Sustainability-Linked Loan Principles

Supporting environmentally and socially sustainable economic activity

APLMA
Asia Pacific Loan Market Association

LMA
Loan
Market
Association

LSTA
ADVANCING
THE CORPORATE
LOAN MARKET

Interpretation of Terms

The following definitions provide guidance for understanding and implementing the Sustainability -Linked Loan Principles:

- **"Shall":** Indicates a mandatory requirement.
- **"Should":** Indicates a recommendation.
- **"May":** Indicates an optional course of action.
- **"Can":** Indicates possibility or capability, for example, that an organisation or individual is able to act.

For all other terms, a plain English approach is adopted.

Introduction

Sustainability-linked loans (SLLs) are designed to facilitate and support the key role credit markets play in funding and encouraging borrowers[1] to advance sustainability goals. These loans are especially instrumental in supporting the transition to more sustainable business practices, helping companies shift towards long-term, positive environmental and social outcomes. To ensure that SLLs fulfil this critical role and that the market thrives, maintaining 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 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 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 financial and/or structural characteristics can vary depending on whether the borrower achieves ambitious, material and quantifiable predetermined sustainability performance objectives.

In that sense, borrowers are committing explicitly (including in loan documentation) to achieving future improvements in sustainability performance within a predefined timeline.

The use of proceeds in relation to an 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 overarching sustainability performance over time.

The borrower's sustainability performance is measured by applying predefined SPTs to predefined KPIs[2].

Sustainability-Linked Loan Principles – Core Components

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

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

An SLL borrower shall clearly communicate to its lenders[3] 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 calibration of the SPT(s) (i.e. ambition level, benchmarking approach, and how the borrower intends to reach such SPTs).

Borrowers should position this information within the context of their overarching objectives, sustainability strategy[4], policy, sustainability commitments and/or processes relating to sustainability.

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

1. The term "borrower" may be used interchangeably with "client" or any other term that is more appropriate to the specifics of the transaction.
2. 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.
3. In broadly syndicated deals, this information could flow to the lenders through the arrangers/bookrunners assisting the borrower with primary syndication.
4. This may include details of the borrower's environmental and social risk management system.

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 sustainability performance, which is measured using one or more KPIs that can be internally or externally derived.

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 robust.

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

The KPIs shall 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;
- consistent with the borrower's overall sustainability strategy;
- measurable or quantifiable on a consistent methodological basis;
- where feasible, externally verifiable; and
- able to be benchmarked i.e. where 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) shall be provided by the borrower and shall include the applicable scope or parameters, as well as the calculation methodology[5], 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.

SPTs shall be set in good faith and remain relevant (so long as they apply) and ambitious to the borrower's overall business throughout the life of the loan. An annual SPT should therefore 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, and giving due consideration to the nature of the transaction and KPI in question, 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, disclose to the lenders any strategic information that may decisively impact the achievement of the SPTs.

The SPTs shall be ambitious, i.e.:

- represent a material improvement in the respective KPIs and be beyond both a "Business as Usual" trajectory and regulatory required targets;
- where feasible be compared to a benchmark or an external reference taking into account the regional and national context of the borrower;
- be consistent with the borrower's overall sustainability strategy, and, where applicable, business strategy; and
- be determined on a predefined timeline, set before (or concurrently with) origination of the loan.

The target setting exercise 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/or
- 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
- where relevant to the KPI, 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, Nationally Determined Contributions, Sustainable Development Goals, Kunming-Montreal Global biodiversity framework, 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 SPTs;
- where relevant, the verified baseline or 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 feasible 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 shall 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)"[6] and, where appointed, they will assist with providing market colour regarding the KPIs and SPTs to the borrower, and facilitate the dialogue

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

between the borrower and the lender group in regard to substantiating the SPTs and answering/coordinating responses to the ESG-related questions the prospective lender group might have

Where deemed appropriate, borrowers should seek input from an external party[7 8], prior to the loan execution to confirm alignment of their loan with the five core components of the SLLP e.g. via 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 and/or policies 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 may ask external reviewers to assess these changes.

In cases where no external input is sought, the borrower should demonstrate or develop the internal expertise to evidence alignment with the five core components of the SLLP. Borrowers should document thoroughly such expertise, including the related internal processes and expertise of their staff. This documentation should be communicated to all financial institutions participating in the loan on request.

3 Loan Characteristics

A key characteristic of an SLL is that the loan's financial and/or structural characteristics can vary depending on whether the selected KPI(s) reach (or not) the selected predefined SPT(s).

The variation of margin under the relevant loan agreement is the most common example, where the margin 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.

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4 Reporting

Borrowers shall, at least annually and in any case for any date/period relevant for assessing the SPT performance leading to a potential adjustment of the SLL's financial and/or structural characteristics provide the lenders participating in the loan with:

- up-to-date information sufficient to allow them to monitor the performance of the selected KPI(s); and
- a sustainability confirmation statement outlining the performance against the SPTs and (where relevant) the related impact, and timing of such impact, on the loan's financial and/or structural characteristics and attaching a verification report.

As transparency is of particular value in this market, borrowers should publicly report information relating to their SPTs, including details of any underlying methodology of SPT calculations and/or assumptions. This information should be included in a borrower's integrated annual report or sustainability report. However, this may not always be feasible and, where appropriate, a borrower can choose to share this information privately with the lenders rather than making this publicly available.

5 Verification

Borrowers shall 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 financial and/or characteristics, until the last SPT trigger event of the loan has been reached.

This is a necessary element of the SLLP and shall be conducted by a qualified external reviewer with relevant expertise, such as an auditor (by way of limited or reasonable assurance), environmental/sustainability consultant and/or independent ratings agency[9]. Where information has already been verified as part of a borrower's (public) annual reporting or regulatory submission, it need not be verified again for the purposes of these SLLP.

The verification of the performance against the SPTs shall be shared with the lenders in a timely manner and, where appropriate, should 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 shall evaluate the borrower's performance against the SPTs and KPIs based on the information available.

7. The SLLP require external reviewers to disclose their credentials and relevant expertise and communicate clearly the scope of the review(s) conducted.
8. See APLMA, LMA and LSTA Guidance for Green, Social, and Sustainability-Linked Loans External Reviews.
9. See External Review Guidance for Green, Social and Sustainability-Linked Loans for more information: https://www.lma.eu.com/application/files/8317/0611/1386/External_Review_Guidance_January_2024.pdf