

Sustainability-Linked Finance Takes Off in 2020

A series of recent developments has driven a rapid increase in sustainability-linked loan and bond issuances in a variety of jurisdictions and industries.

Background: Sustainability-Linked vs. Activity-Based

The market for sustainability-linked loans (SLLs) and bonds (SLBs) is developing rapidly. In contrast to green loans and bonds, SLLs and SLBs are performance-based — rather than an activity-based — sustainable finance instruments, meaning that:

- There are no restrictions on the use of proceeds from an SLL/SLB — the issuer/borrower can use the proceeds for any purpose, not just for ‘green’ expenditure and activities.
- The terms of an SLL/SLB (usually the interest rate) will vary depending on the performance of the issuer’s or borrower’s business instead of pre-defined sustainability performance targets (SPTs):
 - Typically, there will be no other adverse contractual consequences (i.e., breach of covenant, event of default, etc.) if an issuer or borrower fails to achieve its applicable SPT(s).
 - The type and level of the relevant SPT(s) selected will depend on the sector and business model of the particular issuer/borrower, but should be ambitious, measurable, and aligned with the issuer’s/borrower’s long-term sustainability strategy.

Issuers and borrowers are increasingly turning to SLLs/SLBs in order to:

- Optimize pricing, liquidity, and cost of capital by taking advantage of the excess demand for sustainable finance products amongst institutional investors and financial institutions
- Raise sustainable finance while retaining full flexibility to apply the proceeds therefrom
- Evidence and demonstrate their ESG credentials

In turn, financial institutions and institutional investors are increasing their participation in SLLs/SLBs as they:

- Have made huge commitments to finance sustainable objectives and goals, and are facing a relative under-supply of eligible financing opportunities — SLLs/SLBs are an effective way for them to allocate capital to meet their sustainable investment targets
- Are able to support and incentivize issuers and borrowers to transition their businesses towards sustainability
- Retain full recourse to the borrower or issuer
- Can ensure, through the terms of the instruments, that the borrower's or issuer's SPT are subject to external verification or quantifiable reporting
- Have the opportunity to evidence and demonstrate their own ESG credentials

Sustainability-Linked Loans

The SLL market has grown significantly since the inaugural SLL in 2017. In recent months, borrowers across a wide range of jurisdictions (including in Europe, Russia and the Commonwealth of Independent States (CIS), and the Americas) operating in various sectors and industries have entered into SLLs (both syndicated and bilateral) for a variety of purposes, including to finance takeovers, refinance existing loans, spend capital, and for general corporate purposes. The Loan Market Association published the first Sustainability-linked Loan Principles (SLLPs) in 2019, setting out voluntary, but market-leading best practice and guidance for SLLs, under which:

- A borrower should clearly communicate to the lender(s) its sustainability strategy and how it is aligned with its sustainability targets
- A borrower and its lender(s) should agree applicable sustainability targets that are ambitious, measurable, and relevant
- A borrower should report information relating to its sustainability targets to its lender(s) at least once a year, and may also disclose such information publicly
- A borrower and its lender(s) should agree the extent to which an external review of its sustainability targets and performance may be appropriate, particularly if the borrower does not intend to publicly disclose its own reporting

SLLs have been linked to a variety of SPTs, including to a borrower's:

- Greenhouse gas reduction targets
- ESG or CSR rating
- GRESB Infrastructure score
- Employment targets
- Educational targets
- Employee safety targets
- Gender equality targets

An issuer and its lender(s) may determine the extent to which the (non-)satisfaction of an SPT will impact the terms of its SLL, with the most common approach being a decrease in margin upon the achievement of the SPT.

As private documents negotiated directly with the lenders, there is often more opportunity to tailor the SPTs for an SLL more precisely to the particular borrower's business and circumstances. Further, the parties may negotiate and agree SPTs that are not entirely within the borrower's control, such as SPTs which involve actions and interactions with employees and customers, including increasing the percentage of sales for certain types of products or reduced workplace safety incidents.

SLLs are Eurosystem collateral eligible¹ and may contribute to addressing the ECB's expectation that the pricing of loans by financial institutions will reflect credit risk as well as climate-related and environmental risks.²

Sustainability-Linked Bonds

The SLB market is only one year old, with the inaugural issuance occurring in September 2019. However, a series of recent developments has driven growth in the SLB market in second half of 2020:

1. In June 2020, the International Capital Markets Association (ICMA) published its Sustainability-linked Bond Principles (SLBPs), thereby providing a voluntary, but 'best-practice' framework for the issuance of SLBs, which is similar in form and structure to the ICMA's Green Bond Principles. The SLBPs contain five core components:
 - The selection of key performance indicators (KPIs) which should be relevant to the issuer's business and operations, and which are quantifiable or measurable, and externally verifiable
 - The selection of an SPT for each KPI that is suitably ambitious and aligned with the issuer's long term sustainability goals and strategy, and which must be assessed on a pre-defined timeline prior to the maturity of the SLB
 - The selection of bond characteristics that will vary (and the extent of such variation) if SPTs are not achieved
 - The issuer should publish relevant information on the KPIs and the SPTs on an annual basis
 - The issuer should obtain and publish an external verification report covering the performance of each KPI against each SPT on an annual basis

In addition, the ICMA recommends obtaining a pre-issuance second party opinion from an independent expert confirming the alignment of the relevant SLB with the SLBP and the relevance and robustness of the selected KPIs and SPTs.

2. In September 2020, the European Central Bank (ECB) announced that SLBs will become eligible as central bank collateral for Eurosystem credit operations and for inclusion in the ECB's Asset Purchase Programme and Pandemic Emergency Purchase Programme (subject to the satisfaction of general eligibility criteria) effective 1 January 2021. This demonstrates the European Union's continued support for sustainable finance, and in acknowledgement of the development of the SLB as a discrete instrument. Prior to this announcement, SLBs would not have been eligible for purchasing by the ECB because margin step-ups (the traditional means by which SPTs are documented) that are

not predefined over time were not permitted pursuant to the ECB's guidelines. Eligibility for Eurosystem collateral purposes further contributes to the liquidity of the instrument.

3. From September 2020, a number of issuers across a variety of sectors and geographies turned to SLBs to tap the sustainable finance market, including a leading European energy and utilities group (Issuer 1), a leading European fashion and textiles group (Issuer 2), a South American pulp and paper products manufacturing group (Issuer 3), and a leading European pharmaceuticals group (Issuer 4). All issuances were reportedly heavily over-subscribed, with at least one issuer noting it believes its SLB enabled it to obtain a financial advantage equal to 15 bps on pricing.

Although most issuances continue to provide for a 25 bps increase in the applicable interest rate in the event the relevant SPT(s) is/are not achieved, certain recent precedent instead provides for a premium payment of 50 bps and 75 bps, respectively, suggesting that the nature of the linked characteristics and the size of the interest rate step-up may continue to diversify as the market develops.

SUSTAINABILITY-LINKED BONDS			
Issuer, Industry, Jurisdiction	Description	Linked characteristic	Other
<ul style="list-style-type: none"> Issuer 1 Energy and utilities Europe 	<ul style="list-style-type: none"> US\$1.5 billion 2.65% notes due 2024 Issued September 2019 Reg S/Rule 144A Unlisted General corporate use of proceeds 	Interest rate rises from 2.65% to 2.90% unless an assurance report prepared by an external verifier confirms that, as of 31 December 2021, at least 55% of the Group's electricity generation installed capacity is derived from natural resources (excluding nuclear and fossil fuels).	<p>Issuer had not published a sustainability-linked financing framework at the time of issuance.</p> <p>An independent expert was prepared a limited assurance report for baseline numbers.</p> <p>In October 2019, the Issuer issued (i) an additional €2 billion of notes with a step up of 25 bps if the same sustainability target as the 2024 notes is not satisfied, and (ii) an additional €500 million of 1.125% notes due 2034 with a step up of 25 bps if Scope 1 emissions exceed 125 gCO₂/kWh by 2030.</p>

SUSTAINABILITY-LINKED BONDS			
Issuer, Industry, Jurisdiction	Description	Linked characteristic	Other
<ul style="list-style-type: none"> • Issuer 2 • Fashion and textiles • Europe 	<ul style="list-style-type: none"> • €300 million 0.5% notes due 2026 • €300 million 1.0% notes due 2031 • Issued September 2019 • Reg S only • Luxembourg stock exchange listing • General corporate use of proceeds 	<p>One-off premium payment equal to:</p> <p>50 bps under the 2026 Notes on a single date shortly prior to maturity unless an assurance report prepared by external verifier confirms that 100% of electricity used in the Group's operations is derived from non-fossil fuel sources from natural resources</p> <p>75 bps under the 2031 Notes on a single date shortly prior to maturity unless an assurance report prepared by external verifier confirms that the Group's (i) Scope 1 and 2 emissions are at least 50% lower than the base emission levels and (ii) Scope 3 emissions are at least 10% lower than the base emission level.</p>	<p>Issuer published a Sustainability-Linked Bond Framework in September 2020.</p> <p>Issuer obtained a second party opinion from Vigeo-Eiris on the KPIs and alignment with the (ICMA) Sustainability-Linked Bond Principles 2020.</p>
<ul style="list-style-type: none"> • Issuer 3 • Pulp and paper products manufacturing • Brazil 	<ul style="list-style-type: none"> • US\$750 million 3.75% notes due 2031 • Issued September 2020 • SEC registered • NYSE listing • Tender offer plus general corporate use of proceeds 	<p>Interest rate rises from 3.75% to 4.00% unless an assurance report prepared by an external verifier by 16 June 2026 confirms that the Issuer's Greenhouse Gas Emissions Intensity (Scope 1 plus Scope 2 emissions) is 0.190 tCO₂e/ton produced or less by the end of 2025, equivalent to at least an estimated 10.9% reduction</p>	<p>Issuer published a Sustainability-Linked Securities Framework in September 2020.</p> <p>Issuer obtained a second party opinion from ISS ESG on the KPIs and alignment with the (ICMA) Sustainability-linked Bond Principles 2020.</p>

SUSTAINABILITY-LINKED BONDS			
Issuer, Industry, Jurisdiction	Description	Linked characteristic	Other
		<p>as measured against the 2015 baseline year.</p> <p>Subject to applicable carve out for (i) emissions generated by any acquisitions since the issue date; and (ii) the impact of any material amendment to, or change in, any applicable laws, regulations, rules, guidelines and policies, applicable and/or relating to the production of pulp and finished paper following the issue date.</p>	
<ul style="list-style-type: none"> • Issuer 4 • Pharmaceuticals • Switzerland 	<ul style="list-style-type: none"> • €1.850 billion 0.0% notes due 2028 • Issued September 2020 • Reg S only • SIX Swiss Exchange listing • General corporate purposes, which may include the refinancing of existing debt 	<p>Interest rate rises from 0.00% to 0.25% from 31 December 2025 unless an assurance report prepared by an external verifier confirms that the Issuer achieved (i) Flagship Programs Patient Reach of at least 22,604,224 patients; and (ii) Strategic Innovative Therapies Patient Reach of at least 1,642,992 patients, in each case, during the year ending on 31 December 2025.</p>	<p>Issuer had not published a sustainability-linked financing framework at the time of issuance.</p> <p>Issuer obtained two separate second party opinions: one from the Access to Medicine Foundation on the social benefits of the 2025 Patient Access Targets, and the other from Sustainalytics on the social benefits of the 2025 Patient Access Targets and on the alignment of the notes to the (ICMA) Sustainability-linked Bond Principles 2020.</p> <p>An independent expert prepared a limited assurance report for</p>

SUSTAINABILITY-LINKED BONDS			
Issuer, Industry, Jurisdiction	Description	Linked characteristic	Other
			baseline patient reach numbers.
<ul style="list-style-type: none"> • Issuer 1 • Energy and utilities • Europe 	<ul style="list-style-type: none"> • £500 million 1.00% notes due 2027 • Issued October 2020 • Irish stock exchange and Borsa Italiana listings • Reg S/Rule 144A • Ordinary financing needs 	Interest rate rises from 1.00% to 1.25% unless an assurance report prepared by an external verifier confirms that, as of 31 December 2022, at least 60% of the Group's electricity generation installed capacity is derived from natural resources (excluding nuclear and fossil fuels).	<p>Issuer published a Sustainability-Linked Financing Framework in October 2020 which was reviewed by Vigeo Eiris who provided a second party opinion confirming that it is aligned with the (ICMA) Sustainability-linked Bond Principles 2020.</p> <p>An independent expert was prepared a limited assurance report for baseline numbers.</p>

4. For European issuers and financial products that are expected to be marketed in Europe, Regulation (EU) 2020/852 of 18 June 2020 (the EU Taxonomy Regulation) came into effect on 22 June 2020 and introduced an EU-wide classification for environmentally sustainable activities. In order to be labelled “environmentally sustainable” under the EU Taxonomy Regulation, which will begin to apply to eligible activities gradually from 1 January 2022, SLLs/SLBs must:
- Contribute substantially to one or more of six environmental objectives³
 - Not significantly harm any other such objective
 - Comply with applicable technical screen criteria (not yet published as part of delegated rulemaking)
 - Be carried out with certain safeguards

The best practices that are expected to be developed in respect of the “no significant harm” criterion will likely require further consideration in order to weigh SPT objectives against baselines and address the environmental and climate effects of the actions necessary or advisable to achieve the SPTs in a holistic manner.

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Endnotes

¹ Source: <https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200922~482e4a5a90.en.html>.

² Source: Expectation 8.5 at https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/climate-related_risks/ssm.202005_draft_guide_on_climate-related_and_environmental_risks.en.pdf.

³ Climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control and protection and restoration of biodiversity and ecosystems.