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Dear Head of ESG/Sustainable Finance,

Review of the Sustainability-Linked Loans (SLL) Market

One of the themes of our ESG strategy is the importance of building trust and integrity in sustainability-labelled instruments, products, and the supporting ecosystem. This is a key enabler of the role of finance in delivering a market-led transition to a more sustainable economy. And we are committed to working with key stakeholders to enhance industry capabilities and support firms' management of climate-related and wider sustainability risks, opportunities, and impacts.

An important backdrop to our work in this area is the expectation that we have regard to the Government's commitment to a net zero economy by 2050 in all our regulatory activities. In the Chancellor's latest remit letter (published in December 2022), we were also asked to have regard to the Government's ambitions for the provision of sustainable finance. In its recent Green Finance Strategy, the Government made extensive reference to transition finance, also announcing that it will commission an industry-led market review into "how the UK can enhance our position and become the best place in the world for raising transition capital." We will engage closely with this work as part of an expanded FCA work programme on transition finance, building from our ongoing work on transition planning and transition plan disclosures.

Increasing and sometimes negative media coverage of the SLL market observed over the last year has highlighted potential market integrity concerns. These concerns are further corroborated by market intelligence received in the first quarter of 2023 from participants in the SLL market. These concerns include weak incentives, potential conflicts of interest, and suggestions of low ambition and poor design in some SLLs' Sustainable Performance Targets (SPTs) and Key Performance Indicators (KPIs). These may lead to accusations of greenwashing.

Although we do not directly regulate this part of the market, we are keen to ensure that the sustainable finance market works well, and that market integrity is maintained. Accordingly, we engaged with stakeholders in March and April 2023. The objectives of this engagement were to: (i) better understand the functioning of the SLL market; (ii) gather additional market intelligence on the SLL market from a cross-section of key stakeholders; (iii) determine what measures might improve the market integrity of the SLL product, where concerns have been noted; and (iv) understand where we may be able to encourage further development of the SLL market as an important transition financing tool.

Having concluded this work, we are sharing our findings with these stakeholders and publishing this letter on our website so that all interested parties active in the SLL market can reflect on its content, whilst drawing attention to a number of observations and weaknesses in the market that were identified.

Summary findings

The SLL market has grown rapidly over the last 5 years and provides a useful transition finance tool alongside other financing instruments and products. However, we observed a number of weaknesses that may limit more widespread adoption and growth of this market.

We observed that banks typically count SLLs towards their sustainable financing targets. However, a number of firms we spoke to indicated that the classification of SLLs varies considerably between banks. One firm considered that, of 250 SLL transactions completed in 2022, only 30% were deemed 'fit for purpose', and that in 50% of cases, KPIs were not robust. We also heard that in the smaller mid-cap and SME segment, the SLL market has been slow to develop.

We would also highlight two principal areas of concern:

Credibility, market integrity and greenwashing concerns

A number of the issues identified have informed our observations about the possibility of potential risks to market integrity and suspicion of greenwashing in the context of SLLs. In particular, there may be a case for strengthened expectations on SPTs and KPIs, with clearer alignment to borrowers' published transition plans, and disclosure of these by borrowers. In a similar vein, in a recent FCA Engagement Paper on prospectus regulation, we are seeking feedback on the case to elaborate the link between transition plans and SPTs and KPIs for Sustainability-Linked Bonds (SLB) (see Engagement Paper 4, Non-equity securities).

The work of the Transition Plan Taskforce (TPT), with which we have been actively involved, offers a framework for credible transition plan disclosures that could be leveraged to inform the design of SPTs and KPIs in sustainability-linked instruments and products. The TPT is working towards publishing its final framework in the Autumn and we have committed to strengthening our disclosure expectations of listed companies and regulated firms in this area.

Prominent reference to the borrower's transition plan would be consistent with guidance from the International Capital Market Association (ICMA) in its Climate Transition Finance Handbook (updated this month). ICMA's guidance explicitly encourages issuers to disclose their climate transition plan or strategy, emphasising that this should be relevant to the environmentally material parts of an issuer's business model and that it should reference science-based targets and transition pathways. ICMA recommends that the guidance in its Handbook be applied in the application of ICMA's Green Bond Principles, Sustainable Bond Guidelines or (SLB) Principles, where the issuer is seeking to finance a GHG emissions reduction strategy.

Conflicts of interest and weak incentives to issue SLLs

In certain instances, and especially against the backdrop of trust and integrity concerns, the incentives for a borrower to seek an SLL may be low. Small savings on margins may be outweighed by costs and negotiation time with lenders or legal advisors. Some borrowers also seem to be wary of the heightened scrutiny that comes with specifying SPTs and KPIs.

We observed that step-ups in margin for failing to meet SPTs among investment grade names were *de minimis* at around 2.5bps and capped at circa 5bps. These were wider for lower rated and leveraged loans, where step-ups in the 25-30bps range were observed. Since the inception of the SLL market, no observable increase in these step-ups was noted, despite the changes to the global interest rate environment. We heard that disclosure of missed SPTs may attract scrutiny and be interpreted negatively. However, as the market matures, there are likely to be more instances where SPTs are missed.

We also noted a general sentiment among banks that the 'relationship' may matter more than the borrower's sustainability credentials – the former may therefore disproportionately drive the bank's decision to participate in the loan.

Stakeholders observed that a number of banks seem keen to promote SLLs – in some cases additionally incentivised by remuneration linked to achieving ESG financing targets. This may give rise to a potential conflict of interest, encouraging the bank to accept weak SPTs and KPIs.

Next steps

Given the impact of these issues and the importance we attach to building trust and transparency in sustainable finance – including the market for sustainability-labelled instruments and products – we encourage you to consider these observations to help inform your ongoing transition finance strategy.

By raising awareness of the challenges that the market is facing, we hope to encourage industry-led action that will help the market for SLLs scale with integrity. The recently published revision to the Loan Market Association's Sustainability-Linked Loan Principles (SLLP) may help to address some of the observed concerns. Market reaction to these revisions appears to be positive, and broader adoption of the SLLPs could support the growth and development of a trusted market.

We will continue to monitor this market, as part of our wider work on transition finance, with a view to considering the need for further measures to support the development of a robust transition finance ecosystem.

If you have any questions or would like to discuss the issues raised in this letter, please do not hesitate to get in touch with your supervision team.

Yours sincerely,

Sacha Sadan

Director of Environmental, Social and Governance