ATFS Bulletin February 2021 – Sustainability Loans

Background

The 2016 UN Paris Climate Agreement signed by 195 countries (and ratified by 190 as of January 2021) sets out a primary objective to maintain the rise in global temperature below 2 degrees Celsius and on a best-efforts basis to limit the increase to 1.5 degrees Celsius.

Many large organisations are now committed to steering their balance sheets towards these goals. This includes the lending sector where new sustainability products have been introduced as a mechanism to promote the sustainability agenda. Introduced in 2017, Sustainability Linked Loans are quickly growing as an option for borrowers.

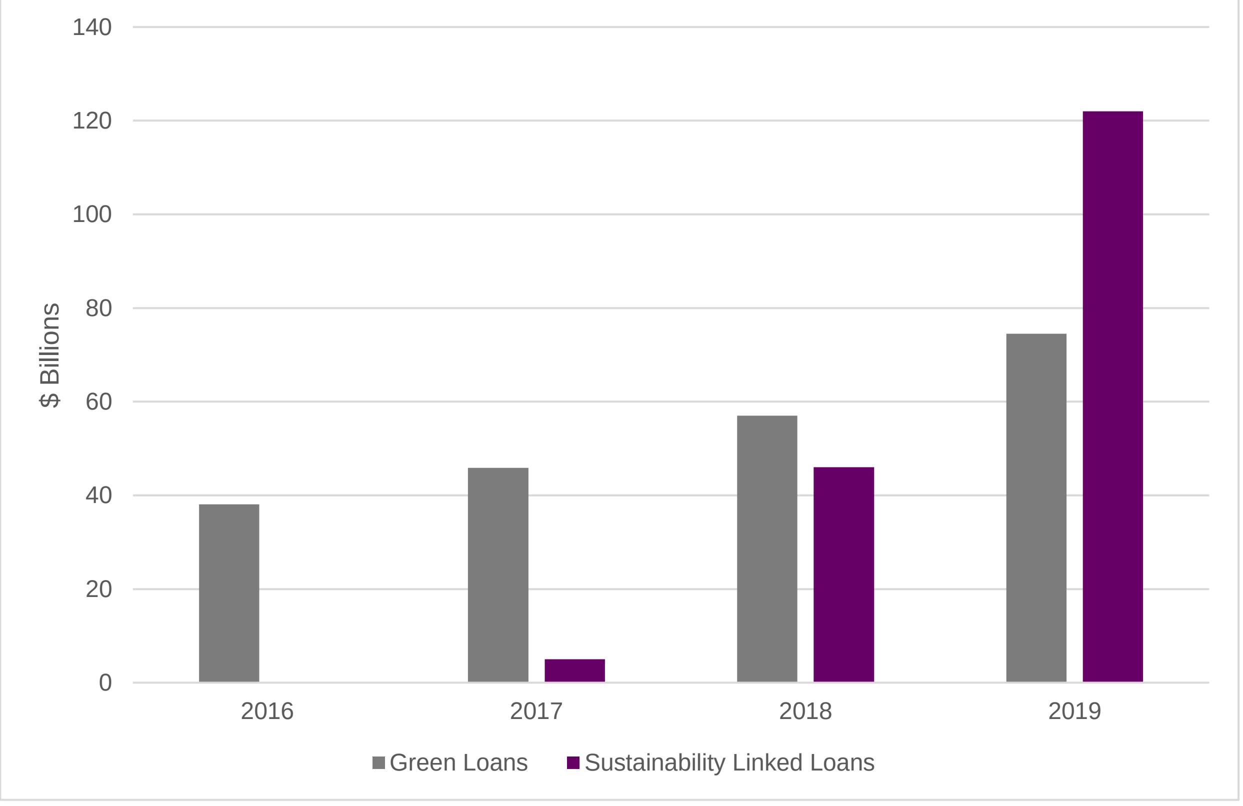
What is a Sustainability Linked Loan?

Unlike green loans and green bonds, which finance specific green projects, Sustainability Linked Loans (SLL) are linked to pre-determined sustainability performance targets. If the borrower is successful in meeting these targets, they receive a discount on their borrowing rate.

The common structure is to have a two-way pricing whereby if the targets are met, the pricing reduces, but if the borrower fails to meet its ESG targets then pricing increases. Typically, the pricing swing is circa 2.5bps to 5bps.

The flexibility offered by the SLL's being classed as a 'general purpose loans', open to organisations from all sectors, has led to a significant acceleration in the adoption of SLL's since their inception in 2017. The chart below illustrates how quickly SLL's have overtaken green loans in terms of market share.

Chart 1: SLL & Green Loan Volumes - Worldwide



SLL's as a product has now been supported further through the introduction of Sustainability Linked Loan Principles by three global loan trade bodies. In Europe the Loan Market Association (LMA) released its guidance in May 2020. Click here to download a copy.

Europe has been at the forefront of this growth, underwriting 81% of the SLL deals in 2019. Recent figures show that USD 21 billion of sustainable loans were signed in 2019 in the Americas, compared to more than USD 100 billion in EMEA.

The key driver of SLL's is to promote a correlation between sustainability performance and lower cost of capital. Borrowers are able to demonstrate a commitment to the sustainability agenda on a macro level given the flexibility in funding, whilst lenders are able to support and promote the climate change agenda through a value-added proposition.

What are the performance measures?

Borrowers and lenders work together to agree a ratchet mechanism for pricing. This can be based on KPI's such as:

- Improved energy efficiency rating of owned buildings
- Reduction in emissions
- Improved water efficiency
- Increased level of renewable energy generation

There are a range of KPI's that can be agreed, and it could be the case that a suite of acceptable KPI's may already be followed by the borrower as part of an existing sustainability policy. Therefore, the level of additional reporting may be minimal. Borrowers can pro-actively align their sustainability policies with that of accepted performance targets to ensure they are able to continually access discounted funds.

Alternatively, external consultants can be mandated to apply an ESG rating to a borrower, which can be updated periodically.

Future of Sustainability Linked Loans

As the market matures it can be expected that the product will evolve further in terms of standardisation of performance targets. The popularity and scalability of SLL's is also likely to lead to development of new products in the sustainable finance industry. There are already specific ESG products available for investments, as well as a rapidly growing sub-sector of Banking through ethical/sustainability focused lenders.

With the sustainability agenda firmly established in the finance world, both borrowers and lenders can work together to influence its continuing development for both mutual and global benefit.

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