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LSTA Issues Additional Guidance for Social Loans and External Reviews

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Over the course of the last several years, interest in Environmental, Social and Governance ("***ESG***") financing has skyrocketed, leading to the growth of several financial products focused on this market, including the sustainability-linked loan ("***SLL***"), which incorporates pricing reductions upon the borrower meeting key sustainability performance targets in its operations, green loans ("***Green Loans***"), which require loan proceeds to be utilized for a specific green purpose and social loans ("***Social Loans***"), which require loan proceeds to be utilized for a specific social purpose.

Following the rise in interest in ESG financing, the Loan Syndications and Trading Association ("***LSTA***") developed guidelines for lenders to utilize in offering SLLs, Green Loans and Social Loans. Known as the Sustainability-Linked Loan Principles, the Green Loan Principles and the Social Loan Principles, respectively (collectively, the "***Principles***") the Principles identify key elements of SLLs, Green Loans and Social Loans and provide a framework to better define the recommended or required components. One such component is the engagement of an independent, external reviewer to review and verify the ESG compliance of the SLL, the Green Loan or the Social Loan, rather than relying solely on the information, representations and certifications provided by the borrower. Though the Green Loan Principles and Social Loan Principles recommend obtaining external reviews and the Sustainability-Linked Loan Principles include external review as a required element of an SLL, there remain inconsistent approaches in the market in terms of when external reviews should be utilized and the frequency, scope and content required. To provide further clarification, on March 3, 2022, the LSTA issued Guidance for Green, Social, and Sustainability-Linked Loans External Reviews (the "***Verification Guidance***") as a complement to the verification components set forth in the Principles.

At the same time, the LSTA also issued its Guidance on Social Loan Principles (the "***SL Guidance***"), for the purpose of providing further information and clarification on the Social Loan Principles and the application and use of Social Loans in the debt markets.

This alert provides a high-level summary of the additional guidance issued by the LSTA and the implications that it may have on ESG debt products.

Guidance for Green, Social and Sustainability-Linked Loans External Reviews

The Verification Guidance is based on the ICMA 2021 Guidelines for Green, Social, Sustainability and Sustainability-Linked Bonds for External Reviews and similar guidance issued from other relevant standards bodies, regulatory commissions and trade associations, in an effort to encourage consistency across debt markets. Given that external reviews may vary significantly in size, scope and subject matter, the Verification Guidance sets forth five voluntary prongs that lenders can consider in selecting, engaging and utilizing external reviewers: (1) Types of Reviews, (2) Ethical and Professional Standards for External Reviewers, (3) Organization of External Reviewers, (4) Content of External Reviews and (5) Disclosure for External Reviews.

(1) Types of External Reviews

The Verification Guidance acknowledges that the scope of an external review will depend on the nature of the financial product. For example, an external review may look at the soundness of the environmental or social standards being applied to a project financed by a Green or Social Loan, or it might independently verify the accuracy of data being provided to support the borrower's compliance with the SLL, Green Loan or Social Loan parameters. As such, the Verification Guidance identifies several types of external input that can be obtained, broadly described as follows:

(A) Second Party Opinions. These are opinions issued by an independent party, and may vary in content as there is no specific parameters as to what can and cannot be opined on by a second party. The key element is that the second party opinion giver is completely independent from the borrower and any agent, advisor or other party that is designing the green, social or sustainability-linked framework by which the borrower must comply. Therefore, the opinion author will reinforce the loan terms agreed by the lender by providing an additional, second opinion as to whether the applicable framework would meet requirements set by the lender, or otherwise relevant to the borrower's operations or the applicable project, including any industry standards, broader policy goals or other guidance (including the Principles).

(B) Verification. A Third-Party Verification will require a third party to independently verify the data provided to the lender to satisfy the borrower's compliance with the terms of its SLL, Green Loan or Social Loan, similar in concept to an audit of the borrower's financial information. The data to be verified will typically relate to compliance with key performance indicators under an SLL or applicable criteria for impact or use of proceeds for Green or Social Loans.

(C) Certification. Certification will occur when the borrower's data, ESG framework, impact or use of proceeds is certified by an accredited third party against a recognized external standard or label that requires specific criteria for compliance. An example of this would include certification of a green bond offering as a Certified Climate Bond by the Climate Bonds Standards Board.

(D) Green, Social and Sustainability-Linked Loan Scoring/Rating. Borrowers may also rely on the use of an ESG/Green Score or Rating, whereby a rater such as a ratings agency, research provider, auditor or other consultant assesses a rating on the borrower's operations, frameworks or environmental or social impact, utilizing set scoring and rating methodology that is applied to companies broadly, taking into account factors such as the company's industry, sector, geographic location and applicable regulations.

(2) Ethical and Professional Standards for External Reviewers

Given the range of types of external reviews and external reviewers, the Verification Guidance further looks to establish ethical standards to consider, particularly in circumstances where the external reviewer is not covered by professional standards or regulation. The Verification Guidance stresses that any external reviewer should be guided by core ethical and professional principles of integrity, objectivity, competence and due care, confidentiality and professional behavior. To the extent that an external reviewer is not subject to professional standards or regulatory regimes, the Verification Guidance recommends a variety of industry wide codes of conduct or professional standards that reviewers can look to, including the International Code of Ethics of Professional Accountants and the Attestation Standards established by the American Institute of Certified Public Accountants.

(3) Organization of External Reviewers

Of particular import is the process utilized by external reviewers to ensure confidence in their review and appropriate steps should be taken to protect the competence of their work and the veracity and integrity of their findings. Such steps will include establishing appropriate working procedures, engaging qualified personnel familiar with the nature and scope of the review and utilizing appropriate professional indemnity and professional liability insurance coverage. The external reviews should also set forth the scope of the review, the qualifications and credentials of the reviewers, the methodologies and other analytics used and clearly identify the conclusions reached. In discussing the qualifications required, the Verification Guidance specifically notes that reviewers providing second party opinions must have expertise in the specific subject of the review, including the related key performance indicators, sustainability performance targets, benchmarks, sectors and industries, and/or the relevant framework or guidance utilized to formulate the borrower's ESG policies.

(4) Content of External Reviews.

While recognizing that external reviews may vary significantly in scope, size, timing and subject matter, the Verification Guidance emphasizes key considerations and findings that should be included in the various types of external review:

(A) Second Party Opinions. The content of these opinions will focus on evaluating the strength of the SLL, Green Loan or Social Loan, as against identified parameters, including whether the components of the borrower's ESG policies or actions or the use of proceeds of a Green or Social Loan are likely to have the desired impact, are sufficiently ambitious and defined, and whether such desired impact and the metrics for measuring, assessing and evaluating progress align with the loan requirements or known frameworks (including the Principles). The second party opinion may also assess key risks that could impact the success of the identified objectives, together with any relevant mitigants that may be utilized.

(B) Verification: Verification of the borrower's data will entail having an independent third-party audit of the processes by which the borrower collects and tracks its information and the accuracy of the data presented. For example, if the borrower's SLL includes reduction of its greenhouse gas emissions on an annual basis as a sustainability performance target, the verification would involve determining how the borrower collects and analyzes information on its emissions, confirming that its processes result in accurate and complete information, and confirming the results provided by the borrower.

(C) Green, Social and Sustainability-Linked Loan Ratings. If the borrower utilizes an ESG score or similar rating, the lender and borrower will need to identify a suitable ratings or scoring agency and ensure that both are comfortable with the methodologies by which the applicable rating or score are assessed. This might include a set of criteria regarding the borrower's ESG policies and operations as assessed against benchmarks or known principles and frameworks (including the Principles) and consider both proactive actions being taken by the borrower and applicable risks being addressed. Taking into account the scoring criteria, lenders and borrowers should also agree to any minimum score or rating thresholds required under the terms of the loan documentation.

The Verification Guidance also notes that external reviews may occur at different times throughout the life of the loan and can be ongoing and used in tandem with other forms of external reviews. For example, the Sustainability-Linked Loan Principles recommend receiving a pre-closing second party opinion as to the ambitiousness, robustness and relevance of key performance indicators (which may need to be updated throughout the life of the loan if there are material changes to the borrower's ESG policies or operations) and require annual verification of the borrower's performance data as against its sustainability performance target.

(5) Disclosure

The Verification Guidance finally notes that any external review should be made readily available to all lenders and the relevant loan documents should specify the timing and process for receipt of external reviews and any other related ESG disclosure. Assuming no confidentiality concerns, it is also recommended that the borrower make external reviews or summaries available to other interested parties including its investors or the broader public.

Guidance on Social Loan Principles.

The SL Guidance begins by setting forth fundamental information on the suitability and applicability of a Social Loan, noting that a Social Loan is defined as “any type of loan instrument made available exclusively to finance or re-finance, in whole or in part, new and/or existing eligible Social Projects” and should align with the four key elements of the Social Loan Principles (the “***SLP***”): (1) use of proceeds for a specific Social Project; (2) process for project evaluation and selection in line with standards set forth in the SLP; (3) management of loan proceeds to ensure they are properly used for the designated purposes; and (4) reporting of progress on the Social Project, including relevant benchmarks, timelines and social impact. Any borrower who has identified a suitable project for utilization of loan proceeds will be eligible for a social loan. While a Social Loan may also include components that form the basis of an SLL or Green Loan, a Social Loan is distinct from a SLL (which does not impose specific requirements on use of proceeds) and a Green Loan (by virtue of its required use of proceeds only for a social, as opposed to green, project). The SL Guidance also clarifies that a Social Loan may be full or partial in nature, may involve the refinancing of Social Projects and can incorporate revolving loan elements as long as there are appropriate parameters for identifying how various loan proceeds are applied.

In discussing how a social project might be designated as eligible for a Social Loan (each such eligible project, a “***Social Project***”), the SL Guidance refers to the examples of Social Projects identified in the SLP, including projects which improve access to basic infrastructure and essential services such as housing, internet, energy, clean water, food, healthcare and education or address large scale social issues such as food security, reduction of food waste, unemployment or social inequalities. In discussing the applicable parameters for a Social Project, the SL Guidance states that the borrower should clearly identify the objectives, strategies and policies relevant to the identified social project as well as the anticipated impacts and risks.

As Social Loans become more prevalent, the risk of “social washing” (where the stated impact of Social Projects is misleading, inaccurate or inflated) is an increased concern. The SL Guidance makes clear that lenders need to maintain the integrity of the Social Loan product by utilizing the core components of the SLP, promoting transparency in reporting and verification and identifying mechanisms to adjust the loan if a change or unanticipated circumstance causes the Social Project to no longer meet the eligibility criteria for a Social Loan.

The SL Guidance also includes considerable discussion on the application of the core components of the SLP, and addresses frequent issues or considerations that might arise in the generation and administration of these loans:

(1) Use and Management of Loan Proceeds

As a key component of a Social Loan is the use of proceeds for a specified Social Project, it is imperative that the borrower provides current information on the application of loan proceeds to the lenders, including allocation of amounts towards the Social Project goals (along with the basis and anticipated impact associated with the project’s designation as a suitable Social Project). To the extent that a Social Loan is included in a loan with other non-social tranches, the use of proceeds for these additional tranches should be tracked separately without commingling of funds.

(2) Process of Evaluation and Selection of Social Projects

Although the SLP includes examples of suitable Social Projects, the SL Guidance clarifies that there is no specific criteria that would mandate suitability of a project for a Social Loan. Rather the lender should look to formulate its own internal policies and criteria in tandem with the borrower's objectives and strategies and third party frameworks such as the United Nation's Sustainable Development Goals and the World Bank's Environmental and Social Standards. The borrower should identify the eligibility and exclusion criteria it is applying to the selection of the Social Projects, including the basis by which a Social Project should be considered eligible for a Social Loan, and any appropriate steps being taken to mitigate risks or adverse effects.

Since the focus of the Social Loan is on the relevant project as opposed to the borrower, a borrower should not be disqualified from utilizing a Social Loan if it otherwise has a low ESG Rating or exposure to controversial business sectors. However, if the borrower's industry or historical record present ESG concerns, lenders may contemplate having additional discussions with the borrower to determine how the proposed Social Project fits into their long term ESG goals and any steps that they are taking to improve their ESG Rating or align their operations with recommended or remedial steps being undertaken by their industry (such as for traditional energy companies, any efforts to align their operations with the emissions goals set by the Paris Agreement).

(3) Reporting and Review

The SLP recommends that the borrower report on the progress, timeline and impact of any Social Project using qualitative performance indicators and quantitative performance measures with appropriate disclosure of underlying methodology and application of assumptions attendant thereto. In selecting these metrics, the SL Guidance recommends that in the absence of standard market methodologies it is appropriate for the borrower to utilize their own policies and methods, so long as the basis of the calculations and data is available to lenders. Since standardization of reporting remains a challenge in the ESG debt markets, full transparency of the borrower's methods is imperative. The borrower should keep its reporting up to date and make it readily available to lenders no less frequently than annually (and all data should be broken down to refer to allocation of loan proceeds among multiple social projects or elements of social projects, if applicable).

The SL Guidance further notes that external review of the impact of the Social Project or its alignment to the SLP or other framework may be required by the lender (and is recommended, but not required, under the SLP). As lenders may have differing areas of expertise with specific Social Projects, the SL Guidance acknowledges that lenders with significant experience in the subject project and a longstanding relationship with the borrower may feel comfortable relying solely on the borrower's confirmation of the alignment with the SLP. Conversely, lenders and borrowers who have less experience in the space would benefit from utilizing an external reviewer. The SL Guidance notes that the content, scope, timing and requirements of any external review are further addressed in the Verification Guidance, discussed in more detail above.

Finally, the SL Guidance identifies areas of loan documentation that should be drafted to specifically address the Social Loan components. While the LSTA has not published any standard documentation clauses, it is anticipated that adjustments should be made to include use of proceed requirements, representations as to the accuracy of reporting, undertakings to provide information and reporting along with required timing for delivery, disclosure of reporting to lenders and in marketing materials, applicable conditions precedent and provisions to address a breach of the provisions relating to the Social Loan, including a situation where a Social Project should no longer be considered as eligible for inclusion as a Social Loan.

Conclusion

As debt markets continue to grow, lenders and borrowers may struggle with the lack of standardization of ESG debt principles. While most SLL, Green Loan and Social Loan terms represent a bespoke arrangement as between the lender and the borrower, the additional guidance provided by the LSTA can assist lenders in formulating their own internal policies and standards for making these financial products available to borrowers.

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