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SLLBs : the saving grace of sustainability-linked financing instruments ?

- The decline of the sustainability-linked financing instruments market is bolstered by a resilient SLL market while SLBs popularity seems to be shrinking.
- The resilience of the SLL market is driven by several factors including the long-standing imperative for the decarbonization of loan portfolios.
- SLLBs have the potential to enhance transparency and boost access to sustainable finance for hard-to-decarbonize sectors.
- However, their positive impacts might be overshadowed by certain challenges such as data confidentiality.

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A declining sustainability-linked financing instruments market bolstered by the resilience of Sustainability-Linked Loans (SLLs)

In 2021, the International Capital Market Association (ICMA) launched the Sustainability-Linked Bond Principles (SLBP) which provide guidelines for linking the financial characteristics of bonds to the achievement of ESG-related objectives. Simultaneously, the European Central Bank (ECB) started to accept SLBs as collateral for its asset purchase program[1,2]. That same year, SLB issuance reached a peak of $97 billion (9.0% of total 2021 labelled bond issuances), highlighting companies' participation in the labelled fixed income market regardless of the size of their pre-identified green and/or social asset pool. However, since then, we have observed a decline in the popularity of the instrument, with just $66 billion in issuance in 2023 (6.7% of total labelled bond issuances)[3]. In parallel, despite a decline in volume (-34% YoY at H1 24 standing at $275 billion), the SLL market proves to be robust and, since 2019, represents the bulk of labelled loans (c. 75% of total labelled loan market in H1 24)[4].

Despite a slowing volume over the past year due mainly to higher interest rates and perceived reputational risks, SLLs have proven more resilient than SLBs for multiple reasons.

The long-standing imperative for the decarbonization of loan portfolios is arguably a key driver of sustainability-linked debt market growth in the banking sector. The initial push came from the regulatory side in 2020, with the ECB requiring banks to incorporate climate-related risks into risk management and stress testing frameworks[5]. The Bank of England, through its Prudential Regulation Authority, also placed significant regulatory pressure on banks when, in 2019, it issued its Supervisory Statement which set out expectations for them to develop robust plans to address climate-related financial risk[6].

[1] ECB, ECB to accept sustainability-linked bonds as collateral, https://www.ecb.europa.eu, September 2020.
[2] Since July 2022, the Eurosystem stopped the net asset purchase under the APP.
[3] Environmental Finance, Sustainable Bonds Insight 2024, https://www.environmental-finance.com, February 2024.
[4] Environmental Finance, Sustainable Loans Insight 2024, https://www.environmental-finance.com, July 2024.
[5] ECB, Guide on climate-related and environmental risks, https://www.bankingsupervision.europa.eu, November 2020.
[6] Mete Feridun, Prudential Supervision of Climate-Related Risks: What's the State of Play?, https://blogs.law.ox.ac.uk, April 2022.

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While a recent ECB study indicates that eurozone banks have started to price climate risk in their lending policies[7], several stakeholders have observed that the integration of climate transition risk has historically focused on reporting and commitments (e.g., heatmap to classify transition risk materiality, financed emissions and associated targets) and that banks have generally struggled to thoroughly embed these risks into decision-making processes[8].

This is why, beyond the initial (and ongoing) regulatory push, the role of initiatives such as the UN-initiated Glasgow Financial Alliance for Net-Zero (GFANZ)[9] and its Net-Zero Banking Alliance (NZBA)[10] sub-group in creating a resilient SLL market should be underlined. For example, NZBA members commit to aligning their lending and investment portfolios with net zero emissions by 2050 and are also required to set targets for 2030 or sooner within 18 months of joining. In addition, members commit to disclosing annual reports, which measure progress relative to board-approved transition strategies, including climate related sectoral policies and action[11].

While investors occasionally lack access to sufficiently exhaustive information on how banks concretely address climate transition risks across their lending portfolios, awareness is growing around how SLLs can contribute positively to reducing the banking sector's exposure to climate transition risks.

Another reason why the decline of SLLs has been less pronounced than that of SLBs is because SLLs are often syndicated by a limited number of banks, with the necessary expertise and know-how. The close borrower-lender collaboration allows for a detailed understanding of sustainable needs and objectives which inevitably facilitates loan structuring and more specifically the fixing of Key Performance Indicators (KPIs) and Sustainability Performance Targets (SPTs), which are closely aligned with the borrower's unique sustainability strategy. The frequent interaction between the borrowers and lenders facilitates monitoring and adjustments to targets and surrounding discussions. It also makes agreeing on the economic outcome easier (e.g., coupon adjustments or one-time payments based on whether the predefined SPTs are met). In contrast, the bond market involves a much larger and more diverse group of stakeholders, which makes such customisation and ongoing engagement more challenging. As such, the loan market can accommodate more complex and numerous KPIs, whereas the bond market tends to favor simpler ones[12].

Last but not least, unlike SLBs, the SLL market has flourished given the adaptability of the instruments to the needs of companies of various sizes, including small to medium-sized enterprises. Furthermore, banks had structures in place for other types of syndicated loans, which could be adapted to SLL[13].

[7] ECB, Climate risk, bank lending and monetary policy, *https://www.ecb.europa.eu*, August 2024.

[8] In its November 2022 *thematic review on climate-related and environmental risks*, the ECB was already stating that "Virtually all the institutions need to make far-reaching and enduring efforts to develop consequential, granular and forward-looking approaches to manage C&E risks". More than a year later, the supervisor reiterated its concerns (specifically on climate transition risks) by stating, in the *"Risks from misalignment of banks' financing with the EU climate objectives"* report that "The euro area banking sector shows substantial misalignment and may therefore be subject to increased transition risks"

[9] GFANZ, *https://www.gfanzero.com/*

[10] NZBA, *https://www.unepfi.org/net-zero-banking/*

[11] KPMG, Climate-related and environmental risks in loan pricing, *https://kpmg.com*, July 2023.

[12] S&P Global, Environmental, Social, And Governance: How Sustainability-Linked Debt Has Become A New Asset Class, *https://www.spglobal.com*, April 2021.

[13] Norton Rose Fulbright, Sustainability-linked loans: Practical observations and thoughts, *https://www.nortonrosefulbright.com*, July 2022.

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Sustainability-Linked Loans financing Bonds (SLLBs): a new instrument that has the potential to enhance the integrity of the sustainability-linked financing instruments market and to support banks in financing their transition plans

Until now, SLBs and SLLs were considered as the main labelled financing instruments to finance the climate transition. However, decreasing confidence in SLBs and SLLs has limited the "transition finance" toolbox, from which companies with limited green or social assets could choose. Such companies often operate in (i) "green enabling industries" which have limited green assets but are essential in the value chain of green projects (e.g., mining industry)[14], (ii) hard-to-abate sectors which have a defined pathway to net zero but which are at the very beginning of their sustainability journey and have limited green assets (e.g., steel production) or (iii) hard-to-abate sectors which do not have a clear pathway to net zero[15] but which have put in place measures that can already drastically reduce their carbon footprint (e.g., long-haul passenger aviation).

Several stakeholders, such as the ICMA or the Loan Market Association (LMA), are actively working to restore confidence in the sustainability-linked market and have recently launched guidelines for a new kind of instrument that could help strengthen the resilience of Sustainability-Linked structures: **Sustainability-Linked Loan financing Bonds (SLLBs)**. SLLBs are defined in *the Sustainability-Linked Loans financing Bonds Guidelines (SLLBG)*[16] as "any type of bond instrument (i) where the proceeds or an equivalent amount will be exclusively applied to finance or re-finance, in part or in full, a portfolio of new and/or existing eligible SLLs, aligned with the SLL Principles and (ii) which are aligned with the four components of the SLLBG (which were inspired by the Green Bond Principles), Social Bond Principles and Sustainability Bond Guidelines".

By involving fixed income investors and enhancing visibility related to the financed SLL portfolios, SLLBs could compensate for the two major weaknesses often associated with SLLs and SLBs. SLLs are often criticized for their lack of transparency and ambition relative to the chosen sustainability criteria (including KPIs and SPTs)[17] and even more so because structuring details are kept behind closed doors. Despite attempts to facilitate access, the SLB market on the other hand has occasionally left certain issuers on the side of the road, namely those operating in hard-to-abate sectors which continue to face greenwashing concerns. Indeed, for companies in hard-to-abate sectors, SLLBs (indirectly) offer a viable pathway to access the sustainable finance market by linking their financing to specific, measurable sustainability targets, thereby mitigating greenwashing concerns. SLLBs can also provide greater market transparency by setting stringent criteria and accountability measures for borrowers. This ensures that sustainability targets are not only ambitious but also verifiable, thereby enhancing the credibility of the labelled finance market. Ultimately, SLLBs foster a more inclusive approach to sustainable finance, enabling a wider array of companies to participate, provided they adhere to rigorous sustainability criteria, and thus facilitating a more transparent and accountable financial ecosystem.

More transparency on the SLL market also means more transparency on measures taken by banks to improve the ESG performance of their portfolios. As sustainable investors, we would like to see banks considering SLLBs as an opportunity (i) to set clear and ambitious standards for SLLs, but also (ii) to be transparent on how those standards align with the bank's own sustainability goals.

As most SLLs have a GHG emissions KPI (>70% according to Moody's[18]), we would obviously expect SLLBs to convey information on how SLLs are used to support the decarbonization of a bank's portfolio. This is already the case for one of the first SLLB frameworks issued in the market[19]. By engaging more openly in the SLLB market, banks can also clarify more precisely the scope of their sustainable financing metrics and associated targets[20], which are commonly viewed as composing a pillar of their sustainability strategy.

[14] In June 2024, ICMA published *guidance for green enabling projects* to support the eligibility of such projects to green labels.

[15] In its *"Financing Credible Transitions" whitepaper*, CBI defines activities with a pathway to zero as "activities needed beyond 2050 and have a clear 1.5-degree decarbonization pathway" while activities with no pathway to zero are defined as " Activities that are needed beyond 2050 but at present, do not have a clear 1.5 degree decarbonization pathway to 2050".

[16] ICMA, Sustainability-Linked Loans financing Bond Guidelines (SLLBG), *https://www.icmagroup.org*, June 2024.

[17] According to Moody's Rating, the level of ambition of an SLL structure is historically lower than other structures such as SLB-SLL for which a so-called integrated frameworks are designed and made publicly available (i.e. sustainable financing frameworks allowing for the issuance of both sustainability-linked bonds and/or loans) Those frameworks have historically tended to benefit issuers familiar with the labelled bond market.

[18] Environmental Finance, Sustainable Loans Insight 2024, *https://www.environmental-finance.com*, July 2024.

[19] In its *SLLB framework*, CACIB requires all eligible SLLs to include "At least one KPI directly addresses borrower's GHG Emissions"

[20] Range of sustainable financing solutions facilitated by the bank – there could be as many definitions of sustainable financing solutions as banks.

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As of today, not all banks have a clear definition of their sustainable finance metrics. When they do have one, they rarely define precise selection criteria regarding SLLs, even though the instrument might represent a significant portion of the sustainable instruments offered by the bank in a year. Sustainable finance metric reports should undergo improvements in order to provide a detailed breakdown of sustainable instruments (e.g., by type, sector and project).

The positive impact of SLLBs could be overshadowed by certain challenges

While we welcome the launch of this instrument, we will closely monitor its development to evaluate how the potential limitations outlined hereafter are addressed.

Sustainability-Linked Loans financing Bonds Guidelines acknowledge various "options that may be available for issuers to achieve an appropriate level of transparency" - one of the main objectives targeted by the initiative.

The first option (used recently by Crédit Agricole) aims to set detailed criteria (e.g., KPIs, SPTs) and to obtain an external review of the overall framework. While this should increase clarity around the SLLs satisfying the detailed criteria, the approach might be too selective. Indeed, higher scrutiny around the SLLB initiative is likely to result in more ambitious and rigid criteria that many SLLs granted by banks may not meet. While we believe that SLLBs offer a significant opportunity to raise the standards and transparency for all SLLs, there is a risk that these positive impacts may only apply to the most ambitious loans (creating a two-speed market). Though the external review can contribute to evaluating the quality of SLL assets, it is not fully comprehensive given its lack of contextual information namely at the transaction level such as the country of operation (the KPI materiality and the SPT ambition can vary depending on this factor) or the company's relevant peer group (used as a benchmark to assess the ambition of the borrower's target).

The alternative approach (recently used by Nordea[21]) provides less details at the framework level but requires an external review for each SLL[22]. Getting an external review is definitely in line with best practices, and setting overarching objectives could make more room to tailor each SLL. While this might help mitigate one of the risks mentioned above – i.e. increasing clarity on best practices for SLLs -, this might end up watering down the main objective targeted by SLLBs: transparency. Indeed, for confidentiality reasons, banks (and external reviewers) might not be able to share the sustainability credentials of each transaction. Even if the third-party review provides comfort to sustainable investors, they will not be able to formulate their opinions if key data is missing. It goes without saying that the existence of those several options might also create some discrepancies in the way banks approach SLLBs.

That being said, we believe that the greatest strength of SLLBs lies in their uniqueness. SLLBs will pave the way to improving the clarity and enhancing the ambitions of the transition strategies of both financial institutions and the business activities they finance.

[21] Nordea, SLL funding framework, *https://www.nordea.com*, 2023

[22] ISS Corporate, External Review - Sustainability Quality of the Issuer and Sustainability-Linked Loan Funding Framework, *https://www.iss-corporate.com*, October 2023

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