

# Energy Transition

## INSIGHTS

March 9, 2023

## New Updates to ESG Loan Principles: Key Takeaways for Borrowers and Lenders

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Borrowers and lenders entering into loan transactions that are marketed or intended to qualify as ESG loan transactions from March 9 onwards will likely be expected to align with recent updates to the Green Loan Principles, Social Loan Principles and Sustainability-Linked Loan Principles (collectively, the “2023 Principles”) developed by the Loan Market Association (“LMA”), Loan Syndications & Trading Association (“LSTA”) and Asia Pacific Loan Market Association (“APLMA”) (collectively, the “Loan Associations”).<sup>1</sup>

The Loan Associations’ principles are voluntary but generally accepted guidelines for borrowers and lenders participating in ESG loan transactions globally.<sup>2</sup> ESG loan transactions include (1) loans the net proceeds of which (or an amount equivalent to such net proceeds) are used to finance or refinance “Green Projects” or “Social Projects”, which are projects, assets, investments or related expenditures with environmental or social objectives, respectively, and (2) sustainability-linked loans, which are loans whose economic terms, typically the margin, are linked to whether the borrower meets certain predetermined sustainability-related key performance indicators (“KPIs”).

The 2023 updates include incremental changes to reflect current market practice, and include expanded guidance on the use and implementation of the 2023 Principles. The 2023 Principles are to apply to loans originated, extended or refinanced as ESG loan transactions after March 9, 2023. Relatedly, the LSTA also recently published drafting guidance for the KPIs and other relevant terms that are included in sustainability-linked loans.<sup>3</sup>

### Key Takeaways for Borrowers and Lenders from the 2023 Principles

- **Use of Proceeds.** The 2023 Principles recognize that Green Projects and Social Projects may have multiple environmental and/or social objectives, and indicate that the borrower should identify the primary objective of the underlying expenditures so as to determine whether the loan should be labeled as a green loan or a social loan. The updates also clarify that use of proceeds may include related and supporting expenditures, such as research and development.
- **Enhancing Disclosure of ESG Risks.** The updates ask borrowers of green loans and social loans to identify actual and perceived environmental and social risks associated with the planned use of

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proceeds and to report on the processes by which it manages such risks. Additionally, borrowers are encouraged to identify mitigants to possible negative environmental and social risks, including undertaking a trade-off analysis if the borrower determines the potential risks are meaningful.

- **External Review.** The Loan Associations now recommend that borrowers obtain external review of their green, social and sustainability-linked loan processes. The external review would be conducted under separate guidelines released in March 2022, by institutions with environmental, social or sustainability expertise, as applicable, that are independent from the borrower.<sup>4</sup> Borrowers are encouraged to make the review, or a summary of it, publicly available. ESG loan market practice currently varies (depending on the type of borrower, lenders and deal structure) on whether an external review is conducted and, if there is an external review, the amount of public disclosure of the results.
- **Sustainability-Linked Loans.** The 2023 Principles emphasize that borrowers should select KPIs that are material to their business and measure and report on its performance against predefined Sustainability Performance Targets (“SPTs”) related to those KPIs. The updates suggest that borrowers should set annual SPTs for each KPI for every year of the loan term, with related reporting and verification provided to lenders. Further, borrowers are asked to provide lenders a sustainability confirmation statement, along with a verification report, comparing actual performance against the SPTs for each year. These statements have become common in the market. Borrowers would also be required to obtain independent external verification for any measurement of an SPT that could trigger a change in the loan’s economics, such as a margin adjustment.
- **Consistency with Broader ESG Developments.** The latest updates are one of many elements in the evolving sustainable finance world, and the accompanying guidance to the 2023 Principles encourages borrowers and lenders to consider wider ESG implications in making sustainable finance decisions. Borrowers should consider relevant ESG developments affecting their own operations, those of their peers and those of their lenders, such as the new reporting obligations under the EU’s Corporate Sustainability Reporting Directive (“CSRD”) and other developing disclosure requirements, the EU’s new Green Bond Standard (which should be finalized imminently and may significantly influence the ESG loan market), and various efforts by bank regulators globally to increase their oversight on ESG matters, in particular climate risks. As a result of these developments, lenders will increasingly be required to report on the ESG impacts and metrics of their loan portfolios. See S&C’s [memo](#) on the CSRD and the [November 2022](#) and [February 2023](#) ESG newsletters for further information.

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### ENDNOTES

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- <sup>1</sup> See Loan Market Association, Resources, LMA Resources, *available at* <https://www.lma.eu.com/sustainable-lending/resources>.
  - <sup>2</sup> These principles are analogous to the Green, Social and Sustainability-Linked Bond Principles developed by the International Capital Market Association. See International Capital Market Association, The Principles, Guidelines and Handbooks, *available at* <https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/>.
  - <sup>3</sup> Loan Syndications & Trading Association, Drafting Guidance for Sustainability Linked-Loans, February 17, 2023, *available at* <https://www.lsta.org/content/drafting-guidance-for-sustainability-linked-loans-feb-17-2023/>.
  - <sup>4</sup> See Loan Market Association, Loan Syndications & Trading Association and Asia Pacific Loan Market Association, Guidance for Green, Social, and Sustainability-Linked Loans External Reviews, *available at* <https://www.lsta.org/content/guidance-for-green-social-and-sustainability-linked-loans-external-reviews/>.

Questions regarding the matters discussed in this publication may be directed to [Craig Jones](#), [Neal McKnight](#), [Inosi Nyatta](#) or [Sam Saunders](#), or to any Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. Additional S&C resources about ESG and energy transition matters may be found [here](#).

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