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Sustainability-Linked Loans Series, Part 2 – The Sustainability-Linked Loans Principles

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In our **May edition** of *REF News and Views*, we provided an introduction to sustainability-linked loans ("SLLs"). As a reminder, SLLs emerged alongside green loans as a result of the movement towards greater awareness and improving environmentally and socially beneficial outcomes in the way corporates and lenders effect their lending, investment and other business decisions. Whilst green loans and SLLs are similar in their macro-mission towards environmental and social sustainability, there are some important differences in their approach.

In this next article in our Sustainability-Linked Loans Series, we further explore this growing field by introducing and outlining the Sustainability-Linked Loan Principles ("SLLP") and the SLLP core components.

Sustainability-Linked Loan Principles

In a joint initiative between the Loan Market Association ("LMA"), the Asia Pacific Loan Market Association and the Loan Syndications and Trading Association, the SLLP were published to provide a framework of principles to help market participants understand and identify the key components in establishing sustainability-linked loans. SLLP was first published in March 2019, and is periodically reviewed and updated, with the latest version being published on 31 March 2022.

By providing a set of guiding principles, its ambition is to help facilitate and support environmentally and socially sustainable economic activity and growth, and to promote sustainable development more generally. It achieves this by seeking to address the following issues:

1. the advantages of entering into a SLL;
2. who can participate in a SLL;
3. the differences between a SLL and a green loan; and
4. documentation issues for SLLs.

As touched upon above, in March 2020 (and later updated in August 2021), the LMA also published a **glossary of terms** applicable to SLLs, providing an alphabetical list of terms and concepts that are relevant to SLLs. It is advised that this is read in conjunction with the SLLPs, as several terms and key concepts applicable to sustainable lending are explained in more detail here.

SLLP – Core Principles

The SLLP core principles are to encourage that the borrower of a SLL should:

1. clearly communicate to its lenders its rationale for the selection of its key performance indicators ("KPI") (*i.e.*, relevance and materiality) and the motivation for the sustainability performance targets ("SPT") (*i.e.*, ambition level, consistency with overall sustainability objectives as set out in its sustainability strategy, benchmarking approach and how the borrower intends to reach such SPTs);
2. position this information within the context of their overarching objectives, strategy, policy and/or processes relating to sustainability; and
3. disclose to lenders any sustainability standards or certifications to which they are seeking to conform.

SLLP – Core Components

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

1. Selection of KPIs

The KPIs selected by the borrower should be clearly defined and relevant, core and material to the borrower's business, and of high strategic importance to its future operations. Each KPI should be measurable or quantifiable on a consistent methodological basis, and capable of being benchmarked against an industry standard where feasible.

The Appendix to the SLLPs contains a list of some common categories of KPIs, with an example of the improvements this category might seek to measure.

2. Calibration of SPTs

   The process for calibration of the SPTs per KPI is key to the structuring of SLLs. The SPTs are an expression of the level of ambition the borrower is willing to commit to (*i.e.*, representing a material improvement in the relevant KPI and going beyond a business-as-usual trajectory). The SPTs should be set in good faith and remain relevant (as long as they apply) throughout the life of the loan.

3. Loan Characteristics

   A key characteristic of a SLL is that an economic outcome is linked to whether the selected pre-defined SPTs are met. A common example is the margin under the relevant loan agreement may be reduced where the borrower satisfies a pre-determined SPT as measured by the pre-determined KPIs.

4. Reporting progress against SPTs

   Borrowers should report at least once per year with up-to-date information sufficient to allow lenders to monitor progress and confirm that targets remain ambitious and relevant to the borrower's business.

   Given transparency is of particular value in this SLLP market, where possible borrowers should be encouraged to publicly report the underlying calculations and methodologies (such as in a borrower's integrated annual report or sustainability report).

5. Verification

   Borrowers must obtain independent external verification of their performance level for each SPT at least once a year (for example, by auditors, environmental consultants or independent ratings agencies).

It should be noted, however, that whilst the SLLP are recommended guidelines, they are currently still voluntary and are expected to be applied on a deal-by-deal basis depending on the underlying characteristics of the transaction.

In the next article in this Sustainability-Linked Loans Series, we will dive deeper into the five core components.