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# Rise of ESG considerations in financing agreements and SLLs

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**Introduction**

Interest in environmental, social and governance (ESG) investing has grown rapidly over the past two decades. Years of research have also improved the correlation between strong financial performance and ESG ratings, attracting more investors than ever before to companies with a high ESG performance. The debt market and financing arrangements have also been influenced by ESG and sustainability considerations.

Consequently, a type of loan that has grown in popularity in the Swedish market in recent years is the sustainability-linked loan (SLL). An SLL is structured in such a way that the borrower is incentivised to achieve certain predefined sustainability-linked objectives. If the borrower achieves these objectives, it is rewarded with a more favourable economic outcome, such as a margin reduction.

The growth of SLLs accelerated in 2019 when the Loan Syndications and Trading Association, the Loan Markets Association (LMA) and the Asia Pacific Loan Market Association published the Principles for Sustainability-Linked Loans, which detail the characteristics of the SLL product. On 4 May 2023, the LMA published model provisions for SLLs.

**SLLs, principles and LMA model provisions**

An SLL is a loan (eg, a letter of credit, revolving credit facility or bonding line) where the economic outcome for the borrower is linked to whether the borrower meets certain predefined sustainability targets (commonly known as "sustainability performance targets" (SPTs)). The performance of the borrower in achieving the selected SPTs is measured through sustainability key performance indicators (KPIs), which are selected before entering into the relevant financing arrangement. The economic outcome adjustment in an SLL is often made in relation to the interest margin. The relevant financing agreement clarifies that the interest margin will be reduced, in the form of a sustainability discount, for as long as the borrower meets the selected SPTs.

SLLs differ from so-called "green loans" in that they can be used for general corporate or other specific purposes rather than for specific green purposes, which expands the potential market for SLLs compared to green loans. This is one reason for the growing use of SLLs. Borrowers that are not typically conducting what is commonly referred to as "green" or "sustainable" business are given the opportunity to participate in the transition to more sustainable financing.

SLLs are governed by the Principles for Sustainability-Linked Loans, a standard document consisting of non-binding recommended guidelines. Participants in the Swedish market often recognise and consult the principles, despite them being non-binding. The principles have been updated several times since their initial publication in 2019, most recently in February 2023. Pursuant to the principles, an SLL must, among other things, have the following characteristics:

- The borrower must select the KPIs and the SPTs for each KPI.
- The KPIs must be:
  - relevant;
  - core and material to the borrower's business;
  - benchmarkable; and
  - measurable and quantifiable.
- The SPTs should be, among other things, beyond business as usual, compared to a benchmark or external reference where possible, and set within a predefined timeline.
- It is recommended that the borrower seeks input from an external party to assess, for example, the relevance and reliability of the selected KPIs, the levels of the proposed SPTs, and the relevance and reliability of the relevant benchmarks.
- The borrower must provide sufficient information to monitor the performance of the SPTs by seeking external verification of the borrower's level of performance against each SPT for each KPI.

Prior to 4 May 2023, there were no SLL model provisions and most lenders developed their own template wording for SLL provisions. On 4 May 2023, the LMA published model provisions for SLLs, which are more ambitious and comprehensive than what has been seen in the market so far. It is hoped that these model provisions will facilitate the implementation of further sustainability considerations and increase the uptake of SLLs.

**Swedish law perspective**

One question that is not regulated in the Principles for Sustainability-Linked Loans is how the price adjustment mechanism for the loan works (eg, whether the margin may only be reduced or whether it may also be increased). The trend in the Swedish lending market seems to be that margin is mostly reduced, although in some cases there is a combination of increase and reduction – for example, the margin is increased if the borrower performs poorly in relation to the SPTs. The LMA model provisions refer to both an increase and a reduction of the margin.

The definition of an SLL in the principles suggests that an SLL is a loan where the "economic characteristics" are linked to the borrower's performance against certain sustainability objectives. However, both the principles and the LMA model provisions only discuss adjustments to the interest. An interest adjustment is also what is most common in the Swedish market. However, it is also possible for the parties to agree that there will be an adjustment to the amortisation rate linked to the achievement of the SPTs, or that some other form of economic outcome will be linked to the SPTs – for example, other fees payable by the borrower.

Under the principles, a breach of sustainability provisions does not in itself constitute an event of default giving the lender the right to terminate the facility. This is also the approach in the LMA model provisions and the most common approach in the market. However, there is nothing stopping parties from agreeing that a breach of the sustainability provisions should result in an event of default with, for example, a cure period to remedy the breach.

Below are some examples of common sustainability loan criteria from Swedish transactions:

- The borrower complies with certain green certifications, labels or ratings (these are in particularly common in real estate financing).
- The borrower meets an ambitious energy class or targets for energy efficiency (eg, percentage of renewable energy used) or reduction of energy consumption.
- The borrower is reducing its transport or carbon dioxide emissions.
- The borrower makes a sustainable use of resources and reduces waste.
- The borrower meets certain targets with respect to carbon emissions or greenhouse gas reduction.

**Comment**

SLLs have rapidly become an important loan product in the Swedish market and in Europe. It also appears that many lenders want to modify their current financing to include sustainability aspects. Legal queries from clients relating to sustainability financing have also become more common in recent years, not least since new regulations give rise to numerous legal questions (eg, the implementation of the EU Taxonomy Regulation).[(1)] It can also be observed how parties in transactions now wish to link their financing to the EU Taxonomy Regulation.

SLLs are beneficial for borrowers since they allow them to signal their sustainability and ESG commitments to their shareholders and external stakeholders, who increasingly expect transparency from companies. Lenders are also motivated to provide SLLs because of the downside protection that good sustainability practices can provide and also in response to regulatory and governmental pressure on banks and other financial institutions to be more responsible and sustainable in their lending. In addition, many credit fund investors have requirements regarding the consideration of ESG issues when giving credits.

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**Endnotes**

(1) Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment and amending Regulation (EU) 2019/2088 (Text with EEA relevance).