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What's Market: 2022 Year-End Trends in Large Cap and Middle Market Loan Terms

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Experts' View: Developments in ESG/Sustainable Finance

Betty M. Huber, Edward Kempson, Karmpreet Grewal of Latham & Watkins LLP discuss developments in the US ESG/Sustainable Financing market in 2022 and what to expect in 2023.

Sustainability-linked loans (SLLs) are any type of loan instruments and/or contingent facilities (such as bonding lines, guarantee lines, or letters of credit) which incentivize the borrower's achievement of ambitious, predetermined sustainability performance targets (SPTs). SLLs are intended to complement and enhance a borrower's existing sustainability strategy. Unlike other certain sustainable loan products (for example, green loans and social loans), borrowers are not required to use the proceeds of an SLL for a specific purpose.

In most instances, SLLs can be used for the borrower's general corporate purposes. Because of the SLL structure's flexibility and adaptability, SLLs are an attractive tool for borrowers from different industries, including those in hard-to-abate sectors, and at different stages of their sustainability journey.

How have sustainability-linked loan transactions evolved over time in the US and what are the latest trends you are seeing in the market?

We have seen significant growth in SLL transactions over recent years in terms of the volume of transactions taking place as well as the players involved in the transactions. For example, in 2022, global green loans and SLL volume exceeded $631.5 billion, setting a new record for dollars raised.

When we first started seeing SLL transactions back in 2017, the "first generation" of SLLs, borrowers were typically publicly listed companies sophisticated in the environmental, social, and governance (ESG) space and lenders were typically large financial institutions. Over time, SLLs have become more prevalent in the leveraged loan market and borrowers have expanded to include portfolio companies and other private companies. Participating lenders have also expanded to include smaller private credit providers and private financial institutions.

We are also seeing more variances in terms of the size and types of facilities, the tenor, the borrower's industry, as well as the scope and extent of pricing adjustments. For example, while most borrowers continue to be in the manufacturing or industrial sectors, there has been more growth recently in technology, media and telecom (TMT), pharmaceuticals, and healthcare. Also, initially the pricing adjustment was typically a one way (downwards) adjustment, but it is now more common for there to be a two-way adjustment (both upwards and downwards). There are also indications that higher ratchets could be considered, especially in sponsor deals. The latest evolution we are seeing are amendments to existing facilities, sometimes due to issues outside of the parties' control, such as new or changing rating methodologies where sustainability metrics are based on a third-party rating, or through the inclusion in loan documentation requiring or permitting the KPIs/SPTs to be amended during the term of the SLL in certain specified circumstances (e.g., acquisition by M&A activities, force majeure events and/or regulatory changes that materially affect the borrower's business and/or the KPIs and SPTs).

Overall, as the market expands to include less sophisticated borrowers, we are seeing that lenders and sustainability coordinators or sustainability structuring agents are playing a bigger role in assisting borrowers in determining relevant and material KPIs and appropriately ambitious SPTs. Additionally, as greenwashing and social washing scrutiny is intensifying, there has also been an increased focus on KPIs and SPTs, with the LSTA's most recent SLL guidance, published in February 2023 and effective for transactions entered into after March 9, 2023, referencing ICMA's latest Illustrative KPI Registry among other external tools that borrowers may reference when benchmarking KPIs.

What are some of the risks associated with sustainability-linked loan transactions and what actions can lenders take to mitigate those risks?

Lenders should be mindful of reputational risks, litigation risk, and possible regulatory scrutiny associated with their sustainable financing products, including SLLs, especially if the financings are included in external reports as part of their sustainable finance goals or commitments.

For example, if a lender approves key performance indicators (KPIs) that are not relevant and material to the borrower and/or SPTs that are not sufficiently ambitious, it may leave the lender and the borrower vulnerable to **greenwashing** or social washing accusations, which may result in reputational harm, stakeholder litigation, or regulatory scrutiny or all three. It can also raise issues for purchasers in the secondary market that may believe they are buying "sustainable" credit and may categorize it as such for internal and/or external reporting purposes. Regulators have been taking an increasing interest in greenwashing, with some regulators defining greenwashing as a form of misleading statement.

To mitigate this risk, it is key that lenders conduct a pre-closing review of the borrower's proposed terms, focusing on the materiality of the proposed KPIs and the ambitiousness of the proposed SPTs. Lenders can review external sources (such as ICMA's Illustrative KPI Registry) to get a sense of KPIs that are material in the borrower's industry, negative news reports, and issues specific to the borrower. They should require the borrower to provide evidence that the proposed KPIs can be benchmarked, where possible, against external science-based scenarios or the borrower's own historical performance, as recommended by the Sustainability-Linked Loan Principles (SLLPs). Lenders may also recommend or require the borrower to have its KPIs and SPTs reviewed by an independent and external verifier before closing. Post-closing verification on an annual basis is market practice and required by the SLLPs, but pre-closing verification may require negotiation.

So-called rendezvous provisions, in which the borrower is typically granted 365 days post-closing to determine and get lender approval for its KPIs and SPTs, can also pose heightened greenwashing or social washing risks, as the lenders are signing the agreement and typically dispersing funds before reviewing the borrower's proposed KPIs and SPTs. Rendezvous provisions were relatively common in the US SLL market in 2022. The LSTA's latest SLL guidance provides, however, that rendezvous provisions should only be used in "exceptional instances," unanimous lender consent should be required in these circumstances (if practicable based on the size of the syndicate) and the loan should not be described as an SLL until or unless the KPIs and SPTs become live. It remains to be seen whether these clauses will remain popular going forward in light of this guidance.

SLLs are a relatively new and evolving financing product, which means there may be risks that are not known when the transaction is documented, especially because market norms have not yet emerged. Lenders should consider putting together a standard form or guidelines to assist deal teams in considering risks in the diligence and documentation stages of these transactions, as well as instituting review processes to evaluate in which instances a transaction should be externally disclosed as a sustainable financing product.

What is the role of the Sustainability Coordinator in sustainability-linked loans and what potential issues should entities looking to take on this role be mindful of?

The role of a sustainability coordinator (sometimes referred to as a sustainability structuring agent) is an evolving role in a syndicated transaction and is typically performed by a key lender or lender affiliate in the syndicate. While the scope of services vary from loan to loan and borrower to borrower, the services are defined in an engagement letter and typically include:

- Promoting dialogue between the borrower and lender(s) regarding the KPIs and SPTs.
- Assisting the borrower with developing KPIs and SPTs so that they are aligned with market standards and the SLLPs.
- Assisting with the preparation of materials to present the SLL structure to lenders.
- Assisting the borrower in responding to sustainability-related questions in connection with the facility.

While greenwashing and social washing risks exist for all parties participating in the SLL, entities looking to take on the role of sustainability coordinator should be particularly mindful of possible risks specific to the role. For example, if the engagement letter does not appropriately limit the sustainability coordinator's scope of services, the sustainability coordinator may be at risk of taking on an advisor role to one or both the lender group or the borrower, which results in fiduciary duties, expanded legal liability, and possible conflict of interest issues. Entities considering taking on this role should also closely review the borrower's profile to determine the borrower's level of ESG sophistication and whether the entity is comfortable working with a potentially less sophisticated borrower, and should carefully analyze the materiality and level and ambition of the proposed KPIs and SPTs.