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Article

Sustainable Lending

How will the Sustainability Linked Loan Principles impact on the sustainable lending market in Singapore and Southeast Asia?

The sustainable lending market is growing across Asia. Singapore continues to position itself as a centre for sustainable finance in Southeast Asia. Other countries in the region, including Indonesia, India, Thailand and Vietnam, are also increasingly focused on sustainable financing and green and sustainable development. The recent publication of the Sustainability Linked Loan Principles by the LMA, APLMA and LSTA represents a further step in the evolution of this rapidly developing market.

In this legal update we provide an overview of some of the key drivers for the growth in sustainability-linked loans in Singapore and Southeast Asia, a summary of the Sustainability Linked Loan Principles and an overview of how the Sustainability Linked Loan Principles may impact on loan transaction documentation and process.

What is a sustainability-linked loan?

The Sustainability Linked Loan Principles define sustainability-linked loans as any type of loan instrument and/or contingent facility which incentivise the borrower's achievement of ambitious, predetermined sustainability performance objectives.

The focus on the borrower's achievement of sustainability performance objectives, rather than the end use of the loan, is one of the key features of sustainability-linked loans and distinguishes the product from green loans, which are defined, under the Green Loan Principles most recently published by the LMA, APLMA and LSTA in December 2018, as any type of loan instrument made available exclusively to finance or re-finance, in whole or in part, new and/or existing eligible green projects.

The broad definition of sustainability-linked loans and focus on incentivising the achievement of sustainability performance objectives opens up the sustainable lending market to borrowers who are looking for incentives to be built into their financing documentation to promote achievement of their sustainability and/or environmental, social and governance (ESG) targets, but who do not intend to use the proceeds of the loan for a particular green project. An example of this would be a revolving credit facility provided for general corporate purposes which includes incentives for the borrower to meet its sustainability performance objectives, for example, by way of a margin adjustment linked to the achievement of sustainability performance targets. The flexibility of the sustainability-linked loan product creates many opportunities for lenders and borrowers to build sustainable and green financing principles into a variety of loan financing transactions.

Key drivers for growth in sustainability linked loans

Lenders and borrowers in Singapore and Southeast Asia are increasingly considering sustainability-linked loans as a potential funding option. This interest is driven by a number of factors, including:

Investor and stakeholder demand

Sustainability and ESG policies are increasingly being seen as an essential part of corporate strategy, both for corporates and lending institutions operating across Southeast Asia, and a key factor in driving long-term growth of a business. Investors, as well as customers, suppliers, lenders and other business stakeholders, are actively assessing whether a company's business plan addresses issues such as:

- Climate change
- Labour conditions and human rights
- Gender pay gap and diversity in the workplace
- Political contributions
- Sustainability and ESG policies

Corporates and lending institutions now view sustainable financing products as an integral part of their overall sustainability and ESG strategy.

The same trend can be seen in private equity across the region, where ESG principles are becoming an area of focus for investors. This is helping to drive demand for new products, such as sustainability linked subscription credit facility financings provided to private equity funds.

Regulatory requirements

Regulators in many key financial hubs are becoming more focused on the disclosure of sustainability and ESG policies. In Singapore, the Singapore Exchange (SGX) requires listed companies to publish a sustainability report explaining their practices at least once a year. In addition, the Association of Banks in Singapore has introduced Guidelines for Responsible Financing to promote responsible financing in Singapore and assist banks in integrating their ESG policies. At a global level, the 2015 Paris Agreement on Climate Change shows that governments are increasingly cooperating on environmental issues and are also increasingly focused on the link between finance and sustainability and sustainable development.

The focus by regulators and governments on disclosure of sustainability and ESG policies and the way in which finance can be used to promote sustainable development and enhance compliance with ESG policies is often considered to be one of the key drivers of demand for, and supply of, sustainability-linked financing products.

Market awareness

As the volume of sustainability-linked loans continues to grow, market participants are becoming more aware of sustainability-linked loan products. Initiatives such as the Asia Sustainable Financing Initiative, launched in Singapore in January 2019 to bring together industry and academic based resources to support financial institutions in implementing ESG best practices, as well as the Asia Pacific Loan Market Association initiatives and other similar initiatives around the region, have helped to promote awareness of the product in Singapore and Southeast Asia.

Accessibility

Sustainability-linked and green bonds have been issued for a number of years and are becoming a mainstream product. However, due to minimum size considerations for bond issuances, sustainability-linked bonds may not be viable for medium and smaller-sized corporates. Sustainability-linked loans allows medium and smaller-sized corporates, as well as large corporates that do not, for whatever reason, want to use bond issuances as part of their capital structure, to have access to a sustainability linked credit product.

The LMA and APLMA Sustainability Linked Loan Principles

The Sustainability Linked Loan Principles aim to promote the development and preserve the integrity of the sustainability-linked loan product by providing guidelines which capture the fundamental characteristics of sustainability-linked loans.

The Sustainability Linked Loan Principles have four core components:

Relationship to the borrower's overall corporate social responsibility strategy

This requires the clear communication to the lender of the borrower's sustainability objectives, as set out in its corporate and social responsibility strategy, and clear communication as to how these objectives align with the proposed sustainability performance targets.

Target setting: measuring the sustainability of the borrower

The lender and the borrower are expected to negotiate appropriate sustainability performance targets for each transaction. These should be ambitious and meaningful to the borrower's business and should be tied to a sustainability improvement in relation to a predetermined performance target benchmark. The sustainability performance targets will apply and be measured throughout the life of the loan. The setting of sustainability performance targets can be achieved with the assistance of a sustainability coordinator or sustainability structuring agent.

Reporting

The borrower is expected, where possible, to make and keep readily available up-to-date information relating to the sustainability performance targets, with that information being provided to the lenders at least once every year.

Review

The lender and the borrower are expected to agree a position on the need for external performance review on a transaction by transaction basis. The Sustainability Linked Loan Principles strongly recommend an external review (by an auditor, environmental consultant and/or independent ratings agency) is carried out for loans at least once a year where information relating to sustainability performance targets is not made publicly available or otherwise accompanied by an audit/assurance statement. For publicly traded companies, the Sustainability Linked Loan Principles note that it may be sufficient for lenders to rely on the borrower's public disclosures to verify whether the borrower's sustainability performance targets are met, although external review may still be desirable. If no external review is sought, the Sustainability Linked Loan Principles recommend that the borrower demonstrates or develops the internal expertise to validate the calculation of its performance against its sustainability performance targets.

How will the Sustainability Linked Loan Principles impact on transaction process and documentation?

The Sustainability Linked Loan Principles are intended to be voluntary guidelines for sustainability-linked loans. They are not prescriptive as to how the Sustainability Linked Loan Principles are met, leaving it to lenders and borrowers to agree this on a case by case basis, taking into account the underlying characteristics of the relevant transaction. In terms of process, it is expected that lenders and borrowers will consider the applicability of the Sustainability Linked Loan Principles as part of initial discussions on the terms of a sustainability-linked loan. Lenders and borrowers will need to consider, amongst other things, the following:

- The scope of the borrower's corporate and social responsibility strategy.
- The setting of clear sustainability performance targets for the loan.
- Whether a sustainability coordinator or sustainability structuring agent will be used to set sustainability performance targets.
- Appropriate reporting requirements for the loan and whether the borrower has adequate procedures in place to fulfil these requirements.
- How sustainability performance targets will be monitored.

The Sustainability Linked Loan Principles do not provide any "market standard" documentation terms for sustainability-linked loans. Accordingly, it can be expected that loan documentation will continue to be negotiated on a transaction by transaction basis. Lenders and borrowers are likely to focus on, amongst other things:

- The inclusion of appropriate incentives, taking into account the borrowers' sustainability and ESG policies and the agreed sustainability performance targets. Incentives could include, for example, a margin adjustment, under which the margin payable by the borrower adjusts depending on the borrower’s compliance with sustainability performance targets.
- The scope of reporting obligations, including requirements to deliver up-to-date information relating to sustainability performance targets and the delivery of other information published by the borrower relating to its sustainability and ESG policies, as well as specific provisions relating to external monitoring and compliance with sustainability performance targets.
- The scope of representations and undertakings relating to a borrower's sustainability and ESG policies and the information provided to lenders relating to these policies.
- The consequences of a breach of the relevant loan documentation provisions relating to sustainability and ESG policies, including whether a breach constitutes an event of default or, for example, only has an impact on pricing or further utilisation of the facility.

Conclusion

The sustainability-linked loan market in Singapore and the wider Southeast Asia region continues to grow. The regulatory background and increasing focus by investors, lenders, corporates and other stakeholders on sustainability all point to a significant expansion of the market. Against this backdrop, the publication of clear guidelines for sustainability-linked loans is a welcome step in the development of the market.

Mayer Brown has been helping clients address a wide variety of ESG-related matters since the concept's formal inception. We are well-equipped to help our clients with sustainability-linked and other green financing products. We have a unified team of legal experts from across a wide range of disciplines who provide integrated advice across the range of ESG risk factors and opportunities, including on both existing and emerging reporting obligations. Further information can be found on our website: www.mayerbrown.com

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