Guidance on Sustainability Linked Loan Principles

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. 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). Both sets of Guidance are intended to highlight the differences between, and suitability of application of, the SLLP and GLP to any particular deal.

2 Fundamentals

A. Is there a definition of sustainability linked loans (SLLs)?

The SLLP define SLLs 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 sustainability performance targets (SPTs), as set against key performance indicators, external ratings and/or equivalent metrics and which measure improvements in the borrower's sustainability profile".

This definition will be reviewed on a regular 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[1], the SLLP do contain a non-exhaustive list of indicative categories of SPTs (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 working 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 four 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.[2] 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.

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.

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

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

F. 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 key performance indicators (KPIs)) are negotiated and set by the borrower and 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; or (iii) a combination of both.

G. What is sustainability washing[3]? 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 pre-determined performance benchmark on a pre-defined timeline. They should apply over the life of the loan. Borrowers and lenders may be encouraged to 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 3.B.II below.

On the second issue, the market can take steps to avoid sustainability washing by ensuring close adherence to the core components 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 loan).

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 pre-determined SPTs.

B. Core components

I. Relationship to borrower’s overall sustainability strategy

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, 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. 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, 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.

3 Also referred to as “green washing” and “ESG washing”.

II. Target setting

The relevant metrics and SPTs (which should apply over the life of the loan) are negotiated and set between the borrower and the lender group for each SLL. Typically, a single lender leads these target-setting negotiations 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) ESG metrics and targets included in the borrower's sustainability strategies and/or policies;
(b) external analysis to establish sector-specific ESG criteria and best-practice performance; and/or
(c) verified industry metrics reported against frameworks[4], with verification or evaluation by civil society organisations[5] 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).

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 metrics and related SPTs are ambitious and meaningful to the borrower's business?

One important way to ensure that SPTs are core to the borrower's business is to map targets against a materiality assessment of the borrower, or at least of its 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. SPT 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.

Borrowers can use industry initiatives and standards to ensure that selected metrics and SPTs are meaningful and ambitious. Such standards include the Science Based Targets initiative, the Transition Pathway initiative[6], or RE100[7]. 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.

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.

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.

III. Reporting

a) Is there a standard methodology for a borrower to report on its 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.

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.

4 For example, the Greenhouse Gas Protocol.

5 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.

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

7 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. Review

a) When might external review take place?

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

Pre-signing, a borrower and its lenders may wish to seek 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.

Post-signing, the SLP strongly recommend that a borrower seek external review of its performance against its SPTs, where information relating to SPTs is not made publicly available or otherwise accompanied by an audit/assurance statement.

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.

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?

The borrower's internal expertise will need to be assessed on a case-by-case basis. Factors which may be considered in making this assessment include, but are not limited to, the presence of a dedicated sustainability team or sustainability personnel; a clear sustainability strategy; the availability of historical data on the relevant metrics; and internal and/or external audit processes.

Where a borrower must report SPT outcomes to a regulator in the ordinary course of its business, the regulator's pecuniary penalties and reputational risk for the borrower in misreporting would ordinarily be sufficient to ensure integrity of the borrower's data.

c) 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.

Parties should also agree whether the borrower's performance against its SPTs needs to be independently verified by a qualified external reviewer during the life of the loan.

C. Parties

I. Sustainability co-ordinator or sustainability structuring agent

One or more of the lenders/loan arrangers may serve as the "sustainability coordinator" 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", 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.

D. Documentation

I. 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:

Target setting

- **SPTs** – The source for the SPTs and the level of each SPT should be clearly identified in the facility agreement. Transparency on how and why a SPT has been established is encouraged in order to eliminate any potential perception of manipulation.
- **Measurement of SPTs** – The mechanism for the measurement of the borrower's improvement against a SPT 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.
- **Sources of information** – Relatedly, it will be important to consider what information is being relied on for measuring SPTs and if this will be independently verified. For example, will this information be provided by way of internally prepared compliance certificates or publicly available data? What external review may be required to verify this information?

Long-term targets and Changes to 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 disposals) 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 SPT(s) definitions and/or calibration so as to maintain SPT 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.

II. 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.

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