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Unlocking Sustainability-Linked Loans

May 12, 2023

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On February 23, 2023, the Loan Market Association (LMA), Loan Syndications and Trading Association (LSTA) and the Asia Pacific Loan Market Association (APLMA) published updates to the Sustainability-Linked Loan Principles (SLLP) and related guidance (SLLP Guidance). Sustainability-linked loans (SLLs) "are any types of loan instruments and/or contingent facilities (such as bonding lines, guarantee lines or letters of credit) for which the economic characteristics can vary depending on whether the borrower achieves ambitious, material and quantifiable predetermined sustainability performance objectives."

The **SLLP** promote the development of the SLL market by providing a recommended framework "to articulate the fundamental characteristics of SLLs" based around five core components: Selection of Key Performance Indicators (KPIs); Calibration of Sustainability Performance Targets (SPTs); Loan Characteristics; Reporting; and Verification. The SLL product incentivizes a borrower to achieve "material, ambitious, pre-determined, regularly monitored and externally verified sustainability objectives through KPIs and SPTs." KPIs and SPTs need to be in place at signing in order for a loan to be classified, referred to or otherwise reported as an SLL.

The reporting requirements for an SLL are the same in Europe as they are in the U.S. A pricing or sustainability compliance certificate should be delivered at regular intervals (typically annually), certifying the borrower's performance in relation to each KPI and SPT. That certificate is delivered together with the sustainability information produced by the borrower supporting the certification of its sustainability performance, and a separate verification report produced by an external reviewer verifies the borrower's own sustainability certifications. The content of the verification report, and level of verification provided by the relevant external reviewer, can vary among transactions. The nature of the KPI itself may dictate the level of verification that the external reviewer is able to provide.

The SLLP Guidance elaborates on the SLLP's core principles with content informed by questions that the associations have received from market participants and the market consensus that has developed on the various issues covered by the Guidance. The LSTA also plans to produce a practice note on how SLLs can be used in fund financing facilities, which is an area of development that the LSTA has observed (particularly in the private equity market). However, the LSTA's major focus for 2023 is on the ESG-integrated disclosure project -- an

industry-wide collaboration working towards the development of a global baseline for disclosure of ESG information. The LSTA's work in this area will focus on educating market participants about the project and encouraging increased usage of the disclosure template that the project has generated.

Taking the Temperature: We have previously reported on recent SLL developments, including the conversion of an €11 billion revolving credit facility into an SLL by Mercedes-Benz and the largest African sustainability-linked real estate debt arranged to date.

SLLs have proved to be resilient despite difficult market conditions that included an overall drop in loan originations. SLLs remain the fastest growing segment of the sustainable loan market with originations holding steady in 2022 in the U.S. and Europe. Unlike green loans and social loans (both of which are "use of proceeds" loan products), SLLs are borrower focused, sector agnostic and can be used for a range of corporate purposes. In effect, a borrower whose business is not suited to investment in standalone 'green' or 'social' assets is able to structure a bespoke SLL catered specifically to its business. This makes SLLs well suited for transition financing and for those corporates without a clear environmental or social agenda. In the U.S., where project and infrastructure loans are relatively less common, this flexibility is a particularly important and useful factor. This continued growth underlines the importance of SLLs as a tool for sustainable development, including in the U.S. (which lacks the same regulatory drivers seen in Europe).

In both the U.S. and European markets, the majority of SLL borrowers' KPIs are concerned with environmental factors (in particular, greenhouse gas emissions). In the UK this emphasis is influenced by regulatory pressures, with the Transition Plan Taskforce continuing to promote climate-related disclosures and the Financial Conduct Authority looking to incorporate similar disclosure obligations within the UK Listing Rules. The associations acknowledge that the cost involved in appointing external reviewers is one of the biggest barriers to SMEs and mid-market borrowers accessing the SLL product, but view this requirement as central to the integrity of the developing SLL market. Borrowers should engage with potential external reviewers at the outset of structuring of an SLL to ensure that they understand the potential costs involved in appointing the reviewer.

CDP Introduces Plastics-Related Disclosure

May 12, 2023

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On April 19, 2023, CDP **launched a request** for 7,000 companies to disclose on the production and use of the most environmentally problematic plastics, i.e., plastic polymers, durable plastics, and plastic packaging, through CDP's online disclosure platform.

CDP is a not-for-profit that runs a global disclosure system supporting companies, cities, states and regions to "measure and manage their risks and opportunities on climate change, water security and deforestation." Originally known as the Carbon Disclosure Project, CDP launched in 2003 and initially focused solely on carbon emissions from 500 global companies. It has now expanded its remit to include disclosure of impact on water security and deforestation, and has further expanded to publish data on individual cities, countries and regions. CDP reports that in 2022 more than "18,700 companies worth half of global market capitalization" disclosed climate-related data using the platform. CDP is a founding member of the **Science Based Targets Initiative** and the **Net Zero Asset Managers** initiative. The CDP disclosure framework is aligned with the disclosure framework conceived by the Financial Stability Board's Task Force on Climate-Related Financial Disclosures.

CDP's plastics launch follows other international initiatives focused on plastic production and use. A range of single-use plastics will be **banned in the UK** starting 2023. Plastics-related regulation **already exists** in the EU, Canada, Kenya and some U.S. states including New York and California. In March 2022, the UN adopted a resolution to establish an **Intergovernmental Negotiating Committee** that will attempt to forge a global agreement on plastic pollution, the UN Plastics Treaty, by 2024. The **UN Plastics Treaty** will be legally binding and include a series of technical provisions that would address the full lifecycle of plastic from "sustainable production and consumption of plastics" to "environmentally sound waste management."

Companies reporting on plastics-related data will do so through a "plastics module" included in the CDP's Water Security questionnaire. Companies will be **requested to answer** five to nine questions that cover "production, use, and disposal of plastics" and about "plastics-related business risks, targets, and raw material content, among other topics." The definition of plastic in the questionnaire includes "synthetic rubber (and other elastomers)," reflecting that "CDP disclosure goes beyond the production and use of plastic packaging (which generally does not include rubber)."

Taking the Temperature: In the absence of mandatory disclosure requirements, voluntary disclosure platforms are key tools for investors and policymakers to access relevant, comprehensive and comparable data. CDP announced in September 2022 that it will integrate the ISSB's climate-related disclosure standards into its platform to facilitate greater integration among voluntary disclosure frameworks. Plastics continues to be a focus of shareholders and environmental groups. For example, the NGO ClientEarth commenced an action in Paris against Danone for allegedly violating France's Corporate Duty of Vigilance Law in that the company supposedly does not have an adequate plan to reduce its plastic footprint. The environmental advocacy group As You Sow announced for formation of a coalition of investors, the Plastic Solutions Investor Alliance, to engage with publicly traded consumer goods companies on the threats posed by plastic waste and pollution. In 2022, 48% of the Amazon shareholders, 41% of McDonald's Corporation shareholders and 37% of ExxonMobil shareholders voted in favor of resolutions asking these companies to address their impact on plastic pollution.

Company responses to these proposals have been mixed. Amazon's board of directors recommended its shareholders to vote against the resolution. On the other hand, McDonald's agreed to publish its first-in-sector report on reusable packaging and As You Sow has subsequently withdrawn its shareholder proposal with the company.

ECB Releases Results of 2022 Eurosystem Balance Sheet Climate Risk Stress Test

May 12, 2023

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As part of the European Central Bank's (ECB) 2021 **action plan** to incorporate climate change considerations into its monetary policy, the ECB conducted a climate risk stress test of the Eurosystem balance sheet in 2022. Those results are **now available**.

The purpose of the stress test was two-fold: first, to analyze the Eurosystem's financial risk profile with respect to climate change, and second, to enhance climate risk assessment capacity itself. The test addressed various Eurosystem portfolios including covered bonds, corporate bonds, asset-backed securities and collateralized credit operations. The results of the stress test indicate that both transitional and physical risk have a material impact on the Eurosystem balance sheet's risk profile.

Stress Test Results

The ECB's exercise tested five scenarios — three long-term scenarios developed by the Central Banks and Supervisors for Greening the Financial System (NGFS) and two short-term scenarios developed by the ECB. The long-term scenarios projected macro-financial and climate variables over a 30-year period. Essentially, the scenarios adjust the extent to which climate change mitigation policies have been implemented and then assess the associated climate risk results. The 'hot house world' scenario assumes climate policies are not enforced. The test indicates that this scenario presents severe physical risk but not transition risk. At the other end of the spectrum, the orderly transition scenario works off the assumption that the implementation of climate change policies is timely. In the middle is the disorderly transition scenario, which assumes climate change policies are delayed in implementation. The test indicates that this scenario presents severe transition risk but only limited physical risk.

In addition to the three long-term scenarios, the two short-term situations considered were a flood risk scenario over a one-year period (posing material physical risk) and a short-term disorderly transition scenario, which tested the potential impact of steep increases in carbon prices over a three-year period (posing material transition risk).

Overall, results from the climate risk stress test show that both transitional and physical risk have a material impact on the Eurosystem balance sheet's risk profile. In terms of long-term scenarios, the disorderly transition and hot house scenarios generate risk estimates 20-30%

higher than the risk estimates under the orderly transition scenario. Analysis of the long-term scenarios suggests that corporate bonds are the main risk driver, while covered bonds, asset-backed securities and credit operations pose less total risk. Corporate bonds are the main risk driver under the short-term scenarios as well, although covered bonds also were a significant risk contributor in the flood risk scenario.

Across all five different scenarios, the transition risk for corporate bonds is concentrated in specific sectors, and the physical risk for corporate bonds is concentrated in certain areas geographically.

Taking the Temperature: As we have observed, financial institutions, including in the EU, are committing to considering climate shocks when stress-testing their own financial institutions. Similar stress-testing initiatives are underway with other major prudential regulators, including the Bank of England and the Federal Reserve. As part of the EU's attempts at implementing an orderly transition, the European Banking Authority's sustainable finance roadmap, released at the end of 2022, sets out a three-year plan that provides guidance on sustainable finance in the EU. The roadmap sets out the EBA's plan for the next three years to "integrate ESG risks considerations" into the banking framework and to "support the EU's efforts to achieve the transition to a more sustainable economy." Relatedly, the ECB recently published its first climate-related financial disclosures. The disclosures provide information on ECB portfolios, including detailing their carbon footprints and exposure to climate risks, and also discuss climate-linked governance and risk management. The disclosures are part of a Eurosystem-wide effort to increase transparency around the sustainability characteristics of European central bank portfolios.

EC Will Not Introduce Minimum Criteria for Sustainability Funds Under SFDR

May 12, 2023

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The European Commission has rejected suggestions that it introduce minimum environmental standards for Article 8 or Article 9 funds under the EU Sustainable Finance Disclosure Regulation (SFDR). On April 14, 2023, the Commission confirmed that it will not provide a definition for "sustainable investment," nor will it introduce **minimum qualifying sustainability criteria**.

The clarifications, published by financial services commissioner Mairead McGuinness, come after European Supervisory Authorities asked the Commission in September last year for further guidance on the interpretation of the SFDR. This was against the backdrop of asset managers downgrading approximately €175 billion ($193 billion) of assets from Article 9 funds (i.e. those holding the SFDR's highest sustainability classification) to the broader, less demanding Article 8 label (which requires sustainability to be only one of the factors informing investment decisions) due to uncertainty over the rules.

The Commission has:

- reiterated that the SFDR is a disclosure regime and that it will not set minimum requirements for the key parameters of sustainable investment, such as "do no significant harm" and governance indicators; and
- affirmed once again that SFDR is not a labelling regime, leaving it up to the market to assess whether a given investment should be considered as sustainable under SFDR.

The Commission **stated** that: "Financial market participants must carry out their own assessment for each investment and disclose their underlying assumptions." It **added** that funds subject to Article 9 under the SFDR remain "neutral" in terms of product design, investing styles, investment tools, strategies and methodologies.

Highlighting the ongoing challenges in compliance with the SFDR, on April 12, 2023 the European Supervisory Authorities (ESAs) published a **Consultation Paper** regarding potential amendments to the Delegated Regulation of the SFDR. The consultation will remain open until July 4, 2023.

The ESAs are proposing changes to the disclosure framework to attempt to address issues that have emerged since the introduction of the SFDR. The authorities are seeking feedback on a number of amendments, including:

- extending the list of universal social indicators for the disclosure of the principal adverse impacts of investment decisions on the environment and society;
- refining the content of other indicators for adverse impacts and their respective definitions and sources of information on which the disclosure is based; and
- adding product-level disclosures regarding decarbonization targets, including intermediate targets and how the target will be achieved.

Additionally, the ESAs have proposed a number of further technical revisions to the SFDR Delegated Regulation that seek to:

- improve disclosure regarding how sustainable investments "do not significantly harm" the environment and society;
- simplify pre-contractual and periodic disclosure templates for financial products; and
- clarify the treatment of derivatives and the definition of "equivalent information."

Taking the temperature: We have previously discussed how climate-related data assessment and disclosure arising in financing transactions remains a work in progress globally, as evidenced by decisions by a large number of asset managers to downgrade ESG funds due to a lack of guidance on how to apply the existing regulatory announcements in distinguishing Article 8 from Article 9 funds. What the Commission's action demonstrates is that, in Europe at least, there is still much work to be done by regulators to resolve this tension. Financial firms will need to continue to be cautious about use of sustainability labels for investment products and must have a documented basis and methodology for supporting any such descriptions.