Guidance on Social Loan Principles

APLMA Asia Pacific Loan Market Association

LMA Loan Market Association

25 Years in the Loan Market

LSTA

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1 Introduction

The Social Loan Principles (SLP) were originally published in 2021 and provide a framework to what is recognised as an increasingly important area of finance. In order to promote the development of this product, and underpin its integrity, the APLMA, LMA and LSTA considered it appropriate to produce Guidance on the SLP, to provide market practitioners with clarity on their application and promote a harmonised approach.

This Guidance note should be read alongside the SLP. Guidance is also available for the Sustainability-Linked Loan Principles (SLLP) and Green Loan Principles (GLP). Each of these sets of Guidance are intended to highlight the differences between, and suitability of application of, the SLP, GLP and SLLP to any particular deal.

2 Fundamentals

A. Is there a definition of social loans?

The SLP define social loans as follows:-

"Social loans are any type of loan instrument made available exclusively to finance or re-finance, in whole or in part, new and/or existing eligible Social Projects."

Social loans must also align with the four core components of the SLP. Social loans can include contingent facilities such as bonding lines, guarantee lines or letters of credit.

This definition will be reviewed on a regular basis in light of the development and growth of social loans. Whilst it is recognised that definitions of 'social' and 'Social Projects' may vary depending on sector and geography, the SLP do contain a non-exhaustive list of indicative categories of eligibility for Social Projects (Appendix 1 of the SLP).

B. What are the advantages of entering a social loan?

The publication of the UN Sustainable Development Goals (SDGs) in 2015 was an important driver behind the development of sustainable financing solutions in the market. Companies are increasingly devising sustainability strategies, incorporating them into their business strategy and aligning their funding mechanisms to their sustainable development commitments. Entering into a social loan in this context may have a number of wide ranging advantages for borrowers, lenders and/or investors.

These benefits could potentially include, but are not limited to:

- positive impact on target populations and broader society;
- positive impact on reputation and credibility;
- building stronger, values-based relationships with stakeholders;
- gaining access to new markets;
- helping to deliver SDGs;
- easily able to be replicated if new financing needs to be linked to the identified use of proceeds as the borrower can set out information in a social loan framework;
- gaining access to a wider/more diverse pool of investors, particularly those seeking investment with a positive social or environmental, social and governance (ESG) focus;
- meeting regulatory, strategy and policy targets/commitments; and
- increasing ability to attract and retain staff who see SDG contribution as an important part of their personal and working lives.

C. Who can borrow a social loan?

Subject to any applicable law, regulation and credit assessment, any entity that may borrow in the bilateral or syndicated loan market may borrow a social loan provided it is aligned with the four core components of the SLP.

D. What is the difference between social loans, green loans and sustainability-linked loans (SLLs)?

The fundamental determinant of a social loan is the utilisation of the loan proceeds for Social Projects.[1] Whilst use of proceeds is the key determinant, the other core criteria set out in the SLP must also be met, i.e., the criteria for project evaluation and selection, management of proceeds and reporting. The GLP also include use of proceeds as a core component, but proceeds must be used for Green Projects rather than Social Projects.[2]

Under the SLLPs, the focus is on incentivising the borrower's efforts to improve its sustainability profile, by aligning the SLL terms to the borrower's performance against mutually agreed, material and ambitious, pre-determined key performance indicators and sustainability performance targets. Unlike green loans or social loans, use of proceeds is not a key determinant in the categorisation of a SLL.

E. Can a loan follow both the SLP and SLLP?

Technically, a loan can follow both the SLP and the SLLP, although such transactions are rare in the market and may be complex to structure. This may be possible, for example, where a social pure-play borrower implements a sustainability-linked transaction.

1 See Appendix 1 of the SLP for a non-exhaustive list of indicative categories of eligibility for Social Projects.
2 The other core criteria under the GLP must also be met for a green loan to be aligned to the GLP.

Care should be taken by the lenders to avoid double counting such loans for the purposes of any internal or external reporting.

F. Can a loan follow both the SLP and GLP?

Yes, a loan can be aligned to both the SLP and the GLP. In such cases, the proceeds will be exclusively applied to finance or re-finance a combination of both Green and Social Projects.

In the bond market, the ICMA has developed the Sustainability Bond Guidelines[3] which apply to bonds that are aligned to both the Green Bond Principles and the Social Bond Principles. ICMA defines sustainability bonds as "any type of bond instrument where the proceeds or an equivalent amount will be exclusively applied to finance or re-finance a combination of both Green and Social Projects."[4] Accordingly, loans which align to both the SLP and the GLP and where proceeds are applied to a combination of both Green and Social Projects are often labelled as 'sustainability loans'.

As above, care should be taken by the lenders to avoid double counting such loans for the purposes of any internal or external reporting.

G. Can a loan follow each of the SLP, SLLP and GLP?

Yes, a loan can be aligned to each of the SLP, the SLLP and the GLP, although this is rare in practice. This may be possible, for example, if a borrower chooses to designate the proceeds of its sustainability-linked loan for specific projects, which are also eligible social projects and eligible green projects under the SLP and the GLP respectively, by it aligning its loan simultaneously with all the core components of the SLP, SLLP and GLP.

As above, care should be taken by the lenders to avoid double counting such loans for the purposes of any internal or external reporting.

H. How do the SLP incorporate ESG considerations?

The SLP explicitly recognise several broad categories of eligibility for social loans with the objective of addressing key social purposes, such as affordable basic infrastructure, access to essential services and affordable housing. This non-exhaustive list is set out in Appendix 1 of the SLP. Furthermore, it is recommended that the borrower of a social loan clearly communicate to its lenders its social sustainability objectives and position this information in the context of its overarching objectives, strategy, policy and/or process relating to social sustainability.

A social loan could have related environmental and governance considerations, but these considerations alone will not qualify the loan as social. However, broader ESG considerations should be included in the impact assessment of the projects – either from a risk management perspective under project selection and evaluation (i.e., negative impacts) or from a positive outcome perspective in the impact reporting.

I. How do the SLP fit with their bond counterparts?

The SLP build on and are closely aligned to the Social Bond Principles (SBP) administered by ICMA, with a view to promoting consistency across financial markets. The SBP are internationally recognised voluntary issuance guidelines that promote transparency, disclosure and reporting in the social bond market.

J. What is social washing? How should the market seek to avoid it?

Social washing is a similar concept to greenwashing (where environmental claims are misleading, inaccurate or inflated), save that it relates to social- rather than environmental- claims.

In the context of social loans, social washing is a term that may be used to describe situations where misleading, inaccurate or inflated claims are made about the social characteristics of the projects to be funded by a social loan. All market participants should seek to preserve the integrity of the product at all times, as any accusation of social washing in connection with social loans undermines the product and may impact investor confidence and cause serious reputational fallout for the institutions involved, as well as the potential for future litigation.

The SLP are drafted so as to give a clear framework of the processes to be followed in order to maintain the integrity of social loans. By closely adhering to all the core components with a view to being as open and transparent as possible, the market can take steps to avoid any allegations of social washing.

Borrowers of social loans should state that they expect the use of proceeds will be considered social, as set out in Appendix 1 of the SLP, for the duration of the loan and not just at the outset of the loan period. During the life of a loan, should an eligible project become subject to a major ESG controversy, or no longer be categorised as social because, for example if new information emerges or there is a change in circumstances (e.g., a change of control or breach of other SDGs), the parties can agree to exclude such project from being categorised as social.

The application of use of proceeds is a key determinant of a social loan and any breach of the use of proceeds provisions should be taken seriously. See section 3.D.II for more information on "What will constitute a "social" breach?"

3 https://www.icmagroup.org/assets/documents/Sustainable-finance/2021-updates/Sustainability-Bond-Guidelines-June-2021-140621.pdf
4 https://www.icmagroup.org/assets/documents/Sustainable-finance/2021-updates/Sustainability-Bond-Guidelines-June-2021-140621.pdf

3
Social Loan Principles

A. Types of social loan

I. Can a revolving credit facility be social?

Social loans are any type of loan instrument which align with the four core components of the SLP, including revolving credit facilities. Appendix 3 of the SLP specifically relates to the application of the SLP to revolving credit facilities.

II. Can a revolving loan be recognised as social if the borrower does not have a designated eligible Social Project at the time of entering into the loan?

Where the borrower does not have a designated eligible Social Project at the time of entering into the loan, it may be possible to designate a revolving credit facility as a social loan provided the eligible category (or categories) of Social Project(s) for which the loan proceeds may be utilised is sufficiently identifiable in the relevant facility agreement and the loan satisfies all four core components of the SLP. The parties may agree a social finance framework for the purposes of identifying what amounts to an eligible Social Project on such transactions. It will ultimately be for the parties to agree whether and at which point the revolving loan can be designated and marketed as a social loan.

Lenders and borrowers will need to determine on a case-by-case basis how best to document the use of proceeds requirement in relation to the relevant revolving credit facility agreement, and agree whether any additional reporting requirements and/or other conditions will apply at the point of drawdown under the revolving credit facility.

Note that for avoidance of doubt, in absence of a designated social project at the time of signing, and where borrower intends to finance multiple social projects, lenders and borrowers may agree a framework under which borrower may select Social Projects that will be financed from the loan proceeds.

III. Refinancing of Projects

Social loans include those made to refinance new or existing eligible Social Projects. Borrowers should clarify which projects are to be refinanced and (re)evaluate and confirm the continuing social benefits of the project. Where appropriate, borrowers should also clarify which projects may be refinanced, and, to the extent relevant, the expected look-back period for refinanced eligible Social Projects.

When looking at refinancing a Social Project, lenders may take into account similar considerations to investors in the bond market, including whether the loan proceeds are to be used for the refinancing of capital projects and operating expenditures.[6]

Where appropriate, it is recommended to have this confirmed through an external review. An external review may be partial, covering only certain aspects of a borrower's social loan or associated loan framework or full, assessing alignment with all four core components of the SLP. See 3.C.II below.

B. Core components

This section looks at the four core components under the SLP, namely (i) use of proceeds, (ii) process for project evaluation and selection, (iii) management of proceeds, and (iv) reporting.

I. Use of proceeds

a) If a tranche of a loan is social, is the whole loan deemed social?

No – only the social tranche will be classified as social.

Where a facility includes a social tranche, the social tranche must be clearly designated, with proceeds of the social tranche credited to a separate account or tracked by the borrower in an appropriate manner.

b) Is disclosure of use of proceeds mandatory?

Borrowers are required to provide, and keep readily available, up to date information on the use of proceeds to the lenders. This information should be updated at least annually until the loan is fully drawn, and as necessary thereafter in the event of material developments.

This information should include:-

- a list of the Social Projects to which the social loan proceeds have been allocated and the basis on which they have been designated as Social Projects;
- the amounts allocated; and
- the expected social impact, if possible, and, where feasible, how this will be measured.

The borrower and the lender(s) may agree that additional reporting in relation to use of proceeds be carried out to ensure that the use of proceeds criteria continues to be met.

II. Process for project evaluation and selection

Social Projects should be consistent with the sustainability strategy of the borrower and in line with local policies and lenders' lending criteria/policies.

As stated in the SLP, borrowers are encouraged to position the information within the context of their overarching objectives, strategy, policy and/or processes relating to sustainability.

a) What standards might be referred to in determining whether a loan is social?

There is no consensus in relation to what constitutes 'social' in the context of social loans. However, there are a

5 Such re-financing may include a re-gearing of the debt under the facility agreement.
6 For more guidance, see the ICMA's 'Guidance Handbook', Section 2.1, A, 2.1.1.

number of standards that may be helpful in this area such as the World Bank's 'Environmental and Social Standards' and the SDGs. There has been some discussion around extending the EU Taxonomy to cover socially sustainable activities,[7] but as yet no consensus has been reached internationally on a social taxonomy.

National living income indexes can serve as a reference point for 'living below the poverty line' when looking to identify target populations for the purposes of social loans. The World Bank's data on low and low and middle income countries can also be used a reference point.[8]

b) The SLP states that a borrower should clearly communicate "the related eligibility criteria, including, if applicable, exclusion criteria or any other process applied to identify and manage potentially material social and environmental risks associated with the proposed projects". What is expected of borrowers in this regard?

Borrowers should seek to clarify any related eligibility and exclusion criteria, as well as any other policies or processes by which the borrower identifies and manages, or will identify and manage, perceived social and environmental risks associated with the proposed projects. The borrower's processes should seek to mitigate adverse social and environmental impacts associated with the proposed projects, and should communicate its analysis, any mitigation measures enacted and the monitoring to be undertaken where the borrower assesses the potential risks to be meaningful.

c) Can a social loan be made to a borrower that has low ESG ratings, exposure to controversial issues or controversial sectors/technologies?

The focus of social loans is on the eligible projects rather than on the borrower itself. It should nonetheless be noted that the SLP recommend that borrowers clearly communicate to lenders their sustainability objectives overall, and how they will identify and manage potential social and environmental risks associated with proposed projects.

In the presence of controversial ESG issues or where the project may have an adverse impact on other SDGs, lenders may require additional transparency from borrowers, particularly around the strategic importance of sustainability for the business and/or sustainability benefits from the underlying projects that go beyond established sector norms and business as usual.

III. Reporting

a) How are metrics chosen to report on the social impact or efficiency of projects?

The SLP recommend the use of qualitative performance indicators and, where feasible, quantitative performance measures and disclosure of the key underlying methodology and/or assumptions used in the quantitative determination.

For the calculation of indicators, where there is no single commonly-used standard, borrowers may follow their own methodologies while making these available to lenders. Reporting data based on a uniform, consistent and published methodology remains a challenge as on-going efforts to harmonise accounting methodologies for relevant sectors take place. Borrowers are therefore encouraged to provide full transparency on the applicable accounting methodology and assumptions they have applied, which can be referenced.

Parties may wish to refer to market guidance, such as the ICMA's 'Handbook: Harmonised Framework for Impact Reporting' and Cerise SPI4, for further guidance on impact reporting.

b) How often should a borrower report?

Borrowers should make and keep readily available up-to-date information on the use of proceeds. This information should be updated at least annually until the loan is fully drawn, and as necessary thereafter in the event of material developments. The borrower and the lender(s) may agree that reporting should take place more regularly.

Where the proceeds are used to finance more than one eligible Social Project, the borrower's report must clearly set out the proceeds being applied to each project and the project's resulting social benefits. Where portfolio level reporting is agreed between the borrower and lender(s), information on proceeds allocation and aggregated impact at the portfolio level should be clearly reported.

C. Review

I. What is an external review and is it required?

The borrower and lender(s) will need to agree at the outset whether any type of external review is required. External review can take place pre- and/or post-signing. Under the SLP, an external review is recommended where appropriate, but is not mandatory and can cover a range of matters in relation to a social loan. An external review may be partial, covering only certain aspects of a borrower's social loan or associated loan framework or full, assessing alignment with all four core components of the SLP.

Given that the loan market is traditionally a relationship-driven market, lenders are likely to have a broad working knowledge of the borrower and its activities and, consequently, self-certification may be appropriate where the borrower has demonstrated or developed the internal expertise to confirm alignment of the social loan with the key features of the SLP.

7 https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sf-draft-report-social-taxonomy-july2021_en.pdf
8 https://datahelpdesk.worldbank.org/knowledgebase/articles/906519-world-bank-country-and-lending-groups

Where lenders do not have a broad working knowledge of the borrower, or the borrower is not able to demonstrate sufficient internal expertise to satisfy the lenders that self-certification would be appropriate, external review is recommended. Similarly, if the lenders do not have sufficient internal expertise on the subject matter, external review is recommended. The SLP provide further information about the possible levels and types of review that are available in the market. These examples are not exhaustive.

For further information, please also see the 'Guidance for Green, Social, Sustainability and Sustainability-Linked Loans External Reviews'.

II. Does a new external review need to be issued on a refinancing?

When refinancing an existing social loan, parties should consider whether it may be appropriate to obtain an external review. This may assist, in particular, where minimum qualitative and/or quantitative thresholds have been set so as to ensure that the eligibility criteria are in line with the best practices prevailing at the time of the (re)financing.

It will also help to ensure that the integrity of the product is maintained.

III. What would external review consist of if the project is clearly social in nature (e.g., construction of a hospital)?

The SLP provide that external review is recommended where appropriate. An external review may be partial, covering only certain aspects of a borrower's social loan or associated loan framework or full, assessing alignment with all four core components of the SLP. As mentioned above, the borrower and lender(s) will need to agree at the outset whether any type of external review, pre- and/or post-signing, is required.

In terms of a pre-signing review of the alignment of the social loan with the SLP, the external review may involve a second party opinion to confirm alignment of the loan with the core components of the SLP. In terms of the use of proceeds component, the second party opinion may look at the social features of the type of Projects intended for the Use of Proceeds; the social benefits and impact targeted by the eligible social projects to be financed by the social loan; and any potentially material environmental and/or social risks associated with the Projects (where relevant) and any process applied to identify and manage such risks.

For further information, please also see the 'Guidance for Green, Social, Sustainability and Sustainability-Linked Loans External Reviews'.

IV. Do self-certified loans need to be externally reviewed before they are compared/ranked against other loans (e.g. league tables)?

None of the APLMA, LMA or LSTA can determine which loans can be included in social loan league tables, nor whether they need be externally reviewed. We are aware that the SLP are often used as screening criteria by data providers.

D. Documentation

I. What social clauses should be included in loan documents?

There is currently no template wording available for use in social loan documentation due to the varied nature of this market and, as such, a case-by-case approach will be required. However, there are some important considerations which should be kept in mind when drafting social loans:

- **Purpose/use of proceeds provisions –** The eligible Social Project categories should be clearly set out in the purpose/use of proceeds provisions.
- **Information undertakings/covenants –** Information undertakings/covenants (including the related timeframes) relevant to the Social Project(s) should be clearly identifiable in the facility agreement.
- **Representations –** The borrower should be under an obligation to represent the accuracy of any reporting.
- **Disclosure –** Given the increasing regulatory requirements on financial institutions to make ESG disclosures, lenders may wish to consider whether to include an express consent from the borrower for lenders to disclose the existence and the details of any social/ESG transaction for both internal reporting and external disclosure purposes.
- **Conditions precedent –** Details of any conditions precedent required to confirm alignment of the social loan with the SLP and/or any other social conditions precedent should be included in the facility agreement.
- **No communication –** The facility agreement will typically include provisions providing that, where there is a breach of the covenants under the facility agreement, the borrower should cease to refer to the facility as a social loan in any future communications.

II. What will constitute a "social" breach?

Whilst there is currently no established market standard in relation to what will constitute a "social" breach, this should be clearly documented in the facility agreement in respect of each deal.

The application of use of proceeds is a key determinant of a social loan. Consequently, any breach of the use of proceeds provisions should be taken seriously and the loan should not be considered social from the date of occurrence of such event, subject to any cure rights.

Parties should give due consideration as to whether or not a failure to apply the proceeds of a social loan towards a Social Project will trigger an event of default, and a subsequent cross-default across outstanding loans.