Guidance on Sustainability-Linked Loan Principles

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LMA Loan Market Association

LSTA ADVANCING THE CORPORATE LOAN MARKET

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1 Introduction

The Sustainability-Linked Loan Principles (SLLP) were originally launched in 2019 and provide a framework to articulate the fundamental characteristics of a sustainability-linked loan (SLL), being a key product in encouraging borrowers to contribute to sustainability. Since inception the SLLP have undergone several revisions to reflect developments in the market.

In order to promote the development of this product, and to underpin and strengthen its integrity, the APLMA, LMA and LSTA considered it appropriate to produce Guidance on the SLLP, to provide market practitioners with clarity on their application and promote a harmonised approach.

This Guidance should be read alongside the SLLP.

Guidance is also available for the Green Loan Principles (GLP) and Social Loan Principles (SLP). These sets of Guidance are intended to highlight the differences between, and suitability of application of the SLLP, GLP and/or SLP to any particular deal.

2 Fundamentals

A. Is there a definition of SLLs?

The SLLP define a SLL as:

"...any types of loan instruments and/or contingent facilities (such as bonding lines, guarantee lines or letters of credit) for which the economic characteristics can vary depending on whether the borrower achieves ambitious, material and quantifiable predetermined sustainability performance objectives".

This definition will be reviewed on a regular basis in light of the development and growth of the SLL product. It is recognised that definitions of "sustainable" and "sustainability" may vary depending on sector and geography[1], and borrowers should therefore be mindful of the sector and geography[1] within which they operate when setting key performance indicators (KPIs) and sustainability performance targets (SPTs).

It should be noted that SLLs are a transitional tool, designed to support a borrower in its transition journey as it seeks to improve its sustainability performance. The label should not be confused with definitions in the respective taxonomies, which are designed to define a specific sustainable economic activity.

B. What are the advantages of entering into a SLL?

The UNFCCC Climate Agreement, ratified in 2016 (known as the "Paris Agreement"), and the publication of the UN Sustainable Development Goals in 2015 were important drivers behind the development of sustainable financing solutions. Borrowers are increasingly devising sustainability strategies, incorporating them into their business strategy and aligning their funding mechanisms to their sustainable development commitments. Entering into a SLL 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:

- building stronger, values-based relationships with stakeholders;
- positive impact on reputation and credibility;
- incorporating environmental, social and governance (ESG) performance into lenders' credit assessment;
- enhancing a borrower's ambitions on ESG performance;
- engaging lenders to support material sustainability improvements by actively directing capital towards supporting a borrower's implementation of a robust sustainability strategy;
- showing commitment to achieve sustainability goals with a correlated economic impact; and
- promoting sustainable long term growth and profitability.

1 See ICMA's Compendium of international policy initiatives at https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds ICMA -Sustainable-finance-Compendium-of-international-policy-initiatives-best-market-practice-February-2020-200220.pdf for examples of international and national initiatives, and taxonomies.

C. Who can borrow a SLL?

Subject to any applicable law, regulation and credit assessment, any type of borrower may borrow a SLL, provided the borrower is able to provide the strategic elements necessary for the structure to be aligned with each of the five core components of the SLLP.

D. Are there any minimum requirements in terms of a borrower's ESG performance or exclusions in terms of business activities or practices?

The SLLP do not prescribe a minimum level of ESG performance or consider any exclusions as long as all of the core components of the SLLP are met.

Many lenders will take into consideration the quality of the borrower's overall ESG profile and the broader conduct of the borrower in order to evaluate the level of ambition of the chosen KPI(s) as well as to assess the likelihood of the borrower achieving the SPTs. Those borrowers that have integrated their sustainability strategy into their business strategy, and are therefore already advancing on their ESG journey, will often be better able to evidence that their chosen KPIs and SPTs meet the requirements set out in the SLLP. In any case, an SLL borrower's ESG trajectory should show improvement beyond "business as usual."

In the presence of controversial issues, lenders may require additional transparency from the borrower. Lenders may also seek to align KPIs to address specific sustainability challenges, in line with the overall guidance that meaningful improvements should be made, or evaluate the SLL package in light of these controversial issues.

E. Can a borrower at the start of their transition journey borrow a SLL?

The SLLP are designed to support a borrower's transition journey, wherever they might be on that journey. SLLs are intended to be accessible to all borrowers, regardless of sector, geography or level of sustainability, provided they deliver alignment with each of the core components of the SLLP.

F. What is the difference between green/social loans and SLLs?

The fundamental determinant of a green/social loan is the utilisation of the loan proceeds for green/social projects. Whilst use of proceeds is the key determinant, the other core criteria set out in their respective principles (GLP/SLP) must also be met, i.e. the criteria for project evaluation and selection, management of proceeds and reporting.

Under the SLLP, use of proceeds is not a determinant in its categorisation. The focus is instead on supporting a borrower in improving its sustainability performance, via the achievement (or not) of predetermined SPTs. As a result, the proceeds may be used to finance any kind of business activities that the borrower is pursuing, be they project based, acquisition based and so on.

G. Can a loan follow a combination of the GLP, the SLP and/or the SLLP?

Technically, a loan can follow a combination of the GLP, the SLP and/or the SLLP.

In this instance, there would need to be a rationale to both qualify the proceeds of the loan as green and/or social and to incentivise the underlying assets' green and/or social performance through the additional introduction of KPIs and SPTs.

H. What is greenwashing[2]? How should the market seek to avoid it?

Greenwashing is a term that has often been used to describe situations where claims on sustainable credentials are misleading, inaccurate or inflated. In the context of SLLs, greenwashing can occur in three key ways: through KPIs that are not material and core to the business of the borrower; through SPTs that are not sufficiently ambitious or meaningful; or through inaccurate or insufficient monitoring, measuring, benchmarking and/or disclosing of borrower performance against SPTs.

On the first two issues, the SLLP are drafted so as to give a clear framework of the processes to be followed in order to maintain the integrity of SLLs. In particular, the SLLP set out guidelines to ensure that targets are ambitious and meaningful to the borrower's business and are tied to a sustainability improvement in relation to a predetermined performance benchmark on a pre-defined timeline. They should apply over the life of the loan, although where appropriate, an update of the SPTs could be permitted at a later stage via an e.g. rendez-vous clause[3].

2 Also referred to as "sustainability washing" and "ESG washing".

3 See 3.B.III.b) below for explanation of a rendez-vous clause.

On the third issue, borrowers and lenders can take steps to avoid greenwashing by ensuring close adherence to the core components of the SLLP relative to reporting (made publicly available where possible) and obtaining an external review at the outset of the facility (where appropriate), with a view to being as open and transparent as possible.

All market participants should seek to preserve the integrity of the product at all times as any accusation of greenwashing in connection with SLLs undermines the product as a whole and may cause serious reputational risk for the institutions involved. Lenders and borrowers should therefore ensure that communications regarding SLLs are accurate and clearly explain the SPT criteria of the loan.

3 Sustainability-Linked Loan Principles

A. SLL definition

I. Types of loan

A SLL can be any type of bilateral or syndicated loan financing, e.g. term loan, revolving credit facility, Schuldschein or any other type of facility (including contingent instruments), where there is an economic impact tied to the borrower's achievement (or not) of predetermined SPTs.

B. Core components

I. Selection of KPIs

a) General

SLLs are an important form of specialised financing, which seek to support and encourage borrowers to attain more sustainable business models. In this way they stand apart as a transition tool.

A SLL could be made theoretically to any borrower, but will be best suited to those that already have a sustainability strategy in place. The SLL will often provide an economic benefit to a borrower for achieving the goals set out in that strategy so long as the KPIs are meaningful for the borrower's business and the SPTs are ambitious.

If the borrower fails to meet the minimum level of the SPTs, it is expected that any previously achieved economic benefit ceases to be awarded from that point and the borrower will often become subject to, for example, a margin premium.

b) Can the sustainability strategy of a parent impact a borrower's eligibility for a SLL?

This will depend on the relationship between the parent and the borrower, and the nature and extent of any sustainability strategy. Where a sustainability strategy applies on a group wide basis, it is likely that any such strategy will cover and be relevant to the borrower as well, although care should be taken to ensure this is the case.

It should be noted that a SLL is intended to reflect or support the borrower's, or its wider group's, existing sustainability strategy, rather than to form part of it.

c) What do the SLLP mean by "material" KPIs?

The notion of materiality is multi-faceted. It can be understood from different vantage points:

- an economic lens or a strategic planning exposure, i.e. the E and/or S and/or G issues captured by the chosen KPIs are the ones that have the greatest impact on the relevant activity, strategic orientation and the borrower's operational and potentially financial performance. KPIs should thereby address the most important E and/or S and/or G challenges of the borrower and its industry sector, should be consistent with the borrower's overarching sustainability strategy, and should reference a core, significant and relevant business activity, for which the outcomes can be influenced by the borrower's decisions and management controls; and/or
- a sustainability standpoint, where the ESG issues captured by the KPIs have the highest impact on the environment and/or society whether to external stakeholders or internally.

By way of best practice, a borrower should seek to benchmark its KPIs by undertaking a materiality assessment of itself and its industry. Materiality assessments identify the most important ESG considerations for both the borrower's business and relevant stakeholders of the business, and help inform the selection of KPIs under a loan.

A growing number of organisations are performing these assessments in accordance with ESG reporting frameworks and standards. Examples of external guidance and/or tools that borrowers may reference where appropriate, include, but are not limited to: the Global Reporting Initiative, SASB[4][5], TCFD, ICMA's Illustrative KPI Registry[6], International Integrated Reporting Council's Framework, the Accountability's Materiality Framework, and the various reports produced by the EU Sustainable Finance Platform.

d) What does providing a "clear definition of the KPI(s)" entail?

By way of example, detail of the following for each KPI would provide a clear definition for that KPI:

- an applicable scope;
- how the target is linked to the borrower's sustainability strategy e.g. how the target is linked to the borrower's ambition to become net-zero across their value chain by 2030;
- any baseline being used;
- what the KPI is being benchmarked against; and
- the calculation methodology e.g. clear definition of the denominator of intensity-based KPIs.

e) Can the KPIs be at project level?

The KPIs can be at a project level provided that any such KPI fulfils the requirement to be "relevant, core and material to the borrower's overall business, and of high strategic significance to the borrower's current and/or future operations".

II. Calibration of SPTs

SPTs (which should apply over the life of the loan) are determined and set between the borrower and the lender group for each SLL. Typically, one or a small number of lenders lead these sustainability metrics selection and target-setting processes on behalf of the lender group (the "sustainability coordinator")[7].

SPTs can be (i) external and set by reference to science; (ii) external and set against a borrower's ESG performance in relation to its peers; (iii) internal and bespoke to the borrower's business referencing past performance where possible; or (iv) a combination of any of these.

With respect to selection of the sustainability metrics and setting of the SPTs, the obligation to determine that the chosen metric is meaningful – meaning core to the borrower's business – and the related SPT(s) is ambitious – meaning a target that represents a true reach for the borrower – will require significant borrower input since it will have the best understanding of its own business activities.

Methodologies for selection of SPTs can include utilising:

- ambitious ESG metrics and targets included in the borrower's sustainability strategies and/or policies; and/or
- external analysis to establish sector-specific ESG criteria and best-practice performance; and/or
- verified industry metrics reported against frameworks[8], with verification or evaluation by civil society organisations[9] or external reviewers who will determine if SPTs are ambitious for the borrower and that borrower's industry, and/or align the SPTs to existing regulatory targets (such as those set out in the Paris Agreement or in other country/regional/international targets).

Notwithstanding that the borrower might have appointed a sustainability coordinator, it is critical that all lenders determine for themselves whether the chosen metrics and SPTs are truly meaningful and ambitious for the particular borrower and to request the information necessary to make such a determination.

4 The International Sustainability Standards Board (ISSB) is developing sustainability-related disclosures that will build on existing reporting initiatives such as the SASB standards.
5 https://www.sasb.org/standards/materiality-map/. SASB's Materiality Map presents the relative priority of sustainability issues on an industry-by-industry basis, allowing users to compare and contrast the materiality of 40+ issues across industries and sectors
6 https://www.icmagroup.org/assets/documents/Sustainable-finance/2022-updates/Registry-SLB-KPIs_Final_2022-06-24-280622.xlsx
7 See 3.C.I below for further information.
8 For example, the Greenhouse Gas Protocol.
9 For example, the Science Based Targets initiative. Targets adopted by borrowers to reduce greenhouse gas emissions are considered "science-based" if they are in line with what the latest climate science says is necessary to meet the goals of the Paris Agreement—to limit global warming to well-below 2°C above pre-industrial levels and pursue efforts to limit warming to 1.5°C

a) On what basis can borrowers ensure and lenders assess whether the SPTs are ambitious and suitably meaningful to the borrower's business?

Borrowers can use industry initiatives and standards to ensure that selected SPTs are ambitious. Such standards include, but are not limited to, the Science Based Targets initiative, the Transition Pathway Initiative[10], or RE10022[11]. These help to provide an indication of a borrower's ambition relative to their industry sector, and help to eliminate any perception that the SPTs represent "business-as-usual" improvements.

Furthermore, SPTs should not be set lower than the performance historically achieved by the borrower without plausible explanation[12], or what is required (or will be during the term of the loan) by law, i.e. SPTs should go beyond regulatory requirements applicable from time to time. Comparison can also be made against any publicly available peer targets. This can be particularly useful for those targets which are not climate-related.

b) Can SPTs that reflect publicly announced targets qualify as ambitious?

Provided the SPTs are set in good faith and remain relevant (so long as they apply) and ambitious throughout the life of the loan, they can be drawn from a borrower's publicly announced targets. Lenders should take care to give any SPTs the due scrutiny and attention they require to ensure they meet the requirements of the SLLP, irrespective of whether they are publicly announced or not.

Where SPTs do reflect publicly announced targets, best practice is to build safeguards into the documentation to allow for these SPTs to be updated so that they are never less ambitious than those publicly announced.

c) Setting targets based on a borrower's performance over time.

In order to allow lenders to evaluate the borrower's historical performance against the KPIs selected, where possible, those KPIs should have already been included in previous annual reports, sustainability reports or other non-financial reporting disclosures, or alternatively, borrowers should seek to provide KPI values covering at least the previous 3 years where possible.

However, a lack of historical data should not create a barrier to potential borrowers' accessing SLLs. Where no historical data is available, parties should work together to ensure that targets selected are suitably robust, ambitious and meaningful to the borrower's business. See 3.B.II.a for further information.

d) How should differences in the sector, geography, governing laws and environmental policies be reflected when defining the ambition of SPTs?

The borrower should select KPIs and SPTs in relation to its sector(s) of operation, giving account to local context. Ambitious SPTs should be based on a combination of benchmarking approaches, such as historical and externally verified values, those selected by the borrower's peers, and industry or sector standards, or other proxies in the sector/industry.

Where feasible, targets should be set in line with official country/regional/international targets and, as much as possible, should aim to go beyond such levels. For example, climate-related targets should be set in line with 'science-based' scenarios.

Sustainability priorities are likely to vary depending on the economic, social and political context of different geographies in which borrowers are domiciled or where they have the largest proportion of their activities situated. For example, environmental SPTs that may be regarded as modest in ambition in developed economies, could be deemed as highly ambitious in regions where the decarbonisation efforts are less advanced. Similarly, differences in social factors including demographics, workforce participation and gender equality where borrower activities are undertaken may mean that what is regarded as an ambitious target in one region may not be accepted as ambitious in another.

The SLLP recommend borrowers clearly communicate to lenders the references to the benchmarks selected, and how the specificities of a given sector and/or local context have been identified and addressed.

10 An initiative assessing borrowers' preparedness for the transition to a low-carbon economy.
11 An initiative to increase renewable energy demand and supply, with corporates committing to source 100% renewable electricity globally in the shortest possible timeline (by 2050 at the latest).
12 For example, where a recent acquisition has changed the profile of the borrower, necessitating the setting of SPTs at a higher level than historical performance.

e) What happens when SPTs cannot be "set before or concurrently with the origination of the loan"?

Where no SPTs are set before or concurrently with the origination of the loan, the loan is not a SLL and should not be communicated as such. Only after both KPIs and SPTs are agreed and set, and all other core components of the SLLP are met, can a loan be communicated, or referred to, as a SLL.

In exceptional instances, for example on deals where time is pressured and the borrower already has a clear sustainability strategy in place, parties may agree to include the mechanics of a SLL within the documentation, with these mechanics to be switched on when the SPTs are agreed post origination. This should take place no later than 12 months post origination.

Parties must ensure that the SPTs undergo the same scrutiny and attention as they would have had they been proposed at the outset of the transaction and it is recommended that all lender affirmative consent be required to the setting of any SPTs, to maintain the integrity of the product. Where this is not practicable due to the size of the syndicate, parties may agree to a lower threshold for consent, e.g. Required Lender consent.

Only after SPTs are agreed and set, and all other core components of the SLLP are met, can a loan be communicated, or referred to, as a SLL.

Where SPTs for the first years of the loan have been set before or concurrently with origination of the loan, but the SPTs for the latter years cannot be set because they, e.g. surpass the borrower's strategic planning, the loan can be labelled a SLL. The final SPTs can be set (in a timely manner) at a later date via an amendment process. In this scenario, should the SPTs not be set for the latter years, the loan should be declassified and no longer marketed as a SLL.

III. Loan Characteristics

a) Are there any best practices in documentation for SLLs?

In September 2022, the APLMA published a Term Sheet (with Sustainability-Linked Loan Appendix).[13]

In February 2023, the LSTA published Drafting Guidance for SLLs.[14]

The LMA is currently undertaking a drafting project for SLL provisions. This will be made available to members in due course.

b) How might the parties to a SLL account for long-term targets and changes to KPIs/SPTs? (Rendez-vous clause)

For longer dated transactions (or transactions subject to extension options), where not all SPTs can be accurately set at the outset of the loan, or where certain SPTs may cease to be relevant over time, the parties may need to consider amendments to the SPTs over the life of the loan. The potential impact of changes to the borrower's core business (for example, merger, acquisition, asset dispositions) on SPTs may also need to be considered.

Provisions may be included in documentation to define the precise conditions under which the borrower may be allowed or required to update KPI/SPT definitions and/or calibration so as to maintain alignment with its business and sustainability commitments over the life of the loan, for example, significant M&A activities, extraordinary/extreme events, and/or drastic change in the regulatory environment. Such provisions typically fall under a "rendez-vous clause" and seek to address, via an amendment to the documentation, any KPI/SPT change required by virtue of a revision, adjustment, or update in methodology or scope, where parties would act in good faith to solve the situation in a set period of time.

IV. Reporting

a) Is there a standard methodology for a borrower to report on its KPIs/SPTs?

To date, there is no globally accepted methodology for reporting on SPTs. The methodology will be determined with regard to the chosen SPTs and the nature of the relevant borrower.

Borrowers should report on their SPTs at least once per annum and are encouraged to provide details of any underlying methodology and/or assumptions (where known). In addition, they should confirm that there has been no change in the calculation methodology. If there has been a change, parties may wish to reconvene to understand that change and its impact. This also applies to any change in methodology relating to the calculating of KPIs.

13 https://www.aplma.com/microsites/categories/3/pages/14#. Available to members only.
14 https://www.lsta.org/content/drafting-guidance-for-sustainability-linked-loans-feb-17-2023/.

Borrowers may make their reporting methodology available upon the achievement of the SPTs or on agreed reporting dates, either directly to the lenders or as part of their overall corporate sustainability reporting. Public reporting is encouraged.

It should be noted that several sustainability reporting methodologies exist in the market today. These include the Global Reporting Initiative's Sustainability Reporting Standards, which provide widely adopted global standards for sustainability reporting.

V. Verification

a) When might external review take place?

External reviewers can be appointed pre-signing or post-signing.

Pre-signing, it is recommended, where appropriate, that a borrower seek an external opinion or KPI/SPT assessment to:

- confirm the alignment of their SLL with the core components of the SLLP;
- assess the meaningfulness, credibility and ambition on the selected SPT(s); and/or
- put the SPT(s) in the wider ESG picture to ensure that SPT achievement is not overshadowed by negative effects of other practices by the borrower.

The need for an external opinion or KPI/SPT assessment is to be considered on a deal-by-deal basis and the responsibilities of an external reviewer are likely to vary depending on the nature of the transaction, the scope of the external review and the in-house expertise of the borrower.

Post-signing:

- in case of any material change to parameters/ KPI methodology/ SPT(s) calibration, borrowers are encouraged to ask external reviewers to assess any of these changes; and
- borrowers are required to seek independent verification of its performance against its SPTs.

b) What will the verification report cover?

Amongst other things, the verification report should describe:

- the level and type of verification, for example whether a limited or reasonable assurance, or other, engagement has been conducted and the standards applied;
- a description of the procedures conducted by the practitioner and any inherent limitations;
- a description of the subject matter of verification and the criteria, such as sustainability standards used to assess conformance; and
- confirmation of the practitioners' independence and conformance with quality management systems.

c) Verification of the performance against the SPTs is required under the SLLP. How will this affect the legal documentation?

The verification of each KPI should occur at least once a year and for any date/period relevant for assessing the SPT performance ("trigger event") that may lead to an adjustment of the loan characteristics. Therefore, it is expected that reference will need to be made in the loan documentation setting out the roles of the parties in confirming whether each SPT has been met.

d) Does a new third party report need to be issued with each new loan/loan extension?

For loan transactions where an external review is sought at origination, parties will negotiate on a case-by-case basis whether the relevant third party report needs to be reissued with each borrowing or loan extension, being mindful that the previously set SPTs may have been achieved prior to the loan extension.

C. Parties

I. Sustainability co-ordinator

One or more of the lenders/loan arrangers may serve as the sustainability coordinator[15] to assist with providing market colour regarding the KPIs and SPTs to the borrower, and to facilitate the dialogue between the borrower and the lender group in regard to substantiating the SPTs and answering the ESG-related questions the prospective lender group might have.

It is important that this role is clearly defined at the outset of a transaction and lenders are conscious that the role is limited. Though a lender may be the sustainability coordinator, it does not assume fiduciary or any other duties to the rest of the syndicate or confirm that the documentation meets the SLLP on behalf of other lenders. Each lender must therefore satisfy themselves as to the borrower's KPIs, SPTs and other credentials irrespective of whether a sustainability coordinator is appointed on a transaction.

See the LMA's An Introduction to the Sustainability Coordinator Role[16] and the LSTA's Sustainability Structuring Agent Engagement Letter Inserts[17] for more information.

15 This role may be referred to as a Sustainability Coordinator or Sustainability Structuring Agent.
16 https://www.lma.eu.com/application/files/3416/5763/4761/Introduction_to_Sustainability_Coordinator_Role.pdf
17 https://www.lsta.org/content/sustainability-structuring-agent-engagement-agreement-inserts-feb-17-2023/