Guidance on Sustainability-Linked Loan Principles

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

1 Introduction

The Sustainability-Linked Loan Principles (SLLP) were originally published in 2019 and provide a framework to what is recognised as an increasingly important area of finance. The SLLP underwent a structural revision in 2021, to provide a clear delineation between the selection of key performance indicators (KPIs) and the calibration of sustainability performance targets (SPTs)[1].

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 SLLP, to provide market practitioners with clarity on their application and promote a harmonised approach.

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

2 Fundamentals

A. Is there a definition of sustainability-linked loans (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) 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, and which measure improvements in the borrower's sustainability profile".

This definition will be reviewed on an ongoing basis in light of the development and growth of SLLs. Whilst it is recognised that definitions of "sustainable" and "sustainability" may vary depending on sector and geography[2], the SLLP do contain a non-exhaustive list of indicative categories of KPIs (Appendix 1 of the SLLP).

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 (SDGs) in 2015 are important drivers behind sustainable financing solutions. Companies are increasingly devising green and sustainable strategies, incorporating them into their business strategy and aligning their funding mechanisms to their sustainable development commitments. Entering into a SLL in this context has a number of wide ranging advantages for borrowers and lenders.

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 incentivise and support material sustainability improvements by actively directing capital towards borrowers implementing robust sustainability strategies;
- showing commitment to achieve sustainability goals with a correlated economic impact;
- promoting sustainable long term growth and profitability; and
- increased ability to attract and retain staff who see SDG contribution as an important part of their personal and professional lives.

C. Who can borrow a SLL?

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

D. What is the difference between green loans and SLLs?

The fundamental determinant of a green loan is the utilisation of the loan proceeds for Green Projects[3]. Whilst use of proceeds is the key determinant, the other core criteria set out in the GLP must also be met, i.e. the criteria for project evaluation and selection, management of proceeds and reporting.

Under the SLLPs, the focus is on incentivising the borrower's efforts to improve its sustainability profile, by aligning loan terms to the borrower's performance against mutually agreed, material and ambitious, pre-determined SPTs. Use of proceeds is not a key determinant in the categorisation of a SLL. The indicative, non-exhaustive list of categories of eligible Green Projects set out in Appendix 1 of the GLP may be used to help identify any green-related KPIs and SPTs agreed under an SLL.

1 All transactions completed prior to 3 June 2021 will be exempt from following the revised SLLP, and instead should be reviewed in conjunction with the SLLP published May 2020

2 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.

3 See Appendix 1 of the GLP for a non-exhaustive list of indicative categories of eligibility for Green Projects.

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

Technically, a loan can follow both the GLP and the SLLP, although such transactions are rare in the market.

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

The fundamental determinant of a social loan is the utilisation of the loan proceeds for Social Projects[4]. Whilst use of proceeds is the key determinant of a social loan, the other core criteria set out in the Social Loan Principles (SLP) must also be met, i.e. the criteria for project evaluation and selection, management of proceeds and reporting.

Under the SLLPs, the focus is on incentivising the borrower's efforts to improve its sustainability profile, by aligning loan terms to the borrower's performance against mutually agreed, material and ambitious, pre-determined SPTs. Use of proceeds is not a key determinant in the categorisation of an SLL, but rather SLLs are tied to the borrower's performance against ESG-related KPIs. The indicative, non-exhaustive list of eligible Social Projects set out at Appendix 1 of the SLP and the list of Target Populations set out in Appendix 2 of the SLP may be used to help identify any social-related KPIs and SPTs agreed under an SLL.

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

Technically, a loan can follow both the SLLP and the SLP, although such transactions are rare in the market.

H. How do the SLLP incorporate ESG considerations?

SLLs are sometimes informally known as "ESG linked loans", "sustainability improvement loans", "KPI loans" and "SDG linked loans". We recommend that lenders and borrowers consistently refer to these products as SLLs to build a common language and understanding in the market.

SPTs (as set against predefined KPIs) are determined and set by the borrower and lender group, or more often the Sustainability Coordinator(s) on behalf of the lender group, in relation to a SLL. The SPTs will be tied to one or more ESG considerations.

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

I. What is sustainability washing[5]? How should the market seek to avoid it?

Sustainability washing 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, sustainability washing can occur in two key ways: either through SPTs that are not sufficiently ambitious or meaningful; or through inaccurate monitoring, measuring and disclosing of borrower performance against SPTs.

On the first issue, 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 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. It is recommended, where appropriate, that borrowers and lenders seek an external review as to the appropriateness of the SPTs and the methodology applied for such SPTs as a condition precedent to the loan. For more guidance on target setting please see B.II below.

On the second issue, the market can take steps to avoid sustainability washing by ensuring close adherence to the core components of the SLLP relative to reporting (made publicly available where appropriate) 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 sustainability washing in connection with SLLs undermines the product and may cause serious reputational risk for the institutions involved. Lenders and borrowers should therefore ensure that communications regarding SLLs are accurate, clearly explain the SPT criteria of the loan, and do not imply that the loan meets sustainability criteria for the loan's use of proceeds (unless the loan is also a green or a social loan).

4 See Appendix 1 of the Social Loan Principles for a non-exhaustive list of indicative categories of eligibility for Social Projects.
5 Also referred to as "green washing" and "ESG washing".

3 Sustainability-Linked Loan Principles

A. Sustainability-linked loan definition

I. Types of loan

A SLL can be any type of loan financing, e.g. term loan, revolving credit facility 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

A SLL is a type of financing intended to complement and enhance a borrower's existing sustainability strategy.

SLLs are not typically green financings or social financings, but are an important form of specialised financing, which seek to incentivise more sustainable business models. In this way they stand apart as a transition tool

A SLL could be made to any company that has a sustainability strategy, and it will reward that company for achieving the goals set out in that strategy so long as the KPIs are meaningful for the company's business and the SPTs are ambitious.

Conversely, if the company fails to meet the minimum level of the SPTs, it is expected that any previously achieved incentive ceases to be awarded from that point and it may be subject to, for example, a margin premium. The metrics identified in the sustainability strategy can serve as the potential metrics to be used in the SLL, provided they are suitably meaningful, measurable and core to the overall business, externally verifiable and able to be benchmarked.

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

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 the borrower as well.

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 does KPIs should be "able to be benchmarked" mean?

A borrower's environmental and social impact, can be benchmarked by reference to, for example, regulatory standards or taxonomies in the choice of relevant KPIs, or from goals and objectives set in international agreements, such as the Paris Agreement or relevant industry standards or averages or the SDGs

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

An applicable scope, e.g., the percentage of the borrower's total emissions to which the target is applicable, how the target is linked to the borrower's sustainability / ESG strategy e.g. how the target is linked to the borrower's ambition to become net-zero across their value chain by 2030, as well as the calculation methodology e.g. clear definition of the denominator of intensity-based KPIs, should be clearly set out for each KPI.

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, a small number of lenders lead these target-setting processes on behalf of the lender group (the "sustainability coordinator").

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:
(a) ambitious ESG metrics and targets included in the borrower's sustainability strategies and/or policies; and/or
(b) external analysis to establish sector-specific ESG criteria and best-practice performance; and/or
(c) verified industry metrics reported against frameworks[6], with verification or evaluation by civil society organisations[7] 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).

It is critical that all lenders play a role, and question the chosen metrics and SPTs to ensure that they are truly meaningful and ambitious.

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

One important way to ensure that KPIs are core to the borrower's business is to map targets against a materiality assessment of the borrower's industry. Materiality assessments identify the most important ESG considerations for both the borrower's business and relevant stakeholders of the business. A growing number of organisations are performing these assessments in accordance with ESG reporting frameworks and standards. KPI

6 For example, the Greenhouse Gas Protocol.
7 For example, the Science Based Targets initiative. Targets adopted by companies to reduce greenhouse gas (GHG) 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.

setting should take into consideration both the importance of an ESG issue on a materiality assessment, as well as the scope for improvement of the ESG issue.

Several independent organisations offer guidance on materiality issues by industry sector and/or company. Amongst these organisations are the Sustainability Accounting Standards Board (SASB) and various ESG rating agencies. SASB's Materiality Map, for example, 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.

Borrowers can use industry initiatives and standards to ensure that selected SPTs are ambitious. Such standards include the Science Based Targets initiative, the Transition Pathway Initiative[8], or RE100[9]. 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.

SPTs should not be set at lower levels, or on a slower trajectory, to those already adopted internally and/or announced publicly by the borrower.

b) 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, they 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.

c) Can a third party ESG rating serve as KPI for a SLL?

In principle, a borrower's ESG rating as provided by an external sustainability rating agency may serve as a KPI for a SLL. Borrowers should clarify if they are using either an ESG rating as a whole or only specific E, S or G parts of the rating. Given diverging and evolving rating methodologies or rating scales, where an ESG rating is not accompanied by other KPIs, borrowers are expected to explain why an ESG rating is the best indicator to reflect their core business ESG challenges.

III. Loan Characteristics

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

There is currently no template wording available for use in SLL 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 SLLs:

- **Selection of KPIs and Calibration of SPTs:** – The source for the KPIs/SPTs and the level of each KPI/SPT should be clearly identified in the facility agreement. Transparency on how and why a KPI/SPT has been established is encouraged.

- **Measurement of KPIs** – The mechanism for the measurement of the borrower's improvement against a KPI must be carefully considered and should be documented in the facility agreement. For example, it will be necessary to consider whether the improvement should be defined as a change in the absolute value of the metric or as a percentage change.

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

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 (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 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 are typically known as a "Rendez-vous clause" or "Clause de rendez-vous", and seek to address 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.

c) What will constitute a breach?

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

Whilst a failure to meet the SPTs may not constitute an event of default under the facility agreement, an economic impact could result, e.g. a margin premium. Inaccurate reporting (or the failure to deliver information) on the borrower's SPTs will constitute a breach and may, in some cases, give rise to an event of default. Whether delivery of inaccurate information results in an event of default is, however, typically left to the interpretation of the standard reporting representations and covenants in the facility agreement.

8 An initiative assessing companies' preparedness for the transition to a low-carbon economy.
9 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).

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.

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.

b) In what ways would a borrower be expected to demonstrate its internal expertise was sufficient so as to validate the calculation of its performance against its SPTs?

- **Reporting requirements** - Reporting requirements in relation to the metrics should be clearly set out in the facility agreement and reporting by the borrower should be required at least annually over the life of the loan.

- **Information undertakings** - Information undertakings relevant to the SPTs should be clearly identifiable in the facility agreement (for example, the borrower may be required to deliver a copy of its sustainability report to the lenders on an annual basis over the life of the loan).

- **Sustainability reporting** - Where a borrower is already providing a sustainability report to its stakeholders, it is recommended that the Information Undertakings in the facility agreement also include delivery of such sustainability report to the lenders on an ongoing basis.

- **Representations** - The borrower should be under an obligation to represent the accuracy of any reporting.

V. Verification

a) When might external review take place?

External reviewers can intervene pre-signing or post-signing.

Pre-signing, it is recommended, where appropriate, that a borrower seek an external opinion to confirm the alignment of their SLL with the core components of the SLLP, to assess the meaningfulness, credibility and ambition on the selected SPT(s), and/or to put 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 external review 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 and the scope of the external review.

Post-signing, the SLLP require a borrower to seek external verification (which can be in the form of an independent audit/assurance statement) of its performance against its SPTs.

b) 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 or sustainability structuring agent

One or more of the lenders/loan arrangers may serve as the "Sustainability Coordinator" or "Sustainability Structuring Agent" to assist with negotiating, testing and validating the SPTs with the borrower; to engage with external reviewers (where relevant); 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 bank may be the "Sustainability Coordinator" or "Sustainability Structuring Agent", it does not assume fiduciary duties to the rest of the syndicate by confirming documentation meets the SLLP on behalf of other lenders, and therefore each lender should still satisfy themselves as to the borrower's credentials if such a role is undertaken on a transaction.