LSTA Issues New ESG Guidance

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As interested parties look for more direction on Environmental, Social and Governance ("*ESG*") matters, the Loan Syndication and Trading Association ("*LSTA*") recently issued new *Guidance for Green, Social, and Sustainability-Linked Loans External Reviews* ("*External Review Guidance*") and *Guidance on Social Loan Principles ("Social Loan Principle Guidance")*. A summary of this guidance is below.

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

The External Review Guidance aims to promote best practices relating to external review processes for borrowers, lenders, external reviewers and others in the loan market. There are currently no universal professional or ethics standards applicable to third party reviewers in the ESG space. The LSTA's External Review Guidance therefore recommends that third party review providers adhere to basic principles, such as compliance with any relevant industry standards, maintaining organizational structure and procedures for carrying out external reviews, employing qualified staff with necessary expertise, and carrying any appropriate insurance.

The External Review Guidance also sets forth fundamental content requirements for the external review process. The guidance covers four types of external reviews – second party opinions, verification, certification, and scoring. The LSTA's guidance on the content of each of these reviews is summarized below:

1. Second Party Opinion. A second party opinion is given by an independent institution with relevant ESG expertise. Second party opinions may be undertaken pre or post signing and the external reviewer should assess the borrower's objectives, strategy, policy, or process. For green and social loans, the reviewer should assess as the environmental/social features of the project, its benefits and impact, and its material risks. For sustainability-linked loans, the guidance recommends that the external reviewer evaluate the relevance, materiality, robustness and reliability of key performance indicators (KPIs) and sustainability performance targets (SPTs), the level of ambition of SPTs as measured against a credible benchmark, and the relevance and reliability of benchmarks.

2. Verification. A verification is done by an independent third party to validate a set of use criteria or impact/ performance metrics pertaining to environmental, sustainability or social projects or targets. The guidance recommends that external verification include attestation of the borrower's tracking methods for use of proceeds, allocation of funds, impact statement, and/or alignment with relevant outside principles. For sustainability-linked loans, borrowers should seek external verification of their performance at least once per year.

3. Certification. A borrower can have its green, social or sustainability-linked KPI or SPT verified against a recognized sustainability standard or label. See above.

4. Scoring. Specialized firms or ratings agencies can rate or "score" a borrower's KPIs, performance metrics, or sustainability-linked loans relative to relevant principles or benchmarks. Scoring/rating may be part of a Second Party Opinion and should reflect material ESG risks. The guidance does not address the issue that an ESG "score" may vary widely depending on the external reviewer's process and whether the reviewer scores against an internal benchmark or external principles.

Guidance on Social Loan Principles

The LSTA developed its Social Loan Principle Guidance to complement the Social Loan Principles (SLPs) that were published in 2021. The SLPs define social loans as "any type of loan instrument made available to finance or re-finance, in whole or in part, new and/or existing eligible Social Projects." In addition to being used to finance a

Social Project, social loans should meet the SLP’s specified criteria for project evaluation and selection, management of proceeds, and reporting. The application of use of proceeds is a key determinant of a social loan.

The Social Loan Principle Guidance acknowledges that there is no standard to define what qualifies as a social loan. Social loans may overlap with green loans and sustainability-linked loans, in some cases, and may be projects undertaken to improve a borrower’s sustainability profile in others. Although social loans may overlap with ESG considerations, accounting for ESG factors will not alone qualify a loan as social. Instead, social loans must explicitly state the Social Project goals or fall within the broad categories set out in Appendix 1 of the SLP. Borrowers should be wary of double counting and “greenwashing” to avoid making misleading statements about their efforts.

The Social Loan Principle Guidance examines four core components of social loans under the SLP: (i) use of proceeds, (ii) process for project evaluation and selection, (iii) management of proceeds, and (iv) reporting. The guidance emphasizes that social loans are tied to the purpose of the loan and are based on projects and eligibility criteria that are agreed upon by lenders and borrowers. Only those tranches of loans that involve social purposes qualify and borrowers must maintain detailed records of the use of proceeds. Once social loans are issued, the SLP recommends that lenders obtain reports that combine both qualitative and quantitative data and that discuss the methodology used to obtain the reported information. This information should be kept available and up to date for the loan’s lifetime and where necessary thereafter. Finally, the guidance provides some drafting considerations on topics such as (i) use of proceeds provisions, (ii) information undertakings/covenants, (iii) representations, (iv) disclosure, (v) conditions precedent, (vi) no communication covenants, and (v) “social breach” definitions.

For More Information

Please contact Kristin Parker or the Chapman attorney with whom you regularly work, or visit our ESG Counsel and Sustainable Finance resources at chapman.com.

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