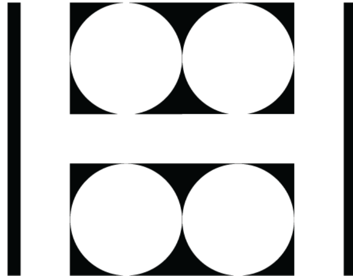

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LEGAL BRIEFING – Banking & Finance

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SLLs: a "green" bet to be won in corporate finance

Over the past decade companies of all sizes strive to respond to the ever-growing list of environmental, social and governance **(ESG)** concerns, so that they can meet the objectives and/or targets aiming towards a positive impact to their business, the investors as well as the society. ESG matters are getting highly important not only for the namely "big companies" (of Law 4308/2014) which are obliged to issue annually reports on ESG issues pursuant to article 151 of the Greek Corporate Law (4548/2018), but also for smaller companies which can also benefit from a positive reputational impact as advocates of such ESG goals.

In light of the above, Sustainability Linked Loans (SLLs) are evolving to be considered as one of the most effective lending options, especially for businesses seeking to resort in alternative types of lending while aiming to "bust" their ESG profile.

What are SLLs?

SLLs are loan facility instruments that incentivize borrowers to set pre-defined sustainability performance targets **("SPTs")** which are assessed by Key Performance Indicators **(KPIs)**. The rationale of SSLs is based on certain core principles such as the creation of SPTs, the selection of KPIs, the particulars of the SSL, the requirement of reporting to the parties participating in the SSL on the performance of the SPTs and the borrowers' obligation to seek "external" verification of the SPTs.

SLLs shall be clearly distinguished from "green loans" or "green bonds". The purpose of the latter must be -exclusively- the finance of "green projects", whereas proceeds from SLLs

are not required to be exclusively linked to "green projects" but they can rather be used for general corporate purposes. In addition, SLLs objectives cover equally societal, governance and environmental aspects and can be applied to any business sector.

Consequently, the only difference between Sustainability-linked Loans and traditional credit facilities, is that in SLLs, typically, the interest payable is linked to KPIs i.e. environmental, social and governance (ESG) targets which are designed in a way to provide an incentive to the borrower. When these predetermined indicators are met, the borrower may receive the benefit of a discount in the margin of its loan, whereas failure to meet the targets may lead to higher interest rates or other penalties.

So, what are the benefits of an SLL?

Apart from the obvious privilege of obtaining more advantageous interest rates, SLLs can be seen as the first step for companies to introduce a new sustainability model based on a resilient sustainability strategy and enhance their competitiveness in the market. In addition to the foregoing, borrowers and lenders are also given the opportunity to strengthen and/or re-define their value-based relationship with investors who operate or intend to operate in the realm of ESG investing, while the positive reputation that accompanies ESG advocates can have a great impact in both parties' profile amongst consumers resulting in macroeconomic advantages.

Consequences (Breach vs Default) and "Exit" provisions

The significant difference between sustainability provisions and traditional facility covenants is that a breach of the sustainability provision or failure to meet a KPI -generally- does not result in an event of default but it may keep the borrower out of the "discount zone". Among the consequences may also be included a higher margin or another financial penalty payable by the borrower until the KPI is next tested and satisfied. In some cases, a serious or persistent breach will result in an obligation on both the borrower and the lender to cease describing the facility as an SLL in their accounts and marketing materials. However, the provisions of the SLLs may provide that a misrepresentation in the reporting related to KPI compliance, may result in an event of default, especially where this misrepresentation is a result of fraud or serious misconduct of the borrower. In any case, any misrepresentation or misleading information produced by the company in relation to the company's "green" operation, products and objectives is illegal and may incur penalties.

SLLs structure and challenges

The structure of the KPIs is the first challenge the parties have to overcome/face. As the KPIs define -typically- the progress of the margin, it is significant to ensure that these targets represent at the same time an achievable / viable but also an ambitious goal for the borrower. The first negotiation might be challenging for both parties, but, once the KPIs are settled, they will usually become its "standard" for other future financings, much in the way of financial covenants.

Another important issue is the measurement of the KPIs. In order to achieve transparency, KPIs shall be externally verified by a third party, in a way similar to the external verification of the financial covenants by auditors/accountants. The facility agreement, among other issues, shall

include clauses related to the time of the KPIs tests (annually or more frequently), the form of the KPIs compliance certificate and the identity of the certifier (or the requirements of such person/entity). “Exit” provisions can also be added, in order to allow one party to switch off the SLL provisions, for example, if the borrower’s circumstances change (i.e. change of control, acquisition of other entities etc) or if there is a change in the SLL regulatory environment.
Of course, the lack -at least at the time- of standard market practices may increase the transaction costs at the beginning while the long negotiations about the KPIs may cause delays in the closing of the deals.

Final thoughts and perspectives

Unarguably, “being green”, although it is a necessity, it’s neither easy nor cheap. The current strategy of providing incentives to the borrower in order to adopt “greener” practices instead of imposing sanctions when they fail to do so, is likely to put SSLs at the top of the borrowers’ lending options. However, whilst SLLs seem to be a useful tool to incentivise positive ESG outcomes, borrowers must ensure that they do not create more ESG (and financial) headaches for their businesses. We expect that the expansion/development of SLLs over the next years will provide a greater ease in the contracting part and reduce the transaction costs. Tax incentives /deductions in respect of those companies that meet the KPIs could also accelerate the expansion of SLLs in the corporate finance industry. Undoubtedly, adopting ESG objectives and opting for environmental-friendly lending products, will be a significant step towards the gradual stabilization of the global economy following the Covid-19 pandemic