Sustainability-Linked Loan Principles

Supporting environmentally and socially sustainable economic activity

APLMA Asia Pacific Loan Market Association 25 Successful years in the loan market 1998-2023

LMA Loan Market Association

LSTA Advancing the Corporate Loan Market

Introduction

Sustainability-linked loans (SLLs) aim to facilitate and support the key role that credit markets can play in funding and encouraging borrowers to contribute to sustainability (from an environmental and/or social and/or governance (ESG) perspective). For such a role to be played and the market to thrive, integrity is of the utmost importance.

The Sustainability-Linked Loan Principles (SLLP) aim to promote the development of the SLL product by providing a recommended framework to articulate the fundamental characteristics of SLLs. The SLLP are voluntary recommended guidelines, developed by an experienced working party consisting of representatives from leading financial institutions active in the global loan markets.

The SLL product incentivises a borrower to achieve material, ambitious, pre-determined, regularly monitored and externally verified sustainability objectives through Key Performance Indicators (KPIs) and Sustainability Performance Targets (SPTs).

The SLLP are intended for 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 to accommodate the development and growth of the SLL product.

Sustainability-Linked Loan Definition

SLLs are any types of loan instruments and/or contingent facilities (such as bonding lines, guarantee lines or letters of credit) for which the economic characteristics can vary depending on whether the borrower achieves ambitious, material and quantifiable predetermined sustainability performance objectives.

The use of proceeds in relation to a SLL is not a determinant in its categorisation and, in most instances, SLLs will be used for general corporate purposes. Instead, SLLs look to support a borrower in improving its sustainability performance.

The borrower's sustainability performance is measured by applying predefined SPTs to predefined KPIs[1].

All transactions completed prior to 9 March 2023 will be exempt from following these SLLP, and instead should be reviewed in conjunction with the version of the SLLP in force at the time of origination, extension or refinancing of the loan as applicable. Care should be taken not to misrepresent such loans as having been originated, extended or refinanced in accordance with this current version of the SLLP. All loans originated, extended or refinanced after 9 March 2023, should fully align with this version of the SLLP to be classified as SLLs.

Sustainability-Linked Loan Principles – Core Components

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

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

A SLL borrower should clearly communicate to its lenders[2] its rationale for the selection of its KPI(s) (i.e. relevance, materiality, whether it is core to the borrower's overall business) and the motivation for the SPT(s) (i.e. ambition level, 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, sustainability strategy, policy, sustainability commitments and/or processes relating to sustainability.

Borrowers are also encouraged to inform lenders of any sustainability standards or certifications to which they are seeking to conform.

1. Please refer to the Guidance for Sustainability-Linked Loan Principles for examples of benchmarks, standards or frameworks that can be used to identify relevant and material KPIs.
2. In broadly syndicated deals, this information could flow to the lenders through the arrangers/bookrunners assisting the borrower with primary syndication.

1 Selection of KPIs

SLLs aim to support a borrower's efforts in improving its 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 internal and/or external.

First and foremost, the KPIs must be material to the borrower's core sustainability and business strategy, and address relevant ESG challenges of its industry sector.

The credibility of the SLL product will rest on the selection of the KPI(s). It is important to the success of this product to avoid the proliferation of KPIs that are not credible.

The KPIs must 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 by the borrower and should include the applicable scope or parameters, as well as the calculation methodology[3], a definition of a baseline and be benchmarked against an industry standard and/or industry peers where feasible.

2 Calibration of SPTs

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

The SPTs must be set in good faith and remain relevant (so long as they apply) and ambitious throughout the life of the loan. It is therefore recommended that an annual SPT should be set per KPI for each year of the loan term. In instances where strong rationale is provided as to why this is not appropriate, exceptions to the annual frequency of SPTs can be agreed between the borrowers and lenders. The borrower should, where possible and taking competition and confidentiality considerations into account, also highlight any strategic information that may decisively impact the achievement of the SPTs.

The SPTs should be ambitious, and take into consideration the following factors:

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

Market participants recognise that any SPTs 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;
- 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, net zero goals, Sustainable Development Goals, etc.) or to recognised best-available-technologies or other proxies to determine relevant targets across ESG themes.

Information provided to lenders with respect to 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 pro-forma adjustments or recalculations of baselines and/or recalculation of KPIs and subsequent SPTs 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 structure its SLL with the assistance of one or more "Sustainability Coordinator(s)"[4] and, where appointed, they will assist with providing market colour regarding the KPIs and SPTs to the borrower, and facilitate the dialogue between the

3. Calculation methodology should follow international standards and science-based methodologies where available.
4. This role may be referred to as a Sustainability Coordinator or Sustainability Structuring Agent.

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 recommended, where appropriate, that borrowers seek input from an external party[5 6], via e.g. a pre-signing Second Party Opinion (SPO) or KPI/SPT assessment. In their pre-signing SPO, 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 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 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 document thoroughly such expertise, including the related internal processes and expertise of their staff. This documentation should be communicated to lenders participating in the loan on request.

3 Loan Characteristics

A key characteristic of a SLL 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 will often be reduced where the borrower satisfies a pre-determined SPT as measured by the pre-determined KPIs and vice versa, and, in some cases, where a strong rationale is provided, the ratchet may include a neutral bracket in which no margin adjustment applies.

4 Reporting

Borrowers should, 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; and
- a sustainability confirmation statement with verification report attached, outlining the performance against the SPTs for the relevant year and the related impact, and timing of such impact, on the loan's economic characteristics.

As transparency is of particular value in this market, borrowers are encouraged to publicly report information relating to their SPTs, including details of any underlying methodology of SPT calculations and/or assumptions. 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.

5 Verification

Borrowers must obtain independent and external verification of the borrower's performance level against each SPT for each KPI for any date/period relevant for assessing the SPT performance leading to a potential adjustment of the SLL economic characteristics, until after the last SPT trigger event of the loan has been reached.

This is a necessary element of the SLLP and should be conducted by a qualified external reviewer with relevant expertise, such as an auditor (by way of limited or reasonable assurance), environmental consultant and/or independent ratings agency.

The verification of the performance against the SPTs must be shared with the lenders in a timely manner and, where appropriate, be made publicly available.

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

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

5. The SLLP encourage external reviewers to disclose their credentials and relevant expertise and communicate clearly the scope of the review(s) conducted.
6. See APLMA, LMA and LSTA Guidance for Green, Social, and Sustainability-Linked Loans External Reviews.