Sustainability-Linked Loan Principles

Supporting environmentally and socially sustainable economic activity

APLMA Asia Pacific Loan Market Association | LMA Loan Market Association | 25 Years in the Loan Market | LSTA

Introduction

Sustainability-linked loans aim to facilitate and support environmentally and socially sustainable economic activity and growth. The Sustainability-Linked Loan Principles (SLLP) have been developed by an experienced working party, consisting of representatives from leading financial institutions active in the global syndicated loan markets.

The goal of the SLLP is to promote the development and preserve the integrity of the sustainability-linked loan product by providing guidelines which capture the fundamental characteristics of these loans. In doing so, the purpose of the SLLP is to promote sustainable development more generally. The SLLP are voluntary recommended guidelines, to be applied by market participants on a deal-by-deal basis depending on the underlying characteristics of the transaction.

The sustainability-linked loan product enables lenders to incentivise the sustainability performance of the borrower.

The SLLP are intended for broad use by the market, providing a framework within which the flexibility of the loan product can be maintained, and will be reviewed on a regular basis in light of the development and growth of sustainability-linked loans.

Sustainability-Linked Loan Definition

Sustainability-linked loans are any types of loan instruments and/or contingent facilities (such as bonding lines, guarantee lines or letters of credit) which incentivise the borrower's achievement of ambitious, predetermined sustainability performance objectives. The borrower's sustainability performance is measured using predefined sustainability performance targets (SPTs), as measured by predefined key performance indicators (KPIs), which may comprise or include external ratings and/or equivalent metrics[1], and which measure improvements in the borrower's sustainability profile.

The use of proceeds in relation to a sustainability-linked loan is not a determinant in its categorisation and, in most instances, sustainability-linked loans will be used for general corporate purposes. Instead of determining specific uses of proceeds, sustainability-linked loans look to improve the borrower's sustainability profile by aligning loan terms to the borrower's performance against the relevant predetermined SPTs. For example, sustainability-linked loans will often align the borrower's performance to margin redetermination over the life of the sustainability-linked loan.

In some instances, a loan may be structured to allow for its categorisation as both a green loan, aligned with the Green Loan Principles[2], and a sustainability-linked loan, or as both a social loan, aligned with the Social Loan Principles[3], and a sustainability-linked loan

Sustainability-Linked Loan Principles – Core Components

The SLLP set out a framework, enabling all market participants to clearly understand the characteristics of a sustainability-linked loan, based around the following five core components:

1. **Selection of KPIs**
2. **Calibration of SPTs**
3. **Loan Characteristics**
4. **Reporting**
5. **Verification**

The borrower of a sustainability-linked loan should clearly communicate to its lenders its rationale for the selection of its KPI(s) (i.e. relevance, materiality) and the motivation for the SPT(s) (i.e. ambition level, consistency with overall sustainability objectives as set out in its sustainability strategy, benchmarking approach and how the borrower intends to reach such SPTs). Borrowers are encouraged to position this information within the context of their overarching objectives, strategy, policy and/or processes relating to sustainability. Borrowers are also encouraged to disclose to lenders any sustainability standards or certifications to which they are seeking to conform.

1. Please see Appendix 1 for a list of examples of the categories of KPIs in relation to sustainability-linked loans.
2. The Green Loan Principles are available at: https://www.lma.eu.com/application/files/9115/4452/5458/741_LM_Green_Loan_Principles_Booklet_V8.pdf.
3. The Social Loan Principles are available at: https://www.lma.eu.com/application/files/1816/1829/9975/Social_Loan_Principles.pdf.

1 Selection of KPIs

Sustainability-linked loans look to improve the borrower's sustainability profile over the term of the loan. They do so by aligning loan terms to the borrower's performance which is measured using one or more sustainability KPIs that can be external and/or internal.

The credibility of the sustainability-linked loan market will rest on the selection of the KPI(s). It is important to the success of this instrument to avoid the proliferation of KPIs that are not credible.

The KPIs should be material to the borrower's core sustainability and business strategy, and address relevant environmental, social and/or governance (ESG) challenges of the industry sector.

The KPIs should 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;
- measurable or quantifiable on a consistent methodological basis; and
- able to be benchmarked, i.e. as much as possible using an external reference or definitions to facilitate the assessment of the SPT's level of ambition.

A clear definition of the KPI(s) should be provided and should include the applicable scope or parameters, as well as the calculation methodology, a definition of a baseline and be benchmarked against an industry standard where feasible.

2 Calibration of SPTs

The process for calibration of the SPT(s) per KPI is key to the structuring of sustainability-linked loans, since it will be the expression of the level of ambition the borrower is ready to commit to.

The SPTs should be set in good faith and remain relevant (so long as they apply) throughout the life of the loan – one of the aims of sustainability-linked loans is to encourage ambitious, positive change through incentives and this should form the basis of target setting.[4]

The SPTs should be ambitious, i.e.:

- represent a material improvement in the respective KPIs and be beyond a "Business as Usual" trajectory;
- where possible be compared to a benchmark or an external reference;
- be consistent with the borrower's overall sustainability/ ESG strategy; and
- be determined on a predefined timeline, set before or concurrently with the origination of the loan.

Market participants recognise that any targets should be based on recent performance levels and be based on a combination of benchmarking approaches::

- the borrower's own performance over time, for which a minimum of 3 years, where feasible, of measurement track record on the selected KPI(s) is recommended; and
- the borrower's peers, i.e. the SPT's relative positioning versus its peers' where available (average performance, best in class performance) and comparable, or versus current industry or sector standards; and/or
- reference to the science, i.e. systematic reference to science-based scenarios, or absolute levels (e.g. carbon budgets), or to official country/regional/international targets (Paris Agreement on Climate Change and net zero goals, Sustainable Development Goals, etc.) or to recognised best-available-technologies or other proxies to determine relevant targets across ESG themes.

Disclosures on target setting should make clear reference to:

- the timelines for the target achievement, including the target observation date(s)/period(s), the trigger event(s) and the frequency of review of the SPTs;
- where relevant, the verified baseline or science-based reference point selected for improvement of KPIs as well as the rationale for that baseline or reference point to be used (including date/period);
- where relevant, in what situations recalculations or pro-forma adjustments of baselines will take place;
- where possible and taking competition and confidentiality considerations into account, how the borrower intends to reach such SPTs, e.g. by describing its ESG strategy, supporting ESG governance and investments, and its operating strategy, i.e. through highlighting the key levers/ type of actions that are expected to drive the performance towards the SPTs as well as their expected respective contribution, in quantitative terms wherever possible; and
- any other key factors beyond the borrower's direct control that may affect the achievement of the SPTs.

Appropriate KPIs and SPTs should be determined and set between the borrower and lender group for each transaction. A borrower may elect to arrange its sustainability-linked loan product with the assistance of one or more "Sustainability Coordinator(s)" or "Sustainability Structuring Agent(s)" and, where appointed, they will assist with negotiating the KPIs and calibrating the SPTs with the borrower.

It is recommended, where appropriate, that borrowers seek input from an external party, via e.g. a pre-signing Second Party Opinion, as to the appropriateness of their KPIs and SPTs as a condition precedent to the relevant sustainability-linked loan product being made available. In their pre-signing Second Party Opinion, external reviewers should assess the relevance, robustness and reliability of selected KPIs, the rationale and level of ambition of the proposed SPTs, the relevance and reliability of selected benchmarks

4. Borrowers should also note the existing and ongoing work on environmental and social impact metrics by the Green Bond Principles (GBP) that may help identify relevant SPTs and calculation methodologies. Impact metrics guidance of the GBP is available at: https://www.icmagroup.org/green-social-and-sustainability-bonds/resource-centre/.

5. The SLLP encourage external reviewers to disclose their credentials and relevant expertise and communicate clearly the scope of the review(s) conducted.

and baselines, and the credibility of the strategy outlined to achieve them, based on scenario analyses, where relevant. 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.

In cases where no external input is sought, it is strongly recommended that the borrower demonstrates or develops the internal expertise to verify its methodologies. Borrowers are recommended to thoroughly document any such expertise, including the related internal processes and expertise of their staff. This documentation should be provided to lenders.

3 Loan Characteristics

A key characteristic of a sustainability-linked loan is that an economic outcome is linked to whether the selected predefined SPT(s) are met. For example, the margin under the relevant loan agreement may be reduced where the borrower satisfies a pre-determined SPT as measured by the pre-determined KPIs or vice versa.

4 Reporting

Borrowers should, where possible and at least once per annum, provide the lenders participating in the loan with up-to-date information sufficient to allow them to monitor the performance of the SPTs and to determine that the SPTs remain ambitious and relevant to the borrower’s business.

As transparency is of particular value in this market, borrowers should be encouraged to publicly report information relating to their SPTs and this information will often be included in a borrower’s integrated annual report or sustainability report. However, this will not always be the case and, where appropriate, a borrower may choose to share this information privately with the lenders rather than making this publicly available. Borrowers are also encouraged to provide details of any underlying methodology of SPT calculations and/or assumptions when reporting to lenders and/or publicly.

5 Verification

Borrowers must obtain independent and external verification of the borrower’s performance level against each SPT for each KPI (for example, limited or reasonable assurance or audit by a qualified external reviewer with relevant expertise, such as an auditor, environmental consultant and/or independent ratings agency), at least once a year.

It is recommended that the verification of the performance against the SPTs should be made publicly available where appropriate.

As opposed to the pre-signing external review such as a Second Party Opinion, which is recommended, the post-signing verification, is a necessary element of the SLLP.

Once reporting has been completed and external review has taken place, the lenders will evaluate the borrower’s performance against the SPTs and KPIs based on the information available.

Appendix 1 – KPIs

The list below sets out some common categories of KPIs together with an example of the improvements which a KPI in this category might seek to measure. The categories listed are intended to be indicative only and are listed in no specific order. Please note that there are a large variety of KPIs and, as a result, this Appendix simply seeks to provide possible examples parties can look to.

Category	Example[6]
Environmental	
Energy efficiency	Improvements in the energy efficiency rating of buildings and/or machinery owned or leased by the borrower.
Greenhouse gas emissions	Reductions in greenhouse gas emissions in relation to products manufactured or sold by the borrower or to the production or manufacturing cycle.
Waste Disposal	Reductions in liquid and solid waste disposals in relation to products manufactured by the borrower or to the production or manufacturing cycle.
Renewable energy	Increases in the amount of renewable energy generated or used by the borrower.
Water consumption	Water savings made by the borrower.
Sustainable sourcing	Increases in the use of verified sustainable raw materials/supplies.
Circular economy	Increases in recycling rates or use of recycled raw materials/ supplies. Achievement of zero waste in production plants.
Sustainable farming and food	Improvements in sourcing/producing sustainable products and/or quality products (using appropriate labels or certifications).
Biodiversity	Improvements in conservation and protection of biodiversity, and contribution to biodiversity.
Global ESG assessment	Improvements in the borrower's ESG rating and/or achievement of a recognised ESG certification.
Social	
Human rights and community relations	Improvements in the borrower's "management of the relationship between businesses and the communities in which they operate, including, but not limited to, management of direct and indirect impacts on core human rights and the treatment of indigenous people. More specifically, such management may cover socio-economic community impacts, community engagement, environmental justice, cultivation of local workforces, impact on local businesses, license to operate, and environmental/social impact assessments."[7]
Affordable housing	Increases in the number of affordable housing units developed by the borrower.

6. Note that the relevant KPIs are very industry-specific, and these examples are meant to be indicative only. They will not necessarily be appropriate for every deal.
7. Examples taken from SASB's Materiality Map (https://materiality.sasb.org/) © 2021. Reprinted with permission from The SASB Foundation. All rights reserved.

Category	Example
Data security	Reduction in the "risks related to collection, retention, and use of sensitive, confidential, and/or proprietary customer or user data. It includes social issues that may arise from incidents such as data breaches in which personally identifiable information (PII) and other user or customer data may be exposed. It addresses a company's strategy, policies, and practices related to IT infrastructure, staff training, record keeping, cooperation with law enforcement, and other mechanisms used to ensure security of customer or user data."[8]
Employee health and safety	Improvements in the borrower's "ability to create and maintain a safe and healthy workplace environmental that is free of injuries, fatalities and illness (both chronic and acute). It is traditionally accomplished through implementing safety management plans, developing training requirements for employees and contractors, and conducting regular audits of their own practices as well as those of their subcontractors. The category further captures how companies ensure physical and mental health of workforce through technology, training, corporate culture, regulatory compliance, monitoring and testing, and personal protective equipment."[9]
Employee engagement, diversity and inclusion	Improvement in specific long-term goals relating to improvements in diversity and training and further education.
Employee training	Increase training hours for employees.
Governance	
Business ethics	Improvement in borrower's "approach to managing risks and opportunities surrounding ethical conduct of business, including fraud, corruption, bribery and facilitation payments, fiduciary responsibilities, and other behaviour that may have an ethical component. This includes sensitivity to business norms and standards as they shift over time, jurisdiction, and culture. It addresses the company's ability to provide services that satisfy the highest professional and ethical standards of the industry, which means to avoid conflicts of interest, misrepresentation, bias, and negligence through training employees adequately and implementing policies and procedures to ensure employees provide services free from bias and error."[10]
Building strong corporate governance & transparency	Improvements in expertise of individuals sitting on the borrower's governance committees, e.g. audit committee, compensation committee, compliance committee and so forth.

8. Ibid.
9. Ibid.
10. Ibid.