Linklaters

The rise of green loans and sustainability linked lending: where are we now?

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Executive summary

The pressure to put environmental, social and governance ("**ESG**") issues at the heart of corporate decision-making comes not just from legal and regulatory change, but from shareholders, investors, clients, customers, suppliers and employees. Two new types of loan have developed over the last few years in response – green loans and sustainability linked loans.

Our Thought Leadership publication on the rise of green loans and sustainability linked lending published in 2019 charted the development of these new types of loan and identified trends in documentation and practice.

This Supplement explains how market practice has changed. It also summarises various key legal, regulatory and industry-driven initiatives, including the publication of additional Guidance on the Green Loan Principles and Guidance on the Sustainability Linked Loan Principles originally published by a joint working group of the Loan Market Association, the Asia Pacific Loan Market Association and the US Loan Syndications & Trading Association in 2018 and 2019.

Defining green loans and sustainability linked loans: what is the difference?

Green loans and sustainability linked loans are two different products, but the term "green loan" is sometimes used as an umbrella term to cover both. The defining feature of a green loan is that the loan proceeds are used for green purposes. Classification of a sustainability linked loan does not depend on how the proceeds are used – the defining feature is that pricing is tied to the borrower's performance against certain pre-determined sustainability criteria.

Developments in green loans

New Guidance on the Green Loan Principles

In May 2020, the joint working group responsible for the Green Loan Principles published new Guidance on the Green Loan Principles (the "**GLP Guidance**"), which takes the form of a series of questions and answers intended to be read alongside the Green Loan Principles. At the same time, the joint working group published new Guidance on the Sustainability Linked Loan Principles (the "**SLLP Guidance**") which also takes the form of a series of questions and answers and is considered later in this Supplement.

The GLP Guidance does not change the features of a green loan as stated in the Green Loan Principles, being:

> **Use of proceeds:** the defining feature of a green loan is that the loan proceeds are used for green purposes;

> **Process for project evaluation and selection:** borrowers should communicate to their lenders their environmental sustainability objectives, the process by which they determine the green projects that they undertake and the related criteria they apply to identify and manage environmental risks;

> **Management of proceeds:** the loan proceeds should be credited to a dedicated account or otherwise tracked by the borrower so as to maintain transparency and promote the integrity of the product; and

> **Reporting:** borrowers should keep readily available up-to-date information on the use of proceeds, including a list of the green projects against which the loan was applied and their expected impact.

The GLP Guidance explains and clarifies the application of the Green Loan Principles in more detail. Among other things, the GLP Guidance makes clear that:

> **Eligibility:** green loans are not the preserve of environmentally-friendly companies. Any entity that can borrow in the loan markets may borrow a green loan. The GLP Guidance states by way of example that "Projects that significantly improve the efficiency of utilisation of fossil fuels are potentially eligible, as long as the loan funding such projects is aligned with the four core components of the Green Loan Principles, and the borrower has committed to an ambitious decarbonisation pathway reasonably considered to be aligned to the Paris Agreement".
>
> There is no requirement under the Green Loan Principles for any borrower to have committed to decarbonisation initiatives. Instead, the focus is on the nature of the project itself needing to be green. The GLP Guidance notes that in the context of "controversial activities, such as fossil fuel, extractive or nuclear based activities", lenders may require additional transparency from borrowers.

> **Projects which cease to be green:** where a green loan has been applied towards a project which is green at the outset, but cannot subsequently be considered green (for example because of a change in circumstances or new technology being developed), the parties can exclude that project from being categorised as green for the purposes of the green loan.
>
> The GLP Guidance does not contemplate a scenario where the parties do not agree on the recategorisation of a project. It is possible that some lenders may wish to have the ability to do so unilaterally in order to address the risk that they could otherwise be associated with a project which is labelled as green, but which is no longer green.

> **No need for an identified green project at the outset:** green loans can be divided into two categories. First, those where the borrower has identified a particular green project to be financed at the outset of the loan. On these transactions, the facility agreement will typically make clear that the loan proceeds may only be applied towards that particular project. Second, those where no such project exists when the facility agreement is entered into and instead green projects are to be identified over the life of the loan. On these transactions, the parties may agree a green finance framework which sets out the criteria for determining whether any given project is green and therefore eligible for being funded under the facility agreement.

> **External review:** the borrower and lenders should agree at the outset whether an external review is required. The GLP Guidance notes that the loan market is traditionally relationship-driven and that lenders are likely to have a broad working knowledge of the borrower and its activities. On that basis, self-certification may be appropriate where the borrower has demonstrated or developed the internal expertise to confirm alignment of the green loan with the requirements of the Green Loan Principles. The GLP Guidance also makes clear that where lenders do not have that broad working knowledge of the borrower, or the borrower is not able to demonstrate that internal expertise, external review is recommended.

> **Reporting:** borrowers should keep readily available up-to-date information on the use of proceeds, which should be updated at least annually until the loan is fully drawn and as necessary thereafter. The parties may agree that reporting should take place more regularly. The GLP Guidance contemplates that where the proceeds are used to finance more than one green project, portfolio level reporting may be possible.

> **Documentary requirements:** there is no market standard drafting for a green loan, but the GLP Guidance highlights four areas of facility agreements that parties will need to consider:

– **the purpose clause:** to ensure that the eligible project (or green framework) is clearly set out;

– **information undertakings:** to ensure that appropriate reporting requirements are applied;

– **representations:** the borrower should be under an obligation to represent the accuracy of any reporting; and

– **breach:** the GLP Guidance says "Parties should give due consideration as to whether or not a failure to apply the proceeds of a green loan towards a green project will trigger an event of default, and a subsequent cross-default across outstanding loans". As a matter of practice, it would be very unusual for a breach of the purpose clause of a facility agreement not to be an event of default. It is possible that parties may adopt additional drafting in facility agreements to make clear that recategorisation of a project after drawing does not give rise to an event of default accordingly.

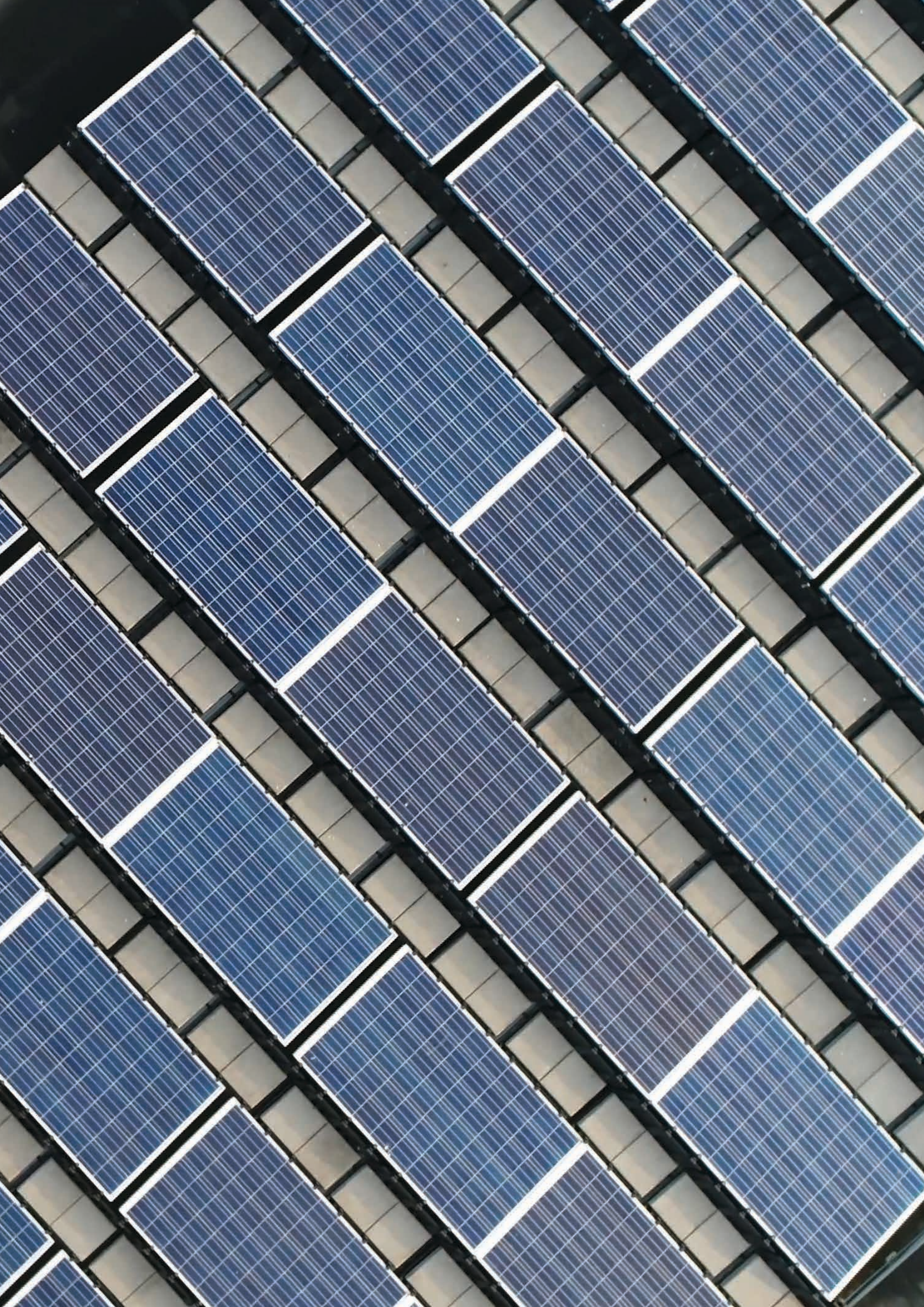
Participants in the project finance markets, where the Equator Principles have been widely adopted, are exploring how certain project finance transactions (for instance, relating to renewable energy) might also meet the requirements of the Green Loan Principles.

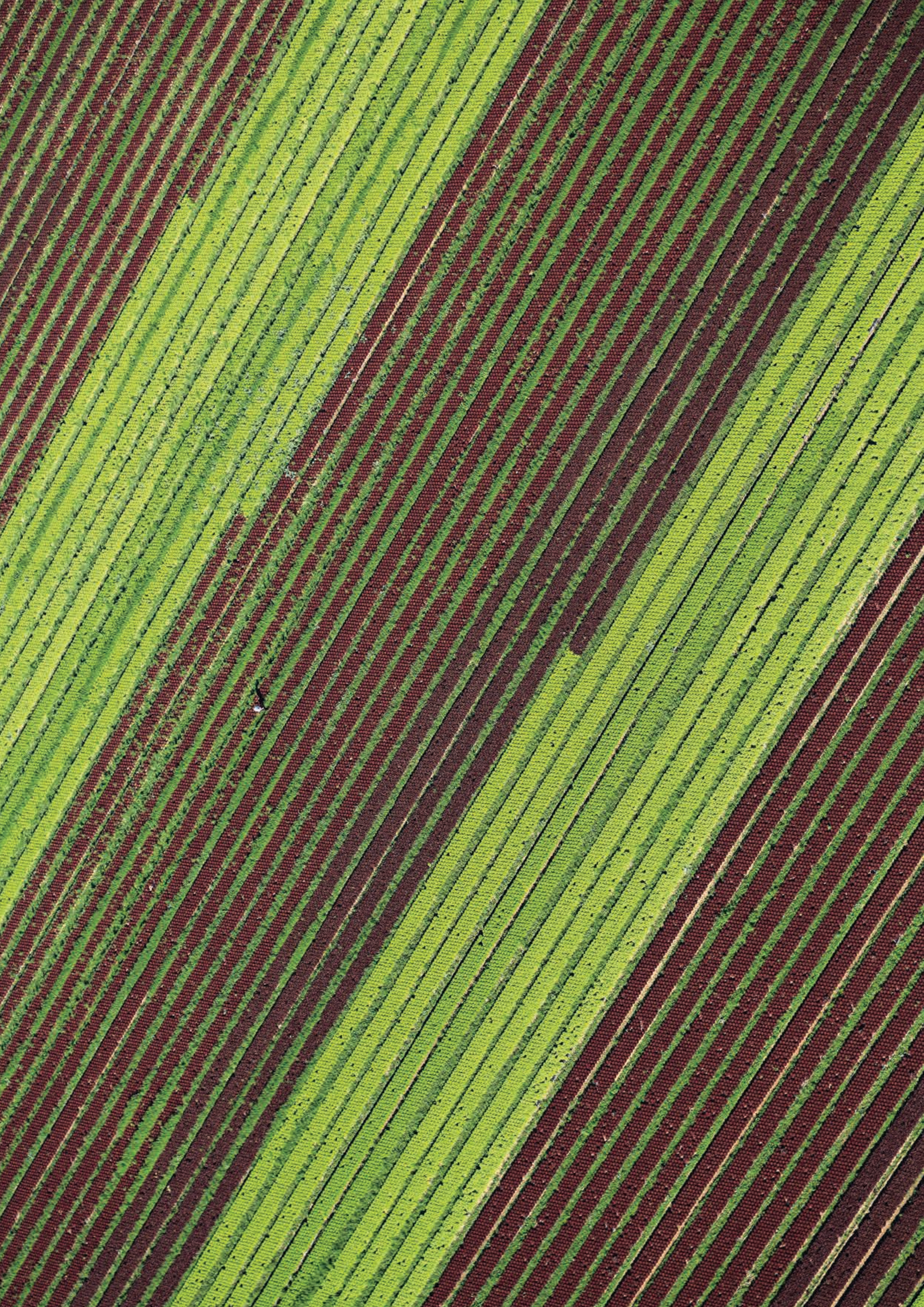
Updated Equator Principles

> The Equator Principles are voluntary standards primarily used by financial institutions active in financing projects for determining, assessing and managing environmental and social risks. The Equator Principles were first published in 2003, long before the Green Loan Principles were published in 2018. The most recent form of the Equator Principles was published in November 2019 and was due to apply from 1 July 2020. However, the implementation date has been postponed to 1 October 2020 in light of the challenges caused by the Covid-19 pandemic.

> Among other things, the updated Equator Principles require an assessment of climate change risk on projects with certain characteristics. This must assess the risks related to physical impacts of climate change on the project and, if the project's CO_2 emissions exceed a certain level, must also consider risks related to the transition to a lower carbon economy. It will also be necessary to undertake an assessment of any potential impact the project might have on human rights, which was previously only required in limited high-risk circumstances.

> Compliance with the Equator Principles is not required by the Green Loan Principles. However, participants in the project finance markets, where the Equator Principles have been widely adopted, are exploring how certain project finance transactions (for instance, relating to renewable energy) might also meet the requirements of the Green Loan Principles. This may lead to an increase in green loan transactions in the project finance markets.





Developments in sustainability linked loans

New Guidance on the Sustainability Linked Loan Principles

New SLLP Guidance was published by a joint working group of the Loan Market Association, Asia Pacific Loan Market Association and the US Loan Syndications & Trading Association in May 2020 alongside the new GLP Guidance referred to earlier.

The SLLP Guidance does not change the fundamental characteristics of sustainability linked loans as set out in the Sustainability Linked Loan Principles – in particular that the loan incentivises the borrower's achievement of ambitious, pre-determined sustainability key performance indicators (or "**KPIs**"). Rather, the SLLP Guidance, which is to be read alongside the Sustainability Linked Loan Principles, explains and clarifies the application of the Sustainability Linked Loan Principles in more detail.

Among other things, the SLLP Guidance makes clear that:

> **Eligibility:** any entity that can borrow in the loan markets may borrow a sustainability linked loan.

> **Pricing:** where a company fails to meet a KPI in a sustainability linked loan, "it is expected that any previously achieved incentive ceases to be awarded from that point" and the loan "may be subject to, for example, a margin premium". The Sustainability Linked Loan Principles did not require that the incentives for achieving the relevant KPIs (typically a reduction in the margin) were disapplied upon failing to meet targets, although in practice this is how transactions have been documented. The Sustainability Linked Loan Principles also did not contemplate that a margin premium could be applied for failing to meet KPIs – such a feature is very common in practice, but not universal.

> **KPI setting:** there is more than one methodology for selecting KPIs. Examples include using:

– **ESG metrics and targets** included in the borrower's sustainability strategies or policies;

– **external analysis** on sector-specific ESG criteria and best practice; and/or

– **verified industry metrics** reported against certain frameworks, with verification by third parties who will determine whether the targets are ambitious for the borrower.

The SLLP Guidance notes that one way to ensure that the KPIs are material to the borrower's business is to map them against a materiality assessment of the borrower, or at least of its industry. A materiality assessment identifies the most important ESG considerations for the borrower (or a given industry) and is undertaken by a third party. The SLLP Guidance gives the example of the Sustainability Accounting Standards Board's Materiality Map which presents an assessment of the relative priority of over 40 sustainability issues on an industry-by-industry basis.

Any entity that can borrow in the loan markets may borrow a sustainability linked loan.

The SLLP Guidance restates that KPIs should be "ambitious" and clarifies that this means they "represent a true reach for the borrower". The SLLP Guidance also makes clear that KPIs should not be set lower than those already adopted internally or announced publicly by the borrower. This is consistent with ensuring the credibility of the product because it helps to prevent the use of KPIs which are not meaningful and ambitious.

The SLLP Guidance also highlights that borrowers can use industry initiatives and standards to help ensure that sustainability-related targets are meaningful and ambitious. One example of such a standard is the Science Based Targets initiative where targets to reduce greenhouse gas emissions are considered "science based" if, amongst other things, if they are consistent with the changes required in order to meet the goals of the Paris Agreement.

- **External review:** whether or not an external review is appropriate is to be considered on a case by case basis, and the responsibilities of an external reviewer will vary between transactions. In some cases, a pre-signing review may be sought, for example to confirm that the sustainability linked loan is consistent with the Sustainability Linked Loan Principles, that the chosen targets are meaningful and ambitious or that the achievement of those targets is not overshadowed by negative effects of other practices of the borrower.

  The SLLP Guidance states that post-signing, the Sustainability Linked Loan Principles "strongly recommend that a borrower seek external review of its performance against its sustainability performance targets where information relating to the sustainability performance targets is not made publicly available or otherwise accompanied by an audit/ assurance statement". The SLLP Guidance also says that parties should consider whether performance will be self-reported through compliance certificates or provided on the basis of publicly available data, and whether any external review may be required to verify the information.

- **Reporting:** there is no standard methodology for reporting on performance since it depends on the chosen KPIs. The SLLP Guidance states that borrowers should report at least annually and are encouraged to provide details of any underlying methodology and/or assumptions. Public reporting is encouraged.

- **Documentary requirements:** as for green loans, there is currently no market standard drafting for a sustainability linked loan. The SLLP Guidance highlights a number of areas of facility agreements for parties to consider:

  - **KPI drafting:** the "source" for the KPIs as well as the target level should be set out in the facility agreement. Transparency on how and why a KPI has been established is encouraged in order to eliminate any possible perception of manipulation.

    The SLLP Guidance also notes that parties should think carefully about how improvements in KPIs are to be measured – a change in the absolute value of a given metric is not the same thing as a percentage change in that metric.

Parties should think carefully about how improvements in KPIs are to be measured – a change in the absolute value of a given metric is not the same thing as a percentage change in that metric.

On some transactions, the KPIs may cease to be relevant over time, and the parties may need to consider amendments accordingly. This may be particularly relevant for facilities with longer maturities or where there is an extension option. The potential impact of any changes to the borrower's business on the KPIs may also need to be considered.

The SLLP Guidance contemplates that facility agreements may define precise conditions under which the borrower may be allowed to update its KPIs. Future-proofing sustainability linked loans is considered further below:

- **information undertakings:** appropriate reporting requirements should be included. Where the borrower already publishes a sustainability report to its stakeholders, a copy of that report should also be delivered to the lenders;
- **representations:** the borrower should be under an obligation to represent the accuracy of any reporting; and
- **breach:** the SLLP Guidance states that there is no established market standard as to what constitutes a "sustainability" breach. It notes that failure to meet KPIs "may not constitute an event of default", but that an economic impact such as an increase in margin could result. In practice, failure to meet a KPI is not an event of default on sustainability linked loan transactions. Whether or not there is an increase in margin depends on the chosen pricing structure. The evolution of pricing structures in sustainability linked loans is set out in more detail below.

The SLLP Guidance states that inaccurate reporting (or the failure to deliver information) on the borrower's performance against its KPIs "will constitute a breach and may, in some cases, give rise to an event of default. Whether delivery of inaccurate information results in an event of default is, however, typically left to the interpretation of the standard reporting representations and covenants in the facility agreement".

A move towards more sophisticated structures in sustainability linked loans

Early one-way and two-way pricing structures

In our 2019 Thought Leadership publication, we explained how early sustainability linked loans were documented on a "one-way" pricing basis – if the borrower satisfied certain pre-determined ESG targets, a discount was applied to the margin payable on the loan. There was no impact of missing those targets, or even of declining ESG performance over the life of the loan. In those situations, the discount did not apply and the pricing remained unchanged.

One-way pricing structures gave way to "two-way" pricing structures. These operated such that an improvement in ESG performance still triggered a discount to the margin on the loan, but if the borrower's ESG performance declined rather than improved, then a premium would be added to the margin instead of a discount.

The ESG targets used on the early sustainability linked loans tended to rely on overall ESG scores assigned to the borrower annually by a third party ESG rating agency such as Sustainalytics or Vigeo Eiris.

These targets were static in the sense that the pricing change was triggered where the borrower's overall ESG score improved (or declined) by more than a fixed number of points from an overall score attained around the time of entry into the loan. For example, if the chosen rating agency scored a borrower at 60 on a scale of 0-100, the facility agreement might set a target score of 65 or higher on subsequent assessments as the trigger for a discount.

Pricing changes were relatively small, settling around 2-4 bps in a typical investment grade sustainability linked loan. Pricing changes were not cumulative – at the end of each year, any discount or premium applied to the margin was cancelled, and a new assessment was undertaken as to whether any discount was justified on the basis of the borrower's ESG performance at that time.

Sophisticated two-way pricing structures

The last year has seen a shift towards more sophisticated two-way pricing structures. The fundamental theme remains that an improvement in ESG performance triggers a discount to the margin, and poor performance triggers a premium, but with some key modifications to the structure outlined above.

i. Increasing use of specific Key Performance Indicators

Relatively few new sustainability linked loans rely on an overall ESG score for the borrower. Instead, performance is now more commonly assessed across a selection of KPIs. Some loans have just one or two KPIs, while others may use as many as six or more. In some cases, the chosen KPIs could be applied to any business (such as CO_2 emissions or the proportion of women in senior management positions). Other KPIs may be tailored to the specific sector or business (such as the proportion of raw materials sourced on an ethical basis in the case of a manufacturing company, or the uptake amongst customers of smart meters in the case of a utilities company).

In practice, many larger corporates have established corporate sustainability programmes and the KPIs used on their new sustainability linked loans can be framed within the objectives of those programmes.

Some new sustainability linked loans apply a separate discount for each KPI target that is met. On others, performance is averaged across all KPIs and compared to a target for overall improvement. Other approaches are followed as well.

ii. Dynamic performance targets

Early one-way and two-way pricing structures typically used a static performance target set by reference to an initial score attained by the borrower around the time of entry into the facility agreement. On these transactions, it would be possible for a borrower to improve its ESG performance to a level sufficient to trigger the margin discount, and then for its performance to flatline for the remainder of the loan and for it to still benefit from a discount.

There have been a number of transactions where dynamic targets have been introduced which require ever-increasing improvements in ESG performance year-on-year in order for the discount to continue to apply.

iii. Triggers for a margin premium

The triggers for a premium to be applied to the margin are changing as well. On the early two-way pricing structures, a decline in the borrower's ESG score was required before a premium was applied. On some of the transactions which have used more sophisticated two-way pricing structures, even a positive improvement in performance can trigger the margin premium where that positive improvement is not large enough. These loans operate such that exceeding a certain level of improvement in ESG performance triggers a discount, but being at or below another (lower) level of improvement year-on-year triggers a margin premium.

Evolving new features

As the market continues to evolve, two features of sustainability linked loan documentation are receiving particular attention.

i. Prescriptive payment provisions

On a number of transactions, a prescriptive payments regime has been included which requires the amounts represented by the pricing changes on the loan to be applied in a specified manner.

On some transactions, for example, the borrower could be obliged to donate an amount equal to the saving realised through any margin reduction to charity, or perhaps to reinvest it back into the business to further improve ESG performance. Similarly, there are transactions where the lenders have agreed that additional amounts received through any increase to the margin will be donated to charity.

ii. Future-proofing sustainability linked loans

Sustainability linked loans can be difficult to future-proof for changes to the borrower's wider sustainability programme or for changes to the borrower group arising from, for example, significant acquisitions or disposals.

The SLLP Guidance notes that provisions may be included in documentation to define the precise conditions under which the borrower may be allowed to update its KPIs and recalibrate targets to ensure that they are appropriate. Many facility agreements do not include such provisions, and lenders may be reluctant to allow the borrower to change provisions that have a direct impact on pricing without their consent, particularly where those changes could result in a lower margin being payable. There are, however, examples of transactions which allow the borrower to "switch off" entirely one or more KPIs by notice to the lenders. On these transactions, if all KPIs are switched off, the loan effectively reverts to a traditional (or non-sustainability linked) pricing structure.

There is a further aspect to future-proofing concerning the potential for third party ESG rating agencies to change their rating methodologies, as Sustainalytics did in 2018 and 2019. It is possible that regulatory initiatives such as the new EU Taxonomy Regulation described in more detail later could lead to future changes in rating methodologies, for example.

A change to a rating methodology may or may not have a meaningful impact on a particular company's ESG rating depending on the nature of its business and how the methodology has changed. For those companies that are affected, a potential problem stems from the fact that the targets in sustainability linked loans are fixed upon the entry into the facility agreement on the basis of the borrower's then-current, and projected, ESG performance. A change in methodology could result in a higher (or lower) ESG performance score being assigned to the borrower when in fact its performance has not changed, with the consequential impact that the targets in the facility agreement may suddenly become easier or harder to meet.

Sustainability linked loans can be difficult to future-proof for changes to the borrower's wider sustainability programme or for changes to the borrower group arising from, for example, significant acquisitions or disposals.

The challenge for the loan markets is that it is not possible to hardwire adjusted targets in anticipation of a future change in calculation methodology – the adjustment required would depend on how the methodology changes. Instead, an amendment to the facility agreement would be required. In some cases, third party ESG rating agencies may operate their new methodology in parallel with the earlier one, at least for a period, which would allow parties some time to consider the impact of such a change.

A new role: the sustainability coordinator

It has become increasingly common on sustainability linked loan transactions for one or more lenders to be appointed as a "sustainability coordinator". The scope of that role varies between transactions, but generally involves leading the process of identifying suitable KPIs and targets for the particular borrower and leading the negotiation of the sustainability-related provisions of the facility agreement on behalf of the lenders. The sustainability coordinator might also lead any renegotiation of those provisions on behalf of the lenders over the life of the loan.

The introduction of a sustainability coordinator on some transactions is acknowledged in the SLLP Guidance. The SLLP Guidance notes that the sustainability coordinator "does not assume fiduciary duties to the rest of the syndicate by confirming documentation meets the Sustainability Linked Loan Principles on behalf of other lenders, and therefore each lender should still satisfy themselves as to the borrower's credentials if such a role is undertaken on a transaction".

In practice, some sustainability coordinators have sought to amend indemnities and other protections for the arrangers and other finance parties to cover the sustainability coordinator as well and to make expressly clear that the sustainability coordinator has no fiduciary duties to any other party.

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Key legal, regulatory and other developments

Our 2019 Thought Leadership publication summarised a wide range of ESG-related legal, regulatory and other developments. While many of these initiatives may have limited direct impact on the way in which green and sustainability linked loans are documented, they emphasise the ongoing shift to promote ESG considerations to the forefront of business decisions. There have been a number of key changes in this area since our earlier publication.

An update on the EU sustainable finance package

The impact of Brexit

The UK formally left the EU and entered a transition period at the end of January 2020. That transition period is set to expire at the end of 2020 unless extended. EU law which has been passed and comes into force before the end of the transition period will be retained in UK law going forward.

A number of the initiatives that make up the EU sustainable finance package are expected to come into force after the end of the transition period and accordingly there is scope for regulatory divergence in the future between the EU and UK.

New Taxonomy Regulation

The Taxonomy Regulation is intended to establish an EU-wide classification system for determining what constitutes an environmentally sustainable economic activity. An eligible activity must contribute substantially to certain environmental objectives specified in the Taxonomy Regulation, must not cause significant harm to other specified objectives and needs to meet certain minimum social and labour standards. Member States will be required to apply the new standards when regulating certain green or sustainable financial products, and certain entities will be required to apply them to non-financial disclosures or when marketing certain financial products.

The Taxonomy Regulation may have an indirect impact on the loan markets. For example, in relation to green loans, where the defining feature is that the loan proceeds must be applied towards a green purpose, it is possible that the standards established by the Taxonomy Regulation may be adopted by some market participants as a framework for determining whether a given economic activity is eligible for green funding under the facility agreement.

It is also possible that the Taxonomy Regulation could have other indirect impacts, for example leading to changes in the methodologies used by third party ESG rating agencies or on the KPIs chosen in sustainability linked loan transactions.

Political agreement on the Taxonomy Regulation was reached in December 2019, with the position of the Council published in April 2020. The legislation is expected to be formally adopted later in 2020, with the rules on environmental objectives to be phased in progressively. The taxonomy relating to climate change mitigation and climate change adaptation will apply from 2022, while the taxonomies for other environmental objectives (specifically, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control and protection and restoration of biodiversity and ecosystems) will apply from 2023.

The Technical Expert Group on Sustainable Finance ("**TEG**") published its final report on the EU Taxonomy in March 2020. This set out recommendations that will be used by the European Commission in drafting the technical screening criteria in relation to climate change mitigation and climate change adaptation. Additional technical screening criteria for the other environmental objectives mentioned above will follow.

The TEG has also published a report recommending the creation of a voluntary EU Green Bond Standard, which the European Commission is to consider taking forward later in 2020.

New ESG Disclosure Regulation

The ESG Disclosure Regulation will require financial advisers and firms conducting investment decision-making activities on behalf of clients to be transparent as to the extent to which they take account of ESG considerations in the services they provide. To help reduce “greenwashing” (meaning presenting a product or service as more environmentally friendly than it really is), those organisations will also have to show how any financial products they promote as having sustainable objectives or positive ESG characteristics justify those labels. The ESG Disclosure Regulation will generally apply from 10 March 2021, save for provisions relating to disclosures in periodic reports, which apply from 1 January 2022. Regulatory technical standards and the specific details of ESG disclosures are being developed, with the European Supervisory Authorities producing a joint consultation paper on draft regulatory technical standards in relation to the content, methodologies and presentation of ESG disclosures in April 2020.

New ESG Benchmarks Regulation

The ESG Benchmarks Regulation will amend the Benchmarks Regulation to introduce two new regulated benchmarks to help investors compare the carbon footprint of their investments. Both of the new benchmarks are underpinned by a methodology linked to commitments laid down in the Paris Agreement. The first is a Climate Transition Benchmark, for which the underlying assets or companies will be selected such that the resulting portfolio is on a “decarbonised trajectory” towards alignment with the Paris Agreement. The second is a Paris Aligned Benchmark, where the underlying assets or companies will be selected and weighted such that the carbon emissions of the resulting portfolio are aligned with the objectives of the Paris Agreement.

The European Commission has been consulting on three draft delegated regulations to be made under the ESG Benchmarks Regulation in relation to:

> the minimum standards and transparency requirements for Climate Transition Benchmarks and Paris Aligned Benchmarks;
> the explanation that should be included in each benchmark of how ESG factors are reflected; and
> the requirements for the explanation that should be included in each benchmark of how key elements of the methodology for the benchmark reflect ESG factors.

The ESG Benchmarks Regulation came into force on 30 April 2020, but without the delegated regulations in place it is difficult for administrators of the new benchmarks to comply. On 29 April 2020, the European Securities and Markets Authority (“**ESMA**”) sent a “No Action Letter” to national competent authorities noting that they should not prioritise supervisory or enforcement action against benchmark administrators until the delegated regulations are in place. ESMA has also called for a swift adoption of the delegated regulations and highlighted the importance of setting an application date that allows benchmark administrators sufficient time to adapt their practices as required.

Consultation on a Renewed Sustainable Finance Strategy

In April 2020, the European Commission announced a consultation on a Renewed Sustainable Finance Strategy. The measures on which the European Commission seeks views will impact market participants across the financial services sector, including buy-side investors (such as asset managers, insurers and pension funds), sell-side firms, financial markets infrastructure providers, benchmark administrators, ESG data providers and corporates.

The Renewed Sustainable Finance Strategy will provide a roadmap with new actions predominantly focussing on:

> strengthening the foundations for sustainable investment by creating an “enabling framework”. The consultation notes that many companies concentrate on short-term financial performance rather than long-term development and sustainability-related challenges and opportunities;
> increased opportunities to have a positive impact on sustainability for citizens, financial institutions and corporates; and
> the need to manage and integrate climate and environmental risks into financial institutions and the financial system as a whole.

Alongside its work on a new EU Green Bond Standard, the European Commission is seeking views on whether new standards for sustainability linked bonds or loans should be developed and how far such standards should make use of the new EU taxonomy referred to earlier.

Update on key ESG developments for prudential regulation

EU regulation

In our 2019 Thought Leadership publication, we highlighted that ESG considerations are being embedded into the prudential regulatory framework through new requirements to be imposed under CRR2 (which will apply to banks and larger investment firms) and IFR/IFD (the new prudential framework which will apply to other MiFID investment firms). In particular, under both CRR2 and IFR/IFD:

> certain firms will be subject to new disclosure requirements for ESG risks; and

> the European Banking Authority (the "**EBA**") is mandated to assess whether exposures related to assets or activities associated substantially with environmental and/or social objectives should receive favourable treatment for prudential regulatory purposes.

Since that publication, the EBA has published an action plan on sustainable finance and a roadmap on technical standards under CRR2. Together, these detail some of the further work to be undertaken to build a deeper understanding and awareness of ESG risks generally and the mixture of ESG risks to which firms are exposed depending on their business portfolios.

This information will be used to help develop and refine ESG metrics, to build detailed disclosure requirements and will ultimately help to inform the appropriate prudential treatment to be applied in respect of the relevant assets.

The EBA intends to issue a discussion paper shortly and to use the feedback received to produce a report by June 2025, with a legislative proposal to follow for CRR2 institutions if appropriate. A similar approach is likely under IFR/IFD.

It is clear that the EBA is considering whether and how ESG risks should be included in the supervisory review and evaluation process for CRR2 firms, and is looking to firms to act now to build ESG factors into their business strategies. Although this is clearly some way off, it would ultimately have an impact on how financial resources are deployed.

UK regulation

In December 2019, the Bank of England ("**BoE**") published a discussion paper setting out a framework for stress testing the resilience of the UK's largest banks and building societies to climate change risks.

The discussion paper contemplated testing bank business models against three different climate change scenarios assuming a 30-year time horizon, and required banks to set out the actions that they would take to mitigate risks and to avail themselves of the opportunities that transition offers (for example, to reduce riskier exposures and invest in "greener" businesses).

The climate change stress tests demonstrate the growing commitment amongst regulators to quantify, assess and manage ESG risks. This may promote the growth of more green and sustainable financial activities in the long term.

Although the original intention was to publish the final form of the climate change stress tests framework in the second half of 2020, publication has been postponed until at least mid-2021 as a result of the Covid-19 pandemic. In postponing publication, the BoE stressed that climate change represents a material financial risk to firms and the financial system and is a strategic priority. Further guidance is expected to be issued.

European Commission to review the Non-Financial Reporting Directive

In February 2020, the European Commission announced a consultation on potential changes to the Non-Financial Reporting Directive. This Directive amended the Accounting Directive to require certain large companies to include non-financial statements as part of their reporting obligations. Those statements are required to include disclosures in relation to four sustainability-related topics – environmental issues, social and employment issues, human rights and bribery and corruption. The aim of the consultation is to improve the quality and scope of non-financial reporting and to align it with the new sustainable finance framework.

FCA consultation on climate disclosure by premium listed companies

In March 2020, the UK Financial Conduct Authority published a new consultation paper which proposes that all commercial companies with a premium listing would be required either to make climate-related disclosures consistent with the approach set out by the Taskforce on Climate-related Financial Disclosures or explain why disclosures have not been made. The consultation also seeks feedback on clarifications as to how existing disclosure requirements applicable to listed companies require climate and sustainability-related disclosures.

UK Stewardship Code updated to require consideration of ESG factors

A revised form of the UK Stewardship Code took effect on 1 January 2020. The UK Stewardship Code consists of a voluntary set of principles for asset managers, asset owners and the service providers that support them, and now makes clear that signatories to it are expected to consider ESG factors when making investment decisions.

Financial Reporting Council to review how companies and auditors report on climate change

Separately, the Financial Reporting Council announced in February 2020 that it would review how companies and auditors assess and report on the impact of climate change. The Financial Reporting Council will also consider how investors are addressing climate change in the stewardship of their investments when it monitors the first reports under the updated UK Stewardship Code.

The EU Green Deal

The EU Green Deal (the "**Deal**") seeks to achieve climate neutrality by 2050 which would mean the EU has net zero greenhouse gas emissions.

The Deal seeks to achieve this through a new "climate law" which will enshrine this target in law, along with a separate target for a 50 to 55 per cent. reduction in greenhouse gas emissions as compared to 1990 levels by 2030.

More broadly, the Deal seeks to achieve clean, affordable and secure energy, a circular economy, energy and resource-efficient buildings, a zero-pollution environment which preserves and restores ecosystems and biodiversity, traceability of food from farm to fork and sustainable and smart mobility.

As part of the Deal, a "Just Transition Fund" would help with the significant structural changes in business models, skills requirements and relative prices necessitated by the energy transition and a "Carbon border adjustment mechanism" would seek to tax imports (whether through a tariff, customs duty or extension of the existing EU Emissions Trading System) so that their price is linked to their carbon content.

There have been indicators from the EU that the Deal may be used as a potential source of green economic stimulus for the post-Covid-19 world.

Industry group initiatives

Many other ESG-related developments have been announced, or completed, by industry groups and trade associations since our 2019 Thought Leadership publication. Recent highlights are set out below.

New ICMA working group on sustainability linked bonds and new high-level definitions

In January 2020, the International Capital Markets Association ("**ICMA**") launched a new working group to take stock of developments in the market for sustainability linked bonds and potentially to propose market guidance.

In May 2020, ICMA proposed a set of high-level definitions for commonly used sustainable finance terms to address the need for a convergence on terminology among market participants. ICMA has acknowledged that there are other ongoing efforts in the financial industry to develop a consensus around key terms and definitions in sustainable finance.

LSTA launches ESG diligence questionnaire

In January 2020, the US Loan Syndications & Trading Association published a new ESG diligence questionnaire. The questionnaire was prepared in response to an increased number of ESG-related questions being put by end investors in loans to buy-side market participants to help them to understand the ESG-related risks in the borrower's business and how those risks are being addressed.

The questionnaire is intended to be completed by the borrower during the loan origination process to help answer those questions and covers points such as whether the borrower has a formal ESG policy, which individuals have formal oversight of ESG issues, how ESG performance is tracked and whether ESG is a factor in management performance evaluation or compensation.

Loan Market Association and European Leveraged Finance Association work on sustainability disclosures

Similarly, in February 2020, a joint working group of the Loan Market Association, the European Leveraged Finance Association and the Principles for Responsible Investment launched an initiative to develop a standard set of material ESG disclosure topics which borrowers could be expected to report publicly. The initiative follows a survey by the European Leveraged Finance Association where nearly half of respondents reported that their firms did not have enough ESG information on borrowers.

Property Industry Alliance ESG best practice principles

In February 2020, the Property Industry Alliance released a set of best practice principles for taking account of ESG considerations within the real estate industry. The principles are intentionally broad, encouraging real estate market participants to go above and beyond applicable legal and regulatory requirements relating to, for example, planning, safety and environmental rules.

New International Securities Lending Association Principles for Sustainable Securities Lending

On 27 February 2020, the International Securities Lending Association published its Principles for Sustainable Securities Lending. These Principles are intended to have a strong and clear impact on the social, governance and long-term thinking elements of sustainable securities lending and to enhance transparency around the impact of securities lending on the environment. Like the Green Loan Principles and Sustainability Linked Loan Principles, the Principles for Sustainable Securities Lending are a high level set of voluntary standards.

Loan Market Association Glossary of Terms

In March 2020, the Loan Market Association published a new Glossary of Terms for green and sustainable lending. The intention is that this will aid transparency and consistency in the terminology used in the loan markets.

International Organization of Securities Commissions report on sustainable finance and the role of securities regulators

In April 2020, the International Organization of Securities Commissions ("**IOSCO**") published a report which sets out an overview of various regulatory and industry initiatives relating to sustainable finance. The report demonstrates that there are diverse sets of standards across regions and products. IOSCO is establishing a Sustainability Task Force to:

- improve sustainability-related disclosures by issuers and asset managers;
- work in collaboration with other international organisations and regulators to avoid duplicative efforts and enhance coordination of regulatory and supervisory approaches; and
- conduct case studies and analyses of transparency, investor protection and other relevant issues within sustainable finance.

The impact of competition law

Many companies are already taking steps to move to lower-carbon business models. Collaboration within industry is potentially the most effective way to achieve such a shift, but competition rules have the potential to cut across such efforts.

EU competition rules are already under review, including in relation to the list of acceptable reasons for companies to work together, but it is not yet clear how far agreements on environmental issues will be factored into that process. This is another area with the potential for regulatory divergence in the wake of Brexit, but there are clear advantages in the UK and the EU working together on the application of competition rules in this area.

The Covid-19 crisis has shown that exemptions (albeit temporary) from the competition rules are possible in testing times – in addition, competition agencies in Europe have reversed a 20-year trend of leaving parties to self-assess their own agreements in favour of giving companies "comfort letters" so that they can pursue collaborative projects without the risk of being fined. These actions during the current crisis may provide a roadmap for competition agencies when considering collaboration between competitors in the context of urgent action to combat climate change in the future.

Market leading expertise

Linklaters has extensive experience advising on green and sustainability linked loan transactions.

We are at the forefront of legal and regulatory developments on ESG across Europe, Asia and the US, as national and regional regulators drive changes to the financial landscape.

We offer our clients a global service, both in outlook and reach. Our network of 30 offices is reinforced by an integrated alliance with Allens, the leading Australian law firm with offices throughout Asia, our collaborative alliance with Webber Wentzel, South Africa's premier full-service law firm, our best friend relationship with Talwar, Thakore & Associates, a leading Indian law firm, our formal association with Zamakhchary & Co, one of Saudi Arabia's leading full-service law firms, and our formal association with Widyawan & Partners, one of Indonesia's leading full-service law firms.

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