Cassels

Sustainability-Linked Loans: Growth of the Sustainable Financing Market and Considerations for Borrowers

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The sustainable financing market has seen considerable growth in recent years as environmental, social, and governance (ESG) concerns continue to be a focus for businesses and financial stakeholders. This growth has been driven, in part, by the use of general-purpose sustainability-linked loans (SLLs). In 2021, sustainability-linked loan issuances more than quadrupled in terms of aggregate loan value, and roughly quadrupled in terms of deal count, from 2020.[1]

An SLL is any type of loan instrument that is structured to incentivize the borrower to achieve meaningful predetermined sustainability objectives. Unlike green loans, which require loan proceeds to be used solely for a green purpose or project, SLLs allow borrowers to use loan proceeds for general corporate purposes. This flexibility, combined with the opportunity to enhance a borrowers overall sustainability profile and credibly signal its ESG commitments to external stakeholders, while also reducing borrowing costs, has made SLLs an attractive debt financing option for Canadian borrowers since they were first introduced in the Canadian loan market in 2019.

Sustainability-Linked Loan Principles

Borrowers and lenders can refer to the Sustainability-Linked Loan Principles (SLLPs) for guidance on SLLs in global markets, including Canada. First published in 2019 jointly by the Loan Market Association (LMA), the Loan Syndications and Trading Association (LSTA), and the Asia Pacific Loan Market Association (APLMA), the SLLPs have since undergone two iterations. As of writing, the latest iteration of the SLLPs was published in March of 2022.

The SLLPs set out a framework of voluntary recommended guidelines to help market participants understand the characteristics of SLLs and apply the principles on a deal-specific basis. The SLLPs outline five core components of SLLs, being (1) selection of key-performance indicators (KPIs), (2) calibration of sustainability performance targets (SPTs), (3) loan characteristics, (4) reporting, and (5) verification.

Framework of SLLs

The general framework of an SLL requires the borrower and lenders to select KPIs relevant to the borrower’s business and then agree upon SPTs that are tied to those KPIs. If the SPTs are achieved, the borrower will typically be rewarded with lower interest and fees. Failure to achieve an SPT will not result in an event of default under the loan agreement, but the borrower may be penalized with higher interest and fees. Generally, adjustments to interest rates have been relatively modest to date, typically around +/- 5 basis points in the aggregate. Lenders, often through a sustainability agent, will determine whether a borrower has achieved its SPTs through reporting and verification of the borrower’s performance.

The SLLPs note that the credibility of the SLL market depends on the selection of appropriate KPIs. As such, borrowers and lenders will typically select KPIs (and the corresponding SPTs) in consultation with a sustainability agent. The KPIs should be material to the borrower’s business and sustainability strategy, address relevant ESG challenges of the borrower’s industry sector, be measurable and quantifiable, and be able to be benchmarked against an industry standard. In addition to the guidelines for KPI selection outlined by the SLLPs, borrowers should identify the KPIs that will have the greatest impact/improvement on the borrower’s ESG profile. The SLLPs include an appendix that contains example categories of KPIs, along with improvements that those KPIs may seek to measure.

Once appropriate KPIs have been selected, ambitious and meaningful SPTs are developed. Each SPT should represent a material improvement in its respective KPI and be tied to a predetermined performance target benchmark with clear timelines throughout the life of the loan. Where relevant, SPTs should refer to verified baseline or science-based reference points along with a rationale for using that baseline or reference point. Examples of SPTs could include reductions to greenhouse gas emissions, achievement of zero waste in production plants, improvements to energy efficiency, improvements to diversity at board and management levels, improvements to the borrower’s ESG rating or an achievement of a recognized ESG certification. If the predetermined SPTs are achieved by the borrower in the specified timeline, then the financial incentives incorporated in the loan agreement will be triggered and the borrower will benefit from reduced borrowing costs as a result.

Generally, independent and external verification of the borrower’s performance with respect to each SPT (where possible/applicable) will occur at least annually. Such verification is a necessary component of the SLLPs, and can be completed by an auditor, environmental consultant, or independent ratings agency.

Tips for Borrowers

In order to access the benefits that an SLL can provide, borrowers must have established internal sustainable policies and processes in place, as any proposed SPTs will need to be consistent with the borrower’s overall sustainability strategy. Clear sustainability objectives, internal expertise or sustainability personnel, relevant historical data and audit processes are all considerations that lenders may take into account.

Borrowers that do not have a developed ESG strategy should monitor relevant KPIs and SPTs in the borrower's industry to get a sense of what the market views as relevant.

There has also been a trend of "sleeping" SLLs, being those loans that either (1) do not have a sustainability link feature included at origination, but which have provisions for a future streamlined amendment to incorporate a sustainability link feature or (2) have an SLL mechanism in the loan documentation, but provided that KPIs and/or SPTs will be determined in the future. Many have argued that "sleeping" SLLs do not meet the SLL criteria and, as such, borrowers should be aware that lenders may resist this approach and, to the extent this approach is adopted, it may not have the intended impact on the borrower's overall sustainability profile.

As sustainable financing continues to become more prominent in the market among growing stakeholder demands, borrowers, particularly those who are already engaged in ambitious ESG initiatives and sustainability targets, may consider an SLL structure for their general corporate credit facilities or other debt financing arrangements. Any type of bilateral or syndicated loan facility can be adapted as an SLL by incorporating SPTs and financial incentives. Once SPTs have been established, amendments to existing loan documentation are relatively straightforward. As a rule of thumb, borrowers should expect the documentation process to take roughly 4-5 weeks (3 weeks to draft and negotiate and 1-2 weeks for lenders to consider and execute). Although there are currently no standard templates for SLLs, it is expected that model credit agreement provisions will be made available by trade associations for use by lenders in the near future, which should assist in streamlining the SLL process.

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[1] Source: Loan Syndications and Trading Association (LSTA)
