loan, associated Green Loan framework, or underlying assets by qualified parties (auditors or independent ESG rating providers)
- ***Certification*** – certification of a borrower's Green Loan or associated Green Loan framework against an external green assessment standard.
- ***Rating*** – rating of a Green Loan or associated Green Loan framework by qualified third parties (*ie,* specialized research providers or rating agencies).

Ultimately, the process and method of reporting and review will develop over time with an emphasis on a lender's internal requirements and the borrower-lender relationship as driving factors.

Documentation and breach

It is important to note that the G-GLP has indicated that there are currently no templates for provisions or terms to be used in connection with Green Loan documentation and no established market standard in relation to what will constitute a "green" breach. The G-GLP provides drafting considerations for both:

- ***Purpose/use of proceeds provisions*** – The eligible green project categories should be clearly set out in the purpose/use of proceeds category.
- ***Information undertaking/covenants*** – Information undertakings/covenants relevant to the Green Project should be clearly identifiable.
- ***Representations*** – the borrower should be under an obligation to represent the accuracy of any reporting.

Determining the severity of a breach of the foregoing covenants will likely be negotiated among the loan parties.

Greenwashing

The G-GLP defines "greenwashing" as situations in which a borrower or project's claims to have green credentials are misleading.[8] The G-GLP suggests that market participants need to be diligent in their efforts to preserve the integrity of Green Loans as a financial product. Lack of integrity in Green Loans may have negative consequences, such as reducing investor confidence, triggering litigation, and reducing overall use of Green Loans as a product.

Sustainability Linked Loan principles

As opposed to a Green Loan in which proceeds are tied to sustainable assets and investments, a Sustainability Linked Loan is a financial product which incentivizes the borrower's achievement of "predetermined sustainability performance objectives."[9] Measurement of these objectives is obtained by using specific sustainability performance targets (SPTs) which include key performance indicators, external ratings or other metrics which measure improvements. These measurements should be viewed as being a part of an overall covenant package, similar to achieving a rating by a ratings agency. It is likely that most sustainability linked loans will be used for general corporate purposes and working capital and not necessarily tied solely to the overall ESG strategy of the borrower.

The SLLP and G-SLLP provide us with four characteristics of a Sustainability Linked Loan:

- Relationship to borrower's overall sustainability strategy
- Target setting – measuring the sustainability of the borrower
- Reporting
- Review

Each of these characteristics has processes, procedures and policies that may differ with each lender, but ultimately the goal is to set out minimum uniform standards for lenders to follow.

Relationship to borrower's overall sustainability strategy

In order for there to be a target to achieve, there needs to be an internal policy or program in place. Similar to any other strategy, a borrower's sustainability strategy should be communicated to its lenders and aligned with its sustainability performance targets. In its simplest form, where the borrower controls the overall direction and strategy of its sustainability policy, there are not as many issues. However, it is highly likely that the sustainability strategy and policy is set forth on a consolidated basis since, in many circumstances, borrowers are consolidated with their ultimate parent. The industry will need to address how a borrower’s consolidated sustainability strategy and policy directly impact a borrower that is a subsidiary of a holding company. Similar questions arise with respect to any guarantors. Lenders will need to take into account an overall sustainability policy that is "fit to purpose" for the borrower, its parent and any guarantors.

Target setting – measuring the sustainability of the borrower

A borrower’s sustainability performance target is intended to be "ambitious and meaningful" to the borrower’s business but it needs to be tied to a predetermined benchmark.[10] The SLLP suggests negotiating the predetermined benchmarks with the assistance of one or more "Sustainability Coordinators" or "Sustainability Structuring Agents."[11] These may be internal or external specialists that understand the "fit for purpose" goals of the borrower or its overall organization. The SPTs are negotiated and set between the borrower and lender(s) for the life of the loan. The G-SLLP provides methodologies for selection of SPTs which may include utilizing:

- ESG metrics and targets included in the borrower’s sustainability strategies and/or policies
- External analysis to establish sector-specific ESG criteria and best-practice performance and/or
- Verified industry metrics reported against frameworks, with verification or evaluation by civil society organizations or external reviewers who will determine if SPTs are ambitious for the borrower or the borrower’s industry, and/or align the SPTs to existing regulatory targets.[12]

The predetermined benchmarks will need to be used as the baseline for testing the SPTs after a particular period of time. The SLLPs suggest that data on a rolling 6-12 month period could be used.[13] The benchmarks and SPTs could be based on internal fit-for-purpose goals and tested against their own program or tested against external standards. Achieving the target will be incentivized by reductions in pricing. The SLLP suggests margin reduction is the key incentive.[14]

Careful thought should be given to how the SPTs and any possible reduction in margin could impact other financial covenants concerning such areas as minimum liquidity, maximum G&A expenses, or maximum capital expenditures. Operating budgets of a borrower will need to take into account the increase in cost regarding achieving each sustainability target. However, the largest driver of these programs and incentives is taking place in the investor and capital markets areas, which indicates that this overall shift will become standard practice in most industries.

Reporting

Data is always the key to measuring a target, whether it is a certification for a borrowing base in an asset-based loan or financial statements being used to calculate a leverage ratio. Borrowers will need to report up to date data related to their sustainability performance targets. The SLLP suggest reporting on at least on annual basis.[15] Similarly with a reserve-based oil and gas loan which uses a reserve report to determine the value of a borrower’s oil and gas reserves, borrowers (and lenders) may want to seek outside opinions or reports regarding the reporting which provides agreed upon methodologies and assumptions. Consideration should be given to tying the collection of data and reporting to uniform standards of the methodologies and assumptions. The G-SLLP indicates that there are several sustainability reporting methodologies existing in the market today. The Global Reporting Initiative’s Sustainability Reporting Standards provide widely adopted global standards for sustainability reporting.[16] Additionally, "ESG Ratings"[17] have been developed by the major ratings agencies, and these ratings have methodologies and assumptions that can be agreed upon as the standards to be used in reporting.

Review

The SLLP suggests that external review is to be negotiated and agreed upon between borrower and lenders on a transaction by transaction basis.[18] Depending upon whether the borrower is publicly traded or private will determine the extent and necessity of external review. However, from a borrower standpoint, having the ability to seek independent verification through some form of audit process should be permitted so that the borrower can determine whether or not it has achieved its performance targets. This is especially important if the borrower is going to invest in its sustainability goals and increase its costs to do so.

SPTs

The SLLP provides an appendix with examples of SPTs. The categories concern energy efficiency, greenhouse gas emissions, renewable energy, water consumption, biodiversity and similar categories of sustainability and conservation.

Sustainability washing

The G-SLLP defines "sustainability washing" as situations in which claims on sustainable credentials are misleading, inaccurate or inflated.[19] The G-SLLP indicates that sustainability washing can occur in two key ways: either though SPTs that are not sufficiently ambitious or meaningful; or through inaccurate monitoring, measuring and disclosing of borrower performance against SPTs. The first issue is addressed by setting appropriate SPTs: the SLLP provides a framework to ensure that targets are appropriately ambitious and meaningful. The second issue is addressed by close adherence to reporting standards by market participants. As with Green Loans, market participant and stakeholder involvement will be the main drivers of the integrity of Sustainability Linked Loan products.

Conclusion

The efforts of the APLMA, LMA and the LSTA to work together to form the GLP, SLLP and each of the guidance documents shows the increase in market acceptance of sustainable finance. Armed with these guidelines and standards, we can foresee an increase in sustainable finance documents and projects in the near future.

Learn more about the Green Loan Principles and Sustainability Linked Loan Principles and their impact on your business by contacting the author.

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[1] Both Green Loans and Sustainability Linked Loans aim to "facilitate and support environmentally sustainable economic activity" according to the GLP and SLLP.

[2] GLP, Appendix 1

[3] The GLP also provides that Green Projects includes other relating and supporting expenditures, including R&D.

[4] Definitions, standards and catalogues.

[5] G-GLP, page 4. The "Paris Agreement" is the Paris Agreement under the United Nations Framework Convention on Climate Change, signed in 2016.

[6] "ESG" stands for environmental, social and governance rating. The ESG DDQ provides a question (Question 8) which asks a borrower to provide its percentage of revenue derived from certain activities which are generally as activities that reduce a company’s ESG rating.

[7] The GLP suggests that the borrowers may be in the best position to self-certify based on experience with the Green Projects and that the borrower-lender relationship may ultimately govern the content and process of any review.

[8] G-GLP page 3.

[9] SLLP, page 1. The G-SLLP suggests that it is any type of loan financing where there is "an economic impact tied to the borrower’s achievement (or not) of pre-determined SPTs." G-SLLP, page 3.

[10] SLLP, page 1.

[11] SLLP, page 1.

[12] G-SLLP, page 4.

[13] SLLP, page 1, G-SLLP, page 4.

[14] SLLP, page 1

[15] SLLP, page 1

[16] G-SLLP, page 4

[17] These ratings determine environmental, social and governance risk and performance.

[18] SLLP, page 2

[19] G-SLLP, page 3.

AUTHORS

Glenn A. Reitman
Partner
Houston | T: +1 713 425 8400
New York | T: +1 212 335 4500
glenn.reitman@dlapiper.com