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ESG Focus: Navigating External Review

LSTA and LMA Jointly Issue Guidance for Green, Social and Sustainability-Linked Loans External Reviews

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Following a surge of interest in environmental, social and governance ("**ESG**") by the financial services industry in 2020, a multitude of factors continues to drive focus on ESG, including the implementation of regulatory requirements around disclosure and mitigation of climate risk. Additionally, consumers and investors increasingly consider ESG factors when deploying capital. Finance providers have, in turn, considered how ESG metrics can be built into finance products to engage with market participants while building out their own ESG strategies and policies. This has led to the evolution of several ESG- focused financial products, 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.

In response to the growing demand for SLLs, Green Loans and Social Loans, industry bodies, including the International Capital Market Association ("**ICMA**"), the Loan Market Association ("**LMA**"), the Loan Syndications and Trading Association ("**LSTA**") and the Asia Pacific Loan Market Association ("**APLMA**"), joined together to produce guidance for financial products across the green and sustainable finance space. Recognizing that the incorporation of sustainability focused provisions into financial products was new to a large swath of market participants, these industry bodies and trade groups sought to provide key parameters and guidelines so as to maintain the integrity of the industry and preclude concerns over greenwashing, social washing or fraud. This has led to the publication of the Green Loan Principles by the LMA, LSTA and APLMA in 2018, supported by the ICMA, followed by the publication of the Sustainability-Linked Loan Principles (the "**SLLPs**") in 2019 and the Social Loan Principles (the Green Loan Principles, the Social Loan Principles and the SLLPs, together being the "**Loan Principles**") in 2021.

One question that arises in all SLLs, Green Loans and Social Loans is how can the lender be confident that the stated green or social impact is sufficiently ambitious to merit designation as a SLL, Green Loan or Social Loan, as applicable, and what steps are needed to verify the underlying data supporting such designation? In particular, without review by independent, knowledgeable entities with sufficient market purview and expertise, concerns may arise over potential greenwashing or social washing, or that specific projects and goals are failing to meet a material or intended impact. The Loan Principles have always contemplated verification by a third party, but historically the varied nature of loans and underlying sustainability goals and metrics has left market participants without a one size fits all approach to external review. To address this issue, ICMA published the 'Guidelines for Green, Social, Sustainability and Sustainability-Linked Bonds External Reviews' in 2022 (the "**ICMA External Review Guidelines**"), and the LSTA and LMA have this week issued the 'Guidance for Green, Social and Sustainability-Linked Loans External Reviews' (the "**2024 Loan External Review Guidelines**"), which aims to largely follow the ICMA External Review Guidelines. The 2024 Loan External Review Guidelines also builds on the previously issued Guidance for Green, Social and Sustainability-Linked Loans External Reviews in March

2022 by the LSTA (the "**2022 Loan External Review Guidelines**" and together with the 2024 Loan External Review Guidelines, the "**Loan External Review Guidelines**").[1]

It is worth noting that external review is not a requirement for all of the Loan Principles. The Green Loan Principles and the Social Loan Principles recommend that an external reviewer be appointed where appropriate, but also recognizes that self-certification by the borrower may be sufficient. The SLLPs, however, require that the borrower obtain independent and external verification by a qualified person with relevant expertise. Post-signing verification is necessary under the SLLPs, whereas a pre-signing external review is merely recommended.

This alert provides a high-level summary of the further guidance issued by the LSTA and LMA in connection with the 2024 Loan External Review Guidelines and the potential implications on ESG-focused debt products.

(1) Type of External Reviews

The type of external review will depend on the Loan Principles being applied and will vary accordingly. The 2024 Loan External Review Guidelines identify several variations for external reviews, including, review of a green, social or sustainability linked loan/finance framework, review of the data supporting individual loans or assets, or audit of the information gathering procedures undertaken with respect to reporting. The type of review will follow an agreed scope and may take one of the following forms:

A. Second Party Opinions ("**SPO**"): SPOs are opinions issued by an independent party and will typically opine on the alignment of the loan transaction with the Green Loan Principles, Social Loan Principles or SLLPs (as applicable). An SPO may also assess whether the specific loan transaction would meet other requirements, goals or parameters 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. The 2024 Loan External Review Guidelines note that best practice will be for the SPO to be issued prior to execution of the relevant loan agreement, and if an SPO is issued post-execution the application of the green, social or SLL label/classification and related publicity should likewise be delayed until the SPO is issued.

B. Verification: Verification refers to an independent third-party verification of financial or non-financial information provided by the borrower. Verification is more detailed than SPOs and will measure information against a stated external standard or methodology. In the case of SLLs, this will involve auditing the performance of the borrower against key performance indicators ("**KPIs**") identified in the loan documentation. For Green Loans and Social Loans, a borrower's claims for application of use of proceeds or impact metrics will need to be verified. The 2024 Loan External Review Guidelines identify three main types of verification:

   i. *Assurance*: Verification by way of assurance is usually in the form of an audit report undertaken by an auditor. Assurance can either be 'limited' or 'reasonable'. Limited assurance is the baseline level of assurance and is limited to specific aspects or a sampling of data compiled in respect of the underlying subject matter (*e.g.,* specific KPIs). Limited assurance will provide a negative confirmation that the reviewer is not aware of any material modifications needed to the data. Reasonable assurance, on the other hand, provides a higher level of assurance where the auditor

[1] Haynes and Boone's prior commentary on the 2022 Loan External Review Guidelines can be found here.

will undertake a more detailed and extensive review of the underlying data provided and confirm whether it is reasonable to believe the reported conclusions are materially correct.

ii. *Attestation*: In an attestation, the external reviewer conducts the measurement or evaluation of the subject matter and produces a report asserting that the data is fairly stated. Attestation is more likely to be used as a verification process for Green Loans and Social Loans, for example by way of an annual attestation of the use of proceeds and the green or social impact thereof.

iii. *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. A label or score will then be awarded showing that the certification criteria have been met. The certification criteria may apply to assets funded by the proceeds of the loan, or KPIs identified in a SLL. Examples include the Sustainable Building Certifications supported by the World Green Building Council, or B Corp Certification.

C. Green, Social and Sustainability-Linked Loan Scoring/Rating: If the borrower utilizes an ESG score or similar rating, for itself, its loans or an underlying investment or project, the attainment and maintenance of such rating can serve as a basis for verification under a SLL, Green Loan or Social Loan or even a KPI under a SSL. The lender and borrower will need to identify a suitable rating or scoring agency and ensure that both are comfortable with the methodologies by which the applicable rating or score are assessed (which should be made transparent by the rating agency). 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 Loan Principles) and consider both proactive actions being taken by the borrower and applicable risks being addressed. Taking into account the scoring criteria, the relevant lenders and borrowers should also agree to any minimum score or rating thresholds required under the terms of the loan documentation.

(2) Ethical and professional standards for external reviewers

The ethical and professional standards for external reviewers promoted by the 2024 Loan External Review Guidelines are largely the same as those suggested in the 2022 Loan External Review Guidelines. In summary, the Loan External Review Guidelines look to establish ethical standards to consider given the range of external reviews and reviewers, particularly in circumstances where the external reviewer is not covered by professional standards or regulation. The Loan External Review Guidelines stress 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 of regulatory regimes, the Loan External Review Guidelines recommend a variety of industry wide codes of conduct or professional standards that reviewers can look to, including the International Code of Ethics and Professional Accounts and the Attestation Standards established by the American Institute of Certified Public Accountants.

The 2024 Loan External Review Guidelines additionally state that external reviewers should be independent from the borrower's adviser for its Green Loan, Social Loan and SLL structure or framework, and should not be a sponsor affiliate of the borrower. If applicable, information barriers should also be established internally to ensure independence and any concerns or circumstances that could reasonably interfere with independence should be disclosed to the lenders.

(3) Organization of external reviewers

It is not only important that third party reviewers meet external ethical and professional standards but also that they satisfy relevant qualifications and requirements to conduct the necessary evaluation. This includes ensuring that organizational structures and working procedures are in place in order to carry out the review, that qualified staff with the requisite experience for the particular review scope are employed, that applicable professional indemnity/liability insurance is obtained (if appropriate) and that they are regularly engaged in the application and monitoring of relevant ESG standards and ESG calculation methodologies.

For SPO providers, it's important that external reviewers must have expertise in the specific subject of the review, including, for SLLs, the related KPIs, sustainability performance targets, benchmarks, sectors and industries, the relevant framework or guidance utilized to formulate the borrower's ESG policies and, where relevant, climate change strategy and governance and science-based trajectories.

(4) Content of external reviews

Although the content of external reviews will differ between providers and products, the Loan External Review Guidelines set out common information to be included in all reviews. These include details of the organization of external reviewers (as detailed above), including the external reviewer's credentials and, if applicable, any international professional standards that the review is subject to. Other details to be incorporated are a general disclosure of the objective and scope of work, including the level of verification, applicable standards being used for benchmarking and any limitations on the external review, a statement of independence and conflict-of-interest policy, details of methodologies used, a clearly stated conclusion and whether or not the borrower has allocated green and/or social loan proceeds according to its predefined eligibility criteria.

The Loan External Review Guidelines also detail what may be included in each type of verification:

A. SPOs: As with any opinion, the scope of what is and is not covered by the opinion should be clear, as well as whether the opinion is partial (*i.e.,* assessing alignment with certain core components of the Green Loan Principles, Social Loan Principles and/or SLLPs only) or complete (*i.e.,* assessing alignment of a loan or framework with all core components of the Green Loan Principles, Social Loan Principles and/or SLLPs).

B. Verification: Any verification report should include details of the level of verification undertaken (*e.g.,* limited or reasonable assurance), any standards applied, a description of the subject of the verification and the verification criteria and procedures for evaluation of data.

C. Green, Social and Sustainability-Linked Loan Scoring/Ratings: Any scoring or rating obtained in connection with a SLL, Green Loan or Social Loan may endeavor to evaluate the borrower's environmental and/or social performance as against the relevant Loan Principles or another benchmark that has been broadly accepted in the market and is clearly stated as a parameter in assessing the rating or score. The Loan External Review Guidelines note that the rating is different from a credit rating but may nonetheless reveal significant risk based on environmental, social or sustainability factors.

(5) Disclosure for external reviews

The 2024 Loan External Review Guidelines largely follow the 2022 Loan External Review Guidelines when it comes to disclosure of reviews and notes that any external review should be made readily available to all lenders.

Additionally, 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 publicly available to other interested parties, including its investors or the broader public.

Summary:

The 2024 Loan External Review Guidelines build upon the 2022 Loan External Review Guidelines, by providing additional detail around the different types of verification and the anticipated scope of review. Many factors may drive the appropriate type of external review, including whether the loan is aiming to align with the Green Loan Principles, the Social Loan Principles and/or the SLLPs, or the structure or sustainability goals of the borrower. Lenders should set out clear expectations for their anticipated external review and review any applicable guidance as to the parameters and process for undertaking a relevant review.