LMA Loan Market Association

25 Years in the Loan Market

A guide to the application of the Sustainability-Linked Loan Principles in real estate finance and real estate development finance

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Important Notice

This Guide is intended as an overview and is not intended to be comprehensive. Whilst every care has been taken in its preparation, no representation or warranty is given by the LMA as to the accuracy or completeness of the contents of this Guide. Most importantly, this Guide is not designed to provide legal or other advice on any matter whatsoever.

Introduction

The built environment impacts almost every part of our daily lives, including our health and wellbeing, our communities, climate change and biodiversity. A sustainable built environment is therefore fundamental to the delivery of the UN's Sustainable Development Goals[1], as well as the Race to Zero[2] target. There are a range of measures that can help improve the sustainability performance of both development projects and existing buildings – some which may be implemented at a relatively low cost, while others will require significant investment.

Following the launch of the Sustainability-Linked Loan Principles (SLLP)[3] in March 2019, the growth of the sustainability-linked loan (SLL) market has been extraordinary. With environmental, social and governance (ESG) issues having risen rapidly up the corporate agenda, we have seen a wave of SLL transactions emerge in the syndicated loan market.

With real estate finance (REF) and real estate development finance[4] markets increasingly looking to integrate sustainability within their financing offerings, the Loan Market Association (LMA) has worked with its REF and sustainable lending working parties, and hosted a number of roundtable discussions, to create this guide to the application of the SLLP in REF and real estate development finance contexts (the Guide). The LMA understands that certain challenges may arise in applying the SLLP in these contexts, and the use of SLLs to-date in the REF and real estate development finance contexts has been largely focussed on financing of real estate investment trusts (REITs) and social housing projects. This Guide seeks to provide further guidance to assist market participants and to support the development and integrity of this important sustainable finance tool in these contexts.

This Guide seeks to provide practical guidance as to the application of the SLLP to REF and real estate development finance SLL transactions, setting out what borrowers, finance parties and their respective advisors should consider when looking to align any such transactions to the SLLP. This Guide should be read in conjunction with the SLLP and the accompanying Guidance on the SLLP.[5] It should be noted that this Guide is not intended to apply to residential mortgages or any other form of retail lending.

Differentiating Green Loans and SLLS

It should be noted that SLLs differ from green loans, which are used exclusively to finance green projects, as there is often confusion in relation to the use of these terms in the market. The SLLP which apply to SLLs do not require use of proceeds for green projects and instead focus on incentivising improvements to the borrower's sustainability performance by aligning the loan terms (for example, the margin under the facility agreement) with pre-defined sustainability performance targets (SPTs).

The LMA has published the following documents, available on the LMA's website, which relate to the application of the LMA's Green Loan Principles in the REF context:

- Guidance on the application of the Green Loan Principles in the REF lending context – Retrofit projects;[6] and
- Guidance on the application of the Green Loans Principles in the REF investment lending context - Green buildings.[7]

1 https://sdgs.un.org/goals

2 https://unfccc.int/climate-action/race-to-zero-campaign

3 https://www.lma.eu.com/guides/sustainability-linked-loan-principles

4 The term 'real estate development finance' is used here to refer to finance for the purpose of funding a residential, commercial or mix-use property development.

5 https://www.lma.eu.com/guides/guidance-sustainability-linked-loan-principles

6 https://www.lma.eu.com/guides/guidance-application-ref-retrofit-projects

7 https://www.lma.eu.com/guides/guidance-application-ref-green-buildings

Challenges in applying the SLLP in the REF and real estate development finance contexts

Practical challenges have been observed in applying the SLLP in the REF and real estate development finance contexts due to the fact that this type of lending is typically asset-based and the borrower will often be a special purpose vehicle (SPV) without a trading history. This, in turn, means that the borrower may not have a pre-existing sustainability strategy and/or access to historical ESG data in relation to the property/ies or development(s) being financed. This can make the selection of key performance indicators (KPIs) and the calibration of SPTs more challenging, although this may be easier, for example, (i) where there is a portfolio of properties to be financed, (ii) where capex is required to finance retrofit works or (iii) where the property being financed is an operating asset.

Further challenges may exist where the borrower does not itself occupy the property/ies being financed due to the fact that they may not have direct control over the fit-out and/or day-to-day operation of these property/ies. Additionally, there are still divergences within the market in relation to what is considered 'doing enough' in terms of improving sustainability performance in the REF and real estate development finance contexts. This can lead to concerns around greenwashing (i.e. the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact it does not meet basic environmental standards) which can cause reputational damage to borrowers and lenders alike.

Nonetheless, various SLL deals have already been seen in the REF and real estate development finance contexts, particularly in relation to funding made available to REITs and in relation to social housing financing. Furthermore, there is still significant potential for further growth of SLLs in the REF and real estate development finance contexts due to, amongst other things, the urgent need to decarbonise existing building stock to meet global climate targets, to improve the sustainability of construction methods and materials, and to tackle the shortage of affordable housing globally.

Terminology

As with all sectors, there is a common language evolving in relation to sustainability. For those new to sustainability, this can seem daunting and can act as a barrier to entry. For that purpose, the LMA has, together with the APLMA and LSTA, put together a Glossary of Terms[8] (the Glossary) common to sustainable lending products generally.

Roles

The transparency and integrity of the SLL product are of utmost importance when applying the SLLP to any loan transaction. It is therefore no surprise that a number of specialised roles have arisen.

In this section, we seek to highlight those roles that might arise in relation to a SLL throughout its lifecycle. However, it should be noted that not all of these roles will be required in all circumstances. It will depend on the transaction at hand.

- **External reviewer –** See the '*Guidance for Green, Social, and Sustainability-Linked Loans External Reviews*'[9] for more information on the types of external review that can be carried out in relation to SLLs and the role of external reviewers.
- **ESG rating providers –** ESG rating providers are typically engaged by the borrower, possibly at the outset of the transaction. ESG rating providers are independent third parties who issue an ESG rating to the borrower. This rating sets out a borrower's capacity to integrate and manage the key sustainability issues in its sector of activity, and indicates the degree to which ESG risks are mitigated. Commonly, an accompanying report sets out areas for improvement.
  - An ESG rating provider will not typically provide advice to the borrower in relation to the setting of SPTs.
  - It is for the borrower to share its ESG rating with the syndicate.
  - An ESG rating provider is likely to have an ongoing role post-signing in re-assessing the borrower's ESG rating periodically (usually annually) where a KPI refers to the borrower's external ESG rating.
  - In the REF and real estate development finance contexts, ESG ratings are used more frequently where funding is made available to REITs or to operating companies where historic ESG data is available. Where financing is made available to a SPV, an ESG rating is unlikely to be available at an entity-level due to the lack of historic ESG data.
- **Sustainability coordinator –** See section 3.C.I (Sustainability coordinator or sustainability structuring agent) of the SLLP Guidance.[10]
- **Sustainable building/design certifiers –** Sustainable building/design certifiers are independent third parties appointed by the borrower to verify whether a building or construction project meets the criteria for the attainment of a sustainable building rating, standard or certification.[11]

Selection and disclosure of KPIs

As mentioned in the SLLP, the credibility of the SLL market rests on the selection of the KPI(s) under the SLL. It is, therefore, vital in the REF and real estate development finance sectors (as with other sectors) that the borrower has taken time to develop and consider its sustainability strategy and to identify KPIs that are material to its business.

Pertinent ESG information should be provided to the prospective lenders by the borrower at the outset of the transaction and in any relevant marketing materials. This will help the borrower to demonstrate a pre-existing and meaningful commitment to ESG prior to entering into the loan transaction. Such disclosure

8 https://www.lma.eu.com/guides/glossary-sustainable-lending

9 https://www.lma.eu.com/guides/guidance-external-reviews

10 https://www.lma.eu.com/guides/guidance-sustainability-linked-loan-principles

11 For an indicative, non-exhaustive list of available green buildings rating tools administered by Green Buildings Councils see: https://www.worldgbc.org/rating-tools

might include, where available, provision of an existing ESG report, historical data (if available), third party reports, such as by an independent ratings agency or a consultancy, or internal reporting provisions that can be benchmarked against regulatory standards or taxonomies.

A. Borrower vs group level KPIs

As mentioned above, there are a number of challenges when seeking to apply the SLLP in the REF and development finance contexts. One of the main challenges of applying the SLLP in the REF and real estate development finance contexts is that the borrower will often be a SPV with no trading history and typically holding no assets other than the property or land which is the subject of the financing. In such cases, the borrower's sustainability strategy will need to be developed and should generally focus on the assets being financed and KPIs should be linked to the assets being financed, although these KPIs may in some instances be linked to the parent group-level sustainability strategy where this also applies to the borrower. Where the REF or real estate development finance transaction includes asset backed security, it will generally be expected that most, if not all, KPIs will be linked to the asset being financed.

B. Materiality

The SLLP provide that KPIs should be 'material' to the borrower's core sustainability and business strategy, and address relevant ESG challenges of the industry sector. The SLLPs say that KPIs should also be measurable or quantifiable and capable of being benchmarked.

There are a range of ways in which borrowers may seek to determine which KPIs are material in the REF and real estate development finance contexts, and there is no one-size-fits-all approach. Accordingly, an individual assessment will need to be made based on the facts of the particular transaction. There are, however, a number of tools which may assist in the identification of material KPIs.

One such tool which may be used to help identify material KPIs on REF and real estate development finance SLLs, is the Sustainability Accounting Standards Board (SASB) Materiality Map.[12] SASB's 'Real Estate SASB Standards'[13] also identify a number material sustainability disclosure topics for companies in the real estate sector. Within these broader sustainability disclosure topics, SASB identify specific accounting metrics against which companies in the real estate sector are encouraged to make disclosures. These metrics may provide suitable KPIs on a pure REF/ real estate development finance transaction but, as mentioned above, a case-by-case analysis of the borrower's business activities will need to be carried out.

Other sources which may be useful for selecting KPIs include, but are not limited to[14]:

- ICMA's *'Suggested Impact Reporting Metrics for Green Building Projects';*[15]
- ICMA's *'Illustrative examples for the selection of KPIs';*[16]
- the Global Reporting Initiative (GRI);[17]
- GRESB benchmarks;
- the Climate Bonds Initiative;
- the Good Economy *'Sustainability Reporting Standard for Social Housing';*[18]
- the NextGeneration Initiative Benchmark;
- the Better Buildings Partnership Real Estate Environmental Benchmark;
- the Climate Disclosure Project;
- Observatoire Immobilier Durable;[19]
- Zebra2020[20]; and
- various surveys used for ESG indexes.

On REF and real estate development finance deals where asset-backed security is being taken, at least one KPI will usually refer to energy efficiency, carbon or greenhouse gas emissions.

A non-exhaustive, indicative only list of KPIs used in the REF and real estate development finance contexts is set out at **Appendix 1 of this Guide**. Some further generic indicative examples of KPIs which may be used for SLLs are included at **Appendix 1 of the SLLP**.

C. Timing for selection of KPIs

Ideally, KPIs, and the associated SPTs, should be included at term sheet stage, with any pertinent information on ESG provided to the prospective lenders by the borrower. This allows the lending group to review and, where appropriate, challenge the KPIs, and associated SPTs. In any event, disclosure of the KPIs, and associated SPTs, should be communicated with sufficient time to the lenders, before they sign into the facility agreement, so they can take an informed lending decision.

Importantly, the borrower and its advisors should not rush to structure a SLL until the borrower is ready to do so. As required under the SLLP, SPTs must be set before or concurrently with the origination of the loan. If this is not possible, an amendment could be sought at a later date to include the SLL provisions (including the KPIs and associated SPTs) when ready, subject to the appropriate level of lender consent being met. Any such deal should not be labelled or marketed as an SLL by finance parties or borrowers until such time as KPIs and SPTs have been agreed, and the loan is aligned to the core components of the SLLP.

12 https://www.sasb.org/standards/materiality-map/

13 https://www.sasb.org/wp-content/uploads/2018/11/Real_Estate_Standard_2018.pdf

14 This list is included to provide some examples only and is not intended to be exhaustive. This list may be updated from time-to-time.

15 https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/Resource-Centre/Final-Green-Buildings-Reporting-Metrics-March-2019-including-Reporting-Templates-200319.pdf

16 https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/sustainability-linked-bond-principles-slbp/

17 See the GRI G4 Construction and Real Estate Sector Disclosures (2014).

18 https://thegoodeconomy.co.uk/resources/reports/SRS_final-report_2020-11-16-094356.pdf

19 www.o-immobilierdurable.fr

20 https://www.zebra2020.eu

Calibration of SPTs

A borrower's sustainability performance is measured using predefined SPTs, as measured by reference to predefined KPIs. The "*SPTs should be ambitious*" and the "*KPIs should be material to the borrower's core sustainability and business strategy and address relevant ESG challenges of the industry sector*."[21] In line with the SLLP, in order to ensure that these ambition and materiality criteria are strictly adhered to by market participants, the SPTs set should:-

- represent a material improvement in the respective KPIs and should be beyond a "Business as Usual" trajectory;
- where possible be compared to a benchmark[22] or an external reference;
- be consistent with the borrower's overall strategic sustainability strategy or, where the borrower is an SPV, its sustainability strategy relating to the building(s) or development to be funded;[23]
- be discussed and devised with assistance from a sustainability coordinator(s) and an external reviewer (in each case, where appointed); and
- be determined on a predefined timeline, set before or concurrently with the origination of the loan.

Market participants should refer to the "Calibration of SPTs" section of the SLLP for more guidance on this point.

Reporting & verification

As explored more fully in the SLLP, borrowers should, where possible, make and keep readily available up to date information relating to their SPTs (such as any external ESG ratings), with such information to be provided to those institutions participating in the loan at least once per annum.

Post-signing, borrowers must seek independent and external verification of their 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, sustainable building/design certifier, 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.

Market participants should refer to the "Reporting" and "Verification" sections of the SLLP for more guidance on these points. For more guidance on external review requirements in relation SLLs generally, market participants should refer to the '*Guidance for Green, Social, and Sustainability-Linked Loans External Reviews*'.

Documentation

There is currently no template wording available for use in SLL documentation due to the varied and deal-specific nature of this market and, as such, a case-by-case approach to drafting will be required. However, there are some important considerations which should be kept in mind when documenting SLL deals in the REF and real estate development finance context.

Term Sheet

- **Market flex –** ESG provisions should not be subject to any market flex. To allow otherwise would undermine the validity of targets set within the deal, and could result in allegations of greenwashing.

Loan Facility

- **Information reporting –** Parties will need to consider which ESG information reporting requirements should be included in the loan facility documentation in order to monitor the borrower's ongoing performance against the KPIs/SPTs throughout the life of the loan.
- **Sustainability-linked margin ratchet –** SLLs typically include a margin ratchet, which is linked to the performance of the borrower against predetermined KPI(s). Generally, the borrower will obtain a premium or a discount to the margin based on its performance against the predetermined KPI(s). Ratchets may include a margin premium if a target is missed and, where applicable, the trigger for the margin premium should be set at a suitably ambitious level to avoid a situation whereby there is no realistic prospect of such margin premium ever being triggered.
- **Fallbacks –** Parties may wish to consider including fallback mechanisms in case SPTs cannot be calculated or observed in a satisfactory manner. Parties may also wish to consider whether provisions are required to govern what happens in exceptional events, such as a significant change in parameters through events, including drastic changes in the regulatory environment that could substantially impact the calculation or scope of the KPI or SPT.
- **"Rendez-vous clause" or "Clause de rendez-vous" -** Parties may wish to consider whether a "Rendez-vous clause" or "Clause de rendez-vous" is required to recalibrate KPIs/SPTs during the life of the loan. See 3.B.II.b) of the Guidance on the SLLP.[24]
- **Breaches –** 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 does not typically constitute an event of default under the facility agreement, an economic impact could result, e.g. a margin premium. Inaccurate reporting (or failure to deliver information) on the borrower's SPTs might constitute a breach if not remedied within a set period of time 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, although it should be noted that a result of inaccurate reporting will not always be a consequence of a failure to meet the SPTs. A "sustainability breach" may also give rise to declassification of the loan as an SLL, and may trigger

21 See the SLLP.

22 For example, a sustainable building/design rating, standard or certification or other sustainability/ESG benchmark (for example, CRREM Decarbonisation Pathways).

23 The SPTs should be set based on the borrower's sustainability strategy for the assets/construction to be funded and, where relevant, the wider sustainability strategy of the borrower group.

24 https://www.lma.eu.com/guides/guidance-sustainability-linked-loan-principles

a restriction on the parties from communicating or labelling the loan as being an SLL until such time as the sustainability breach has been remedied.

Appendix 1 – KPIs in the REF and real estate development finance contexts

The list below sets out some common categories of KPIs seen in the REF and real estate development finance contexts, 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.[25]

Environmental	Description
Energy efficiency	Improvements in the energy efficiency rating of building(s) owned or leased by the borrower.[26] Improvements in energy efficiency can relate to in-use performance and/or the fabric of the building(s).
Greenhouse gas emissions	Reductions in greenhouse gas emissions associated with the building(s) or development being financed.[27]
Waste disposal	Reductions in liquid and solid waste disposals in relation to the building(s) or development being financed.
Renewable energy	Increases in the amount of renewable energy generated or used by the borrower and/or in relation to the building(s) being financed.[27]
Water consumption	Water savings made by the borrower and/or in relation to the building(s) being financed.
Sustainable sourcing	Increases in the use of verified sustainable raw materials/supplies in the construction or refurbishment of building(s) or development being financed.
Circular economy	Increases in recycling rates or use of recycled raw materials / supplies.
Biodiversity	Improvements in conservation and protection of biodiversity, and contribution to biodiversity/ biodiversity net gain.
Global ESG assessment	Improvements in the borrower's ESG rating and/or achievement of a recognised ESG certification.
Embodied carbon	Reductions in embodied carbon associated with the development being financed.
Clean transportation	Improvements in the use of low carbon transport and the related infrastructure, including electric vehicle charging points and dedicated bicycle spaces.
Social	
Affordable housing	Increases in the number of affordable housing units developed by the borrower.
Gender pay gap metrics	Improvements in gender pay gap metrics.
Community and social engagement	Improvements in community and social engagement.
Employee engagement, diversity and inclusion	Improvements in specific long-term goals relating to improvements in diversity and training and further education.
Governance	
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.

25 Parties will need to ensure that the KPIs meet the requirements of the SLLP in relation to KPI selection. It should be noted that this list of KPIs will not be appropriate for use on every REF/ real estate development finance SLL transaction and a case-by-case analysis will be required in order to select the appropriate KPIs.

26 This improvement in energy efficiency will often be demonstrated using a sustainable building rating, standard or certification.

27 Consideration should be given to whether KPI should refer to Scope 1, 2 and/or 3 emissions.