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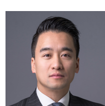
Sustainability-Linked Loans Series, Part 1 – Introduction to Sustainability-Linked Loans



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In our last few editions of *REF News and Views*, we featured the Green Loan Series of articles in which we discussed the emergence of "green loans" and the Green Loan Principles – those principles that form the proposed framework for market standards, guidelines and methodology to be adopted across the green loan market.

In the next series of articles, we want to focus on sustainability-linked loans ("SLLs"), which also emerged alongside green loans as a result of the movement towards greater awareness and improving environmentally and socially beneficial outcomes in the way corporates and lenders effect their lending, investment and other business decisions. Whilst green loans and SLLs are similar in their macro mission towards environmental and social sustainability, there are some important differences in their approach. We look to explore this further in this Sustainability Linked Loans series of articles.

What is a sustainability-linked loan?

SLL is defined as any type of loan instrument and/or contingent facility (*e.g.*, bonding line, guarantee line, letter of credit) that incentivises the borrower's achievement of ambitious, predetermined sustainability performance objectives.

The borrower's sustainability performance is measured by using sustainability performance targets ("SPT"), which can include key performance indicators ("KPI"), external ratings and/or equivalent metrics which measure improvements in the borrower's sustainability profile. These can include measures related to matters such as energy efficiency or sustainable sourcing of raw materials and supplies.

How are sustainability-linked loans different from green loans?

There are three key differences between SLLs and green loans:

- **Purpose**: There is no use of proceeds requirement for an SLL; in fact, many SLLs in the market are for general corporate purpose loans. Instead, SLLs

look to improve the borrower's sustainability profile by aligning loan terms with the borrower's performance against the relevant SPTs. This is in significant contrast to green loans, which are principally categorised by the way in which the proceeds are used towards an eligible green project – that is, the underlying green project investment, the management of the proceeds, and reporting.

- **Pricing**: A key incentive for a borrower in entering into an SLL is the pricing adjustment that can be awarded to it based on its performance against an agreed set of KPIs and SPTs, external ratings and/or equivalent metrics. The principle therefore is that if the borrower meets the agreed targets, then the margin on the loan will decrease accordingly. It is often set to work in reverse, also, such that if the borrower fails to meet its targets then the margin will increase.
- **Flexibility**: With the focus on general performance as opposed to a specific project itself, SLLs provide greater flexibility in their application and use case, opening up the green and sustainable loans market to a broader range of companies that may not otherwise have any projects that are specific to a green project.

In the next article in this Sustainability-Linked Loans series, we will introduce the Sustainability-Linked Loan Principles, which were published in order to provide a framework to help market participants understand and identify the key components in establishing sustainability-linked loans.