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# Skadden Discusses Sustainability-Linked Loans and COVID-19

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**Comment**

Pre-COVID-19, pressure from investors, stakeholders and regulators helped jump-start green financing. The onset of the pandemic brought a temporary chilling effect to the global economy, but because sustainability-linked loans (SLLs) were developed to fill a critical gap in financial markets, they are likely here to stay and to continue growing in popularity, even as COVID-19 remains a public health crisis. Quarterly reports and trends — determined by analyzing Bloomberg Terminal data from 2018 through the second quarter of 2020 — indicate a long-term appetite for SLLs, with investors, stakeholders and regulators demanding sustainability now more than ever. Indeed, in evaluating the future of SLLs, the European Commission highlighted in April 2020 that "[t]he ongoing COVID-19 outbreak in particular shows the critical need to strengthen the sustainability and resilience of our societies and the ways in which our economies function."

## The Rise of Sustainability-Linked Loans

SLLs originated against a backdrop of increased interest in and commitment to green financing. From corporate social responsibility efforts to environmental, social and governance (ESG) policies, in particular since 2019, more and more companies have adopted initiatives aimed at incorporating sustainability principles into their corporate affairs. Similarly, investment mandates and pressure from customers and employees have propelled this trend. Regulatory frameworks have followed suit, with international agreements like the European Union's December 2019 Sustainable Finance Disclosure Regulation and the June 2019 Taxonomy Regulation leading the charge. Lastly, as rating agencies began incorporating measures of ESG risk factors into their rating models since at least 2016, financial institutions began to view companies with the capacity to invest in green projects — initially large entities with the ability to develop large-scale projects — as potentially less risky borrowers deserving more favorable loan terms.

Amid this nurturing environment, SLLs were developed to fill a gap in the financial marketplace. The first SLL was structured in early 2017, on the heels of the green-loan movement that had started a few years earlier, in 2014. As a predecessor of SLLs, green loans also had the ultimate goal of promoting ESG objectives. Unlike SLLs, which do not follow the "use of proceeds" model, green loans require the funds to be used for a qualifying ESG project. Many corporate loans are designed for general corporate purposes rather than specific projects, let alone ESG projects. With SLLs, financial institutions can incentivize borrowers to achieve ESG goals without being required to use loan proceeds toward a specific ESG project. To accomplish their goals, SLLs tie loan terms, primarily interest adjustments, to a predetermined ESG performance metric instead, expanding the universe of companies that can access SLLs. For example, in December 2019, an oil and gas company borrowed $10 billion for general corporate purposes under an SLL credit agreement in which interest rates and fees are adjustable either upward or downward depending on whether the company achieves its short-term net carbon footprint targets as set forth in the company's sustainability report. This type of arrangement provides financial institutions with the proverbial carrot and stick to best incentivize borrowers to achieve their ESG objectives while also providing them with a greater degree of flexibility in cash management.

Global green and sustainability-linked loan volumes increased by nearly 150% from 2018 to 2019. According to Refinitiv's annual report, issuers provided over $160 billion in green and sustainability-linked loans in 2019 — over $137 billion of which was driven by SLLs. In December 2019 alone, noteworthy SLL transactions included the abovementioned $10 billion unsecured revolving credit facility; a $3 billion revolving credit facility, which ties facility fee and margin rate adjustments to hitting targets scheduled in the credit agreement for greenhouse gas emissions, as well as targets for incidents of workplace injuries; and a near investment-grade, $3.25 billion syndicated credit facility, which allows step-downs for margin rates based on a "management score" comprised of ESG factors. By region, Europe, the Middle East and Africa dominated the ESG loan market in 2019 — with roughly 78% of the volume — followed by the Americas and Asia-Pacific, with roughly 10% each.

During the period from 2018 through the second quarter of 2020, the majority of SLL borrowers have been based in EU countries, which likely can be attributed to the EU's regulatory framework. That framework supports SLLs and indicates that the continued growth in SLLs will likely require the support of regulators to create a beneficial environment for SLLs.

## SLL Principles

The growth in popularity of SLLs led market leaders to develop a set of principles governing these transactions. Three leading financial associations — the Loan Syndications and Trading Association (LSTA), the Loan Market Association and the Asia Pacific Loan Market Association — published the Sustainability Linked Loan Principles (SLLP) in May 2019. The SLLP specified four core components to be addressed in SLL financing: (1) the loan's relationship to the borrower's overall sustainability strategy, (2) the establishment and measurement of the desired sustainability performance target (SPT), (3) the reporting of any progress made on the SPT and (4) the review and validation process of the SPT data.

Following these principles, SLL credit agreements have evolved from traditional loan documents, with added provisions to account for predefined sustainability adjustments and reporting requirements, such as the abovementioned $3 billion revolving credit facility, where the borrower's SPT performance is reported annually in a sustainability report that is then audited by a third party.

## COVID-19 and Beyond

While COVID-19 represented a shock to the global economy, in the long run the pandemic may become a catalyst rather than a dampener of the growing popularity of SLLs. Short term, the global SLL volume growth was dampened by COVID-19, but the appetite for these loans has remained strong so far. In the first quarter of 2020, SLL volume was 74% higher in dollar amounts than it was for the same period in 2019, which in turn was 63% higher than the first quarter of 2018. While the second quarter of 2020 — when most countries suffered effects related to COVID-19, such as lockdowns and other governmental measures — saw an 18% decrease year-over-year SLL volume year-to-date is already 29% higher than SLL volume for all of 2018.

For financial institutions and rating agencies, ESG factors have long been part of the traditional credit analysis. Since mid-March 2019, at the request of LSTA, the Big Three credit rating agencies have been providing further transparency into precisely how they incorporate ESG performance metrics into their ratings. Moody's, for instance, has concluded that the "Coronavirus crisis will accelerate credit-relevant ESG trends." COVID-19 has been a wake-up call to many, who will continue to join the ranks of those pressing for ESG initiatives, thereby fueling the long-run upward trend in SLL volumes. SLLs will allow borrowers to tap into potentially cheaper financing. And unlike with green loans where proceeds are earmarked for specific projects, borrowers will have more flexibility in their cash management and the way they achieve their ESG goals.

*This post comes to us from Skadden, Arps, Slate, Meagher & Flom LLP. It is based on the firm's memorandum, "Sustainability-Linked Loans on the Rise Despite COVID-19," dated September 30, 2020, and available here.*