Introduction to Sustainability-Linked Loans

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As companies strive to meet their sustainability objectives, an innovative financing vehicle has grown in popularity to help them achieve their goals.

A Sustainability-Linked Loan (SLL) is a type of financing instrument (such as line of credit or term loan) that incentivizes a borrower to achieve material, pre-agreed sustainability targets (commonly referred to as Sustainability Performance Targets) through the prospect of lowered financing costs. In turn, borrowers must demonstrate that they achieve a predetermined set of milestones towards their stated sustainability ambitions.

Objectives

SLLs provide borrowers with the flexibility to apply the loan proceeds for general corporate purposes. The borrower's performance in achieving the agreed Sustainability Performance Targets (SPTs) is measured through selected sustainability Key Performance Indicators (KPIs) that can be internal and/or external.

The Sustainability-Linked Loan Principles (SLLP) were originally developed in 2019 by a working group of financial institutions. Guidance was provided jointly by the Loan Syndications and Trading Association (LSTA), the Loan Market Association (LMA) and the Asia Pacific Loan Market Association (APLMA) in 2021 in order to promote the development of the product and underpin its integrity. The SLLP were updated in February 2023 to add more robust guidance to the original guidelines.

Sustainability-Linked Loan Principles - Core Components

There are five core components of the SLLP which are outlined as follows.

1. Selection of Key Performance Indicators (KPIs)

Each KPI selected for a company's SLL have the following characteristics:

- Clearly defined and relevant to a company's business and sustainability ambitions;
- Core and material to a borrower's business and future operations;
- Measurable and quantifiable;
- Capable of being benchmarked; and
- Externally verifiable.

Ideally, selected KPIs should already have been disclosed in the corporate borrower's annual reports or other non-financial reporting disclosures for the past three years.

2. Calibration of SPTs

Lenders and borrowers should ensure that selected SPTs have the following qualities:

- Set in good faith and remain relevant through the life of the loan;
- Represent an ambitious, material improvement that goes beyond a "business as usual" trajectory and beyond regulatory required targets;
- Capable of being benchmarked or compared to an external reference;
- Consistent with the borrower's overall ESG strategy; and

- Determined on a predefined timeline, before or concurrent with loan origination.

A number of external organizations, such as the Sustainability Accounting Standards Board (SASB) and several ESG rating agencies, provide independent guidance on materiality issues for various industries. SASB has created a "Materiality Finder" which allows users to compare and contrast the materiality of sustainability issues across 77 industries and sectors.

Where appropriate, it's recommended for a borrower to seek a Second Party Opinion (SPO) from a qualified external party prior to signing the loan documentation. In their SPO, the external party assesses the relevance, robustness and reliability of the selected KPIs and the rationale and reliability of the selected SPTs and associated benchmarks/baselines as well as the formulated plan to achieve them.

3. Loan Characteristics

A key characteristic of an SLL is that there is an economic outcome linked to whether the SPTs established at loan origination are achieved. This typically takes the form of a loan two-way margin adjustment rachet which toggles the overall margin paid up or down depending on how the borrower performs relative to the selected KPIs and SPTs with the goal of incentivizing positive performance.

Loan documentation should clearly describe the source and level of each selected KPI and SPT and ideally provide some transparency on the rationale for their selection. Loan documentation should also clearly describe the mechanism for determining the borrower's improvement against KPIs and whether that improvement is defined as a change in absolute value or as a percentage change.

For longer dated transactions, provisions can be included in the loan documentation to describe the conditions under which a borrower could potentially update particular KPIs/SPTs during the life of the loan to maintain alignment with changing business conditions, M&A conditions, or changes in the regulatory environment.

4. Reporting

There is currently no globally standardized method for reporting on SPTs. Generally, borrowers are expected to report on their SPTs at least once annually and provide details on the underlying methodology or assumptions used in their calculations, where possible. Loan agreements should require the borrower to make a representation about the accuracy of their reporting. Recently updated guidance in the SLLP reference a "sustainability confirmation statement with a verification report attached".

5. Verification

External verification should be conducted by a qualified external reviewer, such as an auditor, pre- and post-signing. Prior to signing loan documentation, it is generally recommended that a borrower engage an external reviewer to confirm the appropriateness of the KPIs and SPTs and to confirm that the structure of the SLL aligns with the core components of the SLLP. After signing loan documentation, the SLLP requires an external review (limited or reasonable assurance) on a borrower's performance against its SPTs for the full duration of the loan. This verification must be shared with lenders on a timely basis and made public, where appropriate.

Contact Us

We welcome the opportunity to answer any questions you may have related to this topic or any other assurance, technology, tax, or advisory matters relative to sustainability and ESG. Please call or email any of the Sustainability and ESG Services team members below:

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