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INSIGHT: The Next Big Thing in Green Finance—Sustainability-Linked Loans

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Sustainability-linked loans are expected to rapidly grow as both issuers and investors become more familiar with their advantages.

The growth of these loans in the U.S. follows their development and speedy expansion over the preceding two years in Europe and the Asia-Pacific region, as an offshoot of "traditional" green finance.

Green finance—which began with "green bonds" about a decade ago—was developed to assist companies in funding projects with positive environmental or climate benefits.

The essential idea of a green bond or green loan is that the proceeds are used to finance a specific green project, such as a renewable energy project or a clean transportation project.

The development of the asset class required careful consideration of standards for what would be considered a "green" project. The International Capital Market Association first published in 2014 the "Green Bond Principles", a voluntary set of guidelines to enhance transparency and disclosure whilst promoting integrity in the green bond market.

More recently, in 2018, the Loan Market Association (LMA) and Asia Pacific Loan Market Association (APLMA) published the first iteration of the "Green Loan Principles" for the syndicated lending market, subsequently extended in partnership with the Loan Syndications and Trading Association (LSTA).

Encouraging Sustainability

Sustainability-linked loans, while often grouped together with more traditional green finance assets, represent a different approach. Rather than obliging a borrower to use the proceeds of such loans for a specific, predetermined green purpose or project, sustainability-linked loans are typically made available for the company's general use.

The key element is that the underlying credit agreement's terms—generally, the interest rate—are linked to improvements in the company's sustainability, which can be a general environmental, social and corporate governance (ESG) rating (typically provided by a third party rating agency) or a more narrowly defined measure, such as reducing a company's level of greenhouse gas emissions.

This linkage creates a concrete, demonstrable financial incentive for improving the selected ESG performance metrics. In other words, the better the sustainability performance demonstrated by a company, the lower the interest rate it is able to secure.

Significant Steps Forward

Over the last year, and especially the most recent quarter, this nascent segment of the syndicated loan market has taken a couple of significant steps forward, establishing a foothold in the U.S. market and developing a global framework of guidelines and standards to enhance the integrity of the asset class.

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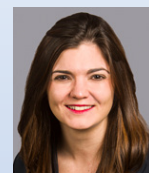

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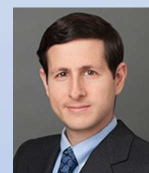

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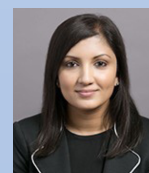

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Mid-2018 saw two U.S. utility companies, CMS Energy and Avangrid, issue sustainability-linked loans, with pricing linked to specific measures of renewable energy and emissions reduction. In early 2019, two additional companies—multinational logistics REIT Prologis, and water technology company Xylem—issued such loans.

Notably, Xylem's credit facility was the first sustainability-linked loan in the general industrial sector in the U.S., and also the first in the U.S. to use a comprehensive third-party ESG score, rather than narrowly defined metrics, as the measure of sustainability.

The credit facility's interest rate includes a factor based on Xylem's overall sustainability performance as rated by Sustainalytics, a leading independent global provider of ESG ratings.

Given the wide variety of ESG performance metrics, and the discretion of market participants in selecting both the metrics to be tested and the target performance levels that will impact the terms of the loan, there is a clear need for a framework to guide the design and negotiation of sustainability linked loans, in order to assure the integrity of the asset class and promote its development.

In a major advance for this asset class, in March of this year the LSTA, LMA and APLMA published the "Sustainability Linked Loan Principles" as a voluntary framework representing "the next step in collaboratively developing global standards for sustainable lending" (*see* LSTA's Week in Review, March 22, 2019).

Benefits for Borrowers, Investors

For borrowers, in addition to the potential pricing discount, sustainability-linked loans offer certain less tangible but important benefits.

Internally, issuing sustainability-linked loans and other green finance products signals a commitment to green/sustainability-oriented values, which can result in a boost to employee morale, reduce turnover, and support recruiting efforts. Externally, sustainability-linked loans can bolster a company's branding and help it communicate its sustainability strategy to both its customers and debt and equity investors.

Sustainability-linked loans also offer borrowers an opportunity to expand their investor base to include investors focused on socially responsible investments. According to the Global Sustainable Investment Alliance's biennial report for 2018, almost $31 trillion of assets globally were being managed under "responsible investment" strategies, of which the ESG factor integration strategy comprised $17.5 trillion. Sustainability-linked loans, along with other green finance products, allow issuers to access that market.

Sustainability-linked loans are not just an attractive option for specialized investors focused on socially responsible investments, and major banks have shown an interest in the developing product. For banks and other investors, investing in sustainability-linked loans are a way of signaling to their customers and employees their commitment to sustainability goals.

The Global Sustainable Investment Alliance found that client demand was the primary motivator for U.S. asset managers' incorporating ESG criteria into their investment process. In addition, there is evidence that companies with higher ESG ratings represent better credit risks for lenders than those with lower ESG ratings.

A 2018 report by Axioma, a risk and portfolio analytics provider, found that companies with higher ESG ratings "rarely underperform[] the market and often outperform[] the market". Similarly, a 2017 report by the Boston Consulting Group found that companies that outperformed their industry-peers in ESG metrics also financially outperformed and were more profitable than their industry-peers. By incentivizing issuers to improve their ESG metrics, sustainability-linked loans may indirectly influence companies to take actions that make them stronger financially.

With the issuance of sustainability-linked loans by U.S. public companies, and especially with the introduction of the concept to the general industrial sector in the U.S., the product seems poised to take off in the U.S. market. Meanwhile, the publication of the Sustainability Linked Loan Principles provides market participants globally with an important framework to guide expectations, inform market practice, and enhance the integrity of the asset class.

We anticipate continued acceleration in this space, in particular with large corporate borrowers, as awareness of this product and its benefits spreads among market participants on both issuer and investor sides.

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Gibson Dunn & Crutcher LLP represented Xylem Inc. in the sustainability-linked loan transaction discussed in this article.

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