

# KPI Selection

## A Matter of Materiality

**Robustness in the selection of key performance indicators (KPIs) is fundamental in ensuring the credibility and integrity of the sustainability-linked loan product. With the growth of sustainability-linked loans, market practice is slowly developing in terms of how best to approach KPI selection and how to ensure that KPIs meet the materiality criteria under the Sustainability-Linked Loan Principles (SLLP).**

In the first of a series of articles focusing on protecting the integrity of the sustainability-linked loan (SLL) product, this article sets out how parties can ensure that KPIs selected are able to withstand the scrutiny of the syndicate, and indeed the wider market and the press.

### 1. Materiality matters

The SLLP require that KPIs should be, amongst other things, *“relevant, core and material to the borrower’s overall business, and of high strategic significance to the borrower’s current and/or future operations”*.

The use of generic, non-material KPIs should not be tolerated in the SLL market, as such KPIs will not deliver the material improvements in sustainability performance that are needed to support transition and meet the international targets set under the Paris Agreement and/or UN Sustainable Development Goals.

Whilst there is no one-size-fits-all approach to KPI selection, tools are available to assist borrowers in this process and are now being used regularly to assist in determining which KPIs are likely to be most suitable for a particular borrower and/or industry sector.



Where specific KPIs have been identified as being core, relevant and material to the borrower’s industry sector (for example climate change, biodiversity and health & safety in the mining sector), it would be recommended to include these KPIs in any related SLL unless there is a strong justification that can be put forward as to why those particular KPIs should not apply. Similarly, alignment in the selection of KPIs in the bond and loan markets for any one borrower/issuer would be expected.

Whilst there is no magic formula to dictate the number of KPIs to be set on any one transaction, it is a case of quality, or in this case materiality and additionality, over quantity. Adherence to the principle of materiality in the selection of each and every KPI will often be overseen by lenders’ internal dedicated sustainability committees. Where possible, the sustainability committee should be independent from the deal team, and the relationship with the borrower, in order to ensure that an objective view is taken as to whether KPIs meet the materiality test.

### 2. The negotiating table

Borrowers still vary significantly in terms of their level of sustainability expertise and the sophistication of their approach to sustainability. Those at the beginning of their sustainability journey will inevitably require more handholding and support than those with dedicated and experienced sustainability teams, and it is incumbent on the syndicated loan community to offer the aid and support to help all borrowers along on their journey, so that we might all achieve the internationally set targets mentioned above.

Experts are at hand to lend help. A sustainability coordinator (or sustainability coordinators) is often appointed to assist with, amongst other things, negotiating KPIs between the lending group and the borrower. The sustainability coordinator(s) may help the borrower to identify those KPIs that are most relevant, core and material to its industry sector and within the context of its business strategy. It should be noted that the sustainability coordinator’s role is typically a non-reliance role, and so the parties will not usually have reliance on the sustainability coordinator(s) with regards to whether the KPIs meet the criteria set out under the SLLP. Ultimately, each lender must carry out its own assessment as to whether the KPIs on any particular transaction satisfy the requirements of the SLLP as well as their own credit and sustainability requirements.

The borrower may also appoint an ESG consultant to assist it with developing its sustainability strategy and/or identifying those KPIs that are relevant, core and material to its business activities. In addition, second party opinion providers are there to offer an independent, third-party perspective and may in some cases be appointed to provide an objective opinion on the materiality of the KPIs selected.

### 3. A failure to see the wood for the trees?

It is observed that KPIs in the SLL market often focus on environmental KPIs, such as greenhouse gas emissions and renewable energy generation. This should be applauded, but when setting KPIs, it is absolutely key that the borrower and the syndicate look at the KPIs set in terms of the broader ESG picture. For example, at present, only a small number of deals use Scope 3 emissions<sup>1</sup> as a KPI, despite the fact that Scope 3 emissions often make up the majority of a borrower's overall emissions. Scope 1 and 2 emissions KPIs may be used instead due to the fact that data is more readily available, but these may fail the test of materiality if they are not material to the borrower's business. It is hoped that a greater emphasis will be placed on Scope 3 emissions going forward as data availability improves, as well as other material ESG topics.

Market participants often experience more difficulty in selecting social KPIs, and particular questions around additionality may be raised where such KPIs are means based KPIs (for example, hours of training completed) since the actual impact of such KPIs in terms of sustainability performance is hard to determine. That does not necessitate their exclusion as appropriate KPIs, but additional dialogue may be required to understand how they sit within the borrower's overarching strategy and/or a basket of means-based KPIs could appear as relevant to encompass the targeted sustainability topic (to ensure abidance by the core, relevant and material principles). Similarly, social KPIs often require additional dialogue and strong levels of ambition to demonstrate the beyond 'business as usual' principle required to enable parties to consider these acceptable in a SLL.

As mentioned above, a case-by-case approach is absolutely fundamental to ensuring that KPIs meet the requirements under the SLLP. A range of factors must be taken into account when selecting KPIs, including where the borrower is based and operating from; what sector it is operating in; to what extent robust calculation methodologies are available; and where the borrower is on its sustainability journey. This nuanced approach can help parties ensure that they do not fail to see wood for the trees by becoming focussed on KPIs that are non-core to the borrower's business.

In summary, parties must take care in the selection of KPIs. Failure to take a nuanced, case-by-case approach to KPI selection risks the integrity of the SLL product. Parties need to focus on KPI selection from the outset of each transaction and ensure that the KPIs selected meet the robust relevant, core and material principles under the SLLP. It is this focus on KPI selection, as opposed to unsubstantiated acceptance based on relationship pressures, that will ultimately preserve the integrity of SLL product.

### About us



**Gemma Lawrence-Pardew**

Director - Legal

gemma.lawrencepardew@lma.eu.com  
+44 (0)20 7006 1372



**Hannah Vanstone**

Senior Associate Director - Legal

hannah.vanstone@lma.eu.com  
+44 (0)20 7006 2034

<sup>1</sup> For an explanation of Scope 1, 2 and 3 emissions, please see the LMA's Sustainable Lending Glossary.